Panel 1E

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Testimony on July 9, 1998 before the Federal Reserve Board, San Francisco, California

Concerning the proposal by the National Bank Corporation, Charlotte, North Carolina, to merge with Bank America Corporation, San Francisco, California

My name is Conrad W. Hewitt. For over the past three years, I served as the State Superintendent of Banks and the Commissioner of Financial Institutions for the State of California. My term ended this past June 30th, 1998. Prior to my position with the State of California, I was a Managing Partner in the firm of Ernst & Young. For over 33 years, I specialized in financial institutions. Consequently, I have been involved in many mergers and acquisitions of financial institutions.

During the past three years, in my capacity as State Superintendent of Banks and as Commissioner, I have approved a number of bank mergers and acquisitions. The largest acquisition was Wells Fargo acquiring First Interstate Bank. The California State laws concerning the sale, merger and conversion of depository corporations are very similar to the federal agency's laws, such as the Federal Reserve.

As a regulator, I had several standards to consider under California banking law, before I could approve or deny such a transaction. Some of the elements of the law included:

1. the transaction will not result in a monopoly
2. Competition will not be lessened or be anti-competitive
3. The convenience and needs of the community will be served
4. The shareholder's equity will be adequate and the financial condition of the combined banks will be satisfactory
5. Directors and executive officers will be satisfactory
6. The surviving entity will afford reasonable promise of successful operation and will be operated in a safe and sound manner

In my opinion, this proposed merger meets all of the standard to be considered under the Bank Holding Company Act.

I note that the proposed transaction does not result in the largest bank in the United States. Also, this merger will operate in only 25 of the 50 states. I publicly stated over three years ago, that there would be consolidation in the banking industry. I had many reasons for this statement and I believe that this trend will continue. There is too much capacity in the banking industry, too many banks and too much competition from outside the banking industry. Thus the need to consolidate. Even the largest US banks

face tremendous competition from companies such as: Merrill Lynch, GE Capital, General Motors Acceptance Corporations, all mutual funds, such as Fidelity, T. Rowe Price, Household Finance and now the internet. Many of these companies are not subject to state and federal regulatory law, as the banks presently are.

Other reasons for this merger are:

1. The high cost of investment in technology helps drive the mergers and consolidations. The non-bank competitors have invested heavily in technology and banks must invest just as much, if not more, in order to compete and survive. This investment requires a larger capital base, and one way to create this base is through consolidation.

2. Our largest U.S. banks are still small compared tot the other banks in the world , which are comprised of the Japanese, German and French banks . The U.S. is rapidly becoming a global player and world trader. Our banks must be large enough to provide the financing and capital necessary for our businesses to compete world-wide.

3. Because there is very little overlap in this merger concerning the consumer, the consumer need and convenience should be satisfied. Branch banking has changed dramatically in the past five years because of ATM usage, banking by phone, computer banking and banking by mail. The consumer has dictated this shift in the delivery system of banks. The consumer has a wide choice and availability of financial institutions from which to chose. As I said earlier, the competition is fierce. This transaction should

enhance the service and products available to the customers of the new bank. This is truly an interstate bank merger as contemplated by the federal Riegle-Neal Interstate Banking and Branching and Efficiency Act of 1994, which Congress passed , with the law becoming effective September 29, 1994. As a result, the consumer will be the benefactor of one of the few, real interstate banks in our country.

Considering the other aspects of this proposed acquisition, both companies are financially strong, as indicated by their financial statements, capital and operating ratios and market capitalization.

If this transaction is approved by the Federal Reserve Board and, in my opinion it should be, then a nationwide franchise will be created which has the potential to deliver financial service to millions upon millions of families and businesses.

Thank you for allowing me to testify and I will be pleased to answer any questions.

Panel 18

TESTIMONY OF

CRAIG COLLETTE

AT THE HEARING OF THE FEDERAL RESERVE BANK OF SAN FRANCISCO ON

PLANNED MERGER OF NATIONSBANK AND BANK OF AMERICA

JULY 10, 1998
SAN FRANCISCO

CRAIG COLLETTE
PRESIDENT,
MARATHON NATIONAL BANK, LOS ANGELES
AND MEMBER, CALIFORNIA INDEPENDENT BANKERS
BOARD OF DIRECTORS

Thank you for the opportunity of addressing this very important topic before the Federal Reserve Bank of San Francisco. My name is Craig Collette, and I a member of the Board of Directors of the California Independent Bankers and am President of Marathon National Bank, a $75 million asset bank located on the West side of Los Angeles. As an independent banker with 33 years of experience, I would like to give you my views on the impact of this gigantic merger of Nationsbank and Bank of America.

I am speaking this morning on behalf of the California Independent Bankers which represents some 200 banks throughout the state.

Let me first address you as a concerned citizen of our state. When legislation was debated in Sacramento three years ago which enabled this kind of merger, the California Independent Bankers raised an important issue. What will the tax impact be of permitting out of state institutions to own large CA banks and shift their headquarters out of state? Little attention was given this critical question. As a concerned taxpayer in this state, I would like to raise the issue again and I would like to see some estimates or projections of what this merger will mean to CA taxpayers when the headquarters of the combined institutions shifts to Charlotte, NC. All of CA's three largest financial institutions are now owned by out of state entities.

As a community bank president I have additional views.

The US, with the passage of the Riegle-Neal bill, is moving from a diversified financial system to one characterized by a lopsided barbell with just a few very large banks at one end and a large number of independent banks at the other. To quote Hugh McColl, chief executive of Nationsbank, US banking will be "...a barbell-shaped industry with a dozen or half-dozen very large players on one end and four or five thousands boutiques on the other." On this issue we agree. But, what are the implications of such a structure?

INCREASED FINANCIAL CONCENTRATION MEANS LESS COMPETITION

Nationsbank and Bank of America's merger at $60 billion is the largest between two American banks. The bank created by this merger will have 8.2% of the nations deposits--dangerously close to the 10% limit set by the Riegle-Neal bill. In a country of our size this is an enormous concentration of economic, financial and political power. An Ironically this very merger will weaken California's voice in the US Congress. The interest of Hugh McColl will not parallel the interest of California.

Unfortunately, this trend toward mega mergers will probably continue given the overvalued asset base our own stock market has created. The trend toward mega mergers, and this includes this merger, is not healthy for Main Street where I come from, it is very risky for Wall Street, and it is bad for the Federal Reserve and other regulators who will have to bail out these mega giants when they are mismanaged, over speculate or reach too far in risk taking. These banks are the new super sized "too big to fail" varieties.

The evidence shows that increased concentration in the banking industry has not benefitted bank customers. The economies of scale that supposedly justify large bank mergers either do not materialize or are not passed on to customers. In addition, large interbank mergers reduce competition in ATM network markets as well as in credit card markets. Consider the following:

A. **Larger banks charge higher fees.** According to Bank Rate Monitor, none of the top 50 banks in the U.S. offer the least expensive checking accounts. In fact, those offering the most expensive checking accounts are banks involved in the latest mega mergers: Citibank and Nationsbank. The best deals are offered by smaller regional and community banks. And a 1997 study found a widening gap between large and small bank fees.

B. A Federal Reserve study found the average fees charged by multi state banks are significantly higher than those charged by single-state banks, even accounting for location and other factors that might explain the differences.

C. **Bank mergers have an adverse effect on consumer deposit pricing.** A Boston Federal Reserve Bank study of 499 bank mergers found the combined banks lowered interest rates paid on deposits regardless of the amount of competition in the market.

D. **Economies of scale?** The evidence suggests that the optimal size for a bank in terms of economies of scale, profitability and efficiency is between $100 million and $1 billion, quite a bit smaller than the $300 to $600 billion behemoths that will be created from the latest mergers. And a Harvard study showed that instances of improved operating results after a merger were due primarily to higher repricing, not economies of scale, suggesting the use of increased market power to raise prices. Given sufficient market power, large banks could price smaller competitors out of the market with below market rate loans or above market rate deposits.

E. **Small business lending receives short shrift in a world of ever-larger banks.** Generally, the percentage of small business lending is inversely proportional to bank size. And mergers involving small banks tend to increase small business lending while mergers of large banks tend to reduce it.

F. **Large interbank mergers will also have negative effects on competition in ATM network markets.** ATM network mergers typically follow big bank mergers. And the current merger mania is paving the way for an oligopolistic ATM network market owned by a handful of the nation's largest banks. Essentially, these banks control the pricing, policies and functionality of the nation's ATM networks. Given this control, large banks could limit access for community banks and their customers by imposing anti-competitive and discriminatory pricing, membership requirements, operating rules or technological barriers. Access at a fair price to ATM and other electronic financial services networks is critical for community banks to insure their customers also have fairly and competitively priced access to these networks to transact their banking business.

G. **Large bank mergers are creating an oligopoly of credit card issuers led by Citicorp, Banc One and Nationsbank.** Today, under the Visa or MasterCard joint venture umbrella, thousands of community banks are issuers of credit and debit cards, set their own pricing and terms, and have the national and worldwide acceptance essential for their card viability. Unfortunately, we believe that increasingly the large banks will promote their own brands to the detriment of the Visa or MasterCard brand. And as the Visa and MasterCard brand names are undermined or destroyed, this would be to the detriment of competition and to thousands of community financial institutions and their customers. We will be back in a tightly controlled card environment detrimental to both consumers and small merchants.

In conclusion, as an independent bank president, I am fully aware that in the beginning, community banks will prosper from the fallout of customers from big bank mergers. After these giants consolidate however, there will no longer be a fair and equitable competitive environment for independent banks in the areas I have pointed out in my testimony. Bank customers and small business will suffer as a result.

Expanded remarks of Craig Collette's testimony before the Federal Reserve Bank of San Francisco on planned merger of NationsBank and Bank of America, July 10, 1998.

Increased Financial Concentration Means Less Competition

Effect on Prices, Small Business Lending and Economies of Scale

We should examine empirically the economic impacts of recently-consummated interbank mergers. What have been their real effects, on access to banking services by consumers, and on convenience? What have been their observable effects on the level of fees and charges, and related phenomena such as minimum balance requirements? Have fees gone down and services expanded, as the proponents of these mergers would have us believe? Or, have fees to consumers gone up as large banks have become increasingly bureaucratized and oblivious to the needs of their customers?

A. Larger Banks Charge Higher Fees:

In fact, the body of evidence shows that increased concentration has not benefitted bank customers, who correctly perceive an across-the-board increase in fees and charges. According to a March 1998 Checking Account Pricing Study of 350 banks nationwide conducted by Bank Rate Monitor, none of the top 50 banks in the U.S. offer the least expensive checking account. The best deals are offered by smaller regional and community banks. Ironically, the banks offering the most expensive checking accounts turned out to be none other than the

banks involved in the latest round of proposed megamergers: Citibank, San Francisco; Barnett Bank, Tampa (merging into NationsBank); NationsBank, Tampa; and NationsBank, Orlando.

B. Federal Reserve Study:

The Federal Reserve Board's Annual Report to the Congress on Retail Fees and Services of Depository Institutions (June 1997) found that the average fees charged by multistate banks are significantly higher than those charged by single-state banks, even accounting for the role of locational and other factors that might explain differences in the level of fees charged. And a 1997 study by the U.S. Public Interest Research Group, *Big Banks, Bigger Fees*, found a widening fee gap between large and small banks as fees climbed at big banks, while dropping at small ones. In the previous two years, fees at large banks had risen 3 percent, but fell 2 percent at small banks.

C. Bank Mergers have an Adverse Effect on Consumer Deposit Pricing:

A recent paper by two economists (Simons and Stavins) at the Federal Reserve Bank of Boston questions whether antitrust enforcement has been sufficiently vigorous since mergers have an adverse effect on consumer deposit pricing. Their study of 499 bank mergers found the combined banks lowered interest rates paid on deposits regardless of the amount of competition in the market. In short, there is reason to believe that the vaunted "efficiencies" to be realized by interbank mergers are not in fact being passed along to the consumers. If not to consumers, then to whom?

D. Economies of Scale?

Equally important, we question whether interbank mergers really present the opportunities of increased efficiency that their proponents claim. One recent study indicates that, except below a relatively low threshold in terms of combined assets, bank mergers do not in fact result in the realization of increased efficiency through economies of scale—a common economic rationale for horizontal mergers in any industry. Several other studies (including those conducted by the Harvard Business School and the Federal Reserve Bank of Atlanta) found no significant cost savings or profit improvement (measured as return on assets or gross operating income) as a result of mergers. Ironically, in the Harvard Business School study of New England bank mergers, instances of improved operating results (such as improvement in net interest margin) was due primarily to higher repricing rather than economies of scale, which strongly suggests the use of market power to raise prices, and again raises antitrust concerns. Given sufficient market power, large banks could price smaller competitors out of the market with below market rate loans or above market rate deposits.

We suspect that economies of scale may actually become negative once a merged banking entity exceeds some critical mass, because the increased costs of management and bureaucratization will at some point overwhelm any theoretical economies of scale. The evidence suggests that the optimal size for a bank in terms of economies of scale, profitability and efficiency is between $100 million and $1 billion. An analysis of the largest 100 banks in the May 1998 issue of *USBanker* shows that as a general rule the largest banks have poorer asset quality, lower profitability, less efficiency and weaker capitalization than the smaller banks on the list.

E. Small Business Lending Receives a Short Shrift in a World of Ever Larger Banks

The effect of interbank mergers on small business lending is also of concern, as small business lending receives short shrift in a banking world of ever larger entities. Generally, the percentage of small business lending is inversely proportional to bank size. According to another Federal Reserve Bank of Boston analysis (Peek and Rosengren), banks under $100 million involved in bank mergers on average had 16 to 19 percent of their loan portfolios in small business loans, while banks over $1 billion involved in bank mergers had on average 6 percent of their loan portfolios in small business loans. And interestingly, small bank acquirers tend to increase small business lending while large acquirers tend to reduce it. Peek and Rosengren note that several recent studies have found small business lending is also growing faster at small banks than large, and that large acquirers are less likely to expand in this sector. They found that banks with less than $100 million or more than $3 billion of assets each had asset growth of about 24 percent from June 1993 to June 1996, yet growth in small business lending (loans under $1 million) was 42 percent at the small banks but only 3 percent at the large banks.

In sum, the recent trends favoring consolidation in the banking industry are coupled with widely-held suspicions that (I) realized efficiencies are overstated or non-existent, and/or (ii) the benefits of such efficiencies as may be realized are not being shared with bank customers, and (iii) increased market power is used to raise prices.

Effect on ATM Network and Credit Card Markets

F. ATM Network Markets:

A key concern in large interbank mergers, and one that does not get the attention it warrants, is the effect on ATM networks. Market concentrations resulting from bank mergers and acquisitions have potential anti-competitive implications for ATM network markets (specifically control of ATM switches).

ATM networks are joint ventures between competing banks. ATM networks are self-regulated, private sector entities, owned and controlled in the majority of cases by large banks, that set their own pricing and related operating rules subject only to the constraints imposed by the antitrust laws. Given the structure of ATM networks, certain anti-competitive aspects are inherent. For community banks, these anti-competitive aspects are more pronounced as they generally have little influence over network fees, bylaws or operating rules. Access at a fair price to ATM and other electronic financial services networks is critical for community banks to insure their customers also have fairly and competitively priced access to these networks to transact their banking business.

Big bank mergers affect ATM networks in two ways. First, ATM network mergers typically follow. For example, NationsBank and First Union acquisitions in the South prompted the merger of the Honor and Most ATM networks (NationsBank owns 30 percent, the largest single share, of the Honor network). NationsBank's purchase of Boatmen's Bancshares of Missouri prompted Honor's acquisition of the BankMate network in St. Louis formerly owned by

MasterCard and three smaller networks. Currently, First Chicago owns 30 percent of the Cash Station network and 25 percent of Magic Line. Banc One owns 20 percent of Electronic Payment Systems, Inc. which operates the MAC network. The pending Banc One/First Chicago merger could result in mergers of all of these networks. (Interestingly, EPS/MAC entered into a consent decree with the Department of Justice in 1994 agreeing to cease certain anti-competitive practices that caused over 1,000 banks, particularly small banks, thrifts and credit unions, to pay higher, noncompetitive prices for ATM transaction processing.)

In the short term, the industry's merger mania is rapidly paving the way for an oligopolistic ATM network market owned by a handful of the nation's largest banks. Essentially, these banks control the pricing, policies and functionality of the nation's ATM networks. Given this control, large banks could limit access for community banks and their customers by imposing anti-competitive and discriminatory pricing, membership requirements, operating rules or technological barriers. Since network policies directly affect the ability of community banks and other small financial institutions to offer competitive ATM services for their customers, they must be allowed to participate fairly in the governance of ATM networks in order to protect these interests.

We note that under current law, the Federal Reserve has the authority to approve or veto ATM network mergers or mergers of other payments processing entities owned by banks. In the past, the IBAA has urged the Federal Reserve to consider the electronic banking markets when determining whether a proposed bank merger/acquisition passes antitrust tests. We have urged the Federal Reserve to ensure that its competitive impact analysis evaluates: 1) the market power of a network brand, 2) fees, 3) routing rules, 4) third-party processing requirements, and 5) other factors that could be used to disadvantage community banks.

The second way big bank mergers can effect ATM networks is that, over the long term, large banks could transfer their transaction processing from regional ATM networks to their in-house operations. BankAmerica Corp. is currently the largest ATM owner, and its merger partner NationsBank is second. Together they control more than 15,000 machines--a number that is comparable to multibank shared networks such as Pulse or NYCE. The Banc One/First Chicago merger will result in the nation's second largest ATM owner with almost 10,000 machines. (By contrast, all community banks combined own fewer ATMs than NationsBank/Bank of America.) Excess capacity could be created in existing regional electronic networks as large banks pull transactions out of the network as a consequence of mergers. If this excess capacity is not shifted to smaller financial institutions, the consumer of electronic payment services will have less and less choice. And the customers of community banks, savings and loan associations and credit unions could be forced out of electronic commerce by pricing and other decisions of the fewer and fewer network owners.

G. Credit Card Markets:

We have a major anti-competitive concern in the credit card area. Large bank mergers could create an oligopoly of credit card issuers led by Citicorp, Banc One and NationsBank. Citibank is currently the largest issuer of credit cards with 65 million cards outstanding. Banc One/First Chicago combined will hold the number two spot with 53 million cards. NationsBank/Bank of America combined will have 24 million cards outstanding. Once the pending mergers are consummated, the top ten credit card issuers will control 72 percent of the credit card market, according to Robert McKinley of RAM Research in Frederick, Md.

Under today's rules of the game, by using the Visa or MasterCard umbrella, thousands of community banks are issuers of credit and debit cards and set their own pricing and terms. Thousands of community banks and their credit and debit card customers can tie into the Visa and MasterCard brands, which confers on the cards the national and worldwide acceptance essential for the cards' viability. Like ATM Networks, the two card associations, Visa and MasterCard are joint ventures and all competing member banks enjoy the strength of two brands that are recognized and accepted around the world.

We have already heard the ad "Don't think Visa, think Citibank Visa" (i.e., it's not just a Visa Card, it's a Citibank Visa Card). It is our concern that down the road the ad you hear from Citibank or Banc One will jettison the Visa or MasterCard brand name in favor of a credit card or debit product that they exclusively own and control. And with the destruction of the Visa or MasterCard brand names, combined with large banks' long-term goal to destroy the FDIC symbol now on every bank door, enormous financial concentration to their benefit and to the detriment of thousands of community financial institutions and their customers will have been achieved. And then the consumer will suffer because we will be back in the brave new world where every credit card issuer charges a $35 annual fee and a 19.6 percent interest rate regardless of market interest rate fluctuations. And the taxpayer will suffer when the inevitable occurs, and a large financial conglomerate Titanic goes down.

At best, the card brands will be systematically weakened to the detriment of smaller issuers forcing them out of the business because they will not have the marketing budgets to compensate. Historically, Visa and MasterCard have offered baseline marketing and enhancement packages that virtually any size member bank could take advantage of. Increasingly the large issuers will not be willing to support such product parity preferring instead

to use their considerable influence to assure their own cards stand out. This in turn, will hinder cooperative brand advertising serving to obscure the message to consumers that other Visa and MasterCard offers are available, not just a "Citibank Visa."

Consumers will not only be disadvantaged by choice limits and higher pricing, some will find themselves "de-marketed" from the card product entirely. With increased consolidation and less competition, large issuers will begin to look for other ways to improve profits. For example, some issuers are already "de-marketing" by eliminating value-added enhancements, changing terms, assessing inactive fees and using other disincentives to discourage transactors, those consumers who pay off their balance each month to avoid finance charges. In addition to simply not offering the card product or raising annual fees, the grace period will be reduced or eliminated as the large card issuers focus on the more profitable revolvers, i.e. those who maintain a balance from month to month and pay finance charges, in a sort of reverse discrimination. In Canada today, where only a few large banks exist, most cards carry a high annual fee, $25 to $39, and reduced grace periods, from no grace period to just over 17 to 21 days (Office of Consumer Affairs of Industry Canada, Feb. 1998). Revolvers on the other hand will be held captive with higher annual percentage rates (APRs) applied using the highest possible compounded calculation methods and no grace periods along with higher late fees, over-limit fees and risk-based pricing.

Small merchants will also be affected. Already, the core interchange rates that form the basis for merchant pricing favor large merchants which are generally contracted with large banks. Just a few years ago, most of the large banks had bailed out of the merchant business leaving it fragmented and primarily in the hands of non-banks and small community banks. Now the big banks are back with a vengeance and have the clout to win market share. In

today's electronic world and with linkages to other commercial services, it will become increasingly difficult for smaller players to compete. With large card bases, the mega banks can also offer special, targeted promotions that will further tie merchants and consumers forcing out the smaller players, primarily community banks. Once the competition is eliminated, merchants, especially small businesses, will have little choice but to pay whatever rates are charged.

The California Independent Bankers (CIB) represents some 200 independent financial institutions throughout California and is politically active on behalf of its members in Sacramento and Washington DC. It is the California Affiliate of the Independent Bankers Association of America which has over 5,500 independent bank members nationwide.

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