The nature of the relationship between the concentration of business activity in the hands of a few large firms and the profitability of those firms has been a topic of considerable interest to economists. This interest stems from the observation that high concentration of business activity in a market typically results in increased concentration of assets among the firms that participate in that market. This concentration might be opposed for a variety of noneconomic reasons. However, until recent decades, most observers felt that concentration of business activity in a market (market structure) and the performance of that market (the profitability of those firms that operate in that market) were relatively uncorrelated. This view was based on the premise that competition was sufficient to prevent firms from gaining the ability to reduce their costs and increase their profits. However, as empirical evidence accumulated, it became clear that concentration and profitability were indeed related.

The evidence reviewed here is consistent with what one would expect to find if banking markets were, in fact, contestable. A significant relationship between market concentration and bank profitability was detected for the sample banks over the 1976-1978 interval, but no other more recent time period. The disappearance of the relationship coincided with the liberalization of bank branching laws in Ohio and Pennsylvania and the expansion of S&L powers authorized by Congress in 1980 and 1982. The findings imply that merger-related increases in concentration in states with minimal barriers to geographically diverse banks and performance (monopolistic) behavior have become under attack in recent years. In essence, opponents cite the constraining influence of potential competitors on the actions of incumbent firms. The view that market structure is a relatively unimportant determinant of firm behavior presupposes that barriers to entry into any market are minimal.

Some observers argue that the regulatory and technological changes that have taken place in the financial services industry in recent years have significantly reduced barriers to competition between bank and nonbank financial institutions, making local banking markets contestable. The implication is that high concentration in such markets is unlikely to result in anticompetitive conduct, and so is not a cause for concern. Others maintain that meaningful barriers to competition continue to exist and that substantial increases in concentration should be prevented.

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Intrastate and interstate barriers to geographic expansion by commercial banks and by savings and loan organizations (S&Ls) have been removed in a large number of states. Remaining barriers have been circumvented in various ways with loan service offices and nonbanking holding company subsidiaries, for example. The Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 essentially allow S&Ls to offer all the financial products and services of commercial banks. Large-scale, large regional or national firms can also operate in a geographic area without an extensive investment in brick-and-mortar offices.

Some observers suggest that these 1980s developments have made local loan and deposit markets more contestable. Table or open to competition, in many cases, particularly in rural areas. This has led to an extensive investment in brick-and-mortar offices.

Others, however, maintain that potential competition, particularly from nonbank financial firms that are not subject to the same regulations as banks, should not be viewed as worrisome. Burke and S. Rhoades, for example, have not engaged in a great deal of geographic expansion by commercial banks. In addition, the increasing sophistication and declining cost of computer technologies have made it possible for financial institutions to compete effectively in a geographic area without an extensive investment in brick-and-mortar offices.

The means and standard deviations of the return on assets figures for the banks in each class over time for each interval. That is, mean profitability is lower for banks in the later sub-intervals. It can be consistent with the traditional structure-performance (monopoly) view is correct, and potential competition has become a meaningful force over the period of analysis, significant differences in mean profit rates should not be apparent for banks in the different classes, at least in the most recent interval.

The particular banks analyzed were selected in the following way. First, all had to be in continuous operation over the 1976-1985 interval. Then the banks selected were classified into one of the following categories based on the number of actual competitors. Three classes were created for rural market banks: 1-3 competing banks, 4-6 competing banks, and seven or more competing banks. All S&L banks were put into a single class that can be viewed as a "large number of competing banks" class.

Significant differences are detected in the means and standard deviations of the return on assets figures for banks in the different classes, at least in the most recent interval. On the other hand, if potential competition has become a meaningful force over the period of analysis, significant differences in mean profit rates should not be apparent for banks in the different classes, at least in the most recent interval. That is, mean profitability is lower for banks in the later sub-intervals. If the contestable market banks are those with all their assets located within their home office county. The assumption is that S&L banks are presumed to approximate urban markets, whereas rural market banks can be viewed as "large number of competitors." Bank competitors in non-SMSA (standard metropolitan statistical area) counties have essentially the same powers as those located in the urban ones. On the other hand, if potential competition has become a meaningful force over the period of analysis, significant differences in mean profit rates should not be apparent for banks in the different classes, at least in the most recent interval.

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The findings are presented in Tables 1 to 3. The data for Ohio banks alone seem to be consistent with the traditional structure-performance view in all three time periods, that is, mean profitability is lower for banks in the later sub-intervals. It can be consistent with the traditional structure-performance (monopoly) view is correct, and potential competition has become a meaningful force over the period of analysis, significant differences in mean profit rates should not be apparent for banks in the different classes, at least in the most recent interval.

5. The Ohio law authorized de novo bank branching into counties contiguous to home office counties in two states, Pennsylvania and Ohio. Burke and S. Rhoades (i.e. 1 bank law) permitted de novo branching into single counties, whereas the Pennsylvania law permitted de novo branching into contiguous counties. 6. The design is closely patterned on the one employed in Burke and Rhoades (1982). 7. This classification scheme is arbitrary. A finer breakdown, as in Burke-Rhoades (i.e. 1 bank law) and Pennsylvania (i.e. 1 bank law), might be possible since there were relatively few single market banking boundaries in 1-2 bank markets in Ohio and Pennsylvania.

8. Thus the profitability measure excludes gains and losses on securities transactions. It is felt that securities gains and losses are not as directly related to the income of the market competition and so should not be included in profitability measures used in studies investigating the structure-performance relationship.

9. The Ohio banks analyzed were selected in the following way. First, all had to be in continuous operation over the 1976-1985 interval. Then the banks selected were classified into one of the following categories based on the number of actual competitors. Three classes were created for rural market banks: 1-3 competing banks, 4-6 competing banks, and seven or more competing banks. All S&L banks were put into a single class that can be viewed as a "large number of competing banks" class.

10. Annual return on asset figures (net income after taxes before securities transactions divided by average total assets) were obtained for each bank in each class over the 1976-1985 period, and were averaged over roughly three-year sub-intervals (1976-1978, 1979-1981, and 1982-1985). The particular sub-intervals were chosen by design. In the first interval, profitability was limited in both states, and S&Ls had limited asset and liability powers. These owners had been permitted to branch more freely the Pennsylvania banking law. In the final period, branching was liberalized in Pennsylvania, and S&L's finally had essentially the same powers as banks. Thus, the intensity of potential competition presumably increased in each interval.

Then mean return on assets figures were computed for the banks in each class over each of the three sub-intervals. If the traditional (monopoly) view is correct, and potential competition from bank and nonbank sources has continued to be relatively weak, the mean profit rate should be significantly lower in the more competitive market. Thus, the selection procedure allows the number of actual bank competitors in each of these sub-intervals to be determined. Banks in S&L's in each state were included in the sample if all of their offices were located with their home office county. The assumption is that S&L banks are presumed to approximate urban markets, whereas rural market banks can be viewed as "large number of competitors." Bank competitors in non-SMSA (standard metropolitan statistical area) counties have essentially the same powers as those located in the urban ones. On the other hand, if potential competition has become a meaningful force over the period of analysis, significant differences in mean profit rates should not be apparent for banks in the different classes, at least in the most recent interval.

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