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Vertical integration to avoid contracting with potential competitors: Evidence from bankers' banks ☆

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ABSTRACT

We examine a vertical integration decision within the commercial banking industry. During the last quarter of the 20th century, some community banks reduced their traditional reliance on correspondent banks for upstream products and services by joining bankers' banks, a form of business cooperative. Research on vertical integration focuses primarily on firm-specific investment, market power, and government regulation. However, this case is difficult to explain in terms of these standard vertical integration motives. Our evidence suggests that bankers' banks are a response to technological change and deregulation that results in increased costs faced by community banks in dealing with correspondent banks as both suppliers and potential competitors. For instance, loan participations require sharing proprietary information about major loan customers, something a community bank would not want to provide to a potential competitor.

1. Introduction

Firms must decide whether to make or buy their inputs. Theory explaining this choice generally focuses on transactions costs, property rights, market power, and government regulation. Related empirical work, which concentrates primarily on testing the transaction cost explanation, provides strong support for the hypothesis that firms vertically integrate to mitigate potential holdup problems associated with firm-specific investments, particularly when inputs are complex and environments are uncertain.[3] Evidence also

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[3] LaFontaine and Slade (2007) review more than 20 papers that test the predictions that the likelihood of backward integration increases with asset specificity, complexity, and uncertainty. Most of these studies

suggests that market power—attempts to create or avoid it—and government regulation can motivate vertical integration.[4] But substantial cross-sectional and time-series variation in make-versus-buy decisions exists in industries where asset specificity, market power, and government regulation appear unimportant (for example, in various trade and service industries). In this paper, we examine additional factors that affect vertical organization within such a setting.

Our study focuses on the make-versus-buy decision within the banking industry during the last quarter of the 20th century. During this period, a number of community banks reduced their reliance on large, independent banks for upstream products and services by contracting with business cooperatives known as bankers' banks. This move toward vertical integration appears difficult to explain using standard arguments. Specific investment in banking is relatively unimportant. The market power of community banks is unlikely to be affected by this organizational change. And, over this period, the market power of large banks within interbank markets does not appear to have increased. Meanwhile, banking is becoming less (not more) regulated.[5]

Prior to 1975, virtually all community banks obtained products and services (such as loan participations and check clearing) through correspondent relationships with large regional or money center banks. Deregulation and technological change during the last third of the 20th century increased the likelihood that these large banks would compete with community banks in their local retail and commercial lending markets. Our evidence indicates that a substantial number of community banks vertically integrated over this period through contracting with business cooperatives, known as bankers' banks. Banker's banks have no retail banking operations. Thus, by establishing correspondent banking relationships with a bankers' bank, a community bank avoids contracting with (and hence providing information to) potential competitors. For example, loan participations require sharing proprietary information about loan customers. A community bank would be reluctant to provide such information to a potential competitor, as this information might allow its correspondent bank to solicit its best customers. Similar concerns arise when a community bank obtains other correspondent services from a potential competitor: internal audit; credit analysis; loan, audit, and compliance reviews; confidential record handling and destruction; consulting; and training.

The business press has expressed concerns about securing proprietary information from competitors in the context of vertical organization and contracting (for example, Barrar and Gervais, 2006). However, academic analysis of this topic is limited. Asker and Ljungqvist (2010) provide evidence that such concerns affect corporations' choices of investment banks. Our paper offers evidence on their importance in vertical organization (long-term contracting versus a form of vertical integration). Our study also provides evidence on the motives for bankers' banks and more generally on why firms form business cooperatives.

We examine the growth of this organizational innovation as a potential example of Economic Darwinism. Alchian (1950) and Stigler (1958) argue that others copy effective innovations. Our data allow us to provide evidence on this frequently offered, but rarely tested, Economic Darwinism hypothesis. Furthermore, we believe that our paper is particularly timely because interest in the interdependencies among financial institutions has increased since the financial crisis of 2009.

Limiting our attention to the banking industry has both advantages and disadvantages. An important advantage is that this recent development of bankers' banks provides a valuable opportunity to analyze both time-series and cross-sectional evidence on vertical organization. In contrast to industries with more static organizational patterns, we can observe important environmental changes as well as resulting organizational innovation. This allows us to identify more precisely the economic factors that are likely to affect vertical organization and to provide evidence on their explanatory power. In addition, by focusing on an industry in which the standard hypotheses do not appear to explain vertical organization choices, we offer a compelling case that the current list of potential (non-mutually exclusive) explanations is incomplete. However, a disadvantage of concentrating on a single industry is that additional work is required to assess the extent to which similar concerns affect vertical organization within other industries.[6]

Our paper is organized as follows. In Section 2 we provide background information about the banking industry and bankers' banks. We review the economics of business cooperatives and develop our hypotheses in Section 3. We present our empirical results in Section 4. In Section 5 we conclude with a brief summary of our results and their implications.

(*footnote continued*)
focus on industries in which investment in physical assets is important (e.g., shipbuilding, aerospace, trucking, coal and electricity).

[4] Evidence on the importance of market power and government regulation is less extensive than for the transaction cost explanations. See Carlton and Perloff (2004, chapter 12) for a summary of how these factors can motivate integration as well as related evidence and examples.

[5] Banking deregulation has enabled bank consolidation, but it also has made banking markets more contestable. Osterberg and Thomson (1999) provide evidence that the net effect of deregulation is not to increase (and possibly to decrease) the power of large banks in correspondent banking (interbank) markets. Community banks contract for services with larger banks located in regional and national business centers. These metropolitan areas contain multiple large banks that supply correspondent services.

[6] Related issues appear to arise within other industries. For instance, the development of the Internet has raised concerns among franchisees of virtual encroachment, the central company marketing competing products to the franchisee's customers over the Internet. This has resulted in contract disputes and litigation and appears to have affected vertical integration decisions in some settings (for example, the decision by the central company whether to use company-owned or franchised units). Also, talks to renew a multibillion-dollar contract between Walgreen Co. and Express Scripts recently stalled. One source of tension is that Express Scripts, a large pharmacy benefits manager, began competing with Walgreen by offering its own mail-order pharmacy ("Walgreen, Express Scripts in Drug-Benefit Spat", *Wall Street Journal*, June 21, 2011).