

The product market in commercial banking: Cluster's last stand?

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Since the 1963 antitrust decision of *United States v. Philadelphia National Bank & Trust Co.*¹ the Supreme Court has held that the "cluster" of commercial banking products is the relevant product market or line of commerce in bank merger litigation. The banking cluster as determined by the Court includes various kinds of credit products as well as services, such as checking accounts and trust administration, that are denoted by the term "commercial banking." The significant implication of this approach by the Court is that banks are assumed to compete only with other banks. As a consequence, financial services providers other than banks are excluded from the competitive analysis.

In the twenty years following the *Philadelphia* decision, legislated deregulation and competitive creativity have drastically altered conditions in the marketplace so that legal and economic barriers to entry into commercial banking product and geographic markets have been eliminated or substantially reduced. The net result is that many nonbank providers of financial services offer reasonable substitutes for nearly all of the traditional commercial bank products that constitute the *Philadelphia* cluster.

The validity of the cluster rule should, therefore, be re-examined in the context of the theoretical approach taken by the Court in nonbanking cases under the Sherman Antitrust Act and the Clayton Act,² and in light of the post-1963 evolution of the financial services industry. This analysis leads to the conclusions that the Court established and perpetuated the cluster rule for reasons that seem questionable in the financial environment of the mid-1980s, and that the *Philadelphia* cluster should be unbundled. A product-based antitrust analysis of bank mergers would be in the mainstream of antitrust analysis generally and would allow for a more informed discussion of competition from nonbank competitors.

The nonbanking cases

In antitrust cases, two markets must be defined: the product market (line of commerce) and the geographic market (section of the country). Defining the geographic market without first establishing the relevant product is meaningless. In the major Sherman Act and Clayton Act decisions, the Supreme Court's discussions of the relevant market have recognized the economic content of antitrust to some extent. Two Supreme Court decisions in non-financial cases stand out as providing guidance in establishing relevant markets in antitrust matters: *United States v. E.I. DuPont de Nemours & Co.*³ and *Brown Shoe Co. v. United States.*⁴

In *DuPont*, the Court stated that product markets were to be determined by the cross-elasticity of demand between the product claimed to be monopolized and other products.⁵ Depending upon the value of cross-elasticity, products may be categorized into perfect substitutes, close substitutes, and non-substitutes. Thus, the Court recognized that all products have substitutes, and therefore the major task of antitrust is the identification and evaluation of substitute products.

The pivotal issue in *DuPont* was whether cellophane constituted a market in isolation or whether cellophane had to share a market with other wrapping materials. If cellophane was deemed to constitute the relevant product market, then *DuPont* would most likely have been found guilty of monopolizing this market under the Sherman Act since it produced 75

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percent of the cellophane sold in the United States during the period relevant to the litigation. Specifically, the Court was concerned with whether wrappings such as wax paper and aluminum foil, among others, could serve as effective restraints on the exercise of market power by DuPont through its production and sale of cellophane.

After assessing the cross-elasticity of demand between cellophane and the other wrapping materials, the Court found that, despite its advantages, cellophane had to meet competition in every one of its uses from other wrapping materials. All told, cellophane accounted for less than 20 percent of all flexible wrapping material sales and less than 22 percent of flexible wrapping material measured by wrapping surface. The Court, finding in DuPont's favor, believed that the exercise of market power could not be accomplished with such a market share.

The *Brown Shoe* case involved the merger of Brown Shoe Company, Inc. and G. R. Kinney Company, Inc., both major manufacturers and retailers of shoes. A major issue concerning product market definition centered on how the market for shoes was to be viewed. The Court determined the relevant lines of commerce to be men's shoes, women's shoes, and children's shoes. It did not opt for further distinctions based on price/quality considerations, although it conceded that such distinctions are not unimportant. Nor did the Court countenance finer age/sex distinctions, believing that such distinctions were unwarranted under the circumstances of the case. In deciding against the merger, the Court concluded that

the relevant market must be drawn with sufficient breadth to include the competing products of each of the merging companies and to recognize competition where, in fact, competition exists.

The Court in *Brown Shoe* believed that a submarket approach allowed it to recognize the proper product market and competition most clearly.

In *Brown Shoe*, the Court decided that "[t]he outer boundaries of a product market are determined by the reasonable interchangeability of use or the cross-elasticity of demand between the product itself and substitutes for it." This proclamation is derived from the

DuPont decision some six years earlier. However, the Court went on to indicate that "well-defined submarkets" that could constitute markets for antitrust purposes may exist.

The Court suggested that an examination of "practical indicia" might be helpful in defining these submarkets. The Court listed seven such indicia: 1) industry or public recognition of the submarket as a separate economic entity, 2) peculiar characteristics and uses of the product, 3) unique production facilities, 4) distinct customers, 5) distinct prices, 6) sensitivity to price changes, and 7) existence of specialized vendors.

The lesson to be learned from *DuPont* and *Brown Shoe* is clear: Products are to be considered within the same market so long as substitutability between them is high. Rather than rely on some precise estimate of substitutability, one should survey the economic environment in which the products and their producers compete. To do so, the seven indicia listed above provide a starting point. In this general way, one may gauge the degree to which products are in competition with one another and the effect of substitute products in restraining the exercise of monopoly power.

The banking cases

The landmark *Philadelphia* decision has served as the basis for product market definition in a banking context for over 20 years. (Table 1 lists a number of important bank merger decisions by the courts.) In the *Philadelphia* decision, four "practical indicia" served to separate commercial banks from other providers of financial services. The relevance of these indicia in today's economic environment is open to question. Therefore, it is imperative to examine the basis for the Court's conclusion that the *cluster* of products and services offered by banks is the relevant line of commerce.

First, the Court perceived that the business of commercial banking was unique, having as it did distinctive products. The Court was impressed by the role of banks in the money creation process and their ability to accept demand deposits. At that time, commercial banks were the only institutions able to accept deposits having transactional capabilities.

Second, the Court was cognizant of the major role banks played in supplying short-

term business credit. The historical role of banks in this regard was particularly significant because small businesses, the type of businesses typically shut out from other sources of credit, had come to rely heavily on commercial banks for their financing needs. And, as the Court perceived, small businesses acted as the linchpin of the U.S. economy.

Third, the regulatory scheme in the banking industry was far more pervasive than any to which nonbanking firms were subjected. In banking, there existed legal restrictions on entry, exit, prices, and expansion that do not exist in most lines of commerce. The rationale for this regulatory scheme dates back to the economic unrest of the early 1930s when it was felt that “excessive competition” prevailed in banking.

Finally, the Court wanted to avoid a too-broad economic investigation into the various submarkets making up the “cluster” of banking products and services. The Court believed that a simplified product market definition would better serve the interests of business planning and also appeal to the courts’ interest in “sound and practical judicial administration.” Thus, the Court believed the expedience of its simplified market definition was a virtue.

The major lesson in product market definition learned from *Philadelphia* and succeeding Supreme Court banking decisions is that, as far as the Court was concerned, banks only compete with one another and that the presence of banks in any given geographic area may be represented by their deposit shares (see box). Other providers of financial services are excluded from the product market in analyzing bank mergers. As Table 1 indicates, however, courts have at times encountered great difficulty in applying this rule to the facts in particular cases.

The *Philadelphia* judgment was followed by an emphatic reaffirmation of the cluster approach seven years later in *U.S. v. Phillipsburg National Bank* (1970),⁶ wherein the Supreme Court determined that “the cluster of products and services termed commercial banking has economic significance well beyond the various products and services involved.” However, in *U.S. v. Connecticut National Bank* (1974),⁷ its most

recent discussion of the product market in bank mergers, the Court held out some hope that nonbanks may one day be included in the line of commerce.

In *Connecticut*, the presidents of a savings bank and five commercial banks, the federal banking authorities, and the Connecticut State Banking Commissioner all agreed that savings banks were direct and formidable competitors of commercial banks. The trial court observed that recent legislative developments evidenced a “national trend toward more equal powers” between banks and thrifts, including the authorization of negotiable order of withdrawal (NOW) accounts for thrifts. Furthermore, the evidence elicited at trial disclosed the “cold, hard realities” that savings banks and commercial banks competed meaningfully in at least five product lines: personal checking, real estate mortgages, personal loans, IPC (Individual, Partnership, and Corporation) deposits, and commercial loans. Accordingly, the court held that the lines of commerce had to include savings banks and thus upheld the proposed bank merger.

On appeal, the Supreme Court struck down the trial court’s conclusion about the correct line of commerce. It held that the facts of banking in Connecticut did not disclose sufficient identity between savings banks and commercial banks to compel any finding other than commercial banking being the line of commerce. To reach that result, the Court had to unbundle its own cluster.

By 1973, savings banks in Connecticut essentially offered most elements of the banking cluster, but the Court did not feel they represented meaningful competition because they made relatively few short-term business loans. In addition, the fact that savings banks did not offer credit cards, loans for securities purchases, trust services, investment services, computer and account services, and letters of credit was considered significant even though each and every commercial bank did not necessarily offer the complete range of typical commercial bank products.

Although the Supreme Court excluded thrifts from the line of commerce in *Connecticut*, it left the door open for their future inclusion. Specifically, the Court stated:

Table 1
Major court decisions regarding the product market in bank mergers

Supreme Court cases:

<u>Year</u>	<u>Citation</u>	<u>Product market findings</u>	<u>Analytical approach</u>
1963	<i>United States v. The Philadelphia National Bank</i> (374 U.S. 321)	The cluster of commercial bank products and services was held to be the product market for anti-trust purposes, including unsecured personal and business loans, mortgage loans, loans secured by securities or accounts receivable, automobile and consumer goods installment loans, student loans, bank credit cards, revolving credit funds, demand, time and savings deposits, trust operations, lock boxes, safety deposit boxes, account reconciliation services, acceptances and letters of credit, correspondent services and investment advice.	Reasons fall into four broad categories: (1) perceived uniqueness of demand deposits and other aspects of commercial banking; (2) public policy (concentration in banking causes concentration in business); (3) pervasive regulatory scheme that governs commercial banking; (4) expediency (desirability of a predictable rule and undesirability of unduly burdening the courts with need to examine submarkets).
1970	<i>United States v. Phillipsburg National Bank and Trust Co.</i> (300 U.S. 350)	The Court reaffirmed the cluster rule and reiterated that commercial banking had a significance "well beyond the various products and services involved."	Cluster rule extended to banks whose portfolios were more characteristic of thrifts'. Majority opinion emphasizing convenience of "one-stop banking" as unique to banks; dissenting opinion criticized disregard for actual composition of bank portfolios in this case and for market power of thrifts.
1974	<i>United States v. The Connecticut National Bank</i> (418 U.S. 656)	The cluster rule was again reaffirmed, although state law had recently authorized personal checking accounts for savings banks and savings banks made commercial loans.	The Court found a "large measure of similarity" of services but insufficient overlap in service to commercial customers to set aside the cluster rule; however, it did acknowledge that trends in the development of savings banks could eventually compel a different result.

District Court cases:

<u>Year</u>	<u>Citation</u>	<u>Product market findings</u>	<u>Analytical approach</u>
1965	<i>United States v. Manufacturers Hanover Trust Company</i> (240 F. Supp. 867)	Wholesale and retail banking were distinguished as separate product markets within the cluster of commercial banking services; competition from nonbank providers was not considered.	A submarket analysis wholly within the cluster, consistent with <i>Philadelphia</i> .
1967	<i>United States v. Crocker Anglo National Bank</i> (277 F. Supp. 133)	The court rejected application of the <i>Philadelphia</i> principle to a case arising under the Bank Merger Act, and considered competition from a Morris Plan company, savings and loan associations, GMAC, finance companies, credit unions, insurance companies and state government.	Product market analysis, inconsistent with <i>Philadelphia</i> , had no effect on outcome of case because merger created no adverse effect on competition in banking regardless of analytical approach.
1968	<i>United States v. Provident National Bank</i> (280 F. Supp. 1)	Finding "reasonable interchangeability and meaningful competition" between commercial banks and thrifts for savings dollars and mortgage loans, the court considered direct competition from thrifts but not other financial organizations (indirect competitors).	Merger found anticompetitive regardless of choice of analytical method. Court agreed with <i>Crocker</i> approach and found <i>Philadelphia</i> rule outmoded because of deletion of "line of commerce" phrase in Bank Merger Act.

Table 1 (cont.)
Major court decisions regarding the product market in bank mergers

District Court cases (cont.):

<u>Year</u>	<u>Citation</u>	<u>Product market findings</u>	<u>Analytical approach</u>
1969	<i>United States v. The First National Bank of Jackson</i> (301 F. Supp. 1161)	The court examined submarkets including short-term business credit and agricultural credit, found competition from thrifts to be "actual, fierce, direct and meaningful", and included a credit union, finance companies, insurance companies, securities firms, and federal agencies.	Court agreed with <i>Crocker</i> and <i>Provident</i> in finding the <i>Philadelphia</i> rule inconsistent "with trade realities," but found no anticompetitive effects from merger even if cluster rule were applied.
1970	<i>United States v. The Idaho National Bank</i> (315 F. Supp. 261)	The court found vigorous competition from thrifts, Production Credit Associations, the Federal Land Bank, life insurance and mortgage companies, and other financial concerns for "interest-bearing deposits, agricultural production loans, farm real estate loans, automobile and other consumer loans, and student loans."	A pure submarket approach, rejection of cluster rule as inconsistent with "facts of life," but method of analysis again did not determine outcome of case.
1970	<i>United States v. First National Bank of Maryland</i> (310 F. Supp. 157)	The court recognized competition from thrifts and other financial organizations for deposits, ("more time than demand") and real estate, small business and consumer loans.	The court criticized mechanical application of the cluster rule but cautioned against undue dilution of the universe of competitors. Yet the merger was found not to be anticompetitive whether or not substantial nonbank competition was included.
1970	<i>United States v. Phillipsburg National Bank and Trust Company</i> (306 F. Supp. 645)	The court found "virulent" competition from thrifts, pension funds, mutual funds, government bonds, insurance companies and finance companies, for savings dollars, conventional mortgage loans, individual and dealer automobile appliance, equipment and commercial inventory financing.	The court's ruling on the merits was reversed and the case remanded by the Supreme Court for reconsideration applying cluster rule.
1973	<i>United States v. First National Bancorporation</i> (329 F. Supp. 1003)	The court adopted the cluster approach in light of a lack of evidence of nonbank competition, and rejected viability of correspondent banking as a submarket wholly within the commercial banking cluster.	Affirmed by equally divided Supreme Court <i>per curiam</i> .
1973	<i>United States v. The Connecticut National Bank</i> (362 F. Supp. 240)	Savings banks were included in the line of commerce based on recent statutory authorization for personal checking accounts and existence of "meaningful competition from savings banks for personal checking, real estate mortgages, personal loans, I.P.C. deposits and commercial loans."	A submarket analysis; reversed on appeal to Supreme Court.

At some stage in the development of savings banks it will be unrealistic to distinguish them from commercial banks for purposes of the Clayton Act [T]hat point may well be reached when and if savings banks become significant participants in the marketing of bank services to commercial enterprises.

Whether the factors that served to separate commercial banks from other financial services providers remain valid is of critical importance. The financial landscape of the 1980s is much different from that which the Court surveyed in 1963.

Before turning to a discussion of legislative, regulatory, and marketplace developments post-*Philadelphia*, however, it is interesting to note how commercial banks are treated in analyses of mergers between commercial banks and other types of financial institutions. The treatment of banks in this regard is vastly different from their treatment in merger cases involving only banks.

Antitrust asymmetry

Based on the rationale of *Philadelphia*, commercial banking is the (relevant) product market, but what is the product market in a merger between a commercial bank and a consumer finance company, for example? Clearly, the cluster rule is inappropriate in this instance because, aside from consumer lending, the consumer finance company's array of products does not materially overlap that of a typical commercial bank. What has been sanctioned by the Court and has been followed by the Federal Reserve Board in deciding upon nonbanking acquisitions under the Bank Holding Company Act is an *unbundling* of commercial bank products. Thus, it has been decided that nonbank firms and their products effectively compete with some (but not all) of the products provided by commercial banks.

In *Phillipsburg*, the Court concluded that "submarkets . . . would be clearly relevant . . . in analyzing the effect on competition of a merger between a commercial bank and another type of financial institution." How this statement could be reconciled and made consistent with the Court's refusal to examine submarkets in bank merger analysis is not clear. It is tantamount to saying that banks compete

with consumer finance companies, for example, but that consumer finance companies do not compete with commercial banks. Thus, competition between banks and nonbanks exists in a one-way flow.

Under its Regulation Y, the Federal Reserve is forced to examine submarkets in cases arising from the acquisition of nonbank concerns by bank holding companies. In these instances, holding companies seek to acquire firms that offer less than the full line of commercial bank services. The relevant market, then, is determined by reference to the particular services in which both the bank and the nonbank firm compete.

For example, in *Bankers Trust New York Corporation*,⁸ a holding company sought to acquire a consumer finance company. The Board of Governors noted that the competition between the finance company and the holding company's bank existed in two product submarkets: personal loans up to \$1,400 and all direct consumer installment loans. The Board reasoned that consumer finance companies were an alternative source of funds for personal loans, auto loans, home improvement loans, and many other loans traditionally made by commercial banks.

This asymmetrical view of banking competition, though supported by Supreme Court dictum, is, in and of itself, strange. How can a consumer finance company be at the same time in competition with commercial banks while being excluded from consideration in analyzing the competitive effects of the merger between two banks? The answer may lie in an examination of the criteria that are claimed to set commercial banks apart from other institutions and the relevance of these criteria in the current financial marketplace.

Legislative, regulatory, and marketplace developments

Prior to 1980, much of the legislation and regulation that applied to banks was a legacy of the early 1930s, designed to shelter banks from excessive competition and from errors and poor management judgment. By the late 1960s, many financial institutions found numerous ways to exploit technological and economic developments. They began to offer new

products and provide new delivery systems that were incongruent with the extant set of banking regulations.

By the 1970s, regulation tended to accommodate competition and expansion to a much greater extent than had been true in the 1950s and 1960s. Even so, regulation tended to lag developments in financial markets.

As a result, during the 1970s, pressures began to build between regulatory and market forces. For example, the interest ceilings on time and savings deposits were held artificially below market rates, and the NOW account was created. This account would have completely broken commercial banks' monopoly on demand deposit accounts were it not for a series of stop-gap legislative and regulatory changes that impeded its spreading throughout the country to households and business firms alike.

Thrift institutions

Significant legislative changes took place in 1980 and again in 1982 that affected the competitiveness of thrift institutions against commercial banks. These were the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St Germain Depository Institutions Act of 1982 (Garn-St Germain).

DIDMCA allowed savings and loan associations (S&Ls) to offer individuals the convenience of "one-stop shopping" and, in effect, to become their "department store of finance." Among its provisions, DIDMCA phased out interest rate ceilings on time and savings deposits over a six-year period and allowed S&Ls to offer consumer loans. Also under DIDMCA, NOW accounts, which were first introduced in Massachusetts in the early 1970s and subsequently spread to other New England states, became permissible nationwide.

At the time of the *Philadelphia* decision, commercial banks were the only institutions that could offer checkable deposits, and in 1963, demand deposits were an important source of funding for commercial banks, accounting for 44 percent of total bank liabilities at year-end 1963. Two decades later, however, demand deposits comprised only 21 percent of bank liabilities. And at year-end 1983, S&Ls, credit unions, and mutual savings banks had \$33.6 billion of checkable deposits, consider-

ably less than the \$349.3 billion on the books of commercial banks, but enough to suggest that the nature of the product that was so important to defining the *Philadelphia* cluster had changed significantly.

DIDMCA did little to aid thrifts in serving the business customer, the class of customer that was so important to the Supreme Court's argument in *Connecticut*. But in order to preserve the viability of thrifts, Congress later enhanced the ability of thrifts to provide services to commercial enterprises. These expanded powers granted under Garn-St Germain allow a federally chartered thrift to invest well over half of its assets in commercial investments, enhance the consumer lending opportunities of thrifts, and allow thrifts (as well as commercial banks) to offer a deposit account directly competitive with money market mutual funds.

A difficult issue is whether the new powers granted thrifts are enough to classify them as falling within the line of commerce for analyzing the competitive effects of bank mergers. According to the Supreme Court's *Connecticut* rationale, to warrant inclusion, thrifts must exercise their new powers to a meaningful degree. The enabling legislation is in place but the follow-through on the part of thrift institutions is an empirical issue. Federal Reserve Board Chairman Paul A. Volcker has testified:

The observation that thrift institutions have essentially become bank-like institutions is indisputable with respect to the powers that they are allowed to exercise and increasingly accurate with respect to the powers they do exercise.⁹

In light of this conclusion, the Federal Reserve Board has since 1980 taken account of bank competition from thrift institutions in deciding a number of bank holding company acquisitions.¹⁰

Empirical studies suggest that thrifts have cautiously taken advantage of their new asset powers.¹¹ Nonetheless, from a competitive point of view, the important distinction when it comes to the exercise of market power is "many potential rivals, not necessarily many existing rivals."¹² The mere ability of numerous thrift institutions to offer products that overlap with those offered by commercial banks may circumscribe the ability of banks to charge prices above the competitive norm even if few thrifts

actually compete directly in selling these products and services.

While each and every thrift institution has not exercised all of their new powers, enough thrifts have utilized their new abilities to have altered the competitive environment of commercial banks in a significant way. Thrifts have moved with neither lightning nor glacial speed, but they have moved forward.

Mutual savings banks are regulated at the state level and their powers began to change during the 1970s, prior to the legislated changes for federally regulated thrifts contained in DIDMCA. Table 2 illustrates the degree to which mutual savings banks have exploited their newfound powers since the mid-1970s. By 1983, more than half offered commercial credit, and more than four-fifths offered consumer credit in a variety of different forms as well as substitutes for commercial bank demand deposits. Table 2 provides suggestive evidence that the situation has changed sufficiently for mutual savings banks to be included in the commercial banking cluster; indeed, were *Connecticut* decided by the U.S. Supreme Court in 1985 instead of 1974, the outcome would likely be different.

S&Ls lag behind mutual savings banks in offering the range of products that would necessitate their inclusion in the commercial bank cluster. But they are not all that far behind. For example, in 1963 when *Philadelphia* was decided, S&Ls did not engage in consumer installment lending; the same was true a decade later in 1973, but by year-end 1983, S&Ls held \$21.6 billion of consumer installment loans. By August 1984, S&Ls held over 6 percent of consumer installment credit, well behind commercial banks, finance companies, and credit unions, which held 45 percent, 24 percent, and 14 percent, respectively. Nonetheless, S&Ls have made a respectable market penetration into consumer lending in just a few years.

S&Ls have begun to penetrate the commercial lending market as well. By year-end 1983, they held roughly \$2.3 billion in commercial loans, 0.6 percent of the commercial and industrial loans held by all commercial banks at that time. In states such as Ohio where state-chartered S&Ls had commercial lending powers prior to DIDMCA, S&Ls are viewed as a viable alternative to banks for small business loans.¹³ Other thrift institutions

Table 2
Percent of Mutual Savings Banks
Offering Selected Services

	1974	1978	1981	1982	1983
Automated Teller Facilities	3%	17%	32%	38%	45%
Business Loans	n.a.	n.a.	40	54	52
Checking Accounts	7	48	56	72	84
Credit Cards	4	39	45	52	59
NOW Accounts interest-bearing	29	66	92	92	90
Personal Loans	64	67	72	95	96
Second Mortgage Loans	n.a.	n.a.	71	80	99*
Total Number of Savings Banks	480	466	448	424	399

*Includes home improvement loans.

SOURCE: *National Fact Book of Savings Banking*, National Association of Mutual Savings Banks, various issues.

also have commercial lending powers; among these are industrial banks in California and Rhode Island and state-chartered credit unions in Rhode Island.

Even the limited and fragmentary evidence presented here suggests that it is becoming easier to defend the inclusion of thrifts in bank merger analysis than it is to defend their exclusion.

Market overlaps between banks and nondepository firms

The line of commerce in bank mergers need not and should not be limited to thrifts and commercial banks. Competition must be recognized when, in fact, competition exists. Thus, an economic appraisal of competition afforded by nonbank, nondepository organizations is necessary and it should go beyond the cluster approach of the Supreme Court because that approach seems out of touch with the marketplace realities of the 1980s.

Indeed, the weight of the evidence compiled in recent years indicates that commercial banks are not unique, multi-product firms and that good, if not perfect, substitutes exist for

virtually every commercial bank product and service. The Federal Reserve Bank of Chicago has recently published several studies that update and extend previous works on the competition offered to commercial banks by nonbanking-based firms.¹⁴ The Chicago Fed's studies revealed that firms other than those whose primary activity involves deposit taking compete with commercial banks in several product lines, including consumer lending, business lending, and the generation of deposits and deposit substitutes. Because these firms do not fund themselves by issuing deposits, they are able to provide nationwide delivery systems for their financial products.

Consumer credit. The nation's 15,000 commercial banks comprise the largest group of consumer installment lenders, with just under 43 percent of the total outstanding loans at year-end 1982. Yet, at that time, the top ten nonbanking consumer installment lenders had \$86.7 billion of these loans outstanding, exactly double that held by the ten largest bank holding companies in this lending category and almost three-fifths as much as the \$152.5 billion of consumer installment credit held by the *entire* banking industry.

In the narrower field of auto loans, commercial banks have maintained their position as the leading lending group, but special circumstances in the automobile market during the 1978-82 period propelled a big shift in market share toward the captive auto finance companies and away from banks. Similar trends, however, were exhibited in the share changes in total consumer lending. In 1978, commercial banks issued 55 percent of net new installment debt (new loans written less paydowns of existing loans) to households; finance companies accounted for only 22 percent of such debt. In 1981, these relative shares reversed themselves; commercial banks issued only 3 percent of the net new consumer installment debt that year while finance companies accounted for 72 percent. Not all of this increased finance company share, however, was in auto loans. Finance companies held at least \$13 billion of second mortgage debt at the end of 1981. In 1982, commercial banks bounced back in new consumer lending and increased their market share (of net new loans) to 33 percent in spite of a poor showing in auto loans.

Thus, it seems clear that households are willing to shift from one institutional supplier to another in response to noticeable differences in price or service. In a deregulated world, old habits may be short-lived. If households perceive the commercial bank cluster as being important, their revealed preferences during the 1978-82 period provide little evidence to support such a notion.

Credit cards. In 1983, charge cards were the fastest growing segment of nonmortgage consumer debt and accounted for almost 19 percent of consumer lending.¹⁵ Charge card usage comprises an important element in consumer credit.

Many firms other than commercial banks issue credit cards. In 1984, when ranked by number of cards issued, not a single bank appears among the top ten issuers. Ironically, despite being in their infancy when *Philadelphia* was decided in 1963, bank cards were among the products included in the *Philadelphia* cluster. In 1984, Sears was the leading credit card issuer with over 66 million cards and is followed by two other retailers, Montgomery Ward and J.C. Penney.¹⁶ Rounding out the top ten are six oil companies and American Express in sixth place. Citicorp (holding company and bank combined) ranks in 11th place, while Bank of America leads the banks in 12th place with a total card base of 9.3 million.

Furthermore, commercial banks are not the only issuers of bank cards. Since 1980, hundreds of thrift institutions have become issuers of Visa and MasterCard. Two credit union groups—Payment Systems for C.U.s, Tampa, Florida, and CUNA Service Group, Madison, Wisconsin—rank 21st and 48th in number of active accounts.¹⁷ Moreover, finance companies have become indirect issuers of bank cards with Associates ranked 20th, Beneficial ranked 25th, and Avco Financial Services ranked 73rd by number of active accounts.¹⁸

Most charge cards are not directly competitive with one another; for example, a Shell Oil card cannot be used at Sears and vice versa. The greatest direct competition takes place between Visa, MasterCard, and American Express, the last of which, strictly speaking, is not a credit card but a travel and entertainment (T&E) card. Of the total installment and noninstallment credit issued through cards in 1983, the bank cards ranked second with al-

most 40 percent of this \$95.7 billion market; they were surpassed by retailers' cards, which had almost 49 percent of the market; T&E, oil company, and other cards combined had just over 11 percent of the market.¹⁹ While bank cards are the most universally accepted charge cards, it would be difficult to make the case that bank cards are unique and belong within the commercial bank cluster, particularly when one considers that both Visa and MasterCard are not themselves banks but co-operative licensing companies.

Business loans. Banks have the largest share of outstanding commercial and industrial (C&I) loans in the United States. The 15 largest bank holding companies held \$155.5 billion of domestic C&I loans at the end of 1982, more than triple the total held by the 32 nonbank companies included in the Chicago Fed study that year. Nevertheless, the importance of nonbank lenders should not be underestimated since 15 industrial firms had \$39.6 billion of commercial loans on their books at that time. These 15 industrial-based companies also engaged in more lease financing than did the 15 largest bank holding companies, and more than the nation's 15,000 insured commercial banks.

In commercial mortgage lending, life insurance companies overshadow banks and bank holding companies. In 1982, the top 15 life insurance companies held roughly \$88 billion in commercial mortgages, \$62.2 billion more than the 15 largest bank holding companies and 67 percent of the commercial mortgages held by the domestic offices of all insured commercial banks. In addition to their direct participation in business lending through private placements and direct commercial loans, insurance companies also engage in indirect business lending through their ownership of corporate bonds and equity securities. According to *American Banker*, Prudential Insurance ranked among the largest commercial lenders in 1983, holding over \$38 billion of business loans—\$29.8 billion of commercial loans, \$1.5 billion of commercial finance company receivables, and some \$7.0 billion of lease assets.²⁰

In providing commercial credit, nonbank companies compete with banks in other ways as well. For example, Commercial Credit Corporation (a subsidiary of Control Data),

Merrill Lynch, and ITT are approved lenders for the Small Business Administration; prior to January 1980, SBA lending was the sole province of commercial banks. Another important nonbank source of credit to small businesses is trade credit. Many large corporations have largely by-passed commercial banks for short-term credit by issuing commercial paper. And, as mentioned previously, S&Ls and mutual savings banks have also begun to engage in commercial lending.

Clearly, the number of alternative suppliers of business credit has increased significantly since 1963 when commercial credit, in particular, small business credit, was a key ingredient of the *Philadelphia* cluster. Recent surveys of small businesses, the customer class that was so important to the line of commerce determination in *Connecticut*, suggest that small businesses view commercial banks as only one of a number of sources of banking services.²¹

Deposits. In 1963, commercial banks were the only depository institution empowered to offer demand deposits. Adding to banks' monopoly power in this product line was the fact that very few good substitutes existed for making third-party payments. The best of these substitutes was money orders, which were widely available from the U.S. Post Office, numerous financial institutions, and some retail stores.

Substitutes for bank deposits have existed for many years. In particular, the number and variety of substitutes for the traditional noninterest-bearing commercial bank demand deposit have proliferated during the last two decades. Repurchase agreements, NOW accounts, money market mutual funds, sweep accounts, and touch-tone telephone bill paying services are just a few of the substitutes that have arisen and have undermined the monopoly power once enjoyed by commercial banks in demand deposits and in controlling access to the nation's payments system.

The money market mutual fund (MMMF) is an innovative product of the early 1970s that serves as a substitute for savings deposits at banks and thrifts but which also has some transactions capabilities. MMMFs grew from only a few billion dollars in assets in 1975 to over \$230 billion in assets by December 1982 when they reached their peak. Banks and thrifts, in 1982, were finally given permission

under Garn-St Germain to offer the money market deposit account, which would be directly competitive with MMFs.

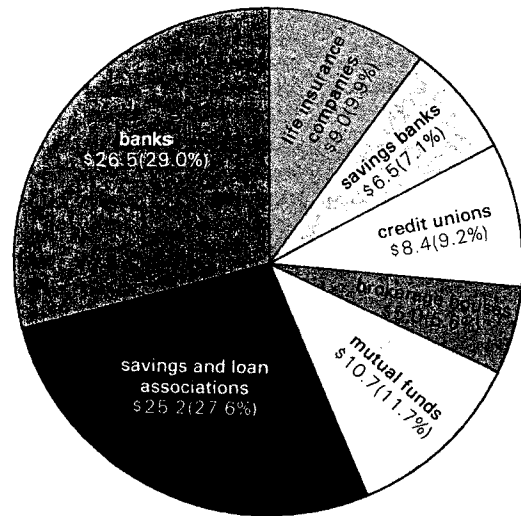
In other new deposit categories, commercial banks have not always gotten the bulk of the market. For example, in a recent survey, it was found that Merrill Lynch & Co. sells the most individual retirement, Keogh, and other consumer retirement accounts. There are no banks or thrifts in the top five competitors for this line of business.²² Competition has been vigorous among all types of financial institutions—banks, thrifts, insurance companies, investment companies and securities firms—for IRA accounts (see chart). This provides a further indication that the cluster notion—banks competing only with other banks—suffers from a credibility problem that gets worse day by day.

Recent regulatory decisions

Over the last four years or so, the Federal Reserve Board has begun to give some weight to the presence of thrift institutions in its rulings in bank mergers and acquisitions, thus undermining the letter, but not necessarily the spirit, of *Philadelphia* and *Connecticut*. The Supreme Court recognized that at some time in the future, commercial banks and the cluster of products that they alone could offer would no longer be unique. It now appears that the *Philadelphia* cluster has entered the phase of its life cycle when it should be of interest primarily to nostalgia buffs and trivia fans. Logic and recent evidence suggest that the *Philadelphia* cluster should not form the foundation of the antitrust doctrine to be followed in viewing and analyzing the anticipated consolidation in the banking industry.

If the *Philadelphia* cluster is out of synchronization with marketplace realities, what product line(s) should be used in place of it? Two very different approaches can be used to redefine the product market in bank merger analysis. At one extreme, a new cluster can be developed that includes suppliers of each and every product contained within the *Philadelphia* cluster. At the other extreme, competition can be analyzed *separately* for each and every sub-market or product within the cluster, and if significant anticompetitive effects are found for even a single product, the proposed merger

IRA deposits by industry: 1983



SOURCE: Investment Company Institute, Washington, D.C.

might be denied. Each of these polar cases has its merits and drawbacks, yet either would seem preferable in some ways to the continued use of the *Philadelphia* cluster.

The first alternative was utilized by the Comptroller of the Currency in a merger decision involving two banks in State College, Pennsylvania.²³ The proposed merger involved the fourth and fifth ranked commercial banks in Centre County, Pennsylvania and would result in the combined entity attaining the second rank in the market with 23 percent of commercial bank deposits, a significant jump in market share *as conventionally defined*.

Recognizing that the two merger candidates faced competition from banks and non-banks not domiciled in Centre County, the Comptroller included in the analysis many of these nonlocal competitors. Among the other competitors reviewed by the Comptroller were: 1) several banks (including a subsidiary of Mellon National Corporation, the state's largest banking organization) which compete directly and indirectly in the market;²⁴ 2) several new and more established S&Ls; 3) several banks having no offices within the defined geographic market but which made loans in the market as evidenced by mortgage and security lien recordings; 4) numerous out-of-area banks

such as Citibank (New York) and Chase Manhattan Bank, which advertise and market their deposit and other financial services through toll-free numbers; (5) Merrill Lynch, which through its offices in State College offers interest-bearing checking accounts, credit cards, money market accounts, and personal and mortgage loans; and (6) other financial firms, such as Household Finance, which offers installment sales financing and commercial leasing; Kissell Company, which offers consumer and business lending services; Finance One, a consumer finance company and a subsidiary of Manufacturers Hanover Corporation; and Dean Witter, a subsidiary of Sears, which offers deposit and lending services. The Comptroller concluded:

Although none of these institutions offers all of the services offered by a commercial bank, in the aggregate they provide viable alternatives for virtually all banking services.²⁵

After taking account of many of the competitors that are typically excluded in bank merger analysis, the Comptroller approved the application, stating that a purely conventional structural analysis of bank market shares would provide an inaccurate picture of each firm's competitive capacity.

While it seems to make more sense to include known competitors than to exclude them, measurement of their competitive contribution is also important. It is not clear that inclusion of these same out-of-market competitors would have produced the same merger decision if the two subject banks had traditionally defined market shares of 50 percent and 40 percent. Inclusion of nonbank firms, thrifts, and out-of-market banks is logical and expedient, but quantification of their competitive impact requires proprietary data at the local level for each such competitor. The collection of such data is expensive and time-consuming. It is easy to see why the Supreme Court opted for the expediency of using only commercial bank data.

An alternative approach to that used by the Comptroller would involve a detailed analysis of competitive alternatives whenever there appeared to be a shortage of substitutes—either products or suppliers—for the products and services offered by *both* merging

firms. If it is known, for example, that numerous alternative suppliers provide consumer loans, time and savings deposits, and a full range of business loans in the relevant geographic area, these products can be ignored in assessing the competitive impact of the merger. If, on the other hand, there are few accessible alternative suppliers of, say, transaction accounts and trust services, then these two product lines might be investigated more thoroughly to ascertain the impact on competition in each product or submarket. This would concentrate the resources needed for quantification and measurement where they are most needed and would not squander resources to quantify what everybody already knows.

This methodology represents a compromise between the almost total lack of quantification involved in the inclusion of every conceivable competitor as was done in the recent State College, Pennsylvania, decision of the Comptroller and the delusory absolute quantitative precision of deposit concentration ratios used in the *Philadelphia* cluster. This line of analysis would seem to combine the theory and logic used by the Supreme Court in analyzing the nonbank cases with a reasonable degree of expediency, since quantification would only be sought for those areas of competitive overlap where an initial case can be built that suggests the elimination of sufficient competition to warrant the allocation of resources for further investigation.

Conclusion

The commercial banking cluster rule is an expedient created by the Supreme Court premised on the alleged uniqueness of commercial banks. This rule accords neither with the traditional principles of product market analysis as enunciated in *Du Pont* and *Brown Shoe*, nor with the reality of competition now faced by commercial banks from nonbank financial institutions. In view of the changes in the industry over the last 20 years, it would be preferable for the courts to unbundle the cluster and examine the anticompetitive effects on a product-by-product basis.

The product-based approach recommended here not only rests in the mainstream of antitrust analysis, but also makes sense be-

cause of the continuing evolution of the financial services industry. Market shares and concentration measures, the stuff of which antitrust decisions are made, are of dubious significance under the cluster rule. A product-by-product analysis overcomes this problem by permitting the identification of all competitors, bank and nonbank. Furthermore, it allows for an informed discussion of potential competitors relative to various markets. A question of paramount importance in any discussion of the competitive consequences of a merger is whether all potential competitors face significant barriers to entry. Unfortunately, under the *Philadelphia* cluster, the effect of the full range of potential competitors in restraining the exercise of market power of incumbent firms is legally precluded from assessment.

A product-by-product analysis would not make antitrust decisions any easier. But, on the other hand, expediency has its price as well. If we are concerned about possible anticompetitive consequences, that is, if the antitrust laws are to be taken seriously, then antitrust analysis must be applied with scrupulous logic.

The objective of the antitrust laws is the prevention of mergers and acquisitions that restrict competition or restrain trade. Continued use of the *Philadelphia* cluster will prevent many acquisitions that do not violate this public interest objective. To be sure, more mergers and acquisitions would be allowed if the product line were broadened to include a wider array of financial services providers or narrowed to a product-by-product basis.

Because of these problems with the cluster rule, and in order to extend the traditional principles of antitrust to bank mergers, the cluster approach should be discarded in favor of a product-by-product analysis.

¹ 374 U.S. 321 (1963).

² These Acts form the foundation of antitrust law in the United States. Their purpose is to prevent the elimination of substantial competition or the exercise of monopoly power.

³ 351 U.S. 377 (1956).

⁴ 370 U.S. 294 (1962).

⁵ Cross-elasticity of demand is a measure of economic substitution. The concept concerns the relationship between the price of one product and the

quantity demanded of another product when other prices, income, and tastes are held constant.

⁶ 399 U.S. 350 (1970).

⁷ 418 U.S. 656 (1974).

⁸ *Federal Reserve Bulletin* 59 (September 1973), p. 694.

⁹ Paul A. Volcker, "Statement," in U.S. Congress. House. Committee on Energy and Commerce, *Financial Restructuring: The Road Ahead, Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance on H.R. 5342, H.R. 4506, and H.R. 3537*. 98th Cong., 2nd sess., 1984, p. 92.

¹⁰ Recent examples of thrifts being accorded considerable weight in the competitive analysis can be found at "Norstar Bancorp Inc.," *Federal Reserve Bulletin* 71 (January 1985), p. 46; and "Wesbanco, Inc.," *Federal Reserve Bulletin* 71 (January 1985), p. 49.

¹¹ Constance Dunham, "Mutual Savings Banks: Are They Now or Will They Ever Be Commercial Banks?" *New England Economic Review*, Federal Reserve Bank of Boston, (May/June 1982); Robert E. Goudreau, "S&L Use of New Powers: A Comparative Study of State- and Federal-Chartered Associations," *Economic Review*, Federal Reserve Bank of Atlanta, (October 1984); and Janice M. Moulton, "Antitrust Implications of Thrifts' Expanded Commercial Loan Powers," *Business Review*, Federal Reserve Bank of Philadelphia, (September/October 1984).

¹² George J. Stigler, *The Organization of Industry* (Homewood, Ill.: R.D. Irwin, 1968), p. 19.

¹³ The legal ability to offer a service does not necessarily indicate that thrift institutions should be considered meaningful competitors of commercial banks in commercial lending. Among the other factors that need to be considered are thrifts' shortage of experienced commercial lending officers, the differences in the control and accounting systems of banks and thrifts, and the differences in tax treatment between the two types of institutions. As a result of these differences, the entry of S&Ls and mutual savings banks into commercial lending still needs to be considered on a case-by-case basis.

¹⁴ Numerous other examples may exist, but the few cited here were contained in U.S. Congress. House. Committee on Banking, Finance and Urban Affairs, *Comparison of Products and Powers of Selected Financial and Nonfinancial Institutions*, by Raymond Natter, committee print 98-13 (Washington, D.C.: U.S. G.P.O., 1984).

¹⁵ Harvey Rosenblum and Diane Siegel, "Competition in Financial Services: The Impact of Non-

bank Entry” Staff Study 83-1, Federal Reserve Bank of Chicago (Chicago: The Federal Reserve Bank of Chicago, 1983); Harvey Rosenblum and Christine Pavel, “Financial Services in Transition: The Effects of Nonbank Competitors” Staff Memorandum 84-1, Federal Reserve Bank of Chicago (Chicago: The Federal Reserve Bank of Chicago, 1984); and Harvey Rosenblum, Diane Siegel, and Christine Pavel, “Banks and nonbanks: A run for the money,” *Economic Perspectives* Federal Reserve Bank of Chicago, (May/June 1983).

¹⁶ *The Nilson Report*, no. 339, (September 1984), p. 3.

¹⁷ *The Nilson Report*, no. 340, (September 1984), p. 3.

¹⁸ *The Nilson Report*, no. 337, (August 1984), p. 4.

¹⁹ *Ibid.*

²⁰ *The Nilson Report*, no. 339 (September 1984).

²¹ Laura Gross, “New Financial Services Scorecard Shows Who’s On First,” *American Banker*, January 4, 1985, p. 1.

²² See Paul R. Watro, “Financial Services and Small Business,” *Economic Commentary*, Federal Re-

serve Bank of Cleveland, (Jan. 11, 1982), and Victor L. Andrews and Peter C. Eisemann, “Who Finances Small Business Circa 1980?” *Studies of Small Business Finance* (November 1981).

²³ Gross, “New Financial Services Scorecard Shows Who’s on First,” p. 1.

²⁴ U.S. Office of the Comptroller of the Currency, “Decision on the Application to Merge Farmers Community Bank, State College, Pennsylvania into Peoples Bank of Central Pennsylvania, State College, Pennsylvania,” November 5, 1984.

²⁵ The Comptroller cited recent court decisions that support the notion that the presence of a small office of a large parent company in a market tends to severely understate the capacity of that office to aggressively compete in the market. It would appear from the Comptroller’s discussion that the *full* size of giants such as Mellon National Corporation, Merrill Lynch, and Manufacturers Hanover Corporation were taken into account in performing the competitive analysis.

²⁶ U.S. Comptroller of the Currency, “Decision on the Application to Merge Farmers Community Bank,” p. 3.