# Bank mergers today: New guidelines, changing markets

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In June of 1982, the Department of Justice (the Department) issued the long-awaited merger guidelines, replacing those issued in 1968. The guidelines have as their principal objective the reduction of uncertainty associated with the enforcement of the antitrust laws. This reduction of uncertainty is expected to assist managers in their expansion strategies by increasing their understanding of the principles and standards involved in the Department's antitrust analysis. By issuing guidelines, the Department reveals to the business community the nature and extent of its antitrust evaluation.

The reduction of uncertainty regarding the Department's antitrust analysis is important. Uncertainty is not costless. The predictability of competitive problems is critical in the identification of likely merger or acquisition candidates. Some merger proposals make economic or financial sense (i.e., are profitable) only if they are handled in a facile manner. Some mergers may not be worthwhile if substantial amounts of legal costs are required to defend the merger before federal agencies or in the courts.[1]

In addition to affecting the choice of merger candidates, uncertainty revolving around the antitrust standard may also affect the timing of merger proposals. This is reflected in the preparation of documents (e.g., merger applications and supporting documents) relating to the proposal.

If antitrust problems are perceived to exist by the merging parties because they are uncertain of the existing antitrust standard, an undue length of time may be spent in preparing an extensive antitrust defense where none is required. On the other hand, the merging parties may believe that their proposal has little chance of encountering opposition on antitrust grounds and, therefore, be totally unprepared when the issue is raised. Again, it will take a lengthy period of time to prepare a rebuttal to an antitrust challenge.

Thus, the Department issued the merger guidelines to reduce the uncertainty surrounding the applicable antitrust standard and, thereby, reduce the costs associated with this uncertainty in the process. Business management has more productive pursuits than wondering whether contemplated mergers will pass antitrust scrutiny. The Department has established criteria to indicate which mergers are likely not to be challenged and which mergers are likely to be challenged from an antitrust perspective.

## The Department of Justice criteria

The 1982 guidelines assume a structural approach toward antitrust policy. With regard to horizontal mergers, that is, mergers involving firms in the same relevant market, the guidelines focus on market structure and the change in that structure as a result of merger proposals should such proposals be consummated.[2] To implement this policy the Department used the Herfindahl-Hirschman Index (HHI) as a summary measure of market structure.[3] The guidelines establish classes of mergers that are likely to be challenged by the Department based on the post-merger level of the HHI and the change

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[1] Paul M. Horvitz, "Alternative Avenues to Interstate Banking," *Economic Review*, Federal Reserve Bank of Atlanta (May 1983), p. 37.

[2] The guidelines are also concerned with conglomerate and vertical mergers. Interested readers should consult the guidelines for the standards regarding these types of mergers.

[3] The HHI is simply the sum of the squares of market shares of each of the firms in the relevant market. Thus, the

**Table 1**

**Department of Justice Merger Guides**

| Post-merger market concentration | Increase in HHI | Department responses |
|---|---|---|
| Highly concentrated (HHI 1800) | Less than 50 points | Unlikely to challenge |
| | Greater than 100 points | Likely to challenge |
| | Between 50 and 100 points | Possible challenge* |
| Moderately concentrated (1000 HHI 1800) | Less than 100 points | Unlikely to challenge |
| | Greater than 100 points | Possible challenge* |
| Unconcentrated (HHI 1000) | Not relevant | Unlikely to challenge |

*The Department evaluates a number of additional factors in determining whether to challenge a merger in this range. Readers should consult the guidelines for an explanation of these factors.

in the HHI resulting from the merger.[4] Table 1 indicates the critical levels of the post-merger HHI and increases in the HHI and the likelihood of a challenge by the Department.

With issuance of the 1982 guidelines, the business community is acquainted with the Department's *written* standards. However, the question remains whether the Department adheres to these standards in its analysis of actual merger proposals. If it does not, business is again confronted with uncertainty and its attendant costs.

The following sections address the Department's analysis of bank merger proposals under the 1982 guidelines. All of the Department's competitive factors reports, for the period June 1982 through December 1983 that concluded that mergers would entail substantially adverse competitive effects, have been tabulated. It is hoped that this tabulation will shed some light on the concentration levels and market shares the Department deems critical in assessing bank merger proposals. With this in hand, it may be easier to judge whether a bank merger proposal is likely to run into the Department's opposition.

## Competitive factors report

Section 18(c) of the Federal Deposit Insurance Act (FDIA) provides, in part, that:

> In the interests of uniform standards, before acting on any application for approval of a merger transaction, the responsible [banking] agency . . . shall request reports on the competitive factors involved from the Attorney General and the other two banking agencies . . .

The reports submitted under section 18(c) assess *only* the competitive factors of the merger and do not evaluate managerial, financial, or convenience and needs factors that are required to be considered by the agency which will ultimately act upon the merger application. Furthermore, the antitrust standard embodied in section 18(c) is virtually identical to that contained in section 7 of the Clayton Act. That is, the responsible agency may not approve any merger "which would result in a monopoly . . . or whose effect in any section of the country may be substantially to lessen competition" unless the agency finds that the anticompetitive effects are "clearly outweighed" by convenience and needs considerations. Thus, it has been held that an

HHI for a market having the structure indicated below is 2200.

| Firm | Share (%) | Share$^2$ |
|---|---|---|
| A | 30 | 900 |
| B | 20 | 400 |
| C | 20 | 400 |
| D | 20 | 400 |
| E | 10 | 100 |
| | 100 | 2200 |

The HHI ranges from near zero (unconcentrated markets) to 10,000 (monopoly markets).

[4]The increase in the HHI as a result of a merger is twice the product of the market shares of the merging firms. Thus, from the preceding footnote, if Firm D merges with Firm E, the resulting increase in the HHI would equal 400 points ($20 \times 10 \times 2$) and the resulting post-merger HHI would equal 2600.

agency may not deny a bank merger or acquisition on competitive grounds under this standard except where the anticompetitive effects rise to a violation of the antitrust laws.[5]

The importance of predicting whether the Department will issue a "substantially adverse" competitive factors report is obvious. First, such reports are carefully considered by the banking agencies in their merger analysis. Any discrepancy in conclusions between the Department and the banking agency must be carefully reconciled. While each banking agency makes an independent analysis of the probable competitive effects of each merger under its jurisdiction, the views of the Department are accorded considerable weight, even if conclusions may differ.[6]

Second, and perhaps more important, the Department may sue to enjoin the merger. Hence, even if the merger passes muster under the analysis of the banking agency responsible for acting upon it, the Department may, nonetheless, seek to prevent the merger under the antitrust laws. Indeed, section 18(c) directs the responsible banking agency to notify the Attorney General of any approval of a merger transaction and delays consummation of the transaction for 30 days after approval to allow the Department time to intercede.[7]

## The first eighteen months of enforcement

In the first 18 months of antitrust enforcement under the 1982 guidelines, the Department issued 11 "substantially adverse" competitive factors reports involving mergers or acquisitions of banking organizations under Section 18(c) of the FDIA.[8] In each merger it was found that the substantial increase in concentration in an already (highly) concentrated market, and the decrease in the number of banking alternatives in the relevant market would result in a substantial lessening of competition in the relevant geographic area.[9]

## The relevant markets

In order to determine the lawfulness of any proposed merger under the antitrust laws, the appropriate question to be addressed is whether the effect of the merger would be to substantially lessen competition in any line of commerce in any section of the country. This requires a determination of the relevant geographic and product markets prior to any structural analysis.

## Geographic market

In determining the relevant geographic market ("section of the country") in the 11 subject mergers, the Department approximates that area where the banks compete and where customers can practicably turn for alternative banking services.[10]

The Department considers several factors in determining that area in which bank customers who are neither very large nor very small find

[5] *County National Bancorporation* v. *Board of Governors of the Federal Reserve System*, 654 F.2d 1253 (8th Cir. 1981); *Mercantile Texas Corporation* v. *Board of Governors of the Federal Reserve System*, 638 F.2d 1255 (5th Cir. 1981); and *Washington Mutual Savings Bank* v. *FDIC* 482 F.2d 459 (9th Cir. 1973).

[6] See, for example, *St. Joseph Valley Bank*, 68 *Federal Reserve Bulletin* 673 (1982).

[7] Shorter waiting periods are provided for mergers requiring expeditious action.

[8] All competitive factors reports issued by the Department between June 14, 1982 and December 31, 1983 involving mergers or acquisitions between depository institutions in which the competitive effects were deemed to be substantially adverse were requested. Eighteen such reports were received. Hereafter, for the purpose of simplicity, all subject transactions will be referred to as mergers. For reasons of consistency and uniformity, this article analyzes only the 11 mergers filed under the FDIA. Of the remaining seven reports, four were issued to the Federal Home Loan Bank Board, involving transactions between savings and loan associations, and three were issued to the Board of Governors of the Federal Reserve System, involving transactions under the Bank Holding Company Act. An analysis of the thrift mergers is available from the authors upon request.

[9] In only one merger was the market not classified as highly concentrated subsequent to the proposed transaction (*Commercial National Bank of Little Rock*). Since June of 1982 the Department has issued no substantially adverse competitive factors reports involving market extension mergers of depository institutions.

[10] " . . . the area of effective competition in the known line of commerce must be chartered by careful selection of the market area in which the seller operates, and to which the purchaser can practicably turn for supplies, . . . " *U.S.* v. *Philadelphia National Bank* 374 U.S. 321, 359 (1963).

it practical to do their banking business. Among the factors the Department takes into account are: (1) the distance between the merging parties; (2) the distance and travel time to the nearest banking alternative and ease of transportation between banking alternatives; (3) worker commuting patterns; (4) shopping patterns; (5) the location of employment, social, and governmental centers; (6) the economic base of the community (e.g., agricultural or industrial); (7) advertising coverage by various media (television, radio, print); and (8) the locations of other major services (e.g., colleges, hospitals, airports).

**Product market**

The Department has used two different product markets in its bank merger antitrust analysis: wholesale banking services and retail banking services. By using the wholesale product market, the Department adheres to the doctrine that commercial banking is a distinct line of commerce identified as "the cluster of products (various kinds of credit) and services (such as checking accounts and trust administration) denoted by the term 'commercial banking'."[11] Wholesale banking services are defined by the Department as generally those services provided to commercial customers, including demand deposit accounts, time and savings accounts, and commercial loans. This product market, in the Department's view, is composed of commercial banks.

By also defining the relevant product market as retail banking services, the Department has taken into account the thrust of changes in the financial services industry as a result of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982. In so doing, the Department seems to be indicating that the banking industry is at a stage where it may be unrealistic to distinguish savings banks and savings and loan associations from commercial banks for purposes of the antitrust laws.[12] Among the retail banking services provided to individual (noncommercial) customers, as defined by the Department, are transaction accounts, time and savings accounts, consumer loans, and residential mortgage loans. Both commercial banks and thrifts (generally) are considered by the Department as part of this product market.

**Characteristics of the mergers**

The salient characteristics of the 11 mergers are presented in Table 2. Two mergers were appraised by the Department using only the product market of wholesale banking services (*Nevada Bank & Trust Co.* and *Citizens American Bank, N.A.*). There were also two mergers analyzed using only retail banking services as the relevant product market (*National Bank & Trust Co. of Norwich* and *The Banking Center*).[13] In the remaining seven mergers, the Department's structural analysis was premised on the use of both relevant product markets—wholesale banking services and retail banking services.

**Market concentration**

Whether using wholesale or retail banking services as the relevant product market, in all but one case the markets were highly concentrated (HHI greater than 1800) subsequent to consummation of the proposed transaction. With respect to wholesale banking, the high, median, and low post-HHI for the eight highly concen-

[11] *U.S.* v. *Philadelphia National Bank* at 356; *U.S.* v. *Phillipsburg National Bank* 399 U.S. at 360 (1970); and *U.S.* v. *Connecticut National Bank* 418 U.S. at 664 (1974).

[12] See *U.S.* v. *Connecticut National Bank* at 665. For information on these acts see: *Economic Perspectives*, Federal Reserve Bank of Chicago (September/October 1980) and *Economic Perspectives*, Federal Reserve Bank of Chicago (March/April 1983).

[13] In *Nevada Bank & Trust Co.* the two subject banks held 96.5 percent of the market deposits and two public credit unions together held an insignificant 3.5 percent of the market's total deposits. In *Citizens American Bank, N.A.* it was concluded that the inclusion of thrift institutions would have a negligible impact on market concentration. *The Banking Center* dealt with the merger of two mutual savings banks. *National Bank & Trust Co. of Norwich* involved two banks located in markets where thrifts have traditionally been considered to provide significant competition to commercial banks.

## Bank Mergers and the 1982 Department of Justice Merger Guidelines

| Mergers | Acquiring organization | | | Organization to be acquired | | | Herfindahl-Hirschman Index | | | Four-firm concentration | | Type of market[c] | Agency decision |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| (Date of Department of Justice Report)[a] | Deposits ($ mil.)[b] | Market share % | Market rank | Deposits ($ mil.)[b] | Market share % | Market rank | Pre | Post | Change | Pre | Post | | (Date) |
| *First National Bank of South Carolina/The Bank of Lancaster* and | 825 | 18.3 | N.A. | 50 | 57.2 | 1st | 4023 | 6132 | 2109 | 100 | 100 | Rural | Approved (Nov. 15, 1982) |
| *Central Carolina Bank* (commonly owned banks) (Aug. 25, 1982) | | 8.2 | N.A. | | 25.2 | 1st | 1912 | 2333 | 421 | N.A. | N.A. | | |
| *National Bank and Trust Company of Norwich/ National Bank of Oxford*[d] (Sept. 10, 1982) | 242 | 54.2 | 1st | 15 | 4.5 | 7th | 3262 | 3750 | 488 | 79.8 | 84.3 | Rural | Approved (April 8, 1983) |
| *Nevada Bank and Trust Company/Nevada National Bank* (branch)[e] (Nov. 9, 1982) | 4 | 31.7 | 2nd | 9 | 64.8 | 1st | 5216 | 9324 | 4108 | 100 | 100 | Rural | Pending |
| *Commercial National Bank of Little Rock/The First* | 280 | 14.0 | 2nd | 267 | 14.0 | 4th | 1335 | 1712 | 377 | 66.0 | 74.0 | Urban | Approved (May 27, 1983) |
| *National Bank in Little Rock* (Dec. 3, 1982) | | 10.0 | 4th | | 9.0 | 6th | 925 | 1171 | 246 | | 59.0 | Urban | |
| *The Banking Center/The Woodbury Savings Bank*[d] (Dec. 6, 1982) | 627 | 28.7 | 1st | 103 | 4.9 | 6th | 1525 | 1813 | 288 | 67.0 | 72.0 | Urban | Approved (Feb. 28, 1983) |
| *Old National Bank of Martinsburg/ Citizens National Bank* | 64 | 37.8 | 1st | 48 | 23.5 | 2nd | 2759 | 4536 | 1777 | 100 | 100 | Rural | Application Withdrawn (Jan. 24, 1983) |
| *of Martinsburg* (Dec. 13, 1982) | | 32.7 | 1st | | 20.4 | 2nd | 2191 | 3525 | 1344 | 86.6 | 97.5 | | |
| *First National Bank of Mayfield/* | 27 | 22.6 | 2nd | 22 | 18.3 | 3rd | 3384 | 4211 | 827 | 98.8 | N.A. | Rural | Denied (April 20, 1983) |
| *The Exchange Bank* (Dec. 16, 1982) | | 12.2 | 4th | | 9.8 | 5th | 2083 | 2322 | 239 | 84.0 | 93.8 | | |
| *Citizens American Bank, N.A./State Bank of Green Valley*[e] (Jan. 14, 1983) | 38 | 15.9 | 3rd | 21 | 7.3 | 6th | 1849 | 2082 | 233 | 77.5 | 84.8 | Rural | Denied (March 2, 1983) |
| *First Security Bank of Utah, N.A./* | 1,700 | 40.2 | 1st | 20 | 17.9 | 3rd | 2986 | 4429 | 1443 | 95.1 | 100 | Rural | Denied (June 22, 1983) |
| *Bank of Iron County* (March 9, 1983) | | 33.3 | 1st | | 14.8 | 3rd | 2237 | 3225 | 988 | 87.5 | 92.1 | | |
| *Peoples Trust Bank/ Indiana Bank and Trust* | 295 | 17.9 | 3rd | 341 | 16.2 | 4th | 2191 | 2769 | 578 | 89.5 | 97.4 | Urban | Denied (Aug. 15, 1983) |
| *Company* (June 30, 1983) | | 14.4 | 3rd | | 13.1 | 4th | 1574 | 1951 | 377 | 72.3 | 82.7 | | |
| *The Peoples National Bank Bank of Central Pennsylvania/Farmers* | 110 | 23.3 | 3rd | 52 | 11.1 | 4th | 2139 | 2656 | 517 | 88.0 | 91.8 | Urban | Pending (Feb. 16, 1984) |
| *Community Bank* (Nov. 18, 1983) | | 16.2 | 4th | | 7.7 | 5th | 1971 | 2219 | 248 | 84.0 | 91.7 | | |

[a] Cases are listed in chronological order by date of competitive factors report. [b] Deposit data represent total bank deposits (not market deposits) and are in millions of dollars. [c] A market is designated as urban if it is in whole or in part an SMSA or RMA; otherwise, the market is designated as rural. [d] Only retail product market was used in competitive factors report. [e] Only wholesale product market was used in competitive factors report. N.A. Not available in competitive factors report.

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trated markets were 9324, 4320, and 2082, respectively. Using retail banking as the relevant product market lowers these figures significantly to high, median, and low post-HHI of 3750, 2328, and 1813, respectively. The only market that was not highly concentrated had a post-HHI of 1712 using wholesale banking services and 1171 using retail banking services as the relevant product market.

While the basis of the structural analysis in the guidelines is the post-HHI and the change in the HHI, the four-firm concentration ratio was discussed in each merger. Apparently, this ratio still has some significance in the Department's antitrust appraisal. A look at market concentration using the concentration ratio provides a rough comparison to the old (1968) guidelines. Of the eight wholesale markets classified as highly concentrated under the 1982 guidelines, all have a concentration ratio greater than 75 percent prior to the transaction, and hence would be considered highly concentrated under the 1968 guidelines. Similarly, of the eight highly concentrated retail markets pursuant to the 1982 guidelines, all but two are also highly concentrated according to the 1968 guidelines prior to the proposed transaction.

### Relative size and change in HHI

In all cases the increase in the HHI resulting from the proposed merger significantly exceeds the thresholds of challenge outlined in the guidelines. The smallest increase in the HHI, 233 points, resulted from a merger between the third largest and sixth largest banks in the market with 15.9 percent and 7.3 percent market shares, respectively *(Citizens American Bank, N.A.)*. The largest increase in the HHI, 4108 points, involved a merger between the top two banks in the banking market, controlling 64.8 percent and 31.7 percent of market deposits *(Nevada Bank & Trust Co.)*. The smallest and largest increases in the HHI for all markets (i.e., both retail and wholesale markets) occurred in wholesale banking markets.

Focusing on retail product markets, the smallest increase in the HHI is 239 points resulting from the combination of the fourth and fifth largest banks in the market, holding 12.2 percent and 9.8 percent of market deposits *(First National Bank of Mayfield)*. Notice that this HHI figure is not significantly different from that in the wholesale markets. However, the largest increase in the HHI for retail markets is 1344 points, which is significantly lower than that for wholesale markets. The 1344 point increase in the HHI involved the merger of the two largest banking organizations in the relevant market, controlling 32.7 percent and 20.4 percent of total market deposits *(Old National Bank of Martinsburg)*.

As indicated, the large relative size of the subject organizations contributed directly to the prohibitively large increases in the HHI. In all but two of the eight wholesale markets, one of the merging parties is either the largest or second largest organization in the market. And in the two exceptions, the acquiring banks ranked third largest in the relevant market. Similarly, for the eight mergers using retail product markets, five involved the largest organization in the market.

### Absolute size

Percentages aside, small absolute size seems to provide no barrier to the issuance of a significantly adverse competitive factors report by the Department.[14] Although three mergers involved an acquiring organization that ranked among the ten largest financial institutions in the state, the remaining cases all involved organizations with less than \$342 million in total market deposits. Indeed, of these eight mergers, the median size of the acquiring organization was \$87 million in total market deposits, whereas the median size of the acquired firm was only \$35 million in total market deposits.

[14]"Mergers of directly competing small commercial banks in small communities, no less than those of large banks in large communities, are subject to scrutiny under these standards. Indeed, competitive commercial banks play a particularly significant role in a small community unable to support a large variety of alternative financial institutions." *U.S. v. Phillipsburg National Bank* at 356.

### Actual enforcement

All eleven mergers significantly surpassed the 1982 guidelines' structural thresholds indicating likelihood of a challenge by the Department. Notwithstanding the violations of the guidelines, only four mergers were denied by the relevant bank regulatory authority. Two mergers *(Old National Bank of Martinsburg and Nevada Bank & Trust Co.)* were withdrawn. Another merger remains pending before the Comptroller *(The Peoples National Bank of Central Pennsylvania )*.

Of the four mergers approved by the bank regulatory agencies, the Department has filed suit in only one *(National Bank & Trust Co. of Norwich)*.[15] In determining whether to litigate, the Department reviews all its competitive factors reports in which the competitive effects were considered to be substantially adverse. Additional information pertinent for a more in-depth antitrust analysis is sometimes requested. Such information may be obtained from other banking organizations and bank customers as well as other sources.

### Differing analyses

Each bank regulatory agency, in ruling upon mergers between depository organizations, uses the Department's guidelines as an aid in its analysis. Although each of the approved mergers violated the structural criteria of the 1982 guidelines, each banking agency also considered other nonstructural factors that lessened the anticompetitive effects implied from a purely structural analysis.

There are several differences between the analysis used by the Department in issuing its substantially adverse competitive factors reports and that used by the relevant regulatory agency in reaching its approval on the same merger. One is the consideration of convenience and needs factors, and the conclusion that such factors outweigh the anticompetitive effects of the proposed transaction *(The Banking Center)*. Another difference was in a basic premise of the analysis, the determination of the relevant geographic market *(First National Bank of South Carolina, National Bank and Trust Co. of Norwich*, and *Commercial National Bank of Little Rock)*. (For an elaboration on the basic premises of the structural analyses, see the following section.) Approval also resulted from an analysis of "nonstructural factors" of the merger, i.e., sections III(B) & III(C) of the guidelines. Among such factors considered were ease of entry and market characteristics *(National Bank & Trust Co. of Norwich* and *The Banking Center)*.

The Comptroller, unlike the Department, also extended its analysis beyond mere market shares *(National Bank & Trust Co. of Norwich* and *Commercial National Bank of Little Rock)*. As indicated in section II(D) of the 1982 guidelines, a firm's market share may overstate or understate its true competitive influence.[16]

### Continuing uncertainties

Evidence from the first year and one-half of operation under the guidelines indicates that the bank regulatory agencies and the Department differ somewhat in their antitrust analyses. Also, it is clear that the Department becomes concerned with bank mergers only when the guidelines are significantly surpassed.

That the Department's application of the merger guidelines in the sphere of commercial banking differs significantly from the thresholds as stated in the guidelines should not be viewed as an inconsistency. The reason for this is that the guidelines *assume* that the major premises of the structural analysis—the relevant markets—are properly defined. In regard to commercial bank-

[15] *U.S.* v. *National Bank & Trust Co. of Norwich* No. 83 CIV 537 (N.D. N.Y., filed May 6, 1983). The Department has filed a consent decree to end this suit. The decree calls for the divestiture of two branch offices and an end to defendant's home office protection.

[16] By using total organization deposits rather than market deposits and market share, the Comptroller in this particular instance *(National Bank & Trust Company of Norwich)* employs the theory that the competitive ability (market power) of a firm within a relevant market should not be measured only by its presence in the market but also should include all or part of its services provided outside of the market. On this point see, William Landes and Richard Posner, "Market Power in Antitrust Cases" 94 *Harvard Law Review* 937 at 963-67.

ing, it is not at all clear as to what precisely are the relevant product and geographic markets. Thus, market shares calculated using wholesale or retail banking as the product markets and countywide approximations as the geographic markets will not generally possess the significance they might when markets are more accurately defined. The ambiguities of market definition that rob market shares and concentration measures of their ordinary significance are discussed below. It is important, therefore, to be aware of the differences between the Department's written standards as expressed in the guidelines and the revealed standards as expressed in the competitive factors reports under discussion. It is likely that these differences exist because of market definition problems. The Department is well-advised to be more lenient in seeking to apply the merger guidelines to commercial bank amalgamations.

**Product market issues**

A long line of court decisions regarding the relevant product market in commercial bank merger cases has held that commercial banks compete only with other commercial banks. *Philadelphia National Bank*[17] represented the first time the antitrust laws of the U.S. were applied to commercial bank mergers by the Supreme Court. The Court determined that commercial banks were unique institutions that were more or less insulated from the competition provided by other financial services firms based on the unique "cluster" of products and services offered by commercial banks.

This rationale has been upheld by the Supreme Court in later decisions, notably in *Phillipsburg National Bank*[18] and *Connecticut National Bank*.[19] Lower courts also have generally followed the lead of the Supreme Court in this matter, as have the bank regulatory agencies. And, to a great extent, the Department is bound by these prior decisions. Yet much has happened in the years following the Supreme Court's most recent affirmation of its product market determination in 1974.

Market forces and legislative and regulatory change have served to erode the commercial banking cluster argument to such an extent that it is now unreasonable to consider commercial banking a distinct line of commerce. The market forces that compelled legislative and regulatory change are by now well known. Foremost among these market pressures were the high and volatile interest rates associated with the latter 1970s that caused bank and thrift deposit rate ceilings to bind and that subsequently resulted in severe bouts of disintermediation. During this period, new, unregulated institutions and instruments were developed; the money market mutual fund is the most prominent manifestation. Finally, technological advances in the processes of collecting, storing, manipulating, and transmitting data have revolutionized cash management and facilitated innovations such as sweep accounts. The advances in technology have made entry into banking (at least in a *de facto* sense) easier, thereby reducing barriers to competition between depository and nondepository financial institutions.

The market forces compelling these changes have pressured legislators to liberalize restrictions on depository institutions, especially those restrictions related to thrift institutions. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 have far-reaching effects with respect to the competitiveness of thrifts vis-à-vis commercial banks.

The Monetary Control Act authorizes all federally chartered savings and loan associations to offer nonbusiness negotiable order of withdrawal (NOW) accounts; invest up to 20 percent of assets in consumer loans, commercial real estate loans, commercial paper, and corporate debt securities; issue credit cards and extend credit in connection therewith; and apply for trust and fiduciary powers under restrictions and protections similar to those applicable to national banks. In addition to the expanded powers granted savings and loan asso-

[17] U.S. v. *Philadelphia National Bank* 374 U.S. 321 (1963).

[18] U.S. v. *Phillipsburg National Bank* 399 U.S. 350 (1970).

[19] U.S. v. *Connecticut National Bank* 418 U.S. 656 (1974).

ciations, federal mutual savings banks were authorized to invest up to 5 percent of assets in commercial loans and to accept demand deposits in connection with commercial, corporate, and business loan relationships.

Through the Monetary Control Act, federally chartered thrifts were able to offer individuals the convenience of "one-stop shopping" and, in effect, become their "department store of finance." Nevertheless, the Monetary Control Act did little to aid thrifts in serving the business customer. Without expanded powers to make loans to commercial enterprises, thrifts were not likely to be viewed as full competitors of commercial banks.

With Garn-St Germain, the resemblance of federally chartered thrifts to commercial banks becomes even greater. The ability of thrifts to provide services to commercial enterprises was enhanced in the interest of preserving the viability of thrifts. The act increases the percentage of assets that may be invested in commercial real estate and consumer loans to 40 percent and 30 percent, respectively. In addition, thrifts are permitted to invest up to 10 percent of capital and surplus in state and local securities and invest up to 10 percent of assets in personal property (leasing). Most important, however, is the authority granted thrifts to invest up to 10 percent of assets in secured or unsecured commercial loans ("pure" commercial loans) and to offer demand deposits to business customers with whom the thrift has a business, corporate, commercial, or agricultural loan relationship. These expanded powers granted under Garn-St Germain allow a federally chartered thrift to invest up to 75 percent of its assets in commercial investments.

While commercial banks and thrifts may be different entities with different missions, the differences between them are not substantial in an antitrust perspective. It is problematic whether the new powers granted thrifts will be enough to qualify them as being within the line of commerce of bank mergers. In this vein, the Supreme Court indicates that in delineating a line of commerce

> its contours must, as nearly as possible, conform to competitive reality. Where the area of effective competition cuts across industry lines, so must the relevant line of commerce . . .[20]

Thus, in *Continental Can*, the Court held that because of the *interindustry* competition between glass and metal containers, it was necessary to treat as a relevant product market the combined glass and metal container industries, noting that for some end uses glass and metal containers did not and could not compete. Indeed, *complete industry overlap need not be shown*.

In reality, a federal thrift might closely resemble a commercial bank, notwithstanding the percentage of asset limitations on commercial assets available for investment and the prohibition on offering demand deposits to individuals. Although technically more limited, the powers granted thrifts under the Monetary Control Act and Garn-St Germain suggest that serious consideration be given to including thrifts in the line of commerce.[21]

However, to limit the line of commerce in bank mergers to thrifts and commercial banks would be irrational. Competition must be recognized where, in fact, competition exists.[22] The Department has recognized the expanded powers of thrifts to some extent. This recognition is manifested in its dichotomy of banking into wholesale and retail banking in several of the mergers herein reported. The presence of thrifts alone would serve to erode the significance of bank market shares and concentration measures. Yet, the Department must also be cognizant of the competition afforded commercial banks by nondepository institutions. The presence of a

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[20]U.S. v. *Continental Can Company* 378 U.S. 441, 457 (1964).

[21]The Board of Governors has taken cognizance of the expanded powers of thrift institutions:

> . . . thrift institutions have become, or at least have the potential to become, major competitors of commercial banks not only in the provision of consumer banking services but also in the provision of commercial lending services. These developments, coupled with the size and market share held by thrift institutions in numerous markets, persuaded the Board that in many cases the competition afforded by thrift institutions to commercial banks may be substantial. *First Tennessee National Corp.*, 69 *Federal Reserve Bulletin* 299 (1983).

[22]*Brown Shoe Company* v. *U.S.* 370 U.S. 294, 326 (1962).

substantial number of nondepository competitors in various submarkets, such as business loans, consumer loans, and trust services that comprise the "cluster" of commercial bank services has been documented in a number of studies by the Federal Reserve Bank of Chicago.[23] In addition to these studies, a number of surveys have revealed that businesses, particularly small businesses, obtain financial services from a broad spectrum of financial services providers aside from commercial banks and thrifts.[24]

Moreover, although commercial bank chief executive officers feel that other local or regional banks provided the current source of their most significant competition, a large percentage of these executives mentioned thrifts (64 percent) and brokerage and insurance firms (35 percent) as providing significant competition.[25] More important perhaps is the impression held by the bank executives that Sears, Merrill Lynch, Shearson/American Express, Prudential-Bache, and E. F. Hutton will be their major competitors by 1990. The first three of these organizations are presently viewed as strong competitors by the bank executives (see Table 3).

Thus, even though the competition provided by thrifts and nondepository institutions is difficult to quantify, it must neither be ignored nor understated. Because of the difficulty of coming to grips with nonbank competition, the Department is justified in not relying solely on the HHI thresholds contained in its guidelines in assessing bank mergers. The apparent liberalization of the guidelines in the case of bank mergers is a reasonable position to take given the uncertainties of product market definition.

**Table 3**

| Institution | Strong competitor Now | By 1990 |
|---|---|---|
| Sears | 83% | 86% |
| Merrill Lynch | 47% | 85% |
| Shearson/American Express | 38% | 70% |
| Prudential-Bache | 15% | 40% |
| E. F. Hutton | 12% | 25% |
| Kroger | 1% | 11% |
| Aetna | — | 9% |

SOURCE: *American Banker*, March 15, 1984. Table reflects the percentage of bank chief executive officers surveyed responding to whether the listed institutions are regarded as strong competitors to commercial banks.

## Geographic market issues

Uncertainties in the definition of the relevant product market engender uncertainties in the definition of the relevant geographic market in bank mergers. The delineation of the appropriate section of the country as an economically viable and realistic geographic market is not without theoretical and practical problems.

## The market in theory and practice

Theoretically, a geographic market is that area which encompasses those buyers and sellers that exert and react to common demand and supply forces that determine the price and quality (nonprice attributes) of a particular output. Although there is agreement conceptually on the definition of a market there is less agreement in practice as to the proper delineation of a geographic market. The lack of a single definitive and pragmatic method of determining the appropriate geographic market is evident in the differing methodologies used by the courts and regulatory agencies.[26]

[23]H. Rosenblum and D. Siegel, "Competition in Financial Services: The Impact of Nonbank Entry", *Staff Study 83-1* (May 1981); H. Rosenblum and C. Pavel, "Financial Services in Transition: The Effects of Nonbank Competitors", *Staff Memorandum 84-1* (January 1984); and H. Rosenblum, D. Siegel, and C. Pavel, "Banks and Nonbanks: A Run for the Money", *Economic Perspectives*, Federal Reserve Bank of Chicago (May/June 1983), pp. 3-12.

[24]For example, see P. Watro, "Financial Services and Small Businesses", *Economic Commentary* (January 11, 1982), Federal Reserve Bank of Cleveland and V. Andrews and P. Eisemann, "Who Finances Small Business Circa 1980?", *Studies of Small Business Finance*, The Interagency Task Force on Small Business Finance (1981).

[25]*American Banker*, March 15, 1984, p. 4. These are excerpts from a national survey of bank chief executive officers compiled by Egon Zehnder International, a management consulting firm. Chief executive officers of the nation's largest 2,000 banks were surveyed.

[26]Discussion of the relevant product and geographic market is continued in Section IIA-IID of the Department's guidelines.

Having determined in prior Supreme Court bank merger cases that the relevant product market is commercial banking, the task remained to define a relevant geographic market both consistent with economic theory and the commercial realities of the banking industry. This market must encompass that area where the competitive effects of the merger would be direct and immediate given the location of the merging banks and the practical alternatives available to customers. In this case, practical alternatives are considered other commercial banks.[27]

Recognizing that in the cluster of banking services some services/products are more local in nature than others, and that each customer's economic scale determines his range of practical alternatives of bank services, the Court faced a dilemma. It was concluded that the antitrust standard for analysis should focus on the locally-limited customer, i.e., consumers and small businesses. Thus, geographic markets were determined to be the localized area encompassing the parties to the merger.[28]

In applying this standard, the Department and the bank regulatory agencies disagree on the appropriate methodology to determine the geographic market.[29] This is evident in agency approvals of bank mergers where the Department has issued substantially adverse competitive factors reports. This is not surprising considering that the practice of geographic market definition is more of an art than a science and includes a good deal of judgment. Even if one *assumes* the relevant product market to be commercial banking, the determination of the geographic area in bank mergers is subject to dispute.

As market forces and regulatory and legislative change have affected the appropriate product market relevant to bank mergers, so too have they influenced relevant geographic markets. As far back as 1965, the lower courts divided the commercial banking business into two distinct product submarkets, wholesale accounts and retail accounts. Each was found to have a different geographic market.[30]

Over the past decade, the U.S. has witnessed a relaxation of legal barriers to entry in terms of the liberalization of state branching laws and holding company bank expansion both intrastate and interstate. In addition, the Board of Governors has significantly broadened the array of bank-like services that bank holding companies may offer without geographical constraint.[31] Moreover, unregulated financial services concerns providing bank-like services are not bound by the geographic constraints faced by banking institutions.

Perhaps more important than the relaxation of legal restraints on location are the developments in technology that serve to reduce transactions costs, facilitating competition over wider geographic areas. This can be observed in the development and expansion of ATM networks, videotex home banking services, and banking by mail and telephone.

In light of the above, the once locally-limited banking customer is now confronted with a broader range of financial services providers serving a broadened geographic area. Inasmuch as these important developments are extremely difficult to assess quantitatively, a strick application of the Department's guidelines to commercial bank mergers is inappropriate.[32]

## Conclusion

Based on this limited sample of mergers, it appears that the Department becomes concerned

[27] *Philadelphia National Bank* at 359; *Phillipsburg National Bank* at 362 and *Connecticut National Bank* at 668.

[28] *Philadelphia National Bank* at 360-61 and *Phillipsburg National Bank* at 363-64.

[29] See Paul R. Watro, "Geographic Banking Markets," *Economic Commentary* (September 12, 1983), Federal Reserve Bank of Cleveland.

[30] *U.S.* v. *Manufacturers Hanover Trust Co.*, 240 F. Supp. 867 (S.D.N.Y. 1965).

[31] Sue F. Gregorash., "Seventh District: Leader or Follower in the Interstate Banking Movement?" *Economic Perspectives*, Federal Reserve Bank of Chicago (March/April 1984). Also see Federal Reserve System Regulation Y (12 CFR Part 225).

[32] This view is expressed in a forthcoming Federal Reserve Board *Staff Study* by Jim Burke, "Antitrust Laws and the Limits of Concentration in Local Banking Markets."

and comments on those mergers which would *significantly* surpass the thresholds of the guidelines' structural criteria. As we have discussed, the Department is justified in not opting for a strict application of the guidelines in bank mergers because of the uncertainties associated with the definition of the relevant markets. It should be noted that in all its competitive factors reports the Department notes that its analysis, which is based solely on information in the subject merger application and other available facts, "is not intended, and should not be relied upon, as precedent or policy" of the Department's Antitrust Division. Notwithstanding this disclaimer, which, if taken seriously, would render the reports essentially otiose, competitive factors reports do provide guidance to interested parties, including the bank regulatory agencies, concerning the application of the merger guidelines by the Department.