

# BANK CONSOLIDATION

## Regulators Always Have the Power to Pull the Plug

By Adam M. Zaretsky

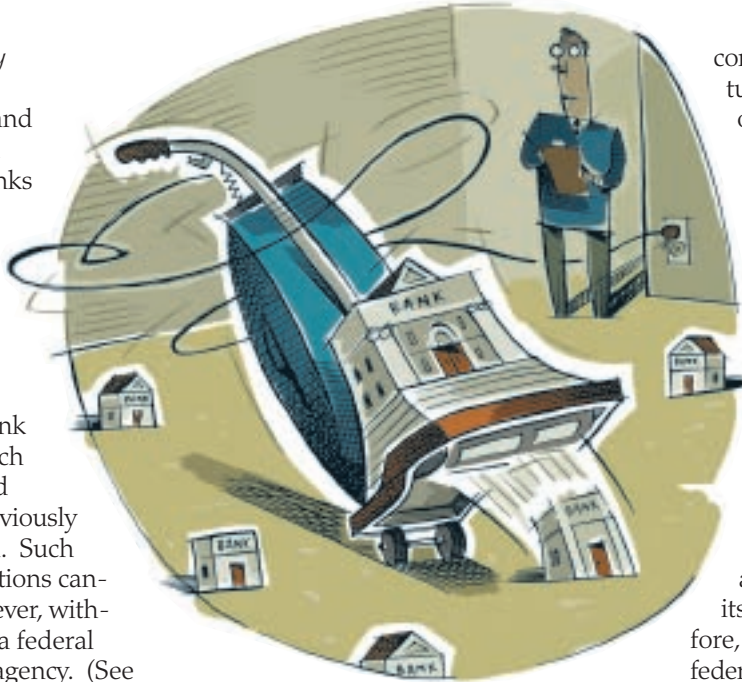
Between 1990 and 2002, the total number of banks and thrifts in the United States fell from 15,131 institutions to 9,336. The foremost cause of the decline was a significant relaxation of U.S. bank branching laws, which allowed mergers and acquisitions that previously had been prohibited. Such mergers and acquisitions cannot take place, however, without the approval of a federal banking regulatory agency. (See table.) These banking regulatory agencies scrutinize proposed transactions to ensure that they do not violate any of the U.S. antitrust statutes.

The practice of antitrust analysis of bank mergers and acquisitions dates back to 1963, when the U.S. Supreme Court held that commercial banking, like other industries in the United States, is subject to the Sherman Antitrust Act of 1890 and the Clayton Act of 1914.<sup>1</sup> In its opinion, the court noted that the test for anticompetitive behavior is whether the effect of a bank merger “may be substantially to lessen competition . . . in any line of commerce in any section of the country.”

### Foundations of Antitrust

To apply this test, the court defined the “line of commerce” for the banking industry as the cluster of products and services—demand deposits, trust administration and extension of various types of credit, for example—that banks uniquely provide to their customers. In other words, the court determined that the products and services denoted by the term “commercial banking” compose a distinct line of commerce.

To define “section of the country”—that is, the relevant geographical market—the court looked to where the effect of a merger on competition would be “direct and immediate.”



For banking, this effect occurs in the customers’ local communities because individuals and firms typically conduct the bulk of their banking transactions at banks with local offices.

A bank regulatory agency’s final step is to determine whether the effect of the merger “may be substantially to lessen competition.” In its ruling, the Supreme Court recognized that the answer to this question involved not only the immediate effects of a merger on competition, but also its anticipated future effects.<sup>2</sup> Such a prediction relies on the structure of the relevant market—that is, market concentration, the market shares of individual banks and number of market competitors.

Banking antitrust is based on the assumption that the structure of a market influences how firms in that market will act, which, in turn, affects the firms’ overall performance (otherwise known as the structure-conduct-performance hypothesis). In other words, the merger’s effect on these measures of structure, particularly market concentration, is thought to be a reliable gauge of whether the merger will lessen competition substantially. Therefore, a proposed merger that increases market concentration considerably would probably fail this test, and the federal regulator would not approve it. The federal regulator might approve it, however, if other evidence exists to mitigate the proposal’s anti-

competitive effects on market structure. That said, the Department of Justice could challenge the decision and possibly sue to prevent the merger.

### Antitrust in Action: the Guidelines

To minimize the chances that a decision will be challenged and to align the antitrust analyses of the federal regulators, the Justice Department has periodically issued guidelines that define the circumstances under which an application is likely to exceed its antitrust standards and, therefore, warrant closer scrutiny. The federal banking regulators use these guidelines to help them identify proposals that are likely to raise concerns about adverse effects of mergers on competition.

The Justice Department’s antitrust standards identify potentially anticompetitive mergers in terms of prescribed levels, and changes in levels, of a commonly used measure of market concentration, the Herfindahl-Hirschman Index (HHI). HHI is calculated by squaring each bank’s share of deposits in a market and then adding these squared shares. The index number can range from zero (a perfectly competitive market) to 10,000 (a pure monopoly). For example, the perfectly competitive market would consist of many firms, each with about the same market share. As the number of firms in this market increases, each firm’s share decreases, until it approaches the limit of zero. The square of zero is zero; so, the sum of those squares is still zero. The pure monopoly market would have only one firm that controls 100 percent of the market. The square of 100 is 10,000.

According to the guidelines, a market can be broadly characterized as unconcentrated if the HHI is less than 1,000 points, as moderately concentrated if the HHI is between 1,000 and 1,800, and as highly concentrated if the HHI is above 1,800.<sup>3</sup> These thresholds apply not only to banking, but to all industries in the United States. The Justice Depart-

ment distinguishes banking from other industries, however, by allowing it more latitude for *increases* in HHI. That is, the department normally will not challenge a bank merger or acquisition unless the resulting increase in HHI is at least 200 points *and* the post-merger market HHI is at least 1,800 (highly concentrated). The additional cushion afforded the banking industry accounts for the competition banks now face from thrifts, credit unions and other providers of financial services. In fact, thrifts—that is, savings and loan associations and savings banks—so resemble banks today in their financial service offerings that their deposits are commonly included in antitrust analyses at 50 percent weight.<sup>4</sup>

Deposits at credit unions are rarely included in banking antitrust analyses. Being membership organizations, credit unions offer their financial services only to their members, and these services are usually quite limited when compared with those offered by banks and thrifts. As such, credit unions do not necessarily compete in the same product market as banks and thrifts.<sup>5</sup> In certain cases, however, credit union deposits might be included in the analysis of a specific market (at fractional weighting) if substantial evidence supports their inclusion. One piece of such evidence would be that the share of deposits at credit unions in the market area greatly exceeded the national average. On top of that, a particular credit union should have liberal membership rules (typically, at least 70 percent of market residents must be eligible for membership) and offices that are easily accessible to local residents.

### Antitrust in Action: Beyond the Guidelines

Determining the change in HHI and its post-merger level is not the end of the story. If these numbers were to fall outside of Justice Department thresholds, the merger or acquisition would not automatically be denied. Such an outcome would indicate only that regulators consider the concentration of the market to be high enough to enable the

firms in the market to keep prices above the competitive level for a significant period of time. Such a case would require that a more-detailed economic analysis be conducted before a decision could be made. This analysis would seek to determine whether other factors, such as potential competition and economic conditions of the market, could mitigate the anticompetitive structural effect of the merger and, thereby, suggest that the HHI does not tell the whole story. An applicant might avoid the more-detailed analysis, however, if it were to choose or agree to divest to a third party some of its offices in the affected markets to get those markets' competitive structures to fall within guidelines.<sup>6</sup>

Having a post-merger HHI and an increase in HHI that exceed the department's thresholds is not the only reason an application might receive closer scrutiny. A bank that would end up controlling more than 35 percent of the deposits in a particular market after a merger or acquisition would also trigger a more in-depth examination by the Federal Reserve, even if the HHI indicates no significant change in market concentration.<sup>7</sup> In such a case, the Fed's antitrust analysis would focus on whether any factors might mitigate the anticompetitive effects of the merger. One such mitigating factor could be that recent economic growth in the market has been strong enough to indicate that it is attractive for entry by other banks or thrifts.<sup>8</sup>

These procedures are an effective and consistent method by which federal banking regulators ensure that bank mergers and acquisitions do not "substantially ... lessen competition ... in any line of commerce in any section of the country." They have been questioned and tested many times, particularly since changes in the law have allowed many more types of financial institutions to offer similar products.<sup>9</sup> In the end, those tests continue to show that these procedures are still the best ones to use in these antitrust analyses.

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### ENDNOTES

- <sup>1</sup> *United States v. Philadelphia National Bank*, 374 U.S. 321 (1963).
- <sup>2</sup> This is how the court interpreted Congress' directive to "arrest anticompetitive tendencies in their 'incipiency.'"
- <sup>3</sup> Department of Justice, Antitrust Division, and the Federal Trade Commission, *1992 Horizontal Merger Guidelines* (revised April 8, 1997). [www.justice.gov/atr/public/guidelines/hmg.htm](http://www.justice.gov/atr/public/guidelines/hmg.htm)
- <sup>4</sup> In some cases, deposits at thrifts may be weighted more or less than 50 percent, depending on the level of activity a particular thrift has in a region's commercial lending market. In addition, deposits of thrift subsidiaries of commercial banking organizations are included in the HHI calculation at 100 percent.
- <sup>5</sup> The types of services credit unions offer are broadening, though. For more information about the evolution of credit unions, see Emmons and Schmid (2003).
- <sup>6</sup> For more information about divestitures, see Webb (2001).
- <sup>7</sup> See Department of Justice, "Bank Merger Competitive Review—Introduction and Overview" (1995), current as of September 2000. [www.justice.gov/atr/public/guidelines/6472.htm](http://www.justice.gov/atr/public/guidelines/6472.htm)
- <sup>8</sup> For other examples of mitigating factors, see Holder (1993).
- <sup>9</sup> For summaries of many of the tests that have been performed recently, see Gilbert and Zaretsky (2003).

### REFERENCES

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## FEDERAL BANKING REGULATORS

AGENCY		REGULATES
Office of the Comptroller of the Currency	OCC	Commercial banks with national charters
Federal Reserve System	Fed	Bank-holding companies and state-chartered commercial banks that are Fed members
Federal Deposit Insurance Corp.	FDIC	State-chartered commercial banks that are not Fed members
Office of Thrift Supervision	OTS	Thrifts
Department of Justice	DOJ	Oversees all