Bank holding companies: Competitive issues and policy

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Many important policy issues regarding bank holding company mergers and acquisitions have come before the Board of Governors in the past few years. In many ways, the past two years have seen subtle changes in Board policy regarding the competitive issues raised by bank holding company applications.

New interpretations have begun to emerge regarding several competitive issues:

- Horizontal acquisitions
- Chain banking
- Geographic and product market definitions
- Potential and probable future competition
- Mergers of bank holding companies

Considerations of convenience and needs have also faced new interpretations.

In an effort to identify these issues in areas where policy is not settled, this article analyzes recent decisions on bank holding company applications.

Horizontal acquisitions . . .

The Board has always responded negatively to horizontal bank mergers and holding company acquisitions—horizontal meaning a holding company's acquisition of an existing bank in a market area where it already competes. This type of acquisition is generally objectionable because a competitor is eliminated from the market, increasing market concentration.

Some decisions handed down by the Board have left the impression that there might be less opposition to certain types of horizontal acquisitions than in the past. In August 1976, the Board denied the application of Michigan National Corporation, fourth largest banking organization in the Detroit market, to acquire Peoples Bank & Trust Company (NA) in Trenton. Michigan National Corporation controlled about 8.5 percent of the market's deposits. Peoples Bank controlled about 0.7 percent. (September 1976, p. 795.*)

In contrast, a few months later, the Board approved the application of Trust Company of Georgia to acquire Security National Bank in Smyrna, Georgia. With approval of the Trust Company of Georgia application, the resulting organization held 14.3 percent of the deposits in the Atlanta banking market, making it the third largest. (January 1977, p. 77.)

There were extenuating circumstances, however. Acquisition of the Smyrna bank was the smallest vehicle open to Trust Company for entry into Cobb County, one of eight counties making up the Atlanta market. Trust Company was prohibited under state law either from branching into Cobb County or from setting up a new bank there.

Though influenced by these special factors, the case may illustrate the Board's willingness to approve certain horizontal acquisitions. Shortly after approving the Trust Company of Georgia application, the Board approved several other horizontal holding company applications.

Huntington Bancshares, for example, the seventh largest banking organization in Ohio, acquired Central National Bank of London, Ohio. Huntington already controlled the second largest bank in the Columbus market, with a 23.2 percent market share. Central National ranked twelfth with 0.7 percent of the deposits in the market. (October 1977, p. 932.)

Governor Coldwell dissented from this approval on grounds that existing competi-

*All citations are from the *Federal Reserve Bulletin*.

tion would be eliminated. He was also unable to conclude that there were overriding public benefits.[1]

After the Huntington approval, however, horizontal acquisitions were more likely to be approved, provided the resulting organization did not control more than about 20 to 25 percent of market deposits and was not the largest banking organization. This observation is consistent with the Board's denial of Texas Commerce Bancshares' proposed acquisition of Bexar County National Bank of San Antonio. Though Texas Commerce was the largest banking organization in the state, it would have held less than 10 percent of the total deposits in the San Antonio banking market. (May 1977, p. 504.)

To some observers of the holding company movement, the Huntington and Trust Company cases may have indicated the direction of future Board decisions.

Despite these approvals, however, the Board has remained concerned over horizontal acquisitions in highly concentrated markets. Its position is reflected in its denial of the Isabella Bank & Trust Company application to merge with the Shephard State Bank. Both banks compete in the Mt. Pleasant, Michigan, banking market. (November 1977, p. 1022.)

Isabella Bank ranked first in the market with 31.8 percent of the deposits. Shephard State ranked fourth with 8.0 percent. Together, they would have held 39.8 percent of the deposits in a market where the four largest banking organizations already held 88.9 percent.

Department of Justice guidelines used in antitrust suits define a highly concentrated market as one where the four largest organizations control more than 75 percent of the market. These guidelines used in defining industrial concentration have been referred to by the Board several times as indications of the potentially adverse effects of additional concentration of banking resources.

[1]In several strong dissenting statements, Governor Coldwell has advocated that the Board take a stricter view of the adverse competitive effects of the elimination of existing competition and increased concentration of banking resources.

. . . and a special case

An unusual situation regarding competition comes up when a bank faces imminent financial problems. Under Section 3 of the Bank Holding Company Act, the Board has to consider whether the adverse competitive factors of an application may be outweighed by either convenience and needs factors or financial and managerial considerations.

Such a situation came up in late 1976, when Manufacturer's National Corporation, the fourth largest banking organization in Michigan, sought to acquire the National Bank of Southfield. Both organizations headquartered in the Detroit banking market, Manufacturer's holding 15.1 percent of the deposits and Southfield holding 0.5 percent. (January 1977, p. 75.)

The four largest banking organizations in the market controlled 71.5 percent of the deposits. As Manufacturer's ranked third, approval of its application would move the market share of the four largest organizations in the direction of the 75 percent believed to define a concentrated market.

But while the Board conceded that the acquisition would have substantially adverse effects on competition in the Detroit banking market, it approved the application on grounds that the Southfield bank could not continue serving the public if the application were denied. Convenience and needs outweighed the adverse competitive effects. In this case, the problems of a weak bank clearly called for special treatment.

Chain banking

Chain banking means control of two or more banks by the same people, whether an individual or a group. Chain relationships have been important in the Seventh District because they provide a means of circumventing multibank holding company and branch banking restrictions in states that prohibit these organizational forms.

One objective of the Bank Holding Company Act of 1956 was the prevention of undue concentration of bank resources in holding companies. Speaking before a subcommittee of the Senate Committee on Banking and Currency in 1966, William McChesney Martin, Jr., then chairman of the Board of Governors, discussed proposed revisions to the act to include one-bank holding companies. Regarding competitive concerns surrounding holding company activities, Chairman Martin said:

> It may be asked why the act now covers only companies and does not apply to control exercised by an individual. It is, of course, possible for an individual to achieve the sort of domination of a banking market that the act seeks to prevent a company from obtaining. But the need to regulate this kind of activity on the part of individuals is not as great as it is for corporations because individuals generally are more limited than are corporations in their ability to attract capital for expansion, and because control by individuals generally is diffused when they die. The decision to cover corporations but exempt individuals entails difficulty in deciding whether to cover holdings by groups of individuals associated together in some form other than a corporation.

Now, 13 years later, the Board is forced to face these definitional problems more directly. Left unchecked, chain arrangements would allow one-bank holding companies with common owners to be operated as multibank holding companies, without the regulatory restrictions imposed on multibank organizations.

In May 1977, the Board denied an application by Mahaska Investment Company to form a one-bank holding company by acquiring Farmers Savings Bank, Fremont, Iowa. Mahaska Investment Company's principal was already affiliated with the largest bank in the market. That bank held 47.7 percent of the deposits. Farmers Savings ranked third among the five banks in the market, holding 13.5 percent of the deposits. If the proposal had been consummated, the applicant would have indirectly controlled more than 61 percent of the market deposits. (June 1977, p. 579.)

The Board could not ignore the identity of interests in Mahaska and the affiliated banking organizations. The anticompetitive effects of this proposal were evident and the application was denied.

The Board expressed the hope, in fact, that denial of the application would result in Farmers Savings becoming independent of the applicant and, thereby, an independent competitive force. By not allowing a relationship to be formally established between the banks, the Board hoped more procompetitive effects would follow.

Similar applications in the Seventh District have also been denied, one where an applicant's principals were already affiliated with a bank in the same market and approval of the application would have resulted in an organization controlling a significant share of the market deposits, and would have sanctioned an arrangement that was anticompetitive in its origin. (December 1977, p. 1083; March 1979, p. 256; April 1978, p. 317.)

Market definition

Several factors are used by the Board and the Reserve Banks to determine the geographic banking markets for bank holding company formations, mergers, and acquisitions. With no focus on a specific bank, a geographic area is defined as a relevant market based on the demand and supply of banking services in the area.

Demand deposits and small to medium-sized commercial loans are emphasized in an effort to pinpoint the location of customers for bank services. These services, being more specifically associated with banks than many other services, are believed to affect locally limited customers most. Large CDs and large commercial loans are not emphasized.

Applicants define their service area, based on where they derive at least 80 percent of their deposits. Since information on small

to medium-sized commercial loans is not readily available, the analysis usually focuses on demand deposit accounts.[2]

By use of information on commuting, shopping and other trade patterns, bank advertising, and general economic conditions in the area, the market can be defined even closer. Prices and services offered by banks in the area are analyzed to see whether changes in prices and services are transmitted from one bank to the next. Discussions with bankers in the area also give insight into the competitive environment.

Natural and political boundaries are taken into consideration. Final delineations often approximate SMSAs (Standard Metropolitan Statistical areas), counties, and RMAs (Ranally Metro areas). This is because data are usually available for these areas. RMA data, being based primarily on commuting patterns and population densities, are particularly useful.

Market definition has been an issue in several cases in the district. Two banks are considered to be in the same geographic market if price and service changes and other competitive practices of one bank cause significant competitive reaction on the part of the other. The Bank Holding Company Act prohibits the Board from approving bank holding company acquisitions where the competitive effect in any section of the country may be substantially adverse. One of the most crucial market definitions in the Seventh District evolved from National Detroit Corporation's proposed acquisition of Brighton State Bank. (June 1977, p. 583.)

Up until then the only applications the Board had considered in the Detroit market were to acquire banks near the center of the area. As Brighton was outside but on the fringe of what had been defined as the market, the Board had to rely on commuting data to determine if the previous market definition was the proper one to use in analyzing the competitive consequences of this proposal. As urban areas grow, banking markets expand to reflect changing work and social habits.

Looking at commuting patterns, population trends, shopping habits, and advertising patterns—all reflecting changes in the area—the Board expanded its definition of the Detroit market and denied the application on grounds that the acquisition would have eliminated a significant amount of existing competition in the Detroit market.

Product definition

How broadly the product market of banking should be defined has been debated since the early 1960s. The Supreme Court has consistently found that commercial banking is a unique line of commerce, rejecting the notion that banks compete with other financial institutions, such as S&Ls, mutual savings banks, and finance companies. As a result, bank mergers and acquisitions have had to be analyzed primarily on the basis of commercial bank competition in a market.

Several times in the past few years, the Board has faced the issue of thrift institutions expanding their products and services, as for example, by introducing NOW accounts.

In approving a bank holding company merger in Connecticut in 1974, the Board took into account the importance of mutual savings banks in that state and disagreed with a Department of Justice recommendation that the application be denied. There were more mutual savings banks in Connecticut than commercial banks, and their deposits exceeded the deposits of commercial banks. (May 1974, p. 375.) Taking both mutual savings banks and commercial banks into account, the Board ruled that approval would not change the applicant's ranking in the market and that statewide concentration would not be increased.

In a recent case in New Hampshire, the Board again commented on the effects of savings banks on competition and the concentration of resources:

> In this connection (concentration of resources) the Board notes that three of

[2] P. R. Schweitzer, "Definition of Banking Markets," *Banking Law Journal*, September 1973, page 745.

New Hampshire's four largest savings banks operate in the Manchester banking market, that together they hold almost twice the amount of market deposits held by all 11 commercial banks in the market, and that each one holds more deposits than any one of the commercial banking organizations in the market. While the Board continues to view commercial banking as a distinct line of commerce, the Board recognizes that the presence of thrift institutions in the relevant banking market, particularly in New England where thrift institutions have certain expanded lending and deposit-taking powers, is one of the factors that may be taken into account in analyzing the competitive effects of a particular acquisition. (December 1978, p. 967.)

In another order, involving a New York holding company's proposed acquisition of a bank, the Board said:

> [C]ommercial banks and thrift institutions do compete in the marketing of certain types of services. The Board believes that the overlap of certain services offered by thrift institutions and commerical banks is not so great at this time as to treat the two types of financial institutions as if they were the same. The Board continues to be of the view that it is the cluster of products and services that commercial banks offer that makes commercial banking a distinct line of commerce for purposes of analyzing the competitive effects of the subject proposal. (November 1978, p. 894.)

With the increase in the package of services provided by thrifts, then, the Board has broadened its view of commercial banking as a distinct line of commerce. In looking at the effects on statewide concentration, it has considered thrifts in some instances.

But in assessing the competitive effects of holding company acquisitions of nonbank subsidiaries, the Board has followed a different line of reasoning. In ruling on applications of bank holding companies to acquire consumer finance companies, for example, the Board has taken the position that banks and finance companies compete directly. In an order denying the acquisition of Public Loan Company by Bankers Trust New York Corporation in 1973, the Board stated:

> The contention that commercial banks serve a different clientele from finance companies is becoming less and less valid as commercial banks place more emphasis on retail banking and seek to attract a greater diversity of customers. There appears to be a substantial class of customers being served by both institutions consisting of high-risk margin clientele of commercial banks and the low-risk margin customers in the case of finance companies. (September 1973, p. 694.)

Another example of asymetric product market definition has come up regarding bank holding company acquisitions of mortgage banking companies. As recently as June 1979, the Board determined that banks and mortgage companies compete directly in some aspects of the mortgage banking business. (April 1978, p. 321; July 1979, p. 566.)

Potential competition

The doctrine of potential competition hypothesizes that outside competitors exert procompetitive influences on the market behavior of companies already in a market. This is because companies in the market see outsiders as threatening to enter. The hypothesis, then, rests on two assumptions:

- That potential entrants will base their decisions to enter on the prices and profits of banks already in the market.
- That to discourage new entry, banks in the market will respond to the threat of competitive entry by following pricing policies that do not fully exploit their oligopoly posi-

tion (they will tend to hold their prices under what they might otherwise charge).

Increasing the number of banks competing in a market tends generally to improve the performance of the market, with benefits to the public. For this reason, the Board is concerned with the probability that a holding company will enter a market by the most procompetitive means. If, instead of acquiring a market leader, the organization enters by acquiring a foothold bank or, better yet, by establishing a new bank, competition will be intensified. This is the thinking behind "probable future competition."

Governor Wallich has taken this position several times in dissenting against some approvals of applications by the Board's majority. A study done in 1977 indicates denials based on arguments of probable future competition led 71 percent of the applicants to use foothold entry or to establish new banks within six or seven years after their applications were denied.[3]

A landmark decision was handed down in December 1973 when the Board denied an application by First International Bancshares to acquire Citizens First National Bank of Tyler, Texas. Under what came to be known as the "Tyler Doctrine," the Board declared it would not look favorably on any of the five largest banking organizations in Texas acquiring the largest banks in the state's secondary banking markets. The basis was thus laid for denials over the next two years of applications that would have eliminated significant potential and probable future competition. (January 1974, p. 43.)

In April 1977, however, the Board reconsidered its position, allowing Texas Commerce Bancshares, a Houston-based company, to acquire Capital National Bank in Austin. The third largest banking organization in the state, Texas Commerce held 6.9 percent of the deposits. Capital National was the second largest bank in Austin. It held 21.4 percent of the deposits in that market and 0.7 percent of deposits statewide. (May 1977, p. 500.)

The Board explained that although it denied some of the largest banking organizations in Texas acquisitions of leading banks in secondary markets, its concern over the increased concentration of resources and increased disparity in the size of Texas banks no longer seemed warranted. Concentration had not increased significantly in Texas. It was low, in fact, compared with other states.

With this acquisiton, Texas Commerce became the largest banking organization in the state and large banking organizations across the country were signaled that the Board would be less likely in the future to block efforts to acquire leading banks in markets where the organizations had not been represented.

Several applications involving acquisitions similar to that of Capital National were approved over the next year. Applicants ranking among the three largest banking organizations in their states were allowed to acquire leading banks in new markets. (October 1977, p. 932.) Only in one instance has an application been denied recently on the basis of potential and probable future competition. And even in that case the Board later reversed its decision.

Northwest Bancorporation, the largest banking organization in Iowa, applied to acquire the First National Bank of Fort Dodge. Northwest held 6.1 percent of the deposits in Iowa. The bank at Fort Dodge held only 0.5 percent of the deposits statewide, but it was the largest bank in its market, holding 30 percent of the deposits. The three largest banks held 85 percent of the market deposits. Northwest's closest subsidiary was 87 miles from Fort Dodge. (June 1977, p. 585.)

Because research showed the market would support another bank and Northwest had the resources to enter with a new bank, the application was denied. Approval would have eliminated potential and probable future competition.

The Board reconsidered the application a few months later, however, when it was shown that the Fort Dodge market was not at-

[3]Stephen A. Rhoades, "Probable Future Competition and Predicting Future Entry in Bank Merger Cases," to be published in *Antitrust Bulletin*.

tractive for new entry. County population had declined in the first half of the 1970s, and an industrial park that had been the main source of expected growth in the area had run into difficulties and never opened. As the market was no longer considered overly attractive for entry with a new bank, the Board decided the proposed acquisition would not have any substantially adverse effect on potential and probable future competition. It approved the acquisition.

Governor Wallich dissented, however, saying Board decisions in 1977 reversing the Tyler Doctrine had added to the concentration of banking resources in Texas, Michigan, and Iowa. They also served to foster similar acquisitions in the future. Specifically, his concern was that approvals in these situations could cause holding companies "to eschew *de novo* or foothold entry into highly concentrated markets in the belief that the Board would approve less procompetitive means of entry."

Evidence to support the concept of probable future competition is scant. Rhoades has shown that banks and holding companies blocked from acquiring leading banks in markets will enter either through the formation of new banks or acquisition of smaller banks that give them a foothold in the market. There is some evidence that *de novo* entry improves the performance of banking markets.[4] There is no compelling empirical evidence, however, to show that foothold entries improve the performance of banks in the market.

Holding company mergers

Mergers of bank holding companies that would not eliminate existing competition have met little resistance from the Board. Texas Commerce Bancshares, for example, was allowed to acquire a one-bank holding company with 21.4 percent of the deposits in its market, making Texas Commerce the largest bank holding company in the state. (May 1977, p. 500.)

Three bank holding companies acquired other holding companies in the Seventh District in late 1977 and early 1978. These acquisitions seem to reflect the current direction of holding company activity.

In December 1977, the Board approved Pacesetter Financial Corporation's acquisition of Western Michigan Corporation and its two subsidiary banks. Although Pacesetter moved up from sixteenth to the fourteenth largest banking organization in Michigan, no existing competition was eliminated. (January 1978, p. 35.)

A month later, the Board approved the merger of the ninth and eleventh largest banking organizations in Michigan. Consummation of the proposal made First American Bank Corporation the fifth largest holding company in the state. Although First American would control 3.9 percent of the deposits statewide, banking subsidiaries of the merging companies competed in different markets, causing the Board to conclude that no existing competition would be eliminated. Governors Wallich and Partee joined in dissenting against approval of the merger, saying probable future competition would be eliminated. (February 1978, p. 119.)

Also in January 1978, the Board approved Central National Bancshares' acquisition of Associated Bank Corporation, Mason City, Iowa, boosting Central National's rank from the fifth largest banking organization in Iowa to fourth. (February 1978, p. 113.)

The Board seems inclined to continue approving mergers of this kind, using the same criteria as for the acquisition of banks—which means applications most likely to be denied are those involving existing competition between the two companies. The frequency of this type of application can be expected to increase, moreover, as the number of attractive independent banks that can be acquired declines.

Another illustration of this type of merger is the Board's September approval of First City Bancorporation of Texas' merger with First Security National Corporation. In its

[4]A. S. McCall and M. O. Peterson, "The Impact of De Novo Commercial Bank Entry," *Journal of Finance*, December 1977, page 1587.

order, the Board reiterated its concern for competitive issues. First City was the second largest banking organization in Texas, with 8.2 percent of the deposits. First Security was the seventeenth largest, with 0.6 percent of the deposits. Combination of the two companies made First City the largest banking organization in the state. The order stated:

> The Board continues to monitor statewide banking structures in general, and more specifically, the size disparity between large banking organizations Statewide and the smaller regional banking organizations. The Board is concerned with the possibility that continued approval by the Board of acquisition or merger proposals involving large Statewide and relatively sizeable banking organizations may perpetuate this size disparity and increase concentration ratios.
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> . . . It should be noted that it is not the Board's intention to suggest by this Order that it will generally approve the acquisition of leading local market competitors by major Statewide organizations. To the contrary, this case approaches the limits in terms of size (First Security, $413.0 million in deposits) of the banking organization being acquired and the effects on competition and concentration of what the Board will regard as approvable in light of present structure and legal considerations. (Order issued September 10, 1979, to be published.)

Convenience and needs

Although convenience and needs are not usually the primary considerations in a Board decision, the Board does expect applicants to comply with the service changes proposed in their applications. When Commerce Bancshares, Inc., Kansas City, Missouri, applied in April 1977 to acquire Farmers State Bank, St. Joseph, Missouri, the Board found adverse competitive factors. It also found, however, in reviewing a previous Commerce Bancshares application, that the company had not made the improvements in public benefits it promised. The bank it acquired had not made the significant changes in its agricultural lending program that Commerce Bancshares proposed in its application. (May 1977, p. 494.)

Since the same promise of improved services was made in the application under consideration, the Board found that, on the basis of Commerce Bancshares' record, little weight could be given to these promises. Considerations of convenience and needs, therefore, did not outweigh the adverse competitive effects.

With passage of the Community Reinvestment Act, considerations of convenience and needs become more important. The act is intended to encourage financial institutions to meet the credit needs of their entire local community, including low and moderate-income neighborhoods. Applicants seeking Board approval under Section 3 of the Bank Holding Company Act are asked to provide certain information on the lending characteristics of their affiliated banks. Regulation BB section 228.7 provides several areas of discussion applicants can use to illustrate the lending performance of affiliated banks. Organizations asking permission to open branches are also required to furnish community reinvestment data. The same data must also be submitted for banks being acquired by holding companies where there is an officer or stockholder interlock.

The Board then evaluates the performance record of the whole organization to see if the institutions have been meeting the credit needs of their entire community, consistent with safe and sound banking practices. If they have not, the applications can be denied.

Summary

The Board of Governors' stand on several competitive issues is still evolving. The Board is constantly reassessing these issues in the light of new findings in bank research. And as

the composition of the Board changes, new perspectives are introduced into the process. Board decisions concerning holding companies lead, nevertheless, to several conclusions about these issues and trends in Board policy regarding the competitive aspects of bank holding company applications.

• Horizontal acquisitions. The Board still takes a critical view of holding company acquisitions in the same geographic market. Decisions involving horizontal acquisitions that tended to increase the concentration of banking resources in a market area and eliminated existing competition left the impression in some quarters that the Board's stand against these acquisitions might not be as rigid as it was. As a result, large bank holding companies could be expected to try to increase their influence in markets where they are already established.

Actually, however, the pendulum may have already started swinging in the other direction. In August, the Board denied a merger of the tenth and thirteenth largest banking organizations in Missouri. Both competed in the St. Louis market, with market shares of 3.2 percent and 2.3 percent of the deposits. The resulting organization would have been the fourth largest in the market. The Board stated:

> In the past the Board has authorized combinations of relatively substantial competitors in various markets when it was persuaded that the effects of the combinations would be minimal, that offsetting benefits of value were likely to be achieved, or that less anticompetitive means of expansion were not reasonably available to the organizations. It is the Board's view that a proposed combination of two banking organizations that are direct competitors of similar orientation within a metropolitan market and are both of a size to have achieved economies of scale and have management, or sufficient resources to attract capable management, that will permit each to continue independently as an aggressive competitor in that market, normally would have serious anticompetitive effects and should not be approved except in compelling circumstances. (Order issued August 27, 1979, to be published.)

• Chain banking. The Board has taken a strong position in opposition to chain banking arrangements with anticompetitive effects. Its current policy is not to sanction the formation of bank holding companies that foster serious anticompetitive chain banking arrangements. The scope of its influence over director interlocks was broadened recently with passage of the Depository Institution Management Interlocks Act.

• Market definition. The Board and Federal Reserve banks still face problems with the definition of banking markets both with respect to geographical markets and product lines. The Board has relied extensively on commuting patterns in defining geographic banking markets. It has also taken thrift institutions into account in weighing the competitive effects of proposed acquisitions.

• Potential competition. The Board no longer accepts the argument of potential competition as the sole reason for denying the acquisition of large banks by the leading holding companies in a state to the extent it once did.

• Holding company mergers. Acquisitions of bank holding companies by other bank holding companies are becoming more common. The Board has not taken the position that these acquisitions are, in themselves, substantially adverse in their competitive effects.

• Convenience and needs. While the Board's main focus is rarely on considerations of convenience and needs, it has recognized in one instance that an applicant's record of fulfilling previous convenience and needs promises should be considered in deciding an application. With the Community Reinvestment Act, issues of convenience and needs could become more important in deciding applications.