Including thrifts in bank merger analysis

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Under the Bank Merger Act of 1966 and the Bank Holding Company Act of 1956, federal banking authorities are required to assess the competitive effects of bank mergers and acquisitions. In the traditional analysis the process usually begins with a determination of the geographic market(s) in which the combining institutions compete. The relevant product market, or "line of commerce" in antitrust parlance, is generally taken to be commercial banking inasmuch as the United States Supreme Court has repeatedly held that, for the purposes of antitrust analysis, commercial banks compete only with other commercial banks.

This paper assesses the impact on bank merger analysis of including thrift institutions (savings and loan associations and savings banks) as if they were full competitors of commercial banks. Asset and liability powers of thrifts have changed considerably since the Supreme Court last affirmed its line of commerce determination in 1974. The lines separating commercial banks from thrift institutions have become increasingly obscure. This process of homogenization may be expected to continue in view of recent legislative initiatives.

This paper is organized into five sections. The first reviews the Supreme Court's rationale in determining that commercial banking is a relevant line of commerce in bank merger analysis. The second discusses the changes in the financial system that have occurred which might tend to vitiate the Court's position since its last pronouncement on the subject. The position of the Board of Governors of the Federal Reserve System (the Board) is then examined. An assessment of the impact of expanding the product line in bank merger analysis to include thrift institutions follows. Hypothetical mergers in Seventh District markets are judged against an appropriate merger standard to assess whether such mergers would pass muster under the antitrust law.[1] A final section provides some overall remarks.

The Supreme Court and the relevant line of commerce

Philadelphia National Bank. In 1963 the Supreme Court decided for the first time that, for the purposes of bank merger analysis under the antitrust laws of the United States, the relevant line of commerce is commercial banking. In *U.S.* v. *Philadelphia National Bank* 374 U.S. 321 (1963), the Court said

> "We have no difficulty in determining the "line of commerce" (relevant product or services market) and "section of the country"(relevant geographic market) in which to appraise the probable competitive effects of appellees' proposed merger. We agree with the District Court that the cluster of products (various kinds of credit) and services (such as checking accounts and trust administration) denoted by the term 'commercial banking' . . . composes a distinct line of commerce"[2]

To support its conclusion, the Court relied on three arguments. First, it concluded that "some commercial banking products or services are so distinctive that they are entirely free of effective competition from products or services of other financial institutions; the checking account is in this category."[3] Secondly, the court

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[1]A similar analysis was undertaken by Alcaly and Nelson with regard to local banking markets in New York and New Jersey. (Roger E. Alcaly and Richard W. Nelson, "Will Including Thrifts in the Banking Market Affect Mergers?", *Banking Law Journal* (April 1980).)

[2]*U.S.* v. *Philadelphia National Bank* 374 U.S. 321, 326.

[3]*Philadelphia* at 356.

determined that other bank products or services enjoy "such cost advantages as to be insulated within a broad range from substitutes furnished by other institutions . . . ."[4] Lastly, the Court indicated that, although some bank services and products are freely competitive with services and products available at other financial institutions, commercial banks "nevertheless enjoy a settled consumer preference, insulating them, to a marked degree, from competition; this seems to be the case with savings deposits."[5]

In summary, commercial banks, in the Court's view, provided unique products; products not unique but supported by cost advantages; and products which, although neither unique nor supported by cost advantages, consumers preferred to similar products offered by other institutions.

The Court, however, was not blind to the fact that banks did compete to some extent with other financial institutions. This is demonstrated in the Court's general overview of the banking industry preceding its analysis of the merger before it. The Court said:

> "It should be noted that many other financial institutions are in the business of supplying credit, and so more or less in competition with commercial banks- . . . for example: mutual savings banks, savings and loan associations, credit unions,. . . . ."[6]

While the Court noted the competition provided by other institutions, the "more or less" hints at its result in determining commercial banking to be a distinct line of commerce. For the Court at that time, the degree to which other institutions were in competition with banks was decidedly rather "less" than "more".

Phillipsburg National Bank. The next major case involving the relevant line of commerce in bank merger analysis before the Supreme Court was that of *U.S.* v. ***Phillipsburg National Bank*** 399 U.S. 350 (1970). In ***Phillipsburg***, the Court severely criticized the lower district court for focusing on ***submarkets***. The district court believed that, because the defendant banks functioned more as savings institutions than they did commercial banks, competition from other than commercial banks must be analyzed. The Supreme Court rejected this reasoning:

> "Submarkets such as the District Court defined would be clearly relevant, for example, in analyzing the effect on competition of a merger between a commercial bank and another type of financial institution. But submarkets are not a basis for the disregard of a broader line of commerce that has economic significance."[7]

The Court further described the reasoning which led to its conclusion that commercial banking was a distinct line of commerce in ***Philadelphia***, employing what has come to be known as the "department store of finance" approach:

> "Philadelphia Bank emphasized that it is the ***cluster*** of products and services that full-service banks offer that as a matter of trade reality makes commercial banking a distinct line of commerce . . . In short, the cluster of products and services termed commercial banking has economic significance well beyond the various products and services involved."[8]

Thus, the Court could argue, for example, that banks and thrifts may resemble each other to a marked degree, yet banks, because they possess certain products not then legally available at thrifts, are separate from thrifts for the purposes of bank merger analysis. In the Court's view, each bank product was somehow intimately related to other bank products and together constituted "commercial banking".

Connecticut National Bank. The Supreme Court's most recent discussion of the relevant product market in bank merger analysis in *U.S.* vs. ***Connecticut National Bank*** 418 U.S. 656 (1974) reflects an attitude of flexibility on the Court's part. The Court noted that its previous

[4] ***Philadelphia*** at 356.

[5] ***Philadelphia*** at 357.

[6] ***Philadelphia*** at 326.

[7] *U.S.* v. ***Phillipsburg National Bank*** 399 U.S. 350, 360.

[8] ***Phillipsburg*** at 360-61. Emphasis in original.

decisions in *Philadelphia* and *Phillipsburg* do not require that courts ignore economic realities in assessing bank mergers. In *Connecticut* the Court held out the promise that someday thrifts may be included in the same product market as commercial banks.

In *Connecticut* the Court found that the district court had erred in including both savings and commercial banks in the same product market notwithstanding the close resemblance of commercial banks and savings banks in Connecticut.

The Court stated:

> "To be sure, there is a large measure of similarity between the services marketed by the two categories of banks. In our view, however, the overlap is not sufficient at this stage in the development of savings banks in Connecticut to treat them together with commercial banks in the instant case. Despite the strides that savings banks in that State have made towards parity with commercial banks, the latter continue to be able to provide a cluster of services that the former cannot, particularly with regard to commercial customers, and this Court has repeatedly held that it is the *unique cluster* of services provided by commercial banks that sets them apart for purposes of section 7."[9]

The fact that there existed differences in what commercial banks and what savings banks could offer customers was the justification for treating commercial banking as a distinct line of commerce. The Court recognized that for non-business customers a savings bank and a commercial bank may serve as reasonable substitutes.[10] It was held that the distinguishing features of commercial banks lay in their ability to serve commercial enterprises.

More specifically, the Court stated:

> "We do not say, and Phillipsburg National Bank and ... Philadelphia National Bank ... do not say, that in a case involving a merger of commercial banks a court may never consider savings banks and commercial banks as operating in the same line of commerce, no matter how similar their services and economic behavior. At some stage in the development of savings banks it will be unrealistic to distinguish them from commercial banks for purposes of the Clayton Act. In Connecticut, that point may well be reached when and if savings banks become significant participants in the marketing of bank services to commercial enterprises."[11]

In *Connecticut,* the door was left open for the inclusion of thrifts in commercial bank merger analysis.

The changing financial landscape

The Supreme Court in *Connecticut* did not require that thrift services completely overlap those of commercial banks before such institutions could be considered competitors of the latter. The Court, however, did distinguish savings banks from commercial banks in Connecticut by indicating some of the services that commercial banks could offer but that savings banks could not. More specifically,

> "Commercial banks in the State offer credit-card plans, loans for securities purchases, trust services, computer and account services, and letters of credit. Savings banks do not."[12]

In addition to these services, one may add the offering of personal and commercial checking accounts and unsecured commercial loans as distinguishing savings banks from commercial banks in Connecticut, although state law was soon to grant savings banks the authority to offer personal checking accounts.

In the face of significant changes occurring in the financial system since 1974, many commentators believe that the time has come for a reappraisal of the Supreme Court's "line of

[9] *U.S.* v. *Connecticut National Bank* 418 U.S. 656, 663-64. Emphasis added.

[10] *Connecticut* at 663.

[11] *Connecticut* at 666.

[12] *Connecticut* at 665.

commerce."[13] Since the decision in *Connecticut*, there has been an intensification of competition among financial institutions. Services once thought to be unique to commercial banks are no longer unique. The forces compelling this result reflect for the most part pressures of the market economy.

Individuals and businesses have become much more sophisticated regarding their financial transactions. Gone is the day when corporations would maintain large sums of idle cash. Today, both individuals and businesses use cash management techniques to reduce cash balances to a minimum so as to achieve higher returns on invested funds. As individuals and businesses become more opportunity-cost conscious as a result of inflation, banks and other financial institutions must respond or be left behind. Money market mutual funds are just one manifestation of the innovative financial system. As George Kaufman has noted:

> "All products have their life spans and the traditional bundle of products offered by commercial banks since the beginning of the twentieth century, whether or not unique or separate, was reaching the end of its life. But its death was hastened in recent years by a new and unpredicted event—virile inflation. Combined with the predictable advancement in technology, outmoded regulation, and the creativeness and resourcefulness of participants in the financial markets, the high and volatile interest rates generated by the inflation have left the old order in shambles, e.g., the virtual bankruptcy of [savings and loan associations] and the almost full grown birth of money market funds. The changes occurred with such speed that market deregulation did not wait for legal deregulation."[14]

Legislative change

Pressures building in the financial system have compelled legislative change, loosening the asset and liability restrictions on thrifts to enable them to remain viable. The two most significant legislative changes affecting the competitiveness of thrifts since *Connecticut* have been the enactment of Public Law 96-221, the Depository Institutions Deregulation and Monetary Control Act of 1980 (Monetary Control Act), and Public Law 97-320, the Garn-St Germain Depository Institutions Act of 1982 (Garn-St Germain). Both acts significantly broaden the asset and liability powers of federally chartered thrifts. However, for purposes of the "line of commerce," Garn-St Germain possesses potential far beyond that of the Monetary Control Act.

The Monetary Control Act authorizes federally chartered savings and loan associations to offer negotiable order of withdrawal (NOW) accounts; establish remote service units; invest up to 20 percent of assets in commercial real estate loans, consumer loans, commercial paper, and corporate debt securities; issue credit cards and extend credit in connection with credit cards; and apply for trust powers. In addition, mutual savings banks were granted the authority to invest up to 5 percent of their assets in commercial loans and to maintain demand deposit accounts in connection with such loans.[15]

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[13]See, for example, Henry C. Wallich and Walter A. Varvel, "Evolution in Banking Competition", *The Bankers Magazine* (November-December 1980); Michael E. Trebing, "The New Bank-Thrift Competition: Will It Affect Bank Acquisition and Merger Analysis?", *Economic Review*, Federal Reserve Bank of St. Louis (February 1981); Michael E. Bleier and Robert A. Eisenbeis, "Commercial Banking as the 'Line of Commerce' and the Role of Thrifts", *Banking Law Journal* (April 1981); Michael E. Friedlander and John H. Slayton, "Determination of the Relevant Product Market in Bank Mergers: A Time for Reassessment?", *The Business Lawyer* (July 1981); and *Commercial Banking as a Line of Commerce* prepared by Golembe Associates, Inc. for the Association of Bank Holding Companies (1980).

[14]George G. Kaufman, "Banking as a Line of Commerce: The Changing Competitive Environment", Staff Memoranda 81-5, Federal Reserve Bank of Chicago. For a discussion of the influences affecting both product and geographic market determinations, see George Kaufman, Larry Mote, and Harvey Rosenblum, "Implications of Deregulation for Product Lines and Geographic Markets of Financial Institutions", Staff Memoranda 82-2, Federal Reserve Bank of Chicago.

[15]For a discussion of the Monetary Control Act, see ECONOMIC PERSPECTIVES, Federal Reserve Bank of Chicago (September/October 1980). For an assessment of Garn St Germain, see ECONOMIC PERSPECTIVES, Federal Reserve Bank of Chicago (March/April 1983).

Thus, federally chartered thrifts became able to offer one-stop shopping convenience to individuals and to be their "department store of finance." Under the Monetary Control Act, however, thrifts' ability to serve the commercial customer, that class of customer which was so important to the Supreme Court's argument in *Connecticut*, remained more or less restricted. Nevertheless, the overlap between commercial bank services and thrift services was becoming more complete.

With Garn-St Germain the resemblance of federally chartered thrifts to commercial banks becomes even greater. Under Garn-St Germain the ability of thrifts to provide services to commercial enterprises was enhanced in the interest of preserving thrifts as viable institutions. The act increases the percentage of assets that may be invested in nonresidential real estate and consumer loans to 40 percent and 30 percent, respectively. In addition, thrifts can now 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. Most importantly, thrifts can now invest up to 10 percent of assets in secured or unsecured commercial loans after January 1, 1984, and are able to accept demand deposits in connection with such loans. In all, up to 60 percent of assets may be invested in the various forms of commercial loans.

Now more than before, federally chartered thrifts begin to take on the hue of commercial banks. Whether the expanded powers granted under Garn-St Germain would be sufficient to include thrifts in the relevant line of commerce is problematic. As one observer has noted, the mere authority to offer expanded services does not compel the inclusion of thrifts in the same line of commerce with commercial banks under the *Connecticut* rationale. To warrant inclusion, thrifts must not only possess the authority to offer services, but must do so to a meaningful degree. It is suggested by the same commentator, however, that this requirement under the *Connecticut* rationale may be abandoned by the Supreme Court if thrifts were to attain the power to offer a cluster of services that is the substantial equivalent of that which may be offered by commercial banks.[16]

The Board's consideration of thrifts

At about the time the Supreme Court was deliberating on *Connecticut*, the Board had before it an application by an Indiana bank holding company to acquire an Arizona savings and loan association under section 4(c)(8) of the Bank Holding Company Act. As the board had not previously determined that savings and loan association activities were permissible for bank holding companies, it inquired into whether such activities were "closely related" to banking. Just as the Supreme Court was cognizant of the trend toward lessening distinctions between thrifts and commercial banks, so too was the Board:

> "Geographic restrictions on mortgage lending by savings and loan associations have been liberalized. Recently, savings and loan associations were permitted by the Federal Home Loan Bank Board to participate in the federal funds market, previously dominated by commercial banks. Savings and loan associations recently were authorized to offer large negotiable certificates of deposits. The role of savings and loan associations in the nation's payments mechanism is growing. The President's Commission on Financial Institutions and others have made proposals to expand the powers of savings and loan associations. The close relationship between banking and operation of savings and loan associations would become even closer should these proposals be implemented. Should this trend continue to the point where savings and loan associations both accept demand deposits and engage in the business of making commercial loans, savings and loan associations would actu-

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[16] J. William Via, Jr., "Commercial Banking as the 'Line of Commerce' In Bank Amalgamations: A Reexamination", *Banking Law Journal* (April 1982). John Kareken suggests that thrifts need not actually exercise new powers in order to exert a competitive influence in banking markets in "Commercial Banks as a Line of Commerce: An Appraisal" in *Commercial Banking as a Line of Commerce* (Golembe), op. cit.

ally become "banks" for purposes of the [Bank Holding Company] Act."[17]

While the Board recognized this trend it was not yet willing to include thrifts in the same competitive analysis with banks in bank merger and bank acquisition proposals.

The Board has generally assumed a cautious approach toward including thrifts in the line of commerce for bank mergers. This approach can be traced, in part, to its adherence to the Supreme Court's dictates in the matter. However, the consideration of thrifts has occurred on a case-by-case basis.

One of the major cases since *Connecticut* and enactment of the Monetary Control Act is *Fidelity Union Bancorporation*.[18] The Board stated that while it "continues to view commercial banking as most relevant in determining the competitive effects of a proposal, it may be appropriate in particular cases to take into consideration direct competition from thrifts in specific areas in evaluating the various competitive influences." However, the Board felt it would be "premature" to view thrifts as full competitors of commercial banks.

The Board's deliberation in *Fidelity Union Bancorporation* led to a more formal consideration of nonbank competition as evidenced by Bank Holding Company Letter 198 (June 25, 1980), an internal letter outlining the procedures Reserve Banks were to follow if thrifts were to be included in the competitive analysis. The letter stipulates that competition among commercial banks is "most relevant" but provision is made for the explicit consideration of thrifts and other nonbank competitors.

The Board, following the Supreme Court's advice in *Connecticut*, looks not only at the mere presence of thrifts in analyzing proposals but also whether such institutions actively engage in direct competition with banks:

> "In evaluating the competitive effects of this proposal, the Board has considered the impact of thrift institutions on competition within the Waco market. Although thrift institutions hold substantial deposits in the Waco banking market, the Board in this instance is unable to conclude from the evidence in the record that these institutions compete actively with commercial banks *over a sufficient range of financial services* to mitigate significantly the anticompetitive effects of the proposal."[19]

This Board posture is delineated clearly in the consideration of a proposal by Hartford National Corporation to acquire Mattatuck Bank and Trust Company:

> "The Board has also evaluated the impact of thrift institutions within the Waterbury market. Although a number of thrifts are located in the market, the Board is of the opinion that thrift institutions do not compete actively with commercial banks over a sufficient range of financial services to consider them full competitors of commercial banks. Thus, even though thrift institutions hold a substantial amount of the market's savings deposits, and make a large number of the market's consumer loans, these institutions are insignificant competitors in the provision of demand deposit services and commercial loans. In addition, commercial banks hold the great majority of the market's NOW accounts. This in particular demonstrates the limited nature of the services provided by thrifts in the Waterbury market."[20]

While the Board has declined to include thrifts as full competitors of commercial banks, it has cited their presence in a number of cases as mitigating factors to offset otherwise adverse competitive effects resulting from commercial bank mergers. This approach is often referred to as "shading" in that the market shares and market concentration levels of commercial banks are adjusted downward by some fraction of total

[17] *American Fletcher Corporation*, 60 *Federal Reserve Bulletin* 869 (December 1974).

[18] *Fidelity Union Bancorporation*, 66 *Federal Reserve Bulletin* 576 (July 1980).

[19] *Republic of Texas Corporation*, 66 *Federal Reserve Bulletin* 788 (September 1980). Emphasis added.

[20] *Hartford National Corporation*, 68 *Federal Reserve Bulletin* 242 (April 1982).