The history of potential competition in bank mergers and acquisitions

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The theory of potential competition and its application to the banking industry has been a subject of continuing controversy since the 1960s, when banks and bank holding companies (BHCs) began to expand the geographic scope of their activities through mergers and acquisitions. During the past decade the policy of the Board of Governors of the Federal Reserve System toward acquisitions involving potential competition has come full circle. Prior to 1975 potential competition was accorded an important role in Board denials. Then, between May 1975 and November 1979, with one limited exception,[1] the Board did not deny an application solely on the basis of potential competition. Since then, however, potential competition has again been emphasized in the Board's analysis of the competitive effects of bank mergers and acquisitions. The past, present, and future roles of potential competition in the regulation of banks and bank holding companies are discussed in this article.

The origin of the potential competition theory

In the years following World War II, corporate mergers occurred primarily between

The economics of potential competition

Traditional microeconomic theory argued that, in the absence of government interference, firms in markets in which sellers were few would recognize their economic interdependence and collusively determine market price and output in order to earn higher-than-competitive rates of return. With complete freedom of entry, however, such cooperation would yield only short-term economic gains. Excessive profitability in a market would attract additional competitors, each of which would cause a rise in market output and a corresponding drop in market price until, eventually, all firms would be earning a normal rate of return. In the presence of significant barriers to entry, however, firms in a market would continue to earn above normal rates of return without inducing additional entry.

While the theory of potential competition dates to the turn of the century, it was not formalized until the 1950s and 1960s, when Joe Bain and Sylos-Labini developed "limit pricing" models to approximate firm pricing decisions when various levels of entry barriers are present.[2] These models suggest that an optimal corporate policy may involve setting prices which do not maximize short-run profits in order to deter entry by new competitors. The modern theory of potential competition thus evolved from the theory of limit pricing. Basically, it states that a firm (the potential competitor), even though it has not entered a given market, may influence the price-output decisions of the firms in that market.

[1]The Board of Governors' denial of Northwest Bancorporation's application to acquire First National Bank, Fort Dodge (63 Federal Reserve Bulletin [FRB] 585 (1977)) was overturned upon reconsideration (63 FRB 1096 (1977)).

[2]Joe S. Bain, "A Note on Pricing in Monopoly and Oligopoly," *The American Economic Review*, vol. 39 (March 1949), p. 448. Paolo Sylos-Labini, *Oligopoly and Technical Progress* (Cambridge, Massachusetts: Harvard University Press, 1962).

directly competing firms. By the early 1960s, however, this trend tapered as the Justice Department won several significant suits blocking such horizontal merger activity. Businesses responded logically to this new regulatory and legal environment by acquiring firms outside their traditional product and/or geographic markets. As these product and market extension mergers became more commonplace, the Justice Department and various regulatory agencies looked for a method to analyze the competitive impact of these actions. Their answer, in large part, was the theory of potential competition.

As the potential competition theory came into use in judicial and regulatory circles, three types of potential competitors were distinguished:[3]

- The **dominant entrant** is a firm which has such enormous resources that it can wield monopoly power upon entering a market.
- The **potential entrant** is a firm which, by virtue of its perceived ability and intent to enter a given market, causes the firms in that market to behave more competitively.
- The **probable future entrant** is a firm which, though it seeks to enter a given market through acquisition, may not have altered the competitive behavior of the market's participants. Permitting this firm to enter precludes the possibility that it could have eventually deconcentrated the market through a de novo or foothold acquisition.

Potential competition and the Supreme Court

Beginning in the late 1950s, the Antitrust Division of the Department of Justice sought to bring merger cases involving potential competition under the purview of Section 7 of the Clayton Act.[4] Having accomplished this task in a series of industrial cases, it then attempted to extend the potential competition doctrine to the banking industry. The Justice Department's early experience in this area was singularly unsuccessful. Beginning with the *Crocker-Anglo* decision in 1967,[5] Justice lost four consecutive potential competition cases involving the banking industry before deciding to appeal to the Supreme Court the attempt by Colorado's First National Bancorporation to acquire the First National Bank of Greeley.

The Greeley decision

First National Bancorporation (FNB) owned the controlling interest in Denver's First National Bank, the largest bank in both Denver and the state of Colorado. At the time, Colorado's banking structure was shifting from being primarily composed of independent unit banks to being dominated by multibank holding companies (MBHCs). As a result, the major BHCs were looking for acquisition candidates throughout the state.

At the time FNB applied to acquire First National, the second largest bank in the Greeley market, it also applied to acquire the largest bank in Pueblo and the second largest banks in Boulder and Colorado Springs. The Board of Governors denied the Pueblo acquisition on potential competition grounds, approved the Boulder acquisition because the bank to be acquired was in financial trouble, and narrowly approved the Colorado Springs

[3]Stephen A. Rhoades, "A Clarification of the Potential Competition Doctrine in Bank Merger Analysis," *Journal of Bank Research*, vol. 6 (Spring 1975), p. 35. *U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526 (1973).

[4]Clayton Act Section 7, as amended in 1950, reads in part:

> That no corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital . . . or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly.

[5]*U.S. v. Crocker-Anglo National Bank*, 277 F. Supp. 133 (N.D. Calif. 1967).

and Greeley acquisitions. The Justice Department filed suit in the latter two cases, alleging violations of Section 7 of the Clayton Act, and FNB subsequently dropped its plans to acquire the bank in Colorado Springs.

First National Bank of Greeley was the largest independent bank in its market with total deposits of $39.2 million, about 34 percent of the market. The Justice Department argued that the elimination of FNB as a potential competitor in the Greeley market constituted a violation of the Clayton Act. The District Court disagreed with this contention for four reasons: FNB officials had testified that they had no intention of entering the Greeley market except by acquiring a leading bank; de novo entry was unlikely because the market was adequately banked and experiencing only moderate growth; regulatory officials testified that approval of future de novo applications was unlikely; and foothold entry was not "a likely possibility" because the only available small unaffiliated bank was not then for sale.

The District Court's ruling against the government was upheld in a 4-4 decision by the Supreme Court.[6] Thus, not only did the Court fail to express an opinion on the application of the potential competition doctrine to banking, but no one could even be sure which justice voted which way.

It is interesting to note the events that transpired in the year and a half following the District Court's Greeley decision. First, FNB, which had argued that it would only enter Colorado Springs by acquiring a leading bank, acquired a local bank with less than 20 percent of the deposits of the bank it initially sought to acquire. Second, after being denied acquisition of the largest bank in the Pueblo market, FNB acquired a bank less than one-third as large. Third, the foothold bank in Greeley, which the District Judge ruled was not likely to be sold, was in fact sold to another Colorado BHC. Fourth, after the District Court had accepted the testimony of regulators that de novo applications would not be approved, the state banking commission granted another BHC approval to establish a new bank in the Greeley market. Finally, the banks which FNB sought to acquire in Pueblo and Colorado Springs formed their own MBHC and subsequently entered the Denver market, competing directly with FNB's lead bank.[7]

[6] *U.S. v. First National Bancorporation*, 410 U.S. 577 (1973).

The Falstaff decision

The same day the Supreme Court handed down the "Greeley" decision, it also clarified some potential competition issues in its opinion in *U.S. v. Falstaff Brewing Corp.*[8] Falstaff, the fourth largest beer producer in the country at the time, sought to enter the New England market by acquiring the market's largest brewer. The District Court held that, in its judgment, Falstaff would never enter the New England market on a de novo or foothold basis, and therefore could not be considered a potential entrant.

The Supreme Court overturned the District Court, ruling that potential entrants are within the scope of the potential competition doctrine. The Court left unresolved, however, whether probable future entrants are also within the scope of the doctrine.

The Marine decision

The Supreme Court issued its first opinion applying the potential competition doctrine to banking in its June 1974 decision, *U.S. v. Marine Bancorporation*.[9] In *Marine*, the Court approved the merger of Washington Trust Bank (WTB) of Spokane, the third largest bank in the Spokane market, and Seattle's National Bank of Commerce (NBC), the second largest bank holding company in the state of Washington.

[7] Donald Baker, "Potential Competition in Banking: After Greeley, What?" *Banking Law Journal, vol. 90 (May 1973), p. 362.*

[8] *U.S. v. Falstaff Brewing Corp.*, 410 U.S. 526 (1973).

[9] *U.S. v. Marine Bancorporation*, 418 U.S. 602 (1973).

The Court agreed with the Justice Department's arguments that the potential competition doctrine was applicable to commercial banking, and that the Spokane market was sufficiently concentrated for the doctrine to be a relevant consideration in the case. It noted, however, that determining the extent of the loss of potential competition in banking markets depends largely on a state's branching laws, which can limit the effective alternatives for entry.

The Court, therefore, held that NBC was not a potential entrant. Banks in the Spokane market, the court majority reasoned, must have recognized that the state's branching restrictions made NBC's entry into the Spokane market infeasible, except by merger with WTB.

The Supreme Court did not rule on whether elimination of probable future competition constitutes a violation of the Clayton Act. In the Court's opinion, the Justice Department failed to establish that feasible means of entry existed and that there was a reasonable prospect of long-term structural improvement or benefits in the target market.

Foothold entry, the Court reasoned, would not be a feasible alternative because the only bank available in the downtown area could not be purchased for four years. Even then, state law would preclude NBC from branching from this location, thus limiting the procompetitive impact of such an acquisition. The Court deemed NBC's other entry alternative, sponsoring a bank and acquiring it later, to be feasible at some indefinite future date, but felt that it was not likely to produce greater competition since NBC could not legally branch from the sponsored bank.

Therefore, the Justice Department did not establish, prima facie, that NBC was a probable future competitor. As a result, the Court did not address the issue of the legality of bank mergers which, while not reducing the present level of competition, might preclude future market deconcentration through de novo or foothold entry.

The Board of Governors and potential competition

Beginning in the early 1960s, it was not uncommon for the Board of Governors to deny a proposed merger on the basis of an adverse impact on potential competition. These denials invariably involved acquisition of one of the leading banks in a market by one of the state's largest bank holding companies. Beginning in 1975, however, the Board grew increasingly reluctant to deny applications on potential competition grounds alone. In fact, it was not until November 1979 that potential competition became a viable issue once again. The Board of Governors' attitude toward potential competition in banking can best be illustrated by analyzing specific issues in some key Board decisions.

The Tyler Doctrine

The first major potential competition denial in the mid-1970s involved an attempt by First International Bancshares of Dallas, the largest BHC in Texas, to acquire Citizens First National Bank of Tyler, the largest bank in the Tyler market.[10] The reasoning behind the January 1974 denial, which became known as the "Tyler doctrine," consisted of two elements:

First, observing that the share of total state deposits held by the five largest BHCs in Texas had increased from 22 percent in 1970 to 31 percent in 1973, and that the same five companies held two-thirds of the deposits of all 24 BHCs, the Board wanted to prevent any worsening in the concentration of state deposits.[11]

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[10]60 FRB 43 (1974).

[11]Denial orders based on potential competition frequently discuss the adverse impact on statewide concentration because, as a rule, the cases involve an acquisition by one of the state's largest BHCs. Theoretically, however, the two issues are distinct: if there is an adverse competitive impact, the change in statewide concentration should be irrelevant. However, a case might arise in which the adverse competitive effects are not significant enough to warrant denial unless combined with the impact on statewide concentration.

Second, because Tyler was the leading bank (30 percent of market deposits) in a highly concentrated market, and because the Tyler market was attractive for de novo entry, the Board argued that the acquisition would harm competition within the Tyler market. De novo or foothold entry, it concluded, represented the only means of providing more competition.

Austin: Before the pendulum swings

An equally important decision was the Board's February 1975 order denying the application by Texas Commerce Bancshares (TCB) of Houston, the third largest BHC in Texas, to acquire Austin National bank (ANB), the largest bank in the Austin market.[12] There was no existing competition between the two organizations.

The Board emphasized that it was "primarily concerned with the significantly adverse effects . . . on the concentration of banking resources *within* the Austin banking market" (emphasis added). It denied the application and stated that the acquisition would have an adverse impact on potential competition in that it would:

- appreciably reduce the likelihood that the market would become less concentrated and more competitive in the future through continued potential competition from TCB;

- eliminate ANB as a lead bank for a BHC that would continue to compete in Austin as well as possibly expand into a regional holding company; and

- eliminate TCB as a "new and aggressive competitor" via de novo entry.

The Texas turnaround

The ANB decision and the Board's position on potential competiton were, in essence, overturned in May 1977 when the Board approved TCB's application to acquire Capital National Bank (CNB) in Austin.[13] CNB was the second largest bank in the Austin market with 21.4 percent of total deposits, slightly less than the 23 percent share of ANB. As with ANB, no existing competition issues were involved.

The Board, however, reversed two of its three conclusions regarding the impact of such an acquisition on potential competition in the Austin banking market. First, acknowledging that "the level of concentration of banking resources in the Austin market has not changed appreciably "since the previous denial, the Board concluded that it

> does not *now* view Applicant's acquisition of Bank as significantly reducing the likelihood that the market would become less concentrated in the future (emphasis added).

The stated reason for this reversal was that, given the attractiveness of the Austin market for de novo entry,

> approval of this application would not foreclose the possibility of such other competitors entering the market de novo or through acquisition of one of the many independent banks.

Of course, the Board had found the Austin market attractive to de novo entry in the ANB case as well. Since neither the ANB nor the CNB acquisition would have foreclosed de novo or foothold entry by these other competitors, the change in attitude apparently reflected the change in the Board's composition.[14]

[12]61 FRB 109 (1975).

[13]63 FRB 500 (1977).

[14]Of the six Governors who voted to deny the ANB acquisition, only one, Governor Wallich, voted to deny the CNB acquisition. Voting to approve the CNB acquisition were the four Governors who were not members of the Board at the time of the ANB application and Governor Burns and Coldwell, who had previously voted to deny the ANB application.

Second, the Board had contended that potential competition would be reduced since ANB could serve as the lead bank for another BHC. CNB, a bank the same size as ANB, could also have become the lead bank for a regional BHC while remaining an active competitor in the Austin market. In the CNB order, however, the Board does not discuss this issue.

Finally, the Board had stated in the ANB order that approval of the acquisition would have an adverse effect on competition by *eliminating* TCB as "a new and aggressive competitor" through de novo entry. In CNB, however, the Board reversed its opinion, stating that "approval of this application may have a positive effect on competition in the market by *introducing* a new and aggressive competitor" (emphasis added). Comparison of the arguments used to justify these contradictory conclusions seems to favor the logic of the ANB case. Though TCB became a new competitor in Austin upon consummation of the CNB acquisition, CNB was eliminated as a competitor; thus, one competitor was merely substituted for another. In the ANB case, on the other hand, had TCB entered the market de novo, the two organizations would have competed head on.

Recent revisions: First City and Old Kent

After the approval of TCB's acquisition of CNB, the Board did not deny an application solely on the basis of potential competition until its November 1979 decision on Old Kent Financial Corporation's application to acquire Peoples Banking Corporation of Bay City, Michigan.[15]

The Board's new attitude first emerged in its September 1979 four-to-three approval of First City Bancorporation's [FCB] acquisition of First Security National Corporation [FSN] of Beaumont, Texas.[16] The order stated:

> . . . 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 the size 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 structural and legal considerations.

FCB was the second largest banking organization in Texas with 8.2 percent of total state deposits, while FSN was the 17th largest with 0.6 percent of deposits statewide. The Board expressed particular concern about the effects on potential competition in the Beaumont market, in which FSN was the leading organization, controlling 24.1 percent of market deposits.

The "limits" referred to in First City were apparently exceeded by Old Kent in its attempted acquisition of Peoples. Old Kent was the sixth largest banking organization in Michigan with 3.5 percent of total state deposits, while Peoples was the 12th largest with 1.6 percent of deposits statewide. The Board argued that the proposed acquisition would have eliminated potential competition. Although there were no banking markets in which subsidiaries of both Old Kent and Peoples operated, each holding company was among the dominant organizations in the majority of markets it served. Since Old Kent several proposed acquisitions have been denied on largely the same grounds.[17] The Board majority in these cases used essentially the same arguments that had been made in the previously cited denials of the mid-1970s and the dissents of the late 1970s.[18] Thus, present Board policy maintains that, in general, the largest BHCs in a state will not be permitted to acquire the leading banks in a

[15] 65 FRB 1010 (1979). See note 1.

[16] 65 FRB 862 (1979).

[17] DETROITBANK Corporation (Second National Corporation), 66 FRB 242 (1980); The Marine Corporation (First National Bank and Trust Co., Racine), March 26, 1980; Mercantile Texas Corporation (Pan National Group), April 16, 1980.

concentrated market when foothold or de novo entry is a feasible alternative.

Empirical evidence

A major factor contributing to the Board's changing policy with respect to the potential competition doctrine has undoubtedly been the lack of any empirical verification of the doctrine and its major assumptions. As postulated, the doctrine makes three implicit assumptions:

- that higher levels of market concentration are associated with above-normal rates of return;
- that de novo or foothold entry will produce market deconcentration and improve performance; and
- that the Board or the courts can accurately predict future entry.

Economic studies to date have generally supported the first assumption. A 1977 paper by Rhoades summarizes the results of 39 studies of the structure/performance relationship in banking undertaken since 1959.[19] Thirty of these studies found a statistically significant relationship. Rhoades concludes that while "market structure clearly affects price and profit performance in commercial banking, . . . the effect is quantitatively small." However, Rhoades notes that more conclusive findings would result from employing improved methodology in future empirical work.

Much less empirical work has been done on the second assumption. The impact of foothold entry on market structure was the subject of a 1978 study by Rhoades and Schweitzer.[20] They employed multivariate regression techniques to analyze the changes in market structure in 70 markets during the period 1966 to 1976 and found no statistically significant relationship between foothold entry and changes in concentration. The authors observed, however, that their conclusions, if accurate, did not necessarily imply that performance in these markets was not improved by foothold entry; additional competition might have been induced by the new entrant, even though market shares had remained constant. No study has provided strong evidence of the impact of de novo entry on market structure.

While the impact of foothold entry on market performance has not been tested empirically, McCall and Peterson have analyzed the impact of de novo entry on market performance.[21] Their results indicate that de novo entry has a positive effect on performance (decreasing prices without reducing profits to threatening levels) in states with restrictive branching laws, while in the other states de novo entry has a negligible impact.[22] McCall and Peterson conclude that this difference may well be due to the fact that the less restrictive branching laws have promoted greater competition.

There is also limited empirical evidence regarding the third assumption. Rhoades examined 50 cases of merger denials from

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[18]Texas Commerce Bancshares, Inc. (Bancapital Financial Corporation), 63 FRB 500 (1977); First City Bancorporation of Texas (City National Bank of Austin), 63 FRB 674 (1977); DETROITBANK Corporation (Lake Shore Financial Corporation), 63 FRB 926 (1977); Northwest Bancorporation, 63 FRB 1096 (1977); First City Bancorporation of Texas, Inc. (Lufkin National Bank), 64 FRB 969 (1978); First City Bancorporation of Texas, Inc. (First Security National Corporation), 65 FRB 862 (1979); National Detroit Corporation (Farmers and Merchants National Bank), 65 FRB 928 (1979).

[19]Stephen A. Rhoades, *Structure Performance Studies in Banking: A Summary and Evaluation*, Staff Economic Studies 92 (Board of Governors of the Federal Reserve System, 1977).

[20]Stephen A. Rhoades and Paul Schweitzer, *Foothold Acquisitions and Bank Market Structure*, Staff Economic Studies 98 (Board of Governors of the Federal Reserve System, 1978).

[21]A. S. McCall and M.O. Peterson, "Impact of De Novo Commercial Bank Entry," *Journal of Finance*, vol. 32 (December 1977), p. 1587.

[22]This finding is interesting in light of the Supreme Court's conclusion in *Marine Bancorporation* that de novo entry is a less viable alternative in states with restrictive branching laws.

1960 to 1975 in which subsequent entry was predicted. He found that 68 percent of the 1960-69 predictions were realized by mid-1975, and that 36 percent of the 1970-75 predictions were realized by August 1977.[23] The study thus gives a good preliminary indication that the Board has been fairly accurate in predicting subsequent entry in the cases it has denied. There is, of course, no way of measuring the number of approvals which, had they been denied, would have resulted in subsequent entry. Without that information, it is difficult to assess the overall accuracy of the Board in forecasting de novo or foothold entry.

The potential competition doctrine: How far have we come . . .

The Board of Governors has led the Supreme Court in the development and application of the potential competition doctrine, particularly with respect to the banking industry. The Court has held that elimination of potential competition can constitute a violation of the Clayton Act. It has also held that this doctrine applies to the banking industry. However, the Court has never found a banking organization to be guilty of a Clayton Act violation on the basis of potential competition. More importantly, the Court has yet to rule, in either a banking or industrial context, on whether the elimination of probable future competition constitutes a violation of the Clayton Act.

While the Board has denied acquisitions which would eliminate potential or probable future competition, it has not done so consistently. This vacillation is probably attributable to the lack of empirical evidence to support the theory of potential competition. The Board has had a longstanding policy of denying acquisitions within the same market, but, as noted above, there is a large body of theoretical and empirical evidence demonstrating the anticompetitive consequences of these horizontal acquisitions. Since neither the Board nor the courts have had the benefit of a theoretical and empirical consensus regarding potential competition, it is not surprising that the Board's use of the doctrine has varied with the Board's composition, and that the courts have been reluctant to address the issue at all.

. . . and where do we go from here?

There is obviously an urgent need to assess empirically the theory of potential competition. If the resulting evidence provides a clear picture of the competitive impact of leading bank acquisitions by large BHCs, it will undoubtedly help formulate a long-term consensus at the Board regarding the potential competition doctrine. However, until such evidence emerges, if it ever does, the question remains: what costs are associated with different potential competition policies?

In order to answer this question, two scenarios are analyzed. First, what would be the costs of pursuing a strong potential competition policy if, in reality, there are few harms associated with the elimination of potential competition? The most significant costs would be incurred by the shareholders of the banking organizations involved in the acquisition.[24] When the Board denies an application, it may be forcing a banking organization to forego some short-run return on its capital.[25] Absent any socially beneficial increase in competition, this cost to shareholders represents a net loss to society.

Second, what would be the major costs of pursuing a weak potential competition policy if, in reality, there are significant harms

[23]Stephen A. Rhoades, "Probable Future Competition and Predicting Future Entry in Bank Merger Cases," *Antitrust Bulletin*, forthcoming.

[24]Most studies show little advantage to consumers from BHC affiliation. See Dwane B. Graddy, *The Bank Holding Company Performance Controversy* (Washington, D.C.: University Press of America, Inc., 1979) and, most recently, Stephen A. Rhoades and Roger D. Rutz, *Impact of Bank Holding Companies on Competition and Performance in Banking Markets*, Staff Economic Studies 107 (Board of Governors of the Federal Reserve System, 1979).

[25]Assuming the banking organization has alternative investment opportunities, the cost in terms of foregone return on capital is represented by the rate of return on the bank acquisition minus the rate of return on the most profitable investment alternative.

associated with the elimination of potential competition? The cost to the consumer from decreased competition is higher prices, fewer, and/or lower quality services. These costs are usually analyzed in two parts: deadweight loss and transfer loss. Deadweight loss is a net cost to society that results from the fact that some people will stop using banking services when the price of these services rises. Transfer loss is the income that is transferred from consumers to the banks when price increases force consumers to pay more for the same quality services.

Moreover, the Board's history of pursuing different policies not only incurs the costs described above, but each policy shift imposes an additional cost upon the shareholders of banking organizations that were planning acquisitions on the basis of the Board's policy before the shift took place.

Quantifying and comparing these costs is a difficult empirical task, given the uncertain and subjective nature of the issues involved. Consequently, there is no potential competition policy that is clearly optimal in an uncertain environment. However, two additional considerations lend weight toward favoring a strong potential competition policy.

First, the costs associated with a weak policy affect a larger number of people in a more basic way. Consumers of banking services outnumber the shareholders of banking organizations. Moreover, the loss to any single shareholder is likely to be small, and the shareholder has the option of reorganizing his investment portfolio. The consumer, on the other hand, has no practical alternative to banking in his local market.

Second, the costs associated with a weak policy are permanent. Acquisitions approved by the Board are, for the most part, irreversible. If it turns out that a strong policy is preferable, the resulting higher prices and fewer services are likely to continue indefinitely. In contrast, under a strong policy, denied acquisitions can be approved at a later date, with the cost to the shareholders being incurred only in the interim period.

Summary

The potential competition doctrine was initially developed and applied in an industrial context. While the Supreme Court has found the concept applicable to the banking industry, it has yet to review a banking case in which the elimination of potential competition constituted a violation of Section 7 of the Clayton Act. Moreover, the Court has never considered a case involving probable future competition, and, as a result, has never ruled on whether the elimination of such competition violates the Clayton Act.

The Board of Governors has led the Supreme Court in applying all three forms of the potential competition doctrine to mergers and acquisitions in the banking industry. Its application of these concepts, however, has shifted with the composition of the Board. This inconsistency is probably due, in large part, to the lack of empirical studies testing the assumptions underlying the potential competition doctrine.

Until such empirical evidence emerges, if it ever does, the Board faces the problem of formulating policy in an uncertain environment. While the major costs and benefits of pursuing alternative policies can be identified, quantifying the absolute and relative magnitudes of these costs and benefits is a difficult empirical task.

The Board of Governors is presently pursuing a relatively strong potential competition policy. While there are costs associated with any of the Board's available alternatives, the potential costs associated with a strong policy appear to be significantly lower than those associated with a weak policy. Moreover, the available empirical evidence, limited as it may be, tends to support the assumptions underlying the potential competition doctrine. Thus, until the uncertainties regarding the doctrine can be resolved, the Board can best serve the public interest by making a firm commitment to pursue the strong potential competition policy established in recent months.