FYI
The Use of Mitigating Factors in Bank Mergers And Acquisitions: A Decade of Antitrust At the Fed

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An important aspect of the industry consolidation experienced over the past decade by the U.S. banking system is the increased pace of bank mergers and acquisitions.[1] From an average of 170 mergers per year from 1960 to 1979, the yearly average grew to 498 during the period from 1980 to 1989 (see Stephen A. Rhoades 1985a and John P. LaWare 1991). The increased number and size of bank mergers in recent years, as well as the relatively large number of bank failures, have renewed interest in how antitrust enforcement is pursued by the federal banking agencies. The federal authorities having primary responsibility for the aspects of bank mergers related to competitiveness are the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Department of Justice (DOJ).[2]

The purpose of antitrust regulation in mergers is to prevent an acquirer from being able to exercise market power, thereby earning abnormal profits at the expense of customers within the market where the merger occurred. From a policy standpoint, a proposed merger may be denied if it carries with it the possibility of significant anticompetitive effects on prices and consumer and business welfare. The Fed's guidelines help anticipate a bank merger's effects on competition. However, a mechanical application of these guidelines, because they provide only approximations, can be misleading, and it may be appropriate to consider additional factors.

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There are substantive, positive reasons for regulators to refrain from interfering in the market for corporate control. For example, mergers may eliminate inefficiencies or poor management. They also provide diversification and reduce excess capacity in local markets. There is a strong argument that industry consolidation is a healthy and even necessary development for U.S. banks to become stronger and remain globally competitive. With these things in mind, the Fed's approach is generally to approve mergers unless competitive effects are significantly adverse. In merger applications that apparently pose problems with regard to competitiveness the Fed looks for factors that might mitigate the anticompetitiveness implicit in a breach of its guidelines.

The essential elements in antitrust analysis of bank mergers are specification of the correct geographic and product markets, determination of all the direct and potential competitors, and the analysis of the merger's effects on the structure of individual markets. The Federal Reserve reviews these factors in a two-stage process, determining first whether a competitive problem potentially exists and, if so, whether the merger could in fact significantly affect competition adversely. The Fed's approach to identifying potential competitive problems is discussed in detail in an article in the January/February 1993 issue of this *Review*. That article examines the Fed's initial screening of proposed transactions for those that could have a significantly adverse effect on competition.

This article, the second in a two-part series detailing how the Fed deals with antitrust issues, deals with the other stage of the Fed's competitive analysis. If a proposed merger's effects exceed the Fed's structural benchmarks and the application goes to the Board of Governors of the Federal Reserve System, the Fed then seeks to determine to what extent the merger might be anticompetitive.[3] During the last decade, the Board has approved most bank merger applications it has reviewed, citing a number of mitigating factors such as competition from thrift institutions, the likelihood of new entry given the market's attractiveness, and the financial health of the firm being acquired. These and other mitigating factors cited by the Board will be the focus of this article.

The Data

Bank merger applications dating from November 19, 1982, through December 1992 were examined in order to identify those that presented possible antitrust concerns and went to the Board of Governors for review.[4] The applications considered were filed by bank holding companies or state member banks to acquire another bank or bank holding company. (Applications from institutions that had a primary regulator other than the Fed and applications involving acquisitions of thrift institutions were not examined.) Acquisitions were judged to pose potential antitrust problems on the basis of the Board's rules regarding delegation of authority to the Reserve Banks that were applicable at the time the merger application was filed.

The Department of Justice guidelines issued in June 1982 are the foundation for the Fed's initial screening of applications.[5] The guidelines discussed market concentration in terms of the Herfindahl-Hirschman Index (HHI) and established three postmerger HHI concentration ranges for considering the likelihood that a particular acquisition would have significant anticompetitive effects. A postmerger HHI below 1,000 is considered unconcentrated; between 1,000 and 1,800, moderately concentrated; and higher than 1,800, highly concentrated. (For a discussion on the calculation and use of the HHI see Christopher L. Holder 1993, 28-30.) The Department of Justice stated that it was more likely than not to challenge transactions with a change in the HHI greater than 100 points in a moderately concentrated market or in a highly concentrated market. A change between 50 points and 100 points in a highly concentrated market might be challenged, depending on the postmerger market concentration, the size of the resulting increase in concentration, and the presence or absence of several other market-specific factors.

For the purposes of this article, these Department of Justice criteria were applied as stipulated in the Fed's Delegation of Authority guidelines for three distinct subperiods over the decade studied: (1) November 19, 1982, to December 1985, (2) January 1986 to June 1987, and (3) July 1987 to December 1992.[6]

A total of 155 merger applications were identified as posing potential competitive problems. Of these, sixteen involved issues of "prior common control" not relevant in most applications and were dropped from the data set. Of the remaining 139 applications, involving 297 local banking markets, applicants in 86 of these markets proposed totally divesting all of either their own or the target's branches, ensuring that the postmerger market share of the applicant was not higher than either its or the target's premerger market share.[7] These 86 markets were dropped from the data set, leaving a total of 211 local banking markets for which competitive issues potentially remained.

Mitigating Factors

A majority of the applications involving the remaining 211 markets were approved. In justifying these approvals, the Board cited a number of factors that mitigated the potential anticompetitive effects of these transactions as indicated solely by the structural, or HHI, numbers. The following discussion examines the fifteen mitigating factors cited by the Board in reference to applications reviewed between November 1982 and December 1992. The factors are grouped here into five categories: strong remaining competition, misleading HHI, potential competition, convenience and needs considerations, and procompetitive effects on the market. Individual markets could, and often did, involve multiple mitigating factors as identified in the Board's decision.[8] (Table 1 presents a summary of the mitigating factors cited over the last decade, and Table 2 presents the results of this analysis summarized by year.)

Strong Remaining Competition

Each of the mitigating factors cited in this category was used to indicate significant competition that was

Table 1
Factors Cited during the Last Decade as Mitigating Potential Anticompetitive Effects of Bank Mergers

Mitigating Factor	Number of Markets	Percentage of Markets
Strong Remaining Competition		
Thrift Competition	113	53.6
Numerous Remaining Competitors	107	50.7
Nonbank and Out-of-Market Competition	10	4.7
Total	**230**	
Misleading HHI		
Partial Divestiture	76	36.0
Deposit Runoff	4	1.9
Total Deposits Incorrect	3	1.4
Passive Investment	3	1.4
Limited Competition	3	1.4
Total	**89**	
Potential Competition		
Likelihood of Entry	34	16.1
Expected De Novo Entry	1	0.5
Total	**35**	
Convenience and Needs Considerations		
Financial Health of Target Firm	30	14.2
No Less Anticompetitive Solution	3	1.4
Total	**33**	
Procompetitive Effects on Market		
Benefits to Acquiring Bank	7	3.3
Market Share of Dominant Firm(s)	3	1.4
Applicant's Small Size in the Market	1	0.5
Total	**11**	
Denials	6*	

** Five merger applications, involving competition in six banking markets, were denied for competitive reasons.*

Table 2
Factors Mitigating Potential Anticompetitive Effects of Bank Mergers, Summarized by Year
(Number of Markets)

Mitigating Factor	Dec. 1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	Total
Strong Remaining Competition												
Thrift Competition	1	9	22	29	20	18	1	3	1	7	2	113
Numerous Remaining Competitors	0	8	9	17	16	19	5	3	8	8	14	107
Nonbank and Out-of-Market Competition	0	0	0	0	0	3	0	0	2	4	1	10
Total	**1**	**17**	**31**	**46**	**36**	**40**	**6**	**6**	**11**	**19**	**17**	**230**
HHI Misleading												
Partial Divestiture	0	4	3	2	5	0	9	1	3	6	43	76
Deposit Runoff	0	1	0	0	0	0	0	0	0	0	3	4
Total Deposits Incorrect	0	0	1	0	0	0	1	0	0	0	1	3
Passive Investment	0	0	0	1	0	0	0	0	2	0	0	3
Limited Competition	0	0	0	1	0	1	0	0	1	0	0	3
Total	**0**	**5**	**4**	**4**	**5**	**1**	**10**	**1**	**6**	**6**	**47**	**89**
Potential Competition												
Likelihood of Entry	0	1	1	3	0	4	2	4	6	2	11	34
Expected De Novo Entry	0	0	0	0	0	0	0	0	1	0	0	1
Total	**0**	**1**	**1**	**3**	**0**	**4**	**2**	**4**	**7**	**2**	**11**	**35**
Convenience and Needs Considerations												
Financial Health of Target Firm	0	5	6	3	0	6	2	1	1	5	1	30
No Less Anticompetitive Solution	0	2	1	0	0	0	0	0	0	0	0	3
Total	**0**	**7**	**7**	**3**	**0**	**6**	**2**	**1**	**1**	**5**	**1**	**33**
Procompetitive Effects on Market												
Benefits to Acquiring Bank	0	1	0	0	0	5	0	0	0	0	1	7
Market Share of Dominant Firm(s)	0	0	1	0	0	0	0	0	1	0	1	3
Applicant's Small Size in the Market	0	0	0	0	0	1	0	0	0	0	0	1
Total	**0**	**1**	**1**	**0**	**0**	**6**	**0**	**0**	**1**	**0**	**2**	**11**
Denials	0	1	1	2	0	1	0	0	0	0	0[a]	6[b]

[a] *The Federal Reserve denied two applications in 1992 in which a bank holding company sought to acquire a thrift institution (see the box on page 41).*

[b] *Five merger applications, involving competition in six banking markets, were denied for competitive reasons.*

not captured by bank deposit market share data and would remain an important aspect of competition in the postmerger banking market.

Thrift Competition. The Board cited competition from thrift institutions more frequently than any other mitigating factor (see Holder 1993, 31).[9] The Board considered such measures as the number, size, and share of deposits held by thrifts in a market, as well as how the thrifts ranked in size within a market. The higher these measures, the more likely it was that thrifts were included as a mitigating factor. In addition, the Board also looked for evidence that thrifts were actually competing with banks by offering the full cluster of traditional banking services. Types of business and consumer transaction accounts (for example, NOW accounts), commercial and industrial loan ratios, the existence of a commercial lending department or commercial lending officers, and active advertisements for business customers were all used as evidence that thrifts were actively competing with banks.

From November 1982 through June 1987, thrifts were generally not explicitly included in HHI calculations but were considered a mitigating factor in 98 out of 116 markets, or 87.7 percent of the markets with competitive issues.[10] After June 1987 the Board automatically assigned thrifts a 50 percent weight in calculating HHIs and gave them an even higher weighting in 15 out of 95 markets.[11]

Numerous Remaining Competitors. The second most often-cited mitigating factor was the Board's recognition that the number of competitors remaining in a particular market after a merger was a signal about the likelihood of monopoly power developing.[12] The expectation was that remaining competitors would rise to the occasion in the event that an acquirer attempted to exercise market power through prices. (This potential is not adequately captured in the HHI because the index is a static measure of competitive structure.) Although the Board has not specified the number of competitors necessary for their presence to be considered a mitigating factor, the type of market (rural or urban, small or large deposit base) apparently played a role in this determination.[13] It appears, though, that while the existence of numerous remaining competitors was often cited as a mitigating factor, it did not play a major role in decisions regarding the transactions studied.[14] In addition, the Board sometimes noted that large statewide or regional banks having a small market share in a particular market may exert a stronger competitive influence than their small market share indicates because of their significant financial and managerial resources. Implicit in the Board's opinion is the assumption that large banks can price independently of market leaders in a particular local market because they can operate with financial support from the home office.[15]

Nonbank and Out-of-Market Competition. Nonbank, nonthrift financial institutions were cited as a source of competition that did not show up in the structural numbers. These financial institutions were viewed as competing with banks in a broad array of financial services, and their presence was considered a mitigating factor if they provided significant competition within a local banking market. In all, the Board referred to this mitigating factor ten times over the period under study: three times in 1987, twice in 1990, four times in 1991, and once in 1992.[16] The appearance of this mitigating factor in decisions in only the latter half of the decade is consistent with, and largely the result of, the increased competition and institutional deregulation generally experienced by the financial services industry during this period.

The most common nonbank, nonthrift competitor mentioned was credit unions—with presences specifically mentioned in six out of the ten markets. Competition from credit unions was assessed by reviewing membership requirements (liberal requirements would attract many more customers), relative and absolute size, loan-to-total-asset ratios, and business accounts offered.

Other nondepository institutions were also cited as providing significant competition for banks—including consumer and commercial finance companies, industrial loan companies, and securities brokerage firms.[17] For one market Mexican financial institutions were cited, and savings and credit union societies (in Puerto Rico) were cited in two markets.[18] Decisions on two applications acknowledged significant competition for financial services from institutions that solicited business from within a market even though they maintained no offices in the market.[19]

*M*isleading HHI

Mitigating factors in this category were used when a mechanical interpretation of the structural numbers might be misleading. The issues raised relate to the accuracy of using the market share of total bank deposits as the sole indicator of competitive influence in a particular market, a data problem. The factors cited were partial divestiture, deposit runoff (with-

drawal of monies because of recent acquisitions), total deposits incorrect, passive investment, and limited competition.

Partial Divestiture. Partial divestiture, reducing an acquirer's new market share by selling some of the deposits and loans of either the applicant or bank involved, was considered a mitigating factor. In such instances, concentration numbers based on the assumption that all the deposits and loans of a target institution would be acquired misrepresented a merger's effects on competition. To compensate, the Board adjusted the HHI for the divestitures by calculating new concentration numbers reflecting the proposed sale of a bank's branches. While the divestiture was sometimes deemed adequate to correct any potential problems, in other cases additional factors played a role.

Deposit Runoff. Deposit runoff was a mitigating factor in two applications (four markets). Because branch-level deposit data are collected annually and as a result often do not reflect an institution's current holdings, this factor can be important. In the first market, the Board noted that the applicant had recently acquired a failed bank in the market and projected that significant deposit and loan losses would result from that acquisition, reducing the applicant's market share. The Board agreed with the applicant's contention that its competitive position as measured by deposits was overstated.[20]

A single application accounted for each of the three remaining instances of deposit runoff cited as a mitigating factor. The applicant had acquired all of its offices in the three markets by acquiring failed or failing thrifts from the Resolution Trust Corporation (RTC). Since these acquisitions, the applicant had experienced significant deposit runoff that other competitors in these markets had not been subject to. The Board concluded that the latest branch-level deposit data available overstated the competitive influence of the applicant in these markets.[21]

Total Deposits Incorrect. Total deposits may not be a perfect measure of competitive influence. Recognizing that fact the Board has, in two merger applications, stated that the deposits of individuals, partnerships, and corporations (IPC deposits) can be the better measure to use when calculating market concentration.[22] The Board's position is that "IPC deposits may be the proper focus of the competitive analysis in mergers and acquisitions in markets, such as those including state capitals, in which government deposits constitute a relatively large share of total deposits."[23] Because government deposits are often short-term (monies from tax collections) or must be invested in lower-yielding, relatively safe assets, they can inflate total deposit figures and be misleading.

In a third merger decision, the Board found that commercial banks in the relevant market had a substantial portion of their deposits in amounts greater than $100,000 that were predominantly short-term in nature. The applicant was cited as having almost 50 percent of its deposits in such accounts. The Board stated that these types of deposits "do not serve as a base for significant lending by banks in this market, and tend to overstate the competitive influence of banks in the market."[24] As above, the Board's conclusion was that total deposits were not the best measure of competition within this market.

Passive Investment. The Board has also cited the fact that in three applications the acquirer was investing passively in a bank and was not seeking control of the institution.[25] Thus, the structural changes as reflected in the HHI overstated the transaction's actual effects on competition. The Board noted that if these proposals had involved acquiring control of the bank, competition most likely would have been substantially diminished in the relevant markets. Relying on commitments that applicants would not seek to influence the bank's independent activities, the Board concluded that control of the bank would not be acquired by the applicant.

The Board pointed out, however, that one company did not need to acquire control of another to reduce competition between them. Partial ownership could dilute independence of action and encourage collusive activities. In approving the applications, therefore, the Board also noted that there would be no director interlocks among applicants and banks and that stock ownership was meant strictly as a passive investment. In two of the applications, the Board also pointed out that the bank was under the firm and active management of a family that collectively owned more than 50 percent of the outstanding stock, the implication being that the applicant's likely influence over the bank's actions would be limited.

Limited Competition. In some cases competition between an applicant and a target bank was already limited by their having common principals or ownership. Thus, the amount of competition actually eliminated would have been less than the HHI indicated. The Board noted in one application that the applicant's principals had formed the target bank de novo (as a newly chartered bank) in 1965 and that the applicant's shareholders already owned 77 percent of the bank.[26] In a

second application, a principal of the applicant was also a management official of the target bank.[27] In another application, it was noted that brothers owned both the applicant and the bank. Each owned stock in the other's institution in addition to having numerous other business relationships.[28] In all of these cases, the Board approved the merger.

Potential Competition

In this category the Board cited likelihood of new entry into the relevant market and expected de novo entry as mitigating factors. The expectation was that future competitors could at least partially offset any current anticompetitive effects of a proposed merger.

Likelihood of Entry. In line with market theory, the Board has tried to assess the likelihood of new entry and its effect on competition within the market of a proposed merger. The relaxation of legal barriers to entry in a large number of states in recent years has significantly increased the pool of potential entrants into most banking markets. Recent empirical evidence supports the hypothesis that an increase in laws permitting interstate banking and statewide branching has made potential competition a more important factor in banking markets (see Dean F. Amel and J. Nellie Liang 1991). Correspondingly, the Board has cited the likelihood of new entry as a mitigating factor much more frequently in recent years. Twenty-seven of the thirty-four occasions in which potential new entry was cited as a mitigating factor occurred after July 1987, with eleven occurring in 1992.

If a market is considered attractive for entry and has few or no legal barriers (restricting branching or prohibiting entry by out-of-state bank holding companies), then new entry can be expected to lessen the possible anticompetitive effects of a merger. The Board reasons that if a bank (or banks) within a market implements noncompetitive pricing and earns greater-than-normal profits, other firms could be expected to enter the market to capture some of this excess profit, forcing more intramarket competition and a return to competitive pricing. A market is attractive for entry if (1) it can easily support a new bank or banks, (2) there are banks that are likely to expand quickly into the market, and (3) the market has certain characteristics associated with market attractiveness.

The Board delineated several characteristics that add to a market's attractiveness—large market size, urban location, rapid population and deposit growth, a relatively high ratio of population per bank or banking office, and a relatively high ratio of deposits per bank or banking office (with high ratios tending to indicate that the market is underbanked or that the population and deposits are enough to support new entrants). Higher-than-average per capita income indicates that a market is attractive as does recent de novo entry into the market. Rapid growth is especially important, making it easier for entrants to attract an adequate customer base.

In the extreme case of an unattractive, declining market, a case can be made that an institution's exit from the market is a necessary adjustment because the market can no longer support the existing number of independent institutions. This factor is generally cited when the bank is in danger of failing. In addition, declining markets are often unattractive for expansion by out-of-market firms so that an in-market merger may be the only means of preventing a bank's failure.

Empirical evidence supports considering the likelihood of entry as a mitigating factor in merger decisions. Studies have developed a fairly consistent set of variables that are positively related to the entry of firms into banking markets, either by acquisition—the more common means—or de novo. These variables include market size, market concentration, profitability, rate of growth, and the number of customers per bank, all of which have been cited by the Board. In addition, urban markets have been found to be significantly more likely to experience entry than rural markets (see Amel 1989).

A high likelihood of entry because of a market's attractiveness was cited as a mitigating factor in applications involving twenty-one markets over the sample period; twelve markets were determined to be unattractive or declining. Legal issues affecting entry played a role in nine markets, and statewide branching or permissible interstate mergers and acquisitions were cited as mitigating factors in eight of those. In one market there were legal barriers preventing branching or interstate mergers or acquisitions, and this factor weighed against approval of the proposed merger.

Expected De Novo Entry. The Board cited the expected de novo entry of a new competitor as a factor that mitigated any potentially anticompetitive effects in one market.[29] No further explanation of the use of this factor was given. It seems obvious, however, that the Board expected the new entrant to provide enough competition to offset at least partially any anticompetitive effects of the merger.

Convenience and Needs Considerations

Section 3(c) of the Bank Holding Company Act (1956) specifies that in supervising bank mergers and acquisitions federal agencies must consider the convenience and needs of the community to be served. If a merger would result in a favorable impact on the convenience and needs of the community, that consideration may outweigh concerns about anticompetitive effects. In Board decisions, two factors fall into this category: the target firm's financial health and the lack of a less-anticompetitive solution.

Financial Health of the Target Firm. The Board cited the financial health of the target firm as a mitigating factor in a total of thirty markets. In eight of these markets, the Board was relatively certain that the bank would fail. The decision indicated that serving the convenience and needs of the community outweighed the anticompetitive effects of allowing the merger. Specific public benefits cited included uninterrupted banking service, continued operation of conveniently located offices, and maintaining employment within the community.

In the remaining twenty-two markets, the Board concluded that the bank had proven to be a weak competitor with a possibility of failing in the future and that this fact lent some weight toward approval. Citing a particular bank as a weak competitor is based on the hypothesis that deposit-share data probably overstate the firm's competitive influence in its market and thus misrepresent the anticipated anticompetitive effects of the merger. The Board cited several factors it considered in reaching its conclusion: regulatory exam results, deteriorating capital levels, past and projected earnings records, declining market share, a low loan-to-deposit ratio, small bank size, and the failure to offer the full range of banking services. Often, the failure of a weak bank to provide a full range of services to its customers is addressed in an acquiring institution's application, with the acquirer promising to improve the range and quality of the services provided to the community.

No Less-Anticompetitive Solution. Another issue considered in such cases is whether a failing bank has potential buyers other than the anticompetitive applicant. The presence of bidders promising less-anticompetitive effects who could also satisfy the convenience and needs considerations of the community is likely to weigh against approval of the merger. On the other hand, the lack of other potential acquirers tends to weigh heavily toward approval of the merger.

In two cases involving acquisition of either a failing bank or one that was a very weak competitor unlikely to survive on its own, the Board recognized that the merger would have some negative effects on competition but cited as a mitigating factor the absence of a better solution. In these markets, the target bank was either offered to or had attracted some interest from investors outside the market or institutions other than the applicant. However, in both applications only the applicant actually agreed to purchase the bank.[30] In a third application, the Board cited the FDIC's conclusion that no less-anticompetitive solution was available.[31]

Procompetitive Effects on a Market

The Board has indicated that factors enhancing competition within a market work in favor of a merger application's approval. Three mitigating factors of this sort have been cited: benefits to the acquiring bank, the market share of dominant firm(s), and an applicant's small size in the market.

Benefits to the Acquiring Bank. The benefits expected to accrue to an acquiring bank were cited in two applications as a mitigating factor supporting approval of the application. In the four markets affected, the regional economy encompassing both the acquirer and the target was suffering an economic downturn, reflected in the operating results of the institutions involved. The Board concluded that the cost savings resulting from the merger would better position the applicants to survive this downturn.[32]

A third application citing benefits to the applicant as a mitigating factor involved an opinion by the Board that the applicant's management could gain financial and operating efficiencies through elimination of duplicate boards of directors and through the pooling of capital accounts, thus positioning itself to be a stronger competitor in the future.[33] In a fourth application, the Board concluded that because both the applicant and the target bank were small in absolute size, they might derive some economies of scale from consolidation.[34] In the final application involving this mitigating factor, the Board found that the acquisition would not disturb the competitive balance within the market, noting that after the merger five of the remaining seven institutions would have market shares greater than 10 percent. The Board concluded that the merger would result in a viable, but not dominant, competitor.[35]

Market Share of Dominant Firm(s). If a high HHI for a market was caused exclusively by the large market

share of one or two firms, this factor worked in favor of mergers that involved other institutions in the market and against approval for transactions involving the dominant firm(s).[36] The implication is that the Board is more willing to approve mergers that result in a market of more nearly equal-sized competitors, thereby reducing the market power of the dominant firm(s).[37]

Applicant's Small Size in the Market. In one application the Board cited the relatively small size of an applicant as a mitigating factor, noting that the applicant had not increased its market share in recent years despite a significant increase in the market's deposits generally.[38] The Board also pointed out that the merger would result in only a modest increase in market concentration relative to the market's overall competitive structure. (The change in the HHI would be 265 points, which would not greatly exceed the applicable guidelines.) While the Board did not express its reasoning, one possible explanation for its decision is that the acquisition presumably would enable the acquirer to become a more effective competitor in the market. The underlying assumption would be that more evenly sized banks would increase competition within a market.

Denials

During the past decade, the Board has denied five applications for which competitive issues were a factor in proposed state member bank and bank holding company acquisitions of another bank or bank holding company.[39] Those applications would have involved the structural changes depicted in Table 3.

Several mitigating factors were considered in these five denials, but they were not seen as overcoming the significantly adverse effects of these proposals. (Citing competitive issues, the Board has also recently denied two bank holding company applications in which those institutions were trying to acquire thrifts. For a discussion of these two denials see the box on page 41).

In all five bank acquisition denials the Board considered competition from thrifts. Including thrifts at 100 percent weight produced the structural changes shown in columns 5 and 6 of Table 3. Even after including thrifts at 100 percent weight, each merger exceeded guidelines. In addition, the Board noted in three of the cases—Pikeville National, Saver's Bancorp, and Sunwest—that the facts of the cases did not warrant 100 percent thrift inclusion.

The Board noted in three of the applications (Pennbancorp, Pikeville National, and Saver's Bancorp) that the acquirer proposed to expand the services currently being provided by the target bank. While these improvements in services apparently lent some weight toward approval, they were not enough to outweigh the potential adverse effects on competition.

The Board noted several factors working against approval of the mergers. In one denial, Pikeville National, the Board noted that significant legal barriers to entry in the market made it unlikely that new competition would mitigate the anticompetitive effects of the transaction. In another case, Saver's Bancorp, the number of competitors in the market was limited, and the Board noted that consummation of the proposal would further reduce that number. The Board also considered financial and managerial factors in the Saver's Bancorp application. Although the bank to be acquired had

Table 3
Merger Applications Denied on the Basis of Competitive Issues during the Last Decade

Applicant	Date	Postmerger HHI	Change in HHI	Postmerger HHI (Thrifts at 100%)	Change in HHI (Thrifts at 100%)
Pennbancorp	1983	3,058	741	2,024	435
Dacotah BHC	1984	2,251	526	2,016	461
Pikeville National	1985	2,573	526	2,405	490
Saver's Bancorp	1985	5,338	658	3,481	287
Sunwest (Market #1)	1987	3,738	868	1,915	388
(Market #2)	1987	5,092	752	3,642*	513

** Thrift weighting in this market is only 50 percent. The structural numbers with 100 percent thrift inclusion were not given by the Federal Reserve Board of Governors for this market.*

Thrift Acquisition Denials

In addition to denying five bank mergers for competitive reasons since November 1982, the Board has recently denied two acquisitions of thrifts by bank holding companies. The first, an application from Norwest Corporation, was denied on April 3, 1992.[1] It involved a change in the HHI, with thrifts accorded half weight, of 565 points, to a postmerger level of 2,727. (The deposits of the thrift being acquired are accorded 100 percent weight in the calculation of the postmerger HHI.) The Board noted four decisive factors: (1) market structure, (2) potential competition, (3) financial health of the target firm, and (4) competition from credit unions. In this case, the structure of the market weighed against approval. Norwest controlled more than twice the share of the market's second-largest competitor. In addition, after consummation, Norwest would control twenty of the forty-eight branches in the market, with only one other depository institution controlling more than three branches. The Board also noted that most of the remaining depository institutions were small.

The Board also found that the market was unattractive for entry and that the merger's negative effects on competition were unlikely to be offset by new entry. The market's small size, the fact that it had not experienced a high growth rate, and the fact that no new competitors had entered the market during the previous five years were all noted by the Board in reaching its conclusion. The Board found that, owing to the financial condition of the thrift, there were public benefits to the merger, but these benefits did not clearly outweigh the likely adverse effects on competition. It also noted that the RTC had received qualified bids from prospective purchasers that did not have a significant presence in the market. In addition, although the Board considered Norwest's argument that the measures of market share did not adequately take into account competition from credit unions in the market and overstated the competitive effects of the merger, this point was not addressed in detail. The Board's decision makes it clear that this factor did not overcome the likely anticompetitive effects of the proposal.

The Board also denied an application from SouthTrust Corporation to acquire a thrift institution on July 9, 1992.[2] The proposed acquisition would have produced a change in the HHI of 672 points, to a postmerger level of 2,488, with thrifts given 50 percent weight (again, in the postmerger HHI the target thrift was accorded a 100 percent weight). Several competitive factors were important in the decision: (1) the structure of the market, (2) potential competition, (3) SouthTrust's contention that the structural numbers overstated the anticompetitive effects because the thrift did not compete with SouthTrust in several banking product lines, and (4) convenience and needs considerations.

SouthTrust contended that the large number of competitors remaining mitigated the potential anticompetitive effects of the proposed merger. However, the Board concluded that other structural factors weighed against approval. These included the fact that upon consummation SouthTrust would become the market's largest competitor with a market share more than 50 percent greater than the second-largest competitor. In addition, SouthTrust would control eight of the market's twenty-two depository institution offices with only one other firm controlling more than two offices. Most of the remaining eleven institutions would be small ones, with seven of them having market shares of less than 5 percent.

SouthTrust also suggested that recent entry made the market attractive to potential competitors. However, the Board disagreed, noting that the market was rural, small, and poor by Florida norms and had experienced slow population growth and deposit growth below the state average for rural counties. In addition, population and deposits per bank and banking office were below comparable rural markets in Florida. The Board also stated that while there had been several indirect acquisitions of branch offices in the market, there had been no de novo entry since before 1987.

SouthTrust contended that the thrift was not a competitor in several product lines, including commercial lending. SouthTrust's approach differed, however, from the traditional concept of a cluster of banking products, and the Board reaffirmed its position that the cluster concept introduced by the Supreme Court in the Philadelphia National Bank case is still the appropriate framework for analyzing the competitive effects of bank mergers.[3]

The Board also noted that potential convenience and needs benefits to the community to be served did not outweigh the expected anticompetitive effects of the proposed acquisition. The decision pointed out that the thrift was in satisfactory financial condition and was an important provider of services in the market, having, for example, an important role as a lender in the market for one-to-four-unit residential mortgages .

Notes

1. "Letter to Norwest Corporation, April 3, 1992," *Federal Reserve Bulletin* 78 (1992): 452.
2. "SouthTrust Corporation," *Federal Reserve Bulletin* 78 (1992): 710.
3. U.S. v. Philadelphia National Bank, 374 U.S. 321 (1963).

previously suffered losses, it had improved markedly over the last few years, and the Board concluded that its prospects were favorable and that it had demonstrated its ability to remain an effective competitor.

In the first market in the Sunwest application, the Board acknowledged Sunwest's claim that various nonbank financial institutions existed in the market but concluded that the record did not clarify the extent to which other institutions competed with banks in the market. The Board noted that it would be "willing to consider any additional facts or information that Applicant may be able to submit regarding this issue."[40] In the second market involved in this application, the Board disagreed with Sunwest that the market was declining and therefore that its decline mitigated the anticompetitive effects within the market.

Each of the above denials involved some question about the correct definition of the relevant geographic market affected by the transaction, and the applicants disagreed with their Reserve Bank's market definitions. The Board noted in detail the points considered in deriving the market definitions used by the Fed in each of the above applications.

Conclusion

The Federal Reserve analyzes the competitive effects of bank mergers in a two-stage process. First, the Fed conducts an initial screening, based largely on the Department of Justice's 1982 merger guidelines, to identify the proposed mergers that may threaten competition. Then, if a proposed merger seems to involve potential competitive issues, the Board and the Reserve Banks conduct an in-depth analysis to determine what the merger's actual effects on competition would be. The Fed's analysis over the last decade cites several factors that can mitigate a merger's potentially harmful effects on competition as indicated by the HHI.

The deregulation and innovations of nonbank financial institutions—especially thrifts—in recent years have allowed many firms to compete more directly with banks in providing financial services. The Fed now generally gives thrifts an automatic weighting of 50 percent when considering potential competitive effects from bank mergers. In addition, the removal of many legal restrictions on statewide branching and out-of-state acquisitions has decreased the anticompetitive effects of mergers in many markets by substantially increasing the likelihood of new entry. The current financial health and competitiveness of the target firm, partial divestitures, and any procompetitive effects on the market were also considered by the Board as important factors mitigating the potential anticompetitive effects of some mergers.

Most bank merger applications that fail the Fed's initial screening for potential anticompetitive effects are eventually approved by the Board. While the Fed has denied only five applications for reasons related to competition over the last decade (plus two denials of thrift institution acquisitions in 1992), antitrust considerations still play an important role in the industry's approach to consolidation. The Fed's consistent use of its guidelines in antitrust enforcement has lead to self-screening on the part of potential acquirers who can proceed with relative certainty about the Fed's reaction to a specific merger proposal. Many proposals are initially structured to include divestiture that addresses likely antitrust concerns, and an unknown number of banks are deterred from even attempting certain acquisitions. The Fed has shown that it examines transactions on a case-by-case basis and is willing to give consideration to mitigating factors unique to specific markets.

Notes

1. Throughout this article the terms merger and acquisition are used synonymously.
2. The Federal Reserve has primary jurisdiction over mergers of state member banks and mergers and acquisitions by bank holding companies. The OCC has primary responsibility for national banks, and the FDIC oversees insured state nonmember banks. In addition, Section 18(c) of the Federal Deposit Insurance Act provides that "before acting on any application for approval of a merger transaction, the responsible agency . . . shall request reports on the competitive factors involved from the Attorney General and the other two banking agencies." Once a merger or acquisition has been approved by the appropriate federal banking agency, the DOJ, by law, has thirty days in which to file suit if it feels the transaction would violate antitrust statutes. If the DOJ does file suit, the merger is automatically stopped pending resolution of legal action.
3. Applications for mergers that seem to involve no issues of competitiveness are "delegated" to the appropriate Federal Reserve Banks for handling. If a particular transaction has potentially significant issues (competitive, legal, financial, and so forth) it is subject to extensive Board review. Au-

thority to deny an application rests solely with the Board. The criteria used to determine whether an application is delegated (processed by the Reserve Banks) or nondelegated (processed by the Board) is given in the Fed's "Rules Regarding Delegation of Authority." See Holder (1993).

4. November 19, 1982, is the date the Board first referred to the 1982 DOJ merger guidelines and the Herfindahl-Hirschman Index (HHI). See "First Bancorp of New Hampshire, Inc.," *Federal Reserve Bulletin* 78 (1982): 769. The Board's actions on applications discussed in this article that potentially posed significant competitive issues are available in the *Federal Reserve Bulletin*.
5. U.S. Department of Justice Merger Guidelines, June 14, 1982.
6. Bank-specific antitrust guidelines differed in these three subperiods. See Holder (1993, 31, 33).
7. Divestiture is considered by the federal agencies as an acceptable means of reducing potential anticompetitive effects of a proposed merger (see Holder 1993).
8. For a previous treatment of the use of mitigating factors by the Board, see Loeys (1985).
9. Academic research generally supports the inclusion of thrifts as competitors of commercial banks. See Burke, Rhoades, and Wolken (1987) and Watro (1983).
10. In eleven of these markets the Board gave thrifts 100 percent weight; in seventy-two markets, 50 percent weight; in two markets, 25 percent weight; and in one market, 15 percent weight. A thrift weighting was not specified in the remaining twelve markets.
11. In thirteen of these markets the Board gave thrifts 100 percent weight, and in two markets, 75 percent weight.
12. The Board usually cited this factor in a simple statement saying that despite elimination of a competitor, numerous banking alternatives would remain in the market.
13. In applications involving divestitures to an out-of-market competitor, the Board cited as a mitigating factor the fact that the number of independent competitors within the market would remain the same after the merger. Because the number of competitors within a market is already reflected in weighting in the calculation of the market HHI, it is not clear why the Board has considered this factor as mitigating the anticompetitive effects indicated by the market's structural numbers.
14. In 103 of the 107 applications in which the presence of numerous remaining competitors was used as a mitigating factor, other mitigating factors were also cited in the Board's decision. Only four applications that exceeded guidelines were approved with numerous remaining competitors cited as the sole mitigating factor. In each of these cases the postmerger HHI and the change in HHI did not greatly exceed applicable guidelines:

Year	Change in HHI	Postmerger HHI
1983	149	1,138
1985	101	1,474
1987	212	2,220
1987	269	1,930

See "1st Source Bank," *Federal Reserve Bulletin* 69 (1983): 311; "The Marine Corporation," *Federal Reserve Bulletin* 71 (1985): 262; "Houghton Financial, Inc.," *Federal Reserve Bulletin* 73 (1987): 870; and "U.S. Bancorp," *Federal Reserve Bulletin* 73 (1987): 941.

15. This mitigating factor is similar to one cited by the OCC in a November 1984 merger decision. In this transaction, the OCC argued that market shares understate the competitive influence of firms that are in the market but have most of their resources elsewhere, and "these market shares would not reflect the capacity of such firms to divert resources from the external market in response to an attempt to exercise market power in the relevant market." "Decision of the Comptroller of the Currency on the Application to merger Farmers Community Bank, State College, Pennsylvania, into Peoples National Bank of Central Pennsylvania, State College, Pennsylvania," November 5, 1984, Press Release. This argument is sometimes referred to as the "deep pockets" hypothesis.
16. "AmSouth Bancorporation," *Federal Reserve Bulletin* 73 (1987): 351; "Sunwest Financial Services, Inc.," *Federal Reserve Bulletin* 73 (1987): 463; "Hartford National Corporation," *Federal Reserve Bulletin* 73 (1987): 720; "First Union Corporation," *Federal Reserve Bulletin* 76 (1990): 83; "WM Bancorp," *Federal Reserve Bulletin* 76 (1990): 788; "BanPonce Corporation," *Federal Reserve Bulletin* 77 (1991): 43; "First Hawaiian, Inc.," *Federal Reserve Bulletin* 77 (1991): 52; and "Laredo National Bancshares, Inc.," *Federal Reserve Bulletin* 78 (1992): 139.
17. "AmSouth Bancorporation," *Federal Reserve Bulletin* 73 (1987): 351; "Sunwest Financial Services, Inc.," *Federal Reserve Bulletin* 73 (1987) 463; "Hartford National Corporation," *Federal Reserve Bulletin* 73 (1987): 720; "First Union Corporation," *Federal Reserve Bulletin* 76 (1990): 83; "WM Bancorp," *Federal Reserve Bulletin* 76 (1990): 788; "First Hawaiian, Inc.," *Federal Reserve Bulletin* 77 (1991): 52.
18. "Laredo National Bancshares, Inc.," *Federal Reserve Bulletin* 78 (1992): 139; and "BanPonce Corporation," *Federal Reserve Bulletin* 77 (1991): 43, respectively.
19. "Hartford National Corporation," *Federal Reserve Bulletin* 73 (1987): 720; and "Laredo National Bancshares, Inc.," *Federal Reserve Bulletin* 78 (1992): 139.
20. "First Tennessee National Corporation," *Federal Reserve Bulletin* 69 (1983): 298.
21. "BankAmerica Corporation," *Federal Reserve Bulletin* 78 (1992): 338.
22. "Norstar Bancorp, Inc.," *Federal Reserve Bulletin* 70 (1984): 164; and "Valley Bank of Nevada," *Federal Reserve Bulletin* 74 (1988): 67.
23. "United Bank Corporation of New York," *Federal Reserve Bulletin* 66 (1980): 61.
24. "Laredo National Bancshares, Inc.," *Federal Reserve Bulletin* 78 (1992): 139.
25. "Sun Banks, Inc.," *Federal Reserve Bulletin* 71 (1985): 243; "First State Corporation," *Federal Reserve Bulletin* 76 (1990): 376; and "SunTrust Banks, Inc.," *Federal Reserve Bulletin* 76 (1990): 542. The percentage ownerships involved in the three applications were 15 percent, 24.9 percent, and 24.99 percent, respectively.
26. "Central Wisconsin Bankshares, Inc.," *Federal Reserve Bulletin* 71 (1985): 895.

27. "Fairfax Bancshares, Inc.," *Federal Reserve Bulletin* 73 (1987): 923.
28. "Lisco State Company," *Federal Reserve Bulletin* 76 (1990): 31.
29. "Centura Banks, Inc.," *Federal Reserve Bulletin* 76 (1990): 869.
30. "Van Buren Bancorporation," *Federal Reserve Bulletin* 69 (1983): 811; and "First National Bankshares of Sheridan," *Federal Reserve Bulletin* 70 (1984): 832.
31. "Indiana Bancorp," *Federal Reserve Bulletin* 69 (1983): 913.
32. "RepublicBank Corporation," *Federal Reserve Bulletin* 73 (1987): 510; and "Alaska Mutual Bancorporation," *Federal Reserve Bulletin* 73 (1987): 921. In addition to a proposal by the applicant to raise additional capital in the Alaska Mutual Bancorporation transaction, the FDIC agreed to make a significant capital contribution to the applicant.
33. "F.S.B., Inc.," *Federal Reserve Bulletin* 78 (1992): 550.
34. "Fairfax Bancshares, Inc.," *Federal Reserve Bulletin* 73 (1987): 923. In drawing this conclusion, the Board relied on a body of empirical work indicating that there are economies of scale in banking. Academic research suggests that banks have a U-shaped cost curve that implies some scale economies. However, the scale-efficient bank size is disputed (see Bauer, Berger, and Humphrey 1992; Evanoff and Israilevich 1991; Humphrey 1990; Hunter, Timme, and Yang 1990; and Ferrier and Lovell 1990). In addition, the efficiency gains are usually small (see Berger and Humphrey 1991). Similar results have been found for thrifts (see Mester 1987).
35. "Old Kent Financial Corporation," *Federal Reserve Bulletin* 69 (1983): 102.
36. "Community Bancshares, Inc.," *Federal Reserve Bulletin* 70 (1984): 770; "Norwest Corporation," *Federal Reserve Bulletin* 76 (1990): 873; and "CB&T Financial Corporation," *Federal Reserve Bulletin* 78 (1992): 704.
37. For an empirical analysis of the results of increasing the size of fringe firms in a market see Rhoades (1985b).
38. "AmSouth Bancorporation," *Federal Reserve Bulletin* 66 (1987): 351.
39. "Pennbancorp," *Federal Reserve Bulletin* 69 (1983): 548; "Dacotah Bank Holding Company," *Federal Reserve Bulletin* 70 (1984): 347; "Pikeville National Corporation," *Federal Reserve Bulletin* 71 (1985): 240; "Saver's Bancorp, Inc.," *Federal Reserve Bulletin* 71 (1985): 579; and "Sunwest Financial Services, Inc.," *Federal Reserve Bulletin* 73 (1987): 463.
40. "Sunwest Financial Services, Inc.," *Federal Reserve Bulletin* 73 (1987): 463.

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