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Protecting the Public Interest in Bank Mergers

Remarks of George W. Mitchell

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Because of the vital nature of banking services to the community, every kind of change in banking structure is deemed to affect the public interest, and, accordingly, is subject to regulatory constraint. The sharpest edge of public concern, however, focuses on merger proposals, for they are deemed the most susceptible to being used by bankers to obtain an extra degree of market power--or a dominant place in the market--to the disadvantage of the general public interest in having reasonably competitive markets.

To bankers in Pennsylvania, mergers are not an academic subject. In the last three years, Pennsylvania has ranked first among all the States in the nation in the number of bank mergers consummated. Its 92 mergers over this period are nearly twice the total for New York, the next most active State. It is in the center of a beehive of merger activity that extends from Maine to South Carolina and west to Michigan, Ohio, and Indiana. This area accounts for over 80 per cent of recent consolidations. If you are a typical Pennsylvania banker, you are about 4-1/2 times as likely to see your bank struck by merger lightning as is your counterpart elsewhere in the country. In these circumstances, I suspect a great many of you share my interest in the task I have set for myself today: to explore some of the questions that need to be asked, and answered, about a bank merger to be sure it is not inimical to the public interest.

Public concern with bank mergers has been codified in the Bank Merger Act of 1960, which sets up what might be called an "obstacle course" for proposals to merge banks. Whether a proposal is successful or unsuccessful in traversing that course must be adjudged by one of the three Federal bank supervisory agencies--whichever one will have supervisory responsibility for the institution resulting from the merger.

The Banking Factors

The Bank Merger Act requires supervisory authorities to consider a set of seven factors in each merger case. The first five are called "banking factors." They cover such considerations as the financial history and condition, the adequacy of capital, the quality of management, and the earning prospects of the institutions involved. In a nutshell, the relevant supervisory agency is to judge whether the status of the surviving bank is strong enough to support a merger and if the position of the bank to be merged is so weak as to impel one. Since banks involved in mergers usually are operating institutions and have a record of performance, ample information on these banking factors is usually already in the hands of the supervisory authorities in the form of statistical, examination and field contact reports. Weighing the balance of evidence still requires a judgment on which reasonable men can differ, but I think the supervisors can hardly plead a need for more facts and guidance in making judgments on the five banking factors.

The other two factors that supervisors are required to consider under the Bank Merger Act, however, are quite a different matter, because they can involve knotty problems, both of information and analysis. The statute specifically refers to these factors as (1) "the convenience and needs of the community to be served" and (2) "the effect of the transaction upon competition, including any tendency toward monopoly."

Community Convenience and Needs

How does one go about judging whether the convenience and needs of the community will be benefitted by a change in banking ownership and management?

One simple technique is to compare the list of services presently offered with the list of those that the new management intends to offer. There are numerous occasions when a greater variety of services is clearly needed by a community, especially when the existing institution has fallen behind the trend in banking accommodations. But equally often an expanded list of specialized bank services will include several that are seldom, if ever, needed because of the modest economic scope of the community's activities.

The critical question, therefore, often becomes: how can one judge the actual breadth and intensity of community demands for various banking services, as distinct from the quantity and quality of services that the existing and proposed new combinations of banks intend supplying?

One possibility is to survey community opinion on the status quo, to find out how both business and household customers appraise the quantity and quality of the banking services available to them. Some investigation along these lines is nearly always made by the field offices of the supervisory authorities in considering a merger application.

It is quite a problem, however, to obtain a sample of community opinion that is unbiased, and informed as well. In particular, it is hard for bank customers to compare services they are accustomed to with those they have never had the opportunity to try out. Such survey results, therefore, should be supplemented by a more sophisticated appraisal. In this connection, the judgment of examiners with a broad experience in the qualitative and quantitative aspects of banking services is particularly helpful.

Another aspect of the impact of bank mergers upon the "convenience and needs of the community" concerns the contribution that banks make to economic growth and stability in their own communities. A bank that is investing heavily in out-of-state business loans, tax-exempt securities, or mortgages contributes less to its community than one that is playing an active role in satisfying the credit needs of local businessmen, farmers, consumers and governments. Clearly, so far as the community's convenience and needs are concerned, a merger involving the first bank would be far less objectionable from the public point of view than would a merger involving the second.

Bank loan and investment portfolios tell nearly all one needs to know about the degree to which the bank employs its resources locally. Data on local and non-local business loans made to trade, construction, manufacturing, or service concerns, and classified by size of borrower, reveal the extent of the bank's participation in the community's business life.

The mortgage and instalment paper portfolios, again sorted on a local and non-local basis, will indicate the bank's participation in consumer financing, particularly if account is taken of how active the bank has been in writing and servicing local mortgages or in generating consumer credit, compared to the extent to which it simply acts as a broker for these types of credit, or buys such paper from outside sources.

Some banks aid their communities by substantial participation in the short- and long-term financing of local governments, a fact that can be readily ascertained by an examination of their tax-exempt securities portfolio. In these ways--through surveys of community views, informed professional judgments, and a review of the record of bank participation in financing the community, its businesses and its citizens--reasonable bases for judgment can be established as to what the "convenience and needs" of the community are and how well the existing institutions have met them. Against this must be weighed the record and assurances of the merging bank as to what it can and will supply. The final balancing of these considerations remains a matter of judgment but, with evidence before them of the type I have outlined, supervisory authorities should be able to judge with a fair degree of assurance how well a proposed merger meets the "convenience and needs" test.

The Competitive Factor

Now we come to the hardest criterion of all to apply--the effect of the proposed merger on competition. Of course, the competitive factor cannot be disassociated from consideration of "convenience and needs," inasmuch as the over-all objective is to provide the banking services desired by the customers on reasonable terms and at fair prices. Indeed, the most conclusive way of assuring that a community's convenience and needs will be met is by the maintenance of so many alternative banking choices that the resulting competition among them will give customers all the opportunity they could wish to move from one bank to another in order to obtain whatever mix of services they desire. But this is rarely a practical criterion: you know as well as I that there is a limit to the number of practicable banking alternatives that it is possible to make available to any given community.

However that may be, in dealing with a change in the status quo there is a basic presumption that any decrease in the number of independent banking units in a given market area will, of itself, decrease competition and increase the tendency toward monopoly. It is my own feeling that this presumption is too harsh a standard to apply without corroborating evidence. Such evidence is to be found in the extent of any unfilled needs of business and household customers in the market areas affected by the proposed merger. And it is to be found in an analysis of the markets involved in the merger--the alternative sources of banking services, the extent of market power exercised by the banks in these markets, and the role in these markets of the particular banks to be merged and the merging bank.

In evaluating the market impact of a proposed merger, several sources of information can be drawn upon: the periodic examination reports, which provide considerable information on the performance of the banks in their market areas; regularly available economic data; the information supplied by the applicants in their merger applications; and supplemental on-the-spot studies of banking services and needs by field staffs of the regulatory agencies.

One of the first tasks in preparing to evaluate the competitive factor is to develop a reasonably accurate outline of the areas that the merger candidates serve. The approximate boundaries of the service area of each bank are needed in order to identify the markets that could be affected by the merger, and to discover any overlap in the respective service areas.

At present, the primary service area of a bank is usually defined as the geographic area from which the bank derives 75 per cent of its demand and time deposits held by individuals, partnerships and corporations. In my judgment, this definition is deficient in two respects. First, it is based on the assumption that a bank has only one service area. Banks, however, provide a variety of loan and deposit services, each of which is likely to have its own market area--and these areas may vary widely. Secondly, the 75 per cent rule, as a rule of thumb, is probably not as indicative as the banker's own subjective estimate of his market areas, expressed in terms of the areas within which he actively competes with other institutions.

The relevant service areas can be defined more sharply by enumerating each of the major markets in which commercial banks compete. As lenders they compete with each other and other financial intermediaries or with capital markets in extensions of credit to business (large and small), to consumers, and to governments (Federal, State, and local). It is quite evident that in many of these markets the merging of any but the very largest banks is unlikely to have significant anti-competitive effects. Non-bank and non-local-bank competition are major factors insuring competitive performance in the Government securities market, in lending to large businesses, and in the market for tax-exempt State and local bonds. Non-bank competition is typically vigorous in the consumer credit markets, where hard goods suppliers have their own sources of credit independent of local banks. The same is true of mortgage markets, where other specialized financial intermediares are dominant. In whatever markets banks face substantial non-bank or non-local-bank competition, the presumption is that the impact on competition of any bank mergers will be negligible.

What, then, are the markets in which competitive considerations must be weighed carefully? The most important single market is for demand deposit services to local business and individuals. These are services that can be provided only by a bank, and for most such customers only by a local bank. Another important local market is that for savings accounts; in this instance, however, other financial intermediaries usually offer a similar service. Lately some rate-conscious savers have escaped the orbit of local alternatives altogether and exported their savings to California.

The small business borrower is another bank customer that may suffer from the removal of an alternative source of bank credit by merger. Even though such borrowers can often obtain trade or supplier credit, the price may be high and the conditions confining. Small businessmen usually find their local banks to be their cheapest, most accessible, and most flexible source of external financing.

In considering the definition of the service area of the bank, then, particular attention should be paid to the potential service areas for small business borrowers and individual and small business depositors; these are the markets most likely to be significantly affected one way or the other by merger.

When chief concern about the possible competitive impact of bank mergers is narrowed down to these two market sectors, a great many merger proposals can be said not to raise the competitive issue at all. This is because the banks involved have little or no overlap in their service areas for small business and personal customers. Such is the case when the major objective of the acquiring bank is to extend its activities into another geographical market or into another service field. For example, in Virginia, a State where there has been a great deal of merger activity in the past three years (47), the preponderance of cases have involved the extension of service areas for banking institutions that are, under a recent State statute, becoming state-wide in their operation. The competitive effect in these cases is not that of the withdrawal of an alternative source of banking service, but typically the substitution of a branch of a larger institution for a community bank.

It is sometimes said or implied that branches of large banks in small communities are unfair competition for local banks. But there are too many instances in which local banks have held their ground in growth and profitability to support a broad generalization along that line. As a practical matter, it may well be that the communities that are most blessed with banking facilities are those that possess a mixture of local banks and branches of larger institutions.

The Hard Core

What remains to be considered is the hard core of merger proposals--those that turn out, upon examination, to involve two or more banks with overlapping service areas for small business and individual customers. In such circumstances, consummation of the merger undeniably will eliminate one competing bank from the relevant markets. Authors of such merger proposals must expect to run into heavy weather on the supervisory front. The loss of one alternative for customers in choosing their banking connections in these market areas will weigh heavily with the supervisors, unless the number of actively competing banks is already large, or the bank to be acquired is so small or ineffective a competitor as not to create any appreciable gap in banking alternatives by its disappearance as an independent entity. Even in this latter instance, however, bank supervisory authorities must be alert to situations whereby an aggressive bank can achieve a position of dominance through a succession of mergers of small banks, no one of which adds materially to the market share of the acquiring bank. A review of the past mergers entered into by the acquiring bank should enable the authorities to detect and resist such encroachment.

There are a few extenuating circumstances that could lead supervisors to look with favor upon a merger of two banks competing in a common service area. For instance, if the acquired bank is one of the smaller banks in the area, and if one or two large banks already operate head offices or branches in the area, the merger might actually stimulate competition by introducing a new and lively competitive force. On the other hand, if the acquired and acquiring banks are among the larger banks serving the area, the merger might well serve to dampen competition by creating a dominant institution. There may be certain other market situations in which the merger of two apparent competitors could in practice serve to invigorate rather than reduce the actual competitive rivalry among the surviving institutions, with corresponding benefits to their customers; but such a possibility is sufficiently contrary to the most reasonable expectation to require the fullest kind of documentation in order to be given credence.

Decisions in these "hard core" cases demand the most careful appraisals of the shares of the relevant markets that have been captured by all the individual banks serving such markets and the presumed future effectiveness of these banks as competitors. Such appraisals need to rest on estimates of local loans and investments in each lender's portfolios, on the degree of satisfaction expressed by bank customers, and on the professional judgments of examiners regarding the degree of management aggressiveness. Much of this information can be obtained from published sources and from examination reports. Sample survey techniques can be utilized to elicit a fair representation of customer opinion. Occasionally these sources may need to be supplemented by a field investigation.

When all this evaluation is completed, however, the chances are that any merger proposals found to involve the joining of two vigorous bank competitors with overlapping local service areas are likely to have a high mortality rate. In this category of cases, we supervisors have to be expected to resolve doubts on the side of preserving competition.

A Summing Up

This brings me to the end of my description of the obstacle course, erected in the public interest, which each bank merger needs to run. It is difficult in spots; it may often be frustrating; but it is not unconquerable.

Those merger cases that hinge upon the banking factors present straightforward issues that ordinarily can be perceived and resolved with dispatch. Cases in which issues of convenience and need are involved pose tougher analytical problems, but the obtainable data and expert opinion are usually adequate to resolve the issues.

When the competitive issue is central to the decision, the resolution is more in doubt. A good many of these cases also turn out to be manageable given the data and analytical techniques that presently can be brought to bear upon them. But some merger applications will inevitably present situations too closely entwined with potential anti-competitive effects to pass muster, given the current state of our knowledge and understanding. These you must expect to have returned to you, marked Application Denied.