Antitrust and the Banking Revolution

Lee Loevinger

NEARLY EVERYONE AGREES that the U.S. banking system—bound up for decades in a regulatory scheme that is more the product of historical accident than intentional design—is now shaking off its old coils and emerging in a strikingly new and much more intensely competitive shape. Ironically, this transition to competition is being hampered by, of all things, antitrust—specifically, antitrust doctrines that may have made sense within recent memory but have not changed with the times.

Antitrust entered the banking scene in 1961, when the Department of Justice filed half a dozen antitrust suits against bank mergers. Before that, most experts had assumed that banks were exempt from the anti-merger provisions of the Clayton Act. As Justice saw it, however, bank mergers should be treated like those of other businesses. In 1963 the Supreme Court confounded the experts and agreed with Justice in the case *United States* v. *Philadelphia National Bank*. The principles laid down by the Court in that decision have set the tone for bank antitrust policy ever since.

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Justice Becomes the Fourth Banking Agency

For many years the regulation of banks has been divided among no less than three federal agencies. The Comptroller of the Currency controls all national banks, chartering new ones and supervising the existing ones. The Board of Governors of the Federal Reserve System supervises state banks that are members of that system and also supervises the operation of bank holding companies. The Federal Deposit Insurance Corporation (FDIC) supervises all state banks that are not members of the Federal Reserve System and that are covered by the federal insurance system. Less than 4 percent of all banks are state-chartered and not subject to regulation by any federal agency.

During the last fifteen years the Antitrust Division of the Department of Justice has increasingly acted as a fourth administrative regulator—without having the banking expertise of the other three. In the years since the *Philadelphia Bank* decision, the department has filed more than five dozen antitrust complaints challenging commercial bank mergers and acquisitions. Equally important, many proposed mergers were abandoned when Justice rendered an

adverse opinion on competition. By 1970 the department had reached absurd levels of prosecutorial zeal, seeking to prevent the attempted merger of two small banks in Phillipsburg, New Jersey, population 18,500. The two banks' combined assets totaled some $41 million, a far cry from the $1.8 billion involved in *Philadelphia Bank*, or the even larger sums involved in other bank merger cases before that. Nevertheless, the Supreme Court ruled in favor of the department's complaint. Two dissenting justices wondered: "With tigers still at large in our competitive jungle, why should the Department be taking aim at such small game?"

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Congress had moved to restrain antitrust enforcement shortly after the Philadelphia case when it passed the Bank Merger Act of 1966. That law provides, in substance, that bank mergers are to be judged, in the first instance, by the federal agency with regulatory authority over the surviving bank, that Justice will advise that agency as to the competitive effects of any proposed merger, and that Justice can bring an antitrust suit against a bank merger within thirty days after the responsible agency had approved the merger but not afterward. The law also provides that both the banking agencies and the courts are to judge bank mergers not only by conventional antitrust standards but also by considering the merger's probable effects on the convenience and needs of the bank's local community. This last provision effectively reversed the Court, because the Philadelphia bank had raised the local-needs line of defense—claiming that its proposed merger would serve the convenience of its customers—only to see that defense rejected by the Court:

> We are clear [said the Court] that a merger the effect of which "may be substantially to lessen competition" is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress when it enacted the amended [Clayton Act] §7. Congress determined to preserve our traditionally competitive economy. It therefore proscribed anticompetitive mergers, the benign and the malignant alike, fully aware, we must assume, that some price might have to be paid.

What Is the "Market" for Banking Services?

Because of the Bank Merger Act of 1966, banking has not experienced as much regulation by the Justice Department as have some other industries such as railroading and telephones. But another factor has encouraged the department's activism in the banking area, which is that the courts are clinging to an increasingly unrealistic view of what constitutes competition in banking services. The crux of an antitrust suit is determining competitive impact; a court will probably approve a merger if many strong competitors remain in the market to challenge the merged firm. But that means that courts must define what is the relevant market and which firms are competitors. The courts have been construing "competitor" narrowly to mean only conventional banking offices located within a given local area. When the anti-merger provisions of the Clayton Act are applied to such narrowly defined markets, many proposed acquisitions do not pass muster. In the *Philadelphia* case, the Court conceded in a footnote that "many other institutions are in the business of supplying credit, and so more or less in competition with commercial banks," but ap-

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parently attached no significance to this fact. Instead, it announced:

> Commercial banks are unique among financial institutions in that they alone are permitted by law to accept demand deposits. . . . Some commercial banking products or services are so distinctive that they are entirely free of effective competition from products or services of other financial institutions; the checking account is in this category. Others enjoy such cost advantages as to be insulated within a broad range from substitutes furnished by other institutions. . . . Finally, there are banking facilities which, although in terms of cost and price they are freely competitive with the facilities provided by other financial institutions, nevertheless enjoy a settled consumer preference, insulating them, to a marked degree, from competition; this seems to be the case with savings deposits.

In later cases, narrowly confining the "market" in question to commercial banking alone proved to be a significant factor in reaching the conclusion that proposed bank mergers were anticompetitive. In the Phillipsburg case, for example, the trial court considered competition between the merging banks and other financial institutions, such as savings and loan associations and finance companies. But the Supreme Court restricted the examination to the market for full-service banks. In a 1974 case involving Connecticut National Bank the Court took a similar approach, though it conceded that "at some stage in the development of savings banks it will be unrealistic to distinguish them from commercial banks for purposes of the Clayton Act. . . ."

The court's view on this question was probably an accurate reflection of the competitive situation in the 1960s and early 1970s, but things have changed radically since then. In 1980 Congress passed the Depository Institutions Deregulation Act, which provides for the progressive elimination by 1986 of controls on the interest banks can pay on deposits. The same year savings and loan associations were authorized to establish NOW (negotiable orders of withdrawal) accounts, which are, for all practical purposes, checking accounts. In 1982 the Garn–St. Germain Act was passed, which permits federal savings and loans and newly created "federal savings banks" to engage substantially in commercial lending.

Many other businesses are now also competing directly with banks. Securities firms, money market mutual funds, and credit unions offer the equivalent of checking accounts and savings accounts. The anomalous "non-bank banks," which are limited service banks established under a loophole in the banking statutes in order to cross jurisdictional lines, provide the same services as commercial banks except that each such institution must refrain from *either* making commercial loans or accepting demand deposits (checking accounts). Mortgage companies and personal and industrial loan companies have long made both personal and business loans.

The breakdown of institutional boundaries has led to a breakdown of geographic boundaries. Merrill Lynch customers nationwide can use that firm's Cash Management Account to make deposits, write checks, and in general carry on ordinary bank functions. Manufacturers Hanover boasts that it can deliver every financial service available on Wall Street from more than a thousand locations in forty-four states. Banking services are also being offered on a nationwide basis by firms without local offices, such as credit card companies.

As banking by mail has become common, banks from California to New York have begun to advertise their certificates of deposit in national publications. Even more significant is the competition fostered by new technologies. Automated teller machines are now sprouting in such locations as shopping centers and supermarkets, and ATM networks are forming that permit any participating machine to access accounts in any bank that is a member of the system. Thus a bank in one city can inexpensively obtain the equivalent of branch offices throughout the state. A few large institutions have begun to offer bank-at-home services to owners of personal computers that communicate with the bank's computers by telephone. Although not yet available in this country, systems are in operation abroad that provide similar service through ordinary touch-tone telephones.

These developments have provided depositors, savers, investors, and borrowers with a far greater range of choices and information than has ever been available to any but the most affluent. At the same time banks in small and

medium-sized cities have come under new and much more intense competition from larger banks and from other financial institutions in general. The premises of *Philadelphia Bank*—that checking accounts held by commercial banks "are entirely free of effective competition," that savings accounts are insulated from competition, and that commercial banking is a separate and distinctive market or line of commerce—seem like distant memories.

Bracing for Change

But courts have long memories. The new circumstances have not been presented to the Supreme Court in the last ten years, and lower courts, though expressing some disquiet at having to follow the *Philadelphia Bank* ruling, have so far not been persuaded to step out of line. However, two developments of late 1984 may be harbingers of change.

The State College Case. In November the Comptroller of the Currency approved a merger application by the third- and fifth-largest commercial banks in State College, Pennsylvania. Applying conventional antitrust analysis to the data submitted in the original application, Justice had earlier concluded that the local markets for both consumer and business banking were highly concentrated and that the proposed merger would increase concentration to an unacceptable level. Justice conveyed its view to the Comptroller, at which point the banks wisely decided to engage Washington counsel (my firm) to make a further market analysis.

After an extensive survey of the actual market, the banks filed a supplementary economic brief contending that savings and loans were competitive with commercial banks despite the line of court cases to the contrary; that nonbank financial institutions, such as mortgage companies, finance and loan companies, and large securities dealers, were in direct competition with the banks; that financial institutions that had no offices in the local market but that advertised for business in that area had a significant competitive influence on the market; and that in appraising the relative competitive strength of the competitors the total financial resources of the corporate complex of which each was a part should be considered. The brief provided factual information supporting each contention in voluminous detail.

These arguments seemed to convince the agencies. Justice investigated anew and decided that "mitigating circumstances" reduced the importance of the concentration-level and market-share indicators, and that the merger would not be significantly adverse to competition. The Comptroller's office then reanalyzed the competitive situation in somewhat more detail and came to the same conclusion—that the bank resulting from the State College merger would not have substantial market power. Its opinion cited the competitive influence of such firms as savings banks, stockbrokers, and out-of-town institutions that advertise in publications distributed within the area and that provide easy access through toll-free telephone numbers. Finally, the Comptroller accepted the proposition, approved in a different context by the Supreme Court in *Copperfield Corp.* v. *Independence Tube Corp.* (1984) that for antitrust purposes a corporate complex must be viewed as a single economic unit, so that the resources of the large parent corporations of the firms within the local market must be considered.

The Task Force Report. Further clues to the Reagan administration's direction on these matters came ten days later with the release of the final report of the Task Group on Regulation of Financial Services, a panel chaired by Vice President Bush and including the heads of relevant federal departments and agencies. The report, in the making since December 1982, was mostly a venture in good housekeeping, its main recommendations involving organizational and procedural changes that would simplify and tidy up what is described as "the caprice of historic forms of regulation." In some ways, the recommendations would ease the transition to competition. For instance, no federal supervisory agency would be required to approve the establishment of branch offices or the installation of ATMs that were permitted under state law. But on antitrust issues, the report capitulates to the Justice Department's old ambitions. The "convenience and needs of the community" consideration established by the Bank Merger Act would be repealed, and bank mergers would be resolved under ordinary antitrust standards. Moreover, all anticompetitive analysis would be performed by the Department of Justice,

with the banking agencies apparently having no voice.

The report's blueprint is something less than detailed and leaves much to be determined by the draftsmen of actual legislation. It also gives no sign that the task force considered a number of questions that the proposals raise. Is it really a good idea to forbid the department from giving any consideration to the convenience and needs of the community? If all competitive analysis must be performed by the Justice Department, are the banking agencies prohibited from considering competitive factors? If Justice is freed from the limitations of the Bank Merger Act, will banking be subjected to the same type of regulatory supervision by Justice Department lawyers as other industries?

This last question has crucial implications. The Justice Department's lawyers have a strong regulatory inclination that is manifested in the treatment of merger cases. When the Antitrust Division concludes that a proposed merger will lessen competition, it frequently negotiates with the parties to compel a restructuring of the firms involved before the merger may proceed. If the company agrees, it is subjected to a "consent decree" or legal order that requires it to meet specified conditions of divestiture or restructuring. The best-known recent example is Norfolk Southern's proposed acquisition of Conrail, which is being conditioned on the sale of certain routes and assets.

Justice's regulatory oversight is more heavy-handed in cases where businesses are found guilty of antitrust violations and placed under judicial decrees that require continuing supervision. The motion picture industry, for example, has operated for thirty-five years under the supervision of one federal judge in New York and one lawyer in the Justice Department. In such a situation the judge acts as if he were the administrator of a regulatory agency in charge of the industry, and the Justice Department's lawyers act as if they were his staff. A more recent example is the AT&T case, where all of the companies involved are subjected to a decree that in effect requires them to get permission from the antitrust staff and the court for any activity beyond the conduct of ordinary business transactions. Note also that the telephone industry, like the banking and railroad industries, is subject to separate regulation by another federal agency, the Federal Communications Commission, and that legal battles may be brewing between that agency and the court.

Despite the 1966 law, the department has already assumed an important regulatory role in the banking field. In recent years Justice has adopted a series of "guidelines" that delineate the circumstances in which it will initiate lawsuits, which in practice operate as regulations enforced by the sanction of burdensome and expensive litigation. Indeed, the department itself urges its own "guidelines" on the courts as standards for judicial decision. If the 1966 act is repealed, Justice will probably employ the same approach in banking.

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The Prospects

As the regulatory revolution proceeds, banking will continue to be closely regulated, but the distinctions between the different types of financial institutions will continue to erode, though not entirely disappear. Federal restrictions on interest rates and prices for banking services have been falling fast, and will end almost entirely within a few years. The geographical restrictions on depository institutions will keep on eroding as well. Although interstate banking is a hotly debated topic, de facto interstate banking is already here. Anyone in any state can open an account, make deposits and withdrawals, and conduct other business with a bank in some other state at the cost of only slight inconvenience and delay. Banks will continue to expand their functional and geographical service areas through branch offices, ATMs, new technologies, and other means.

No matter what the regulators or courts do, the total number of banks is likely to decrease in the next decade, by perhaps as much

as a third. It also seems certain that unless inhibited by regulation there will be an increase in the number of banking facilities, although not necessarily in the number of brick-and-mortar branch offices. Currently we have some 55,000 bank offices in the United States, of which some 40,000 are branch offices.

Undoubtedly all banks will increasingly employ the new techniques, for reasons of economy, efficiency, and customer convenience. An ATM is much more economical and efficient, and frequently more convenient, than a branch office. The problem is that only large financial institutions now have the resources to engage in such activities efficiently.

Compare Merrill Lynch's assets of $26 billion, Manufacturers Hanover's of $75 billion, or Citibank's of about $150 billion (Citibank is now offering a nationwide checking account like Merrill Lynch's) with the assets of America's thousands of small banks. Of the roughly 15,000 commercial banks in this country fewer than two dozen individual banks and only 256 bank holding companies have assets of more than $1 billion, and only one-third of that number have more than $10 billion. Yet the 1.8 percent of bank companies with assets of more than $1 billion hold over 60 percent of the total assets of all banks. Two-thirds of all commercial banks have assets of less than $50 million, which is not a large amount for a bank, and 84 percent have assets of less than $100 million.

The small and medium-sized banks will not be able to compete against the giants through internal growth alone. They lack the resources to extend their customer base to a national or even a wide regional base, as a few of the megabanks have already done. Their logical course is to merge with other small and medium-sized banks. Yet the courts have effectively foreclosed many such attempts. The megabanks can get along without mergers; they can expand through acquisitions of nonbank financial institutions and through banking by mail and wire. But if smaller banks are not permitted to merge into somewhat larger units to meet the megabank competition, many of them will simply wither and perish.

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One need not subscribe to the view that large size by itself is either culpable or dangerous (and I have inveighed against that position) to believe that inhibiting the ability of small and medium-sized banks to strengthen their positions by merger, while the megabanks and other large financial institutions are able to compete in every part of the country, threatens a drastic change in our banking system. Unfortunately, even if the Justice Department sees fit to allow the inevitable increase in small-bank mergers to take place, it will have more opportunities, occasions, and temptations than ever before to restructure banks by imposing conditions on mergers. If Justice follows strict antitrust principles and its recent regulatory practices, it will ultimately increase concentration and reduce consumer choice—all on behalf of a policy meant to promote competition.

Congress, the banking authorities, and the public have heretofore been convinced that the dispersed and somewhat fragmented banking system that has developed in this country is necessary to serve the large, diverse, complex, and vigorous American economy. In addition, Congress has been influenced by a consistent fear of concentration of wealth and economic power. The question facing us in the coming decade is whether the Department of Justice and the courts follow the position of the Phillipsburg case or that of the State College case. Under Phillipsburg principles the only surviving banks a decade from now may be those with a billion plus in assets. Under State College principles there will be many local and regional banks, larger and stronger than they are today but smaller and more diverse than the megabanks. The answer to that question will help determine whether the banks that survive the technological revolution now taking place will be only the national behemoths or whether the 84 percent of small banks and the 98 percent of small and medium-sized banks will be allowed to band together to offer a strong local alternative. ■