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Bank Mergers and the 1992 Merger Guidelines: The BankAmerica/Security Pacific Transaction

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I. Introduction

Bank mergers raise many important and challenging competition policy issues. These issues relate to all of the basic elements of merger review as delineated in the 1992 Agencies' Horizontal Merger Guidelines. Of course, even prior to the release of the Guidelines, the Department had an extensive experience with reviewing bank mergers. Nonetheless, the release of the 1992 Merger Guidelines offered a new impetus for re-assessment of the economic models that were used to examine the likely competitive effects of bank mergers.[2]

Both of us were especially concerned that even though the Division quite well understood that bank mergers could – in some cases – cause harm to consumers, these likely competitive effects were not clearly delineated or set out as an express analytical framework. We were concerned, for example, that the link between the reduction in the number of banks in relevant product and geographic markets and the enhanced risk of collusion required a fully spelled-out assessment of its relevance to bank mergers rather than a mechanical application of the standard paradigm. In particular, we wanted to better understand how, given the nature of the banking business, banks might be able to coordinate their diverse activities. The Guidelines also raised the possibility of (indeed gave much prominence to) the

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[2] The letter from the AAG James F. Rill to the Chairman of the Federal Reserve Board, Alan Greenspan, reporting on the likely competitive effects of the acquisition of First Interstate of Hawaii by First Hawaiian, dated October 5, 1990, provides first extensive discussion of the approach to bank mergers that was informed by the 1992 Merger Guidelines, which at that time were in the process of being revised under the energetic leadership of DAAG/Economics, Robert D. Willig.

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unilateral effects from mergers. A key question for our evaluation of bank mergers during this period was whether and how unilateral effects enter into the pertinent competitive assessment of bank mergers.

The release of the 1992 Merger Guidelines offered a convenient context for a re-examination of both the analytical process of market definition and the use of divestitures of bank branches and related assets as proper remedies for concerns about the likely competitive effects of specific mergers. With respect to product market definition in particular, merging parties had increasingly argued that 'fundamental changes' in banking markets, especially in the small business lending area, required similarly fundamental changes in the Division's approach to market definition. The 1992 Merger Guidelines provided particular insights into the role of sunk costs in assessing market participants as well as new insights into the types of evidence that could be used to define markets and the relevant participants.[3] With respect to divestitures, it seemed that branch divestitures had become somewhat "routinized", with merging parties proposing branches for divestiture often without much specific connection to the nature and types of divestitures that may have been needed to address specific concerns. Perhaps the expectation had been built up that the Division would want to extract a pound of flesh (or, at least receive a bone) before the deal would be allowed to go through.

All of these factors led us to conclude that although the Division had a well-worked out routine for examining bank mergers, the routine was ripe for review to ensure that it captured and effectively incorporated the fundamentals of competitive analysis in the context of bank mergers.

The timing of the development and release of the Guidelines coincided with a massive wave of major bank consolidations, precipitated in part by interstate banking legislation. The BankAmerica–Security Pacific bank merger, which was filed with the Division and the Federal Reserve Board for review, provided us with an important opportunity, if not need, to undertake the review of the Division's approach to bank mergers. Although the deal was notified – and cleared – before the Guidelines were officially issued on April 1, 1992, the analytical approach underlying the 1992 Guidelines was already familiar to the lawyers and economists on the Division's "Bank Merger SWAT Team".

This paper examines some of the competitive issues raised by the BankAmerica–Security Pacific transaction and places them in the broader context of bank merger review.

II. Bank Merger Review at the Division

It is commonly agreed that despite continuing bank consolidation, that the number of independent banks in the U.S. is high relative to other highly-developed market

[3] For example, specific thrifts were at times included or excluded from the relevant universe based on analysis of such issues.

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economies and is largely accounted for by historical and regulatory factors.[4] It is not surprising, therefore, that once certain regulatory restrictions on banks were eased with proposed new regulations on interstate banking and branching, bank mergers picked up significant pace. Responding to these changes, banks wanted to take advantage of available scale and scope economies.[5] The pace of bank mergers accelerated in two dimensions – the number of transactions and the relative size of transactions. The early 1990s witnessed some of the largest bank merger transactions in history, as measured by total assets, branches, and number of discrete cities and towns in which the merging parties operated. Not surprisingly, this trend has continued and accelerated in the last few years.

It is important to realize, however, that only a very small percentage of the many bank mergers that are undertaken each year become the subject of extensive investigations, advisory letters, and, in some cases filing of complaints by the Division followed by divestitures of assets. The Department reviews virtually every proposed bank, thrift or bank holding company merger, consolidation or acquisition, including RTC or FDIC transactions involving failed or troubled institutions. The total of such transactions reviewed each year could be as high as 2,000. Most of them raise no competitive concerns of any kind.[6]

The Division generally does not oppose mergers of banks that operate in different geographic markets or mergers of small banks operating in areas that are not already highly concentrated.[7] Indeed, in some markets where there are many competitors, even a merger of two large participants may not present significant competitive problems. For example, during our tenure at the Division, the Department did not challenge the acquisition by Chemical Bank of Manufacturers Hanover – two very large New York banks – or a merger of Comerica with Manu-

[4] For a listing of trends in the industry, see for example, the special issue on antitrust and banking in The Antitrust Bulletin, Vol. XLI, No. 2/Summer 1996.

[5] There is an extensive literature on the issue of economies of scale and scope in the banking industry; this literature has mixed empirical findings with respect to the extent of economies of scale and scope in banking, although some of these results relate to difficulties in estimating appropriate cost functions for multi-product and multiple office organizations. Some relevant articles (with extensive bibliographies) include: Srinivasan, Aruna. "Are There Cost Savings from Bank Mergers?" Federal Reserve Bank of Atlanta, *Economic Review*, vol. 77 (March–April 1992), pp. 17–28; Srinivasan, Aruna ,Larry D. Wall. "Cost Savings Associated with Bank Mergers", Working Paper 92-2. Federal Reserve Bank of Atlanta, February 1992; and Berger, Allen N., and David B. Humphrey. "Megamergers in Banking and the Use of Cost Efficiency as an Antitrust Defense", *Antitrust Bulletin*, vol. 37 (Fall 1992), pp. 541–600.

[6] For a summary of recent Department of Justice enforcement activity in the financial markets arena, see Statement of John M. Nannes, Deputy Assistant Attorney General, Antitrust Division, U.S. Department of Justice, Before the Committee on the Judiciary, United States House of Representatives, Concerning Mergers in the Financial Services Industry, June 3, 1998.

[7] Concentration is measured a number of different ways in banking markets, and includes measures based on deposits of banks with a local branch presence in the area, branches, as well as volumes of loans (such as commercial loans to small businesses). These measures reflect efforts to approximate the capacity of banks to offer particular banking products; although in some cases, such as with loan volumes, they reflect measures of sales.

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facturer National. In such cases, after a thorough review and investigation of all the overlapping products, market conditions, and other relevant competitive factors, such as the ability of rival banks to expand their lending capacity and the likelihood of entry, we concluded that these substantial transactions would not harm competition in the relevant product and geographic markets.

On the other hand, when the Division finds that the transaction is likely to lessen competition, it is prepared to challenge the transaction and demand remedial actions from the merging parties. For example, just prior to the BankAmerica–Security Pacific merger, the Division challenged the takeover of First Interstate of Hawaii by First Hawaiian and the acquisition by Fleet-Norstar of the "bridge" banks of the failed Bank of New England.[8] Similarly, around the same time as the BankAmerica–Security Pacific merger was being resolved, the Division challenged the deal between Society and Ameritrust banks.

These particular transactions represent circumstances in which the Division sent advisory letters to the relevant bank regulatory agency (in each of these cases, the Federal Reserve Board) indicating that the Division had substantial concerns that the merger, as structured, would tend to lessen competition. In these cases the Federal Reserve Bank, as the relevant banking agency nonetheless chose to approve these transactions. As a result, the Division filed suits to stop the transactions. There are relatively few cases that reach this stage of a filing of a complaint with subsequent settlement via consent decree. There have been no cases litigated by the Division in the bank merger area in the 1990s and no complaints filed since 1993. In the vast majority of cases in which the Division has filed such "adverse" advisory letters, the parties have addressed the specific concerns prior to the decision date of the bank regulatory agency and the agency approval orders have provided the mechanism by which the divestitures or resolution of competitive concerns were enforced.

As we noted above, the Federal Reserve Board approved these three transactions, in one case with more limited divestitures (*First Hawaiian*). The Division believed that the Fed-requested divestitures in that matter were not sufficient to obviate the competitive concerns. Also importantly, the Division not only asked for additional branch divestitures, together with the concomitant deposits and loans, but also, in the *First Hawaiian* case, asked that the buyer also be required to divest the "First Hawaiian" franchise, which was deemed to be an important competitive *asset.* The Division was clearly signaling to the banking community that it would not be looking for fig-leaf divestitures but would demand corrective actions that would restore the competitive *status quo ante* in the relevant product and geographic markets.

The other two cases revealed additional important differences between the agencies. The original difference in view on the Society–Ameritrust merger was driven

[8] The bridge banks were the banking entities formed after the failure of the Bank of New England to maintain the assets of the banking subsidiaries of the Bank of New England until they could be sold by the FDIC.

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largely by differences in definition of the geographic market. The Fed had traditionally used broader geographic markets that were "pre-defined", that is defined based on general market conditions rather than defined in the context of the merger. In this particular case, the Division's approach to defining merger-specific markets led to a smaller geographic market with fundamentally different competitive structure and dynamics. As a result, the Division required divestitures where the Fed had required none. Finally, the Fleet/Norstar case reflected differences in approach to policy on failing firms, where the Division took the stance that the transaction should not be approved because there was a less anticompetitive alternative. Once the transaction had been approved, the Division required divestitures to resolve the competitive concerns.

The fact that the Division went beyond the divestitures requested by the Fed also indicated that there was a degree of dissonance between the two agencies in how they gauged the effects of mergers on competitiveness. Overall, differences between the Division's and the Fed's competitive assessments can also be attributed to differences in how thrifts were treated as competitors in relevant markets and some differences in the threshold levels of concentration raising competitive concerns as compared to Merger Guidelines' thresholds. The perception of substantially different policy decisions on three major mergers within a relatively short period of time precipitated concern that there were more fundamental differences in approaches to mergers. These concerns ultimately led to the establishment of the Bank Competition Working Group chaired by the Division with members from each of the bank regulatory agencies and the Treasury. There was also close coordination on a day-to-day basis among the staff members in the agencies to discuss analytical frameworks, identify sources of differences, and work to develop common approaches. This eventually culminated in the release of the Bank Merger Screening Guidelines in July 1994. These Guidelines went far both to harmonize the approaches of the agencies and to clarify the information required for review.

III. The BankAmerica–Security Pacific Merger

1. Introduction

The BankAmerica–Security Pacific merger was an important matter for the Division for several reasons. Besides being the largest bank merger up to that date, it was one of the largest mergers handled by the Division. It was also one of the more complex banking merger because it required that the Division assess competitive conditions in multiple product markets in over 200 separate geographic markets.

Despite the size and the complexity of economic issues, the Division completed its review of the merger in record time: about four months. The application was filed with the Federal Reserve Board on December 17, 1991 and the Division made its final recommendation to the Board on March 12, 1992, in a letter from Assistant Attorney General James F. Rill to Alan Greenspan at the Fed. The letter

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provides a wealth of detail into the competitive concerns and the approach used by the Division to gauge the economic effects of the transaction.

Resolution of the competitive concerns in the transaction involved one of the largest as well as most complicated divestitures in the Division's history. In particular, BankAmerica agreed to divest 211 branches with $8.8 billion in deposits and $2.7 billion in loans spanning five states. Given the overall size of the transaction, these divestitures constituted a small percentage of the total transaction. These divestitures – which entailed sales to multiple parties – were crafted in a manner that best resolved competitive concerns in multiple product and geographic markets.

The BankAmerica–Security Pacific merger provided challenges in all aspects of the new Guidelines, but also served as the model for analytical framework development that guided many subsequent mergers. The following sets out the highlights of the merger review, organized along the lines of the 1992 Guidelines.

2. Market Definition

A. *Overview*

Any merger assessment requires an identification of the key banking assets whose agglomeration in the hands of the merging parties could lead to lessening of competition in the relevant product and geographic markets. At the most fundamental level, the enforcement agency must deal with the problem of defining the relevant product markets in which the transaction can raise competitive concerns. Here, as has been recognized in *Philadelphia National Bank*, the analytical challenge stems from the fact that banks provide many services that are potentially available from many non-bank institutions.

There are two issues involved. First, there is the nagging question whether services available from banks comprise a cluster of services that consumers cannot obtain or self-assemble from other sources. Clearly, if the bank services are a cluster market then even crudely measured concentration indexes are likely to be much higher than if the whole plethora of financial institutions is found to be competing with (traditional) banks for each of the individual services. Since concentration (still) matters, how this question is resolved clearly could drive the outcome of the merger review. Second, if one determines that it is more appropriate to evaluate individual products as candidate product markets, an extensive examination could be required of the alternatives for each banking product and a conclusion as to whether these products are sufficiently close substitutes for banking products.

Of course, whether the relevant market is the cluster market or not is ultimately an empirical matter. The Guidelines provide a simple way to approach the analysis. In particular, if the hypothetical owner of the cluster could elevate the price profitably by 5 to 10% then the cluster is the relevant market. If, however, customers would abandon the cluster for individual sellers than a product-by-product definition would be more appropriate.

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Actually, the evidence gathered in the BankAmerica investigations suggested that in early 1992 and in that fact pattern, the competitive assessment of the transaction did not much turn on whether the relevant products were clusters that included commercial loans and transaction accounts or commercial loans alone. Given the evolution of the banking and financial sectors in the U.S. economy, this assessment may come out differently today. Interestingly, banks increasingly stress the importance of the full relationship with the customer as an important component of competitive advantage in marketing their products. This suggests that these relationships may constitute an important asset that, perhaps less critical for the definition or the relevant product markets, could bear quite significantly on the assessment of the likely competitive effects from the merger and on the identification of market participants who could defeat the ability of the merging firms to exercise market power after the merger. Stated simplistically, while there are a lot of institutions with loanable funds, it is the knowledge of how to use them and with whom that could be critical for market success.

The BankAmerica transaction coincided with an extensive review by Division economists of the economic and banking literature on key banking products. Business loans are among the most important products provided by banks and not surprisingly this has been the product that has received the most attention in bank merger analysis, even reaching back to the Supreme Court's concern in Philadelphia National Bank about competition for small business customers. Other products of important concern in bank merger review, and also in the Division economists' review were transactions accounts and other retail deposit products.

Another question central to the product market definition – which was also implicated in other banking transactions – was whether certain loans provided by non-banks (e.g., asset-based lending by commercial finance companies) were sufficiently close substitutes for bank commercial loans (called commercial and industrial or "C&I" loans) to constrain the pricing of these loans. In addition, other products can be considered as possible candidates for inclusion in the relevant product market with C&I loans; these include personal loans secured by the owner of a business, trade credit, or mortgages on commercial real estate. This question was vetted and tested by Division economists through empirical analysis of data, review of pricing and other econometric studies, interviews, and document review. The analysis required an assessment of the attributes of commercial loans, their uses and functions in the business operation (e.g., for working capital) as compared to those of the other products.

The conclusion reached was that, at the time the merger was examined, these products were not close substitutes in the antitrust sense, although they shared many similar attributes. One important reason for this conclusion was that these other sources of C&I lending were sufficiently distinguished in the types and amount of collateral required and the terms and conditions attached to them that (frequently) made them less desirable to potential borrowers as alternatives to C&I loans. For example, we confirmed the conclusion reached in *First Hawaiian* that

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personal loans and real estate secured loans ("commercial mortgages") were not in the same relevant market as commercial loans. This indicated that in response to a small, but significant, non-transitory increase in price ("SSNIP") customers would not likely turn to these alternatives in sufficient numbers to render the worsening in the terms of the C&I loans unprofitable.

We are stressing here that our focus in the analysis of demand substitution was broader then just rates charged on the loans (e.g., the relative pricing of specific loan products). Other terms of the loan are also important to the borrowers, of course. While, in principle, these other terms can be converted into the "price" of the loan and subject the adjusted interest rate to the usual comparative statics examination mandated by the SSNIP approach, it proved simpler and expedient to examine separately the importance of changes in various loan terms on borrowers' decisions. In particular, we attempted to determine whether the specific attributes of loans made it less likely that a sufficient number of customers would turn to a particular loan product to avoid supracompetitive pricing on C&I loans. Attributes that were considered included the amount of credit available, the timing of repayment, the flexibility to use the funds at the discretion of the consumer, the speed with which the funds were available upon need, and the amount of collateral required to commit for the loan. We also considered the extent to which banks took these products into consideration when pricing their C&I loans.

B. *Product Market Definition*

1. Middle Market Loans and Depository Services. The BankAmerica–Security Pacific was the first major bank merger that fully raised the issue of competitive effects from a merger on middle market lending and deposit services. Middle market loans are commonly defined as C&I loans of approximately $1–10 million in size. Middle market businesses have typically been defined as customers with sales of between $10 and $150 million, and possibly more.

Preliminary assessment tentatively suggested that while middle market lending was plausibly a relevant product market, we were unable to rule out the possibility that many customers in that putative market could turn to sufficiently many financial institutions so as to obviate the concerns that the transaction would be anticompetitive. Moreover, we conjectured that the relevant geographic market for these types of loans was most likely broader than the geographic markets for C&I loans to small business customers. Here, the basis for this analytic starting point was the well-accepted view that loans for large enterprises are competed in the global market. It turned out, however, that for reasons noted below, the middle market lending was much more geographically constrained than we thought.

Our analysis of middle market lending was guided by the Guidelines' principle that permits consumer-driven markets when price discrimination is possible. Thus, even though the relevant product market was defined as commercial and industrial loans, the identity of the consumer (as measured by the size of the loan and the size of the customer) proved important to the assessment of the likely

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competitive effects of the transaction. Moreover, digging deeper also indicated that there could be product markets even narrower than "middle market" lending. In particular, interviews with customers pointed to the fact that middle market lending to customers in particular lines of commerce could, conceivably, also constitute a relevant product market. (In the pre Guidelines days of merger assessment in which "submarkets" featured prominently and often misleadingly, this would not be surprising, of course.) While these concerns ultimately did not have major implications for the transaction, we concluded that highly consumer-specific effects could not be dismissed out of hand and that recognition had some impact on the specifics of the required divestitures. The possibility of narrow middle market lending markets arises from the nature of the product itself. While to an uninformed observer lending-is-lending and money-is-money, commercial lending at the middle market (and also at the small level) requires a great deal of specialized knowledge and localized information as well as close working relationships with the customers.

Our initial presumption regarding the intensity of competition in the provision of middle market loans was not fully borne out by the evidence and the Division concluded that there were competitive risks from the transaction. We address the reasons for this conclusion below.

2. Retail Products. Relatively few mergers before the Division raised concerns about competition for retail products such as transactions accounts (checking accounts) or other deposit and loan products provided to retail consumers. In large part, this is due to the fact that the Division regards thrift institutions as providing products that are close substitutes for those provided by banks. This being the case, it is usually implausible to consider it likely that a merger would so increase concentration as to significantly worsen the terms on which retail consumers can engage in retail transactions. At the same time retail customers potentially suffer when branches are consolidated after the merger. Parties often argue that the merger will generate efficiencies from branch closings. The Division properly did not (and most likely does not) include cost reductions from branch closings in the "efficiencies" column because branch closings possibly harm (some) consumers by denying them access to their locationally most preferred branches.

In the BankAmerica case, the retail overlap between the merging parties in some states – most notably, Arizona – was caused by the fact that both parties had acquired thrifts in prior years. Hence, even though there was limited business banking activity by the merging parties in these states, there was a substantial overlap in retail accounts. The analysis of the competitive effects of this aspect of the transaction turned largely on the assessment of the retail customer runoff experienced by the merging banks in several Arizona markets. There was evidence that there was substantial runoff, suggesting that other banks had been quite successful in diverting customers from one or both of the merging banks. In addition, the runoff evidence implied that market shares based on historical measures of deposits

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tended substantially to overstate the relative size and importance of the merging banks relative to the competition. Unlike in other merger investigations, we actually attempted to adjust "market shares" of the merging parties to account for the fact that consumers will leave the banks not as a result of (hypothetical) price elevations but for other reasons. Looking back – as we are supposed to do on the occasion – on our analysis of consumer behavior, we toyed with very crude versions of the "diversion ratios" that were subsequently developed and popularized by DAAG for Economics Carl Shapiro as a valuable tool in merger analysis.

C. *Firms Competing in the Market – Middle Market Again*

Once the relevant market has been defined, the next step is the identification of firms that compete in the relevant market. In bank, as in other mergers, this is a two step process. First, the "identities" of the firms competing in the relevant market are established. In the second step, the "competitive significance" of these firms is determined based on some measures of market presence. In the first step we obviously identified all commercial banks engaged in commercial lending as possible competitors for middle market customers. The analysis of the competitive significance of various financial institutions in step two, revealed some important facts. Examination of each of the banks lending patterns as well as customer borrowing patterns showed that banks with aggregate deposits below a certain size were substantially limited in their ability to make middle market loans, and hence, affect pricing. As a result, certain smaller banks were effectively excluded as suppliers of any competitive significance in the middle market. This exclusion was not only attributable to the fact that banking regulations affected the lending capacity of the smaller banks, thereby constraining their presence in the middle market commercial lending. The exclusion was also due to the fact that these smaller banks did not appear to have the necessary expertise and relations to participate in such lending. Again, our examination of the middle market revealed the importance of "information" as a competitive asset of relevance.

Also in step two, we noted that solicitation and loan patterns revealed that out-of-market banks could not be relied upon to respond with substantial increases in lending in response to a SSNIP. The analytic strategy was to try to infer the volume of out-of-market loans that would likely be induced if the in-market banks were to suppress lending. While it initially seemed plausible that the hypothetically constricted lending capacity could be replaced by inflows from out-of-market institutions, the Division ultimately concluded that there was insufficient supply response to discipline middle market pricing.

The term "uncommitted entrant" had yet to be released to the general public, but the concept played an important critical role in our competitive analysis of the thrifts. The analysis of the thrifts in *First Hawaiian* provided us with the launching pad for our own investigation. The analysts at the Fed historically relied on rather mechanical approach to the competitive assessment of the thrifts. In *First Hawaiian*, Division's economists significantly fined-tuned the analysis of the role

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of the thrifts by taking into account regulatory, commercial, and other business factors. In BankAmerica–Security Pacific transaction we followed the same principles and tried to distinguish between uncommitted thrift entrants and those who (for whatever reason) either could not expand or could not even be perceived as (possible) committed entrants. In the end, certain thrifts were included as suppliers for business loan products to smaller businesses – but not to the middle market – they possessed some expertise and likely did not have to incur significant sunk costs we concluded that they were able to expand into commercial lending. The shares of the included thrifts were based on our assessment of their lending capacity and the associated cost of expansion; of course, other thrifts were excluded for analytically the same reason.

In sum, the BankAmerica–Security Pacific transaction forced the economics staff to assimilate and also extend the work on measurement of share and capacity that had been initiated under DAAG for Economics Robert Willig in the *First Hawaiian* matter. In particular, a great deal of attention was paid to getting a clear definition of the "production process" for bank products, including specification of the role played by loan officers, branches, deposits, other funding, and regulatory constraints. This analysis affected the ultimate outcome in many markets; for example, the activities of BankAmerica and Security Pacific in small business lending varied from state to state (e.g., Arizona) and was taken into consideration in the analysis.

The multiplicity of product and geographic markets involved in the transaction put a great strain on the capacity of the staff, however, there was no other way to make informed divestiture recommendations but through a careful examination of the competitive conditions and "productive capabilities" of the merging banks (and their actual and potential rivals) across both the product and geographic dimensions.

3. Entry Analysis and Definition of Bank "Assets"

Increases in concentration in the relevant product markets do not raise competitive concerns if entry into the relevant product markets is timely, likely, and sufficient ("TLS"). The assessment whether entry satisfies the TLS requirement of the 1992 Merger Guidelines shifts the analytical focus on the assets owned by the merging banks. If "out-of-market" banks and non-bank financial institutions can readily replicate the assets owned by the merging banks without significant sunk costs, the risks to competition from the transaction are not likely to be high. Our analysis of entry in the BankAmerica case followed the road map laid out in the yet-to-be released 1992 Merger Guidelines. Admittedly, this may have put the lawyers (and economists) for the parties at some disadvantage because the distinctions between "uncommitted" and "committed" entry were hardly in the proponents' tool kit. We tried to clarify the differences, of course, and were able to resolve whatever gaps

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in understanding there may have been. The novelty of the concepts did make the early exchanges with the parties somewhat difficult.

We believed that the focus on the relevant assets (and to the extent to which they are sunk) was central to our understanding of the issues relating both to entry as well as the possible remedies for the identified competitive concerns. As we noted in several places in this paper, some critical bank assets turn out to be more subtle than may appear at first. The key issue is: what are the assets that are important for a bank's ability and capacity to compete to deliver certain products to its (or other banks') customers? The key assets hardly are just the "dollars" in the banks' coffers – these in fact are banks' liabilities – and, in any case, there is a lot of "dollars" sloshing around the world (or there used to be before bankers got cold feet yet again and decided to be as they are supposed to be: i.e., conservative).

Perhaps the relevant bank assets are the "brick and mortar" sunk into the banks' branch networks? This seems quite implausible that the brick and mortar at the branches are what makes branches relevant, despite the fact that parties are frequently allowed to proceed only after they *divest* some branches. After all, locations of bank branches can be changed (or repositioned, in the language of the 1992 Horizontal Merger Guidelines) and rivals can open new branches, possibly without incurring significant sunk costs. Moreover, many commentators regard that branches are becoming more superfluous and costly in the era of electronic banking. Some have suggested that the continued prevalence of brick and mortar may be due to regulatory requirements that banks maintain facilities across communities, unless and until a bank can demonstrate that more streamlined facilities or delivery mechanisms can provide the relevant services in the community.

A review of many banking transactions and as well as competition in other financial markets, has made it increasingly apparent that critical bank assets comprise the relations with bank's customers and information that the bank develops from the provision of the multitude of bank services. For example, the knowledge that a bank has regarding its clients – their credit-worthiness and their banking needs – could be invaluable to the ability of the bank to cross-sell financial services as well as to offer loan products on terms that are best tailored to both the needs of the customer and the customer's riskiness. This type of information gives the bank a competitive advantage and is confirmed by the fact that customers in small and middle markets do not churn banks. Indeed, when a customer decides to change a bank, it can be viewed as an adverse signal to other potential lenders. Competition among banks is, therefore, best understood in the context of a marketplace in which information is "impacted", in which "moral hazard" and "adverse selection" are important constraints of the how well the market approaches the competitive ideal of (undergraduate) microeconomics textbooks.

From this perspective, it is also quite clear why divestitures that do not transfer relations and information but merely the more traditional assets are not likely to accomplish their desired objective of restoring competition to the pre-merger levels. This simple proposition guided the divestitures in the BankAmerica transaction

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and was visible also in the *First Hawaiian* case where the acquirer was compelled to divest the "franchise" together with more traditional assets.

4. Competitive Effects Analysis: Coordinated and Unilateral Effects

Prior to the BankAmerica–Security Pacific transaction, one of us (Ordover) had a rather limited experience in evaluating competitive effects bank mergers. What struck him was that it was not necessarily transparent what was the appropriate theory that would explain how a merger would significantly lessen competition in the provision of C&I loans, given how idiosyncratic loan terms were and how invisible the interest rates and other terms were to any bank's rivals. How would rivals know when a bank deviated from a collusive agreement – other than by going after the clients of the rival – and what kind of collusive agreement could be readily fashioned that would be sustainable and that would be appropriate to the diverse group of potential lenders and borrowers?

The 1992 Guidelines identify two possible competitive concerns from mergers, including bank mergers. One concern is that the merger will enhance the scope and the opportunity for coordinated interactions among the participants in the relevant market. The second concern pertained to the post-merger ability of the merging firms unilaterally to raise price without risking loss of a substantial number of customers to rivals. Both theories of potential harm were addressed directly in the BankAmerica case.

The underlying principle of market definition in banking in the loan area is that small or middle market businesses could be identified by banks and could be the target of price discrimination. A key issue addressed in this case was the mechanism by which coordination could occur in what was regarded as a highly differentiated product market. The theories developed along the lines of the Guidelines focused on the identification of possible mechanisms that could be devised to coordinate on some aspects of the terms that were being offered to C&I loan customers. Interviews and other sources, had revealed that the degree to which products were differentiated, while significant, could be overstated. Banks were increasingly relying on credit scoring models for small business loans. Some of the models were proprietary, to be sure, but there were also third party scoring models available to the banks. The terms of the loan and loan products were becoming more standardized. This made plausible a theory that the interest rate could be the principal component of the loan and a candidate for the focal point of coordination. In addition to standardization, other information was considered in support of this theory. For example, during the period of the investigation, the trade press was replete with stories about the availability of information on pricing of loans, including sources such as the Loan Pricing Corporation service. This was yet another channel through which pertinent information regarding the trends in pricing of loan products, by customer size, risk category, geography, and terms, was becoming

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available to the banks. As a result, we concluded that while coordination on C&I loans was difficult it was not impossible and that the reduction in the number of active market competitors could harm borrowers, by making coordination among the remaining competitors easier.

We also asked whether a supracompetitive equilibrium could be sustained and examined the conditions that would make coordination more likely and effective. These conditions were later spelled out in the Guidelines, and included monitoring, detection of cheating, and punishment for cheating on an agreement. We asked: even if banks could agree, in principle, to some loan terms to a specific class of customers or could “allocate” customers to banks, could they detect cheating and punish the deviating bank? Could they implement a scheme where competition would be confined to new customers only? Detection seemed very likely, given that banks were typically well informed when more favorable terms and conditions were offered to an existing customer or when such customers were solicited. It also seemed possible that punishment mechanisms could include making counter-offers to key customers of the “cheating” bank. These theories were being tested in markets in which the structural requirements for concern about coordinated effects were present (i.e., there were relatively few and very large organizations); which led us to believe that coordinated effects concerns had merit.

We also consider the relevance of unilateral theories to the banking industry. The presence of certain very specialized loan products offered to specific industries suggested a fact pattern in which the merging banks could be the first and second choice for a large number of customers. We undertook a detailed examination of the characteristics of the banks, their customers, and the competitors to determine, among other factors, whether rivals could reposition to respond to increased prices. Our analysis of these unilateral effects entailed a rather crude application of the diversion ratio, mentioned above, and which was subsequently refined and applied in several consumer products cases. We concluded that for areas outside of retail banking, the relevance of that analytical tool was probably limited. However, because of the importance of specific customer information and lending expertise, we concluded that in some areas the transaction raised unilateral competitive concerns.

5. Divestitures: The Guidelines in Action

Many regard the scope and size of divestitures in the BankAmerica case as a marker of the case’s importance. More important from a Guidelines’ perspective are the details of the divestitures in a single market: Seattle. The specifics of that divestiture, which included business banking centers, retail and business branch networks, the “sale” of relational assets, such as availability of specialized personnel and loans, and the divestiture of loans, were all tailored expressly to resolve the competitive concerns identified by application of the Guidelines. The sale to major banks without substantial prior presence in the market allowed for the prospect of re-positioning of firms as well as reduced the probability of effective coordination.

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In addition, the divestitures in each of the other areas were tied to the specific concerns raised by the markets at issues, and were either more or less stringent in requirements depending on the competitive analysis.

IV. Conclusions

The BankAmerica–Security Pacific merger provided an opportunity for a test run of some of the most interesting aspects of the 1992 Horizontal Merger Guidelines. It also was a key case for setting forth clearly the theories of competitive effects of a bank merger transaction and for using these theories in devising credible divestiture strategies.

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