The New Bank-Thrift Competition: Will It Affect Bank Acquisition and Merger Analysis?

MICHAEL E. TREBING

The Depository Institutions Deregulation and Monetary Control Act (MCA) enacted by Congress in March 1980 will significantly affect the competitive environment in which financial institutions operate. This act broadens both the asset and liability powers of savings and loan associations (S&Ls), mutual savings banks and credit unions, opening opportunities for these institutions that traditionally have been limited to banks. In light of these new powers and the increasing erosion of both legal and economic differences between thrift institutions and banking organizations, thrifts have become important competitors in markets for banking services—especially for transaction or checking accounts. Logically, the presence of thrift institutions should carry greater weight in analysis of mergers between commercial banks and acquisitions of banks by bank holding companies (BHCs).

The following discussion reviews several provisions of the MCA that permit more intense bank-thrift competition, describes the current approach used by banking regulatory agencies to review applications for approval of bank mergers and BHC acquisitions, and discusses its validity in light of the new legislation. Finally, the article discusses some alternative approaches to the analysis of competition in local markets.

THE MCA PROVISIONS

The distinctions between thrifts and banks have become less rigid because of a long list of recent financial innovations and the geographic expansion of so-called "non-banking" institutions. The MCA, in response to these developments, reduces even further the actual differences between banks and thrifts. Regulations that have attempted to control or constrain pricing and portfolio decisions of financial institutions are being liberalized. In essence, the act provides for a greater reliance on market forces to determine both the flow of deposits to financial institutions and the flow of credit from these institutions to borrowers. The major elements of the MCA that will affect bank-thrift competition are listed in table 1.

An important change is the authorization of interest-earning "transaction" accounts at both banks and thrifts. This is achieved through the nationwide legalization of negotiable order of withdrawal (NOW) accounts, automatic transfer service (ATS) accounts and credit union share drafts. In some areas of the country (especially New England), depository in-

1The term "thrift institutions" in this article is defined as savings and loan associations, credit unions and mutual savings banks.
Table 1
Selected Provisions from the Depository Institutions Deregulation and Monetary Control Act of 1980

1. The phase-out of interest rate ceilings on deposits over a six-year period
2. The authorization to offer NOW (negotiable order of withdrawal) accounts (fundamentally, interest-earning checking accounts) at all federally insured depository institutions beginning December 31, 1980 to individuals and non-profit organizations
3. The authorization of share drafts at federally insured credit unions (effective March 31, 1980)
4. The authorization for mutual savings banks to offer demand deposits to business customers
5. Increased investment options for thrift institutions
   For federal-chartered savings and loans:
   a. consumer lending, commercial paper, and debt security investment of up to 20 percent of assets
   b. issuance of credit cards
   c. trust-fiduciary powers
   For federally insured credit unions:
   a. real estate loans
   For federal mutual savings banks:
   a. commercial, corporate and business loans (up to 5 percent of assets)

Credit market activity of thrifts over the past decade has developed by piecemeal expansion; these institutions evolved originally as special-purpose institutions whose asset-liability powers have been extended only by gaining legislative approval. Legislation in the 1970s has increasingly widened their powers and scope of business. The new powers legalized in the MCA will affect further the traditional lines of business that have separated these institutions; banks and thrifts will now compete more directly for many lines of business.

CURRENT METHOD OF ANALYZING COMPETITION

The Bank Holding Company Act of 1956 requires the Federal Reserve to consider the likely effects of proposed holding company formations and acquisitions on competition, the convenience and needs of the communities involved, and the financial and managerial resources and future prospects of the institutions involved. If the Board of Governors finds that a transaction will substantially lessen competition (or tend to create a monopoly or be in restraint of trade), the Board must deny the application unless the anti-competitive effects are judged to be clearly outweighed by “the convenience and needs of the community.”

Legal Doctrine

The critical problem in antitrust law is selecting the specific industry and industry output (or “line of commerce”) to use in analyzing competition between firms. In analyzing cases under the Bank Holding Company Act, the Federal Reserve has generally chosen “commercial banking” to be the relevant line of commerce. This definition is based on the Supreme Court’s controversial Philadelphia National Bank decision in 1963.

In this case, the Court concluded that commercial banks have an advantage over other financial institutions in attracting funds for loans and other services.
since only they can legally accept demand deposits. In addition, banks were said to enjoy "settled consumer preferences" for full-service banking. Thus, the "general store" nature of the banking business made it a distinct line of commerce, distinguishing banks from other financial institutions.

Banking agencies have relied on simple market share tests to judge the likely effects of mergers or BHC acquisitions on competition, using "concentration ratios" as a form of prima facie evidence of these effects on competition. A concentration ratio is a summary measure intended to represent the degree of market power that larger firms possess. This ratio is defined as the percentage of total industry activity (measured by output, employment, assets, etc.) accounted for by the larger firms. A four-firm concentration ratio (using total deposits as a proxy for output) for all the commercial banks in a local banking market, for example, may be 75 percent; that is, the four largest banks hold 75 percent of the total bank deposits in this market.

Although other factors are analyzed in evaluating the competitive effects of mergers and acquisitions, concentration ratios continue to be the main factors in such analysis. The important issue is that the calculation of concentration ratios using commercial bank organization deposit data alone accepts the Court's

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9See the appendix for a discussion of how the relevant geographic market is defined.

10This point is highlighted by the merger guidelines published by the Justice Department in 1968 which are frequently cited in bank merger and acquisition analysis. These guidelines indicate that the department will challenge a horizontal merger between firms in a concentrated industry (i.e., one with a four-firm concentration ratio greater than 75%) when the following market shares are involved:

<table>
<thead>
<tr>
<th>Acquiring Firm</th>
<th>Acquired Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>4%</td>
<td>4% or more</td>
</tr>
<tr>
<td>10%</td>
<td>2% or more</td>
</tr>
<tr>
<td>15%</td>
<td>1% or more</td>
</tr>
</tbody>
</table>

In nonconcentrated markets (i.e., ones with four-firm concentration ratios less than 75%) the Justice Department challenges mergers with the following shares:

<table>
<thead>
<tr>
<th>Acquiring Firm</th>
<th>Acquired Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>10%</td>
<td>4%</td>
</tr>
<tr>
<td>15%</td>
<td>3%</td>
</tr>
<tr>
<td>20%</td>
<td>2%</td>
</tr>
<tr>
<td>25%</td>
<td>1%</td>
</tr>
</tbody>
</table>


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12An alternative argument holds that banks have offered diverse services in the past because they have been prohibited from paying interest on demand deposits since 1933. Customers holding large demand deposit balances receive "implicit interest" in the form of other services offered below cost to depositors. In other words, competition resulted in institutions, faced with prohibition on direct payment of interest, offering "implicit interest" in the form of services, such as low or zero service charges, drive-in facilities, branches, and occasionally gifts (porcelain china, silverware and calculators, for example).
a distinct market defined in terms of specific groups of buyers (for example, by location of customer, or maturity and denomination of the particular loan). Therefore, choosing the appropriate measure of bank "output" is a difficult task.13

The above reasoning suggests that the usefulness of the line of commerce definition adopted in the Philadelphia case should be determined on empirical grounds. Although the "department store" or "cluster of service" approach may be valid in some instances, the concept is completely irrelevant for many readily identifiable bank "products." For example, an individual seeking a mortgage loan will choose an institution primarily on the basis of the price of the loan (the interest rate); the package of other services offered by competing institutions is not pertinent in this decision.

Measuring the extent of competition between different types of institutions in a product line must be based upon the degree of substitution between products of these institutions. In economic terms, the important issue is the magnitude of the "cross-elasticity" of demand between individual products offered by financial institutions.14 The higher the cross-elasticity between the products of banks and thrifts, the greater the substitution and the stronger the argument for including the outputs of these institutions in the same industry or the same product line. The cluster approach used by the Supreme Court assumes that the degree of substitution between lines of commerce (thrift output and bank output) is "small." For example, if institution A (say, a thrift) increases the (explicit or implicit) interest rate on savings deposits while institution B (a bank) keeps its rates unchanged, the volume of business transferred by local customers from bank B to thrift A rises with the magnitude of the cross-elasticity of supply. The other services offered by bank B (for example, checking services), however, may preclude a significant transfer of business between institutions. Since both thrifts and banks can now offer transaction accounts, the degree of substitution between their respective outputs will increase.15

Bank regulatory agencies have emphasized the "locally limited" customer in analysis of bank mergers and acquisitions. As such, regulators have tended to stress the services provided to individuals and small business customers. Since most large commercial and industrial customers have access to national and regional markets, competition for these accounts is intense. Empirical estimates of the relevant cross-elasticities for retail and small business customers in local banking markets, however, are difficult to obtain. Regulatory ceilings on interest rates interfere with obtaining good estimates of these magnitudes. As previously mentioned, competitive forces have resulted in institutions competing by means other than the payment of explicit rates of interest. Institutions located in different market environments offer differentiated clusters of outputs. Differing degrees of branching restrictions across governmental jurisdictions, for example, may affect the form of implicit interest paid to consumers.

Even before the MCA, other structural changes since the last Supreme Court ruling on a merger case (1974) had cast doubt on the validity of the banking regulatory agencies' approach to competition. The asset and deposit liability growth of thrifts has outpaced that of banks over most of the periods from 1960-79 (tables 2 and 3). It is unlikely that the previous degree of substitution between the outputs of banks and thrifts has remained constant since the Philadelphia definition in 1963. Retail customers in local banking markets have reacted to significant financial developments in the 1970s. Inflation, interest rate ceilings, and new instruments such as money market certificates, money market funds, ATS accounts and telephone transfer accounts, have all contributed to an increased degree of substitution between services offered by banks and non-bank institutions. The nationwide legalization of thrift transaction accounts further weakens the argument that banks have a clear advantage in attracting customers.


14The "cross-elasticity" of demand is defined as a measure of the relationship between the demand for one firm's output when the price of another firm's output changes (when all other things remain the same). The cross-elasticity between goods 1 and 2 is given by the equation

\[
e = \frac{\% \text{ change in quantity of good } 1 \text{ demanded}}{\% \text{ change in price of good } 2}
\]

If \( e \) is less than zero, the outputs are normally considered "complements." If \( e \) is greater than zero they are considered substitutes. The degree of substitution can be gauged by the magnitude of this coefficient: higher positive cross-elasticity coefficients correspond to greater degrees of substitution.

15Accumulated evidence prior to the MCA supports the view that customers already treat time and savings accounts of banks and thrifts as substitutes. For a review of the empirical evidence before 1970, see Gary G. Gilbert and Neil B. Murphy, "Competition Between Thrift Institutions and Commercial Banks: An Examination of the Evidence," Journal of Bank Research (Summer 1971), pp. 8-18.
The presumed "settled consumer preference" for banks over competing institutions has become less and less evident. First, S&Ls have unique advantages over banks. They enjoy statewide branching privileges. Secondly, new technology continues to alter the traditional methods of marketing financial services. Electronic banking is the most obvious example of the declining importance of locational convenience in banking — i.e., one-stop banking. Automated teller machines, automatic payroll check deposit, banking by mail and point-of-sale terminals expand the geographic scope of competition among depository institutions for what was once considered the locally limited customer.

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### Table 2

**Distribution of Assets — Commercial Banks and Thrifts (billions of dollars)**

<table>
<thead>
<tr>
<th></th>
<th>End of Period</th>
<th>Annual Growth Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COMMERCIAL BANKS (insured only)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Business loans</td>
<td>$43.1</td>
<td>$71.2</td>
</tr>
<tr>
<td>Mortgages</td>
<td>28.7</td>
<td>49.4</td>
</tr>
<tr>
<td>Consumer loans</td>
<td>26.4</td>
<td>45.5</td>
</tr>
<tr>
<td>U.S. Treasury and agency securities</td>
<td>60.4</td>
<td>69.2</td>
</tr>
<tr>
<td>State and local securities</td>
<td>17.3</td>
<td>38.5</td>
</tr>
<tr>
<td>Other assets</td>
<td>60.4</td>
<td>111.6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>256.3</td>
<td>375.4</td>
</tr>
<tr>
<td><strong>SAVINGS &amp; LOAN ASSOCIATIONS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgages</td>
<td>$60.1</td>
<td>$110.3</td>
</tr>
<tr>
<td>Investment securities</td>
<td>4.6</td>
<td>7.4</td>
</tr>
<tr>
<td>Other assets</td>
<td>6.8</td>
<td>11.9</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>71.5</td>
<td>129.6</td>
</tr>
<tr>
<td><strong>MUTUAL SAVINGS BANKS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mortgages</td>
<td>$26.7</td>
<td>$44.4</td>
</tr>
<tr>
<td>U.S. government securities</td>
<td>6.2</td>
<td>5.5</td>
</tr>
<tr>
<td>State and local securities</td>
<td>7.7</td>
<td>3.0</td>
</tr>
<tr>
<td>Corporate and other securities</td>
<td>5.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Other assets</td>
<td>1.9</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>40.6</td>
<td>58.2</td>
</tr>
<tr>
<td><strong>CREDIT UNIONS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans outstanding</td>
<td>$4.4</td>
<td>$8.1</td>
</tr>
<tr>
<td>Other assets</td>
<td>1.3</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>5.7</td>
<td>10.6</td>
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</tbody>
</table>

Table 3
Composition of Deposits (billions of dollars)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>COMMERCIAL BANKS</strong></td>
<td></td>
<td></td>
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<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Demand</td>
<td>$155.7</td>
<td>$183.8</td>
<td>$247.2</td>
<td>$319.6</td>
<td>$429.5</td>
<td>3.4%</td>
<td>6.1%</td>
<td>5.3%</td>
<td>7.7%</td>
</tr>
<tr>
<td>Time and savings</td>
<td>73.3</td>
<td>147.7</td>
<td>235.3</td>
<td>455.5</td>
<td>666.5</td>
<td>15.0</td>
<td>9.8</td>
<td>14.1</td>
<td>9.6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>229.0</td>
<td>331.5</td>
<td>482.5</td>
<td>775.2</td>
<td>1,086.0</td>
<td>7.7</td>
<td>7.8</td>
<td>9.9</td>
<td>8.8</td>
</tr>
<tr>
<td><strong>SAVINGS AND LOAN ASSOCIATIONS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Savings capital</td>
<td>$62.1</td>
<td>$110.4</td>
<td>$146.4</td>
<td>$285.7</td>
<td>$470.2</td>
<td>12.2%</td>
<td>5.8%</td>
<td>14.3%</td>
<td>13.3%</td>
</tr>
<tr>
<td><strong>MUTUAL SAVINGS BANKS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time and savings</td>
<td>$36.1</td>
<td>$52.1</td>
<td>$71.2</td>
<td>$109.3</td>
<td>$144.1</td>
<td>7.6%</td>
<td>6.4%</td>
<td>9.0%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Other</td>
<td>.3</td>
<td>.3</td>
<td>.4</td>
<td>.6</td>
<td>1.9</td>
<td>5.4</td>
<td>4.8</td>
<td>6.6</td>
<td>35.1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>38.3</td>
<td>52.4</td>
<td>71.6</td>
<td>109.9</td>
<td>146.0</td>
<td>7.6</td>
<td>6.4</td>
<td>8.9</td>
<td>7.4</td>
</tr>
<tr>
<td><strong>CREDIT UNIONS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Member savings</td>
<td>$5.0</td>
<td>$9.2</td>
<td>$15.5</td>
<td>$33.0</td>
<td>$56.2</td>
<td>13.1%</td>
<td>10.9%</td>
<td>16.3%</td>
<td>14.2%</td>
</tr>
</tbody>
</table>


Legal Issues

The Supreme Court case that most recently addressed the relevance of thrifts in competitive analysis was the Connecticut National Bank case in 1974.17 A lower court had found that savings banks were "fierce competitors" of banks in certain markets. The Supreme Court, however, reaffirmed the line of commerce definition adopted in the Philadelphia case, maintaining that commercial banks offer a unique cluster of services that distinguish them from other institutions. The Court in particular emphasized that there was a lack of significant competition between banks and mutual savings banks for commercial accounts.

There was, however, an indication that the Court realized that the Philadelphia definition's usefulness was declining. For example, in the Connecticut case the Court stated:

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. In Connecticut, that point may well be reached when and if savings banks become significant participants in the marketing of bank services to commercial enterprises. But, in adherence to the tests set forth in our earlier bank merger cases,... such a point has not yet been reached.18

The Court's emphasis on competition for commercial business has led some analysts to speculate that, even with the passage of the MCA, thrifts will still be excluded from the Federal Reserve's competitive analysis of mergers and acquisitions. Indeed, the quantitative impact of the new law is greater with respect to the array of services offered to retail customers. All depository institutions in the nation may offer NOW accounts, but not to commercial and business enterprises.19 Mutual savings banks are now permitted to

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18Ibid.
19NOW accounts are to be made available only to an individual or to an organization that is "primarily for religious, philanthropic, charitable, educational, or other similar purposes and which is not for profit." These depositors have been defined by the Federal Reserve Board to include individuals, sole proprietors, husbands and wives operating unincorporated businesses, local housing authorities, residential tenant security deposits, independent school districts and redevelopment authorities.
extend business loans (up to 5 percent of total assets) to firms within 75 miles of their main office, but since most mutual savings banks are located in the East, their competitive impact will be limited to eastern markets. Likewise, the commercial lending authority granted to mutual savings banks applies only to savings banks with federal charters. In addition, expanded services to corporations would remain generally unavailable from S&Ls. The MCA, however, permits Federal S&Ls to invest in commercial paper and corporate debt securities (up to 20 percent of assets).

Whether these specific changes will be sufficient to alter the line of commerce definition in court cases is an unsettled issue. Although the competitive impact of the MCA on competition for commercial customers may not be viewed as substantial in quantitative terms, any marginal increases must be considered significant since these new powers allow additional entrants into markets for these services.

SOME ALTERNATIVES

Many analysts believe that a different approach to the analysis of competition among depository institutions is called for. To a limited degree, banking authorities have already begun to introduce the influence of thrifts into their analysis. The question still remains, however, how the impact of increasing thrift competition should be weighted in the analysis. In other words, how would the line of commerce be “unbundled?” Should commercial banks, mutual savings banks and S&Ls together encompass a line of commerce, or should individual product markets of these institutions be analyzed? Several options are available.


Add Thrifts to Line of Commerce Framework

One alternative is simply to include thrift institutions as direct competitors of banks; in other words, treat thrifts as commercial banks for purposes of a line of commerce definition. Concentration ratios would continue to be the most likely candidates as the key proxies for measuring competition under such an approach. Including thrifts into the analysis would liberalize merger and acquisition policy to some degree. Since concentration ratios would be diluted by deposits or assets of thrifts, the number of possible bank mergers meeting the Justice Department’s current merger and acquisition “standards” would be increased.

Unfortunately, this approach suffers from the same flaws that exist with the general use of “commercial banking” as a line of commerce definition. Because significant differences exist in the asset and liability powers between banks and thrifts, competition varies across relevant product lines. Likewise, the varying forms of financial structure observed among geographic areas of the country (location of mutual savings banks in the East and different thrift and bank branching laws across states, for instance) make such concentration ratios difficult to apply consistently.

Maintaining the line of commerce framework by including thrifts but continuing to rely on aggregated market share statistics also suffers from major economic flaws. As argued above, the relevant cross-elasticities among products of banks and thrifts have been altered by changes in technology and a great number of financial innovations in recent years. Likewise, as regulations on interest rate ceilings are removed over the next six years, financial institutions will undoubtedly “unbundle” their own services. Competition among institutions will result in independently priced services and these prices will more closely approximate the marginal costs of their provision.

Maintain Current Approach With “Subjective” Addition of Thrifts

Another alternative is to maintain the current approach of including only banks in concentration analysis, except in cases where thrifts are seen as “significant competitors.” In such cases, thrifts would be used...
in calculating market share data. In essence, this is
the approach that the banking regulatory authorities
are now using and, given the uncertainties of the
MCA's impact, is the likely route they will follow
during a transition period. This methodology provides
enough flexibility to accommodate regional differences
in market structure, but is not likely to be legally
satisfying given its subjective framework. In addition,
it suffers from the same problems as the current line
of commerce definition of lumping together the many
outputs of banks and thrifts into one aggregate
measure.

Unbundle Financial Institution Products

A third alternative, more consistent with economic
theory, is to disaggregate the traditional line of com-
merce (defined as commercial banking) into spe-
cific subcategories. Though this strategy would more
accurately reflect the actual competitive situation, it
would increase the difficulty of assessing the impact
on “overall” competition. Regulators would first be
faced with the problem of assigning weights to the
competitive effects of a merger or acquisition across
product lines. Since institutions are multi-product
producers, it is possible that competition among firms
may be lessened for some outputs but not for others.
For example, two local banks proposing to merge
might produce a monopoly on local trust services but
still generate vigorous competition with many other
financial institutions for checking and savings deposits.
Depending on the relative weights assigned to the
competitive effects across product lines (which would
continue to be measured by concentration ratios),
the disaggregated product approach might result in
a more restrictive stance against mergers and
acquisitions.

A second limitation to the disaggregation approach
is the lack of detailed statistics measuring some prod-
uct lines. Each product line might correspond to a
different geographic market. Correspondent banking
services, for example, would have to be analyzed in
terms of larger geographic regions (e.g., a state),
whereas small business loans would be analyzed
within a more localized market. One would have to
identify both customers of such product lines and the
financial institutions offering close substitutes for this
approach. Practical data problems would therefore
limit the degree of disaggregation possible.

CONCLUSION

Although Supreme Court cases to date have con-
sistently upheld “commercial banking” as a distinct
line of commerce definition in bank merger cases, the
foundation of the Court’s reasoning has eroded since
1963. Significant market changes since the last Su-
preme Court case (1974) cast doubt on the practice
of evaluating mergers and acquisitions as narrowly as
the traditional analysis requires.

With the passage of the Monetary Control Act,
there is greater reason to depart from the established
tradition of treating commercial banking as an exclu-
sive line of commerce in antitrust analysis. A more
broadly defined line of commerce would increase the
number of mergers and acquisition proposals meeting
antitrust standards. On the other hand, a disaggre-
gated approach to analyzing the product lines of banks
and thrifts would more accurately scrutinize proposals
for actual anticompetitive effects. Such changes in
product and geographic market definitions will have
important implications for the future structure and
competitive performance of the financial industry.
Although the proper analytic approach is still evolv-
ing, increased thrift competition will certainly play
a more significant role in the evaluation of future
bank mergers and BHC acquisition proposals.
Appendix
Defining Banking Markets

The most crucial element of competitive analysis in many bank merger and acquisition cases is the definition of the relevant local banking market. In many proposals analyzed by the Federal Reserve, the only dispute (over which approval or denial of an application depends) is over the appropriate market definition. Given the tendency of the courts in recent years to rely on simple market share tests, it is important to understand the logic and reasoning behind the delineation of banking markets.

There are both conceptual and empirical problems in defining banking markets. The conceptual problems deal with describing the relationship between "sellers" and "buyers," so that an area can be defined as a market. The most basic and widely accepted concept for analyzing markets is "cross-elasticity of demand." The cross-price-elasticity is a measure which summarizes the relationship between the change in price of any one firm's output and the amount of business done by others (see footnote 14 in text). If an increase (decrease) in the price of one firm's service results in a significant increase (decrease) in the sales of another, the two may be considered to be subject to the same market forces — and are in the same market. Economic theory does not tell us, however, what magnitude of the cross-elasticity should be used for such determinations. It does tell us that if competition exists, output prices of these firms tend to equalize to prices equivalent to the marginal cost of providing these services.

Implementing this conceptual framework in actual casework is not easily achieved. Since price data to measure cross-elasticities are difficult to obtain, a number of other proxies are used in defining a market. Most of these indirect measures of cross-elasticity center around judgments about the "reasonable interchangeability" of the products of firms. The "products," of course, have been defined as the general category of banking services (total deposits, loans, etc.). Confusion reigns among bankers about the difference between PSAs and markets as economists define them. The lack of overlapping service areas between banks does not necessarily mean that banks are located in distinct market areas. The two are not equivalent concepts. All of the factors mentioned above may make the market substantially larger than a bank's PSA. In other words, two banks, competing in the same market, need not have common customers or overlapping PSAs.

For those wishing to review the literature on the analytics of defining banking markets, the following sources are suggested:


