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Banking Mergers: The Case to Replace the 1995 Banking Merger Guidelines—Part II: Market Definition Issues

Michael D. Noel*

Significant changes on the horizon in how the Department of Justice Antitrust Division evaluates mergers in the banking industry will materially affect the types of mergers that will be challenged and the advice attorneys give to their banking clients. The current set of banking-specific merger guidelines, published in 1995, have long fallen out of date, and are no longer consistent with economics best principles contained in the 2010 Horizontal Merger Guidelines. After recent merger reviews highlighted problems with the banking guidelines, the Division requested public comments on how it might revise its current approach to banking merger review analysis.

In the first part of this two-part article, which appeared in the March 2021 issue of The Banking Law Journal, *the author introduced the topic and commented on the guidance generally. This second part of the article comments on the Herfindahl-Hirschman Index Threshold, relevant product and geographic markets, rural versus urban markets, non-traditional banks, and the de minimis exception, and offers conclusions.*

COMMENTS ON HERFINDAHL-HIRSCHMAN INDEX ("HHI") THRESHOLD

Should the Screening Thresholds in the 1995 Banking Guidelines Be Updated to Reflect the HHI Thresholds in the 2010 Horizontal Merger Guidelines?

Yes, the screening thresholds in the 1995 BMG should be updated to match those in the 2010 HMG. There is no basis for applying a different set of thresholds to the banking industry, provided the market definition exercise is carried out properly in the first place. The discrepancy occurs only because the 1995 BMG is long out of date. The threshold in the 1995 BMG derives from the then current 1992 HMG, which divided markets into unconcentrated,

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moderately concentrated, and concentrated markets, using HHI cutoff thresholds of 1,000 and 1,800. These thresholds were introduced almost 40 years ago in the 1982 HMG, and had fallen out of date by the 1990s. The thresholds were updated to 1,500 and 2,500 in the 2010 HMG, reflecting more recent agency experience, and the 1995 BMG simply lags behind the change. It is easily fixed.

COMMENTS ON RELEVANT PRODUCT AND GEOGRAPHIC MARKETS

Depending on the Transaction, the Division Generally Reviews Three Separate Product Markets in Banking Matters: (1) Retail Banking Products and Services, (2) Small Business Banking Products and Services, and (3) Middle Market Banking Products and Services. Are There Additional Product Markets That the Division Should Include in Its Analysis?

The three product markets are suitable for most banking merger analyses. They are necessarily simplifications, of course, since banks are multiproduct firms that offer a wide variety of related financial and technology services. If meaningful competitive concerns surround a particular service, a finer product market could be considered in those particular instances.

As previously discussed, it is important to carefully consider the metrics used to estimate market shares in each of the product markets. Banks face competition from a wide variety of bank and non-bank entities:

- National and online lenders;
- Farm bureaus;
- Credit unions;
- Venture capitalists;
- Brokerage and investment houses;
- Money transfer services and apps;
- Currency distribution;
- Closed-loop credit card companies;
- Prepaid cards;
- Commercial assistance;
- Foreign exchange services;
- Secure storage; and many others.

Many competitors compete along a few lines of business, but collectively these companies compete with banks on the full suite of products and services that banks typically offer.

The 2010 HMG discusses several potential metrics for general use, with revenues being the most common. But in banking markets, the most common metric is deposits and, in secondary analyses, loans. As discussed below, there are limitations of each. Deposit-based metrics, which are not a measure of bank revenues or even the revenues of any product that a bank sells, excludes many legitimate competitors that compete with banks but that do not take deposits, including online and investor-funded lenders.

Loan-based metrics are closer to revenues but exclude many legitimate competitors that compete with banks but do not issue loans, including most specialty service providers. Large numbers of legitimate competitors are excluded under both metrics due to data availability issues or arbitrary adjustments. These lead to biased measures of market shares and HHIs and subsequent errors in merger analysis. It is important to estimate (and not exclude) the market shares of competitors even if ideal data is not available. Multiple metrics can be used to provide a more rounded understanding of the competitive constraints banks actually face.

The 1995 Banking Guidelines Specify That the Division Screens Bank Merger Applications Using the FRB-Defined Geographic Markets and/or at a County-Level. Should There Be Other Geographic Market Definitions Used in the Screening Process? If So, What Should They Be and Why?

The current set of geographic banking markets should be retired in their entirely, and geographic banking markets rethought from the bottom up. The current set of markets as defined by the Fed are a significant source of error in banking merging analysis today. The reason is that they are based on a model of strictly local competition that does not take into account the way modern consumers and businesses bank. Markets are defined too narrowly, often egregiously so, resulting in HHIs that are systematically biased and unreliable for use in merger analysis. Since current market definitions no longer reflect consumer substitution opportunities and the set of competitive constraints that banks face, they are inconsistent with the economic principles laid out in the 2010 HMG and should be reconsidered.

This is true even for recently defined markets, which rely on the same older approach. In fact, these often contain the greatest errors, since they generally involve the rural spaces between large metropolitan areas and the degree of arbitrariness tends to be the highest in these areas. Geographic banking markets are defined so narrowly in many rural areas that the HHIs derived from them are essentially meaningless.

It is instructive to go through a short history of how we got here. Fed economist Nisreen Darwish describes in a *Chicago Fed Letter* published in 2014, that the 1963 Supreme Court opinion "to consider a bank's geographic market to be its local area remains the foundation of the Fed's delineation of banking markets."[7] The Court's guidance, in *U.S. v. Philadelphia*, states:

> "In banking, as in most service industries, convenience of location is essential to effective competition. Individuals and corporations typically confer the bulk of their patronage on banks in their local community; they find it impractical to conduct their business at a distance" and "The factor of inconvenience localizes banking competition as effectively as high transportation costs in other industries."[8]

The Court emphasized the importance of "convenience" which in 1963 meant that a bank branch had to be within a short walk or drive from home or work. Since a consumer needed to go in and speak with a teller to perform even basic and routine banking tasks, such as depositing or withdrawing cash, cashing checks, or updating passbooks, and to do so on a frequent basis, "convenient" and "local" were synonymous at that time. But this is no longer true today.

Some readers may remember a long-ago time when waiting in long lines at the bank at lunch hour, just to do routine banking tasks like withdrawing cash or depositing a paycheck, was normal. As discussed earlier, credit cards, debit cards, direct deposit and other electronic money transfers, nationwide ATM networks, remote commercial services and online banking and lending have revolutionized the way consumers and businesses do their banking. Fewer and fewer individuals step inside a physical branch anymore, and those that do, do so less and less often. Even significant tasks like opening an account, investing, or applying for a mortgage or small business loan can easily be done online. Accessing banking services today is as convenient as logging on to a computer or reaching for a smartphone or credit card. Many automatic services (direct deposit, bill pay) take place quietly in the background without any customer intervention at all.

In a 2018 survey conducted by the American Bankers Association, only 18 percent of respondents stated that in-branch banking was their preferred method of service. Another 80 percent of respondents stated that non-branch delivery channels were their preferred method, with internet and mobile banking accounting for the vast majority (72 percent).[9] This represents a

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[7] Darwish, N. "Keeping Banking Competitive: Evaluating Proposed Bank Mergers and Acquisitions," *Chicago Fed Letter*, Federal Reserve Bank of Chicago, May 2014.

[8] *United States v. Philadelphia National Bank et al.*, 83 S. Ct. 1715 (1963).

[9] American Bankers Association. "Preferred banking methods infographic," September 2018.

significant reversal from the world of 1963. In fact, some banking services are so intrinsic to everyday life today that many respondents may not recognize that every time they use a debit or credit card, or have a paycheck deposited or a bill paid automatically, those are also banking services. The shift is only going to continue—younger people are most likely to express a preference for internet and mobile access (79 percent for ages 18–34), and least likely to express a preference for branches (13 percent). Branches will continue to become less and less important going forward.

This has been known for some time. In a study documenting the early days of online banking, Fed researchers Dean Amel, Arthur Kennickell, and Kevin Moore find that, even by 2004, "the Internet has become an important means of accessing financial services regardless of the location of the institution; at the same time, it may also have facilitated the discovery of non-local institutions or the opening on non-local accounts."[10] They find "a steady decline in the shares of accounts and loans at local institutions" and that "In 2004, 57 percent of households used at least one non-local provider of financial services."[11] This is back in 2004. The trend has only grown stronger in the 16 years since.

The problem with 57-year old Court guidance from 1963 is that it predates the technological transformation in the banking industry and does not take into account the competitive options that consumers and businesses have today. New electronic and online service delivery channels for banking products and services break the synonymy between "convenience" and "local" that the Court discussed in 1963. They vastly increase the number of banks and other entities that are viable substitutes to customers and businesses, and this makes geographic banking markets larger.

It actually makes them larger in two ways. First, there are increasingly more consumers and businesses that rely almost exclusively on electronic and online services rather than physical bank branches (e.g., online banks or online lenders) and this works towards larger, regional markets (and, in time, national ones). Second, for consumers and businesses that still prefer physical branch access, they are less likely to go into a branch for frequent and routine tasks (such as withdrawing cash, deposit checks, or making payments on a loan) and more likely to reserve branch visits for more infrequent and significant banking

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Available at https://www.aba.com/news-research/research-analysis/preferred-banking-methods, last accessed September 18, 2019.

[10] Amel, D., Kennickell, A., and Moore, K. "Banking Market Definition: Evidence from the Survey of Consumer Finances." Finance and Economics Discussion Series, Federal Reserve Board, 2008.

[11] *Ibid*.

tasks (e.g., applying for a loan). Customers shop more widely for these more infrequent and significant items, and this works towards regional markets as well.

The current COVID-19 pandemic emphasizes just how optional branches have become to the banking experience today. While one might miss going to a favorite restaurant or a live sporting event, attending a class or going to the movies, few consumers or businesses experience any interruption in banking services. Reaching for a debit or credit card, accepting a debit or credit card, withdrawing spending cash at one of the half-a-million ATMs nationwide, applying for a mortgage or business loan, making a payment on a credit card or loan, and so on, all continue electronically or online without supply-side interruption. Automatic bill pay and direct deposit continue to be automatic. Perhaps the only function that requires a physical branch visit today involves the few consumers that still have a safety deposit box at a bank. Safety deposit boxes were always a tiny fraction of a bank's business, and now with easy software encryption of important documents and fireproof home safes for other items, it is that much smaller today.

An early recognition of the expanding nature of a bank's geographic reach dates all the way back to 1974, when it was argued in *U.S. v. Connecticut* that a state-level competitive effects analysis, and not just a local one, was necessary to evaluate potential competitive effects post-merger. Ironically, it was the Department of Justice—and not the merging banks—who made this argument.[12] The Court affirmed its 1963 decision but emphasized that "the Government cannot rely only on Standard Metropolitan Statistical Areas" or "town boundaries" and that it "must make a determination as to the geographic market in which each of the banks operates and to which the bulk of its customers may turn for alternative commercial banking services."[13] Forty-six years later, consumers and businesses have many alternative choices to which they can turn, and are not limited by MSA or town or county boundaries anymore.

The Fed's methodology has not kept pace with these changes. As an example, the Fed writes that it places much weight on *daily* commuting patterns, based on the idea that consumers and businesses are likely to be restricted to only those banks they physically drive past each day.[14] However, few consumers and

[12] *United States v. Connecticut National Bank*, 418 U.S. 656 (1974). The merging banks had already agreed prior to the case to divest branches in the minimal area of local overlap. The Department of Justice argued against the merger on the grounds of state-wide effects.

[13] *Ibid.*

[14] Norwest Corporation. 84 Fed. Res. Bull. 1088, 1091 n. 19 (1998).

businesses need that frequent a level of branch access today, if they need any access at all. In rural areas, where towns are often only a few miles across and the nearest big city may only be an hour or two away, daily commuting patterns are largely meaningless. For rural residents, even an occasional supply run into a regional hub city is more than sufficient to visit one of dozens of banks in that hub city for infrequent and significant tasks. Obviously, daily commuting patterns are irrelevant altogether for the growing number of customers that do their bank electronically and online.

The transformation of banks and other entities from brick-and-mortar operations to largely electronic and online operations is fundamental and forces us to rethink geographic banking markets. The 2010 HMG presents two different approaches to defining geographic markets—markets based on the location of the firms ("firm-centric") and markets based on the location of its customers ("customer-centric"). The 2010 HMG states that the former applies when "customers receive goods or services at suppliers' locations" and the latter applies when "suppliers deliver their products or services at customers' locations."[15] The banking industry was clearly the former in the 1960s, but has since shifted mostly into the latter. Banks now travel to you. Banking is increasingly customer-centric and distance to a branch is less and less important.

The question then is not how far consumers and businesses will travel to go to a bank branch but rather: What competitive banking choices do consumers and businesses in any given area have? Customers today can select among a range of local banks, banks outside their local area, online banks, and a wide variety of local, regional, and national non-bank entities, including online lenders and service providers. Prices are sometimes nationally set and sometimes regionally set. Taking the smaller of these, this makes geographic banking markets regional in nature, not local.

Should Geographic Markets for Consumer and Small Business Products and Services Still Be Considered Local?

No. As discussed previously, geographic banking markets for consumer and small business products are no longer local, they are regional in nature at a minimum.

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[15] Department of Justice Antitrust Division and Federal Trade Commission. 2010 Horizontal Merger Guidelines. Section 4.2.

COMMENTS ON RURAL VERSUS URBAN MARKETS

The Dynamics of Rural and Urban Markets Can Differ Significantly. In What Ways, If at All, Should These Distinctions Affect the Division's Review?

Rural and urban areas differ significantly and these differences must be taken into account when applying the economic principles laid out in the 2010 HMG. The underlying principles from the 2010 HMG do not change, but the economics of these areas are different, so the outcomes will often be different, and this has not always been recognized.

Consider two concrete examples. The first concerns geographic market definition in rural areas, and the second concerns potential efficiencies in rural area mergers.

With respect to the first, the approach taken by the Fed and adopted in the 1995 BMG is based on an out-of-date notion of local banking and results in geographic banking markets that are too narrowly defined. The problem is especially pronounced in rural areas. Obviously, rural areas have access to all the same electronic and online services as urban residents, and the same biases exist there. But the decreased reliance on physical bank branches, for those that still want branch access, disproportionately expands rural geographic banking markets relative to urban ones. The key to understanding this is understanding the differences in rural and urban life.

Small rural counties and communities often contain only have a few thousand people or maybe a few tens of thousands of people. There may be a few banks on Main Street, a small supermarket, some agricultural supply stores, and perhaps a few basic fast food or restaurant options for immediate needs. But many of the services that urban residents take for granted—large department stores, big-box stores, specialty retailers, malls, dealerships, auto repair, the full range of dining options, recreational activities, colleges and universities, sporting facilities, golf courses, parks and so on—are rarely present in a rural town. Rural residents would need to make the occasional trip into a nearby regional hub city for these things. The hub city is often only an hour or two away and is an easy drive on uncongested and open rural highways and interstates.

A hub city would not have been a convenient banking option to rural residents in the 1960s, where everyday branch access was necessary, but that is not true today. Relatively few people visit physical branches for frequent and routine tasks and are more likely to reserve branch visits for infrequent and significant tasks, if at all. It is not inconvenient to stop into a branch in a nearby hub city from time to time when already there for other reasons. This makes rural area geographic banking markets regional in nature and—at a minimum—attached to a full-service supply hub city.

In short, small rural cities and towns that have few banks have few of everything else, and are not economically self-contained areas like a large metropolitan area would be. It makes no sense to think of them as separate banking markets, or as scaled-down replicas of a large metropolitan area.

This is not properly reflected in the geographic banking markets defined by the Fed and adopted by the 1995 BMG. One might expect to see larger regional-based markets in which economically integrated rural areas are combined with respective hubs, reflecting the social and economic integration of these areas, but this is not the case. It appears that the defined geographic banking markets for rural areas are based on drawing arbitrary circles (and squares) around small rural population centers, that are not meaningful banking markets in any sense, and creating scaled-down replicas of large metropolitan area markets. It leads to egregiously narrowly defined banking markets in many rural areas. There are two related errors: (1) not taking into account the modern competitive choices that rural area residents have today, and (2) superimposing urban concepts (e.g., daily commuting patterns, bank branching patterns, and public transportation routes) onto rural areas where they do not apply.

Some examples illustrate. Consider the state of Texas and the largest predefined banking markets in that state. The predefined Houston area banking market consists of Houston and its surrounding suburbs, and includes all or parts of ten different Texas counties. The predefined San Antonio market consists of six counties, the predefined Austin market consists of five, and the predefined Dallas and Fort Worth markets consist of six counties each. In each case, boundaries are drawn around the built-up population area and ends where the open farmland and ranchland begin (except the awkward division through the middle of the DFW metroplex). According to Google Maps, it takes approximately three hours to drive from one end of the Houston area banking market to the other on a typical weekday morning, and approximately two hours to drive from one end to the other in other metropolitan area markets. Each large city contains over a hundred thousand brick-and-mortar businesses providing all the products and services large city residents come to expect, putting aside countless other online choices.

Now consider examples of rural area banking markets defined in Texas. The defined geographic banking market of Matador, in northwest Texas, consists of a single county. Matador is the largest town in Motley County, with a population of 700 (the whole county having a population of 1,200). The town is only one mile wide. According to Google Maps, there are two restaurants in Matador, a café and a restaurant inside a motel, a small grocery store, and a small number of shops. It should be obvious that Motley County is not an economically self-contained metropolitan area and there is no reasonable sense in which the one and only bank in Motley County constitutes a separate banking market.[16] That bank does not and cannot charge "monopoly" prices. Residents access most products and services from one of the area's hub cities, (Lubbock or Amarillo in this case), where they have access to dozens of physical banks, even setting aside online options.

The defined geographic banking market of Wellington is another example of a single county market. The market consists only of Collingsworth County, with a population of 3,000. Wellington is the largest city in Collingsworth County, with two-thirds of the county's residents, and is just one mile across from east to west. According to Google Maps, there are five small restaurants in Wellington and a seasonal kiosk that sells snow-cones. There is a Dollar General, a tire repair shop, a few gas stations, and a small assortment of shops. Collingsworth County is not an economically self-contained metropolitan area and there is no reasonable sense in which the two (and only two) banks in Wellington are a separate banking market. Residents access most products and services from Amarillo, where they have access to dozens of physical banks, setting aside online options.

There are other examples. The Snyder defined geographic banking market was defined earlier this year and contains only a single rural county, Scurry County. Snyder, the largest city with a population of 11,000, is equidistant to three major supply hubs, Lubbock, Midland-Odessa, and Abilene (10 to 20 times as large), and is easily connected to these cities by open rural freeways. The Eastland defined geographic banking market does not even make up a full county but only a part of a county, Eastland County, along I-20. The city of Eastland, the largest city in the county with a population of 4,000, is a short drive from Abilene (30 times its size) and an easy trip to Dallas Fort-Worth (2,000 times its size). The Mineral Wells defined geographic banking market contains only Palo Pinto County and a tiny notch out of Parker County. The city of Mineral Wells, the largest city in the market with a population of 16,000, and is a short 40-minute drive to the Dallas Fort-Worth metroplex (500 times its size). The Granbury defined geographic banking market consists of two extra small counties (Hood and Somervell Counties, which have a smaller combined area than most single Texas counties) and these counties are

[16] There is also a Farm Credit System lender, which is erroneously disregarded in HHI calculations.

actually *inside* the Dallas Fort Worth MSA itself. Yet the Granbury defined market has been arbitrarily separated from Dallas-Fort Worth. Granbury, the largest city in the market with a population of 8,000, and is just twenty miles away from built-up areas inside the city of Fort Worth. Residents in all these "markets" have vastly more physical bank choices than their narrowly defined geographic banking markets would suggest, even before considering the spectrum of online options.

Other defined markets that involve more than a single rural county are no more reasonable. The Hereford defined geographic banking market is based around the city of Hereford, a small city with a population of 15,000. Hereford has modest services commensurate with its size but its residents must rely on the much larger city of Amarillo to the east for the full range of products and services. Hereford is a short 45-minute drive from Amarillo on an open rural interstate. Hereford is not an economically self-contained metropolitan area and there is no reasonable sense in which it is a separate banking market, cut off from its large supply hub to the east. If Hereford were 45 minutes away from downtown Houston, Dallas, or San Antonio, it would be well inside that defined geographic banking market.

The Plainview defined geographic banking market does not contain any complete county at all but is made up of small pieces of three different counties in an awkward oblong shape. The largest city in the market is Plainview, a small city with a population of 20,000, near the eastern edge of the market. Plainview has a modest set of services commensurate with its size but its residents rely on the much larger city of Lubbock to the south for the full range of products and services. Plainview is a short 40-minute drive from Lubbock on an open rural interstate. Plainview is not economically self-contained and there is no reasonable sense in which it is a separate banking market. If Plainview were 40 minutes away from downtown Houston, Dallas, or San Antonio, it would be well inside that defined geographic banking market.

The Lamb County defined geographic banking market is based around the city of Littlefield, a city with a population of 6,000. Littlefield has few services but is a short 38-minute drive from Lubbock. Littlefield is not economically self-contained and there is no reasonable sense in which it is a separate banking market. If Littlefield were 38 minutes away from downtown Houston, Dallas, or San Antonio, it would be well inside that defined geographic banking market. There are numerous other examples.

Open farmland or ranchland may give the illusion of distance when viewed through an urban lens, but are not, by themselves, determinative of a market's boundaries, as the 1974 Court noted. The set of banking alternatives to which consumers and businesses can turn, in response to a post-merger price increase, is. While consumers are unlikely to drive from one metropolitan area, such as Dallas, across miles of open farmland to another, such as Houston, for the sole purpose of accessing a physical bank branch, rural area residents regularly drive across open farmland to neighboring towns and hub cities for many reasons, both economic and social.

It is not inconvenient for rural residents to visit a physical bank branch in a hub city, assuming they want a physical branch in the first place, when they are in that city for other reasons already. It makes no sense to assume that residents of a place like Matador would never leave their tiny town, or that residents of Littlefield would never spend the half an hour it takes to visit a city 40 times its size and access the full range of products and services there, including dozens of physical banks. Or shop more widely for better deals on large purchases like a mortgage or a farm loan. And then there is the spectrum of online options. The number of customers that still restrict their choices to physical bank branches even for major items is getting smaller all the time.

Defining geographic banking markets too narrowly in rural areas has significant consequences for banking competition policy in these areas. Rural counties may only have a handful of physical bank branches, so that any merger with even minimal overlap in a rural city or town will almost certainly lead to deposit-based HHIs exceeding the threshold. A recent study by the St. Louis Fed shows that 88.8 percent of rural banking markets, when defined too narrowly as counties, already exceed the HHI screen threshold prior to any merger and are, in the author's words, "stuck."[17] The average HHI across such markets exceeds 3,400. Any merger with any overlap in these areas would be challenged or stopped, indiscriminately including pro-competitive mergers, and only because of a flawed geographic market definition that inflates HHIs.

Over time, the rural geographic banking markets defined by the Fed have grown into a patchwork of arbitrarily and much too narrowly defined markets in the rural spaces between large cities. There are countless inconsistencies and, as the map continues to be filled in over time on an as-needed basis, it only gets more arbitrary. Northwest Texas is an excellent example of a patchwork of arbitrarily defined markets that makes no sense as economic markets and is unworkable going forward.

It needs to be rethought from the ground up. Geographic banking markets have historically been taken to be firm-centric, but markets based on a customer-centric approach is now more appropriate. Banks travel to consumers

[17] Meyer, A. (2018). "Market Concentration and Its Impact on Community Banks." Federal Reserve Bank of St. Louis.

and businesses more than consumers and businesses travel to banks. Markets are likely to be similar in size under either approach, provided firm-centric markets still take into account banks and non-bank entities that offer services to customers inside a given area, whether or not they have a physical branch presence in the area. They are, after all, on your computer and in your pocket. This implies that markets are regional in nature at a minimum.

To fix the problem more broadly, a new and complete geographic banking market map must be drawn for the nation as a whole, in line with the economics principles in the 2010 HMG, and without holes and gaps. The holes and gaps are currently substantial, creating uncertainty for banks seeking to merge and modernize their offerings in these areas. The new map will be a significant collaborative effort, but will provide the best guidance, and prevent the inevitable inconsistencies that come with markets defined in a piecemeal fashion by different analysts at different times with potentially different goals in mind. The map can be amended over time as new information becomes available, and the integrated national approach will ensure that any changes are applied in a consistent way nationally.

The second example of how urban ideas applied to rural areas can be misleading for merger review deals with efficiencies. Efficiencies are nowhere mentioned in the 1995 BMG. Yet efficiencies are especially high in many rural area mergers because of the nature of the targets—many targets are smaller, less efficient, and less technologically advanced than their larger counterparts. Absent economies of scale and the ability to offer the latest banking and security technologies that consumers and businesses have come to expect, many of these banks find it difficult to compete and are at greater risk of eventual failure. Merger activity in rural areas is often necessitated by the need to keep pace with the increasing minimum efficient scale in the industry. Some consolidation of local and regional banks is not only expected but generally pro-competitive.

There have been small rural area mergers that appear to show deposit-based HHIs high in the 3,000s (as calculated using much too narrowly defined county-based geographic market definitions, and disregarding or downweighting competitors as is currently done), and yet having no realistic chance of adverse competitive effects. It emphasizes how uninformative the calculated HHIs have become, with out-of-date definitions and arbitrary exclusions of competition. The aforementioned St. Louis Fed article, which shows that almost 90 percent of rural counties are "stuck" with inflated HHIs above the current threshold regardless of the competitive reality on the ground, implies that efficiency-motivated mergers in these areas will repeatedly encounter this problem, and lead to predictable policy errors.

In banking agency reviews, it can be difficult for banks to overcome a failed HHI screen, even if known to be biased, and even when efficiency effects are strong. This disproportionately affects smaller banks and banks in rural areas, since efficiency motives are often strong in these areas but even the slightest overlap in physical branches can significantly inflate the HHI, given much too narrowly defined markets and the arbitrary exclusion of most sources of competition. Efficiencies are not always afforded the conversation that they deserve and this needs to be rectified. Otherwise, many pro-competitive rural area mergers may be unintentionally pre-empted and banking competition unintentionally harmed.

Should the Division Apply Different Screening Criteria and HHI Thresholds for Urban vs. Rural Markets? If So, How Should the Screening Criteria and the Thresholds Differ?

No, it is not necessary to apply different screening criteria or HHI thresholds for urban versus rural markets. The same thresholds can be used provided that the product and geographic banking markets are properly defined in the first place. Earlier it was discussed that rural area geographic banking markets are arbitrarily and much too narrowly defined, often egregiously so, inconsistent with the economic principles laid out in the 2010 HMG. Significant sources of competition are systematically disregarded as well. Both biases significantly inflate the HHIs in these areas. Once more meaningful regional geographic banking markets are adopted, and all significant sources of competition are considered, the HHI thresholds can remain the same for both urban and rural markets.

Having said that, it is always important to recognize that the HHI screen is intended only to be a screen, and is not intended to be determinative as is sometimes taken to be. Efficiencies are exceptionally important in many rural area mergers, which will often exceed the HHI threshold even in a properly defined market, and these countervailing effects must be given due consideration.

The Division Often Considers Farm Credit Lending as a Mitigating Factor. Is There a More Appropriate Way to Measure the Actual Lending Done by Farm Credit Agencies in Rural Markets?

The general principle is to use the best available information and not arbitrarily "zero out" competitors. The Farm Credit System ("FCS") associations represent a substantial competitive constraint on traditional banks in rural areas and must be taken into account. A recent study by the Kansas City Fed shows that traditional banks and FCS associations each hold about forty percent of farm loans in agriculturally important areas.[18]

Yet lenders in the farm credit system do not take deposits and are entirely excluded from deposit-based HHI calculations. FCS loans are generally excluded from loan-based HHI calculations as well because loan data is not available on a market level. The result is systematic and known biases in the HHI in rural areas that can vastly overstate the potential for adverse competitive effects post-merger.

If actual market-specific FCS loan data is available, use it. If not, the aforementioned Kansas City Fed article provides a possible estimation method. No single method is perfect, but the underlying principle is that the resulting HHIs should be free of systematic and known biases. The default assumption that the market shares of FCS association loans is exactly zero creates a systematic and known bias and is not defensible.

One last small point on this question highlights a deeper issue. FCS loans should be not called a "mitigating" factor. If FCS loans are properly taken into account, they will become an integral part of the product and geographic market definition exercise and recognized as the significant competitive constraint on banks that they are in rural areas. The HHI will account for them. "Mitigating" factors should refer to factors that are relevant for evaluating competitive effects but not captured in a correctly calculated HHI. Calling FCS associations a mitigating factor is in the mold of the "additional analyses" section of the 1995 BMG and should be avoided.

COMMENTS ON NON-TRADITIONAL BANKS

Should the Division Include Non-Traditional Banks (e.g., Online) In Its Competitive Effects?

Yes, absolutely. There is no basis for arbitrarily excluding competitors that impose significant competitive constraints on merging banks. The purpose of the market definition exercise is to understand the competitive choices that consumers and businesses have and whether they can defeat any attempted post-merger price increase. Disregarding a vast amount competition creates systematic and known biases in the HHIs and predictable errors in merger analysis.

A similar problem occurs with the practice of downweighting credit unions and thrifts to 50 percent. The reason given by the Fed is that "thrifts typically

[18] Morris *et al.*, *supra* note 5.

have not provided a full range of retail banking products and services provided by commercial banks" and that "thrifts have not been active in commercial lending." But there is no economic justification for downweighting or excluding legitimate competition in a properly defined product market.

In terms of retail banking products, there are many service providers that compete with banks on only some of the services banks provide but, collectively, they compete with banks on essentially all the services that banks provide. The piece-by-piece dismissal of individual competitors because they are not full service providers is ultimately the wholesale dismissal of full-scale competition that is. In terms of less commercial loan activity, it is straightforward to calculate a loan-based HHI for commercial loans to examine that. The current approach is to make arbitrary adjustments to the wrong metric (deposits) to compensate for a failure to use the right metric (commercial loans) that is of interest. If a credit union or thrift accepts deposits (and does not do nothing with the other 50 percent) then all those deposits must be included in a deposits-based metric.

Does the Division Give Appropriate Weight to Online Deposits?

No. If the Division does not currently give full weight to online deposits in its deposit-based HHI calculations, then it does not give appropriate weight to online deposits.

The Fed currently disregards online deposits, as stated in its online FAQ: "Deposits of Internet banks are generally not included in local market share calculations, because it is not possible, given current data, to determine where the depositors of such banks are located." But disregarding these large competitors is not defensible. It is equivalent to assuming their market shares are exactly zero, leading to systematic and known biases in the HHIs and predictable errors in merger analysis.

Given That the Geographic Dispersion of Deposits from Online Banks is Not Publicly Available (by Market or Branch), Suggest How These Institutions Can Be Incorporated into Screening and Competitive Effects Analysis.

There are several methods. No single way is perfect, but the principle is to estimate market shares using the best available information to produce HHIs that are free of systematic and known biases. The current practice of assuming market shares of online banks are exactly zero does not do this.

It is straightforward to gather deposit information for online banks on a national level through their SEC 10-K filings. Banking-market-specific market shares can be estimated using this data and one or more estimation methods.

One estimation method assumes that online deposits are distributed across regions in the same proportion as deposits of traditional banks. A region that holds one percent of the nation's traditional bank deposits would be estimated to hold approximately one percent of the online bank deposits. This is the most natural and obvious approach, but there are other methods as well.

A second estimation method assumes that deposits are distributed proportionately based on population. A region that holds one percent of the population would hold approximately one percent of online bank deposits.

A third estimation method would assume that deposits are distributed proportionately based on income. A region that holds one percent of the nation's income would hold approximately one percent of online bank deposits.

A fourth estimation method would assume that deposits are distributed proportionately based on wealth. A region that holds one percent of the nation's wealth would hold approximately one percent of online bank deposits.

The deposit-based estimation is likely to be most informative, since it involves known deposits directly, while the wealth-based estimation is likely to be least informative since wealth distributions are highly skewed and wealthy individuals hold the vast majority of their wealth outside of deposit accounts. It is possible to use a weighted average of several estimates, and the procedure can be fine tuned over time as more information becomes available on how online deposits correlate with traditional deposits, population, and income. The estimated market shares for online banks can be made available by the Division. Obviously, if future regulations make market-level deposits available for online bank customers, use them.

COMMENTS ON *DE MINIMIS* EXCEPTION

Should the Division Implement an Internal *De Minimis* Exception for Very Small Transactions Whereby the Division Would Automatically Provide a Report on the Competitive Factors of the Transaction to the Responsible Banking Agency but Would Not Conduct an Independent Competitive Effects Analysis if These Deals? If So, What Would Be an Appropriate *De Minimis* Size of Transaction?

It seems prudent, but applicants in small transactions should still have the option of requesting an independent review from the Division, should there be disagreements with the responsible banking agency in terms of approach. Banking agency guidelines have not always been consistent with the economic principles set out in the 2010 HMG, and this will help ensure the approach of all four agencies are aligned with each other and with the economic principles in the 2010 HMG.

Countervailing effects in small transactions in particular must be given careful consideration, as small transactions often hold the greatest potential for post-merger efficiencies, and/or involve small targets that have the highest risks of eventual failure. As the minimum efficient scale in the industry increases, small banks are less well-positioned to meet competitive challenges, offer competitive rates, gain economies of scale, spread out the fixed costs of regulatory compliance, or keep up with the latest technologies. Such mergers are often the only feasible means to ensure the long run survival of older and smaller community banks.

It is inadvisable as a policy matter to wait until a small bank failure is imminent before a merger is allowed when it is clear that a small bank is on a direct path to eventual failure. Enabling efficiency-motivated mergers now leads to stronger and more effective competitors in the marketplace in the long run.

Industry participants are best positioned to place a figure on the appropriate size of a *de minimis* transaction.

CONCLUSION

For all the above reasons, the 1995 BMG, now long out of date, lead to systematic biases in banking merger review. The problems exist in any banking merger, but are especially pronounced in mergers that involve one or more regional or rural area banks. The implication is that application of the 1995 BMG can actually hamper, rather than protect, competition, in many areas. Efficiencies are important in a technologically driven industry, which includes the banking industry, and must be afforded due deference. Product and geographic market definition methodology needs to be reconsidered from the top down and made consistent again with the economic principles contained in the 2010 HMG. This will give banks and attorneys that represent banks greater clarity on which mergers will be challenged and, importantly, which mergers should be challenged.