

## The Role of Supervisory Authorities in Connection with Bank Mergers

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**Overview.** Consideration of supervisory procedures regarding bank mergers is timely and important. Consolidation in the banking industry is proceeding at an accelerated pace,<sup>2</sup> and poorly conceived or badly executed bank mergers can present risks to the participating banks, to the banking system and to other economic sectors. Bank mergers can have long-lasting effects, for better or for worse, on the structure and performance of a market; the preservation and enhancement of competitiveness in the banking system should be an important objective of national policy in every market-based economy that requires a realistic appraisal to be made of the likely competitive effects of a bank merger.

The term “bank mergers” as used here includes not only bank-to-bank mergers, but also bank holding company acquisitions of additional banks and bank holding company formations when two or more previously unaffiliated banks are brought under common ownership; it does not refer to acquisitions by banks or bank holding companies of

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<sup>2</sup> During the decade of the 90s, consolidation in banking proceeded rapidly, compared to historic levels, throughout much of the world. In the United States alone there were more than 4000 bank mergers, including some of the largest transactions in the nation’s history. Rhoades, Stephen A., *Bank Mergers and Banking Structure in the United States*, (Board of Governors of the Federal Reserve System, Washington, D.C., Staff Study 174 (2000)). Many other parts of the developed world also experienced increased bank merger activity during that time. Group of Ten, *Report on Consolidation in the Financial Sector* (January 2001). The reasons for the increased pace of consolidation include the elimination of geographical barriers to bank expansion; improvements in information technology; search for cost savings and revenue enhancement and shareholder pressure for improved financial performance. In Europe, the introduction of the Euro has eased the way for financial market integration. Emerging markets have experienced similar trends, although cross-border transactions, many of them driven by a need to resolve problem banks, form a much larger part of the total number of bank mergers in the developing world. International Monetary Fund, *International Capital Markets—Development, Prospects, and Key Policy Issues* (World Economic and Financial Surveys, August 2001), Ch. V.

interests in non-banking organizations, nor to bank mergers that are corporate reorganizations, nor to joint ventures and strategic alliances, nor to transactions under change-in-bank control laws. Techniques used in connection with the acquisition of seriously troubled banks merit an article of their own and are not discussed here.

This article, while growing out of experience in the United States, will focus on international best practices affecting bank mergers; references to the law and practice in the United States are provided only for purposes of illustration, and not to suggest that, in every case, they represent best practices. In the United States, mergers of institutions that meet the federal definition of “bank” must be approved by one of the three “responsible agencies” under the Bank Merger Act, 12 U.S.C. § 1828(c).<sup>3</sup> Each of those supervisory authorities has issued regulations, directives and developed application forms that articulate their policies and procedures regarding bank mergers.<sup>4</sup> In addition, the Federal Reserve Board must approve any mergers of bank holding companies and of financial holding companies under the Bank Holding Company Act, 12 U.S.C. § 1841, *et seq* (the “BHCA”). The Antitrust Division of the Department of Justice (the “DOJ”) issues advisory reports on the competitive aspects of all bank mergers, and is authorized to bring suit to block proposals that it believes will have a significantly adverse effect on competition.

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<sup>3</sup> The responsible agency is the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”), where the bank to result from the merger will be a state-chartered bank that is a member of the Federal Reserve System; it is the Comptroller of the Currency (the “OCC”), where the resulting bank will be a national bank (i.e., a bank chartered under federal law); and it is the Federal Deposit Insurance Corporation (the “FDIC”) where the resulting bank will be a state-chartered bank that is not a member of the Federal Reserve System.

<sup>4</sup> Most of the 50 states within the United States also have separate requirements applicable to the merger of banks for which the states are the chartering authorities. In addition, the federal and state chartering authorities for other depository institutions such as savings and loan associations and credit unions, have requirements applicable to mergers where the resulting institution will be one that is supervised by that authority. These requirements are not further discussed here.

This article will discuss the following matters:

*first*, considerations regarding governmental policy towards bank mergers suggested by principles of transparency, will be addressed,

*second*, the teaching of Basle Core Principle 4 <sup>5</sup>(Prudential Supervisors must have authority to review and reject proposals to transfer ownership in banks to other parties), will be considered,

*third*, issues regarding bank mergers presented by Basle Principle 3 (Supervisors must have the right to review and reject proposals by entities not meeting licensing criteria), and by Basle Core Principle 5 (Supervisors must be able to review major acquisitions and investments by a bank to ensure that they don't expose the bank to undue risk or hinder supervision), will be discussed,

*fourth*, the elements of an antitrust/competition law policy applicable to bank mergers, will be discussed, and

*fifth*, the impact of other policy considerations affecting banks, including considerations raised under local law, will be addressed.

### **I. The Bank Merger Process Must be Transparent and Accountability Must be Provided For**

Mergers of banks, and in particular, of large banks, are often sensitive and potentially contentious because of concerns held by the public regarding the financial power wielded by large banks, fears about the possible loss of competition resulting from mergers, worries about the potential closure of nearby banking offices and alarm at possible losses of employment (this concern is particularly strong where the merging

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<sup>5</sup> Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (September 1997), Core Principle 4 (when referred to individually, the Core Principles will be cited as “Basle Core Principle \_\_\_”).

banks operate within the same geographical market). These concerns are best addressed through procedures that provide for transparency and accountability on the part of the agencies of government that deal with bank mergers.

The International Monetary Fund has developed a code of *Good Transparency Practices for Financial Policies by Financial Agencies*<sup>6</sup>; as applicable to the financial agencies responsible for bank supervision, these principles may be distilled as follows:

1. The objectives and institutional framework within which bank supervisors operate should be clearly defined, preferably in relevant legislation or regulation,
2. Financial policies should be communicated to the public in an open manner, compatible with confidentiality considerations and the need to preserve effectiveness of actions,
3. Bank supervisors should issue periodic public reports on major developments in the financial system, report aggregate data on a timely and regular basis, make texts of regulations and directives readily available to the public, and publicly disclose special protections such as deposit insurance schemes and consumer protection arrangements, and
4. Bank supervisors should be accountable for their actions through reporting to public authorities and otherwise to explain the basis for actions taken and their effect on the financial system.

In connection with bank mergers, principles of transparency require that members of the public and the financial institutions industry generally should be able to determine, in advance of the filing with the Supervisor of any proposal for a bank merger, just what

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<sup>6</sup>International Monetary Fund, *Code of Good Practices on Transparency in Monetary and Financial Policies: Declaration of Principles*, (September 26, 1999), and related Factsheet entitled *Transparency in Monetary and Financial Policies* (March 2001).

information future proponents will be required to submit; what opportunities will be available for participation by the public in the process; what criteria the prudential and antitrust authorities will bring to bear on the proposal; what time frames will govern supervisory action on the proposed merger; and how persons aggrieved may obtain judicial review of the decisions of the Supervisor (and of the antitrust authority, where applicable) on the proposal.<sup>7</sup> In addition, notice to the public of the filing of a bank merger proposal should be provided in timely fashion; members of the public should be provided with the opportunity to inspect non-confidential<sup>8</sup> portions of the filing, and to submit comments thereon for consideration by the Supervisor in passing upon the proposal; and the proponents should be given the opportunity to respond to any comments filed in this fashion.<sup>9</sup>

It is common in the United States for opponents of a merger to request the action agency to hold a public hearing on the proposal. Public hearings are expensive and time-consuming, thereby delaying administrative processing of the merger proposal; in addition, in most cases they add little to the record that could not be provided in a more cost-effective manner. Therefore, the agencies ordinarily require a party requesting a hearing to specify what questions of fact are in dispute, such that examination of

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<sup>7</sup> Application forms are available upon request from the Federal Reserve Board, the OCC, and the FDIC; and from the agencies' websites. Criteria for supervisory action on bank mergers (including action by the competition law authority, the Antitrust Division of the Department of Justice) is provided in the Bank Merger Act at 12 U.S.C. § 1828(c), and in the BHCA, 12 U.S.C. § 1842. Opportunities for public participation and time frames for action (where applicable) are described in agency regulations. See, e.g., 12 C.F.R. §§ 5.1, et seq.; 12 C.F.R. § 262.3.

<sup>8</sup> The agencies' regulations provide for confidential treatment of certain information, including proprietary business information and trade secrets. See, e.g., 12 C.F.R. § 261.

<sup>9</sup> The proponents of a bank merger are required to publish notice of the filing in newspapers of general circulation, and the agencies arrange for publication of notice in the Federal Register, the "official gazette" of the U.S. Government. The newspaper notices must describe the manner in which public portions of the merger application may be inspected, and the time period provided for submission of comments. The same information is provided by the agencies' regulations. See 12 C.F.R. §§ 5.8, 262.3(b).

witnesses at a hearing would be likely to resolve them; and what evidence the party would present at the hearing.<sup>10</sup> When the parties have been given a reasonable opportunity to inspect the application filed by proponents to the merger, and to submit written materials in opposition to it, it is usually difficult to meet the burden of demonstrating that principles of fairness require that a hearing be held.

Further, the Supervisor should ordinarily provide a written opinion explaining his/her reasons for the action taken, at least in those cases where there were contested issues of law or fact. In all cases, the administrative record should disclose the basis upon which the Supervisor acted, thereby permitting meaningful judicial review of the decision, without need for taking testimony from agency personnel. Further, at least in those cases raising significant questions regarding foreclosure of competition, the antitrust law authority's conclusions and reasoning regarding competitive aspects of the merger should be made available to the public.<sup>11</sup>

The Supervisor must be accountable in connection with action taken on bank mergers. In addition to meeting reporting obligations to public authorities, the process should provide for the possibility of judicial review of the Supervisor's decision at the instance of aggrieved persons, such as disappointed applicants, competitors and

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<sup>10</sup> See, e.g., 12 C.F.R. § 262.3(e).

<sup>11</sup> In the United States, the agencies ordinarily provide written opinions in connection with their action on bank mergers. While these opinions are perfunctory in connection with routine transactions, they are quite detailed in those cases where the proposal presents significant issues of law or fact. See, e.g., *In the Matter of North Fork Bancorporation, Inc., Melville, New York*, 2001 Fed. Res. Bull. 779 (October 31, 2001); *In the Matter of First Union Corporation, Charlotte, North Carolina*, 2001 Fed. Res. Bull. 683 (August 13, 2001); *Decision of the OCC on the Application of NBT Bank, N.A., Norwich, New York, to merge with Central Nat'l Bank, Canajoharie, New York*, 21 OCC Quarterly Journal No 1 (March 2002).

customers believing themselves to be adversely affected by the proposal.<sup>12</sup> While judicial review should therefore be available with regard to the Supervisor's decision on a bank merger proposal, the Supervisor and his/her staff should be shielded from personal liability for official actions taken, except in those extremely infrequent cases in which a plaintiff is able to establish that the Supervisor acted in bad faith or outside the scope of official duties.<sup>13</sup>

Despite the importance of transparency in regard to these processes, it is desirable, in the interest of preserving public confidence in the banking system, for the Supervisor to have the flexibility to permit proponents to withdraw an application for merger, rather than to have the proposal publicly denied for supervisory reasons.

## **II. The Supervisor Must Have Ultimate Approval/Disapproval Authority on Bank Mergers**

Basle Core Principle 4 provides that:

Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Regardless of the division of responsibilities between the Supervisor and other authorities for licensing (such as a deposit insurance authority) and the consideration of antitrust/competition law issues, the Supervisor, as the prudential regulator, must have

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<sup>12</sup> Judicial review is provided for in the United States District Courts in the case of decisions under the Bank Merger Act (see 5 U.S.C. §§ 702,703; 12 U.S.C. § 1828(c)(7); 28 U.S.C. § 1331); and in the United States Courts of Appeal, in the case of merger decisions under the BHCA. 12 U.S.C. §§ 1848, 1850.

<sup>13</sup> Agency employees and officials in the United States are ordinarily shielded from personal liability for actions taken in connection with their official duties. *Harlow v. Fitzpatrick*, 457 U.S. 800, 818 (1982).

ultimate veto authority over any bank merger proposal.<sup>14</sup> The antitrust/competition law authority may seek to block, on competition law grounds, a merger approved by the Supervisor, but that authority should not be able to cause a transaction opposed by the prudential Supervisor to be approved; and the law should require that action by the antitrust/competition law authority be coordinated with that of the Supervisor so as to permit timely action by the latter. Further, the law should require that any challenge instituted by the antitrust/competition law authority to block the merger be filed within a short time following the Supervisor's approval of the transaction, to eliminate regulatory uncertainties and to avoid having to "unscramble the eggs".

Both the Bank Merger Act and the BHCA provide for, in most cases, a 30-day mandatory post-approval waiting period commencing on the date of approval of a bank merger transaction during which the parties are prohibited from consummating the merger; and during which any challenge to the merger on antitrust grounds by the Antitrust Division of the Department of Justice must be filed. 12 U.S.C. §§ 1828(c)(6), 1849. The Antitrust Division is also entitled to a mandatory stay of the merger until the litigation has concluded, or until the presiding judge lifts the stay. The Antitrust Division is barred from challenging the merger on expiration of the 30-day post-approval waiting period.

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<sup>14</sup> See, e.g., Bank Merger Act, § 1828(c) and BHCA, § 1841, et seq. *passim*. See Andrews, Michael A., *Addressing the Prudential and Antitrust Aspects of Financial Sector Mergers and Acquisitions* (Operational Paper MAE/00/06 of the IMF/Monetary and Exchange Affairs Department, October 2000).

**III. The Supervisor Must be Able to Ensure that the Entity  
Resulting from the Merger Satisfies Licensing Criteria;  
and be Authorized to Review Major Acquisitions  
and Investments of the Constituent Banks**

Basle Core Principle 3, in language that is applicable both to initial licensing procedures as well as to changes in structure such as those associated with a bank merger, provides that:

The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.

The Supervisor should not approve a bank merger proposal unless positive findings can be made on the licensing criteria.<sup>15</sup>

The Supervisor should make available to the public an application form to be used by proponents of a bank merger that will elicit the information required to enable the agency to determine whether the necessary findings can be made, and the proposal approved. The precise information to be requested by the application form will be tailored, to some extent, to the requirements of local law; a list of the information

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<sup>15</sup> Basle Core Principle 5 also concerns the prudential aspects of the Supervisor's role in connection with bank mergers and other major acquisitions or investments. This Principle provides that:

Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

With regard to Core Principle 3, in the United States the action agency typically does not make all initial licensing findings in connection with a bank merger: such an exercise is viewed as redundant because the banks are already in operation and well-known to the Supervisors. However, the author believes that this has little significance, as the agencies closely examine *pro forma* capital adequacy ratios as well as the adequacy of managerial resources. Any person being added to senior management or directorate from outside the banking industry would also be scrutinized under a "fit and proper test".

typically elicited in an application form for a bank merger is attached to this article as Appendix A.

Since every merger transaction will be different, the Supervisor should retain the right to require that proponents provide any additional information that may be needed to resolve ambiguities in a particular case. The Supervisor should always be mindful that the burden is upon the proponents to demonstrate that the statutory criteria have been satisfied, and the proponents should be anxious to discharge that burden; the Supervisor should therefore not hesitate to require that proponents provide any further or additional information as the Supervisor may, in good faith, believe is needed to complete the record and provide a predicate upon which findings regarding the pertinent criteria may be based. By the same token, the Supervisor can reduce the burden on proponents in particular cases by waiving the submission of information that will obviously not be required by those proposals.

Once the Supervisor has obtained the necessary information, then the subjective work of determining whether the merger proposal meets the prudential criteria, may commence. Many bank mergers, especially those involving banks that operate in the same market, predicate their financial projections on anticipated cost savings and claimed efficiencies. The Supervisor has an important role to play in ensuring that the acquiror's projections are not unduly optimistic, as achieving the required capital adequacy ratios will likely depend on them. Consider a case in which the acquiring bank has excess back office capabilities, while the target institution outsources its data-processing operations to a third party. Elimination of the outsourcing costs by utilizing the acquiror's excess capacity would appear to be a reasonable basis for projecting post-merger savings;

however, termination of outsourcing, particularly where the vendor has made substantial commitments to customize software or has made significant investments in hardware to meet its contractual obligations, may require the payment of substantial early termination penalties that could erode, or even exceed for some years, the benefits to be obtained from consolidating operations. The Supervisor may wish to ensure, particularly where the acquiror does not have extensive experience with bank mergers, that the provisions of any outsourcing contracts to be affected by the merger have been closely reviewed and that any costs related thereto are reflected in the projected financial statements.

Similarly, where the proponents anticipate cost-savings through reductions in the resulting bank's workforce, consideration should also be given to the severance and outplacement costs that effectuation of such plans may require. In addition, staff cuts typically have an adverse effect on employee morale generally, may erode the business of the resulting bank by weakening ties to customers, and—given that the post-merger process of integrating two banks is very demanding on employees generally--may eliminate staff needed to avoid operational difficulties once the merger has been consummated. Employees of an acquiree bank often feel that they are being asked to shoulder an inappropriately large share of staff cuts; such concerns, if not responsibly addressed, can hinder the post-merger integration process. The Supervisor may wish to ensure that the acquiror is devoting appropriate attention to the human resource requirements related to the bank merger.

An acquiror will often assume optimistically that the resulting bank will accede to all of the business of the bank being acquired; however, retention of some of that business may depend on the maintenance of customer contacts with certain personnel, or

on the retention of particular pricing and marketing strategies utilized by the target institution. The bank resulting from a merger typically prefers to establish uniform product and prices throughout its system, and to coordinate advertising campaigns; indeed, this centralization may be necessary for it to achieve its cost-reduction goals. However, these preferences of customers at the bank to be acquired, combined with the acquiror's desire to reduce staff levels, may bring into question the reasonableness of projections regarding the level of business of the acquiree bank likely to be retained.

The accounting treatment to be accorded to a merger proposal also can raise significant issues. Where goodwill will be created on the balance sheets of the resulting bank, the Supervisor should carefully consider what effects any requirement to amortize that goodwill will have on earnings, and on the bank's ability to achieve its financial goals. Until recently, many bank mergers in the United States were accounted for under the "pooling of interests" method, in which the accounts of the two combining entities were restated as though they had always been parts of the same business enterprise; this method avoided the creation of goodwill. However, in July of 2001, this method of accounting for mergers was eliminated, and mergers in the United States will henceforth be accounted for under the purchase accounting method; in some cases, that will result in the creation of goodwill. The Supervisor should ensure that the proponents of the merger are using valuations and accounting procedures that are appropriate for the transaction as they develop financial statements and capital ratios for the combined entity.

A key document is the agreement between the merging parties; it should provide an appropriate framework for managing the merger process, and should (a) address formalities of structure of the resulting bank, such as the initial capitalization, the

consideration to be paid to the owners of the merging bank, the charter and bylaws under which the resulting bank will operate, and any approvals of shareholders that may be required, (b) set forth mutual undertakings to provide access to books and records and to cooperate in the process of obtaining approvals of shareholders and of supervisory authorities, (c) possibly include provisions to protect against interlopers<sup>16</sup>, and (d) provide representations and warranties regarding the existence and quality of the assets subject to the merger, and the absence of undisclosed liabilities.

The Supervisor may request the parties to enter into commitments to take specific actions to mitigate negative effects of the transaction; such commitments are enforceable where so provided by the underlying banking law.<sup>17</sup> For example, if the capital adequacy of the bank to result from the merger appears marginal, no other source of a capital infusion is present, and all other factors favor approval, then the Supervisor might approve the transaction subject to the condition that assets be sold in an amount sufficient to raise capital to a specified level. In addition, the pendency of the merger, coupled with the usual eagerness of proponents to remove any obstacles to the transaction<sup>18</sup>, provides

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<sup>16</sup> It is common in the United States for each of the parties to a bank merger to provide to the other an option to acquire 19.9% of the voting stock of the issuer; the option is exercisable by each optionee at a bargain price in the event that an interloper should make an offer to the issuer's shareholders in competition with that mutually agreed to between the parties to the merger agreement. The intent is to discourage an interloper by depriving it of some of the value that it hoped to realize and to provide some compensation to the disappointed bank for loss of the merger opportunity. The amount of each option is set at an amount below the level at which the conclusive presumption of control in the BHCA would come into play. 12 U.S.C. § 1841(a)(2). The options are automatically cancelled as soon as the merger is consummated.

<sup>17</sup> In the United States, written agreements entered into between regulated financial institutions and their regulators are subject to specific enforcement at the behest of the agency. See, e.g., 12 U.S.C. §§ 1818(b), 1818(i).

<sup>18</sup> The parties to a bank merger (in particular, the acquiror) generally feel under considerable pressure to consummate the transaction as quickly as possible for many reasons, including the possible loss of valued employees during an extended interregnum; the possibility of a downwards fluctuation in the valuation of their stock that will cause the merger to become more dilutive to existing shareholders; and inability to pursue other transactions while the merger is pending.

an excellent opportunity for the Supervisor to clear up any lingering regulatory issues (whether coming out of the merger or not) relating to the proponents. In one case, one of the parties to a bank merger transaction had, for years, resisted regulatory pressures to sell some real estate acquired through foreclosure years earlier and thereafter held DPC, in the apparent hope that the land would appreciate in value; upon learning that retention of the properties was an obstacle to approval of the merger transaction, the land was quickly sold.

#### **IV. Elements of an Antitrust /Competition Law Applicable to Bank Mergers**

The existence of appropriate antitrust/competition law standards, and the conduct of a meaningful analysis of likely effects of a proposed merger on competition in banking, are essential to preservation of a competitive banking system. The elements of such an analysis include (a) the identification of the appropriate product market, (b) the identification of the appropriate geographic market, and (c) a determination whether, within the identified geographic and product markets, the effect of the transaction will be to substantially lessen competition<sup>19</sup>. In connection with the merger of commercial banks, the Supreme Court determined in 1963 that the appropriate product market is the “cluster of services” typically offered by such institutions, such as checking accounts, loan products, letters of credit, and trust administration services. *United States v. Philadelphia Nat. Bank*, 374 U.S. 321 (1963).

With regard to definition of the geographic market, in the past it was seen as that localized area where the service areas of the banks (defined as the smallest area that would encompass the home addresses of 75% of each bank’s depositors) overlap. Under

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<sup>19</sup> See Fisher, Keith R., *Mergers and Acquisitions of Banks and Savings Associations* (Little Brown 1993).

the modern view, the geographic market is generally seen as a broader economic area within which competitive forces are freely transmitted and competition between the merging banks has a direct effect on the price and supply of banking services. See, e.g., *In the Matter of FleetBoston Financial Corporation, Boston, Mass.*, 2000 Fed. Res. Bull. 751 (September 27, 2000). The modern view gives greater weight to commutation patterns, modern methods of marketing and accessing banking services, and other factors. The modern view favors bank mergers that take place in large integrated metropolitan areas, where the competitive effects of the merger are diluted by the presence of many competing institutions, and disfavors bank mergers in small, isolated communities, where the effect of the merger appears to be severe because of the limited numbers of competitors.

Accordingly, within the product and geographic markets determined as outlined above, the likely effects on competition in banking of the proposed merger is tested through use of a screen known as the Herfindahl-Hirschman Index of Market Concentration (the “HHI”). Use of an index of market concentration to screen those mergers unlikely to have significantly adverse effects on competition (which may therefore proceed free of further scrutiny on antitrust grounds) from those that require more intense scrutiny, is premised on the belief that tacit collusive behavior among market participants is possible only where markets are concentrated; and that tacit collusion is rarely a problem where markets are not highly concentrated.<sup>20</sup> Therefore, under this view, official concern and efforts to interdict a bank merger are not necessary where the transaction will not create or aggravate a high level of concentration.

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<sup>20</sup> Posner, Richard A., *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 Stanford L. R. 1562, 1601 (1969). Collusive behavior that is the result of an outright agreement between competitors (which could form the predicate for serious criminal and civil sanctions) is seen as unlikely to escape detection.

The HHI measures the level of concentration both in terms of the number of competitors and their relative size; it is determined by adding the squares of the market shares of all banks in the market. Thus, the HHI approaches zero when the market is served by a large number of firms of equal size; and it goes to 10,000 in the case of a perfect monopoly (i.e., the entire market is served by a single firm).

Under the Merger Guidelines published by the Antitrust Division<sup>21</sup>, a market in which the post-merger HHI is below 1000 is viewed as unconcentrated; between 1000 and 1800, as moderately concentrated; and over 1800, as highly concentrated. In industries other than banking, a merger producing an increase in the HHI in excess of 50 points in a highly concentrated market, in the absence of mitigating factors, is viewed as potentially raising significant competitive concerns. Merger Guidelines, § 1.51.

However, in the banking industry, the Department of Justice has indicated that a bank merger will generally not be challenged, in the absence of other factors indicating anti-competitive effects, unless the post-merger HHI is at least 1800 and the merger increases the HHI by at least 200 points.<sup>22</sup> The DOJ has indicated that the higher than normal

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<sup>21</sup> Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission (April 2, 1992) [available on the Department of Justice's website and elsewhere]

<sup>22</sup> The operation of the HHI may be illustrated in the following hypothetical example. Assume that there are six firms in the market, with market shares of 20%, 20%, 20%, 20%, 10% and 10%, respectively; and that a bank with 20% proposes to merge with a bank holding a 10% market share. The HHI is calculated by summing the squares of the market shares of the individual firms. The resulting HHI, and the increase in the HHI, would be calculated as follows:

<u>Market Share</u>	<u>HHI (Pre-merger)</u>	<u>HHI (Post-merger)</u>
20%	400	400
20%	400	400
20%	400	400
20%	400	900
10%	100	100
<u>10%</u>	<u>100</u>	
100	1800	<u>2200</u>

The post-merger HHI would be 2200 and the increase in the HHI would be 400, thereby making this transaction subject to further analysis and possible challenge under the DOJ's guideline for bank mergers.

thresholds for screening bank mergers are intended to take into consideration the competitive effects of limited purpose lenders such as credit unions and savings and loan associations and other non-depository financial institutions. *In the Matter of NationsBank Corporation, Charlotte, North Carolina*, 1998 Fed. Res. Bull. 858 (August 17, 1998).

In those cases where a proposed bank merger will both cause an increase of over 200 points and the post-merger HHI will exceed 1800, then inquiry turns to the question whether factors are present that mitigate the apparent adverse competitive effects. For example (i) if the market is attractive for entry because it is growing rapidly, or because it is underbanked based on ratios of deposits and population per banking office, and (ii) there are banks outside the market that are likely potential entrants, with no legal barriers to entry, then the presence of such banks on the fringes of the market may mitigate concerns that would otherwise arise from the merger. Similarly, if finance companies, money market funds, brokerage firms and other non-bank financial institutions are especially strong in a particular market, that may mitigate concerns that would otherwise exist regarding an increase in concentration brought about by a bank merger in that market. See, e.g., *In the Matter of NationsBank Corporation, Charlotte, North Carolina*, 1997 Fed.Res.Bull.129 (December 10, 1997).

In the absence of mitigating factors, further analysis may be conducted by unbundling the cluster of services, and examining the effect of the proposed merger in particular product markets such as lending to small businesses; consideration may also be given whether adverse competitive effects may be mitigated through divestitures. Divestitures have the potential to lower the increase in concentration to result from a merger (i) by causing the acquiror to acquire fewer assets, and (ii) by simultaneously increasing the

size of a competitor, or by creating a new competitor, of the acquiror in the pertinent market. To be fully effective, a divestiture program should (i) require the acquiror to execute a sales agreement with regard to the assets to be divested before consummating the merger, (ii) require the purchaser to have a small market share or be from outside market and be acceptable to the Supervisor from a prudential perspective, (iii) provide that the Supervisor may retain authority to pass on the proponents' selection of branches to be divested and to require the transfer of loans related to branches to be sold, and (iv) require that divestitures be completed within a specified time period following consummation of merger (e.g., 180 days) with possible transfer to a trustee for mandatory disposition if the sale doesn't go through as planned.<sup>23</sup>

It should be acknowledged that a conflict is inherent between the Supervisor's interest in preserving stability of the banking system, on the one hand, and the public interest in maintenance of a competitive banking system, on the other hand; the existence of this conflict may suggest, as a matter of policy, that separation of responsibility for making the prudential and antitrust/competition law reviews (with the prudential Supervisor having ultimate veto authority), is desirable.

## **V. Other Considerations**

In addition to the considerations discussed above, mergers of banks can raise other supervisory concerns and issues under local law. For example, if the resulting institution will be very large, will it be perceived by the public, by the institution itself, and, possibly, by the supervisory authorities, as being "too big to fail"? Institutions that are publicly perceived as being too big to fail often enjoy an advantage in raising funds as

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<sup>23</sup> See, e.g., *In the Matter of Firststar Corporation, Milwaukee, Wisconsin*, 2001 Fed. Res. Bull. 236 (February 12, 2001).

depositors and lenders are willing to commit funds to at a lower risk premium than might otherwise be demanded; smaller banks that do not benefit from this perception often feel that creation of this large institution through merger puts them at an unfair competitive disadvantage. The perception of being too big to fail can create so-called “moral hazard” and lead to greater risk-taking by the institution’s own management as well; and it may result in less rigorous supervision by examiners who also believe that the institution will never be permitted to fail.

Where one of the merger partners is a foreign bank, the need exists for appropriate upstream and downstream coordination of supervisory action to ensure that consolidated supervision is provided effectively; and the host country supervisor should ensure that the home country supervisor has no objection to the transaction before approving the merger.<sup>24</sup> The Supervisor should ensure that there are no impediments to the exchange of information with the supervisory authorities in the foreign bank’s home country, and should consider entering into information sharing agreements if needed to achieve that objective.

Additional burdens are placed upon the Supervisor when a hostile bid is made in the hope that it will culminate in a bank merger. Hostile bids are difficult to carry out in the banking industry because of the regulatory procedures to be complied with, and they do present risks not found in consensual transactions. For example, a hostile bid presents supervisory risks such as the potential loss of key staff members at the target institution, and a potential for erosion of the target’s customer base because of business uncertainties as the takeover process proceeds. There is a potential, even a likelihood, of costly and disruptive litigation. However, in a market economy, hostile bids fill a useful role if, for

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<sup>24</sup> See Basle Core Principles 3, 23, 24 and 25.

no other reason, than that their mere possibility provides a useful measure of discipline to under-performing bank managements. The Supervisor's procedures should, therefore, attempt to accommodate the dynamics of a hostile bid with adherence to the agency's prudential standards.

In jurisdictions with deposit insurance programs, a merger of two insured banks may bring together in one institution deposit accounts that the depositor had split between the merging banks in order to avoid exceeding the maximum levels of coverage at a single institution. The merging banks in such circumstances should be required to advise their customers that they may need to take action to preserve deposit coverage of the entire amounts of their deposits, assuming that the rules of the pertinent deposit insurance program state that coverage is not provided for amounts that exceed the limit for coverage as a result of the merger of two insured institutions.

Concerns are frequently raised, in light of the cost-cutting rationale that drives many bank mergers, regarding politically sensitive losses of employment. Acquirors typically do not wish to be specific about anticipated employment cutbacks until they are ready to announce them, in order to avoid premature loss of valued employees who "jump ship" while the job market remains uncrowded, before layoffs are announced. In the United States, a potential loss of employment is generally viewed as the price to be paid for achieving the greater efficiency anticipated as a result of the merger, and it is not among the factors required to be considered by the federal regulators in connection with bank mergers. However, some states have leveraged their own authority to pass on a merger transaction under state antitrust laws to exact concessions regarding preservation of, for example, data-processing facilities (and the employment related thereto) within

their own borders. In some countries, preservation of employment in the banking industry is explicitly made one of the considerations to be weighed by the Supervisor. While there is no way to remove the sensitivity of these issues, it is believed that openness and transparency in supervisory procedures regarding bank mergers, is the best way to deal with them.

Local law may also provide other areas for consideration by the Supervisor. For example, in the United States, the “needs and convenience of the community to be served” is a factor, in addition to prudential and competitive factors, required to be considered by the action agencies under the BMA and the BHCA.<sup>25</sup> In addition, the Supervisor must take into consideration, in all applications seeking authority to expand banking operations, the record of the acquiror bank under the Community Reinvestment Act, a federal statute that creates an obligation on the part of banks and other depository institutions to serve the credit needs of the communities from which they derive deposits, including the needs of credit-worthy residents of low- and moderate-income communities.<sup>26</sup>

### **Conclusion**

This article has discussed the importance of transparency and accountability in relation to the Supervisor’s action regarding bank mergers; the requirement that the Supervisor have ultimate veto authority regarding bank mergers; the need for the Supervisor to ensure that the entity to be created by the merger satisfies licensing requirements; and the importance that a realistic appraisal of likely effects of the

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<sup>25</sup> See 12 U.S.C. §§ 1828(c)(5), 1842(c)(2).

<sup>26</sup> 12 U.S.C. § 2901, et seq. In keeping with Basle Core Principle 3, these statutory provisions, while potentially providing grounds for denial of a bank merger proposal, do not form grounds for overruling the Supervisor’s determination regarding the proposal on prudential grounds.

transaction on competition be made. Other issues of policy and local law that are often presented in connection with bank mergers were also discussed.

What should be expected for the future? Many of the reasons that fueled the rapid pace of bank mergers in the 90s (the breakdown of geographical barriers to expansion, the need to reduce excess capacity and shareholder pressure for improved financial performance) are still influencing banks. In the United States, despite all the merger activity that has occurred, the banking industry remains unconcentrated and we may expect to see more bank mergers—though at a slower pace, now that “pooling of interests” accounting treatment has become unavailable. In Europe it is likely that we will see more cross-border consolidation as in-country opportunities become scarcer. And in some emerging markets the opportunity for more cross-border acquisitions in connection with resolution activity will continue, although recent turbulence in some of these markets is likely to cool the ardor of some would-be acquirors for a period of time.

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**Appendix A**  
**Illustrative List of Information to be Requested**  
**Through the Application Process**

1. Copies of all agreements entered into, or to be entered into, in connection with the proposal;
2. A description of the effect of the transaction on competition;
3. Applicants should be directed to provide a complete description of the financial effects of the merger proposal. Any plans to raise additional equity or to incur debt should be described; and copies of any offering circulars to be distributed to existing or prospective shareholders should be furnished. Financial information, including a description of assumptions used to prepare the projected statements, a list of material changes since the date of the financial statements, as follows:
  - *Pro forma* balance sheet, as of the most recent quarter and for the first three years of operation after the merger. Applicants should indicate separately for each institution each principal group of assets, liabilities and capital accounts; debit and credit adjustments (explained by footnotes) reflecting the proposed acquisition; and the resulting *pro forma* combined balance sheet. Goodwill and all other intangible assets should be listed separately on the balance sheet;
  - Projected combined Statement of Income for the first three years of operation following consummation;
  - *Pro forma* and projected Regulatory Capital Schedule, as of the end of the most recent quarter and for the first three years of operation, indicating:
    - a) Each component item for Tier 1 (Core) and Tier 2 (Supplementary) Capital, Subtotal for Tier 1 and Tier 2 Capital (less any investment in unconsolidated or nonincludable subsidiaries), Total Capital (include Tier 3 if applicable),
    - b) Total risk-weighted assets including off-balance sheet items,
    - c) Capital ratios: (1) Tier 1 capital to total risk-weighted assets; (2) Total capital to total risk-weighted assets, and (3) Tier 1 capital to average total consolidated assets (leverage ratio).
4. Directors and senior officers of the resulting institution should be identified and financial and biographical information on each such person provided,
5. All branches sought to be operated by the resulting institution should be identified,
6. All consents and approvals requested by applicants (in this and any other jurisdiction ) in connection with the merger proposal should be listed,
7. The integration strategy to be followed to combine the operations of the constituent institutions should be described. Applicants should be requested to list

merger transactions engaged in during the past five years; to briefly describe the integration strategy followed in each such transaction; to describe how integration difficulties were dealt with in such transactions; and what steps will be taken to avoid similar difficulties in connection with the instant proposal,

8. Corporate governance matters relating to the resulting entity should be discussed, including Board and management committees that will come into existence, their composition, responsibilities, and reporting obligations; internal controls; any operating companies, and their respective corporate governance., should be discussed.

### **Biographical Sketch**

John Austin received his undergraduate degree from Harvard College and his law degree from Georgetown University Law Center. In 1967 he joined the Office of the Comptroller of the Currency, a bureau of the United States Treasury Department that regulates national banks; his work there involved general bank regulatory activities, bank mergers, enforcement activities, and litigation concerning the agency's activities. In 1972 he entered the private practice of law; as a partner in a Washington, D.C., law firm, he represented financial institutions from many parts of the United States in mergers and acquisitions, new product development, cross-industry acquisitions, enforcement matters, resolution of failing institutions (including the rehabilitation and sale of thrifts during the savings and loan association crisis of the 1980s), deposit insurance issues, participation in non-banking activities, issues relating to fiduciary activities, and other matters. Since retiring from the practice of law in July 2000, he has worked as an international consultant on legal issues involving financial institutions in Europe, Central and South America, and the Pacific region