Antitrust Implications of Thrifts' Expanded Commercial Loan Powers

*Janice M. Moulton**

With the deregulation of financial institutions, thrifts have gained expanded asset and liability powers, and the distinctions between commercial banks and thrift institutions have eroded.[1] Previously, commercial banks were thought to offer a unique cluster of banking services; they were the only institutions offering personal checking, commercial checking, and unsecured commercial loans. Now thrifts' legal restrictions on offering these services have been eased, and they are beginning to compete directly with banks in both commercial and consumer services.

More direct competition between banks and thrifts, particularly in commercial loans, has major antitrust implications. Regulators are charged with ensuring that bank mergers will not substantially reduce competition in banking markets. The way that regulators try to keep markets competitive is to prevent the banking markets from being domi-

*Janice M. Moulton is a Research Officer and Economist in the Research Department of the Federal Reserve Bank of Philadelphia, where she heads the Banking and Financial Markets Section. The author would like to thank Diane Mayer for excellent research assistance.

[1] For the purposes of this article, thrift institutions include savings and loan associations and both mutual and stock savings banks, but exclude credit unions.

nated by a few banks, which might use their market power to raise prices—in particular, interest rates on loans—or to block the entrance of new firms. Before thrifts were authorized these new powers, the Supreme Court did not consider them to be competitors of banks, ruling that thrifts must "significantly participate" in commercial lending and deposit-taking services in order to be included in what is called the commercial banking line of commerce. Now that thrifts look more like banks in terms of their authorized powers and the services they offer, regulators are viewing thrifts as increasingly important competitors with banks. The presence of thrifts in the commercial banking line of commerce makes it easier for a merger between commercial banks to be approved by bank regulators, since more competitors would be present in the market. Indeed, regulators recently have approved some bank mergers—which they would have denied otherwise—on just these grounds.

Pennsylvania provides a good example of a state where thrift competition with banks in making commercial loans can be important in analyzing mergers. For many years, Pennsylvania, like other states in the northeast, has had thrifts that are active competitors in making loans and attracting deposits. Moreover, recent changes in the state's banking law have encouraged many banks to merge. The extent of competition can be assessed using measures of thrifts' commercial loan activities, from both a market share and a balance sheet viewpoint. A picture of some increased thrift competition emerges, reinforcing the view that a more comprehensive analysis of thrift competition is necessary in assessing the effects of bank mergers.

ANTITRUST ISSUES

Mergers and Competition. There is one undeniable fact about mergers—the merged firm or holding company is larger than either of the two separate firms that existed previously. But whether the resulting firm acts to reduce competition or to strengthen it depends on many factors and ultimately involves subjective judgment. Certainly mergers can have important positive effects on the way firms compete. Mergers can increase a firm's efficiency by facilitating more effective use of investment capital and the sharing of productive assets, such as computer equipment and technology. Two firms producing similar services may find that, by combining their resources, they can offer a larger volume of those services at a lower unit price than either could before. Or perhaps two institutions find that their services complement one another's strengths. Thus the combined institution may be able to offer higher quality services, or more of them. In addition, mergers may indicate that the new owners believe they can better manage the institution and increase performance. In these cases, consumers can benefit from mergers because customers are likely to receive lower prices, a greater variety of products, or better quality or convenience of service.

While most mergers have beneficial effects, there may be mergers which are harmful to competition. Mergers sometimes are used to promote collusion in a market, especially where a few large firms sell most of the product. Collusion occurs when the parties agree to coordinate their actions to reduce competition in the market, and thus are able to exercise market power. Market power is the "ability of one or more firms profitably to maintain price above competitive levels for a significant period of time."[2] When mergers create market power or facilitate its use, consumers are hurt because they face higher prices—lower interest rates on deposits or higher interest rates on loans, in the case of banking—lower service levels, or a restricted menu of products. In addition, resources are impeded from moving into products where they would flow if markets were competitive.

The antitrust laws attempt to prevent adverse competitive effects from occurring in proposed mergers. Section 7 of the Clayton Act prohibits mergers if their "effect may be substantially to lessen competition, or to tend to create a monopoly" in any line of commerce in any section of the country.[3] It's up to the regulatory agencies—the Federal Reserve (Fed), the Federal Deposit Insur-

[2] U.S. Department of Justice Merger Guidelines, June 14, 1982, p. 3. Market power also applies to the ability of buyers to lower the price paid below competitive levels (often called "predatory pricing"), and to the ability of the buyer or seller to reduce competition in other respects as well.

[3] See section 7 of the Clayton Act as amended by the Celler-Kefauver Act of 1950. The Supreme Court has interpreted "line of commerce" to mean the market for the product and "section of the country" to mean the geographic market.

ance Corporation (FDIC), and the Comptroller of the Currency—to interpret this legal framework and to apply it to the banking business in a way that denies those few merger proposals that are anticompetitive, yet does not hinder the many mergers that do not impair competition.[4] When assessing the competitive effects of mergers, regulators first must decide on the geographic market and on which institutions compete there. Deciding what type of financial institution to include in the analysis depends upon how the product or service line is defined; the more specific the product line is, the narrower the range of qualifying financial institutions. Thus the choice of competing institutions affects the chances of regulatory approval.

Supreme Court Rulings on Bank Competitors. Supreme Court decisions help guide the regulatory authorities in determining which institutions are competitors when applying antitrust laws to banking. In the 1963 landmark decision, *United States vs. Philadelphia National Bank*, the Supreme Court defined commercial banking for the first time as a separate line of commerce. That is, commercial banks were thought to offer local customers a cluster of banking services different from any other depository institution. At that time, commercial banks were essentially the sole suppliers of many banking services, such as business and personal demand deposits, bankers' acceptances, correspondent banking services, and commercial loans. The court also stressed the customer convenience of buying the unique cluster of banking services from the same institution.

The Supreme Court reaffirmed its 1963 decision that commercial banking is a separate line of commerce in *United States vs. Phillipsburg National Bank* (1970). This case involved the proposed merger of two small commercial banks in New Jersey whose loan portfolios included a large amount of residential real estate loans. Since the portfolios of these banks were similar to those of many thrifts, the question was whether local thrifts could be considered competitors of small commercial banks. The Court's answer was no, rejecting any broadening of the line of commerce. It emphasized again that commercial banks had the authority to provide a wide range of banking services unavailable at other types of financial institutions. In this way, the court distinguished between banks and other financial institution competitors based on the powers authorized to them, rather than on the extent to which they exercised those powers.

In the 1974 Connecticut National Bank case, however, the Supreme Court's decision recognized that mutual savings banks, particularly in New England, were indeed "fierce competitors" with commercial banks in some service lines.[5] Yet, while not requiring equivalent powers in *all* areas, the court stressed that thrifts must offer a number of personal and commercial banking services in order to be included as competitors. Further, thrifts needed to "significantly participate" in major service lines. While finding that thrifts did not qualify yet as competitors in the banking line of commerce, the court left the door open by admitting that at some future time thrifts may become significant competitors. In setting up preconditions for including thrifts, the court anticipated a time when thrifts might become a routine part of merger analysis.

Since the last Supreme Court decision in 1974, sweeping changes have been made in the laws governing thrift asset and liability powers. Originally established to encourage savings and to promote home purchases, thrifts have maintained a sheltered tax status and have continued to specialize in residential mortgages.[6] But in the last

[4]The Comptroller is the agency responsible when the institution resulting from the merger is a national bank; the FDIC handles state-chartered banks that are not members of the Federal Reserve System; and the Fed handles state-chartered banks that are members of the Federal Reserve System. Where relevant, each agency submits advisory opinions to the responsible agency and to the Justice Department. There is a 30-day waiting period before the merger is consummated to allow the Justice Department time to bring suit under the antitrust laws.

[5]*United States vs. Connecticut National Bank* (418 U.S.664).

[6]Tax incentives encourage thrifts to hold a high percentage of their assets in the form of residential mortgages. If savings and loans have 82 percent of their loan portfolio in certain qualifying assets, mainly residential mortgages and U.S. government securities, they receive a bad debt deduction equal to 40 percent of their taxable income. This bad debt allowance is reduced an additional .75 percent of income for each successive 1 percent drop in qualified assets below the 82 percent level. See "Tax Barriers to Diversification by Savings and Loan Associations," by Herbert Baer, Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 1983.

few years, restrictions on thrifts have been relaxed. Two major pieces of legislation, the Depository Institutions Deregulation and Monetary Control Act of 1980, and the Garn-St. Germain Depository Institutions Act of 1982, have enabled thrifts to offer commercial loans and other services that traditionally fell within the domain of commercial banks.[7] Savings banks (SBs) were authorized to make commercial loans in 1980, while savings and loans (S&Ls) followed in a more limited way two years later. Through a series of steps, S&Ls and SBs reached a par with each other; on January 1, 1984 both types of institutions could invest up to 10 percent of their assets in commercial and industrial (C&I) loans. Moreover, these laws significantly expanded the powers of SBs and S&Ls to make consumer loans and commercial real estate loans, and to purchase commercial paper and offer transaction accounts.

HOW THRIFTS FIT INTO MERGER ANALYSIS

The Supreme Court's rulings on antitrust appear to require that thrifts offer a broad cluster of services and significantly participate in those services in order to be included in merger analyses. But beyond that, while some specific issues have been addressed by the district courts, there is basically little guidance on when thrifts offer enough bank-like services to be included as competitors in the line of commerce definition. As a result, now that thrifts are more like banks in their authorized loan and deposit powers, and in the services they offer, it is often difficult to know how to fit thrifts within the framework of the courts' rulings on antitrust.

In the face of these uncertainties, it is the regulatory authorities' responsibility to assess thrift participation in commercial services and to establish guidelines for evaluating how important thrifts are as competitors. The regulatory agencies involved are the Comptroller, the FDIC, and the Fed, as required by the 1966 revisions to the Bank Merger Act. Besides considering various financial and managerial factors, the agencies are directed to consider the effect of the merger on competition, including any tendency toward monopoly. Only after evaluating these factors, and finding any anticompetitive effects to be outweighed by the convenience and needs of the community, can a regulatory agency approve the transaction.

A Structural Approach. When the Fed considers a merger proposal, its approach has been to fit thrifts into the standard framework for analyzing the competitive effects of bank mergers. That framework relies primarily upon a structural test to evaluate competition. The Supreme Court endorsed a structural approach in the 1963 PNB case, where it stated:

> . . . a merger which produces a firm controlling an *undue percentage share of the relevant market*, and results in a *significant increase in the concentration* of firms in that market, is so inherently likely to lessen competition substantially that it must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anti-competitive effects (374 US at 363). [Italics added by the author.]

A significant increase in the concentration in a market usually has been measured by the combined market shares of the larger firms in that market. For example, if the merger of two banks would increase the combined market shares of deposits of the three or four largest banks from 50 percent to 65 percent of total deposits, then the merger would likely be examined closely because of the presumed anticompetitive effects of such an increase in concentration. The larger the combined market shares of the three or four largest banks, the more highly concentrated the market is.[8] Many studies have found a relationship between the market structure—or number of firms

[7]For more information on expanded asset and liability powers authorized for thrifts under these Acts, see "Recent Developments in Federal and New England Banking Laws," by Joseph Gagnon and Steve Yokas, *New England Economic Review*, Federal Reserve Bank of Boston, (Jan/Feb 1983). Although both these Acts pertain to federally-chartered thrifts, they also affect state-chartered SBs and S&Ls in Pennsylvania, which have parity with federally-chartered institutions.

[8]The Justice Department in June 1982, issued new merger guidelines for a wide range of industries, which rely upon an alternative measure of concentration in the local banking market—the Herfindahl-Hirschman index (HHI). This index is calculated by squaring the market share of each institution competing in the market and summing over these institutions. Unlike the concentration measures of the top three or four firms, the HHI includes all institutions in the market and weights those with large market shares more heavily.

and concentration in a market—and the competitive performance of the firms in the market.[9] This structural approach is also evident in the Justice Department guidelines for mergers. Under these guidelines, mergers between banks with large market shares, particularly in highly concentrated markets, may be anticompetitive. The Federal Reserve's competitive analysis generally is consistent with Justice's approach, though the guidelines have not been formally adopted by the Fed.

When thrifts are present in the relevant market, the Federal Reserve fits them into the competitive analysis by judgmentally *shading*,or discounting, the market shares of commercial banks within the relevant banking market. This procedure results in thrifts being included somewhere between 0 and 100 percent. Here's how shading works. Once the appropriate banking market is chosen, the share of deposits held by each commercial bank in that market is calculated. Commercial banks are considered the only competitors in the market and thrifts aren't included at all. Next, a second calculation is made of deposit shares including all thrift institutions as full competitors within the relevant market. That is, the deposits held by all the commercial banks *and* all the thrifts are summed together to make the total market pie, which lowers the measured market shares of the commercial banks in the market.[10] Between these two extremes, judgment is needed to determine to what extent thrifts should be included as active participants in the market.

In the past, the judgmental part of the shading procedure generally has relied upon supplementary data on the nature of thrift activity in the market, and in general these data have been restricted to commercial loans and transaction accounts such as NOW (Negotiable Orders of Withdrawal) accounts. If thrifts offer these services, they are likely to receive more weight in the analysis. That is, a greater percentage of thrift deposits would be included in the shading process, increasing the chances of regulatory approval of the merger.

When analyzing the competitive effects of thrifts in bank merger cases, the Federal Reserve Board asks several questions to help build a profile of thrift activity in a particular market. For example, what are the market shares held by thrifts in deposits and in commercial loans? How many institutions are making commercial loans in the market? What kinds of resource commitments to these activities do their balance sheets suggest? How big are the thrifts, and does their size relate to their commercial lending activity? When answering these questions, it is useful to analyze the data statewide, as well as at the market and individual firm levels.

THRIFT C&I LOAN DATA FOR PENNSYLVANIA

The combination of merger activity and thrift activity in Pennsylvania makes it an interesting case-study for assessing thrifts' role in the competitive effects of mergers. Pennsylvania has seen a surge in merger proposals, due in part to recent changes in the state's banking law. In 1982 the state law was amended to increase the number of subsidiaries a bank holding company could control from one to four. With this change, a bank holding company could merge two or more of its subsidiaries to "make room" for acquiring additional subsidiaries without exceeding the legal limit. In fact, many bankers have taken advantage of the relaxed law to merge, and others have plans to do so. Moreover, Pennsylvania has over 200 S&Ls and SBs in the state, dating back to the first S&L and the first SB in the country. Several different measures of thrift participation are presented here for Pennsylvania and each provides a slightly different view of thrifts' competition with banks.

What Shares do Thrifts Hold in Deposits and in Commercial Loans? Traditionally, deposit market shares have been an important measure of thrift competition with banks. Thrifts have always offered time and savings deposits, and Pennsylvania thrifts have been authorized to offer transaction accounts since 1980. By the time and savings deposit measure, thrifts already have an active presence in Pennsylvania, with SBs and S&Ls together holding

[9]For a review of this literature, see Stephen Rhoades "Structure-Performance Studies in Banking: A Summary and Evaluation," Staff Studies No. 92, Board of Governors of the Federal Reserve System, 1977. See also his more recent paper, "Structure-Performance Studies in Banking: An Updated Summary and Evaluation," Staff Studies No. 119, Board of Governors of the Federal Reserve System, August 1982.

[10]However, the measure of overall market concentration could actually increase by including thrifts, if the market contains one or two thrifts that are large relative to the commercial banks.

about 35 percent of statewide deposits (see Table 1).

Thrifts are not nearly so active in making commercial loans as in taking deposits, but they are making some headway: thrifts make almost 7 percent of all C&I loans made by commercial banks and thrifts in Pennsylvania, which amounts to more than $1.00 out of every $20.00 that is lent (see Table 2). While still small, these figures signify important gains since 1980, especially for SBs.[11] From 1980 to 1983, in fact, Pennsylvania SBs increased their share of statewide C&I loans from .5 percent to 6.6 percent, primarily because of one large institution in the Philadelphia area. S&Ls, however, experienced only slight growth in market share, reaching 0.2 percent during 1983. The 33 percent statewide growth in total C&I loans probably aided the thrifts in obtaining what share they did. However, commercial banks still do the lion's share of commercial loan business in Pennsylvania, making over 93 percent of the state's C&I loans.

[11]The national picture differs somewhat from Pennsylvania's. In 1983 thrifts nationally had about 1.5 percent of total C&I loans. Of that amount, S&Ls have a 0.4 percent share, greater than what they hold in Pennsylvania. But SBs nationally, with a share of only 1 percent, are less active than they are in Pennsylvania. From 1980 to 1983, the total amount of C&I loans in the country has grown by about 50 percent, somewhat more than in Pennsylvania.

TABLE 1

DEPOSIT MARKET SHARES IN PENNSYLVANIA[a]

(Millions $)

	1980	%	1983	%
Commercial Banks	$48,407	60.1	$74,484	64.7
Savings Banks	12,499	15.6	16,913	14.7
Savings & Loans	19,681	24.4	23,711	20.6
TOTAL	$80,587		$115,108	

[a]Data for national banks and state member banks are from the Report of Condition filed with the Federal Reserve, while data for state nonmember banks and savings banks are from the Report of Condition filed with the FDIC. Savings and loan data are from the Statement of Condition filed with the Federal Home Loan Bank Board. June filings were used from 1980 through 1983. These data are the basis for all subsequent tables.

Are More Thrifts Making Commercial Loans? If thrifts in a market are more likely to make commercial loans, they are judged to be more competitive with banks in their lending. And indeed, the data in Table 3 show that there are more thrifts making commercial loans today than there were in 1980. In the case of SBs, which are few in Pennsylvania, twice as many institutions participated in 1983 as in 1980. For S&Ls, mergers helped to boost the participation rate from 7 percent to 15 percent during the same period by reducing the total number of S&Ls statewide. Nearly all of the commercial banks in Pennsylvania make some form of commercial loan.

How Important are Commercial Loans on the Thrifts' Balance Sheets? Recently, balance sheet measures of thrifts' lending activity have received greater emphasis because they provide a useful supplement to deposit market shares in assessing competition for C&I loans. Balance sheet measures, such as the ratio of the volume of C&I loans to total loans, are particularly useful when thrifts are much fewer in number than commercial banks. In this case, the small loan market share of the thrifts compared to commercial banks may obscure the significant participation of a few institutions which could be quite active in bidding for commercial loans. The ratio of C&I to total loans also can be used to compare the commitment of the average SB to that of an average S&L or commercial bank. And within types of institutions, such a measure can pick out those thrifts whose portfolios differ substantially from the norm.

As expected, the portion of total loans devoted to commercial loans at thrifts still is relatively low (Table 4). On average, commercial banks hold 36 percent of their loans in the form of C&I loans, savings banks hold 15 percent, and savings and loans hold less than 1 percent. In particular, the savings bank figure reveals stronger lending activity than is indicated by their loan market share. Since the total volume of C&I loans in the state has

TABLE 2

C&I LOAN MARKET SHARES IN PENNSYLVANIA

(Millions $)

	1980	%	1981	%	1982	%	1983	%
Commercial Banks	$14,049	99.4	$14,886	94.8	$17,133	93.0	$17,590	93.2
Savings Banks [a]	75	0.5	810	5.2	1,276	6.9	1,236	6.6
	(73.9)	(0.5)	(71.6)	(0.5)	(76.5)	(0.4)	(114.8)	(0.6)
Savings & Loans[b]	4	0.03	5.8	0.04	4.8	0.03	39.8	0.2
TOTAL	$14,128		$15,702		$18,414		$18,866	

[a]Data in parentheses exclude PSFS from the savings bank numbers.

[b]While a commercial and industrial loan category was available on the call reports, commercial loans for S&Ls were defined strictly to include unsecured construction loans, wholesale mobile home loans, and other non-consumer loans. Commercial real estate was excluded from the definition.

TABLE 3

C&I LOANS: PARTICIPATION RATIO FOR PENNSYLVANIA INSTITUTIONS

(Participants/Total)

	1980	1981	1982	1983
Commercial Banks	359/367	346/355	337/344	328/335
Savings Banks	3/9	3/9	6/8	6/8
Savings & Loans	18/258	25/247	26/225	29/194
TOTAL	380/634	374/611	369/577	363/537

NOTE: March 1984 data show 100 percent participation by SBs: of the two that were not making C&I loans in 1983, one has now begun to do so, and the other has been acquired by a commercial bank holding company.

TABLE 4

BALANCE SHEET MEASURE: COMMERCIAL LOANS AS A PERCENT OF TOTAL LOANS

	1980	1981	1982	1983
Commercial Banks	32.4%	33.0%	36.0%	36.0%
Savings Banks[a]	1.0	13.6	15.0	14.9
	(1.9)	(1.7)	(2.7)	(4.1)
Savings & Loans	.02	.03	.02	0.2

[a]Data in parentheses exclude PSFS from the savings bank numbers.

increased relative to that of total loans since 1980, it is perhaps not surprising that the ratio of commercial loan volume to total assets has grown for all three types of institutions.[12] Savings banks substantially altered their portfolios to expand into commercial loans, however, while S&Ls, on average, added a limited amount of commercial loans to their balance sheet. These averages, of course, hide considerable variability from one thrift to another. The ratios for savings banks range from 20 percent down to 1.5 percent while those for S&Ls range from 10 percent to negligible amounts.

Does Size Matter? In recent merger cases, the Federal Reserve Board has cited the size of thrift institutions, along with other factors, as a basis for assessing the competitive influence exerted by thrifts.[13] If larger thrifts are more likely to engage in commercial lending, for example, then size can be used to predict whether thrifts are likely to embark upon a commercial loan program in the future. This assumption that larger thrifts have become, or have the potential to become, significant bank competitors probably stems from the belief that larger thrifts are more likely to be in a better position to exercise their newly authorized powers. Size may be important because the initial cost of setting up a commercial loan department or of hiring a full time commercial loan officer may exceed the expected future earnings of a small thrift. And, because small thrifts have fewer deposits, they have a lower capacity for making loans of any kind. Thus if local thrifts fit this pattern of behavior, large thrifts would tend to count as stronger competitors with banks than would smaller thrifts.

What is the relationship between size and commercial lending for thrifts in Pennsylvania? The evidence suggests that larger thrifts make more commercial loans, but it is not conclusive for either SBs or S&Ls. Since there are so few SBs, it is not clear that any strong conclusion can be drawn. But it appears that larger savings banks are more likely to enter the commercial loan business and to make a greater volume of loans. The largest SB in the state, Philadelphia Savings Fund Society (PSFS) is by far the biggest thrift player in the commercial loan market.[14] With over $1 billion in commercial loans, PSFS has ten times the amount of the next largest SB participant and nearly forty times the loans of the largest S&L participant. Generally, savings banks are the largest thrifts in the state; even the smallest SB made nearly half a million dollars in C&I loans in 1983.

S&Ls show some tendency for greater size to be associated with greater commercial loan activity when they are sorted into size groups (Table 5), but the relationship is not as strong as the groupings suggest.[15] On the whole, Pennsylvania's 200 S&Ls are small institutions—only three have more than $1 billion in deposits and only six S&Ls are as big as or bigger than the *smallest* SB, and their median deposit size is only $55 million. Larger institutions appear to make a greater volume of commercial loans and to have a higher participation rate in making C&I loans. S&Ls with less than $25 million in deposits made no C&I loans at all in 1983.

Why Haven't Thrifts Expanded More? The most important reason thrifts haven't used their new lending powers more probably has been the weakened financial condition of thrifts stemming from the mismatch of their assets and liabilities in a period of high interest rates. With the elimination of interest rate ceilings on deposits, thrifts were compelled to pay higher rates on MMDAs, NOW accounts, and savings certificates in order to compete with banks, money market mutual funds and other alternatives for their deposit funds. Even with large amounts of funds in passbook accounts, their costs of funds went up dramatically. At the same time, thrifts still were holding a large

[12] The ratio of C&I loans to total loans for the state increased from 19.8 percent in 1980 to 23.6 percent in 1983.

[13] In the Sun Banks-Flagship merger in Florida, the Federal Reserve Board concluded that "Based upon the number, size, and market shares of (thrift) institutions in the ... market, ... thrift institutions exert a significant competitive influence that substantially mitigates the anticompetitive effects of this proposal." Cited in the *Federal Reserve Bulletin*, December 1983, p. 936.

[14] In 1983, PSFS alone held almost 6 percent of the C&I loans in Pennsylvania. Though PSFS dwarfs the contributions of the other savings banks in the statewide figures, its volume has declined by about $150 million since 1982, while C&I loans of other SBs were rising.

[15] Correlation coefficients were calculated for 1983 deposits and C&I loans for each type of institution. For commercial banks, the correlation coefficient is .94; for SBs, it is .98 (.46 excluding PSFS); for S&Ls, it is only .06.

TABLE 5

SIZE AND C&I LOAN ACTIVITY FOR S&Ls IN PENNSYLVANIA, 1983

Deposits (Millions $)		C&I Loans (Thousands $)	S&Ls Making C&I Loans
Range	Average for Group	Total for Group	Participants/Group Total
$150.2 - 1,867	$401.7	$32,761	13/40
74.5 - 143.8	101.7	4,760	7/40
40.0 - 74.4	54.9	2,026	7/40
15.9 - 37.7	18.6	263	2/40
3.1 - 15.8	9.7	0	0/34

volume of long-term fixed-rate mortgages bearing low interest rates, which meant that their assets, on average, were yielding considerably less than what they were paying on deposits.

Another reason why thrifts have been slow to move into the commercial loan business is the high start-up costs involved. Thrifts did not have commercial loan experience, and they have had to build up their expertise slowly in-house or else hire experienced loan officers from commercial banks. Many smaller and middle-sized institutions likely have found it too costly to hire a full time commercial lending officer or establish a department; their loan volume isn't large enough to justify such an expenditure.[16] Of course, significant incentives remain for thrifts to continue their traditional emphasis on residential mortgages.

BROADENING THE SCOPE OF COMPETITIVE ANALYSIS

Does the modest profile of thrift commercial loan activity presented for Pennsylvania mean that it is unimportant for analyses of bank mergers? Certainly not. Though thrifts are just beginning to act as competitors in this important commercial area, they have an impact on the analysis in several ways.

First, mergers are approved mostly upon the basis of *local* banking conditions. Although statewide numbers indicate a modest level of commercial lending activity across Pennsylvania, they are likely to mask what is going on in particular areas. Thrifts have stronger lending activity in metropolitan than in nonmetropolitan markets in Pennsylvania, and many mergers occur in the more populated markets. For example, despite the fact that thrifts make less than 2 percent of the total C&I loans in the Pittsburgh market, C&I loans at savings banks in Pittsburgh are more than 10 percent of their total loans, indicating a fairly significant balance sheet commitment to this lending activity.

Second, *individual* thrift institutions may be quite important in particular markets. When looking at the more specific measures of thrift competition, one striking finding is the tremendous variability in thrift commercial loan behavior. Thrifts which make commercial loans differ markedly in their market shares, the amount of resources on the balance sheet devoted to commercial loans, and their size. Because thrifts in a particular market might behave quite differently, analysis of the competitive effects requires a careful look at how individual institutions use their expanded powers before forming an overall judgment of thrift competition in that market.

[16] Other reasons for the modest commercial loan participation include high default risk on some types of commercial ventures over the past few years, variable rate mortgages that reduced interest rate risk and therefore the need to diversify into commercial lending, tax incentives that continue to encourage mortgage lending, and the short time that expanded powers have been authorized. For a good discussion of the factors influencing thrift commercial lending, see "How Quickly Can Thrifts Move Into Commercial Lending?" by Constance Dunham and Margaret Guerin-Calvert, *New England Economic Review*, (Federal Reserve Bank of Boston, Nov/Dec 1983).

New Ways of Including Thrifts. The courts have determined that, for antitrust purposes, commercial loans are one of the most significant services in which banks and thrifts compete. One approach to assessing thrift competition would be to add use of this expanded power to past strengths that thrifts have traditionally shown in making residential real estate loans and in issuing time and savings deposits. When credit is given to thrifts for building on the areas where they have been strong competitors with banks in the past, thrifts look like more serious competitors *today* even though they have made only modest inroads in C&I lending. Indeed, there is some recent evidence that thrifts substantially influenced commercial bank behavior and performance in Pennsylvania back in the early 1970s.[17]

Recognizing that banks and thrifts may compete over a broad range of services leads to a multi-service line approach. Recently, the Federal Reserve's staff proposed to the Board of Governors informal guidelines to bring balance sheet measures of the major service lines formally into the shading process. This approach could be applied to the commercial loan service line as an example, since this service alone can justify substantial shading of commercial bank shares. To analyze the balance sheet commitment of thrifts to commercial lending, the average ratio of commercial loans to total loans for SBs and S&Ls could be compared to each other and to the commercial banks. The commercial banks' ratio would serve as an indicator of the strength of the demand for commercial loans in that market. For commercial loans, other factors would include the number of thrifts actually making commercial loans, the size of the thrifts in the market, and whether the thrifts have established commercial loan departments, hired a commercial lending officer, or have plans to do so in the near future. After considering all such factors for the thrifts in the relevant market, a judgment would be made regarding the degree of competition that thrifts offer banks in the commercial loan service line. For example, if thrifts in the market are deemed to be moderately strong competitors in commercial lending, they could receive, say, a weight of 20 percent—that is, 20 percent of the deposits of each thrift in the market would be added onto the total commercial bank deposits, and the market shares would be recalculated using this larger total deposit figure. Thus, the service line—in this case commercial loans—would collapse at the end of the shading process back into the concept of the market share of deposits.

This approach need not be limited to commercial loans. Each major service line with its own characteristics could be analyzed in the same kind of way; such an approach could help to ensure consistency across markets. Other service lines might include consumer loans, commercial and residential real estate loans, transaction accounts, and time and savings accounts.[18] All together, a thrift weight of 100 percent would be possible if thrifts were judged to be strong competitors with banks in every major service line in the market. More likely, however, only a proportion of thrift deposits would be added to the total deposits of banks in the market to calculate the measures of market concentration. Even 50 percent inclusion of thrifts' deposits could significantly reduce measures of concentration in the market, increasing the likelihood of regulatory approval of mergers. It should be noted, however, that some writers have urged caution in including thrift institutions; they point out that mergers already resulting in much larger market shares for banks are permitted, compared to when commercial banks were considered the sole competitors.[19]

---

[17]See Timothy Hannan, "Competition Between Commercial Banks and Thrift Institutions: An Empirical Examination," *Journal of Bank Research*, Spring 1984, pp. 8-14.

[18]A multi-service line approach raises questions about how much to depart from the traditional line of commerce doctrine. If regulators judge thrifts to be competitors in some but not all of the service lines, thrift deposits may be included to a substantial extent, though thrifts may not be competing with banks in some important areas. For example, how much can active thrift competition in consumer loans offset moderate thrift competition in commercial loans? Closer adherence to a unique line of commerce would tend to require significant participation in commercial loans, whether or not the thrift competes in consumer services. These issues probably will not be resolved until the Supreme Court again rules on the line of commerce definition.

[19]See "Antitrust Laws, Justice Department Guidelines, and the Limits of Concentration in Local Banking Markets," by Jim Burke, Staff Studies No. 138, Board of Governors of the Federal Reserve System June, 1984, p. 14.

OUTLOOK FOR THRIFTS IN MERGER ANALYSIS

Thrifts are moving close to the point where they may be considered serious competitors in the commercial banking line of commerce. With today's complex financial institutions, it's difficult to evaluate *when* thrifts offer sufficient volume and breadth of major banking type services to be considered significant competitors. Both SBs and S&Ls now are authorized to offer a wide range of personal and commercial banking services. Currently, thrifts are participating in commercial loans in Pennsylvania in a limited way, but given the financial difficulties and earnings losses in the industry, this current level of activity is not surprising. Still, as a group, thrifts are moving to exercise their commercial loan powers more fully and to compete in more of the commercial banks' major service lines, and will probably continue to do so. And some thrifts are now making greater inroads into the commercial loan markets to the point of affecting competition in local banking markets. As a result, thrift activity now receives more weight in the competitive analysis of bank mergers, significantly increasing the chances of regulatory approval of bank merger applications. For policymakers, legislators, and the judiciary, these developments likely will require continued scrutiny and adjustment in assessing the antitrust implications for bank mergers of thrifts' new lending powers.

Working Papers

The Philadelphia Fed's Research Department occasionally publishes working papers based on the current research of staff economists. These papers, dealing with virtually all areas within economics and finance, are intended for the professional researcher. The nine papers added to the Working Papers Series in 1983 are listed below.

A list of all available papers may be ordered from WORKING PAPERS, Department of Research, Federal Reserve Bank of Philadelphia, 10 Independence Mall, Philadelphia, Pennsylvania 19106. Copies of papers may be ordered from the same address. For overseas airmail requests only, a $2.00 per copy prepayment is required.

1983

No. 83-1	Robert H. DeFina, "Union-Nonunion Wage Differentials and the Functional Distribution of Income: Some Simulation Results from a General Equilibrium Model."
No. 83-2	Nicholas Carlozzi, "The Structure, Parameterization and Solution of a Multicountry Simulation Model."
No. 83-3	Nicholas Carlozzi and John B. Taylor, "International Capital Mobility and the Coordination of Monetary Rules." (Reissued in *Exchange Rate Management Under Uncertainty*, ed. J. Bhandari, MIT Press, 1984.)
No. 83-4	Brian R. Horrigan, "Pitfalls in Analyzing Deficits and Inflation."
No. 83-5	Herb Taylor, "The Role of the Discount Window in Monetary Policy Under Alternative Operating Procedures and Reserve Requirement Systems."
No. 83-6	Brian C. Gendreau, "Carrying Costs and Treasury Bill Futures."
No. 83-7	Edwin S. Mills, "Metropolitan Central City Population and Employment Growth During the 1970's."
No. 83-8	Gerald A. Carlino, "Declining City Productivity and the Growth of Rural Regions: A Test of Alternative Explanations." (Revision forthcoming in the *Journal of Urban Economics*, 1984.)
No. 83-9	Simon Benninga and Aris Protopapadakis, "General Equilibrium Properties of the Term Structure of Interest Rates."

83-1

UNION-NONUNION WAGE DIFFERENTIALS AND THE FUNCTIONAL DISTRIBUTION OF INCOME: SOME SIMULATION RESULTS FROM A GENERAL EQUILIBRIUM MODEL

Robert H. DeFina

During the past two decades, a number of studies have established the ability of unions to obtain wages for their members that exceed the payment to similar, but nonunionized workers. This article investigates empirically the impact that this wage differential has on the real incomes of union labor, nonunion labor, and capital. The analysis is accomplished by solving explicitly a numerically specified general equilibrium system with and without the union wage premium. Comparison of real factor incomes in each equilibrium yields the desired information. The findings indicate that union labor gains as a result of the differential, while nonunion labor and capital lose. This outcome is realized both in terms of real income levels and in a redistributive sense.

Selected Abstracts 1983

83-3
INTERNATIONAL CAPITAL MOBILITY AND THE COORDINATION OF MONETARY RULES
Nicholas Carlozzi
and
John B. Taylor

The paper develops a two-country model with flexible exchange rates and perfect capital mobility for evaluating alternative macroeconomic policy rules. Macroeconomic performance is measured in terms of *fluctuations* in inflation and output. Expectations are rational, and prices are sticky; wage setting is staggered over time. The countries are linked by aggregate spending effects, relative price effects, and mark-up pricing arrangements. The model is solved and analyzed through deterministic and stochastic simulation techniques. The results suggest that international capital mobility is not necessarily an impediment to efficient domestic macroeconomic performance. Changes in the *expected* appreciation or a depreciation of the exchange rate along with differentials between *real* interest rates in the two countries can permit macroeconomic performance in one country to be relatively independent of the policy rule chosen by the other country. The results depend on the particular parameter values used in the model and suggest the need for further econometric work to determine the size of these parameters.

83-4
PITFALLS IN ANALYZING INFLATION AND UNEMPLOYMENT
Brian R. Horrigan

When can we know whether deficits cause inflation or inflation causes deficits? The correlation we observe between deficits and inflation does not permit an inference about causality. In steady state, higher inflation is always associated with higher deficits, regardless of what caused the inflation. The causal relation between deficits and inflation can only be inferred from a study of disequilibrium situations. In disequilibrium, the inflation-adjusted deficit is a better measure of the stance of fiscal policy than the conventional deficit.

83-5
THE ROLE OF THE DISCOUNT WINDOW IN MONETARY POLICY UNDER ALTERNATIVE OPERATING PROCEDURES AND RESERVE REQUIREMENT SYSTEMS
Herb Taylor

The paper uses a simple model of the reserves market to demonstrate the implications of discount window administration procedures for short-run money control. It is shown that when the Fed uses a funds rate operating procedure to control the money stock, discount window procedures do not affect the volatility of the money stock. When the Fed uses a reserves operating procedure combined with lagged reserve requirements, a relatively liberal discount window policy is shown to improve money control. With contemporaneous reserve requirements, the case for a more restrictive discount window policy is stronger, though a penalty discount rate does not necessarily maximize short-run money control.

83-6
CARRYING COSTS AND TREASURY BILL FUTURES
Brian C. Gendreau

Researchers have consistently found that yields on Treasury bill futures differ significantly from corresponding forward rates implicit in the term structure of interest rates. This paper focuses on the borrowing costs faced by investors as the source of that difference. Rates of return attainable on forward bills created implicitly by financing Treasury bills with term repurchase agreements are calculated and found to be not significantly different from yields on Treasury bill futures contracts. These results suggest that risk premia in the repurchase market are reflected in Treasury bill futures yields, and can explain why those yields differ from forward rates.

83-7
METROPOLITAN CENTRAL CITY POPULATION AND EMPLOYMENT GROWTH DURING THE 1970s
by Edwin S. Mills

This paper studies the determinants of Metropolitan Central City Population and Employment Growth from 1970 to 1980 using census data for metropolitan areas with at least 250,000 population. Central city and suburban population and employment growth are analyzed in a four-equation model. Population and employment growth reinforce each other strongly in central cities. Suburban population growth stimulates central city employment growth, but suburban employment growth is at the expense of central city employment growth. Central city population and employment growth are affected strongly by variables over which communities have control. Many eastern and northern central cities could have replaced decline with substantial growth by better control of crime and taxes and by improved educational systems.

FEDERAL
RESERVE BANK OF
PHILADELPHIA

Business Review
Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, PA 19106

Address Correction Requested

POSTAGE DUE