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ARTICLES

PERCEPTIONS OF THE FUTURE OF BANK MERGER ANTITRUST: LOCAL AREAS WILL REMAIN RELEVANT MARKETS

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When asked to offer “perceptions of the future” on bank merger antitrust enforcement, I recalled a statement attributed to physicist Niels Bohr: “Prediction is very difficult, especially about the future.”¹ And so it is for the future of antitrust. Nevertheless, my perception is that bank merger antitrust will change very little in that the geographic scope of the relevant market for important banking services is, and will remain, local.² Before peering into the future, however, it is useful to lay a foundation by considering past and present bank merger enforcement.

The U.S. Department of Justice (“DOJ”) reviews roughly 600 bank mergers per year,³ of which it “challenges” roughly one, although these “challenges” do not entail the filing of complaints in district court. In fact, the DOJ has not filed a complaint against a bank merger since 1993.⁴ Rather, approximately once per year the DOJ issues a press release announcing that competitive concerns with a bank merger have been resolved through the divestiture of branches along with associated deposits and outstanding loans.⁵

1. The Quotations Page, <http://www.quotationspage.com/quote/26159.html> (last visited Feb. 26, 2008).

2. My perception is not based so much on expertise in the banking industry as on expertise in the delineation of relevant markets in merger cases. See, e.g., Gregory J. Werden, *Beyond Critical Loss: Tailored Application of the Hypothetical Monopolist Test*, 4 COMPETITION L.J. 69 (2005); Gregory J. Werden, *Demand Elasticities in Antitrust Analysis*, 66 ANTITRUST L.J. 363, 387–96 (1998); Gregory J. Werden, *Market Delineation under the Merger Guidelines: A Tenth Anniversary Retrospective*, 38 ANTITRUST BULL. 517 (1993) [hereinafter Werden, *Tenth Anniversary Retrospective*]; Gregory J. Werden, *Market Delineation and the Justice Department’s Merger Guidelines*, 1983 DUKE L.J. 514; Gregory J. Werden, *The Use and Misuse of Shipments Data in Defining Geographic Markets*, 26 ANTITRUST BULL. 719, 721 (1981).

3. U.S. Dep’t of Justice, Antitrust Division Workload Statistics Fiscal Year 1998-2007, at 3, <http://www.usdoj.gov/atr/public/workstats.pdf> (last visited Mar. 12, 2008).

4. The last two complaints filed in district court were those in *United States v. Texas Commerce Bancshares, Inc.* 1993-2 Trade Cas. (CCH) ¶ 70,326 (N.D. Tex. 1993) (challenging the acquisition of New First City Bank-Midland N.A.) and *United States v. Texas Commerce Bancshares, Inc.*, 1993-2 Trade Cas. (CCH) ¶ 70,363 (N.D. Tex. 1993) (challenging the acquisition of New First City Bank-Beaumont N.A.).

5. See, e.g., Press Release, Dep’t of Justice, Justice Department Reaches Agreement Requiring Divestitures In Merger Of First Busey Corporation And Main Street Trust Inc. (June 12, 2007), available at http://www.usdoj.gov/atr/public/press_releases/2007/223869.htm (merger of First Busey Corp. and Main Street Trust Inc.); Press Release, Dep’t of Justice, Justice Department Reaches Agreement Requiring Divestitures In Merger Of Regions Financial Corp. and AmSouth Bancorporation (Oct. 19, 2006), available at http://www.usdoj.gov/atr/public/press_releases/2006/219180.pdf (merger of Regions Financial Corp. and AmSouth Bancorporation); Press Release,

In reviewing bank mergers, the DOJ and the bank regulatory agencies employ a well-publicized screening process.⁶ The process focuses primarily on shares of deposits within geographic areas delineated by the regional Federal Reserve banks.⁷ The 1202 rural regions delineated by the Federal Reserve banks are quite narrow; 573 of them consist of a single county.⁸ Conversely, the 424 urban areas delineated by the Federal Reserve banks are much broader.⁹ Indeed,

Dep't of Justice, Justice Department Reaches Agreement With Wachovia Requiring Divestitures In Wachovia/Southtrust Merger (Aug. 25, 2004), available at http://www.usdoj.gov/atr/public/press_releases/2004/205184.pdf (merger of Wachovia Corp. and SouthTrust Corp.); Press Release, Dep't of Justice, Justice Department Reaches Agreement With BB&T Requiring Divestitures In BB&T/First Virginia Merger (May 8, 2003), available at http://www.usdoj.gov/atr/public/press_releases/2003/201009.pdf (merger of BB&T Corp. and First Virginia Banks, Inc.).

6. See Bank Merger Competitive Review—Introduction and Overview (1995), <http://www.usdoj.gov/atr/public/guidelines/6472.htm> (last visited Mar. 11, 2008). For useful overviews on the statutes governing bank mergers and the procedures applied in reviewing them, see AMERICAN BAR ASSOCIATION, SECTION OF ANTITRUST LAW: BANK MERGERS AND ACQUISITIONS HANDBOOK 5–12, 60–63 (2006) [hereinafter ABA SECTION OF ANTITRUST LAW]; David S. Neill, *Geographic Market Definition in the Antitrust Analysis of Bank Mergers*, 123 BANKING L.J. 291 (2006); and Tim McCarthy, *Refining Product Market Definition in the Antitrust Analysis of Bank Mergers*, 46 DUKE L.J. 865, 884–98 (1997).

7. To find the relevant geographic market for any bank branch, one may utilize a tool provided by the Federal Reserve Bank of St. Louis. See CASSIDI, <http://cassidi.stlouisfed.org> (last visited Feb. 23, 2008).

8. Elizabeth S. Laderman & Steven J. Pilloff, *Using County-Based Markets to Support and Federal Reserve Markets to Implement Bank Merger Policy*, 3 J. COMPETITION L. & ECON. 127, 136 (2007).

9. *Id.* Only 9.9% of the urban areas are single counties, whereas 47.7% of the rural areas are single counties. *Id.* The markets for major metropolitan areas often contain many counties. The market for Houston consists of 10 counties. Federal Reserve Bank of Dallas, Banking Market Definitions, <http://dallasfed.org/banking/apps/mkdef.html> (last visited Mar. 11, 2008). The market for Atlanta consists of 17 counties and parts of others. Federal Reserve Bank of Atlanta Banking Market Definitions, http://www.frbatlanta.org/bank_info/bankmarkdef/bmd_index.cfm (follow “Georgia” hyperlink) (last visited Mar. 11, 2008). The market for New York City consists of 30 counties and parts of others. Federal Reserve Bank of New York, Banking Markets, http://www.ny.frb.org/banking/ma_bankingmarkets.html (last visited Mar. 11, 2008). In addition, the market for Boston contains over 200 cities and towns. Federal Reserve Bank of Boston, Banking Market Definition, <http://www.bos.frb.org/bankinfo/struct/ind ex.htm#mardefs> (follow “Massachusetts” hyperlink) (last visited Mar. 11, 2008).

they are markedly broader than the relevant markets found in the Supreme Court's bank merger decisions of the 1960s and 1970s.¹⁰

*United States v. Philadelphia National Bank*¹¹ was the seminal Supreme Court case on the application of antitrust law to bank mergers, and one of the seminal Supreme Court cases on the application of section 7 of the Clayton Act¹² to mergers in general.¹³ In that decision, the Court observed that “[t]he factor of inconvenience localizes banking competition as effectively as high transportation costs in other industries.”¹⁴ The Court also explained that different bank customers do their banking within areas of varying geographic scope, but the Court grouped all of them together and found that a four-county area surrounding Philadelphia represented a “workable compromise” as to the geographic area in which banks competed.¹⁵ The Court defended this area on the basis that the same area had been delineated as the relevant market by the bank regulatory agencies.¹⁶ Today, however, the Federal Reserve Bank of Philadelphia delineates a far-broader ten-county market for that city.¹⁷

In *United States v. Phillipsburg National Bank*,¹⁸ the Court found the relevant geographic market included only the Phillipsburg-Easton area in western New Jersey, specifically rejecting the district court's

10. See *infra* notes 11–18 and accompanying text (comparing two key Supreme Court decisions).

11. 374 U.S. 321 (1963).

12. 15 U.S.C. § 18 (2006).

13. Most significantly, *Philadelphia National Bank* established a presumption of illegality for a merger that “produces a firm controlling an undue percentage share of the relevant market, and results in a significant increase in the concentration of firms in the market.” *Phila. Nat'l Bank*, 374 U.S. at 363. This presumption emerged just one term after the Court held that “the proper definition of the market is a ‘necessary predicate’ to an examination of the competition that may be affected by the horizontal aspects of the merger.” *Brown Shoe Co. v. United States*, 370 U.S. 294, 325, 335 (1962). The Court also set out “practical indicia” for delineating the relevant market. See Gregory J. Werden, *The History of Antitrust Market Delineation*, 76 MARQ. L. REV. 123, 154–58, 172–79 (1992).

14. *Phila. Nat'l Bank*, 374 U.S. at 358.

15. *Id.* at 360–61.

16. *Id.* at 361.

17. See Federal Reserve Bank of Philadelphia, Banking Markets, <http://www.philadelphiafed.org/files/bm/mktframe.htm> (following hyperlink to Philadelphia/South Jersey) (last visited Mar. 11, 2008).

18. 399 U.S. 350 (1970).

inclusion of the adjoining part of Pennsylvania.¹⁹ Today, the Federal Reserve Bank of New York includes the adjoining part of Pennsylvania and Phillipsburg-Easton within its huge New York City metro area market, which consists of thirty entire counties and parts of others.²⁰

Phillipsburg National Bank is of interest, however, mainly because it expanded on the Court's rationale for delineating local markets by explaining what the Court termed "[c]ommercial realities."²¹ The Court explained that the banks at issue "generally compete for deposits within a radius of only a few miles" and that convenience is especially important for "small customers."²² Most importantly, the Court observed that the merging banks' loans were mostly quite small, and declared that the "small borrower . . . must often depend upon his community reputation and upon his relationship with the local banker."²³ The Court's rationale for the narrow geographic scope of the relevant market is significant because small business loans have been a major focus of concern in the DOJ's bank merger investigations over the past two decades.²⁴ The Court's rationale foreshadows economic literature that formalized and tested this rationale when it appeared decades later.²⁵

Before proceeding further on the geographic scope of relevant banking markets, it is necessary to consider briefly the product scope of these markets. The Supreme Court decisions mentioned above held that the relevant product was the entire cluster of services provided by commercial banks.²⁶ In contrast, since at least the early 1980s, the DOJ has delineated relevant product markets consisting of narrower ranges of services.²⁷ In many of its merger investigations, the DOJ found that the

19. *Id.* at 362–65.

20. Federal Reserve Bank of New York, Banking Markets, http://www.ny.frb.org/banking/ma_bankingmarkets.html (last visited Mar. 11, 2008).

21. *Phillipsburg Nat'l Bank*, 399 U.S. at 362.

22. *Id.* at 363.

23. *Id.* at 364.

24. *See, e.g.*, ABA SECTION OF ANTITRUST LAW, *supra* note 6, at 36; Robert Kramer, Address before the Antitrust Section of the American Bar Association (Apr. 14, 1999), *available at* <http://www.usdoj.gov/atr/public/speeches/214845.pdf>; Constance K. Robinson, Address before the 31st Annual Banking Law Institute (May 30, 1996), *available at* <http://www.usdoj.gov/atr/public/speeches/1003.pdf>.

25. *See infra* notes 43–74 and accompanying text.

26. *See Phillipsburg Nat'l Bank*, 399 U.S. at 359–61; *United States v. Phila. Nat'l Bank*, 374 U.S. 321, 356 (1963).

27. The DOJ alleged that "retail banking" and "wholesale banking" were two

relevant product market in which the merger's effects on competition would be most significant was loans to small businesses or loans to small and medium-sized business.²⁸

The narrower markets delineated by the DOJ resulted from the application of its 1982 Horizontal Merger Guidelines ("Merger Guidelines"),²⁹ which set out the basic methodology still used today for delineating relevant markets. The Merger Guidelines articulated a hypothetical monopolist paradigm for market delineation, which gradually was adopted by courts in the United States and by enforcement agencies around the world.³⁰ As set out in the Merger

distinct relevant markets in *United States v. Virginia National Bankshares, Inc.*, 1982-2 Trade Cas. (CCH) ¶ 64,871 (W.D. Va. 1982). The DOJ alleged that "consumer banking" and "business banking" were two distinct relevant markets in *United States v. National Bank & Trust Co. of Norwich*, 1984-2 Trade Cas. (CCH) ¶ 66,074 (N.D.N.Y. 1984). See also Eugene M. Katz, *Determination of Line of Commerce for Bank Mergers: A Contemporary View*, 5 J.L. & COM. 155, 169-71 (1985).

28. *United States v. Central State Bank* is the first case in which the DOJ alleged a relevant market for small business loans, and it remains the last bank merger case in which the DOJ has litigated to judgment. 621 F. Supp. 1276 (D. Mich. 1985), *aff'd*, 817 F.2d 22 (6th Cir. 1987). In that case, the district court found, "as a matter of law, the relevant market [was] the cluster of services and products that comprise the full range of services offered by commercial banks." *Central State Bank*, 621 F. Supp. at 1291-92. Despite the fact that the district court explicitly stated that the relevant market was "a matter of law," the court of appeals held that the "trial court anchored its decision upon the facts developed during the course of the trial" and that its cluster market finding was not "clear error." *Central State Bank*, 817 F.2d at 24. McCarthy erroneously stated that the first case in which the DOJ alleged a relevant market for small business loans was *United States v. First Hawaiian, Inc.*, 1991-1 Trade Cas. (CCH) ¶ 69,457 (D. Haw. 1991). McCarthy, *supra* note 6 at 882-83; see also ABA SECTION OF ANTITRUST LAW, *supra* note 6, at 225-57 (providing a reproduction of a report prepared by the DOJ on the competitive effects of that merger).

29. DEP'T OF JUSTICE, 1982 HORIZONTAL MERGER GUIDELINES, reprinted in 4 TRADE REG. REP. (CCH) ¶ 13,102 [hereinafter MERGER GUIDELINES]. The Merger Guidelines were significantly revised in 1984 and 1992 and slightly revised in 1997. See DEP'T OF JUSTICE, 1992 HORIZONTAL MERGER GUIDELINES, reprinted in 4 TRADE REG. REP. (CCH) ¶ 13,104 (for the current version); see also ABA SECTION OF ANTITRUST LAW, *supra* note 6, at 57-72; Margaret E. Guerin-Calvert & Janusz A. Ordovery, *The 1992 Agency Horizontal Merger Guidelines and the Department of Justice's Approach to Bank Merger Analysis*, 37 ANTITRUST BULL. 667 (1992) (providing comprehensive overviews of bank mergers).

30. See Gregory J. Werden, *The 1982 Merger Guidelines and the Ascent of the Hypothetical Monopolist Paradigm*, 71 ANTITRUST L.J. 253 (2003). Coincidentally, the first litigated case in which the DOJ applied the hypothetical monopolist test was the bank merger case *United States v. Virginia National Bankshares, Inc.*, 1982-2 Trade

Guidelines, the hypothetical monopolist paradigm delineates the dimensions of the relevant market through an iterative process.³¹ Products and areas are added one at a time until a hypothetical monopolist over a candidate market would find it in its interest to increase prices significantly.³² An increase of more than five percent is generally considered significant. In this regard, price may serve as a metaphor for all terms of trade, and for small business loans it suffices to focus on the interest rate charged. In determining whether the relevant market for small business loans is limited to a particular area, the hypothetical monopolist paradigm inquires into the extent to which small businesses served by the local banks would respond to higher interest rates by turning to outside lenders. If a sufficient loan volume would shift, the hypothetical monopolist would not want to increase interest rates significantly and the relevant market, therefore, would be larger than the local area.

Delineation of the relevant market under the Merger Guidelines does not account in any way for the *range* of products the merging firms actually sell.³³ Neither does it take into account the ability of competitors to alter what they sell through supply substitution.³⁴ The Merger Guidelines' separate identification of the competitors in the relevant market accounts for supply substitution, however.³⁵ A firm with no current sales in the relevant market nevertheless could be considered a competitor in that market by virtue of its ability to quickly

Cas. (CCH) ¶ 64,871 (W.D. Va. 1982) (key issue being the geographic scope of the relevant market).

31. See MERGER GUIDELINES, *supra* note 29, § 0.

32. See *id.* § 1.0.

[A] market . . . [is] a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and nontransitory" increase in price, assuming the terms of sale of all other products are held constant.

Id. The Merger Guidelines define a "relevant market [as] a group of products and a geographic area that is no bigger than necessary to satisfy this test." *Id.*

33. See *id.* § 1.11 (describing the procedure for determining which products are in the relevant market).

34. See *id.* § 1.0 ("Market definition focuses solely on demand substitution factors—i.e., possible consumer responses. Supply substitution factors—i.e., possible production responses—are considered elsewhere in the Guidelines in the identification of firms that participate in the relevant market and the analysis of entry."); Werden, *Tenth Anniversary Retrospective*, *supra* note 2, at 529.

35. See MERGER GUIDELINES, *supra* note 29, § 1.3.

and cheaply begin selling in the market using resources currently deployed elsewhere.

When many products are readily substitutable in supply and have essentially identical competitive conditions, they are often aggregated together as what the Merger Guidelines term a “matter of convenience.”³⁶ From the perspective of a small business, loans of different amounts may be poor substitutes, but a bank can freely substitute among loan amounts. Consequently, a range of loan amounts could be aggregated together to form a category such as “small business loans.”³⁷ The relevant market delineated under the Merger Guidelines could resemble the Supreme Court’s cluster of banking services only if success in providing individual banking services was dependent on providing all of the other services. As this seems highly unlikely, it is also highly unlikely that the application of the market delineation analysis of the Merger Guidelines could yield anything like the full cluster of services provided by commercial banks.

The Merger Guidelines also introduced the concept of a price discrimination market,³⁸ in which a relevant market can be delineated not just on the basis of the characteristics of products or services, but also on the basis of the characteristics of the particular customers to which they are provided.³⁹ The Merger Guidelines permit a separate market to be delineated for loans to small businesses if financial institutions can and do lend to them on different terms than to other borrowers.⁴⁰ One way or another, application of the market delineation

36. See *id.* § 1.32 n.14; Werden, *Tenth Anniversary Retrospective*, *supra* note 2, at 533–34.

37. See ABA SECTION OF ANTITRUST LAW, *supra* note 6, at 36–37 (giving examples of what actually has been done); Guerin-Calvert & Ordovery, *supra* note 29, at 679.

38. See MERGER GUIDELINES, *supra* note 29, §§ 1.12, 1.22.

39. See *id.* § 1.0.

40. See *id.* § 1.12.

Existing buyers sometimes will differ significantly in their likelihood of switching to other products in response to a “small but significant and nontransitory” price increase. If a hypothetical monopolist can identify and price differently to those buyers (“targeted buyers”) who would not defeat the targeted price increase by substituting to other products in response to a “small but significant and nontransitory” price increase for the relevant product, and if other buyers likely would not purchase the relevant product and resell to targeted buyers, then a hypothetical monopolist would profitably impose a discriminatory price increase on sales to targeted buyers.

Id.

methodology set out in the Merger Guidelines almost certainly leads to the conclusion that loans to small businesses constitute a relevant market. Moreover, abandoning the cluster concept eliminates the need for the “workable compromise” of *Philadelphia National Bank*. That decision correctly observed that the geographic area within which a customer obtains banking services depends on the customer and the service.⁴¹ In applying the approach of the Merger Guidelines, one can focus just on loans to small businesses.

Return now to *Phillipsburg National Bank*'s notion that its “relationship with the local banker” is important for a small business.⁴² Economic literature appearing long after that case was decided also focused on the relationship between a small business and its local bank.⁴³ This literature posited that the creditworthiness of a small business is evaluated by a local bank on the basis of “soft” information often acquired through a banking relationship.⁴⁴ Soft information is contrasted with hard information in financial statements. The hypothesis put forward was that hard information on small businesses is either lacking or is less useful in evaluating creditworthiness than the soft information lenders acquire through meeting business persons face-to-face, visiting their places of business, and providing them with other banking services such as checking.⁴⁵ It was also hypothesized that soft information is accumulated gradually over time through long-term relationships.⁴⁶

41. United States v. Phila. Nat'l Bank, 374 U.S. 321, 360–61 (1963).

42. United States v. Phillipsburg Nat'l Bank & Trust Co., 399 U.S. 350, 364 (1970).

43. See Allen N. Berger & Gregory F. Udell, *Small Business Credit Availability and Relationship Lending: The Importance of Bank Organizational Structure*, 112 ECON. J. F32, F32, F38–F39 (2002) [hereinafter Berger & Udell, *Bank Organizational Structure*]; Allen N. Berger & Gregory F. Udell, *Relationship Lending and Lines of Credit in Small Firm Finance*, 68 J. BUS. 351, 351–52, 354–55 (1995) [hereinafter Berger & Udell, *Small Firm Finance*]; Mitchell A. Petersen & Raghuram G. Rajan, *The Benefits of Lending Relationships: Evidence from Small Business Data*, 49 J. FIN. 3, 5–6 (1994) [hereinafter Petersen & Rajan, *Benefits of Lending*].

44. See Berger & Udell, *Bank Organizational Structure*, *supra* note 43, at F33–F38; Petersen & Rajan, *Benefits of Lending*, *supra* note 43, at 5.

45. See Berger & Udell, *Bank Organizational Structure*, *supra* note 43, at F37; Petersen & Rajan, *Benefits of Lending*, *supra* note 43, at 6.

46. See Berger & Udell, *Bank Organizational Structure*, *supra* note 43, at F32, F34, F37; Petersen & Rajan, *Benefits of Lending*, *supra* note 43, at 5–6.

To the extent that soft information is important, it follows that distant lenders either cannot accurately evaluate a small business's creditworthiness or can do so only at a much higher cost than a local bank. Consequently, a small business either would be unable to borrow from a distant lender or would be able to do so only on unfavorable terms that reflect the added default risk arising from the lack of good information on creditworthiness. Two studies empirically examined the importance of soft information as of the late 1980s with data derived from a survey of small businesses.⁴⁷ Both found clear indications that soft information was important. All else being equal, one study found that the interest rate for a line of credit was significantly lower when a borrower had a longer relationship with its lender.⁴⁸ The other study found that a greater availability of credit was associated with a longer relationship.⁴⁹ Both studies lent support for the notion that relevant markets were local.

The foregoing economic literature supports only the proposition that relevant markets for small business loans were narrow in geographic scope back in the 1980s. Patterns of small business lending have changed quite a bit since then, and small businesses have increasingly turned to distant lenders for some of their borrowing. A 1993 survey of small businesses found that the median distance between a business and its bank was just four miles, but some long-distance lending brought the average distance up to 43 miles.⁵⁰ The survey also inquired about the non-bank institutions with which the small businesses had financial relationships and found that the average distance between the small business and the non-bank financial institution with which it had a relationship was 251 miles.⁵¹ Analysis of the data from the survey indicated that the distance between the businesses and their financial institutions was significantly greater the more recently the relationship was entered into. The average distance between the small business and its bank was 16 miles for relationships entered into in the 1970s, but 68 miles for relationships entered into in the 1990s.⁵² Similar data from a

47. See Berger & Udell, *Small Firm Finance*, *supra* note 43; Petersen & Rajan, *Benefits of Lending*, *supra* note 43.

48. See Berger & Udell, *Small Firm Finance*, *supra* note 43, at 377–78.

49. See Petersen & Rajan, *Benefits of Lending*, *supra* note 43, at 34.

50. See Mitchell A. Petersen & Raghuram G. Rajan, *Does Distance Still Matter? The Information Revolution in Small Business Lending*, 57 J. FIN. 2533, 2537 (2002).

51. See *id.*

52. *Id.*

1998 survey indicated that the average distance between a small business and its lender more than doubled between 1993 and 1998.⁵³ A study analyzing the 1993 data concluded that improvements in information technology reduced the disadvantages faced by more distant lenders.⁵⁴

Many of the improvements in information technology were not specific to the financial sector. They include the use of personal computers, spreadsheet programs, and the Internet. However, one important innovation uniquely affecting the financial sector was the use of credit scoring—a systematic method for transforming available hard information into a single number predictive of the default risk associated with a loan.⁵⁵ Credit scoring was first applied to individuals and then to small businesses. Fair Isaac Corporation pioneered credit scoring in the 1970s and introduced a small business credit scoring model in 1993.⁵⁶

Credit scoring offered lenders an alternative, which many adopted, to reliance on soft information. An analysis of data from a 1997 survey of large banks found that the adoption of credit scoring led to a significant increase in lending to small businesses, which was attributed to a reduction in information costs.⁵⁷ Studies have also concluded that the use of credit scoring led to increased lending to distant small business borrowers.⁵⁸ One study found that the bulk of the increase in distant small business lending between 1996 and 2001 was accounted

53. See Kenneth P. Brevoort & Timothy H. Hannan, *Commercial Lending and Distance: Evidence from Community Reinvestment Act Data*, 38 J. MONEY, CREDIT & BANKING 1991, 1993 (2006) (citing an unpublished memorandum written by employees of the Federal Reserve Board).

54. Petersen & Rajan, *Benefits of Lending*, *supra* note 43.

55. See Loretta J. Mester, *What's the Point of Credit Scoring?*, BUS. REV., 3-4 (Sept./Oct. 1997).

56. Fair Isaac Corporation provides a description of the latest small business model. Fair Isaac Corp., http://www.fairisaac.com/NR/rdonlyres/30FB9F27-E88B-4DB5-A19F-13A76241F82F/0/SBSS_6_PS.pdf (last visited Mar. 11, 2008).

57. See W. Scott Frame, Aruna Srinivasan & Lynn Woosley, *The Effect of Credit Scoring on Small-Business Lending*, 33 J. MONEY, CREDIT & BANKING 813 (2001).

58. See Allen N. Berger, W. Scott Frame & Nathan H. Miller, *Credit Scoring and the Availability, Price and Risk of Small Business Credit*, 37 J. MONEY, CREDIT & BANKING 191 (2005); W. Scott Frame, Michael Padhi & Lynn Woosley, *Credit Scoring and the Availability of Small Business Credit in Low- and Moderate-Income Areas*, 39 FIN. REV. 35 (2004).

for by banks that were significant issuers of credit cards and, consequently, experienced in the use of credit scoring.⁵⁹

These developments and the resulting changes in small business borrowing patterns might suggest that the relevant markets for small business loans have expanded significantly in geographic scope and might even be national. Although the available information does not eliminate all doubt, my perception is that developments in small business lending most likely have not broadened the geographic scope of the relevant markets.

To understand why this is so, one must appreciate that what matters is not the loans local banks no longer make, but rather the loans they still do make. Applying the hypothetical monopolist paradigm of the Merger Guidelines,⁶⁰ one asks whether a hypothetical monopolist over a candidate banking market would find it profitable to significantly worsen the terms on which it provides its services. For a hypothetical monopolist over small business loans in some local area, one would ask whether an increase in interest rates on such loans would cause a sufficiently large loan volume to shift to lenders outside the area to dissuade the hypothetical monopolist from imposing the increase. The characteristics of the loans actually made in the candidate market clearly are what matter in determining the loan volume that would shift outside the local area. The loans those banks do not make, for whatever reason, have no affect on the amount by which a hypothetical monopolist would want to raise interest rates.

The economic evidence appears to paint a picture in which innovation has shifted relatively small loan volume away from local banks, leaving local banks with the loans for which they continue to have a significant advantage due to their proximity to the borrower. Data collected under the Community Reinvestment Act indicate that in 2001, out-of-area banks accounted for just 12% of the small business lending volume in urban areas and just 17% in rural areas.⁶¹ The respective figures for the number of loans were 55% and 40%.⁶² This discrepancy is explained by the fact that out-of-area banks use credit scoring for what is sometimes termed “micro-business lending,” in

59. See Timothy H. Hannan, *Changes in Non-Local Lending to Small Business*, 24 J. FIN. SERVS. RES. 31, 37, 45 (2003).

60. See *supra* notes 29–40 and accompanying text.

61. Hannan, *supra* note 59, at 37.

62. *Id.*

which the loan amount may be limited to as little as \$100,000.⁶³ Thus, distant banks appear to compete primarily for the smallest business loans.

Recent studies also indicate that distant lenders using credit scoring suffer from a significant informational disadvantage. One study examined loans guaranteed by the Small Business Administration.⁶⁴ Among its findings were that, holding distance constant, the default rate was 23% higher for loans made by banks using credit scoring.⁶⁵ In addition, the default rate was 22% higher on loans made to borrowers more than fifty miles from a bank than on loans made to borrowers less than twenty-five miles from the bank.⁶⁶ A second study was based on reports which banks in nine selected metropolitan areas filed under the Community Reinvestment Act.⁶⁷ It found that the average distance between the small business borrower and the relevant branch was only about three miles.⁶⁸ It also found that greater distance made banks, especially small banks, significantly less inclined to lend.⁶⁹ The study concluded that the loans banks still make to local small businesses are loans for which soft information is important and, hence, distant lenders are not significant competitors.⁷⁰ A final study examined yields realized by commercial banks on business loans of all sizes between 1996 and 2001.⁷¹ It found that smaller banks, which made smaller loans, had significantly higher risk-adjusted yields on their business loans, other things being equal.⁷² The study attributed the higher yield for smaller

63. See Robert DeYoung, William C. Hunter & Gregory F. Udell, *The Past, Present, and Probable Future for Community Banks*, 25 J. FIN. SERVS. RES. 85, 96 (2004).

64. Robert DeYoung, Dennis Glennon & Peter Nigro, Borrower-Lender Distance, Credit Scoring, and the Performance of Small Business Loans (FDIC Ctr. for Fin. Research, Working Paper No. 2006-04, Mar. 2006), available at http://www.fdic.gov/bank/analytical/cfr/2006/wp2006/CFRWP_2006_04_DeYoungGlennonNigro.pdf.

65. *Id.* at 32.

66. *Id.*

67. Brevoort & Hannan, *supra* note 53.

68. *Id.* at 2000.

69. *Id.* at 2006.

70. *Id.* at 2006–07.

71. David A. Carter, James E. McNulty & James A. Verbrugge, *Do Small Banks Have an Advantage in Lending? An Examination of Risk-Adjusted Yields on Business Loans at Large and Small Banks*, 25 J. FIN. SERVS. RES. 233 (2004).

72. *Id.* at 249–50.

banks to the informational advantages associated with proximity and relationships.⁷³

There may be a need to fine-tune the product dimensions of the relevant market to better focus on the characteristics of the loans local banks still make, but it seems most likely that banks still compete to make small business loans within narrow geographic radii. Moreover, that will likely remain true well into the future. This appears to be especially true in rural areas, where the Federal Reserve banks delineate the narrowest markets.⁷⁴ Rural areas are of special interest because the banking industry is most highly concentrated in rural areas,⁷⁵ so mergers are most likely to raise serious antitrust concerns in those areas. Moreover, rural areas tend to be served by small banks,⁷⁶ and substantial empirical evidence indicates that small banks rely on soft information much more than larger banks.⁷⁷ Finally, it appears small banks remain economically viable,⁷⁸ so they can be expected to be around for many years to come. Thus, my perception of the future is that bank mergers, especially in rural areas, most likely will continue to be properly analyzed within local relevant markets.

73. *Id.* at 250.

74. *See supra* notes 8–10 and accompanying text.

75. *See* Tim Critchfield et al., *The Future of Banking in America—Community Banks: Their Recent Past, Current Performance, and Future Prospects*, 16 FDIC BANKING REV. 1, 10 (2004) (reporting that in 2003 the average deposit HHI in rural markets was 3671, while in three other categories of more populous areas it was less than 1600).

76. *See id.* (reporting that in 2003 community banks accounted for 53% of the deposits held by FDIC-insured institutions in rural areas).

77. *See* Allen N. Berger et al., *Does Function Follow Form? Evidence from the Lending Practices of Large and Small Banks*, 76 J. FIN. ECON. 237 (2005); Rebel A. Cole, Lawrence G. Goldberg & Lawrence J. White, *Cookie Cutter vs. Character: The Micro Structure of Small Business Lending by Large and Small Banks*, 39 J. FIN. & QUANTITATIVE ANALYSIS 227 (2004); Jonathan A. Scott, *Small Business and the Value of Community Financial Institutions*, 25 J. FIN. SERVS. RES. 207 (2004).

78. *See* DeYoung, Hunter & Udell, *supra* note 63.