Financial Industry Megamergers And Policy Challenges

By Thomas M. Hoenig

In the past few years, the pace of consolidation in the banking industry has accelerated, and combinations between banks and other financial service providers have become increasingly prevalent. In some countries, consolidation has resulted from the need to eliminate weak or problem institutions. More generally, however, the unprecedented wave of merger activity in financial services is being driven by powerful changes in telecommunications and information technology and by the removal of legal and regulatory barriers to national and international linkages. An important recent development is a change in the scale of financial industry mergers. Indeed, the size of these business combinations has increased to the point that, both in the United States and Europe, "megamergers" are reshaping the structure of the financial services industry.

Financial megamergers raise a number of important public policy issues. Some of these issues are very familiar and apply equally to megamergers and to more traditional mergers between financial service providers. For example, regulatory approval of megamergers may depend on antitrust implications and industry concentration.

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However, the rise of banking and financial industry conglomerates brings into sharper focus a long-standing concern not addressed in existing merger guidelines. In a world dominated by mega financial institutions, governments could be reluctant to close those that become troubled for fear of systemic effects on the financial system. To the extent these institutions become "too big to fail," and where uninsured depositors and other creditors are protected by implicit government guarantees, the consequences can be quite serious. Indeed, the result may be a less stable and a less efficient financial system.

In my remarks, today, I will focus on the challenges posed by financial industry megamergers and examine some possible policy options currently under study. My discussion will begin by briefly reviewing consolidation trends and the rise of megamergers. I will then highlight some of the policy issues raised by megamergers and discuss some of the policy alternatives under review.

Not surprisingly, there are no easy answers to the challenges accompanying the advent of megamergers. I am decidedly less optimistic than some about whether we will, in the end, be able to rely sufficiently on market discipline to correct for potential distortions stemming from government guarantees. I suspect we will inevitably

find ourselves having to deal with an institution that is too big to fail and, over time, relying more heavily on regulation and prudential supervision to oversee activities. Part of our challenge is to outline how we might in the future deal with "too big to fail" as we attempt to balance the economic benefits of consolidation against the potential costs to the financial system.

I. THE RISE OF MEGAMERGERS

In the United States and other industrialized countries, consolidation in financial services is occurring along three dimensions: within the banking industry, between banks and other financial service providers, and across national borders. To date, much of the consolidation has happened within the banking industry. In the United States we have seen the number of banking organizations fall from around 12,000 in the early 1980s to about 7,000 organizations today, a decrease of over 40 percent. In European countries, where the number of banks is much smaller than in the United States, a similar trend nevertheless is apparent.

There are also growing linkages between banks and other financial service providers. In the United States and Canada, there has been a trend toward consolidation of commercial banking and investment banking operations. In Europe, where the universal banking model is more prevalent, the trend has been to combine banking and insurance activities.

While much of the consolidation, thus far, has occurred within domestic financial markets, there are signs of increased cross-border activity as well. In the United States, Canadian, Japanese, and European banks have acquired a variety of institutions. In Europe, important mergers have occurred between financial institutions in Belgium and the Netherlands, and more cross- border activity is expected with the launch of the euro.

At the same time that mergers are reducing the number of financial institutions, the size of these combinations is increasing dramatically as compared both to previous mergers in the industry and to nonfinancial mergers. For example, in the United States we have seen such combinations as NationsBank/Bank of America and Citibank/Travelers. In Canada, two proposed mergers involving four of the top five Canadian banks were recently denied by the government. In Europe, we have seen megamergers in Switzerland, France, Austria, Belgium, Spain, and the Netherlands. And, Deutsche Bank's acquisition of Bankers Trust will create a significant global banking organization.

The trend toward consolidation in the financial services industry can be traced to several factors. In the United States, one impetus was the need to eliminate weak or problem institutions during the thrift and banking crises of the late 1980s and 1990s. Some European countries experienced similar problems with institutions weakened by exposure to real estate lending.

A more important factor behind the wave of merger activity, however, is technological change in telecommunications and information processing, which has dramatically lowered the cost of providing many financial services. In this environment, mergers may allow financial institutions to achieve greater economies of scale made possible by the new technologies. These same forces have also increased pressures for consolidation by lowering costs of entry, increasing competition within the financial services industry, and causing less efficient firms to merge.

Merger activity has also been stimulated by a reduction in legal barriers to consolidation both nationally and internationally. In the United States, for example, consolidation within the banking industry accelerated with the removal of barriers to interstate banking. Many countries have also relaxed existing barriers to combinations of banks with other financial service providers. Finally, barriers to consolidation across countries have also been lowered as many

countries have opened up their domestic financial markets by liberalizing foreign ownership of domestic financial institutions.

II. POLICY ISSUES RAISED BY MEGAMERGERS

Rapid banking consolidation and the recent creation of very large financial institutions are beginning to raise a number of important public policy issues. For example, how can we be certain that these megamergers are in the public interest, and are our traditional regulatory tools adequate for addressing policy concerns that might arise with such mergers?

Traditional policy issues

Within the United States, the Justice Department and banking agencies must consider a variety of public policy issues before approving bank mergers and acquisitions. The Federal Reserve Board, for instance, must approve acquisitions and mergers of bank holding companies, and each proposal must satisfy several specific factors. These include the competitive effects of the transaction, the financial and managerial resources and prospects of the resulting organization, and the effect on the communities to be served.

In judging competitive effects, the Board primarily focuses on competition within local banking markets or individual metropolitan areas, where the effects are likely to be the most direct and observable. Competition is judged by the structure of each market—most notably the number of banks within the market, the amount of banking concentration both before and after the merger, and the level of competition from nonbank sources. One other potential constraint on large mergers is the Riegle-Neal Interstate Banking Act, which sets a 10 percent nationwide deposit concentration limit on organizations making interstate acquisitions and a 30 percent statewide limit (unless a state chooses a different limit).

So far, few of the megamergers within the United States have posed significant competitive issues under our antitrust guidelines or concentration limits. Most of the large mergers have been interstate acquisitions in which an organization expands into new markets, leaving local market concentration unchanged. Also, for large in-market mergers, the markets have often been of low or moderate concentration with numerous competitors. In other cases, large organizations have been able to divest of a portion of their offices to meet the competitive guidelines. Although at some point megamergers will likely raise antitrust concerns, our current competitive standards still leave substantial room for further consolidation in the United States.

The other factors used to judge mergers also would appear to have only a limited restraining influence on megamergers. In addressing financial and managerial considerations and future prospects—the safety and soundness criteria for mergers—large organizations commonly claim improved earnings growth as they enter new, attractive markets. They also emphasize prospects for better diversification of risk as they expand geographically and begin serving a wider range of customers. In addition, the organizations most active in merging and expanding are likely to be those with the most attractive stock and whose prospects the financial markets therefore view most favorably. To satisfy convenience and needs considerations and public benefits, organizations that continue to be active in the merger business will necessarily have established a record of serving their communities.

Consequently, many financial industry megamergers do not appear to raise serious antitrust issues under traditional U.S. merger guidelines. In addition, large combinations between banks and other financial service providers—which appear to be our next big merger wave—would likely receive approval under the traditional merger guidelines, since the merging firms focus on a somewhat different range of services.

Also, while antitrust and safety and soundness criteria differ across countries, the recent merger trends in Europe and other areas seem to indicate that considerable scope exists for larger financial institutions within the context of current regulatory parameters.

New policy concerns

Although the new banking and financial conglomerates may pass our traditional statutory and regulatory guidelines, I believe that such combinations require that we refocus our attention on a long-standing, vexing concern. To the extent that these institutions become too big to fail and are perceived as protected by implicit guarantees, the consequences can be quite serious. Moreover, under these circumstances our current mix of market and regulatory discipline may tend to shift further away from market discipline and increasingly toward regulatory discipline resulting, perhaps, in a less efficient industry.

What is "too big to fail"?—What do we mean when we say a financial institution is too big to fail (TBTF)? This term might best be applied to institutions so large that their activities make up a significant portion of a country's payments system, credit-granting process, or other key financial roles. As a result, any substantial disruption in the institution's operations would likely have a serious effect on a country's financial markets, either preventing the markets from operating properly or raising questions about their integrity. The outgrowth of TBTF is that countries extend protection to large institutions and their customers not granted to others. This protection, moreover, can take a variety of forms. Even when regulators sell a large failing bank, remove its management, and let stockholders take the full loss, TBTF would still exist if uninsured depositors are protected or other groups of creditors or customers receive favored treatment.

The concept of "too big to fail" came to prominence in the United States during the banking problems of the 1980s and early 1990s. Regulatory steps were taken to protect uninsured depositors and, in some cases, other types of creditors in large bank failures including Continental Illinois, several major banks in Texas, and the Bank of New England. A number of concerns were used to rationalize this policy. In particular, there was some fear that a more general panic might extend to similar types of banks. In this event, any deposit losses might severely harm smaller banks with correspondent accounts, other business customers, workers due to receive payroll checks, and a broad range of public and private organizations. Consequently, there could be significant effects on the local and regional economy.

Following these events, the Federal Deposit Insurance Corporation Improvement Act was passed to limit future bailouts of uninsured depositors. The act attempts to restrict the use of TBTF policies by prohibiting the FDIC from taking steps to protect uninsured depositors if that would increase insurance losses. However, the act contains an exception. TBTF could be adopted if a bank failure would have "serious adverse effects on economic conditions or financial stability." Although the law's standards for making this exception are quite restrictive, I must also point out that its effect is to give statutory recognition to the concept of TBTF.

While U.S. banking authorities are fully committed to the 1991 restrictions, how the market views the possibility of TBTF is still critically important. If uninsured depositors and other market participants believe they will be protected and therefore fail to exert the desired discipline, then the risk-return tradeoff within the largest institutions, over time, will tend to become unbalanced. Furthermore, it may be more difficult to discipline uninsured depositors in today's world where banking involves instant communications and where solvency and resolution decisions on ever larger, more complex institutions cannot be made at a moment's notice. I might

also add that recent history throughout the world suggests that TBTF may be the policy of choice in crisis situations, particularly when mega institutions play a large role in a country's economy and financial markets.

Consequences of "too big to fail"—What are the some of the consequences of TBTF? One obvious result is the creation of competitive inequalities. To the extent that very large banks are perceived to receive governmental protection not available to other banks, they will have an advantage in attracting depositors, other customers, and investors. This advantage could threaten the viability of smaller banks and distort the allocation of credit.

A second danger of TBTF is the creation of additional moral hazard problems beyond those resulting from the existing deposit insurance systems. If uninsured depositors and creditors of large institutions are protected from loss, the safety net is likely to be extended to a broader range of financial activities. Market discipline will be curtailed and prevented from working through to an appropriate solution, and institutions will have greater risk-taking incentives. Consequently, to preserve financial stability, regulation and prudential supervision may have to be extended to a larger part of the financial system.

A third danger of TBTF is inefficiency. Making large banks a protected class of institutions will lead to a less efficient financial system in a variety of ways. Creditors and investors will not have the appropriate signals for directing their funds to the most efficient institutions. In addition, bank management will not face the full force of marketplace discipline and so may be under less pressure or delayed pressure to operate efficiently. And as large institutions take on an expanding range of activities, these inefficiencies and distortions will be extended to an increasing portion of the financial system and overall economy. Are these inefficiencies a serious problem or just a conjecture? I think if we look at the countries that experienced serious banking problems and were protective of their major banks, we are made aware of the inefficiencies and how quickly they can spill over into the general economy.

III. DEALING WITH MEGAMERGERS: THE POLICY OPTIONS

If megamergers increase the possibility financial institutions may indeed be too big to fail, what is the appropriate policy response? It seems to me there are two approaches. We could attempt to prevent the formation of mega institutions that might raise concerns, using either existing or modified merger guidelines. Alternatively, we could allow megamergers to occur but alter the supervisory and regulatory framework to attempt to mitigate the distortions caused by TBTF.

As I noted earlier, existing merger guidelines are unable to deal with the TBTF problem because they center on the competitive effects of mergers in local markets. Since many megamergers will involve market or service extensions, we would not generally expect to find serious competitive effects in local markets. Put somewhat differently, the effects of megamergers and related concerns of TBTF will surface long before anticompetitive effects show up on our radar screen.

Nor do I feel it is feasible to modify merger guidelines to reflect TBTF concerns. In general, I fail to see how we can establish a size threshold for institutions beyond which TBTF considerations dominate. We clearly want to permit mergers that enhance efficiency within the financial system. Mergers we want to prevent are those with no clear efficiency gains and that are viable, in part, because of the subsidy resulting from the institution becoming too big to fail. As a practical matter, it would be extremely difficult for regulators to make these kinds of judgments and to develop effective merger guidelines that incorporate TBTF considerations.

Consequently, I believe we should not focus

on limiting megamergers but, rather, on minimizing the distortions arising from TBTF. One strategy currently receiving attention relies on steps to reinforce market discipline. The appeal of this approach is that, if market discipline can be increased, excess risk-taking can be controlled and efficiency increased. Proposals to enhance market discipline generally rely on increasing the incentive and ability of the market to monitor financial institutions. Incentives to monitor can be enhanced through such mechanisms as the required use of subordinated debt or private insurance. The ability of the market to monitor performance can be improved through greater disclosure of information.

While I certainly favor moving in this direction, I question whether enhanced market discipline can adequately deal with TBTF. The key issue is credibility. Proposals that rely on increased incentives to monitor risk-taking simply won't be effective unless market participants are convinced they will not be protected in times of financial stress and unless they have the power to quickly alter management practices. Generally speaking, credibility will depend not only on current policy but also on past practices. Unfortunately, as we know from experience, in times of crisis credibility comes at a high price.

As a result, I believe, reluctantly, that much of the burden of dealing with megamergers and the effects of TBTF will inevitably fall to more traditional forms of regulation and prudential supervision. Here we have two distinct challenges. First, as megamergers create linkages between banks and other financial service providers, how do we prevent the extension of TBTF beyond the banking system? Second, where market discipline is to a degree muted, how do we control the risk-taking activities of those institutions that are too big to fail?

With regard to the first challenge, the critical issue is how to contain TBTF, even if we cannot totally eliminate it. If we cannot limit TBTF, we risk extending the safety net as megamergers evolve to combine traditional banking with other financial and nonfinancial activities. At issue is whether we can develop an organizational structure for financial service providers that serves to contain the effects of troubled institutions perceived to be TBTF.

One form this debate has taken in the United States is how to insulate banks and the payments system as affiliated entities take on a broader range of activities and risks. The essence of the argument focuses on the trade-off between operational flexibility and containment of the fallout from a problem institution. Although this issue has not been as prominent in Europe because of the dominant role of universal banks in providing financial services, it is likely to become more relevant as banks face increased competition from capital markets. In my view, this is an issue of fundamental importance, and how the debate is resolved will impact how the world handles TBTF in future crises.

Regardless of how this debate comes out, we still face the challenge of managing the risk-taking incentives of institutions that are TBTF. If we cannot rely entirely on enhanced market discipline, much of the burden will fall on regulation and supervisory oversight. As megamergers produce larger and more complex institutions, regulators will have to respond to these changes. There are several efforts under way including the Group of 30 activities and attempts to revise the Basle risk-based capital standards to incorporate more accurate measures of risk exposure. And, in the United States, we have taken steps to change the emphasis of bank examinations toward a better understanding of an institution's principal risk exposures and an assessment of its risk management controls and procedures.

Realistically, however, there are limitations to the effectiveness of regulation and supervision in accomplishing these tasks, particularly in

large and complex organizations. Relying on regulation and supervision to control risk-taking requires a delicate balance between providing effective oversight without becoming intrusive and imposing excessive costs on the institution.

In the end, I doubt that we can yet be confident in our ability to either completely isolate the effects of the failure of a large institution or to provide a regulatory and supervisory mechanism that can eliminate TBTF as a possibility over the business cycle. With the advent of financial megamergers, TBTF is likely to become even more prominent as an issue, particularly in times of financial stress. Thus, while I strongly support our efforts to improve both market and regulatory oversight of global institutions, I believe we must also spend more energy preparing now, in a public policy context, to deal with these institutions and TBTF when the crisis inevitably occurs.

IV. SUMMARY AND CONCLUSIONS

Let me close with a brief summary and some final observations. The recent consolidation trend in banking and financial services is clearly changing the financial landscape in many countries. While the creation of larger institutions holds out the prospect of gains in the efficient delivery of financial services, it also raises important public policy issues. In addition to traditional antitrust and related issues, financial megamergers refocus a difficult and troubling concern. To the extent that these institutions become too big to fail, the loss of effective market discipline creates an environment where the risk-return trade-off may become unbalanced and where inefficiency can creep into the system.

Unfortunately, there are no simple solutions to this problem. Attempts to enhance market discipline, while important, are unlikely to be fully successful; meaning that more of the burden will move toward regulation and prudential supervision. But, unless we can find a way of limiting the extension of government guarantees, we risk the inevitable extension of regulation into an ever-widening part of the financial system. We would be wise, therefore, to recognize that TBTF will be an important public policy issue going forward and as we work to allow the benefits of consolidation, we also work to avoid sacrificing competitive fairness, efficiency and, most certainly, financial stability.