BIGGER ISN'T BETTER:
Consolidating Banks and Their Policy Impact

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In preparing for this talk, I was struck by a fascinating contrast. While industry CEOs think consolidation is a good and necessary change, the consensus of academic research is that its benefits are, at best, ambiguous. Certainly, all of us as customers of ever-larger banks have experienced the gap between promise and performance that characterizes all too many of the industry's recent mergers.

Today, we have to ask why the gap is so wide between the industry's view of itself and that of outside analysts and customers. We then, I think, need to consider whether this difference has public policy implications. If it doesn't, then the industry can and should go on getting bigger and bigger unless or until its shareholders and customers push back and the trend reverses itself. If, though, very big financial services firms increase the likelihood of systemic risk, reduce industry competitiveness, slow down the pace of innovation or threaten economic growth, then public policy can — indeed, it must

— decide whether changes in law or rule to mitigate these adverse effects are desirable.

In my view, consolidation has not yet shown any alarming market implications, despite its dubious benefits to the industry itself. Thus, there seems to be little reason for Congress to set new antitrust standards or otherwise change the way in which industry mergers are analyzed. There may, though, be good reason to worry about increased systemic risk and the ability of the deposit insurance system, as currently structured, to handle problems at very large institutions. Further, the increasing opacity of very big companies — sometimes even to themselves — argues for aggressive efforts to improve the quality and timeliness of financial disclosures.

It is, I think, also time to revisit the issue of how the insolvencies of very large financial services firms — banks, non-banks and GSEs alike — are to be handled. The current rules fight the last war — the thrift debacle of the 1980s — and are out-of-step with today's market

realities. The ad hoc response to Long-Term Capital Management was a desperate measure taken in a policy vacuum that should not be allowed to happen again.

How Big Are We Now?

Perhaps the first question we should ask about consolidation is the one with which we all too often puzzle small children: how big are we now? The answer, at least with regard to banks and other financial services firms is that, now we are very big indeed, and we have become so very, very fast.

The statistics on consolidation are familiar. In the U.S., for example, the number of banks and thrifts has dropped by about one-third in just ten years. The percentage of assets controlled by the 25 largest banks has rocketed up from 32% in 1990 to 55% in 1999. With recent mergers among the top 25, the concentration totals are clearly on the rise since the FDIC last collated this data.

Concentration is not, of course, solely an American phenomenon. The recent G-10 study of concentration found that, during the 1990s, half of the large industrialized countries surveyed experienced a decline of 20% or more in the number of their banks. This is a particularly striking statistic when one remembers that most of these nations started with far fewer banks than the U.S. In the 1980s, Texas had more banks than the entire European continent. This was, of course, before intra- and interstate branching — helped along by the sharp downturns in the oil patch — thinned the ranks of $100 million country banks in Texas and other one-bank states. However, the U.S. still has more banks per capita than any other industrialized country.

Does Consolidation End Competition?

A simple survey of trends in the U.S. could well lead one to conclude that all small banks are born to be merged or die.

However, the marketplace presents a far more complicated picture than a graphic of big fish swallowing smaller ones. From 1993 to 1997, 2,839 banks and thrifts were acquired through consolidations and 40 banks were liquidated. However, during the same period, 431 new banks were chartered. Thus, the U.S. banking system is shrinking to be sure, but new life is springing up as the old growth is cut back.

One of the results of this dynamic picture is the changing profitability of consolidated versus free-standing banks. The G-10 analysis of consolidation characterizes the market results as a net transfer of wealth from acquiring companies to their targets. This is consistent with our observations in the market. In all too many cases in the U.S., acquiring banks have paid very large premiums. After the deals close, the acquiring banks must then make such radical changes in the acquired institution's operations — often including massive cost cuts and personnel

lay-offs — that the value for which they over-paid is seriously undermined.

It is also important to recognize that some of the nation's largest financial services firms have never merged at all. Fannie Mae and Freddie Mac now hold on their books more mortgages than the entire thrift industry, with on- and off-balance sheet risk topping $2.4 trillion. Neither of these GSEs grew large through mergers or acquisition. Their growth is in part the result of their government advantages and in part due to expert exploitation of emerging technologies that permit them to manage mortgage risk without vast networks of retail branches or thousands of employees.

Consolidation has also characterized other sectors of the industry that have not experienced much M&A activity. Specialized services have been particularly marked by this trend. In custody services, for example, there were twenty or so competitors a decade ago, and now there are six. Some firms (Morgan Stanley, for

example) simply exited the business when they were not able to achieve necessary economies of scale, although others (e.g., the Bank of New York) have expanded through acquisition of other portfolios. Almost none of this consolidation, however, has occurred through outright acquisition of entire institutions.

One final thought on consolidation: it's not at all clear that the trend towards massive institutions focused on retail banking will hold in the on-line era. One can and indeed should be skeptical about the phase-change that the Internet is supposed to bring to basic banking. So far, customers have proven very resistant to banking on-line. They are not, though, at all hesitant to shop for financial services through the web, and many are accessing accounts for balance verification, trading or bill paying services at home or on the road. I believe that the ease of shifting from one provider to another on the web will disaggregate the industry in very short order.

Where the Problems Lie

The more dynamic picture of industry consolidation presented above suggests that a simple approach to the potential problems of consolidation through tougher enforcement or revisions to the antitrust laws will have little impact. Although there is considerable consolidation at the top of the asset scale, new institutions are springing up to service niche markets. Further, consolidation is often the result of technology or market developments not germane to traditional antitrust analysis. Therefore, new rules making it harder for financial services firms to merge could well have little impact on the degree to which the industry amalgamates.

However, even if larger financial services firms are not a long-term trend or an anti-competitive problem, they do raise novel policy questions. Some of these are important to individual institutions, but have relatively

small market impact. In this category, I would put the question of the future of the Federal Home Loan Bank and Federal Reserve Systems as currently structured. Both are based on a turn-of-the-century view about the number and geographic distribution of the nation's banks and thrifts. Why there should be a dozen or so marble halls for each of these institutions dotted across the landscape is, at the least, an open question.

However important these institutional issues are to those within or belonging to them, they pale in comparison with the larger systemic implications of consolidated financial services firms. In my opinion, we have no public policy in place to deal with serious solvency or liquidity problems among the largest institutions, especially those which, by virtue of their charter, fall outside the legal framework established for big banks.

Indeed, recent legal changes could well exacerbate the problems associated with large failures. In

1991, Congress fought the thrift wars by instituting a series of major regulatory changes, including "prompt corrective action" and new standards designed to make it tougher for the Fed to support banks considered too big to fail. The PCA requirements mandate specific regulatory actions as a bank falls below minimum capital thresholds. The FDIC has calculated that 143 large banks would have been considered "critically under-capitalized" under the PCA rules had they been troubled during the 1990s, instead of the 1980s. Certainly, Bank of America — then the country's biggest bank — would have had to be shuttered. In the 2000s, regulators will have little flexibility; any large bank that becomes critically under-capitalized will have to find new capital quickly or shut its doors. This could mean lots of shot-gun marriages that only exacerbate systemic risk and the adverse competitive effects of consolidation, or it could throw many more institutions into the FDIC or Fed's support system.

Further, the approach to "too big to fail" in FDICIA needs work. A set of hurdles was established to rescue big banks, with the cost of any such rescue being borne by the industry as a whole. This creates significant post-hoc inequities in the deposit insurance system, as the FDIC has recently pointed out. The current system is designed to give the Fed and Treasury maximum flexibility to deal with a large failing bank, but the ambiguities remain so great that the market is still convinced that the regulators will step in as they did in the 1980s. If this bluff is called, as it may well be, systemic risk could be exacerbated by the resulting market panic.

There is good reason to be cautious about the outlook for large banks. Since the implementation of the 1988 Basle Accord, the relative riskiness of bank books has significantly increased. A 1999 Fed study found that the 26 largest banks held 52% of their assets in BBB or lower-rated risk. This has occurred in large part because of changes in capital markets that

permit higher-rated entities to access the market directly, as well as because of the capital rule's current indifference to the relative riskiness of the assets a bank may hold. Changes in the capital rules may address this over time, but it is likely that short-term economic factors will only increase the risk profile at many large banks.

The Policy Solution

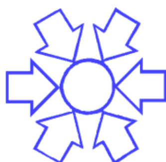
In talking last year about the GSEs, Rep. Richard Baker stated that the right time to do airplane maintenance is when the plane is on the ground. Right now, the banking system is still on the ground, although it looks to me as if it's revving its engines to push back from the gate.

First, policy should reflect the fact that size is not in itself a competitive issue. Many consolidated or consolidating banks are under-performing the market, which will, over time, lead to new competitors and a changed market landscape. A simple policy response that attempts to keep

financial services firms small would not only be an unnecessary market intervention, but would have an adverse impact on the ability of many firms to take advantage of the technological and market trends that require some companies in some market segments to bulk up.

However, all very large financial institutions — regardless of how they got to be so big — raise serious systemic implications. Current law deals only with the potential failure of large insured depositories and then, as noted, only in a way that could well prove disastrous in current market conditions. We have no policy for dealing with the instability of a large GSE or a major non-bank. It is time to go beyond the old debate over which bank is "too big to fail" to a new one that offers a way to liquidate even the largest financial services firms, regardless of their chartering options. We know a good deal about the right and wrong ways regulators should intervene in the event of systemic risk, and it is time to take this academic knowledge and convert it

into meaningful statutory initiatives. ❑



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