Consolidation in Banking and Financial Services: The Demise of Glass-Steagall

John C. Soper
John Carroll University

What is the long-run equilibrium structure of the banking industry after the termination of the Glass-Steagall Act? Obviously we do not know the answer to this question now, but some intelligent speculation may illuminate our thinking about this question and lead us to some useful predictions about the future shape of the U.S. banking industry. In addition, there may be implications both for the more broadly defined financial services sector and for the regulatory apparatus that seeks to control banking and financial services in general.

Consolidation in the U.S. banking industry has resulted in a decline by more than forty per cent in the number of banks since 1984 (Gunther, 1996).[1] Although there appears to be a reduction in the rate of consolidation dating from mid-1998, the recent termination of most of the regulatory provisions of the Glass-Steagall Act of 1933 suggests that the banking industry is likely to see significant additional consolidation in the near future, say over the next decade. The United States still has a very large number of banks (8,604 as of September 30, 1999). This makes it likely that many of these institutions will find merger partners in the banking sector or in the broader financial services sectorCincluding insurance firms, brokerages, investment banks, etc. Mergers of banks with other banks mean *consolidation*. Mergers of banks with non-bank financial service providers mean convergence.

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[1]In 1984 there were approximately 14,500 banks in the U.S. By September 30, 1999 the number had fallen to 8,604, a decline of more than 40%.

Dominant factors

A number of issues emerge in the consideration of the expected continuation of bank merger and acquisition activity. High on the list of important issues is what factors are likely to dominate in future bank mergers and acquisitions, in the long run and in the short run?

In their 1996 article, Spiegel and Gart listed a number of factors motivating bank merger and acquisition activity:

$ Revenue growth from a larger customer base;
$ Efficiencies in operations;
$ Ability to spread fixed costs over a larger customer base;
$ Diversification of income from both products and geographic area;
$ Stabilization of asset quality;
$ Optimal deployment of excess capital; and
$ The search for higher value of common shares.

To these we might add another factor seldom mentioned to shareholders: fear. That is, management fear of being acquired by a larger and/or more aggressive bank, or fear of becoming Aa bit player@ in a field of giants. Furlong (1998) has added the motivating factor of attempting to achieve a higher valued output mix through merger activity. Akhavein, *et. al.* (1997) found evidence of this result for mergers in the 1980=s, while Berger (1998) extended the findings to include mergers in the 1990=s. Both of these studies conclude that merged banks have enhanced their output mix by shifting the composition of assets from securities to higher yielding loans. It also appears that merged banks were able to lower the cost of borrowed funds. Perhaps this was due to the reduction in risk through diversification (both in terms of geographic extent and in terms of product mix) and risk reduction through diversification of earnings.

The most significant source of earnings diversification is increases in fee income relative to traditional interest income.

In a recent paper revisiting mergers of publicly traded banking firms between 1989 and 1999, Kwan and Eisenbeis (1999) examined 3,844 merger transactions. They list three reasons for the surge in acquisitions: (1) to achieve cost savings and/or operational efficiencies; (2) to be better able to compete in the global marketplace; or (3) to provide for the controlled exit from the financial services industry of inefficient competitors. Their findings indicate that the widely touted earnings, efficiency, and other performance and earnings benefits of large bank mergers remain largely in doubt.

Historically, bank merger and acquisition activity began to turn up as a result of bank failures in the 1970=s and 1980=s. Changes in merger guidelines under the Reagan administration accelerated the pace of banking industry consolidation. More recently, the rapid changes in information technology (under the ANew Economy@ rubric) have brought added impetus to banking consolidation. These might all be grouped under longer run factors in banking industry consolidation, but some short run factors have also been operative, tending to slow down the pace of merger action, and working against the long run forces encouraging consolidation.

Short run effects

The year 1998 appears thus far to have been the high water mark for merger and acquisition activity, particularly in terms of megamergers. Announced megamergers in 1998 included the $73 billion CiticorpBTravelers merger (April 6), the $59 billion NationsBank BBank of America merger (April 13), the $34 billion Wells FargoBNorwest merger (June 8), and the $26 billion Bank OneBFirst Chicago/NBD merger (April 13). Since the summer of 1998 there has been a marked deceleration in mergers and acquisitions with the above four deals accounting for two-thirds of the $286 billion total for all of 1998. Why the abrupt slowdown, presumably a short run effect?

Perhaps the major reason is the sharp decline in bank stock prices. The tanking of bank common stocks appears to have been driven in part by rising interest rates and in part by miserable results from some of the recent megamergers (BancOne with First USA and then with First Chicago/NBD; First Union with CoreStates). With significantly devalued share prices, potential acquirers no longer possess the Apreferred currency@ for further takeovers and must look behind them to see if they themselves are suddenly takeover bait. The current stance of monetary policy, clearly signaling more tightening in interest rates, which are already sharply higher than they were in early 1999, suggests that many larger superregional banks may be in trouble. Banks such as Key Corp, Comerica, US Bancorp, and National City appear to be vulnerable to rising rates given their high loan/deposit ratios, some as high as 145 % (Silverman & Michaels, 1999). In a period of rising interest rates, banks funding their loans with a significant amount of borrowed funds will find their margins being squeezed and their stock prices headed south. Another reason for the merger and acquisition slowdown in recent months has to do with Apooling of interests@ accounting techniques in bank mergers. These techniques are scheduled for the boneyard in early 2001, a fact which *should* lead to a short-run acceleration in bank mergers and acquisitions. But that acceleration has not materialized, in part because the SEC has already started to question *previous* mergers, which used pooling of interest methods.

Anticipated response of the regulators

There is at least a glimmer of hope that bank regulators have learned something from the atrocious track record of past regulatory attempts. For instance, Jordan (1996b) argues that regulatory reform must proceed from three principles: (1) a level playing field,

(2) functional regulation, and (3) value-added supervision. Leveling the playing field means that all types of financial service providers ought to be subject to the same regulatory regime and rules. Functional regulation means that regulation ought to focus more on functions and less on institutions. The notion of value-added supervision suggests that regulators A . . . should be less concerned with playing >financial cop= and more concerned with helping firms work safely and efficiently@ (Jordan, 1996b, p. 4).

Greenspan (1999) has stressed that in the future, regulation must lean more on market forces as the primary source of regulatory discipline. And since markets work best with complete information, greater transparency is to be encouraged so that market participants are able to make informed judgments about financial firms and their products. The regulators are likely to make greater use of banks= own internal risk assessment models rather than applying a Aone size fits all@ rule from the outside. Although it is still unclear how greater disclosure will be achieved, it is obvious that improved market information will not only enhance market discipline but also create additional incentives for banks to improve their internal risk-management tools, technologies, and practices.

Adequacy of the regulatory apparatus

One serious question raised by the recent mergers and acquisitions forming large, complex banking organizations has to do with the ability of the present regulation and supervision mechanisms to deal with such new entities. Is the regulatory apparatus now in place adequate to the task of overseeing and supervising the emerging megabanks and conglomerate financial service firms such as CitiGroup? Our present system of supervision and regulation is the product of historical development, past legislation, and evolutionary change. But recent changes in the structure of the banking industry, due to both consolidation and convergence, have been anything but evolutionary. How can an early twentieth century regulatory mechanism control the twenty-first century behemoths now in place and being formed? According to Greenspan (1999) in his fall address to the American Bankers Association, the Federal Reserve System has established teams of examiners and other experts to oversee each of the thirty largest banking organizations in the U.S. A senior Federal Reserve official heads up each of these teams. It remains to be seen, however, if these Amegabank teams@ will be able to deal effectively with the higher level of systemic risk created by the emergence of these large, complex banking organizations. The effectiveness of these teams awaits a test from a major financial system shock some way down the road.

There is the added concern of international standards for capital adequacy and whether or not the Basel Committee=s proposals will go far enough in terms of making adequate distinctions among different categories of risk. Greenspan is concerned that arbitrary and inconsistent treatment of risk internationally has undermined the credibility of our current capital requirements. Said Greenspan, Athe fundamental credibility of regulatory capital standards as a tool for prudential oversight and prompt corrective action at the largest banking organizations has been seriously undermined.@ Getting international agreement on realistic and enforceable capital standards becomes more important as foreign banking organizations increasingly confront the fact of industry consolidation and convergence. The added complexity brought on by financial globalization makes the task of prudential oversight and supervision all the more difficult and no doubt increases the level of systemic risk.

Moral hazard and AToo-big-to-fail@

A related problem is the issue of Atoo-big-to-fail@ banking organizations and rising moral hazard concerns. Due to recent megamergers and the emergence of large, complex banking entities, do we now find ourselves in a state of elevated moral hazard where Atoo big to fail@ becomes a dominant concern? Recent research by Moore and Siems (1998b) indicates that merger activity is not the source of too-big-to-fail problems. In their words, Asome of the recent megamergers are combinations of banks that are already too-big-to-fail. Those mergers are not creating a new too-big-to-fail institution. That=s worth remembering because some people claim that the desire to become too-big-to-fail is driving the current megamergers@ (Moore & Siems, 1998b, p. 13).

In fact, the Federal Reserve and the International Monetary Fund may have more to do with creating moral hazard than anything done by merged megabanks creates. The Fed=s role in engineering the fall 1998 bailout of Long-Term Capital Management has been acknowledged by Greenspan as representing moral hazard. And the IMF=s legendary exploits extending international liquidity to states that had defaulted on private-sector loans moves moral hazard to a new plane of world magnitude. Blaming megabanks for creating moral hazard problems seems to make little sense when central banks like the Fed and international lending agencies such as the IMF are manufacturing moral hazard on a much larger scale.

So, what of the demise of Glass-Steagall?

Does the termination of the Glass-Steagall Act bring with it other economic bads? One alleged downside risk of the post-Glass-Steagall era and resulting increased consolidation and convergence activity is the Aproblem@ of increased layoffs and job losses in the banking industry. Such job losses are a fact, but is this a cost or a benefit? In the current environment of full employment (or perhaps over-full employment), bank downsizing may be seen as a blessing rather than a curse, at least in the global sense. Individual bank employees threatened with layoffs may not feel very good about bank downsizing, but it does liberate scarce labor for redeployment to rapidly growing industries crying out for more workers.

There is also the purported argument that the end of Glass-Steagall will bring on greater concentration in the banking and financial services industries. But Moore and Siems (1998a) have found that although recent merger activity has brought greater industry concentration at the national level, this has not been the case in local markets. Moreover, local concentration where it does occur does not bring higher profitability. The same pair of researchers also have found that while big banks may ignore small business lending, there is evidence that de novo banks take up the slack so that small-business lending does not appear to suffer as a result of consolidation or convergence (Moore & Siems, 1998b).

Conclusion

The merger explosion of the '90s was a response to the deregulation of the banking industry that gathered a significant head of steam during the '80s. We might well anticipate that a number of these mergers would fail, perhaps spectacularly, in the not-too-distant future. Years of bad government policyCattempting to regulate everything about the banking industryCcannot be wrung out of the system painlessly. Bad policy is likely to lead to bad mergers! The current pause in merger and acquisition activity is no doubt due to:

$ The poor results of several recent mergers.

$ The depressed stock prices of banking firms in recent months.

$ The attitudes of the SEC and other regulatory agencies toward Apooling of interest@ merger arrangements.

$ The recognition that relatively few bargain acquisitions are still available in the marketplace.

Where we end up is also far from certain in terms of what a bank looks like later in the twenty-first century. The convergence phenomenon, where commercial banks merge with brokerage houses, investment banks, credit card processors, insurance companies, or other types of financial service firms, is perhaps still in its infancy. We do not yet know if CitiGroup will turn out to be a success, let alone a model for the rest of the industry. Successful cross-business mergers often fail because the corporate cultures do not meld easily. Commercial bankers tend to be people bred and raised to be cautious and suspicious (due to problems of adverse selection inherent in lending activities). By comparison, investment bankers tend to be free-wheeling entrepreneurial types who are always in pursuit of Athe next big deal.@ These two personality types (read corporate cultures) do not sound as if they would make a great fit within a single corporate entity. Many more moons will have to rise before we can assert the success of such Aconvergence mergers.@ In the end, we shall still have a payments system but its exact complexion and structure is not knowable in the present. It should be clear, however, that change will continue to take place in the banking and financial services industries. We might hope that the regulators have truly learned from decades of regulation-induced failures, so that market participants will be spared the pain of future Acomplete control@ attempts.

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