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Summary of Session 1 Presentations

How do economists view the synergies between the banking, securities, and insurance industries? This timely topic was examined by three papers; comments by an industry analyst followed.

Overall, the presenters predicted further consolidation in the financial industry, each emphasizing different aspects of the benefits. Anthony Santomero and David Eckles argued in their paper that consolidation will benefit firms through revenue enhancement, rather than through cost reduction. The study by Cara Lown, Carol Osler, Philip Strahan, and Amir Sufi emphasized that banks merging with life insurance firms are likely to provide the biggest gains in terms of reduced bank risk. Lown et al. offered additional perspective by discussing the evolving "bancassurance" industry in Europe, while the paper by Randall Kroszner predicted that subsequent regulatory changes are likely to occur. Furthermore, Santomero and Eckles noted that arguments can be made both for and against the increased stability of the resulting financial system, and although systemic risk is an appropriate concern, enforcement of regulation, competition, and open markets can keep these issues at bay.

However, in his comments on the papers, Christopher Mahoney observed that with the likely emergence of large financial conglomerates, a policy of "too big to fail" may be an appropriate reaction to financial distress, despite growing political pressure to do otherwise.

Santomero and Eckles

Anthony Santomero and David Eckles discussed what is likely to happen in the financial sector in light of the recent regulatory and environmental changes that have occurred. The presenters began by discussing the impact that these changes would have on the operating scale of financial firms. They then reviewed five issues relating to firm size, beginning with operating costs. The existing literature, they observed, indicates that larger institutions may be more efficient in terms of average operating costs. Expenses may also be reduced if an institution can offer several products at a lower cost than separate competing institutions. Yet in reality there seems to be little cost improvement resulting from these economies of scale and scope. Santomero and Eckles argued that aggregating over many businesses adds a layer of complexity, with the result being that the overall cost structure does not seem to improve very much.

The second issue they addressed was revenue enhancement. Rather than cost savings, the driver behind mergers is the potential for additional revenue. To the extent that firms can cross-sell multiple products and that customers are willing to take additional products through the same channel, benefits associated with revenue can result. Santomero and Eckles' third issue with respect to firm size is that, for some businesses, size is necessary to be competitive. Because the nonfinancial

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The views summarized are those of the presenters and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

industrial sector is consolidating, the scale of the business of finance is growing. Hence, by increasing its size, a financial organization can conduct an entire transaction on its own—something it otherwise could not have done. In other words, size itself has some positive attributes in the financial industry.

The last two issues concerned whether or not larger firms are inherently more stable. On the one hand, a greater number of businesses should, according to the law of large numbers, imply greater stability. On the other hand, the businesses typically are highly correlated, which can mitigate this law. Moreover, when there are a lot of businesses, something is likely to go wrong all the time. To the extent that this phenomenon occurs, a firm's value could be more unstable, rather than more stable.

Weighing all of these issues, Santomero and Eckles concluded that, on balance, the universal bank is favored. They followed with a discussion of how firms are likely to expand. If a firm is going to expand a product line, it is more likely to do so de novo. If a firm is making a leap, it is more likely to do so through an acquisition. A relevant issue, however, is how much it costs to enter a business. The presenters observed that as long as barriers to entry exist, firms will expand through acquisition because it is easier to buy infrastructure than to build it. Furthermore, firms will tend to acquire small firms, or to extend their own businesses, if they are expanding into a market close to their own. But as long as a firm needs a brand name to achieve market penetration, it will try to purchase the name through acquisition.

Santomero and Eckles also noted that alliances constitute a middle ground. However, they emphasized that what we have seen in the industrial sector, and to a large extent in the banking sector, is that alliances are a lot of trouble and usually dissolve because of governance problems. They also said that the resulting structure is not likely to be a single firm type, but rather a mix of specialized firms and universal firms.

A discussion of public policy implications concluded the presentation. Regulators are concerned about systemic risk, which Santomero and Eckles viewed as an appropriate concern: large organizations must be overseen. They also contended that there is some truth to the idea that large organizations might gain an advantage by having the government safety net extended to them. Enforcement of regulation, though, should keep these issues in check. In addition, the impact of consolidation on the concentration of power in their opinion is an issue but, as long as we have competition and open markets, it is not a big one. Finally, they noted that some people are apprehensive about predatory pricing and practices. However, they added that many of these practices are illegal, should be the subject of enforcement, and are not unique to the new environment.

The remainder relates to the synergies that could take place in these larger firms. According to Santomero and Eckles, however, as long as there is sufficient competition to impose market discipline, such synergies can create many opportunities for consumers.

Kroszner

Randall Kroszner introduced his paper by noting that his focus is on positive analysis—describing what he sees concerning how politics and banking work—and makes no judgments. He then discussed five theories of regulatory change in order to explain why so much of this change has occurred in the financial services industries in recent years.

The first approach to regulatory change—the traditional, or public interest, view—represents the idea that government's role is to correct market failures. For example, deposit insurance protects small depositors as well as the stability of the banking system. A challenge to this view, however, is that many regulations are difficult to rationalize on public interest grounds. The second approach is the private interest theory of regulation. What characterizes this regulatory process is interest group competition, wherein well-organized groups capture rents at the expense of less organized groups. The success of the well-organized lobby of small banks is an example that has been effective in the discussions of both geographic and product expansion.

The "ideology" of voters and politicians is an alternative approach that some researchers have offered to explain the widespread economic deregulation that has taken place during the past two decades. However, what constitutes ideology—the third approach to regulatory change—and whether it can be measured independent of economic interests is the subject of ongoing controversy. The fourth approach, referred to as the institutional approach, concerns how alternative policymaking structures influence the incentives of both special interest groups and politicians in shaping policy. Kroszner cited the structure of the regulatory institutions in the savings and loan industry as an example. The structure was seen as being vulnerable to industry "capture" and ultimately was eliminated. Kroszner also pointed to the interaction between congressional committees and interest groups. Finally, the idea behind the fifth approach, which he identified as the leviathan approach, is that the objective of government is to increase its size. An example of this approach is the competition among regulators over which agency would be the main supervisor of banks with expanded powers.

Kroszner observed that, taken together, these five explanations for regulatory change suggest that one look to technological, legal, and/or economic shocks to understand why there has been so much recent regulatory reform in the banking industry. He argued that such shocks have in fact occurred over the past two decades, and they have served to alter the relative strengths and effectiveness of competing interest groups.

Kroszner offered examples of these shocks. Technological developments such as automated teller machines and cash management accounts, for instance, introduced more competition, and more options for depositors, while Regulation Q and Glass-Steagall left banks unable to respond. On the lending side, credit-scoring techniques and better information processing began to change the relationship character of bank lending. As a result, he noted, alternatives to traditional lending have developed and large banks have entered the territory of small ones. Moreover, legal shocks such as court decisions have eroded the insurance industry's long-standing opposition to the expansion of bank powers, while the high costs of the savings and loan crises and the bank failures of the late 1980s have heightened support for eliminating antiquated regulations and strengthening the financial system.

Kroszner ended by predicting that we will see pressure for additional regulatory changes, such as in the supervision of insurance at the state level. He added that academic analysis can play a role in the debates over these changes by offering well-grounded and well-supported arguments.

Lown et al.

The likely evolution of the financial services industry following the passage of the Gramm-Leach-Bliley (GLB) Act was considered by Cara Lown, Carol Osler, Philip Strahan, and Amir Sufi. They began by reviewing the recent consolidation trend in the banking industry, noting that from 1989 to 1999 the share of total assets held by the eight largest banking organizations rose significantly while the share of assets held by small organizations fell. Excess capacity in the industry, the existence of economies of scale resulting from technological developments, and deregulation all contributed to this trend. With the passage of GLB, these same factors could fuel consolidation across the financial services industries.

Turning to the likely consequences of GLB, the presenters described how financial firms' stock prices reacted when the compromise legislation was announced. Large excess returns recorded by firms with strong merger and acquisition records in the financial sector suggested expectations of future consolidation within the sector. Shareholders also appeared to favor life insurance companies and bank holding companies (BHCs) that had expanded into securities underwriting prior to the law's passage. Lown et al. then discussed whether any diversification benefits from combining BHCs with insurance and securities firms were significant enough to lower the risk of the merged firms. This issue is important because diversification would allow these firms to operate with less capital or to expand into somewhat riskier and more profitable activities. Furthermore, previous studies have not found such benefits, and hence they have recommended against allowing banks to expand into these other industries.

Using data from large financial firms during the 1990s, Lown and her coauthors constructed pro-forma mergers for BHCs with life insurance, securities, and property and casualty firms, and then calculated risk measures for the resulting firms. The presenters, acknowledging the limitations of such a study, found that there were clear diversification benefits achieved from combining BHCs with life insurance firms. Combining BHCs with either securities firms or property and casualty firms raised the riskiness of the resulting firm only modestly relative to that of the BHC.

Lown et al. also looked at how the financial services industry has evolved in Europe, where banking, securities, and insurance activities have coexisted in various forms for some time. More cross-industry mergers have occurred in Europe than in the United States, they observed. Banks and life insurance firms merged most frequently, while unions between banks and securities firms also were common. In contrast, mergers between banks and property and casualty firms almost never took place. In an examination of why European banks have expanded into life insurance, the presenters indicated that banks appeared to have several cost advantages over traditional life insurance firms. The main ones are economies of scope, for example, using the bank branch system and leveraging existing resources in such areas as administration. The European banks also have been successful in penetrating the life insurance market. Their share of sales averaged more than 20 percent, and the banks have actually transformed part of the life insurance business by developing products and procedures tailored to client needs.

In conclusion, Lown et al. suggested that the three parts of their study—the stock price reaction, the diversification analysis, and the European model—all point to further consolidation in the financial services industry. Moreover, the expansion of banks into life insurance seems particularly likely.

Commentary by Mahoney

Offering his comments on the three papers, Christopher Mahoney said that he generally agreed with Santomero and Eckles' conclusions, but he was skeptical about synergies and cross-sales. He viewed cross-industry mergers as more difficult to effect than intraindustry ones, in part because of cultural conflicts, but also because there are fewer opportunities for cost savings in cross-industry mergers. Furthermore, although the acquisition route has its risks, Mahoney saw de novo expansion as equally challenging. It is difficult to obtain market share through such expansion, he argued, yet franchise value is limited without it. Mahoney also agreed with Santomero and Eckles' point that there are risk-reduction benefits to greater diversification and that, ceteris paribus, larger and more diversified firms are more creditworthy.

Turning to Kroszner's paper, Mahoney agreed with the conclusion that the enactment of Gramm-Leach-Bliley was the result of a rare alignment of interests. GLB was successfully enacted only after years of technological change, innovation, and economic shocks had fully undermined the Depression-era structure of the financial services industry and shifted the balance of competing interests. The question we now face is, what will the financial services structure look like in the future?—a question also addressed by Lown et al. Mahoney noted that this last paper provided an interesting analysis of diversification and the risk-return trade-off in financial services. The study predicted that bancassurance combinations were the most likely ones following GLB, although other cross-industry mergers would increase bank risk only modestly. However, Mahoney was less optimistic than the authors were when it came to mergers between banks and life insurance firms. He observed that the cultural challenges of such mergers could lead to combined companies that were less profitable than the separate entities. He also noted that life insurance is less profitable today than banking, a factor that might explain the lack of announcements of bank-insurance mergers since GLB was enacted.

Mahoney devoted the balance of his remarks to the implications of GLB for the safety net and for systemic stability, an issue that Santomero and Eckles also examined. He indicated that our segmented financial system structure, put in place in the 1930s, has worked remarkably well in maintaining financial stability over the past sixty-five years. Nevertheless, it was inevitable that market forces would attempt to erode the barriers, as technological and financial innovations have made the separations seem anachronistic. And although Mahoney believed that benefits will be derived from entering a new financial world, he also thought that we risk greater financial instability. In his view, the political costs of rescuing a financial firm have risen. This rise has occurred because of an increasing discomfort with the moral hazard created by the existence of the regulatory safety net, coupled with the erosion of barriers between the banking sector and the rest of the financial services industry. But he also urged us to remember a key lesson of the Great Depression: financial instability is a lot worse than inefficiency and moral hazard.

Mahoney noted that official policy today states that no bank is too big to fail, a policy predicated on what he sees as the fiction that financial conglomerates can be allowed to fail. Yet in times of financial distress, when such a failure is likely to occur, he believes that a failure would be intolerable—an intolerance he supports. According to Mahoney, it is appropriate for some banks to be considered too big to fail. Banks are illiquid, confidence-sensitive institutions that have large exposures to each other and whose solvency is unknowable to market participants, especially during times of financial distress.

In sum, Mahoney remarked that as a result of GLB, many institutions ultimately will emerge as being too big to fail. He stressed that it was appropriate to maintain ambiguity around this fact, but that we should not deny it too vehemently—or prohibit it by law—as we might find ourselves tripping over our own words someday.