

# Monetary Trends



## Implications of Financial Sector Consolidation

In a recent report, the Group of Ten (G10) assesses possible effects of financial sector consolidation on financial risk, monetary policy, market structure and the payment system.<sup>1</sup> The financial sector, as defined in the report, comprises commercial banking, investment banking, insurance and, in part, asset management. The report covers the eleven G10 nations, Australia and Spain.

The report was commissioned in September 1999 by the central bank governors and finance ministers of the G10 countries in response to a decade of high and accelerating levels of merger and acquisition (M&A) activity. The strong M&A activity has created a number of large and complex financial services providers—many with multinational operations.

The report views efficiency gains from large-scale operations as the driving force for consolidation in the financial sector. Improvements in information technology have allowed for economies of scale in providing services. Financial deregulation, along with integration of financial markets, has extended the business opportunities for large entities. The impetus for moving to large-scale operations has been reinforced by increased shareholder pressure for more efficient use of capital.

In terms of financial risk, the report notes that larger entities are not necessarily more diversified or less risky than their smaller counterparts. The post-merger portfolio of a financial firm might differ from the sum of the respective pre-merger portfolios as the merger changes market conditions and offers new business opportunities. The report points out that financial “workouts” might be harder to bring about for large distressed institutions than for small ones.

The report also investigates three possible means through which financial sector consolidation could impair the functioning of monetary policy. First, consolidation might affect how monetary policy is implemented. In

conducting open market operations, the central bank interacts directly with private sector financial institutions. If market structure changes—for instance through a decrease in the number of market participants—the central bank might have to make institutional changes to these operations. Isolated cases of such changes have been reported.

Second, consolidation might affect the way monetary policy is transmitted to the real sector. For instance, in the “monetary channel,” interest rate changes are relayed through financial markets via arbitrage. Larger, more integrated financial institutions might accelerate this process through internal capital markets. On the other hand, less competition among financial institutions might slow down transmission as price changes are passed on in the market to a lesser degree or less rapidly. Similarly, in the “credit channel,” changes in monetary policy are transmitted to the real sector through bank lending. Again, increased concentration might weaken competition and lead to incomplete or slower delivery of liquidity supplied by the central bank. As the report points out, so far, there is little evidence that the monetary transmission mechanism has been impaired through consolidation in the financial sector.

Third, when in distress, large and complex financial institutions pose risk to the financial system. By becoming too big to fail, institutions shift risk to the lender of last resort. The central bank, which in some G10 countries supervises banks and serves as the lender of last resort, should bear in mind the moral hazard implied in this activity. The central banks should also consider carefully the consequences of providing emergency liquidity for the stance of monetary policy.

While it is impossible to predict future scenarios, it seems likely that the strong M&A activity in the financial industry will persist. The potential effects of consolidation on financial risk and monetary policy outlined in the report should be monitored as consolidation continues.

—Judith H. Hazen  
—Frank A. Schmid

<sup>1</sup> Group of Ten, *Report on Consolidation in the Financial Sector*, January 2001, <http://www.bis.org>.

