Robert T. Parry, President
Federal Reserve Bank of San Francisco

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The Uncertain Economics of Banking Consolidation

I. What will the future structure of the banking industry look like?

A. This question is as important to central bankers like me, who are interested in broader questions of credit supply, as it is to you and your financial institutions.

B. And there's no shortage of speculation on what the answer will be.

1. For example, a number of people have noted the recent trend in consolidation,

2. and they've taken it as a signal that more and more consolidation is coming--that it's the inevitable outcome of economic forces.

C. So today I want to take a look at those economic forces and also probe with you some of the regulatory issues underlying the consolidation phenomenon.

1. Forecasting economic trends is difficult. Forecasting trends in banking is even harder because of the influence of public policy and regulation.

a. Few industries in the US face the degree of active policy intervention that banks face every day.

(1) I think there are important justifications for the regulation of the banking industry.

b. But exactly how this policy is practiced can have an important impact on the performance of the industry and the economy itself.

D. So, as we talk about consolidation, it's important to distinguish between economic forces and the effects of regulatory policies.

1. And I think I can convince you that it's not possible to forecast banking consolidation trends without first forecasting banking policy.

II. Let me begin with a narrow focus, and discuss first just the basic economics of the banking consolidation issue.

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A. As I see it, three main factors determine the optimal degree of consolidation:

1. First, "production efficiencies:" that is, whether or not economies of scale and scope exist.

2. Second, portfolio diversification: does being larger help smooth out the effects of risky assets?

3. And third, marketplace effects: does being larger give a bank market power over its competitors, or make a bank more attractive to customers?

B. Let me discuss them in turn.

III. First, production efficiencies.

A. Every banker in this room can think of ten ways to save money by combining two smaller banks into one.

1. Some involve economies of scale:

a. To name just a few, you could eliminate administrative, accounting, and computing overhead expenses.

2. Some involve economies of scope:

a. that is, you can combine the service offerings of both banks without proportionately increasing costs.

B. But, when economists look at the data, they find a surprising result:

1. Many studies find that once a bank is larger than $400 million in deposits or so, economies of scale appear to be exhausted;

a. and economists don't find much evidence of scope economies, either.

2. Likewise, when you do a post mortem on most bank mergers, the combined institution does not appear to be running more cheaply or profitably than the two did separately.

a. Indeed, studies of the stocks of the affected banks generally don't support the profitability of mergers, particularly

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interregional ones.

C. What does this say about production efficiencies?

1. It could be that the data are misleading; certainly there are plenty of analytical problems in doing these kinds of studies.

2. Or it could be that in big institutions, certain factors come into play that overwhelm the potential for operating cost savings.

a. Big institutions can become difficult to steer, and vulnerable to volatile market conditions if they can't react quickly.

b. And the uniform pricing policies of big institutions may hurt them in market niches, by subjecting them to cream-skimming by smaller, more reactive banks.

3. That is, the quality, or effectiveness, of management is far more important than the size of a bank in determining its efficiency.

a. This means that if it's hard to cut costs in big banks, then the rate of consolidation will be determined by the availability of good "big bank" management.

IV. Now let me turn to the second economic factor: portfolio diversification. Multiregional consolidation, in particular, can result in a more diversified loan portfolio.

A. Theory says that, other things being equal, a diversified portfolio reduces the effects of non-systematic risk, that is the risks that are peculiar to individual assets.

1. And the market rewards such portfolios with lower costs of financing, which can increase banks' profits.

B. But this presupposes that the market has no other way of achieving this diversification.

1. In theory, however, investors can always achieve diversification through owning a mix of bank stocks, even if the individual banks are undiversified.

a. This has been confirmed by comparing the performance of the stock prices of regionally consolidated banks with those

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that are not consolidated.

C. Thus, although diversification effects are real, a bank cannot expect lower costs of financing or rewards from the marketplace for achieving diversification through merger.

V. Finally, let me turn to the consequences of the merger on the marketplace.

A. One obvious possibility is that a larger, consolidated organization can support a wider range of products than a smaller bank.

1. The ability to offer a full range of services, in turn, may be important to attracting, and retaining, certain banking customers.

B. Countering this view is the fact that more and more, banks can economically offer certain services--like ATMs--via third parties

1. So even fairly small banks can offer a reasonably wide range of services.

C. This says to me that the marketplace advantages of consolidation simply will be less significant in some products than others.

1. Hence, size doesn't necessarily win every time, which leaves room for smaller banks.

2. This certainly has been our experience in California,

a. where we have a population of about 400 smaller banks coexisting--mainly profitably--with some of the nation's biggest banks.

D. A more ominous market effect, though, is the chance that consolidation could extinguish competition--at the customer's expense.

1. Without some support from government policy, I think it's very hard for producers to "monopolize" a market.

2. So long as entry--even the threat of entry--is relatively unrestricted, markets can be quite concentrated without yielding to monopoly behavior.

3. However, if regulation limits the flexibility of competitive forces,

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consolidation could result in less than perfect competition for some banking services.

VI. This leads me to the point I made earlier about the importance of public policy toward banking.

A. Unlike most other industries, entry into banking is regulated, and government has direct influence on day-to-day business.

1. For example, it provides deposit insurance and certain payment and credit services.

B. Depending upon how these policies are administered, an inadvertent bias for or against consolidation could emerge.

1. For example, it seems clear that the stated, too-big-to-fail policy that the FDIC has followed creates a bias in favor of consolidation.

2. I happen to think that TBTF is not a wise or necessary policy,

a. but even if it were, it gives "bigness" an implicit subsidy along the way.

C. Bank entry is not only regulated, it's also fairly heavily restricted.

1. To begin with, bank regulators don't allow "just anyone" to buy a bank, so the field of buyers is mainly other banks, and the hostile takeover process is less common.

a. Hence, the takeover process tends to involve, by necessity, consolidation of banks.

2. Furthermore, to start up or acquire a bank requires clearing some significant, and expensive, regulatory hurdles.

a. And in some states, branching is restricted as well.

3. All of this is to say that the checks and balances that operate in unregulated markets to preserve competition and enhance organizational efficiency may not operate as fully in banking.

a. So, in order to protect the welfare of the consumer, bank regulators and the Department of Justice must be extra-diligent when considering consolidation proposals.

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VII. I hope I've conveyed the complexity of the issues surrounding consolidation.

A. On balance, I must say that I certainly see the banking system becoming more consolidated than it is today, but not to the extent of some forecasts.

1. I think the California banking structure, blown up to national scale, is probably the range of consolidation one can expect to see.

a. This would mean 4,000 to 5,000 commercial banks and 7-8,000 total institutions nationally.

2. And I definitely expect small banks to remain viable

B. But the actual outcome will depend crucially on the course of banking policy.

1. If the TBTF policy is addressed, of course, consolidation will be less than this.

2. But there could be additional impetus for consolidation if the House passes its current proposal on interstate branching.

a. This proposal lets states limit interstate branching only to acquisitions of existing branches.

3. Consolidation will gain even more impetus if antitrust policy is not applied stringently.

a. Indeed, much of the high levels of consolidation observed abroad appear to have arisen in environments that were protective of banks.

b. For example, many countries, such as Canada, the U.K., Japan, and more recently, France, stimulated concentration of commercial banking through government policy to reduce the number of banks directly or to permit cartels in key banking services.

c. Hence, their structures cannot be seen as "natural" ones.

(1) In France earlier this decade, for example, the number of financial institutions declined by 80% in 6 years under a socialist policy to nationalize banking.

4. The most relevant foreign comparisons are countries, such as Germany and Denmark, that have not had artificial barriers to entry, and that have

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practiced aggressive regulation of bank capital.

a. Extrapolating from the German case, we would have about 1,000 commercial banks, and 14,000 total deposit-taking institutions

b. Extrapolating from Danish case, we would have about 7,000 commercial banks, and about 20,000 total deposit-taking institutions.

c. My California number, of about 4,000-5,000 commercial banks fits nicely in between.

C. So, when it comes to consolidation trends, you can pick your own number!

1. But neither the economics, nor the empirical reality, say that the U.S. banking system will be as concentrated as some, in the past, have forecasted.

2. Not unless that becomes a specific, or inadvertent, target of public policy.

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