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Containing Bank Cost: A Policymaker's Perspective

I. It's a pleasure to be here today addressing the West Coast segment of your conference.

A. In preparing my remarks, I took a look at your agenda, and I think it's terrific.

1. In my role as President of the Federal Reserve Bank of San Francisco, I am, of course, very concerned about the health and competitiveness of our nation's banks and our District's banks.

2. So I applaud the down-to-earth, aggressive approach this conference is taking toward maximizing banks' profitability through cost containment.

B. To give you a policymaker's perspective, I want to step back a bit from the hands-on issues you're addressing in your meetings.

1. I want to talk about an issue that always comes up in discussions of how to make banks more efficient, more "lean and mean."

a. That issue is bank consolidation.

2. Any number of people would say that the current consolidation trend signals that more is on the way--that consolidation is 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. Few industries in the U.S. face the degree of active policy intervention that banks face every day.

a. I think there are important justifications for the regulation of the banking industry.

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

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 doesn't seem to run 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 interregional ones.

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b. And recent Federal Reserve Staff studies look at the ratio of non-interest operating expenses to assets and find that it declines only temporarily after a merger, and subsequently returns to its prior level.

C. What does this say about production efficiencies?

1. It could be that the data are misleading;

a. 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--that is, if it's hard to stay "mean" enough to be "lean"--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.

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

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

    a. This has been confirmed by comparing the performance of the stock prices of regionally diversified banks with those that are not diversified.

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

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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, 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. These policies can create an inadvertent bias for or against consolidation.

1. Let me give you an example. Under the current policy, regulators have protected banks that are "too big to fail."

a. So banks obviously have had an incentive to get bigger, to consolidate.

2. Fortunately, the banking reform bill that Congress just passed has put a dent in "too big to fail" with measures that apply to all institutions, regardless of size. These include

a. prompt corrective action,

b. restrictions on extended discount window loans to troubled banks,

c. and limits on reimbursements for uninsured deposits.

3. This kind of policy change effectively reduces one of the incentives for banks to get bigger.

C. Working in favor of consolidation, though, are the restrictions on bank entry.

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

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less common.

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 customer, bank regulators and the Department of Justice must be extra-diligent when considering consolidation proposals.

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 four to five thousand commercial banks and seven to eight thousand total institutions nationally.

2. And I definitely expect small banks to remain viable.

B. But the actual outcome also depends crucially on banking policy.

1. The shape of the reform legislation that Congress just passed tilts the bias somewhat away from consolidation.

    a. The apparent abandonment of "too big to fail" that I mentioned earlier is one such tilt.

    b. Another is the failure to pass interstate branching, which also would have stimulated consolidation.

2. On the other side of the coin, consolidation could gain impetus if antitrust policy isn't applied stringently.

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

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1. But neither theory nor a careful review of case studies says that the U.S. banking system will be as concentrated as some, in the past, have forecast.

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

D. This means that you, the people in this room, have the most to say about the future competitiveness of your institutions.

1. Consolidation, and other "macro" changes in your organization, are less important than your day-to-day efforts.

2. Only managers like you can devise the internal procedures to keep a bank "lean and mean" over the long haul.

3. This is why, across the spectrum of types and sizes of banks, we see such variety in their underlying performance.

4. It is really up to you to create the performance you want for your bank.

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