

Bank Mergers and Financial Consolidation

Prepared Statement

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Mr. Chairman, Members of the Committee:

I thank you for the privilege of being invited to testify before the Committee, and commend you for scheduling this important series of hearings examining the magnitude and consequences of mergers and concentration in key sectors of the American economy.

My testimony today, on the topic of banking mergers, is drawn from my study of the field, as well as a number of my publications addressing the issues of mergers, market power and antitrust policy more generally, including *The Bigness Complex* (1986), *Dangerous Pursuits: Mergers and Acquisitions in the Age of Wall Street* (1989), *Antitrust Economics on Trial: A Dialogue on the New Laissez-Faire* (1991), and *The Structure of American Industry* (1995) -- all co-authored with Walter Adams, Distinguished Professor of Economics and Past President, Michigan State University.

The views I express are my own; I represent no person, organization or interest other than myself.

1. Dimensions of Merger-Mania in Banking

As the Committee is well aware, the American economy is ensnarled in an epic merger mania. In 1997, a record \$1 trillion of mergers and acquisitions occurred, with 1998 on pace to shatter even that unprecedented total. To put this magnitude in context, there are only seven nations in the world whose gross national product exceeds \$1 trillion; it is an amount roughly equal to the GNP of nations like Italy and Great Britain.

Banking is caught up in this merger fever. In fact, financial firms have been in the forefront of the merger and consolidation movement for two decades: In the 1980-1994 period, more than 6,300 bank mergers were recorded, involving nearly 80 percent of all domestic U.S. banking assets.⁽¹⁾

The bulk of this consolidation has been engineered primarily by the nation's very biggest banks: The twenty-five largest banks accounted for nearly one-half of all bank assets acquired over the 1980-1994 period.⁽²⁾

More recently, the magnitude and pace of financial merger-mania has accelerated sharply: The value of mergers and acquisitions involving U.S. banking firms has leaped 166 percent over the past four years, rising from \$70 billion in 1995, to \$123 billion in 1996, and reaching \$186 billion in 1997.⁽³⁾

As Table 1 shows, eight of the ten very biggest financial mergers in American history have occurred just in the past year and a half.

The tremendous concentration of power and control over financial

Table 1

Ten Largest U.S. Financial Mergers

Value of Deal Combined Assets

Year (billion) (billion)

Citicorp/Travelers 1998 \$83 \$698

Bank of America/Nationsbank 1998 60 570

Banc One/First Chicago NBD 1998 30 239

First Union/Core States 1997 17 206

Nationsbank/Barnett 1997 16 284

Wells Fargo/First Interstate 1996 12 108

Chase/Chemical 1995 11 297

Dean Witter/Morgan Stanley 1997 11 261

Wash. Mutual/H.F. Ahmanson 1998 10 150

Source: Wall Street Journal, various issues.

resources cumulatively resulting from this succession of ever-larger combinations is apparent in Chart 1, which traces the merger-based evolution of this emerging money trust.

At the same time, the number of banks in the country has dropped by more than a third since 1980.⁽⁴⁾

And while some 9,000 banking firms remain in operation, the level of concentration in the field is high and rising: The ten largest banks currently control about one-half of the nation's total commercial banking assets, with the largest 25 together controlling 71 percent. If not interrupted, these concentration levels

Table 2

Banking Concentration by State

(1997)

Top Five Banks 'Top Five Banks'

State Share of Deposits State Share of Deposits

Alabama 67% Montana 54%

Alaska 92 Nebraska 46

Arizona 89 Nevada 79

Arkansas 41 New Hampshire 82

California 68 New Jersey 66

Colorado 56 New Mexico 59

Connecticut 73 New York 61

Delaware 73 North Carolina 70

District of Col. 86 North Dakota 45

Florida 71 Ohio 62

Georgia 68 Oklahoma 36

Hawaii 99 Oregon 83

Idaho 87 Pennsylvania 65

Illinois 42 Rhode Island 99

Indiana 44 South Carolina 66

Iowa 29 South Dakota 54

Kansas 29 Tennessee 56

Kentucky 39 Texas 45

Louisiana 63 Utah 79

Maine 79 Vermont 81

Maryland 68 Virginia 61

Massachusetts 85 Washington 77

Michigan 69 West Virginia 56

Minnesota 54 Wisconsin 57

Mississippi 55 Wyoming 64

Missouri 54

Source: Division of Research and Statistics, Board of Governors
of the Federal Reserve System.

will continue to escalate, reaching projected levels of 70 and 85 percent, respectively, over the next two years.⁽⁵⁾

Concentration of banking within individual states is even higher, as Table 2 shows.

II. Dangers of Merger-Mania in Banking

Is this massive financial merger-mania cause for jubilation? Is it the price we must pay to obtain economies, efficiencies, and greater global competitiveness for America in the new millenium -- not only in banking, but throughout an economy dependent on the lifeblood of financial capital? Is it, at worst, merely a benign phenomenon offering the nation the chance for great gains but without any problematic downside risk?

Regrettably, experience and the evidence strongly suggest the contrary, on at least four important grounds:

1. Anticompetitive Consequences. As market concentration rises, and as fewer financial firms collectively control larger shares of markets, the vigor of competition declines and the discipline of the competitive marketplace is subverted. The reason, as one bank analyst candidly confides, is that "Oligopolies are a wonderful form of business for banks.... You can control your deposit prices and leverage your market share."⁽⁶⁾

Another analyst urges that "the key motivation for merges and acquisitions among banks is, or at least should be, exerting more control over pricing of financial services offerings."⁽⁷⁾

"Fortune 500" firms can, of course, shop the globe for their financial needs. And individual consumers can choose from among thousands of mutual funds in investing their personal funds. But the vast majority of consumers and American businesses are far more dependent on local markets for the bulk of their banking needs, and, thus, they are more easily exploited as financial consolidation constricts the competitive options from which they can choose.

Under these circumstances, the consequences of high - and rising - concentration in banking are predictable and observable, on a variety of fronts: Higher interest rates for loans;⁽⁸⁾

lower interest rates paid on deposits;⁽⁹⁾

declining interest in serving the financial needs of smaller businesses and individual consumers;⁽¹⁰⁾

sharply rising fees conventionally charged for various services (such as checking accounts⁽¹¹⁾

and the use of automated teller machines⁽¹²⁾

); and the unilateral imposition of a plethora of new fees which, according to industry trade reports, have more than doubled during the current decade.

Beyond this, the giant financial conglomerates that are being merged together can undermine competition in a variety of additional ways that are divorced from competitive merit in any meaningful sense;⁽¹³⁾

By virtue of their “deep pockets” the banking behemoths can outbid, outspend and outlose their smaller, more specialized financial rivals by utilizing profits and resources drawn from less competitive segments and regions to cross-subsidize their expansionary campaigns in other areas. By engaging in various forms of reciprocal dealing, they can exploit the economic leverage of their massive buying power to compel suppliers to patronize their financial services side. In a closely related vein, they can leverage their size in one field in order to enhance their position in other fields by tying the provision of one service to the client’s purchase of other services;⁽¹⁴⁾

And as fewer, larger financial firms stake out dominant positions in particular geographic and service product lines, they become superpowers versed in the art of peaceful coexistence and respect for the status quo.

Mergers between banks with operations located in different geographic regions also undermine the central goal of deregulation efforts to break down artificial barriers to competition. Particularly when the merging banks are large and well-known, these trans-geographic and trans-service consolidations enable merging firms to eliminate their most likely potential competitors. Put differently, it is futile to undertake the enormous effort required to reduce regulatory barriers to competition in financial services if the most important potential competitors merge together in advance.

Finally, it is important to emphasize that these latter, larger anticompetitive problems are not captured by focusing solely on the question of overlaps of merged operations in narrowly-defined “relevant markets”. Nor are they addressed by antitrust settlements requiring merging financial giants to spin off relatively inconsequential operations where a few such overlaps might be found.⁽¹⁵⁾

2. Adverse Impact on Economic Performance. Remarkably, the overwhelming weight of the evidence from a mountain of statistical studies fails to support the grandiose claims concerning the benefits alleged to flow from big bank mergers. There is no credible evidence that financial mega-mergers are being forced by the dictates of technology or by any autonomous economies of even greater scale.

To the contrary, whether analyzed in terms of various measures of profitability, or in terms of various measures of costs and expense ratios, or in terms of the performance of stock prices before and after merger, the overwhelming weight of the evidence suggests that mega-mergers fail to improve the economic performance of the merged entities. Instead, more often than not, the weight of the evidence strongly suggests that mega-mergers and excessive organizational size tend to undermine good economic performance. As summarized by one of the nation’s leading students of the field, “evidence from studies of the economies of scale and scope, the effects of mergers, the relative growth and market share gains of large and small banks, and the adoption of electronic technology does not indicate that there are scale economies or any other operating

imperative requiring large size for success in the community banking industry.”⁽¹⁶⁾

In fact, the very biggest banks typically exhibit less efficiency, higher operating cost ratios, and lower profitability.⁽¹⁷⁾

Of special significance are the results of a recent study of the stock price performance of big bank mergers undertaken by the financial analysis firm Keefe, Bruyette & Woods. Examining the eight largest bank mergers occurring in 1995, this study finds that, three years later, the “Class of ‘95” performed miserably: Six of the eight largest merged banks underperformed an index of bank stocks generally, with three of them falling short by 40 percent or more; the very best of the “superior” performers turned in stock price gains only 1.3 and 0.1 percent better than the average for all banks.⁽¹⁸⁾

Obviously, mega-mergers in the financial sector have failed to meet the stock market test of success.

Rather than delivering better services more efficiently, bank mega-mergers seem to generate lower-quality, higher-cost services, as the elephantine organizational structures being created succumb to the inefficiencies of excessive size -- misplaced deposits, good checks mistakenly bounced, funds incorrectly withdrawn from some accounts and put into others, more and longer automated phone messages for customers, Babylonian towers of computers incapable of communicating -- in short, all the hallmarks of the diseconomies of excessive scale.⁽¹⁹⁾

In fact, the debilities of giantism in financial services are a matter of general recognition, with objective experts suggesting that it may be “Time to Break Up the Banking Behemoths.”⁽²⁰⁾

Or as Barron’s puts it in assessing Citicorp’s \$80 billion merger with Travelers, “if the history of mergers is any guide, the smart thing for Citicorp shareholders to do may be to sell immediately, or shortly after the Travelers deal is completed.”⁽²¹⁾

-- hardly a stirring testimonial to the enduring benefits of mega-mergers.

3. The Opportunity Cost of Merger-Mania. Merger-mania also inflicts an immense opportunity cost on the nation.⁽²²⁾

The time, energy, attention and multi-billion dollar sums being devoted to mergers and acquisitions are, at the same time, energy, effort and multi-billions of dollars not being invested directly into the nation’s economic base. They are scarce resources not being invested directly in the research and development of genuinely new products and services. They are human and financial resources not being invested directly in the construction of new plant and equipment. And they are time, energy and billions of dollars not being invested directly in constructing new state-of-the-art production techniques -- much less addressing the daunting “Year 2000” computer problems faced most prominently by the nation’s financial firms.

Put more concretely, the \$1 trillion spent on mergers and acquisitions last year is roughly twice the amount spent on research and development by all of American industry (\$113 billion) plus

the combined net new investment by all American firms (\$432 billion) in the 1996-1997 period.
(23)

The \$123 billion spent on banking and financial mergers in 1996 is four times greater than the total amount spent on all basic research (\$30 billion) in the United States by government and business in the same year.⁽²⁴⁾

Instead of being invested in the kind of creative capitalism that enhances the real wealth of the nation, these multi-billion dollar sums -- and the energy, attention, effort and talent behind them --- are being devoted to the economically sterile game of reshuffling paper ownership shares of organizations and operations that already exist.

4. Government Bailouts and the “Too Big To Fail” Problem. The financial bigness complexes being created by these mega-mergers subverts the discipline of the private enterprise system in an even more fundamental way, by rendering society increasingly vulnerable to a government bailout problem of growing proportions.

Once any organization is allowed to attain disproportionately large size, its fortunes unavoidably reverberate throughout the economy. Once any organization attains disproportionately large size, its private mistakes and errors become public catastrophes. As Lockheed and Chrysler show, once corporations are allowed to become disproportionately large, they are considered too big, too important and too influential to be allowed to fail.

Then, society becomes a hostage to bigness. And when corporate bigness complexes manage their way into trouble, they do not meekly sacrifice themselves on the altar of private enterprise. Instead, they assault Washington and confront a democratic, private enterprise society with an intractable dilemma: (a) Rescue corporate giants from the consequences of their self-inflicted injuries, thereby subverting the essential discipline of a competitive, free enterprise economy; or (b) allow ailing giants to fail, thereby inflicting possibly catastrophic consequences on society while, at the same time, rendering government less accountable to the concerns and fate of the citizenry. The “flunk insurance” accorded giant firms produces “reverse” economic Darwinism -- giant firms survive, not because they’re better but because they’re bigger -- not because they’re fitter, but because they’re fatter.⁽²⁵⁾

The problem is especially acute in the financial sector, where firms not only control the financial lifeblood of the entire economy, but where they repeatedly have demanded -- and obtained -- multi-billion dollar government bailouts from the consequences of their own decisions: Continental Illinois in the mid-1980s (Continental’s assets of \$40 billion at the time pale in comparison with the assets of the behemoths being merged together today); bad loans made by the biggest banks to third-world and developing countries, including Mexico; and most recently, the big banks’ exuberance in pouring their funds into risky East Asian ventures. In each of these cases, the American government -- and the American taxpayer -- have been forced to contribute billions to rescue financial giants from the adverse consequences of their own actions.

Mega-mergers, of course, exacerbate the magnitude of this bailout dilemma. In fact, some experts estimate that the number of American banks too big to be allowed to fail has doubled

over the past decade.⁽²⁶⁾

-- a list that grows with each announcement of a new record-breaking merger among banking firms.

In this connection, it is relevant to note that a listing of the world's very biggest banks (Table 3) reveals the majority of them to be

Table 3

Ten Largest Banks Worldwide
(as of Dec. 1997)

Rank Company Country

1 Bank of Tokyo-Mitsubishi Ltd. Japan

2 Deutsche Bank Germany

3 Crédit Agricole France

4 Dai-Ichi Kangyo Bank Japan

5 Fuji Bank Japan

6 Sanwa Bank Japan

7 Sumitomo Bank Japan

8 Sakura Bank Japan

9 HSBC Holdings Hong Kong

10 Norinchukin Bank Japan

Source: N.Y. Times, Dec. 9, 1997.

headquartered in Japan -- which also is the location of the developed world's biggest banking problems and the biggest challenge in bailing out collapsing financial giants.

These facts are not coincidental. Big organizations, like all organizations, make mistakes. None are infallible. The crucial difference is that because of their disproportionate size and impact, the

mistakes made by giant firms are also disproportionately large and, as a result, pose equally large problems for an entire society, including its elected representatives in government.

III. Conclusion

In examining mega-mergers in banking, Mr. Chairman, I invite you and your colleagues to recall V.I. Lenin's admiration of financial consolidation and organizational giantism. A century ago, he devoutly believed that consolidation of banking would provide "advantages accruing to the whole people." He declared -- in terms eerily similar to those heard today -- that the benefits of financial bigness "would be enormous. The saving in labour would be gigantic... making the use of banks universal, increasing the number of their branches, putting their operations within easier reach," and greatly enhancing the "availability of credit on easy terms for the small owners..."⁽²⁷⁾

Lenin's faith -- and that of Stalin -- in the virtues of organizational giantism, coupled with their criticism of the competitive market as a duplicative, wasteful and inefficient system, was the foundation on which the centrally planned Soviet economy was built.

It is bizarre, and more than a little incongruous, that that failed delusion has been repudiated by the formerly communist countries, only to be resuscitated in the hallowed halls of Wall Street.

Perhaps it is time to call a halt to the sovietization of the American financial system.

1.

Board of Governors of the Federal Reserve System, Bank Mergers and Industrywide Structure, 1980-94, Staff Study, Jan. 1996.

2.

Ibid.

3.

Mergers and Acquisitions magazine, annual merger survey, March/April issues, 1996-1998.

4.

U.S. Bureau of the Census Statistical Abstract of the United States: 1997, Table 785, p. 515, and Katerina Simons and Joanna Stavins, "Has Antitrust Policy in Banking Become Obsolete?" Federal Reserve Bank of Boston, New England Economic Review, March/April 1998, p. 13.

5.

Alan Gart, "The Long Reach of Banking's Acquisition Wave," Mergers & Acquisitions, May/June 1998, pp. 26.

6.

Racine, "Minneapolis Seen as Model for Consolidation," *American Banker*, May 25, 1994, p. 20.

7.

Matthews, "The Next Merger? Look at Market Share," *American Banker*, Aug. 10, 1994, p. 20. This and the preceding quotation are cited in Stephen A. Rhoades, *Competition and Bank Mergers: Directions for Analysis from Available Evidence*, *Antitrust Bulletin*, Summer 1996, pp. 361-62.

8.

For one exhaustive survey, see Leonard W. Weiss, *A Review of Concentration-Price Studies in Banking*, in *Concentration and Price* (L. Weiss ed., 1989), pp. 219-54.

9.

Allen N. Berger and Timothy H. Hannan, "The Price-Concentration Relationship in Banking," Division of Research and Statistics, Federal Reserve Board, Washington, D.C., April 1988.

10.

Stephen E. Frank, "Consumer Wonder if Deals Will Deliver Better Services," *Wall Street Journal*, Apr. 14, 1998, p. A3.

11.

U. S. Public Interest Research Group, "Banks Think Fees, Not Free," Aug. 1995.

12.

See "Mad as Hell at the Cash Machine," *Business Week*, Sept. 15, 1997, p. 124, General Accounting Office, *Automated Teller Machines: Survey Results Indicate Banks' Surcharge Fees Have Increased*, Apr. 1998.

13.

For a detailed exposition of the anticompetitive problems posed by large conglomerate mergers, see Walter Adams and James W. Brock, *The Bigness Complex* (1987), Chap. 14.

14.

See, for example, *Money with Strings Attached*, *Business Week*, Dec. 21, 1992, pp. 74-75; and Jeffrey Taylor and Emory Thomas Jr., "NationsBank Letter Sparks Investigation," *Wall Street Journal*, Aug. 15, 1994, p. A4.

15.

In the case of Nationsbank's \$15 billion acquisition of Barnett Bank, for example, the operations required to be divested by the Justice Department in return for its blessing represented less than 4 percent of the total number of offices being combined in the merger. Department of Justice, Press Release, "Justice Department Reaches Accord Agreement with Nationsbank," Dec. 9, 1997.

In the \$16.6 billion CoreStates/First Union merger, the number of branch offices ordered divested by Justice represented 1.3 percent of total number of offices being merged. Department of Justice, Press Release, "Justice Department Approves First Union/CoreStates Merger After Parties Agree to \$1.1 Billion Divestiture in Pennsylvania." Apr. 10, 1998.

16.

Stephen A. Rhoades, "Commercial Banking," in *Industry Studies* (L. Duetsch ed. 1993), p. 287.

17.

John H. Boyd and Stanley L. Graham, "Investigating the Banking Consolidation Trend," Federal Reserve Bank of Minneapolis, *Quarterly Review*, Spring 1991.

18.

Keefe, Bruyette & Woods, Inc. "The Class of '95 Mega Mergers," July 18, 1997.

19.

See, for example, Jim Carlton, "Wells Fargo Discovers Getting Together is Hard to Do," *Wall Street Journal*, July 21, 1997, p. B4; Stephen E. Frank, "Consumers Wonder If Deals Will Deliver Better Service," *Wall Street Journal*, Apr. 14, 1998, p. A3; Saul Hansell, "Clash of Technologies in Merger," *N.Y. Times*, Apr. 13, 1998.

Banks and financial firms are not unique in this respect. Instead, evidence of the adverse impact of mega-mergers on economic performance is found for American industry generally. See Walter Adams and James W. Brock, *Dangerous Pursuits: Mergers and Acquisitions in the Age of Wall Street* (1989).

The debacles following the Union Pacific Railroad's acquisition of the Southern Pacific Railroad, and those stemming from Boeing's acquisition of McDonnell Douglas and the defense and aerospace operations of Rockwell, are the latest manifestations of the problem.

In the former case, the firm's president declared at the time of the merger that the Union Pacific/Southern Pacific combination would produce "improvements that truly deserve the term "unprecedented." So far, the merger's only "unprecedented" result has been massive congestion tying up rail traffic throughout a large portion of the continental United States. See Peter Coy,

“The Antitrust Cops Should Ride the Rails,” *Business Week*, Mar. 2, 1998, p. 48, and Brian O’Reilly, “The Wreck of the Union Pacific,” *Fortune*, Mar. 30, 1998, pp. 102.

In Boeing’s case, the firm suffered its first financial loss in a half century following its latest acquisitions, and its chief executive concedes that the mergers distracted too much attention from Boeing’s own operations. See Frederic M. Biddle and John Helyar, “Behind Boeing’s Woes,” *Wall Street Journal*, Apr. 24, 1998, p. 1.

20.

Saul Hansell, “Time to Break Up the Banking Behemoths?” *N.Y. Times*, Apr. 7, 1995, p. C1.

21.

Leslie P. Norton, “Merger Mayhem: Why the Latest Corporate Unions Carry Great Risk,” *Barron’s*, Apr. 20, 1998, p. 34.

22.

For a more detailed examination of this problem, see Walter Adams and James W. Brock, *Dangerous Pursuits: Mergers and Acquisitions in the Age of Wall Street* (New York: Pantheon, 1989), 114-123.

23.

1998 Economic Report of the President, Tables B-14 and B-18; U.S. Bureau of the Census, *Statistical Abstract of the United States: 1997*, Table 962.

24.

1997 *Statistical Abstract*, Table 963.

25.

For in-depth examinations of this problem, see Walter Adams and James W. Brock, *The Bigness Complex* (New York: Pantheon, 1987); *Antitrust Economics on Trial* (Princeton, NJ, Princeton University Press, 1991), and “Corporate Size and the Bailout Factor,” *Journal of Economic Issues*, March 1987, pp. 61-85.

26.

Ron J. Feldman and Arthur J. Rolnick, “Fixing FDICIA: A Plan to Address the Too-Big-To-Fail Problem,” *Federal Reserve Bank of Minneapolis*, March 1998.

27.

Lenin's Economic Writings (Meghnad Desai ed., 1989), p. 186.