

# Report for Congress

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## **Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects**

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# Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects

## Summary

Competitive, legislative, and regulatory developments in financial services in the United States have all contributed to significant industry changes here. The landmark financial services legislation, the Gramm-Leach-Bliley Act (P. L. 106-102, GLBA) is speeding ongoing changes in the United States financial services industry. Overall, it allows providers flexibility in responding to economic trends. Global and especially technological advances are likely to affect the financial services industry in ways yet unforeseen. Such factors are part of the larger picture reflected in recent mergers among large banking organizations in Europe, Japan, and the United States, and expanding product lines of domestic financial institutions.

Mergers of very large banking organizations in Europe and Japan move the size of single organizations to new heights. American providers of financial services are similarly growing through combinations, as exemplified by the fusion of J.P. Morgan into the Chase Manhattan companies, and the joining of Wachovia and First Union.

Increasing diversification of financial services offered within single entities in the United States is occurring through acquisitions and internal development of new businesses. GLBA allowed new forms of affiliations among banks, insurance, and securities firms and increased diversification within individual financial organizations. In response to this increased flexibility, many institutions are taking advantage of the newly authorized organizational arrangements.

Specific changes for policy consideration depend on the predominant ways in which the financial system unfolds. Policymakers can evaluate policy issues better once global economies have gained some experience with the new dynamics in the financial system. For now, observers will be watching to see how the marketplace continues to respond to new opportunities embodied in GLBA, multinational financial integration, and volatile economic conditions around the world. GLBA clearly ended the isolation of the investment banking business from the commercial banking businesses, through its repeal of the Glass-Steagall Act of 1933. In the current financial climate, the financing of Enron Corporation and other tarnished corporations through both securities and loans from prominent financial holding companies has called the commercial and investment banking combination of businesses into some question, in Congress and the financial press.

CRS will update this report as developments warrant. Further information on financial services issues of current interest to Congress appears in the CRS Electronic Briefing Book on Banking and Financial Services [<http://www.congress.gov/brbk/html/ebfin1.shtml>].

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# Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects

Two types of structural trends affecting banking and financial services firms have been prominent. First, there have been amalgamations of financial companies, including banks, into ever-larger entities generally within the same industries. Second, there has been increasing diversification of financial services offered within single entities, whether through acquisitions or internal development of new businesses, crossing traditional industry lines. Ultimately, these size and product changes will shape the performance of the domestic and international financial systems. As nations gain experience with these changes, legislative and regulatory bodies in the U.S. and elsewhere will be maintaining oversight to evaluate possible effects. Volatility in the insurance and securities sectors adds impetus to changes in financial acquisitions as well. Fallout from problems of corporate governance in nonfinancial sectors may also come to have a large role in the evolution of financial companies. (For example, banking companies have taken over financial and even some nonfinancial operations of Enron and Polaroid in 2002.)

## **Consolidation Worldwide**

Consolidation is occurring not only in the United States, but worldwide. Varied factors are contributing. In Japan, a dominant factor is the belief that the nation requires larger institutions to ease recovery from serious financial difficulties. In Europe, the dominant business philosophy is that cross-boundary transactions are increasing within the European Union, now with a largely common monetary system and set of business practices, and with former communist countries. The belief driving change in the United States is that organizations containing diversified financial services should have a place alongside compartmentalized financial services firms. Much of the change, not only domestically but worldwide, is taking place through holding companies, which “hold” controlling stock positions in banks and other financial companies through two forms of absorption: merger and/or acquisition. Technically the term “merger” denotes one corporation purchasing another and absorbing it entirely into its own structure, while “acquisition” means one (holding) company buying another to “control” it. In this country, most financial fusions of large size take the form of an acquisition. Canada, too, has moved toward a holding company-based framework of financial firms’ acquisitions.

In the increasingly international financial economies of a computerized world, new institutions spring up while existing institutions, feeling threatened, assemble together in defensive reaction. Prominent observers believe that large bricks-and-mortar providers of services and small, niche providers are the most promising to

survive the onslaught of their new and more nimble competitors. Those in the middle, in size or technology, might seem less likely to succeed.

## The Biggest Mergers Worldwide

The government-sponsored fusion of Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan made the resulting trillion-dollar group the largest banking organization in the world. Table 1 shows how it and another Japanese firm created by merger as an alternative to collapse, Mitsubishi Tokyo, have kept that nation's institutions at the top of the ranks. Both Japanese super-giants, and the European ones to a lesser extent, have emerged as the result not of strength but of weakness. (Japanese banks, in particular, are widely believed to keep vast quantities of severely overvalued bad loans on their books, a fact that calls into question their actual asset sizes.) Three American institutions resulting from acquisitions are among the world's largest, as they were years ago.

**Table 1. The World's Largest Banking Groups**

Institution	Country	Assets, \$Trillions
Mizuho Holdings	Japan	\$1.28
Citigroup.	U.S.	1.05
Mitsubishi Tokyo	Japan	0.85
Deutsche Bank	Germany	0.82
BNP Paribas	France	0.73
HSBC Holdings	U. K.	0.69
J.P. Morgan Chase	U.S.	0.69
Bayerishche Hypo-und-Vereinsbanken Agency	Germany	0.64
ING	Netherlands	0.63
Bank of America	U. S.	0.62

Source: Veronica Augusta, "Japan's Banks Are Again Among the World's Biggest," *The American Banker*, June 18, 2002. Data are as of December 31, 2001, or the end of the latest fiscal year of the institutions. Fluctuations in exchange rates, affecting the value of the U. S. dollar in which these institutions are measured, may change rankings. A falling dollar, resulting in fewer yen or euros per dollar, will raise the dollar sizes of foreign entities while lowering those of U.S. firms.

Not all mergers succeed. One prominent example, called off before it continued, was of Deutsche Bank and Dresdner Bank in Germany. That proposed merger would have created a banking organization to have become the largest anywhere. Dresdner sold itself to the Allianz insurance firm in mid-2001, instead. Other mergers, here as well as abroad, which observers had anticipated would become successful have not worked out as planned. Such marketplace downside phenomena do not raise public policy questions if bankers accomplish the mergers within acceptable guidelines and potential difficulties do not become national or

international economic problems. Should institutions grow so large as to become instruments of national policy, or pose systemic risks to their economies, however, they are considered to be “too-big-to-fail:” governmental intervention will almost certainly occur to assure their survival in the event of difficulty.

## **Mergers of Large Financial Institutions in the United States**

As for banking-based entities, fusions of U.S. institutions beginning in the mid-1990s significantly changed the country’s financial institutions both in size and diversification of services. The buoyant economic environment, with its richly valued stock prices, encouraged corporate deals of all kinds, including in finance.

U.S. banking law changed to encourage large amalgamations by market extension across America, coast-to-coast or regionally. Major financial legislation: the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328) envisioned these mergers. That Act provided the statutory authority and set the framework for bank holding companies to acquire banks outside their home states and for banks to secure branches on an interstate basis. As a result, the share of industry assets of the ten largest U.S. banking organizations essentially doubled in the decade ending in 1999, the latest reported time frame, although financial industries are much less concentrated than others such as railroads.

In terms of notable deals, the most prominent was clearly the process forming Citigroup, which uniquely mixed domestic and international financial services of many kinds. It anticipated P.L. 106-102, discussed in more detail below, in its combination of banking, securities, and insurance businesses into one holding company. Its formation predated enactment of that law that would ratify all of its deals, because it had received a special regulatory exemption from the Federal Reserve. Citigroup continues to expand by acquisition along traditional lines, including recent deals for European American Bank, Golden State Bancorp in California, and Banamex in Mexico. The complex formation of J.P. Morgan Chase included the former Chemical taking over Chase Manhattan, several securities businesses, and then J.P. Morgan before changing its name. Name change also occurred after Wachovia absorbed First Union, the latter having been on a value-destroying path of multiple acquisitions culminating in its unlucky acquisition of the large CoreStates. Insurance companies, too, are engaging in mega-mergers, most notably the acquisition of American General Corp. by American International Group and that of Lincoln Re (Lincoln National) by Swiss Reinsurance Co. of Zurich.

Such mergers are important steps in the deregulation of the traditionally tightly limited commercial banking and insurance industries, even while finance began shifting away from bank loans and deposits to securities throughout America. Investment banking and other securities firms have become perhaps even more important than traditional commercial banking to acquirers. Antitrust concerns over geographic concentration of traditional banking products remain, however: the Justice Department has required divestiture of branches as a condition of some recent banking fusions. Antitrust concerns embody societal views that banks should provide customer services in an atmosphere of some competition: customers ought not to be charged much more for or be discouraged from loans, deposits, and other financial services because of declines in numbers of providers. Many believe that

individuals and small businesses become disadvantaged from the creation of large, complex financial organizations lacking a community orientation. Securities and insurance companies, lacking any equivalent of the Community Reinvestment Act which requires banking companies to consider the financial needs of low-to-moderate-income people and other worthwhile entities in their areas of operation, might siphon funds away from localities even further, in that view.

## **Expanding Lines of Business for U.S. Financial Companies**

Industry followers expect further growth and diversification among United States institutions following ongoing application of legislation enacted in 1999: the Gramm-Leach-Bliley Act (P.L. 106-102, GLBA). That law eases affiliations among banking, insurance, and securities firms in the U. S. and increases diversification within individual financial organizations. Responding to the increased flexibility in GLBA, institutions had been rapidly making new organizational arrangements.

GLBA has several provisions easing diversification by financial services companies. Thus, whether through mergers and acquisitions or through startups, changes are likely to occur. Structurally, companies subject to bank regulation may expand their array of financial products through several options. GLBA provides for a financial holding company option and a financial subsidiary option. A new mechanism is also in place for the Federal Reserve (the Fed) and the U.S. Department of the Treasury to decide what is an appropriate financial activity, besides activities authorized by statute in GLBA.

Companies wishing to expand services through a holding company framework have more latitude to do so post-GLBA. In that measure, Congress repealed provisions of the 1933 Glass-Steagall Act that had long precluded the affiliations of banks and securities firms, and provisions of the 1956 Bank Holding Company Act that formerly precluded affiliations of banks and insurance underwriters. Bank holding companies wishing to become financial holding companies (FHCs) file notice of their election to choose new status with the Fed, as do foreign banks under a modified procedure. FHCs have since grown to prominence. As of June 2002, more than 600 domestic and foreign financial firms of all sizes have become FHCs.

Another way for commercial banks wishing to expand product lines directly is through the creation of financial subsidiaries (FS). This arrangement allows banks to own companies performing financial activities that the banks may perform, directly, or more significantly, activities that banks may not otherwise engage in directly. Banks wishing to do so follow the certification and notification procedures prescribed by their primary federal regulator, most prominently the Office of the Comptroller of the Currency, which charters and regulates national banks. The Federal Reserve and the Federal Deposit Insurance Corporation govern FS of state banks. An institution's chartering authority, whether the OCC or a state, must also permit contemplated activities. Many FS have been insurance agency subsidiaries.

An unforeseen aspect is that despite GLBA's encouragement, fusions of insurance and banking companies have not been going on rapidly in the U. S.

Volatile, often low, returns on many lines of insurance underwriting (policy-writing) and investments deter bankers from becoming buyers. The property-casualty sector in particular remains unattractive for most FHCs not only following the events of September 2001, but also because it lacks a nationally uniform system of regulation such as depository institutions enjoy. The prototype FHC, Citigroup, plans to exit much of the property-casualty underwriting business it had avidly sought, by divesting almost all of Travelers Insurance. Citigroup sold 23% of Travelers to investors as an Initial Public Offering in March 2002, and plans to retain only 9% of it while spinning off the rest to its own stockholders. In contrast, profits in the insurance field are generally greater and more predictable in the sales or agency capacity that banks often undertake directly or through subsidiaries, because policy losses do not negatively affect the resulting sales commissions.

Insurance companies themselves have been moving slowly into the banking field following the example of MetLife in 2001. Securities firms are taking on full-service banking, especially Merrill Lynch, which has come to have major deposits in the banks it controls under authorization in GLBA. Momentum may be gathering for both nonbanking industries to increasingly fold banks into their operations, especially if economic uncertainties increase the attractiveness of federally insured deposits as safe assets in comparison with securities.

Competition measured as numbers of providers in the nation may continue to decline. That has been the direction for many years in both banking and other financial sectors. Table 2 indicates that even prior to GLBA, the number of financial organizations was declining over time. Only mutual fund complexes (firms running increasingly popular professionally managed investment companies) increased. Their number remained small in comparison with the other industries (and apparently has fallen since the collapse of the stock market bubble in 2002.) Table 2 suggests that overcapacity in financial businesses has become reduced through consolidation. Customers generally believe that there are still enough providers to serve them, at least for entities willing to transact business across political boundaries such as many insurance and securities companies have historically done. Even for mortgages, the historical major and locationally limited products of savings and loan associations, a national market developed through brokers and other parties across America while the associations imploded.

Simultaneously, nonfinancial providers offer new customer choices relating to financial services. Consumers may access financial services through software products offered by nonfinancial providers. While internet-only banking has not proven a great success to date, offerings of on-line access of bricks-and-mortar financial institutions have proven viable. Various kinds of businesses are also linking their products to other services, directly for advertising revenues or for a slice of transactions as “agents.” Such new products are increasing competition for business in this broader sense. A significant possibility along these lines is the attempt of banking interests to have the Federal Reserve and the Treasury issue a regulation allowing FHCs to become real estate brokers and property managers, whose consideration under a procedure legislated in GLBA has been postponed until 2003. Under the same procedure, FHCs have become allowed to become “finders,” bringing parties to a contract for purchase and sale of many goods and services



together. FHC finders are not allowed to engage in any process requiring a real estate license, however. In other expansions into e-commerce and non-traditional

**Table 2. Number of Financial Service Businesses, Selected Years 1985-1999**

Businesses	1985	1990	1995	1999
Commercial Banks	14,430	12,347	9,910	8,580
Savings and Loan Associations	3,640	2,358	2,030	1,640
Life Insurance Companies	2,261	2,195	2,079	1,512
Investment Banking and Brokerage Firms	6,300	5,800	5,400	5,100
Mutual Fund Complexes	220	361	370	433

Source: Zabihollah Rezaee, *Financial Institutions, Valuations, Mergers, and Acquisitions: The Fair Value Approach* (New York, John Wiley, 2001), p. 4.

businesses, banking companies have taken on trading in the kinds of derivatives that Enron marketed. UBS Warburg, a unit of diversified banking company UBS of Switzerland, beat out Citigroup to take on Enron's trading operations, while the Office of the Comptroller of the Currency has just allowed a large national bank to initiate trading in energy derivatives. Using a provision of GLBA known as "merchant banking," which allows FHCs to invest in nonfinancial businesses, Bank One will acquire the camera and imaging businesses as well as the trademark of the failed Polaroid Corporation.

Yet with the sharp decline in stocks beginning in 2000, the events of September 2001, and weakening in the economy generally, the pace of corporate deal-making has slowed. Restructuring rather than growth for its own sake seems to characterize many transactions. The peak in mergers and acquisitions in all industries of 1999-2000 has subsided, as has activity of this nature in financial services. A few prominent deals achieve headlines, even while many other firms are selling off pieces of themselves without fanfare, or for several prominent failed businesses, with publicity to their creditors. Nonetheless, in the low-key deal environment of 2002, investment, banking and financial, and insurance transactions remain prominent. Table 3 presents the year-to-date industry rankings of the ten largest industry sectors involved in merger activity, in which financial industry deals are important.

## **Areas of Public Policy Interest**

The kinds of government oversight required, particularly to maintain the integrity of the store of value and means of payment known as money, may be subject to reexamination as the financial system changes. Rules governing fairness in competition and consumer protection might need to be revised as well. Antitrust standards especially may have to become revised. Specific changes for policy

consideration will depend on the ways in which the financial system unfolds. Some questions that could become subjects of public policy debate include the following.

**Table 3. Merger and Acquisition Activity, by Value of Industry Rankings, Year to Date 2002**

Classification	Number of Deals	Value of Deals, \$Billion
Computer Software, Supplies, and Services	641	\$15.6
Brokerage, Investment, and Management Consultants	209	13.5
Miscellaneous Services	382	12.5
Communications	105	12.3
Banking and Finance	137	12.0
Electric, Gas, Water, and Sanitary Services	60	8.7
Oil and Gas	46	6.9
Automotive Products and Accessories	21	6.9
Insurance	126	6.3
Broadcasting	41	6.2

Source: "Mergerstat Reports on Industry Rankings, Year to Date 6/24/200," on web site [[http://www.mergerstat.com/free\\_reports/free\\_reports\\_industry\\_rankings.asp](http://www.mergerstat.com/free_reports/free_reports_industry_rankings.asp)], last visited June 25, 2002.

What may be the effect of the consolidation and diversification of individual financial services companies? Will the new conglomerates result in efficiencies and increased profits? Will access to, and the cost of, financial services be improved?

How will changes in the volatile insurance sector affect financial activities, safety, and, so, financial consolidation? How might greater federal involvement in property-casualty insurance, in chartering and terrorism reinsurance through federal funds, affect interindustry relations and fusions?

Will regulators be able to track what is going on? How is industry concentration likely to be viewed, in contrast to the bankcentric system that existed previously?

Will capital mechanisms built into new laws and international agreements be appropriate to risk-taking? Will international mechanisms work to coordinate supervision of multinational enterprises? Will product diversifications overwhelm

managers and regulators of large, complex banking organizations? How will the complex financial companies of the future prevent and be prevented from internal self-dealings? What happens if a gigantic financial institution experiences severe financial distress? Might gigantic financial enterprises bypass the conduct of domestic and international monetary policies?

Are new regulatory standards, agencies, or tools needed to detect problems and maintain a sound financial system? Is the Federal Reserve the proper super-regulator of the integrity of the entire financial system, or should a new federal body have jurisdiction over all financial firms: banking, insurance, securities, and other businesses? Might simultaneous investment banking (securities, derivatives) and commercial banking (loans) activities within the same corporate FHC become viewed as unsafe, anti-competitive conflicts of interest, as they were during the Great Depression? Did bankers lower their lending standards to get investment, advisory, and other nontraditional revenues from Enron and other collapsed businesses including Global Crossing, Adelphia, and WorldCom?

How will local communities and low-and moderate-income individuals and small businesses be affected by changes toward a new system? Should the obligations of depository institutions to serve the needs of low-to-moderate income members of their communities be applied to bank-related financial conglomerates who do not offer deposit services to identifiable communities?

These are the kinds of questions that observers can evaluate better once America has gained more experience with the new dynamics. Observers are still watching to see how the marketplace responds to the new opportunities offered in GLBA, the trend toward multinational financial integration, and volatile economic conditions worldwide. Regulators are already moving somewhat back toward a mode of containment of risks that may arise from new financial activities, such as their limits on direct investments of banking companies via merchant banking. That practice involves taking a direct equity position in businesses as part of financing them, a Wall Street/venture capital practice allowed for FHCs in GLBA. Similarly, the Fed's proposed clarification of "firewalls" that define proper transactions inside FHCs that banks can make with riskier nonbank parts of the same organization, in the form of a proposed "Regulation W," may restrain both risks and returns from diversification within FHCs. GLBA's bank insurance sales provisions have been contested in court filings recently, while other parts of the law, including other insurance provisions and interactions between depository institutions and commercial firms remain open. Congress will continue to monitor its consequences for financial and nonfinancial businesses, including interindustry consolidations and resulting business practices.

## For Further Reading

CRS Report RL31459. *The Canadian financial system*, by Barbara L. Miles.

CRS Report RS20197. *Community Reinvestment Act: regulation and legislation*, by William D. Jackson.

CRS Report RS21188. *Enron's banking relationships and congressional repeal of statutes separating bank lending from investment banking*, by William D. Jackson

CRS Report RS20724. *Federal deposit and share insurance: proposals for change*, by William D. Jackson.

CRS Report RL31045. *Financial risk: an overview of market and policy considerations*, by Mark Jickling.

CRS Report RL30891. *Global Markets: Evaluating Some Risks the U.S. May Face*, by Craig K. Elwell.

CRS Report RL30375. *Major financial services legislation, the Gramm-Leach-Bliley Act (P.L. 106-102): an overview*, by F. Jean Wells and William D. Jackson

CRS Report RS21104. *Merchant banking: mixing banking and commerce under the Gramm-Leach-Bliley Act*, by William D. Jackson and Gary W. Shorter.

CRS Report RS21153. *Optional federal chartering for insurers: legislation and viewpoints*, by S. Roy Woodall.

CRS Report RS21134. *Should banking powers expand into real estate brokerage and management?*, by William D. Jackson.

First, pressures have increased for further consolidation within the banking sector. Second, there has been a trend towards the development of conglomerates that can supply a wide range of financial products within the same organisation. The financial system has been of concern not only as a direct source of instability but also in worsening the impact of a real shock. These firms competed successfully with banks through specialisation in the provision of only one or two product lines. Although the Australian Government has abandoned the "six pillars" policy that ruled out mergers between the four major banks and the two largest insurance companies, it has rejected the possibility of mergers between the four major banks until competition has increased sufficiently.