Merger Mania:

Why "Four Pillars" Should Go

An address by

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THE URGE TO MERGE

- **The <u>number</u> of merger deals in the financial services sector is growing**
- **The <u>value</u> of these deals is increasing even faster as average deals get larger**

WHY MERGE?

- **Banks are living through a technological revolution**
  - “balance sheet” intermediation is being displaced by trade in securities
- **The new technology does not need as much capital**
  - banks are carrying *too much* capital
  - or the capital is earning *too low* an ROE

THREE WAYS FORWARD

- **Banks face <u>three</u> alternative ways to shed capital or raise the ROE on capital they hold**
  - repay capital to shareholders
  - acquire or merge with another bank/financial institution
  - dissipate capital through failure & insolvency
- **Options 1 and 2 are clearly preferable to Option 3!**

A CLOSER LOOK AT OPTION 2

- **Acquisition releases capital to the shareholders of the acquiree**
  - it helps the industry to shed capital and may raise the risk-adjusted ROE on the capital that remains
- Merger aims to raise the rate of return to the combined capital base of the merged entity
  - the aim is to retain capital but to make it work harder

SOURCES OF MERGER EFFICIENCY (1)

- **Cost reductions**
  - spreading fixed costs over more units (scale) and different business lines (scope)
  - making larger investments in technology
  - eliminating duplication of plant & processes
- **Revenue gains**
  - opportunities for cross-selling and exploiting relative marketing strengths
  - participation in larger-scale deals to earn larger fee shares
  - bigger spend on brand

SOURCES OF MERGER EFFICIENCY (2)

- **Capital efficiency**
  - diversification lowers risk and allows less capital to be held for a given portfolio size
  - top 25 US banks by asset size have lowest Tier 1 capital ratios

- **Risk absorption**
  - larger banks can withstand bigger shocks and recover from bigger mistakes!

POTENTIAL PROBLEMS (1)

- Will mergers amongst the four majors be anti-competitive?
  - forces for change are increasing competitiveness and contestability of financial markets
  - merger is a response to the *need* to improve efficiency and lower cost
  - BUT ACCC can judge the merits on a case-by-case basis

POTENTIAL PROBLEMS (2)

- Do mergers amongst the four majors raise prudential concerns?
  - larger banks are more diversified and better placed to absorb risk
  - BUT make a bigger splash when they crash!
  - Wallis felt that prudential concerns needed to be addressed but probably should not block a merger

THE BOTTOM LINE

- Banks face a stark choice
  - **improve the ROE on bank capital OR release it for alternative uses**

- Mergers & acquisitions are <u>one</u> way to achieve either or both of these goals

THE BOTTOM LINE

- There are potential problems with mergers amongst the four majors —
  BUT we have the machinery to assess anti-competitive and/or prudential concerns

- What we should NOT do is rule out mergers amongst the four majors as a matter of principle

- ***Mergers should be assessed on their merits!***

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