The Australian Economic Review, vol. 33, no. 1, pp. 67–72

Policy Forum: Merger Policy in Australia

Mergers in Financial Services: Why the Rush?

Ian R. Harper
Melbourne Business School
The University of Melbourne

1. Introduction

The financial services industry worldwide is gripped by merger mania. More than 4000 mergers have taken place annually in the United States alone in the last few years. In many countries, including France, Italy, Germany, Japan, the United Kingdom and Canada, major mergers amongst the largest banks have either been announced or mooted subject to legislative approval.[1] Not only is the number of deals growing, so too is the average value of merger deals. The merger of CitiBank with Travelers' Insurance and Salomon Smith Barney to form CitiGroup created the largest financial institution in history. In 1997, merger deals in the financial sector in the United States were worth more than $US500 billion. The merger of BankAmerica and Nation's Bank alone was worth more than $US60 billion.[2]

Australia has not been exempt from merger pressure in the financial services arena. Mergers amongst small to medium size financial institutions are commonplace. Higher profile mergers have also been permitted in special circumstances, including the merger/takeover of the ailing State Bank of Victoria by the Commonwealth Bank of Australia in the early 1990s and the merger of the Colonial Mutual Life Assurance Society with the State Bank of New South Wales in 1994.

Government policy has prevented some of the largest potential mergers from taking place in Australia. Prior to 1997, the Australian government maintained the so-called 'six pillars' policy introduced by Treasurer Paul Keating in the late 1980s to block the announced merger of the ANZ Bank and the National Mutual Life Assurance Society. The policy prohibited mergers amongst any of the four major banks in Australia and either of the two largest life offices.

In March 1997, the Financial System Inquiry chaired by Mr Stan Wallis recommended the repeal of the six pillars policy on the grounds that competition policy administered by the Australian Competition and Consumer Commission (ACCC) is sufficient to test the potential anticompetitive effects of mergers. A blanket ban on mergers in the financial services sector was neither necessary nor desirable in the Committee's view. Receiving the Wallis Committee's Final Report (1997), the Commonwealth Treasurer, Mr Peter Costello, announced the partial repeal of the six pillars policy. Mergers would henceforth be permissible (subject to ACCC review) between any of the major banks and either of the two largest life offices but not amongst any of the major banks themselves. The six pillars policy was replaced with a 'four pillars' policy that, to this day, prohibits mergers amongst the major banks in Australia.

What explains the rash of merger activity in financial services around the world? If mergers were allowed, it is highly likely that two mergers amongst Australia's four major banks would be sought. Where is the pressure coming from? Just what do banks, both here in Australia and elsewhere in the world, hope to gain from merger?

© The University of Melbourne, Melbourne Institute of Applied Economic and Social Research 2000
Published by Blackwell Publishers Ltd, 108 Cowley Road, Oxford OX4 1JF, UK and
350 Main Street, Malden, MA 02148, USA

2. The Urge to Merge

The financial services industry is living through a technological revolution. Financial services are information-intensive and the digital revolution in information processing is having a profound effect on the production and distribution of financial services. Financial services are in the eye of the e-commerce storm.

Banks and other financial intermediaries owe their existence to information asymmetry. Information asymmetry impedes the use of markets to fulfil intertemporal exchange and financial intermediaries step in to fill the breach. As information asymmetry subsides in the face of increasingly low-cost and ubiquitous access to information, financial intermediaries find themselves increasingly in competition with financial markets. Financial markets force the *disintermediation* of intertemporal exchange as well as encouraging the *securitisation* of claims that were previously held to maturity on the balance sheets of financial intermediaries.

The increasing reliance on financial markets forces financial intermediaries to make a stark choice: they must find ways to incorporate financial market activity within their traditional operations or face extinction as their business disintermediates. The wave of merger activity in financial systems worldwide is the manifestation of this evolution. The transformation of financial systems from the traditional reliance on balance-sheet intermediation towards market exchange is releasing capital from the balance sheets of intermediaries, predominantly banks and life offices.

The capital that once underpinned the classic risk, liquidity and maturity transformation undertaken by intermediaries is no longer needed, at least not in such large volumes. Trading securities on open markets simply does not require as much capital. Risks are traded on markets rather than absorbed through capital held on a balance sheet. The importance of liquidity and maturity transformation wanes as the depth and breadth of financial markets increase.

The key factor driving mergers and acquisitions in financial systems is the industry's need to rationalise its use of capital. Old-style balance-sheet intermediation is a capital-intensive business whereas new-style market exchange requires significantly smaller amounts of capital. This leaves financial intermediaries facing the need either to release surplus capital or to raise the rate of return to the capital they retain. The first option is achieved as firms leave the industry following their acquisition by another player. Capital is returned to the shareholders of the acquired party. Merger is a means of raising the rate of return to the consolidated capital base of the merged entity.

Either capital is released from the industry or its productivity within the industry is improved. The competing technology does not employ capital as intensively as traditional balance-sheet intermediation. A firm which refuses to release capital or to raise the internal rate of return on the capital it retains will be outcompeted by those who substitute the use of market exchange for balance-sheet intermediation.

3. Three Ways Forward

Acquisition is one way for a firm or industry to release surplus capital. Merger retains capital but aims to improve its marginal efficiency. There are two other ways in which the financial services industry might adjust to the need for lower capital. Firms can simply repay their shareholders. This is a common tactic in the financial services industry. Many banks have repurchased shares from their shareholders, both here in Australia and elsewhere, in recent years. The demutualisation of mutual life assurance societies is another manifestation of the same phenomenon. Demutualisation both releases capital locked up in the capital reserves of a mutual life office and facilitates its merger with, or acquisition of, another entity. All of Australia's large life offices have demutualised in recent years, AMP Limited being the most recent. Demutualisation was a prerequisite (imposed by the regulatory authorities) of the merger between Colonial Mutual and the State Bank of New South Wales.

If a firm fails to adjust its capital usage by releasing capital or improving its performance,

© The University of Melbourne, Melbourne Institute of Applied Economic and Social Research

the most likely outcome is failure. Insolvency of a firm represents the dissipation of its capital through operating losses. In this respect, if capital is not willingly given up to the market through acquisition or share-repurchase, or its rate of return is not raised to meet the higher industry standard, capital will be taken forcibly through the failure and subsequent liquidation of the firm and its assets.

Faced with competition from a new technology for the production and distribution of financial services, one which requires far less capital than traditional balance-sheet intermediation, banks and other intermediaries have only three alternative ways forward:

- merge with, acquire and/or be acquired by one or more competitors;
- adopt the new technology and repay surplus capital to existing shareholders; or
- maintain the status quo, dissipate capital through persistent losses and eventually fail.

4. Mergers Aim to Raise Capital Efficiency

While many intermediaries have opted to repay surplus capital to their shareholders, the desire to merge with and/or acquire other intermediaries is also a popular choice. The aim of a merger is to raise the productivity of capital deployed within the firm. This can only occur if a firm raises the risk-adjusted rate of return to capital. To do so, it must raise revenue, lower cost and/or lower risk for a given rate of return. Mergers are intended to achieve all three.

Cost reductions through economies of scale and scope are the time-honoured justification for mergers. It must be conceded that the evidence for such cost economies arising from mergers in the financial services sector is at best ambivalent (Berger et al. 1999). Most studies of financial intermediaries, especially banks, show constant returns to scale over large ranges of output. The evidence for economies of scope is more encouraging but only slightly. This evidence should be expected to apply broadly to the major Australian banks with one exception. A merger between two major Australian banks would facilitate substantial rationalisation of bank branches. Notwithstanding significant branch closures in recent years, there is still duplication of branches of the major banks in most centres. A merger is arguably the only way in which branch duplication can be addressed, since each bank acting independently is reluctant to be the first to leave town. The merged bank can close one in two branches while still maintaining a presence in all centres.

The scope for enhanced branch rationalisation is an effect unlikely to be fully captured in research findings based overwhelmingly on US data. Interstate branching was illegal in the United States from the 1930s until quite recently. US bank mergers, especially large mergers, would add state-based branch networks together, with minimal branch duplication. The branch networks of Australia's major banks are national, giving rise to considerable duplication (and therefore scope for efficiency gains following amalgamation). Comparatively few mergers in the United States would entail amalgamation of national branch networks.

While academic studies of bank mergers tend to downplay the significance of cost economies, they are more sanguine on the revenue side. Merged entities gain from the capacity to cross-sell to their respective customer bases. Generally speaking, the two parties to a merger will bring complementary skills in different parts of the financial services business. These skills can be used to offer services to the 'captive' market represented by the customers of the other firm. Even before the merged entity begins to offer a full suite of services to outside clients, it can profit by cross-selling to its existing customer base.

Size also enhances revenue-earning capacity in another respect. As corporate finance moves increasingly off the balance sheets of banks and into open capital markets, banks find themselves competing to lead-manage or underwrite corporate securities. This is a lucrative source of fee income with which to replace lost margin income as corporate finance disintermediates. However, size matters in the business of taking

© The University of Melbourne, Melbourne Institute of Applied Economic and Social Research

corporate securities to market. A bank that is large enough to manage a substantial corporate fund raising without the expense and effort of forming a syndicate has a significant advantage in any tender. Larger banks win larger tenders and earn significantly larger fees.

Size is also a major factor in establishing and maintaining a brand name. Brand recognition is increasingly important in a world dominated by information technology and e-commerce. Information goods, which include financial services, are 'experience goods'. To a large extent, the buyer cannot know the quality of the goods/services until after they have been purchased. This is clearly true of a financial product like a home mortgage. Firms compete in such markets by establishing brand names which consumers use to discriminate amongst alternative suppliers. As the range of suppliers accessible by the average consumer grows, through continuous extension of the worldwide web, for example, firms will need to spend more on establishing and maintaining a brand name. Larger firms can afford to spend larger absolute amounts on advertising and promotion. The same is true of the technology required to reach larger numbers of consumers and deal effectively with their needs. Larger firms can afford to spend larger absolute amounts on the necessary technology platforms.

Mergers raise the return to capital if they lower operating cost or raise operating revenue or both. But lowering risk can also raise the *risk-adjusted* return to capital. Larger firms have the potential to diversify risk across a wider class of assets. This is especially true of financial conglomerates, which combine banking risks with those normally associated with insurance. But even large banks or large insurance companies tend to benefit from risk diversification through size. In the case of banks, this is evidenced by the fact that the largest 25 banks in the United States have the lowest Tier 1 risk-weighted capital adequacy ratios. Their capacity to absorb risk through diversified portfolios enables them to economise on capital, thus raising its risk-adjusted rate of return.

Size also reduces the so-called 'risk of ruin'. Modern financial institutions carry enormous financial risks, many of which are magnified due to trade in financial derivatives. Losses large enough to ruin a financial institution can accumulate with frightening speed, as Barings discovered to its cost. Larger institutions simply have greater capacity to absorb large losses and hence to survive unforeseen disasters. In this respect also, sheer size has a risk-reducing effect on the firm's capital base. The risk of insolvency through massive unforeseen losses is mitigated.

5. Mergers Might Be Good for Banks But …

It is clear why banks are under pressure to merge. It is also clear why a policy of outright prohibition of bank mergers places banks under unnecessary stress. Banks must adjust to the increasing pressure placed upon them by the twin forces of disintermediation and securitisation. Blocking mergers rules out one means of effecting this adjustment. Banks will be forced to cut costs and raise revenue in other ways or risk persistent losses and the prospect of failure. The irony is that banning bank mergers may well deliver outcomes far less palatable to the general public than allowing mergers to proceed. There may well be more branch closures and staff reductions than otherwise, as well as faster increases in bank fees. Blocking these avenues of adjustment in addition to mergers (which the government has not yet contemplated but could easily be forced to do) would be extremely ill advised. Bank distress is one way to release capital from the industry but cannot be a rational choice given the inordinate social cost involved.

Yet it remains true that mergers raise potential concerns that must be weighed against the putative benefits to the institutions involved. The two chief concerns are the potential impact on the competitiveness of the financial system and its prudential soundness.

The Wallis Committee recommended that mergers within the financial system be tested for their potential anticompetitive impact by the ACCC. The Committee saw no justification for a separate test, let alone an outright ban, to be applied to financial mergers but not

© The University of Melbourne, Melbourne Institute of Applied Economic and Social Research

to mergers outside the financial system. The Committee's recommendation that the six pillars policy be abolished was thus a vote of confidence in the capacity of the ACCC to guard the public interest by weighing the potential benefits of mergers, both to the merging parties and to the public, against the potential costs.

The logic of the Committee's opposition to the six pillars policy applies with equal force to its successor, the four pillars policy. Concerns about the potential anticompetitive effect of bank mergers should be addressed by the ACCC. Such an approach gives the merging parties an opportunity to address concerns raised by the Commission through undertakings. The outright ban blocks all possibility of a negotiated outcome. While it is possible that bank mergers raise more problems for the community at large than they solve for the banks, this needs to be tested. The four pillars policy assumes either (i) that there is nothing to be gained from bank mergers or (ii) that any potential benefits are clearly outweighed by potential social costs. The machinery of competition policy in Australia is considered adequate for testing such propositions in other industries. What is so different about the Australian banks that the ACCC cannot be trusted to protect the public interest?

A second issue of concern to public policy-makers is the prudential soundness of the Australian financial system. The Wallis Committee acknowledged that mergers within the financial system would impinge upon prudential soundness but considered such effects to be manageable and unlikely to warrant blocking a merger. Mergers would need to be cleared by the Australian Prudential Regulation Authority (APRA), the body responsible for regulating deposit-takers and insurers in Australia.

APRA's chief concern in the event of a merger amongst Australia's major banks would be the effect on its ability to protect depositors of the merged entity. On the one hand, as argued above, a larger bank would benefit from greater diversification, and hence lower the risk to depositors of losing their funds. On the other hand, larger banks become 'too big to fail'; that is, it is effectively impossible for governments to allow them to fail, given the potential political backwash from subsequent losses to depositors. Bank directors know this and may well adopt riskier lending policies in the knowledge that gains would accrue to shareholders while, in the worst case, losses would accrue to taxpayers rather than depositors. Managing 'moral hazard' of this type would be a priority for APRA but it is relatively easily addressed by maintaining or enhancing capital requirements on a merged entity. These would limit a merged bank's ability to reduce its capital base and focus its attention on raising the return to capital.

A further concern would be the pragmatic issue of managing distress in a large merged bank. On the two occasions since 1945 that Australian bank regulators have had to manage bank failure, they have successfully arranged the takeover of the failed bank by another Australian institution. This becomes more difficult the larger the failed institution and the fewer healthy large institutions remain to be 'asked' to pick up the pieces. Again, APRA would need to give consideration to the likely difficulty of managing failure of a large merged bank in setting the regulatory standards it would impose on the merged institution. As in the case of competition policy, it would seem unnecessary to ban mergers amongst major banks so as to avoid potential difficulties in prudential policy. Appropriate prudential standards need to be formulated and implemented.

6. Four Pillars Should Go

Australia's major banks need flexibility to adjust to revolutionary forces for change sweeping the financial services industry worldwide. The regulatory changes recommended by the Wallis Committee were predicated on those same forces for change bearing down on Australia's outdated system of financial regulation. It is hardly fair or sensible to change the regulatory apparatus while blocking necessary change in some of the largest regulated institutions.

It is no answer to say that mergers amongst Australia's major banks may compromise the competitiveness or prudential soundness of the Australian financial system. The ACCC and

© The University of Melbourne, Melbourne Institute of Applied Economic and Social Research

APRA are more than adequate to the task of assessing these likely effects and imposing conditions, as necessary, on merger proposals. The present position in which major bank mergers are simply ruled out of the question is untenable. The stakes are too high for the banks and ultimately for the Australian public. The four pillars policy should be abolished immediately and merger proposals scrutinised by the appropriate authorities.

November 1999

Endnotes

1. For example, in the Canadian case, see Whittington (1999).

2. The causes and consequences of the overseas merger activity in financial services is reviewed in Amihud and Miller (1998), Berger, Demsetz and Strahan (1999), and Dymski (1999).

References

Amihud, Y. and Miller, G. 1998, *Bank Mergers and Acquisitions*, Kluwer Academic Publishers, Boston.

Berger, A., Demsetz, R. and Strahan, P. (eds) 1999, 'The consolidation of the financial services industry: Causes, consequences and implications for the future', *Journal of Banking and Finance*, vol. 23, pp. 135–94.

Dymski, G. 1999, *The Bank Merger Wave: The Economic Causes and Social Consequences of Financial Consolidation*, M. E. Sharpe, New York.

Financial System Inquiry 1997, *Final Report*, AGPS, Canberra.

Whittington, L. 1999, *The Banks*, Stoddart, Toronto.

© The University of Melbourne, Melbourne Institute of Applied Economic and Social Research