BANK MERGER POLICY
IN A TOO-BIG-TO-FAIL ENVIRONMENT

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1. Too-Big-to-Fail Has Been an Intractable Problem

The toxicity of the problems raised by "too big to fail" (TBTF) has been widely understood, in the United States at least, since the collapse of Continental Illinois in 1984. Congress and the federal bank regulatory agencies have, since then, made efforts to address the issue, but clearly without success. It is unclear, as yet, whether the current legislative proposals will be effective. In this discussion, I will not address the question of why TBTF has been so difficult to deal with. I will, rather, suggest changes in bank merger policy that can contribute to its mitigation.

2. Too-Big-to-Fail Has Two Faces

TBTF can be viewed in two distinct but closely related aspects—something like two sides of the same coin.

A. *Crisis face:* Over the last several years, and periodically since the 1970s, we've seen the crisis face. It is marked by the failure of one or more large financial companies, concern about the systemic threat their failure(s) pose, and anxiety in balancing the financial and moral hazard costs against the benefits of government support for private companies through regulatory forbearance, forced mergers, purchases of loans and investments, and extension of the deposit insurance safety net.

It is appropriate at this conference to recall that very early on Hy Minsky recognized the vulnerability of the economy to financial crises, analyzed runs on banks like Franklin National in 1974, and evaluated the role of the Federal Reserve as a lender of last resort, and of the FDIC in protecting uninsured creditors. He recognized both the costs and the benefits of such protection.

B. *Prosperity face*: The other aspect of TBTF is manifest without much turmoil during periods of growth and prosperity. During these times, the market identification of some large banking companies as TBTF enables them to obtain funding at relatively low rates. Low rates tend to encourage greater risk taking that may contribute to a subsequent crisis. They also provide a competitive advantage over their smaller rivals that can result in faster growth and/or higher profits. This low-cost advantage can augment market power and facilitate oligopolistic behavior in concentrated markets. Unequivocally, even without acute symptoms, it raises a competitive issue. But we typically see TBTF, in periods of prosperity, through a glass darkly.

3. Crises Produce Remedial Proposals; Prosperity Produces Apathy

Regulatory and congressional focus on the problem in times of crisis generates a wide spectrum of proposals aimed at eliminating too-big-to-fail, typically accompanied by a multitude of expressions for the term "never again." After the savings-and-loan debacle of the 1980s and the commercial bank / real estate collapse of the early 1990s, the problem was addressed indirectly in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA, 1989) and directly in the Federal Deposit Insurance Corporation Improvement Act (FDICIA, 1991). But regulatory and congressional focus tends to wander during periods prosperity. In general, high profits earned by large banks, for whatever reason, are more often than not welcomed by bank supervisors as supporting improvements in their capital position and, presumably, making them safer.

4. Growth of Banking Companies through Merger

Over the last quarter of a century, the largest banking companies in the country have grown in absolute and relative size through mergers and acquisition. A relatively few have emerged as clearly posing a systemic threat.

The contemporary bank merger movement can be traced to the 1980s. Between 1980 and 2009, there were well over 10,000 mergers. The number of independent commercial banking organizations has been cut in half, declining from about 12,000 (12,342) to about 6,000 (5,944).

The most notable structural change has been the increase in national concentration. Over this roughly 30-year period, the deposits held by the five largest commercial banking organizations in the United States increased from about 12 percent to 43 percent. (The top five became the top four with the Wells Fargo acquisition of Wachovia in 2008.)

Since 1991, the now four largest grew substantially through large acquisitions of multibillion-dollar banks whose size reached into the many hundreds of billions. Over this period, the modern Bank of America, the largest banking company in the country today, materialized out of 18 such large mergers. The modern Wells Fargo was forged in 12, JPMorgan Chase in seven, and CitiGroup in three, including the massive combination of CitiCorp and Travelers.

5. Bank Merger Review

Every proposed bank merger undergoes review by a federal bank regulatory agency (the Comptroller of the Currency, Federal Reserve, or FDIC). Since the early 1960s, they have evaluated the competitive effects of these proposals under the Bank Merger and Holding Company Acts. The evaluation typically focuses on local market competition and is based on current antitrust standards. The Justice Department provides the banking agencies with an advisory memorandum on competitive effects in bank merger cases; it retains jurisdiction over bank mergers under the antitrust laws. Even before competitive issues came within the domain of the banking agencies, they had the responsibility to consider the effects of bank mergers on "the convenience and needs of the community" and the financial condition of the acquiring and resulting banks—so-called "banking factors." None of these agencies have ever considered the too-big-to-fail issue in any aspect of their merger evaluations or reviews.

Large banks have typically merged through holding companies. The Federal Reserve has primary authority over holding company combinations. While its evaluations of both holding company and bank mergers resulted in a number of important denials in the 1960s and the early 1970s, since the mid-1980s there have been few denials, and none of large bank combinations.

There have been several reasons for these developments that emanate from the conviction that most mergers will not injure local market competition. These include:

(1) *Changes in the banking environment.* Liberalization of branching and activity restrictions permitted geographic and product market expansion and, thereby, freer entry and more potential competition.

(2) *Improved analytical techniques.* A revision of the Justice Department's "Merger Guidelines" provided a better basis for bank market determination that tended to expand markets and, thereby, reduce concentration levels.

(3) *Changes in the Federal Reserve's approach to merger review.* By the mid-1980s, the Federal Reserve had established a new approach that effectively made possible the approval of all large bank mergers. It provisionally accepted the Justice Department's "Guidelines" as to the impact of a proposed merger on local market concentration. If the Guideline levels,

which were provisionally accepted, were violated by the proposed merger, the Board would negotiate concentration-reducing divestitures If these did not fully correct the problem, it would consider "mitigating factors" as offsets. These mitigating factors included:

> (a) the continued presence of potential competitors; (b) the existence of a substantial number of banks remaining in the market; and (c) improvements in efficiency.

An example illustrates the extent to which this approach permitted the Federal Reserve to disregard competitive issues in approving mergers. In 1997, the Federal Reserve permitted the largest bank in Columbus, Ohio, with about 61 percent of market deposits, to acquire the second-largest bank in the market, with about 19 percent. It did require divestitures that notably restrained the increase in the leading bank's market share to about 64 percent. The approval nevertheless permitted the merger to increase bank concentration in a local market where concentration, in terms of the Herfindahl concentration index (HHI), was more than double the level that the Justice Department viewed as "highly concentrated." Approvals such as this, and others, raised questions as to whether the Federal Reserve, which in earlier years had been the most aggressive federal banking agency in constraining mergers, would ever deny another one. In fact, for more than a decade, it has not.

Throughout their thousands of merger reviews, as mentioned, neither the Federal Reserve, nor any other federal banking agency—nor, for that matter, the Justice Department—has ever once considered the anticompetitive implications of establishing or augmenting a banking organization too big to fail. For that matter, none of the federal banking agencies have ever considered the systemic threat possibilities as a "banking factor" in any of their evaluations.

6. Proposal: Revision of Merger Policy

Almost a decade ago, a colleague and I proposed a revision of merger and related policies aimed at constraining large banking firms likely to be too big to fail (see Shull and Hanweck, *Bank Mergers in a Deregulated Environment,* 2001). I repeat these proposals here because I believe they are still relevant. They should be an element in any program that aims to keep the TBTF problem from getting worse.

First, we need a more complete analysis of proposed mergers by the Federal Reserve and other banking agencies. Mitigating factors have facilitated large bank mergers with adverse consequences. We propose the addition of aggravating factors as a counterweight. These should include:

Establishment or augmentation of a bank TBTF and related considerations, such as (1) the effect of the merger on market dominance by merged organization; (2) evidence of reduced competitive effectiveness of the banks remaining in the market; and (3) the impact of the merger on the likelihood of intermarket coordination between the merged banks and other large banks.

Second, the Riegle-Neal Act should be amended. The Act (1994) now prohibits mergers where the resulting bank will have 10 percent or more of national deposits or 30 percent or more of a state's deposits. If these limits are to make any sense, they need to provide for progressively increasing negative weights in merger cases as 10 percent and 30 percent limits are approached. If aggregate concentration has anticompetitive and/or other adverse effects, they are likely to develop incrementally, not suddenly, above a specific limit—one that, by the way, can be avoided through the shifting of deposits.

Third, restrict negotiated divestitures. Bar divestiture agreements where one or both of the merging banks is "too big to fail," or will become so as a result of the merger. Divestiture agreements have, by reducing projected local market concentration, enabled large bank mergers that have created and augmented such banks, thus sacrificing the anticompetitive and systemic risk consequences of too-big-to-fail on the altar of local market concentration.

Fourth, impose higher capital requirements and deposit insurance premiums on large banks. On determination by a federal banking agency that the insolvency of a banking organization is likely to present as a systemic threat, its capital requirements and deposit insurance premiums should be raised to approximate the costs to other banking firms not similarly supported. The aim is to moderate advantages and perverse incentives that flow from the likelihood of government support that reduces funding costs, expands borrowing capacity, creates incentive for greater risk taking, encourages additional mergers, and promotes anticompetitive behavior.

Finally, we propose annual reports to Congress on banking and financial structure. We believe the federal banking agencies and the Justice Department should provide annual reports to Congress, with public hearings, on banking structure and competition, comparable to the monetary reports now provided by the Federal Reserve. Reports should include: merger policy developments, changes in banking and financial structure, evaluation of competitive issues created by developments, current practices and policies, and expectations for the coming year. There is a need for continuing congressional oversight of developing banking and financial structure as managed by federal banking agencies and the Justice Department.

8. Conclusions

TBTF has been an intractable problem. I pose this as a fact, without explanation.

Financial crisis and injury to competition are two sides of the same TBTF coin. I'm reminded of Adolph A. Berle's dictum when the amendments to the Bank Holding Company Act were passed in1970: "When these [big banking organizations] . . . go full steam ahead, they face two possibilities. They may succeed, in which case you have terrific financial and industrial concentration. Or they may fail, in which [case] you have a disaster damaging many, many people."

Merger policy has facilitated growth of banks that are too big to fail. We have been our own worst enemy in facilitating the growth of firms TBTF by merger policy during periods of prosperity.

The 2008–09 crisis was a missed opportunity. We missed an opportunity to downsize the largest banking companies when they failed during the recent crisis. Instead, we merged large failing financial firms into large floundering banks—exacerbating the problem, as Jan Kregel has observed in his policy note on TBTF for the Levy Institute last year [*Observations on the Problems of "Too Big to Fail/Save/Resolve*, Policy Note 2009/11, December 2009].

A new merger policy is necessary. The merger policy that has facilitated the growth of companies too big to fail needs to be revised along the lines suggested. I fully understand that the proposals I've made are modest in that they will not, in themselves, solve the problem. But they are doable; and over time, they will help.