

MERGERS AND ACQUISITIONS IN THE FINANCIAL SERVICES INDUSTRY- A FOCUS ON BANK MERGERS

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Abstract: Mergers and acquisitions (M and A) among financial services institutions have been somewhat of a phenomenon over the last decade, and even more so over the last four to five years. Each week in the USA, the press has been rife with announcement of merger and acquisition plans by large corporations. This merger-mania is not only sweeping throughout a country in epic proportions, but is now undertaken on a global scale as corporations increase their efforts to become more dominant players in a competitive market place. At the international level, this trend continues, as can be seen by huge deal makings, such as the bank of Tokyo and Mitsubishi of Japan merger to become the largest banking institution in the world. In Switzerland, Bank of Switzerland and Union Bank of Switzerland have merged to become the second largest bank in the world. Here in this paper, an attempt has been made to explore the changing pattern of competition in financial services industry in the USA. However, the paper also discusses the important issues in mergers and acquisitions in general. The study is significant as today, we see that companies are becoming larger in order to compete with each other. A clear understanding of the issues will help organizations to survive in the competitive world. So, the study has got importance both at managerial and academic level.

Keywords: Merger; Acquisition; Competition; Consolidation; Diversification

Introduction

The financial services industry in the US has undergone significant structural changes. The scope, magnitude and the frequency of mergers and acquisitions have surpassed anticipated level, with new and even more robust deals taking place each day. Some of the most recent mega-merger deals that have taken place over the last few years are listed below in chronological order:

Table 1: Growth of some mega-merger deals in last few years

| Year | Name of Financial Institutions | Asset of combined entity |
|------|---|--------------------------|
| 1990 | ABN and AMRO | \$218 billion |
| 1996 | Chemical Bank and Chase Manhattan | \$297 billion |
| 1996 | Mitsubishi Bank and Bank of Tokyo | \$752 billion |
| 1997 | Union Bank of Switzerland and Swiss Bancorp | \$595 billion |
| 1998 | Royal Bank and Bank of Montreal | \$330 billion |
| 1998 | Toronto Dominion Bank and CIBC | \$320 billion |
| 1998 | NationsBank and Bank America | \$570 billion |
| 1998 | Bank One and First Chicago NBD | \$240 billion |
| 1999 | Citibank and Travelers Insurance | \$700+ billion |

Source: Boston Globe, October 16, 1999.

There are several others financial institution mergers in the USA. Though not classified as mega-mergers, but are of the magnitude to significantly affect an entire geographic region and to continue in helping to reshape the structure of the financial services industry. These include the merger of CoreStates and First Union in 1987, the Wells Fargo-Norwest deal of 1998 and the Fleet-BankBoston deal.

We attempt to address the issues surrounding mergers and acquisitions in the financial services industry of the USA. This includes a discussion on the trends and the underlying driving forces behind financial service corporation's mergers, along with a discussion of the structure of the banking industry. We also address the impact of government regulation and deregulation in the banking industry on the current merger trend. And lastly, we highlight some of the positive and negative outcomes of merger and acquisition in the financial services industry. Though particular attention is given in the US case, lessons can be drawn for Bangladesh Financial Markets. Taking perspectives from the paper, regulators and practitioners will get some insights to leverage the mergers and acquisitions.

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Merger Trends in the Banking Industry

There have been well over 7000 bank mergers since the 1980s in the USA. The pace has accelerated from 190 with \$10.2 billion in acquired asset in 1980 to 649 with \$123.3 billion in acquired asset in 1987 (Meyer, 1998). In the 1990s, the pace of both the number and the dollar volume of bank mergers have continued to grow to a significantly high level. So far, the rapid rate of the bank mergers has continued.

The incidence of "mega-mergers" or mergers among very large banking organizations has been a truly remarkable aspect of the current merger activity. In 1980, there were no merger or acquisition of commercial banking organizations where both parties had over a \$1 billion in total asset (Meyer, 1998). The years of 1987 through 1997 brought a growing number of those acquisitions. The largest merger in the US banking history took place during the 1990s. These included the mergers between Chemical-Chase, Wells Fargo-First Interstate, BankOne-First Chicago, NationsBank-Barnett and First Union-CoreStates. These mergers have set size and precedents for later merger such as the deal between NationsBank and Bank America (\$570 billion in asset) to become the largest bank in the United States. The question we now face is, whether this trend in merger and acquisition among financial institutions is expected to continue and where will it take the financial service industry in the near future? To address this, we look at the structure in the banking industry of the USA.

Structure of the Banking Industry

The change in the banking structure since 1980s has been possible due to a number of factors. This includes consolidation on account of mergers and acquisitions as well as bank failures (Avery and Samolyk, 1999). In 1980, total number of banks including independent banks and banks owned by holding company was over 14,800. Between year-end of 1994 and early 1996, the number of banking organization- bank holding companies, independent banks had declined by 36 percent from 14,800 to 9,400. By 1997, the number of organization (bank holding companies, independent banks) had fallen to 7,100. As can be seen, the number of organization had declined over 40%. While there were over 1,450 bank failures, there were over 7,000 bank acquisitions between 1980 and 1997 (FRS testimony, 1997).

These trends have been accompanied by a substantial increase in the share of total banking assets held by the largest banking organizations. By some degree, the banking industry had become more concentrated. At the end of 1984, the largest 42 banking corporations held 25% of US domestic deposits. At the end of third quarter of 1996, the largest 13 banking organizations held 25% of US domestic deposits (FDIC, 1996).

The increase in concentration reflects to a large degree, a response by the larger organizations to the removal of state and federal restrictions on geographic expansion, both within and across states. The 1994 enactment of the Riegle-Neal Interstate banking and Branching Efficiency Act, a key and very significant piece of banking legislation, provided impetus for the ongoing trends.¹ The major impact of this law was the authorization of interstate branching. The industry was moving from the many states banking structure towards a nationwide banking structure, that would have existed, had it not been for legal restrictions. Given the consolidation that had previously occurred in states where branching laws were already liberalized, banking organizations are making extensive use of this authorization. These increased opportunities for interstate banking are allowing many banking organizations to reach for the twin goals of geographic risk diversification and for a new source of deposits.

Two key and very significant legislation are The Banking Act of 1993- known as the Glass-Steagall Act, which prevents commercial banks from underwriting securities. The other is the 1956 Bank Holding Company Act and its 1970 amendments, which restricted banking and now banking acquisitions of multibanks holding company. These are about to be tested in the light of the recent merger trend and the changing structure of the banking industry.

Factors Driving Mergers and Acquisitions

In today's highly competitive business environment, the formation of mergers and acquisitions have become virtually unavoidable for firms committed to expanding their international presence (Lei et al., 1997; Larsson et al., 1998; Chan et al., 1997). There are obvious reasons for such kind of formation as they provide significant advantages. This might also be justified due to the fact that to be globally competitive, firms must be globally cooperative (Perlmutter and Heenan, 1986). To the extreme, this kind of formation has been a necessity and is not a fad or a fashion.

There are a number of forces or factors driving the merger and acquisition boom in the financial services industry. The key importance among them is the deregulation in the banking industry or more specifically, the ease of regulations that limits interstate banking. Another is the impact of global competition and the

need to increase customer base. Other factor contributing to merger is a need for corporations to reduce costs. Then, there is the need for product diversification and to some degree, the pursuit of geographic diversification. The significance of each of this factor may vary depending on the size of the merger, whether it involves institution operating in the same market and or the merger involves only combination of depository, or other financial services providers. Further, low interest rates and improved US economy have combined to push bank profit to record levels. This in turn has boosted stock prices, giving the acquirer more purchasing power. When firms see that their stocks are overvalued, they sometimes see it as a cheap way of refinancing new acquisitions. In fact, many of the recent deals have been paid for with stocks, rather than with cash. Anyway, in the following paragraphs, we describe some factors driving mergers and acquisitions in the USA.

Impact of deregulation on consolidation

For most of the US nations' history, state boundaries controlled and curtailed the growth of individual banking organizations. Moreover, the ability of a US banking organization to expand within its home state was often limited. This was made possible through the passage of the Mcfadden Act of 1927. One significant result of this situation was decentralized banking industry with numerous participants and protected geographical regions. But the banking industry has undergone a structural change over the last decade. At mid year of 1984, 33% of the nations banking assets were controlled by banks and thrifts organization with operation in two or more states. By midyear of 1995, the proportion had grown to 67% representing two-thirds of the nation's banking assets (FDIC, 1996).

Beginning in the late seventies and the early eighties, a number of state acknowledged the changing economics of banking by allowing the creation and development of bank holding companies that own banks in two or more states. These state laws varied considerably, though. Some state law limited permissible out of state entrants to those from the neighbouring geographic region. Some acted individually, while some acted only in reciprocity, granting permission to out-of-state companies only if those states granted similar permission for companies from the target state. Many of the uncertainties concerning state initiatives to remove barriers to bank holding companies expansion across state lines were eliminated in 1985. That time, the US Supreme Court upheld the ability of states, under the bank holding Company Act, on restriction of entry by out-of-states holding company.²

In 1994, congress in the Riegle-Neal Interstate Banking and Branching Efficiency Act, added a federal element to state initiatives on interstate banking. Under this act, most of the remaining state barriers to bank holding company expansion were removed. The rapid growth of interstate banking and the accompanying industry consolidation through merger and acquisition has been propelled, to an extended degree, by this deregulation in the industry, by passage of the Riegle-Neal Act. Consolidation has been due to a large number of exits from the industry mainly due to mergers and acquisitions of healthy institutions, and to a lesser degree, bank failures. From 1984 to first quarter of 1996, the number of commercial banks declined 32% from 14,483 to 9,848. The number of saving institutions declined 41% from 3,418 to 2,016. The number of bank holding company declined 7% from 5,707 to 5,307 (FDIC, 1996).

Competition and Efficiency

Increased competition caused by rapid technological advances and the resulting blurring of distinctions between banks and other financial firms, lower barriers to entry due to deregulation, and increased globalization have significantly contributed to merger activities. Greater competition has forced inefficient banks to become more efficient, accept lower profits or close their doors and go out of business. Mergers have provided a way for many firms to increase efficiency and profitability by taking advantage of economies of scale and economies of scope (Furlong, 1997). A recent study of economies of scale in banking suggests that efficiencies associated with larger size may be achieved up to a bank size of \$10-25 billion in assets. Increased competition forces banks to merge with another bank in order to survive in a market. Another possible motive for these mergers include the simple desires to achieve market power. In fact, some mergers have probably occurred to prevent the acquiring bank from being acquired, as in the BankBoston-Fleet merger, or to enhance bank's attractiveness to other buyers. Further, Global competition appears to be important for banks that specialize in corporate customer and wholesale services, especially among the largest institutions.

Technological Advances

A US treasury department study done in 1997 by Linton and J. Rauch indicated that technological advances have spurred financial innovations, especially in securitization and derivatives instruments that improve the

identification, dispersion and the pricing of risks (Hawke Jr., 1998). The results have been a broad array of financial products available at lower cost and a blurring of financial boundaries among types of financial service providers. With the dramatic growth in transnational finance during the last decade, financial institutions need to expand sufficiently to compete in the global business, large firms are better able to afford the technological sophistication required to compete successfully, with potential cost saving to consumers.

Product expansion

Many financial institutions have faced return and risks problems due to constraint on product diversification. Because of the changing nature of the financial service industry, many banks have become increasingly susceptible to non-bank competition. The growth of mutual funds that offers checking account like deposit services with high liquidity, stability of value and an attractive returns, have proven very strong competition for bank deposit and transaction account products. In addition to that, banks have been threatened by the growth of annuities, a type of saving products that offer many of the same features as bank certificate of deposits offered by the life insurance industries.

Many banks and financial institutions are taking up the challenges of diversity into new product markets. In order to be competitive and to gain significant market shares, many of the institutions are merging or forming some sort of strategic alliances with firms specializing in particular products. BankBoston started selling mutual fund products in the early 1990s. It subsequently acquired another firm specializing in mutual funds and recently acquired Robertson Stephens- an investment firm, to further boost its market positioning.

Geographical Diversification

Banks have been restricted from expanding geographically, to a large degree, due to tight regulation on interstate banking. With the passages of the Reigle-Neal Act in 1994, financial services industry, banking in particular, has taken off in a wave of inter-state merger. One of the main reasons for mergers and acquisitions on a geographical level is the potential cost and revenue synergy that may result from the economies of scale and scope. Revenues may be enhanced by the acquiring bank in a growing market that is fully competitive. An example of market extension mergers with geographic dimension is the bank of America purchasing Continental Bank. In this case, California based, retail oriented Bank of America acquired the wholesale oriented, Chicago-based Continental Bank. The BankAmerica-NationsBank and the Wells Fargo-Norwest deals truly reflect mergers based partly on geographic diversification. Mergers have provided a way for many corporations to enter new product markets and diversify the risks stemming from product and geographic concentration of earning resources.

Impact of Mergers and Acquisitions

Consolidation in the financial services industry through merger and acquisition has raised concerns about the increased concentration of banking services in a particular area. Concerns for consumer range from what consumer will pay, the quality of service they will receive, the adequacy of consumer protections and so on. Of no less importance, are the concerns raised about the effects of large institutions formed by acquisition on communities, the availability of loans for individuals and small business and the impact of mega-mergers on small business.

Although there are definite advantages from forming alliances, which eventually translate to higher profits, there are definite drawbacks of corporate mergers. Consolidation will create a wave of layoff for employees as the merged companies get rid of overlapping jobs to make the deal pay off. Such is the case with the BankBoston-Fleet (USA) merger deal.

Anyway, recent mergers have raised the concerns about the effects that increase concentration on small communities. While data indicate that local market concentration is not generally increasing, the absorption of locally owned and operated banks by large institutions headquartered in a distant cities present conflicting information. On one hand, large institutions should be able to bring local markets the benefits of efficiencies and product diversification. Surveys, however, indicate that many individual customers of local banks acquired by large ones believe that they are losing benefits that only smaller banks can provide. Other data indicate that larger institutions charge higher fees than smaller ones.³ This sort of attitude on the part of consumers partly explains why community banks continue to thrive in spite of recent consolidation trends. It can be said that larger fee charge by large combined banks may be offset for lower lending rates and a greater variety of services.

On the other hand, while concentration has increased in some local markets, it has decreased in others, so that the average percentage of bank deposits accounted for by the three largest US banks have remain steady or actually slightly decline, even though nationwide concentration has increased.

Government Regulations

In order to understand the impact of government regulations on mergers and acquisitions in this industry, it is imperative that we provide a brief on the structure and the level of regulation in the US financial industry. Regulation for the financial services industry is carried out both through state regulators as well as federal. Insurance companies, for example, are chartered by the states and are primarily regulated by the state commissions with inputs from National Association of Insurance Commission- NAIC. Securities firms, investment banks, and mutual funds companies are regulated mainly by the Securities and Exchange Commission- SEC and other state and non-government agencies like National Association of Securities Dealers- NASD. Finance companies, on the other hand, do not face such tight regulation, neither on a state or federal level, although they make loans at all levels, they do not accept deposit of trade securities.

The banking industry is one of the most heavily regulated industries in the United States. With the existence of dual banking system, both state and federal regulators regulate the industry. On a federal level, the key regulators are the Federal Deposit Insurance Corporations (FDIC), the Office of the Controller of Currency (COC), the Federal Reserve System (FRS) and the state bank regulators (Judd and Rudebusch, 1999). The FDIC insures the deposit of member banks, manages the deposit insurance funds and carries out bank examinations. The FDIC also acts as receiver and liquidator once a bank is closed. The COC is a sub-agency of the US Treasury whose function primarily is to charter national bank and closes them. The COC also conducts regulatory examination and is empowered to approve or deny applications for mergers. The FRS, in addition to its function as a central bank, carries out regulatory examination on banks and their holding companies when necessary.

Apart from the regulatory bodies mentioned above, some key players involve in the regulation of merger and acquisition is the Antitrust division of the department of Justice (DOJ) and Federal Trade Commission (FTC). The Antitrust division is the enforcement agency that reviews acquisitions and mergers among depository institution, carrying out an in-depth competitive analysis. This is done in an effort to prevent anti-competitive accumulation and an abuse of private market power, fraud and deceptive practices. Authority to approve or disapprove the merger rests with the appropriate federal agency (FRS or COC) based on the competitive report from the DOJ. Albeit, to-day, we do see a lot of changes in the regulations. The following section gives an overview of these changing landscape.

The Changing Landscape

The challenges of the regulatory bodies have increased significantly as the industry landscape changes. Bigger and bigger deals are taking place and nature of acquisition is changing. In the past, bank to bank acquisitions were common. A vast number of recent alliances, mergers and acquisitions in the financial services market involve holding companies or non-bank firms, including non-bank affiliates of banks. Example of such cross-industry merger is the Citicorp/Travelers Group transaction. The merger brings together a bank holding company, an insurance company and an investment bank. Further acquisition of financial services companies through a bank's operating subsidiary, instead of through the holding company, does not require COC approval under the bank Merger Act.

Anyway, Congress, banking regulators and antitrust authorities all must ask what is the implication of the changing landscape. From an antitrust perspective, will these transactions require a change in the focus of bank merger review? Are transactions of these types likely to limit consumer options such that price and quality will be adversely affected? Are the current regulations and processes adequate to ensure that transactions are looked at in the light of the changing industry structure? We leave these questions open for discussion.

Conclusion

Based on findings from the research and analysis of the issues surrounding merger and acquisition, we conclude that companies have a wide range of reasons for joining forces. Many are doing in order to survive, while others are hedging bets against an uncertain future. Many companies are forming these alliances because they see the coming shape of the financial services industries. While some mergers and joint ventures represent a sound response to deregulation, other may likely to create anti-competitive power. Hence, enforces and regulatory bodies must undertake careful analyses to ensure that consumer benefits will not dissipate by private power or markets that fail to provide adequate consumer protection. As the financial industry joins other industries in which competition has replaced extensive regulation due to technological changes and improved understandings of markets, it is important that deregulation be accompanied by effective antitrust and consumer protection law enforcement.

Furthermore, because of phenomenal surge in mergers and acquisitions and the changing nature of the industry, it seems unclear if regulatory bodies have caught up and are prepared to address each of these unique cases. These mega-mergers are themselves shaping the industry, hence it seems likely that regulatory bodies will have to look at these issues carefully in an effort to protect each participant- corporation, customer as well as the well being of the economy. It is fairly safe to predict that the financial service industry consolidation trends have not run its course. The Riegle Neal Act has opened the floodgates for mergers across states. Critical issue at hand is how regulatory bodies propose to deal with the changing structure of the financial industry. Further not only the firms at international level would face the changing structure of the financial industry, but also the firms at national level would be facing the challenge. We consider that Bangladesh financial markets would follow this trend. Anyway, though the paper is confined only in the US case, we believe that the paper would enable practitioners to leverage the mergers and acquisitions for maximum advantage. They would be able to learn from the US perspective and would be able to draw lessons and implications for Bangladesh. Overall, the paper would give impetus for the regulatory to revise and restructure the regulatory framework that may arise out of mergers and acquisitions. We offer these openings for future research.

Notes:

¹ *Workshop on Bank Supervision and Small Business Administration, at the FDIC and the Federal Reserve Board, USA, 1999.*

² *Northeast Bancorp vs. Board of Governor of the Federal Reserve System, 472 U.S., 1998.*

³ *Federal Reserve Bulletin, published by the Board of Governors of the Federal Reserve System, February, 1999, USA.*

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