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Statement of the Shadow Financial Regulatory Committee

on

Mergers and Acquisitions in the Banking Industry

May 4, 1998

The recent announcements of the proposed mergers between Citicorp and Travelers, and between several large banks, raise two important public policy issues:

-- Will such mergers harm consumers of financial services by diminishing competition in banking or financial services markets more generally?

-- Will mergers between banking organizations, and non-bank financial institutions, such as Citicorp and Travelers, ultimately result in an extension of the public "safety net" that now extends only to insured bank depositors?

Competition. The Shadow Financial Regulatory Committee does not believe that the proposed mergers will diminish competition. In general, the merger partners do not compete in the same geographical and product markets, and there continues to exist a large number of potential entrants into all geographical and product markets in financial services industries.

Extension of the safety net. Some observers have argued that mergers between nonbank financial institutions and bank holding companies or banks with insured deposits, such as Citicorp and Travelers, and mega-mergers among banks, have the potential for extending the federal safety net that now stands behind the banking industry to nonbank activities. The Shadow Financial Regulatory Committee does not believe that the Citicorp-Travelers merger will result in an expansion of government guarantees.

First, such mergers will not expand the activities that banks are permitted to engage in. Thus, an extension of the safety net to other financial activities can only occur if bank capital were used more extensively to support the activities of

nonbank affiliates. There already exist, however, substantial regulatory restrictions on inter-affiliate dealings and fund transfers which strictly limit the exposure of banks to losses incurred by affiliates. Also, if these restrictions are not deemed sufficiently limiting, the appropriate policy response is to tighten these restrictions rather than prohibit bank and nonbank affiliations.

Second, it might be argued that mergers such as those that have been proposed could effectively expand the federal safety net by creating a greater number of "too-big-to-fail" financial institutions. In particular, in the past the Federal Reserve and bank regulators have shown a predisposition to bail out the uninsured depositors and creditors of large banks on the ground that the failure of such institutions could precipitate a financial crisis. If mergers were to create a greater number of financial institutions that qualify for "too-big-to-fail" regulatory treatment, the effect could be to expand the implicit federal bank guarantees to more nonbank financial activities.

The Shadow Financial Regulatory Committee does not believe that mega-mergers such as Bank of America and Nationsbank will have this effect. First, if special "too-big-to-fail" treatment is in fact afforded to large banks, both of these banks would probably already qualify for such assistance. Second, to the extent that there does exist a "too-big-to-fail" policy, we should take steps to reduce the need for such a policy and to mitigate its potential adverse moral hazard effects. To this end the Committee believes that we should take this opportunity to require that all large banks have to raise a certain portion of their capital through the continued issuance of subordinated debentures. To count towards a bank's capital requirements such debentures should have maturities of two years or longer. Subordinated debentures would more closely tie a bank's cost of funds to its financial condition and activities, imposing greater market discipline on banks and mitigating the moral hazard problem associated with a "too-big-to-fail" policy.

Benefits of mergers. The Shadow Financial Regulatory Committee believes that, if there are no adverse "competitive" or "safety net" effects of mergers, the stockholders of the prospective merger partners should be the sole judge of whether there are benefits of the merger. Possible benefits include greater geographical and product diversification, and greater economies of scale and scope. To the extent that such benefits exist and there is no reduction in competition, consumers of financial services will be the ultimate beneficiaries of the consolidation and reorganization of the financial services industry that is now taking place.