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Consolidation and Convergence of Financial Institutions

By Francis H. Schott*

The tide of combination and convergence of functions among financial service institutions is running high and is still rising. The logic of a full portfolio of financial services for customers capable of analyzing and demanding a range of such services is compelling, and advanced technology facilitates a try at one-stop accommodation of customers. Apart from the gradual pace of deregulation, the main obstacle to fully integrated financial service organizations may be the difficulty of bringing under one roof corporate cultures running the gamut from large-scale mechanical tasks to high-risk entrepreneurship. Soon far fewer institutions will exist than even after recent major consolidations, but specialists will survive by clever niche play.

EVOLUTION bordering in its rapidity on revolution is unfolding before our eyes in the provision of financial services. Evolution is difficult to recognize as it occurs, in good part because the eventual outcome remains uncertain. Nevertheless, the number of financial institutions is declining sharply while their functional distinctions are being eroded, and evolution is trending toward large entities with all-purpose functions, consolidated across national and international boundaries. History teaches that there will be a limit short of monopoly to this consolidation. Difficult as such limits are to discern in midtrend, the relevant factors will be explored.[1]

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FINANCIAL CONSOLIDATION IN CONTEXT

Developments in the financial sector are, of course, part of a broad and widely recognized restructuring trend. Table 1 shows the large size and growth of Merger and Acquisition (M&A) activity since the early 1980s, when this activity first became a feature of the recent economic landscape. The table also shows that until the "breakout" year 1995, financial M&A remained between 20 and 25 percent of the total. In that year, the financial share approached 30 percent, led by commercial-bank restructuring. Almost certainly this burst of activity has a "catchup" aspect – the easing of legal and regulatory restraints upon banks finally permits consolidation moves that in a free market would have occurred earlier.[2]

Table 1
Financial Merger and Acquisition (M&A Activity)
1981-83, 1993-95 and Year 1995

	Total M&A Value ($ bil.)	Financial M&A Value ($ bil.)	Financial M&A as % of total
1981-83 ave.	210	45	21.0%
1993-95 ave.	410	88	22.2
Year 1995	524	148	28.4

Breakdown of 1995 Financial M&A

	Value ($bil.)	% of Total M&A Activity
Commercial banks	86.5	16.5%
Insurance	27.6	5.3
S&Ls, mutual savings bks.	6.7	1.3
Real estate brokers & mortgage bks.	13.0	2.5
Investment banking and brokerage	10.0	1.9
All other financial	4.2	0.9
	148.0	28.4

Sources: 1981-83 W.T. Grimm & Co. (as reprinted in "The Market for Corporate Control," *Economic Report of the President*, Feb. 1985, p. 194.)
1993-95 Securities Data Co., Newark, NJ

[1] See footnotes at end of text.

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Restructuring can be and should be understood to include also outright closures and failures. Table 2 gives an impression of the enormous change in the composition of the financial services industry induced by the totality of relevant factors. Depository institutions, life-insurance companies and brokerage firms have fallen sharply in numbers. Mutual funds, even if measured by "complexes" (i.e., administrative units running families of mutual funds), have experienced spectacular growth.

Table 2
Number of U.S. Financial Institutions
1985 and 1995 (figures rounded)

	1985	1995	Annual Rate of chg., 1985-95
Commercial banks	14430	9910	-3.7%
Savings & Loan Assns. & mutual sav. bks.	3640	2030	-5.7
Life insurance cos.	2260	1770	-2.4
Mutual funds			
Number of funds	1530	5790	+14.2
Number of mutual fund complexes	220	370	+5.3
Investment banking & brokerage firms	6300	5400	-1.5

Sources : Federal Deposit Insurance Corp. (FDIC)
Federal Home Loan Bank Board (FHLB) & Federal Finance Board
Investment Company Institute (ICI)
American Council of Life Insurance (ACLI)
Securities Industry Assn. (SIA)

Unfortunately, both tables still deal in "recognized" categories of financial service institutions. There are no readily available data on convergence, i.e., the cross-invasion of each other's traditional functions that in effect render out of date the categories by which the tables are organized. This subject will have to be pursued qualitatively and by example rather than by quantification. It is also not yet possible to give a numerical accounting of across-national-boundaries consolidation in finance, although such growth has been major over the past two decades.

DEREGULATION, INTERNATIONALIZATION, TECHNOLOGY AND EVOLVING CONSUMER PREFERENCES

The driving forces behind financial services consolidation have been identified and discussed for some time – most of all by the strategic thinkers and planners within the industry. No one can be sure of the hierarchy among various identifiable and largely qualitative reasons for the occurrence. The four main factors will be mentioned and discussed in what to this observer constitutes an ascending order of importance.

The first factor is the breakdown of regulation as established along traditional functional lines. Inflation in the late 1970s and early 1980s forced deposits out of banks and thrifts into money-market funds and open-market instruments. Insufficient and inappropriate regulatory response contributed to the thrift crisis of the 1980s, which in turn – by virtual necessity – sharply reduced commercial bank-thrift barriers. In addition, the flood of M&A activity of the 1980s in the industrial sector was bound to spread to the financial sector once the potential benefits of restructuring could be realized in a more open regulatory climate. The background of victory for market-oriented over statist economies in terms of growth and opportunity became a driving force behind deregulation in general.

Second, the growing integration of the world economy expressed itself more easily in finance than in any other field. The London Euromarket led the way in the 1960s toward internationalization of deposit rates. Cross-invasion of lending market participants into each other's national territories quickly followed. Claims for national treatment by the foreign invaders immediately raised the issue of regulatory disparities. Competitive pressures might have forced a trend toward the lowest common denominator had central banks and other regulators not decided by the late 1980s to institute minimum international regulatory standards, as in the 1989 Basel Agreement on commercial bank capital adequacy. As the enormous growth of international capital flows continues, both pressures toward permissiveness and the search for appropriate controls are still in full swing.

The worldwide fungibility of money is the despair of regulators and the delight of money and capital market participants on both sides of the market. The all-time best example remains the explosion of money market funds (MMFS) in the 1970s as deposit-rate regulation met its deadly enemy in the form of a combination of inflation and correspondingly high market interest rates. In more recent years, similarly massive diversions into mutual funds (within the United States) and into increasingly sophisticated currency futures and options (internationally) have again shown that market forces will overwhelm national and international barriers unless the regulators "flow with" and supervise – perhaps moderate – the tide rather than resist it. Financial markets have acquired vitality stronger than institutional barriers. The availability of capital and brain power rather than institutional identification provide the raw material for market penetration.

Third, technology has become as important in services as it has been in manufacturing since the Industrial Revolution. Never has there been a clearer case of necessity as the mother of invention than in the application of technology to financial services. The quadrupling of check-clearing totals and the tenfold

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expansion of foreign-exchange trading during the past two decades could not have been accomplished without sharply enhanced computing power at declining prices. Nor could the evolving internal and regulatory control mechanism such as risk modeling under hundreds of simultaneously calculated interest-rate scenarios be imposed and executed without constantly enhanced financial technology.[3]

There are, to be sure, stresses and strains associated with rising technical capability. Fraud and error thrive on complexity, and top management, the accounting profession and regulators appear to be in a perpetual catchup mode with respect to the latest risk-creating ideas of financial "rocket scientists." Yet, technology as a servant has decisively enhanced productivity in financial services, lowering both costs and required profit margins as volume has risen.

Financial services are a superior good relative to income and education: The demand for increases in such services is elastic with respect to real income advances and educational achievement. In this context, formal education is only part of relevant life experience. The "Great Inflation" of the late 1970s and early 1980s induced a sharp upward shift of the financial learning curve at all education levels. In retrospect, the flight into market-rate-paying money market funds (and later into money market deposit accounts) conclusively taught the lesson to regulators and institutions alike that defense of institutional barriers could become impossible in the face of rational consumer reaction to market factors. The educated consumer thus is the fourth and possibly most important factor in encouraging financial-service consolidation. By the 1980s, the consumer education virtually forced upon the public by inflation had acquired a life of its own. The allure of evaluating relative returns among instruments and institutions became a feature of the consumer landscape even after inflation subsided. Again, technology in the form of PCs helped greatly.[4]

The decisive turn in undermining institutional barriers came when managements decided to join the sophisticated consumer rather than to put up futile resistance. Naturally, institutions of every type had long sought to invade the others' turf while protecting their own. But while lobbying often resulted in standoffs, the market power of consumer demand for an integrated, customer-oriented range of services came close to putting an end to the quibbling by the mid-1990s. Naturally the growth in the attractiveness to consumers of an instrument relatively open to cross-institutional invasion - mutual funds - has greatly speeded the drive toward convergence.[5] At present, one has to look largely though not exclusively to market forces as an eventual limiting factor to the size and range of full-service financial institutions, as we shall do in the section on such limits (below).

The case of mutual funds also permits a fairly concrete description of what might constitute a reciprocally satisfactory relationship between a financially educated consumer and a financial institution seeking to capture a broad range of such a consumer's business. Mutual funds have found that they are most successful by offering under one roof a variety of investment options ranging nationally and internationally from conservative to aggressive. Asset management fees and commissions, even though regulated, are kept within bounds by competitive pressures (e.g., discounters). Transfers among asset classes must be easily arranged at consumer option and convenience. A record of positions and results must be readily obtainable. It is easy to see that these conditions, *mutatis mutandi*, can be applied to deposit and credit card transactions, life insurance coverage and cash values, to mortgage payments and outstandings, etc. Once a customer is on the books, any institution may find it cost effective to aim for a larger share of that person's total financial transactions by providing affinity services rather than to attract more customers. Technology will facilitate integrated financial statements.

THE PATH TO CONVERGENCE - LIFE INSURANCE AS A CASE STUDY[6]

As recently as the late 1960s, life insurance management believed in the uniqueness of the life insurance product. How else could a young person obtain family protection and an "instant estate" in case of premature death?

Even then, however, market developments were closing in on parochialism. Pension funds were growing far more rapidly than traditional life insurance. Such funds required actuarial advice and investment expertise. Commercial banks and independent pension fund managers easily outcompeted life insurance in providing investment services, because pension-oriented portfolios were leaning toward a heavy equities component not permitted in the general account of life insurance companies. The industry thus had to obtain permission to establish separate accounts for individual or groups of corporate clients and acquired investment expertise in nontraditional fields. By the late 1960s, the industry was competitive in pension management.

Individual variable annuities and variable life insurance received a big forward push in the 1970s when average interest rates on existing portfolios of long-term bonds and mortgages started falling behind current rates while policy loans drained potential cash flow into higher-yielding instruments. In variable life, for example, it was possible to provide protection while permitting the insured to assume the risks and

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rewards of an equity portfolio for the savings component of the premiums paid.

This basic idea was amplified in universal variable life (UVL) in which the amount invested through premiums became, at least in part, a customer decision. Most important, single-premium deferred annuities (SPDAS) turned out to be a tax-favored savings and investment vehicle gaining progressive acceptance during the 1980s. In order to accommodate customer demand, the industry giants had to develop their own families of investment outlets such as bond and equity mutual funds, and also sought to acquire additional investment expertise by acquiring established money management companies. Even these steps proved too slow. By the early 1990s the tide of mutual-fund growth required a degree of name recognition for investment management that could best be satisfied by marketing established mutual fund managements under insurance-company flags. Thus originated the current convergence of life insurance and mutual funds.

Meanwhile, life insurance *per se* continued to labor under the gradually increasing handicap of a cottage-industry distribution system. Traditional high commission rates virtually invited an invasion by the brokerage industry, which considered life insurance and annuities a useful ancillary product in brokerage sales. The eventual countermove by life insurers – an alternative sales channel of special-brand products through brokerages – is developing in the mid 1990s.

In addition, commercial banks took an interest in insurance sales at established sites (branches) at low loads, viewing insurance distribution systems as a ready target. Banks were partly spurred by the immense growth of securitized instruments – commercial paper, mortgage derivatives, loan syndications by nonbank specialists – that are cutting into traditional business loan volume. In turn, the insurance industry has invaded the banks' credit markets. As average insurance liability duration has declined with the rise of annuities over insurance, asset duration has had to be shortened substantially for the relevant portfolios, right down to the bank term loan market (three to seven years). By now, a few small-bank ownerships by large insurance companies exist, but alliances rather than mergers are a reasonable near-term prediction for large-bank/large insurance relationships. Meanwhile, a few large insurance companies are in mid-1996 closer to full-line financial service operations than any other type of U.S. financial institution.

The effect of financial-institution trends upon the structure of financial markets is an important subject for another day. Yet, it may be noted in passing that the life insurance industry's adaptation to a changing marketplace has had substantial effects in the direct placement bond market and in the commercial mortgage market – areas in which the industry had traditionally held a dominant role.

The industry has largely shifted its bond acquisitions from direct placements into the public market, has raised the share of bond holdings of less-than-ten years original maturity to roughly two-thirds from a little over one-half during the decade ended in 1995, and it has greatly enhanced the average quality rating of its bonds, especially after the junk bond debacle of the early 1990s. While the industry has about maintained the share of bonds in its assets, it has turned from a "buy-and-hold" strategy toward a "trader's stance" so as to have assets match the yield and maturity requirements of the rapidly changing specific segments of its liabilities. Along with growing bond mutual funds, the industry has thus contributed to rising volume and volatility in the public bond markets. As to commercial mortgages, this market virtually dried up, and commercial construction itself became severely depressed for several years in the early 1990s as life companies found this asset class poorly adapted to shorter-term and less predictable liabilities. A slow revival, partly via marketable REIT securities, got underway in the mid-1990s.

LIMITS TO CONSOLIDATION AND CONVERGENCE

It is perhaps as interesting to speculate on the limits of consolidation as it is to observe the current push toward "one-stop service." While the sure bet is a continuation of the present trend, telltale indicators of possible limits are available. In judgmentally arranged ascending order of importance, such limits appear to relate to the remaining legal and regulatory barriers to unification; the problems associated with large size, which are shared by financial-service firms with other lines of business; the strong likelihood of success for niche players, or boutiques, that will seek to exploit profitable specialty markets as full-service firms aim for the mass market; and, perhaps crucially, the difficulty of achieving a meshing of corporate cultures among functions ranging the gamut from conservatism and mechanical customer order execution to high-risk financial entrepreneurship.

The fierce battle over relaxing the barriers between commercial and investment banking created by the Glass-Steagall Act of 1932 epitomizes the first limit – legal and regulatory barriers die hard. Successive Washington administrations have since the early 1980s sought relaxation or outright abolition of this Act. Academic support for easing the barrier is strong and the Federal Reserve and other commercial bank regulators have been supportive, in good part precisely because of the cross-invasion of other institutions into commercial banking. Existing U.S. law glaringly

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contrasts with universal banking as practiced in Canada, Germany and other financial centers. Yet, the law persists despite decade-long forecasts of its imminent or eventual demise and the gradual creation of significant loopholes.[7]

Part of the problem reflects the need to formulate acceptable rules that would still the apprehensions giving rise to the law in the first place. A more fundamental difficulty is that, as long as institutional and legal differentiation persists, that very fact generates differences in regulations that then become new obstacles. Thus, risk-based capital requirements for banks have, after a long struggle, become an international standard since the late 1980s and were still being refined and brought closer to full implementation in the mid-1990s. Meanwhile, stung by major insurance company failures, the National Association of Insurance Commissioners (NAIC) promulgated risk-based capital guidelines for insurance companies that have been enforced since 1993. The two sets of requirements bear a generic resemblance to each other but are far from identical. These differences will become one of the major problems in any combination – yet to occur – of a large U.S. bank with a substantial insurance company.

The splitting up of large businesses into smaller, more directly manageable or functionally distinct units is as much a part of the wave of restructuring of U.S. industry as are new combinations. To be sure, it appears that nonfinancial business is ahead of financial services in this "next phase" of restructuring. Yet, the correlation of size or market share with return on equity has never been close over longer periods. The reasons are well known – lines of management become longer, degrees of responsibilities are watered down and personal initiative is stifled as the administrative apparatus increases. It is illusory to believe that technology – e.g., high-tech MIS systems – can overcome this problem. There are, of course, vast gray areas with respect to what is reasonable to attempt under one roof. Yet, one suspects that the current financial-service convergence will steer in the direction of either all services to a few or else a few services to all as soon as cold-blooded calculation supplants universalist ambitions.

This point directly leads to the potential for successful specialization amidst the drive for generalism. Sociology and observation tells us that ethnic, religious, age, professional (and other) groupings are highly significant in personal identification. Financial service providers can create links to such groups far more easily than commodity manufacturers. The TIAA-CREF connection with the academic community is a classic example of a "niche franchise." Such links are likely to prove more durable and pervasive than any financial product specialty, most of which are nonpatentable and subject to rapid duplication. "Home country advantage" – knowledge of a specific national market – could and most likely will turn out to be another long-lasting limit to full international unification of financial services.

Let us turn to the candidate for top honors in the list of obstacles to financial-services integration – differences in corporate culture associated with each of the contributing traditions. Examples abound, and possibly the most striking of these is the contrast between stock market brokers and insurance agents. The first group is low-margin, high-volume oriented; the second is accustomed to high-margin, modest-volume operations. The underwriting function in investment banking on one hand and in insurance on the other hand is another illustration. The name is the same – but, in securities underwriting, risk and capital exposure in each transaction are a multiple of that of insurance, where risk-minimization is in fact a primary objective of the underwriting function.

Faced with such potentially profound problems, managements have come up with close to every conceivable approach at overcoming the obstacle. There is the test of affinity in combining, e.g., a commercial bank begins by acquiring or merging with a thrift. This approach reduces the risk of failure but also the opportunity for full service. Then there is the "parallel organization," i.e., permit different functions to continue essentially intact under a common corporate umbrella. This approach may help preserve brand names and may also aid in coping with the different regulatory requirements of categories of financial services. The approach, however, generates coordination and control problems. Still another approach is similar to that of the incohesive conglomerates of the M&A drive of the 1970s and early 1980s – let each part compete for the best results and shed "weak sisters" unhesitatingly. Obviously, this approach is unsuitable when the eventual aim is a full-service integrated firm.

Nevertheless, internal competition as a discipline in coordination may well emerge as the preferred model. Mutual funds with a vast variety of portfolio selection and managers are a clear precedent. Perceived customer preferences dictate the function to be performed. The approach is compatible with a large range of activity on the risk/reward curve. "Selecting out" for reasons of declining demand or poor manager performance is fairly easy. Many financial-service functions, however, have more cost-allocation and unavoidable capital need and risk problems than do mutual funds, and the full-service objective requires expansion beyond mutual fund groupings.

Although corporate-culture questions are more readily identified in dealing with cross-functional integration, they also exist in merging firms of allegedly similar franchise, e.g., in combining a retail-cus-

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tomer-oriented bank and one that specializes in business loans. The most typical problem, common to all M&A activity, is, of course, the choice of top management among the combining organizations.

CONCLUSION

The tide of combination and convergence in financial-service institutions is running high and is still rising. There is a catchup aspect to this activity as the degree of regulation of financial institutions is beginning to adjust to the worldwide freeing of markets. More fundamental, however, is the logic of a full portfolio of financial services for customers capable of analyzing and demanding a variety of such services. Advanced technology facilitates a try at one-stop accommodation of customers by an aggressive combination of functions. The obstacles to fully integrated financial-service organizations, however, are numerous. These may fundamentally boil down to the difficulty of bringing under one roof corporate cultures running the gamut from large-volume mechanical tasks to high-risk entrepreneurship. The likely outcome is a far smaller total of financial service organizations than exist even after the major consolidation of the past decade, with most of the survivors performing more functions than they presently do, but specialists will remain part of the scene and may prosper by clever niche play.

FOOTNOTES

[1] Among the dual subjects of this article, consolidation and convergence, the former is more extensively covered in the current financial literature than the latter. Helpful references for both are "Global Monetary Order: 1992 and Beyond," *The Cato Journal*, Vol. 10, 2, Fall 1990, esp. Peter J. Ferrara, "International Trends in the Combination of Banking, Securities and Commerce," *Ibid*. pp. 329-346; and Richard K. Berry and Patricia L. Guinn, "Developing New Life Forms," *Emphasis* (Towers Perrin, New York) 1995 No. 1, pp. 18-21.

[2] Large-scale depository-institution consolidation began in the 1980s with the easing of commercial bank/thrift restraints under the pressure of the dire need for thrift rescues. By now, according to the president of the Federal Reserve Bank of New York, "the... Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994... effectively ends interstate banking restrictions by 1997." (William J. McDonough, "Achieving Bank Safety and Soundness," New York, Address March 1996, *FRBNY*, p.11.)

[3] A striking example of advanced financial technology in internal and external bank control can be found in David M. Wright and James V. Houpt, "An Analysis of Commercial Bank Exposure to Interest Rate Risk," *Federal Reserve Bulletin*, Vol. 82, No. 2, Feb. 1996, pp. 115-128. The New York State Insurance Department's "Regulation 126" has since the mid-1980s required similar interest-rate-model testing for life insurance companies.

[4] The computer-induced technological evolution in personal finance is, of course, only beginning to unfold. No one can currently judge the eventual success of the commercial bank-led push toward home-based financial transactions.

[5] In the five years ended 1994, mutual-fund assets grew at over 17 percent annually (Investment Company Institute *Annual Report 1994*, Washington 1995, computed from p. 8- includes money market, bond and equity funds).

[6] All major life insurance developments eventually find their way into the brief text and many numbers of the American Council of Life Insurance's (ACLI) annual *Fact Book* and its Research Reports. The rating agencies, especially Moody's and Standard & Poor's, supply annual update and outlook reports for the industry. The *Federal Reserve Bulletin*, vol. 79, No. 2, Feb. 1993, analyzed "Recent Developments in the Market for Privately Placed Debt." A company history supplying more of the context of life insurance adaptation to the changing external environment is John Roumaniere, *The Life and Times of the Equitable*, New York: The Equitable Companies, 1995.

[7] "The New Wall Street," *Investment Dealers Digest*, May 22, 1995, Supplement, prints the views of ten leading investment-banking CEOs who appear to be unanimous in the view that Glass-Stegall is on the way out. Yet, in the 1995-96 Congressional session, repeal or substantial modification again appear to be doomed.

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