JOHN H. BOYD AND STANLEY L. GRAHAM

6. Consolidation in U.S. banking: Implications for efficiency and risk

1. INTRODUCTION

We don't really know why the U.S. banking industry is consolidating rapidly, as it has been doing for the last decade or so. After a large number of studies on the topic including this one, what seems clear is that consolidation is not producing significant efficiencies – at least not on average. Other dimensions of the consolidation trend – such as its heavy concentration in large banks – are just as poorly understood. Given this ignorance as to the "why" of consolidation, it is extremely risky to predict its future effects. Based on past experience and data, at least, we can conclude the following.

First. Consolidation is having a minimal effect on the efficiency of the banking industry. For some reason, the lion's share of mergers has occurred among relatively large banks, which have the least potential for efficiency gains due to economies of scale. New empirical work presented in this study finds that when small banks do merge, the average result is significant gains in cost efficiency and profitability. This finding seems quite robust and is consistent with predictions of the empirical literature on economies of scale in banking. However, small bank mergers are simply too infrequent – and involve too small a share of industry assets – to have any significant effect on overall industry performance.

Second. The consolidation trend has increased concentration in the banking industry very substantially at the state and national levels. However, at the level of actual bank markets (counties, SMAs and so on) it has not had a large effect – at least not yet. Thus, assuming that the traditional measures of banking market structure are the correct ones, consolidation has not yet had a

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great effect on competition in banking. To the extent that it has, however, the effect has surely been detrimental. From an antitrust perspective, this trend is reason for concern.

Third. Recent years have witnessed an extremely profitable banking industry; but, there is no reason to believe that consolidation is causing this enviable profits record, or vice versa. In such an environment, the efficiency and risk effects of consolidation are difficult to ferret out. The next major downturn in the banking industry, whenever that is, will provide the test. On the one hand, consolidation should in principle result in banking firms that are better diversified, both in terms of products lines and geographically. On the other hand, there is no evidence that, ceteris paribus, large banks are less likely to fail than are small banks. Recent events in France and Japan clearly demonstrate that even the largest banks can get into dire trouble.

Fourth. What is most troubling about the consolidation trend, is its implications for the policy of "Too Big to Fail" (TBTF). Whether officially stated policy (as in the U.S.) or not, such a policy exists. Government claims to the contrary are time-inconsistent, and resultantly are discounted by the marketplace. TBTF conveys an unfair, unintended competitive advantage upon large banks, since it defacto insures their liabilities at no cost. In addition, it is a source of moral hazard, beyond the moral hazard produced by deposit insurance systems. The more concentrated a banking industry, the more of its firms that fall into the TBTF category; thus, the more subject it is to such distortions. And, the risk of TBTF government bailouts is commensurately greater. These disadvantages could be offset by significant efficiency advantages to a banking industry composed of large banks. Unfortunately, these other advantages do not appear to exist, except for scale economies resulting from the consolidation of very small banks.

2. Recent developments: the consolidation phenomenon

As shown in Figure 1 and Table 1 the number of new bank charters exceeded exits via merger and failure between 1975 and 1984. In 1984 the number of banks and trust companies in the country peaked at 14,496. Between 1984 and 1994 new charters declined, failures jumped sharply, and the rate of mergers increased almost monotonically. As a result, the number of banks in the United States fell to 10,451 in 1994, or about 28 percent from the peak in 1984. Exit via failure was primarily due to the hard times the industry experienced from 1987 to 1991. However, the rate of new entry remained extremely low by historical standards after 1991, and the merger rate remained high during the 1990s. Over the five-year period 1990 to 1994, on average 460 banks were merged out of existence in each year.

Table 2 shows that the large decline in the number of firms has not been confined to commercial banks; it has similarly affected the savings and loan industry. Indeed, over the period 1985-94, while the number of banks declined