

## US Banking Mergers, Consolidation and Bancassurance: More or Less Risk?

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Good morning. I'd like to make a small change in the topic which I was assigned, "US Banking Mergers, Consolidation and Bancassurance: More or Less Risk." I'd like to change it to "More *and* Less Risk," because, as we shall see, financial services consolidation tends to reduce some risks while increasing others.

It's a rather broad subject as well, so let me try to simplify it a bit by dealing with bancassurance first, then moving on to mergers in banking and investment banking.

At this point in the consolidation process, my sense is that bancassurance has not had much impact on risk in the US financial services industry, if only because bancassurance itself hasn't really had much impact in the marketplace. I'm not sure that it will. With the conspicuous exception of Citigroup, a unique company with a unique history, there haven't been any significant mergers so far between banks and insurance companies, nor have any US insurance companies other than Citigroup yet obtained financial holding company status under Gramm/Leach/Bliley.

To this point at least, the US banking industry's response to bancassurance was probably best stated by Dick Kovacevich, chairman of Wells Fargo: "We don't have to own the factory to sell the product." Even in terms of marketing, the bank channel appears to be best suited to selling simple, commodity-like insurance products to customers with correspondingly simple needs, rather than those products and customers which require the specialized expertise of a trained and experienced agent.

Unfortunately, those simple, easily-commoditized products also tend to be the ones with the lowest profit margins and the most vulnerable to online competition, so the marketing window for bancassurance products would seem to be customers with simple needs who have not yet figured out how to find what they want online. Not the most promising of outlooks, so it's hardly surprising that US banks have not devoted a lot of resources to this area.

Dick and his fellow bankers, I believe, have three basic reasons for not being very interested in manufacturing property and casualty insurance. The risk-adjusted return on capital, or RAROC, is not especially attractive when averaged over the cycle, the property/casualty cycle

itself tends to be highly volatile, and the risks involved are not those which bankers are experienced at managing.

While banks and insurance companies have some areas of expertise in common, such as investment management and capital markets, the core competence of banking is credit, not insurance underwriting. While it is certainly true that the convergence of derivatives with insurance products is continuing to grow, and that some of the larger banking companies are quite expert in derivatives, there are still substantial basis risks between what is available in the derivatives market and the specific needs of particular insureds. Covering those risks through underwriting is the core competence of insurance companies, and again with the principal exception of Citigroup, few if any US banking companies would claim expertise in this area.

The management of risk is a theme that I want to stay with, as we move on to consider the implications of mergers and consolidation in the US banking industry.

Jake Garn, the Republican from Utah who served as chairman of the Senate Banking Committee in the 1980s, once said that Congress tends to follow developments in the marketplace, with a lag of approximately 10 years. True to form, the initial moves of J.P. Morgan and Bankers Trust into investment banking in 1990, or thereabouts, through the regulatory loophole of Section 20, were followed 10 years later by legislative Glass-Steagall reform through Gramm/Leach/Bliley.

By this time, virtually all of the US banking companies that wanted to get into investment banking have already done so. On the other side, the interest among investment banks in getting into commercial banking has always been very limited. Apart from Citigroup once again, the only such transaction which has taken place so far is Charles Schwab's purchase of US Trust, which does not make commercial loans and specializes in asset management for families with more than \$2 million to invest. So far, Schwab is the only securities firm to have applied for Financial Holding Company status under GLB.

As someone who began his banking career at Bankers Trust and continued it in the unique environment of Brown Brothers Harriman, I must say that I've never been completely convinced that the benefits to be gained through the full merger of commercial and investment banking outweigh the risks.

There are strong arguments, which I would generally support, for bringing down whatever barriers still remain between commercial lending and bond underwriting, since the two types of financial instruments have much in common, are both traded in secondary markets and the management expertise required is very similar. Credit, interest rate, currency and country risks are what they are, even though the specific terms of the instruments employed -- loans and bonds -- vary. Having both functions performed in the same institution enables customer needs to be met more effectively, as market conditions tend to favor each at different times.

I'm less convinced, however, about the synergy between lending and equities. I began my banking career financing shipping and shipbuilding, and one of the first creditors' meetings I attended involved a shipowning company on the verge of going completely bust, of which there

were quite a few in those days. When the chairman of the company began to take questions, someone stood up and asked, “Sir, why is your company leveraged 30:1?” An honest man, the borrower looked the banker in the eye and replied, “Because that’s as far as you would let me go!”

As that story illustrates, the interests of creditors and shareholders often are not the same, nor are the risks and management cultures which they represent. What’s good for shareholders, and the equity-oriented investment bankers who serve them, is not always so good for lenders and bondholders. As another example, many of the share buybacks we’ve seen in recent years have already resulted in credit rating downgrades. Trying to serve both lenders and shareholders in the same institution will often create tensions which then tend to be managed by keeping the two functions apart through firewalls and the like. If that’s the case, then why merge them in the first place?

It’s no accident, I believe, that the firms which still dominate equity underwriting are mainly those rooted in traditional investment banking, while the importance of the large universal banks in fixed-income businesses is steadily growing. I’ll be as interested as anyone to see how all of this plays out in the years to come.

That brings me to the final subject I want to cover, consolidation within the banking and investment banking sectors themselves. This trend has gone on for decades, but recent months have seen the creation of some extremely large and powerful institutions.

As I alluded when I began, the effects of such mergers on risk can be both positive and negative. On one hand, the creation of diverse revenue and earnings streams within the same institution can prove highly beneficial. Look, for example, at the fate of my former firm, Bankers Trust, in the wake of the Russian and high-yield debt market collapses of 1998. According to published figures, several other firms such as Citigroup, Credit Suisse and UBS each lost more money, in absolute dollar terms, in that market environment than did Bankers Trust, but their profits from other businesses and their larger balance sheets enabled them to survive and move on from there. Citigroup, in fact, didn’t have an overall quarterly loss at all, just smaller-than-normal quarterly earnings. Bankers Trust, the smallest and least diversified of the four, found itself having to sell out to Deutsche Bank.

On the other hand, the existence of firms as large as these cannot help but affect market liquidity, especially during periods of crisis as with Long-Term Capital Management in 1998. Much has already been written about this, and I have little to add except that the topic deserves further study.

The disruptions, cultural issues and added complexity introduced by consolidation all add to the difficulty of managing risk *within* the merged institution as well, and I haven’t seen this written about to anything like the same extent. J.P. Morgan and Chase Manhattan, for example, have said that it will take approximately 12-18 months after closing to develop consolidated risk-management systems. If they succeed in meeting this timetable, they will have bettered the typical merged firm’s performance by approximately a factor of two.

In the meantime, they and other recently-merged firms face the difficulty of managing their market risks, as well as their counterparty, sector and country exposures, without the consolidated real-time systems that enable managers to keep up with fast-changing markets, run “what-if” scenarios and do much of the analytical work of modern risk management. Such consolidation must be accomplished manually, typically from systems whose outputs are not fully compatible. Then, once their systems integration has been completed, the process must begin again as soon as the next acquisition is announced.

Firms such as Credit Suisse and Citigroup, which now encompass global activities in insurance and securities as well as banking, present additional issues for everyone concerned with the management of systemic risk, since today’s supervisory structure is not really set up to handle them. The next such global financial-services conglomerate may not be quite as solid as they. Moreover, as we have seen, even the strongest giant firms raise issues of risk concentration, market liquidity, internal controls and external transparency.

Appropriate supervisory and, possibly, legislative responses to large-scale consolidation need to be considered – not to prevent such market developments from occurring, but rather to see that the stability of the world financial system is adequately protected. How can we promote the beneficial effects of such mergers while effectively managing the risks? Should, for example, the US governmental merger-approval process continue to focus primarily on issues of competition and consumer protection, or should the consideration of systemic risk receive additional emphasis? Should there be changes in the ways cross-industry and cross-border transactions are addressed? How should such firms be supervised after merging?

I have no ready answers to these very important questions. They do need to be studied seriously, and I believe it essential that such a study should involve not only supervisors, central bankers and government officials, but also the giant global firms themselves if the study’s results are to be meaningful and practical.

Thank you very much.