Christopher T. Mahoney

Commentary

Santomero and Eckles

Anthony Santomero and David Eckles predict more consolidation in the financial services industry, but they remind us that there are still a number of obstacles that suggest that not every merger will necessarily be successful. The authors see these obstacles as providing room for smaller niche players to survive and prosper.

In general, I agree with these conclusions. I would just like to provide my view on a couple of the points raised. I am quite skeptical about synergy and cross-sales, which remain the holy grail of financial services. I also see cross-industry mergers as being far more difficult than intraindustry mergers. This is not only because of the risk of cultural conflicts, but also because there generally are fewer opportunities for cost savings in a cross-industry merger. Finally, while the acquisition route is clearly fraught with peril, the alternative, de novo expansion, is equally challenging. In most financial services, I have observed that it is very difficult to obtain substantial market share solely through de novo expansion. And without such market share, franchise value is likely to be limited and earnings are likely to be less reliable.

The paper goes on to examine the public policy implications of further consolidation, about which I will have more comments later.

Kroszner

Randall Kroszner provides an excellent description of how difficult it can be to achieve financial regulatory reform. I would certainly agree with his conclusion that the recent enactment of the Gramm-Leach-Bliley (GLB) Act was the result of a very rare alignment of interests both within the financial services industry and among its regulators. I am not sure I can even count how many times Congress has attempted, and failed, to repeal Glass-Steagall over the past fifteen years.

As the paper describes quite well, GLB was successfully enacted only after years of technological change, innovation, and economic shocks had fully undermined the Depression-era structure of the financial services industry and shifted the balance of competing interests.

Lown et al.

The question we now face is, what will the financial services industry's structure look like in the future? The paper by Cara Lown, Carol Osler, Philip Strahan, and Amir Sufi attempts to predict what the financial services industry will resemble post-GLB. The study provides a very interesting analysis of diversification and the risk-return trade-off in financial

Christopher T. Mahoney is a group managing director of Moody's Investors Service.

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services. It concludes that mergers between banks and life insurance companies will produce firms that are less risky but no less profitable. The authors predict that such "bancassurance" combinations are most likely following GLB. Using similar analysis, they show that even other cross-industry mergers—between banks and securities firms and between banks and property and casualty insurers—would increase bank risks only modestly.

I agree with the authors that consolidation will continue within the financial services industry. While GLB may help to accelerate this trend, in large part I see consolidation as being driven by underlying factors that existed long before this legislation.

On the specific topic of mergers between banks and life insurers, my view is less sanguine than that of the authors. I certainly agree that diversification can reduce risk. But I am not as confident of the returns on such mergers. The cultural challenges of cross-industry mergers are substantial, and can lead to a merged company that is less than the sum of its parts. Also, our own research would indicate that the life insurance business today is far less profitable than banking. This is a significant hurdle for any bank or insurer thinking about combining, and it helps explain why, even eight months after GLB was enacted, we still have not seen the announcement of any U.S. bank-insurance combinations.

Kroszner explains how the sixty-five-year-old Glass-Steagall regime was finally dismantled. Both Santomero and Eckles and Lown et al. raise questions about the implications of this change for firms and public policy. As a credit analyst, there is not much that I can say about the process by which Glass-Steagall was dismantled, but I am required to assess its implications for rated institutions and for financial stability in general. On the firm level, I agree with Santomero and Eckles that there are risk-reduction benefits to greater diversification and that, ceteris paribus, larger and more diversified firms are more creditworthy. I also agree that there are nonetheless legitimate worries about the manageability of such complex enterprises.

I could elaborate on the firm-level implications of deregulation, but I do not have anything particularly provocative or new to say in this regard. I think the papers cover this issue quite thoroughly.

The Public Policy Implications of Gramm-Leach-Bliley

Santomero and Eckles also address the implications of GLB for public policy in general and systemic stability in particular. This topic is of great interest to me, and one that I would like to devote the balance of my remarks to addressing.

Santomero and Eckles conclude that "the emergence of the universal financial firm exacerbates the stability concerns of regulators." They discuss the costs and benefits of the regulatory safety net: stability versus moral hazard risks. But they say that "the increased size of the [post-GLB] financial firm makes government intervention a virtual certainty, notwithstanding FDICIA."

I would like to review this issue in greater depth by talking about the implications of GLB for the safety net and for financial stability.

The superstructure of financial regulation that we have today reflects the segmented structure of the financial system created by the New Deal in the 1930s. These structures have worked remarkably well in maintaining financial stability over the past sixty-five years. It is true that things did not go perfectly in the 1980s, but system stability was never threatened. This is because of the prudent management by the authorities of the financial safety net. At critical junctures, financial institutions—and not just big banks, but also smaller banks, securities firms, government securities dealers, and hedge funds—were not allowed to fail at times of creditor uncertainty and market disturbance. This was perhaps unfair—and it may have contributed to moral hazard—but we have not had a 1931-33 financial convulsion since this superstructure was put in place in the mid-1930s.

It was inevitable that market forces would in time begin to batter against the barriers created in the 1930s and would attempt to erode them and, ultimately, tear them down. Financial firms wanted to get into each other's segments, distinctions between segments were blurred by technology and financial innovation, and the separations appeared increasingly anachronistic. And so, after much debate, the walls have finally been torn down by GLB.

After having lived in one kind of financial world for sixty-five years, we are now entering one that will be different. Many benefits will be achieved from the tearing down of these walls. But as Santomero and Eckles ask, will deregulation risk greater financial instability?

My answer is yes. Two forces have been converging in the field of financial regulation over the past ten years: 1) an increasing discomfort with the moral hazard risks created by the existence of the regulatory safety net, and consequently an increasing emphasis on market discipline, culminating in the passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1992, and 2) the erosion of the barriers between banking, which were sacrosanct until 1969, and the rest of the financial services industry.

These two trends are interrelated. The more that banks have been allowed to become parts of larger financial

conglomerates, the more uncomfortable market observers have become with deciding which parts of these conglomerates are protected by the safety net and which are not. Officially, of course, in the post-FDICIA era, no one is protected by the safety net except insured depositors of banking subsidiaries. But this is an official fiction. There is a very large list of financial institutions that the authorities cannot permit to fail, no matter what the law says. It is ironic to contemplate that, legally, the authorities cannot rescue Citibank or Bank of America without the magical three signatures, but in practice they could not contemplate the failure of an unregulated hedge fund.

My point here is not to criticize the rescue of Long-Term Capital Management (LTCM), but to praise it. My concern is that the political costs of such rescues are steadily rising. The conservative think tanks criticize such rescues as the socialization of credit risk and an unwarranted government intrusion into the free market. Liberal think tanks criticize such rescues as a misuse of taxpayer money to protect rich bankers or Nobel Prize–winning financial speculators. I am not sure whether both sides realize that they are echoing the statements of President Hoover as he witnessed the near-collapse of the U.S. financial system.

Paul Krugman has argued that as the world abandons Keynesianism and embraces monetarism, we should not forget the lesson of the Depression: deflation is worse than inflation. Similarly, I am arguing that, as we abandon the rigid, safe, and predictable world of functional segmentation protected by a broad safety net, we should be careful not to forget the other lesson of the Depression: financial instability is worse than inefficiency and moral hazard.

I have great confidence in today's top regulators (who *did* rescue LTCM, and took the heat for doing so). But will we always have people of such wisdom and courage? Might not we have a regulator who chooses to follow the letter of the law, and stands by as something big collapses? I think the risk of this is low, but it has been steadily rising, and GLB has added to this risk.

When banking institutions were segregated from the rest of financial activity, it was possible to delineate and manage a discrete policy for banking with respect to provision of the safety net. The implicit contract was that, in exchange for access to the discount window, deposit issuance, and implicit support for uninsured depositors and other creditors, banks accepted minimum capital requirements, periodic examinations, and prudential supervision. Unregulated financial services firms received none of these benefits, but they also avoided all of the burdensome regulatory impediments to which banks were subjected. The new consensus is that this arrangement is inefficient and unfair, resulting in an unlevel playing field. It is further felt that, if the barriers between banking activities and financial services are to be taken down, the correct solution to the safety net problem is *not* to extend it beyond banking, but rather to limit it as much as possible. Consequently, official policy today is that no bank is too big to fail and that, should a big bank fail, it should be resolved using the least-cost method. Official policy states that since neither banks nor other financial services firms enjoy the government's implicit guarantee, the former regulatory distinction between them has been ended and the banking business can now be mixed into financial conglomerates that are not too big to fail.

But it is my view that this policy is predicated on the fiction that such financial conglomerates can be allowed to fail. At times of extreme financial stress, which is precisely when a financial conglomerate would be most likely to fail, the failure of such a firm would be intolerable. If you disagree with that, I invite you to read the congressional testimony of Chairman Greenspan and New York Fed President McDonough on the rescue of LTCM. If the authorities could not contemplate the failure of a hedge fund at a time of robust economic growth and unprecedented financial system profitability, how could they contemplate the collapse and liquidation of a major financial conglomerate at a time of financial panic or economic turmoil?

Why is a special safety net required for banks, such that some of them should be too big to fail? The reasons are: 1) banks are illiquid and thus confidence-sensitive institutions by their very nature due to the maturity mismatch between their short-dated liabilities and their longer dated assets, 2) their solvency is objectively unknowable to market participants, especially at times of panic and upheaval, 3) banks are subject to contagion runs during panic periods, and 4) they have large exposures to each other.

Consequently, while it may be theoretically feasible to allow the occasional bank to fail during times of confidence and prosperity, without threatening financial stability, such a scenario is inherently unrealistic. Banks do not fail during periods of confidence and prosperity; they fail during periods of panic and recession. And they tend to fail for reasons that are at least somewhat cyclical and generic, such that there is typically not one sick bank, but several, as we had in Texas and New England, or in Japan in the 1990s. If one sick bank is allowed to default on its uninsured deposits and interbank liabilities, how long will it be before the run begins against the next weakest name? It is easy to speak of market discipline in theoretical terms, but it is pretty scary to confront its implications in a crisis.

In my opinion, many of the institutions that ultimately will emerge as a result of GLB will be, by and large, too big to fail. This fact is like the elephant at the picnic—everyone is aware of it, but no one wants to mention it. It is appropriate to maintain

constructive ambiguity around this fact. It is not necessary to codify it into regulation or law. But we should be careful not to deny it too vehemently or to prohibit it by law, or else we may find ourselves tripping over our own words someday. As Paul Krugman says, we should not need to repeat the mistakes of the 1930s to learn the lessons of the 1930s.

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