Research on the Impact of Government Financial Deregulation on Banking M&A

Based on Case Analysis Method

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Abstract. The tightly regulated financial system after the 1933 banking crisis gradually eased the banking business restrictions, deposit insurance and interest rate control, driven by financial liberalization and the technological revolution. Under the joint influence of financial innovation and competitive pressure, the waves of large mergers and acquisitions (M&A) in the banking industry was set off. Basically, there is a lack of discussion into what impacts the financial deregulation of laws launched after the 1933 Great Recession would have on banking M&A. Therefore, this paper mainly use case analysis method to state that the financial deregulation plays a driving role in the promotion of banking M&A and the final market can reach the Pareto effect. Through the research on the effect of deregulation, this paper is of research significance to how the government can maintain the market stability, optimize the market structure and improve the market efficiency through financial supervision.

Keywords: financial deregulation · M&A · innovation · competition · Pareto effect

1 Introduction

Crisis is one of the main forces shaping financial regulation [1], while reversely the loss of efficiency caused by excessive regulation is one of the impulses for deregulation. Banking crises inevitably bring forth more and different regulation of banks, and the economic recession from 1929 to 1933 was no exception. In the 1930s, American banks excessively supported stock speculation, which led to the collapse of stock prices in the American stock market. The banking crisis with a large number of bank failures fully illustrated the unstable function of financial markets. In order to maintain the stability of the financial sector and restore public confidence, The Glass-Steagall Act (1933) was an effective reflection of the government's efforts to regulate the scope of business of banks. It separated the businesses of commercial banking from investment banking. After the 1970s, as the development of the global financial industry accelerated, deregulation became an inevitable requirement for the continued development of the financial industry. As the wave of financial deregulation sweeps across the world, the development of information technology is also changing every aspect of the way of human life and

F. Balli et al. (Eds.): ESFCT 2022, AEBMR 226, pp. 920–928, 2022.
https://doi.org/10.2991/978-94-6463-052-7_104

production at an incredible speed. Both of them jointly shape the new development mode of the world financial industry. After the gradual deregulation, the United States has experienced several massive banking M&A. The degree to which the government implements financial controls swings like a pendulum, changing with the bargaining and lobbying power of regulated institutions and the prevailing ideology of how to ensure the maintenance of the market effectiveness [2]. Based on endogenous growth theory, Aghion and Howitt (1992) considered that financial deregulation impacts firm-level innovation and, thereby, economic growth [3]. Kumar and Gulati (2013) believed that deregulation programme has had a positive impact on the cost efficiency of banks [4].

The remaining of this paper is organized as follows. Section 2 is to describe the specific deregulation actions, including financial product restrictions, limit of interest rate on deposit. Section 3 is to research the impact of deregulation for banking M&A, under the specific economic background and the support of information technology. Increased innovation capability and fierce competition, as necessary results due to financial deregulation, work to facilitate banking industry including investment banks, commercial banks and insurance companies, to expand scale and achieve profit-maximization through M&A. Section 4 is to study how the stability of banking market form and what negative factors would limit the constant banking M&A wave.

2 The Deregulation After 1933 Economic Crisis

2.1 Deregulation on Financial Product Restriction

Since the great crisis of the 1930s, the strict financial controls represented by the United States have made the separate operation a basic pattern of the world financial industry (see Table 1). As some countries did not have separation between deposit taking banks and investment bank, those banks without product restrictions regulation took over an absolute advantage, which means that they can out compete with United State's banks. What the European banks criticize on Union Bank of Swiss and Dutch Bank was that they had a big balance sheet due to the deposits of customers, so that they have stronger negotiation power that using the balance sheet from the depositors to compete to gain business against the American investment banks. The Glass-Steagall Act limited the

Table 1. Part of history of deregulation about financial product restrictions

Regulation	The Glass-Steagall Act of 1933 separates operation of commercial banking and investment banking and insurance companies.
	The Bank Holding Company Act of 1956 forbids holding companies to set insurance or securities subsidiaries.
Deregulation	In 1987, Federal Reserve permits banks to underwrite corporate debt and equity.
	From 1989 to 1996, Federal Reserve looses the limit on revenue of bank's subsidiaries underwriting securities.
	Financial Modernization Act of 1999 allows banks to underwrite insurance and securities through setting subsidiaries.

Table 2. Part of history of deregulation about interest control

Regulation	The Banking Act of 1933 limits interest rate cap on fixed term deposits and saving deposits.
Deregulation	From 1966 to 1982, Federal Reserve relaxes the restriction on interest control.
	In 1986, all interest rate caps are canceled, but still no interest can be paid on current accounts

ability to compete for United State, which means that all the investment banks in activity will be taken over by foreign banks. In order to compete at the same level, the financial deregulation on product restrictions is the necessary trend.

According to Financial Modernization Act in 1999, it allows banks to underwrite insurance and securities through affiliated and subsidiary companies. George, et al. (1984) believed that the deregulation created convenience for commercial banks to have more access to financial activities [5].

2.2 Deregulation on the Interest Control

Regulations have historically constrained pricing of both bank deposits and bank loans [6]. In the 1970s, commercial banks in the United States faced restrictions on interest rates, both on the deposit and lending sides of their business [7]. A big challenge needs to be considered was that if the rapid increase of the inflation rate exceed the interest rate of commercial banks, the depositors would be under the loss of money since the money that they can spend is less valuable over time, so as to choose to withdraw their deposits, the commercial banks would also face up high risk that the interest income would less interest expenditure. In 1986, Federal Reserve canceled all interest rate ceilings on deposits, except that no interest is paid to current accounts (see Table 2).

3 The Effect of Deregulation on Banking M&A

In financial markets where financial controls are easing, under the background of global financial liberalization, considering that the breakthrough of information technology established the foundation for financial product innovation, the expanding space for financial innovation means more intensified competition pressure in the banking industry, which can be proved that the increasing competition also promotes the progress of innovation ability (see Fig. 1). After that, it created the feasibility of the banking M&A and bolstered the driving force of the willingness of banks to diversify their services so that they can pursue greater benefits and economies of scale.

3.1 Deregulation with Technological Advances Provides Practical Possibilities

Since the 1980s, the revolutionary development of information technology, especially Internet technology, was also the main support of financial innovation. It means that the financial service industry could make great breakthrough in product design and transaction simplification, costs reduction and the lowering of market barriers to entry.

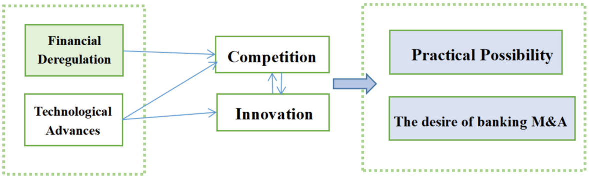

Fig. 1. The effect of deregulation on banking M&A

3.1.1 Boost Financial Innovation

Kroszner and Strahan (1999) argued that banking deregulation and technological change are correlated [8]. Those improvements on the technology created fundamental conditions for convenient activities of merger and acquisition. There is no doubt that financial institutions could easily enter each other's field to provide a wider range of financial services, including bank payment and deposit and loan, securities brokerage, investment management and insurance sales, etc., and even non-financial institutions could enter the field of financial institutions. As a result, the number of market participants greatly increased, competition would intensify even.

In the 1970s, the instability of interest rate, exchange rate and inflation rate got rise to the surge of financial market price, which means financial institutions, enterprises and individuals always live in the risk and uncertainty of price changes in the financial market, so that the requirements of avoiding market risks would further expanded. Hence, as an emerging means of risk management, futures, options and swaps as the main financial derivatives instruments came into being.

In terms of constant rising interest rates, commercial banks and savings institutions, for instance, have experienced severe deposit losses and were at a disadvantage in the competition with market-based substitutes, especially money market funds. After considering a series of outcome, the regulator adopted deregulation to adjust market efficiency. The first action is to raise or remove the interest rate ceiling on long-term and large deposits, and then extend to the types of deposits with shorter maturities and smaller amounts [9]. At the same time, banks have launched new deposit products that are directly equivalent to and can directly compete with money market funds, such as the Money Market Deposit Account created in 1982 and the Super Transferable Payment Order Account starting in 1983, both with no interest rate cap.

Due to global loosened financial controls and the implementation of financial liberalization measures from many developed countries like United States, Britain and Japan, a looser financial competition environment gradually formed, the diversification of financial products has had a lot of room for innovation. Many banks would face a "not to advance is to go back" situation. More importantly, the deregulation of the financial environment provides more spaces and potentials for inventing new markets and developing new businesses, accordingly accelerating the sustainable development of financial derivatives.

3.1.2 Intensify Fierce Competition

The continuous innovation of financial products has made the product boundary classification not as clear as before, and the original competitive pattern of financial institutions has changed significantly. The reason was when financial institutions specializing in different businesses lose their bound in their products from laws, the most convenient way for financial product innovation is to acquire banks with different businesses to improve their market competitiveness and maintain their market share. Apart from convenience, those banks that did not take M&A activities felt panic since they were under the disadvantage situation, which is a driving factor for fierce competition. Meanwhile, the competition will accelerate the innovation of financial products, and the diversified development of financial products will obtain certain support.

Since the government adjusted regulation to allow commercial banks to operate investment banking businesses including insurances and securities through establishing subsidiaries. Financial institutions in the United States can operate a variety of financial products under the name of financial holding companies (FHC) or financial subsidiaries (FS), providing a full range of financial supermarket services. By diversifying across industries, financial institutions benefit not only themselves but also consumers, individuals' and corporate clients desired for a one-stop-shop services. Therefore, it encouraged banking industry to merge and acquire each other through starting to lobby hard for the regulator to further strive for greater degree of deregulation.

3.2 Deregulation Stimulates the Desire of Banking Industry to Merge

3.2.1 Cost Reduction and Economics of Scale

As an important strategic decision of financial institutions, M&A in banking industry should be regarded as a strategic response and adjustment of enterprises to the changes of external market competition environment. In the fierce competition in the global financial market, "Bigger is Better" had become the philosophy of many financial institutions [10]. It is the focus of many financial institutions to reduce unit costs and expand market share through expanding scale along with increasing financial products varieties, consequently to meet customer needs, increase revenue sources as well as reduce sales costs.

Banking industry relies on public confidence to survive [11]. The size of their scale plays the decisive function for competitive advantages. Based on the purpose to gain the trust of wide clients, M&A activities are the quickest way for banking industry to expand scale and capture market shares. Nearly all of America's biggest banks with more than $20 billion in assets were created through M&A. Citygroup, for instance, the consolidation of Citybank and the Traveller, has been one of the biggest financial groups in the world, with total assets of nearly $700 billion, providing comprehensive retail and commercial banking, investment banking financial services, including asset management, credit card insurance and other financial services to about 100 million customers in 100 countries around the world.

Just like the globalization of financial institutions, the cross-industry consolidation and diversification of financial institutions also bring the benefits of economies of scale, scope and risk diversification to the industry. Another benefit that attracts the banking industry to expand scale through M&A is that it can not only save a lot of technology costs and network construction costs, but also eliminate some redundant business settings and reduce staff accordingly.

3.2.2 Synergy Effect

Indeed, the value of a company depends on the discounted value of expected future profits. The motivation of M&A is to transfer competitive advantages through integration with target institutions. One reason for the desire to merge or acquire banks may be that the bank could obtain management synergies and financial synergies, reflected on the full utilization of management resources and cash flow, and thus the cost-benefit ratio decrease and the return on assets increase. According to a survey by Salomon Brothers on 50 large banks in the United States, from 1992 to 1997, the average return on assets of consolidated banks rose obviously, specifically from 1% to 2.29%. Besides, the shareholder returns rose from 13.6% to 15.9%. In addition to obtaining scale effect, M&A also made it possible to cross-sell some related financial products. A kind of financial supermarket emerged through the combination of different specialized banks, which boosts many opportunities on sales and improves efficiency on operation and management, so as to achieve effect of scope economy.

4 Final Equilibrium: Reach the Pareto Effect of Market

During 1991–1998, there were about 4033 M&A cases in the US banking industry, which increased from 129 M&A cases in 1989 to 557 M&A cases in 1998 (see Fig. 2). The M&A activities of the US banking industry were active. In the whole 1990s, there were about 504 M&A cases in the US banks every year on average. In April 1998, the United States banking M&A again raised the climax, the first is Citibank and Travelers reached a merger agreement, formed the world's largest financial services enterprises, then Bank of America (No. 5), merged with National Bank (No. 3). At the same time, First Bank merged with First Chicago Bank to become the fifth largest bank in the United States. According to statistics, the first half of 1998 also create a new high record, totaling $239.6 billion, more than the sum of previous three years (see Fig. 3).

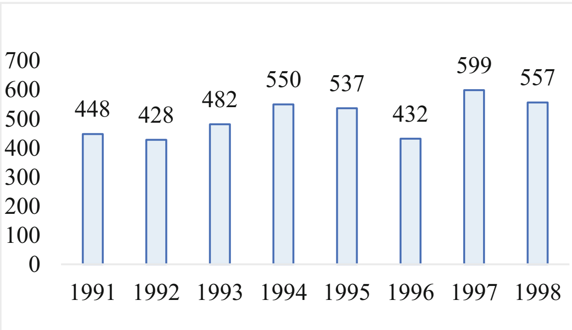

Fig. 2. Total number of merger and acquisition deals of U.S. banks, 1991–1998, (unit: case)

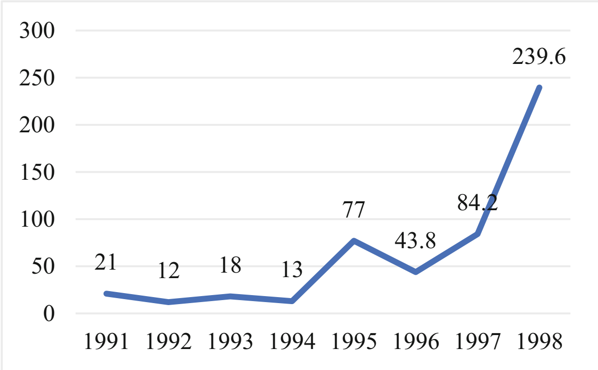

Fig. 3. Total value of merger and acquisition for U.S. banks, 1991–1998, (unit: billion dollar)

It was not until 1999 that the U.S. Congress passed the Modern Financial Services Act and The Financial Services Reform Act, which took the financial combinations as the core. After then, it marked that the American financial industry entered a new era of mixed operation and comprehensive management, along with a new management system under the centralized management of the Federal Reserve plus the financial regulator of the federal government. Thus, the basic mode of financial legal supervision in the United States was finally established.

It is noticeable that sometimes there are some negative effects about the diversification development of financial institutions and the constant enhancement of their positions in certain fields through cross-industry M&A, including the loss of efficiency caused by cultural conflicts and differences in operation and management modes. As investment banks tend to pay more attention to the performance of individual roles, they encourage innovation, initiative, product promotion and customer relations, while commercial banks tend to be more procedural and robust. Accordingly, M&A sometimes do not always create an overall advantage, but can lead to loss of efficiency, demoralization and the loss of professional staff. For instance, after Suisse Credit Bank bought DLJ, an American investment bank (and merged with its earlier acquisition of First Boston), they lost expertise to rivals such as UBS, Goldman Sachs and Lehman [10].

According to the theory of first-mover advantage, after the wave of M&A, many business giants with diversified services have gradually formed. A fact can hardly be ignored is that the followers may be under the disadvantage situation due to the change of market economics environment when they continued to operate crossing-industry. When market growth slowed and the economy becomes sluggish, it is difficult to fulfill the commitment made when the market development trend is booming. Whatever is the market environment, those followers' profitability is always far lower than business giants unless the followers' business rises sharply due to certain disruptive technological breakthrough. As a result, not all cross-industry mergers and acquisition can create economies of scale and scope.

Many institutions opted to diversify, especially in investment banking and asset management, while others have begun to rethink more focused or specialized operations after several years of attempts. Finally, the trend of fierce M&A activities could automatically ease unless there are new market environment changes.

5 Conclusion

Through the research on the effect on government financial deregulation based on the case analysis, this paper has several implications. Firstly, in the context of global financial liberalization and technology revolution, the government's financial deregulation, as an external factor to expedite the large-scale merger of the banking industry, created the realistic and feasible conditions for the M&A activities. Apart from that, it inspired commercial banks, investment banks and insurance companies to expand to each other's fields, so as to improve their profitability and potentials. The second is that, according to the first mover advantage theory, business giants usually give priority to banking M&A activities, while followers continue to uphold the philosophy that the bigger the scale, the brighter the development prospect of the enterprise, so as to expand the scale and achieve synergistic effect through M&A, which is also the one of main reasons for the wave of banking M&A. The third is that eventually the banking market will reach a stable state of the Pareto effect after the wave. Since M&A do not always bring benefits to the banking industry, and some negative factors are worth considering. The financial control measures of the government play a very important role in ensuring the market efficiency and play a certain reference significance for the implementation of future policies.

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