

The Practice of Bank Mergers

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1. Introduction

Since the 1980s, a wave of bank consolidations has swept swiftly over many countries in the world. One result of these consolidations is that Canada's banks, once among the top-tier globally, have slipped to second-tier status in recent years. Twenty years ago, Canada's largest bank ranked 17th in the world in asset value and Canada had 4 banks in the top 50. Today, Canada has only one bank in the top 50, ranked 48. Feeling the crisis, Canada's four biggest banks, Royal Bank of Canada, Bank of Montreal, Toronto-Dominion Bank (TD), and the Canadian Imperial Bank of Commerce (CIBC), are eager to become global players. On 23 January 1998, Canada's first and third largest chartered banks, the Royal Bank of Canada and Bank of Montreal, announced that they intended to merge. On 17 April, the CIBC and TD followed suit. In terms of size, the Royal Bank of Canada and Bank of Montreal merger would make it the ninth largest in North America and the CIBC and TD merger would make them the tenth largest. On December 14, 1998, then Finance Minister Paul Martin announced that the proposed bank mergers would not be allowed to proceed as they were "not in the best interests of Canadians". Recently, the newly appointed finance Minister Ralph Goodale announced that the moratorium on domestic bank merger is expected to end on June 30, 2004. Banking consolidation is a major concern for both governments and consumers. In this paper, we perform a comprehensive analysis of the theory and practice of bank mergers.

This paper begins with a glimpse into the history of bank mergers. In section 3, we analyze the incentives for merger. Section 4 and section 5 discusses the advantages

and disadvantages of bank mergers. Advantages include economies of scale, international competitions and job creation, while disadvantages incorporate job cuts and branch closures, higher fees and cultural conflict. Section 6 analyzes how to avoid the side effects of bank merger. Section 7 concludes.

2. History

There aren't many examples of world bank merger. The U.S. has a relative complete record for bank mergers. The three phases of merger wave¹ show the main process of the world bank mergers. In this section, we examine the history of bank mergers in the U.S.. After the Great Depression in the U.S., Roosevelt's New Deal set up a strong regulated banking system. The Glass-Steagall Act prohibited financial firms from dealing in wholesale and retail banking at the same time. Similarly, the McFadden Act forbade interstate banking. With limits on product diversification and market entry, local monopolies in U.S. banking system emerged naturally. That's why anti-trust regulation was broadened to the banking system (Bernstein, 1994).

In the 1950s, it seemed that banks begun to prosper. Money-center banks, especially large banks, tended to increase their assets by purchasing funds. They struggled with the Federal Reserve (Fed) through the 1960s to gain their ability to access purchased funds through the newly created market. The Fed ceded following the Penn Central bankruptcy² in May 1970: large banks can have access to large deposits and to the Euromarkets without restrictions.

In the 1970s, the Bretton Woods fixed-exchange rate system was suspended because of the worsening U.S. and global economic environments. The result of the suspension was exchange-rate depreciation, two recessions, and higher inflation. The

¹ Phase 1: distress in the 1980s. Phase 2: upscale retail banking in the U.S. Phase 3: globalized mega-banking.

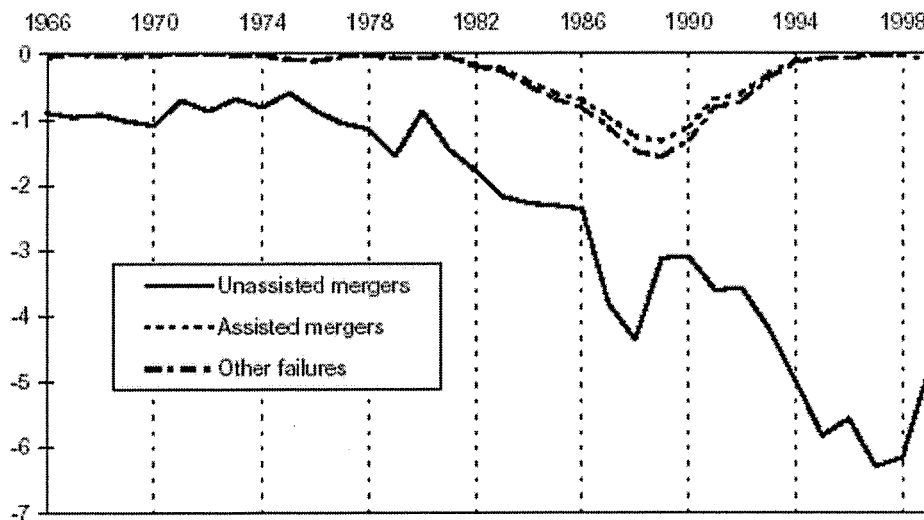
² Penn Central Company was formed in 1968 by the merger of the Pennsylvania Railroad and the New York Central Railroad. After the merger, many problems faced the combined company, such as incompatible computer systems and signaling systems. By the early 1970s the railroad was bankrupt.

unprecedented high nominal interest rates stimulated the generation of money-market mutual funds, which provided high-income households with a liquid, interest-earning alternative to bank deposits. This put pressure on banks of all sizes because of widespread disintermediation (Glyn, 1996).

In the 1980s, there was a crisis in the thrift (Savings and Loans) industry. This crisis gave expansion-oriented commercial banks the chance to pick up interstate banking assets by acquiring failing or troubled Savings and Loans. The thrift crisis also induced the government into agreeing to the rule that troubled institutions should be rescued on the basis of a “least cost to the taxpayer” criterion.

Similarly, many commercial banks had troubles – not only in loans to Latin America and to oil-exporting states, but also performing poorly in commercial real estate and merger-related lending. The “least cost” criterion was applied for troubled banks, like insolvent thrifts.

Figure 2.1: Percentage reduction in the commercial bank population by reason, 1966-99



Source: FDIC.

Note: Figures depict percent of bank population in previous year.

From 1982 to 1989, assisted mergers³ increased in every year as a percentage of all banks, as shown in figure 2.1. Because real-estate prices decreased and some income was lost, there was a banking crisis in Texas. In the late 1980s, the downturn in the assets of the Texas oil-patch explains many distress mergers. Only after the Texas Legislature allowed the entering of out-of-state banks in 1987, was this crisis settled down. In the same year, Chemical Bank of New York acquired the Texas Commerce Bank, with \$11.4 billion in assets. In the same year, RepublicBank Corporation merged with Interfirst Bank, with \$8.8 billion in assets. In 1988, First Interstate Bancorp of California acquired Allied Bank of Texas (\$4.9 billion); with help from the FDIC, NCNB Corporation (NationsBank) bought First RepublicBank and BancOne of Ohio bought MCorp. Thus within two years, there were large banks in Texas (White, 1997).

In 1994, the passage of the Riegle–Neal Interstate Banking and Branching Efficiency Act removed restrictions on geographic expansion in the banking industry. In June 1995, nationwide interstate banking through holding company banks were permitted. That legislation opened up such a wide range of opportunities for bank mergers that resulted in the large number of bank mergers during 1995-1998, as shown in table 2.2.

³ Mergers with help from government or other institutions.

Table 2.2. Number of large mergers, 1990–98

Years	Large mergers	Large interstate mergers
1990	6	1
1991	16	12
1992	22	15
1993	17	11
1994	15	10
1995	14	11
1996	28	21
1997	25	24
1998	34	32

Source: Rhoades (2000)

During the 1990s, the major players seemed to slow their expansion. The pace of mergers aimed at the U.S. banking market has not been as fast as before. The position of the largest U.S. banks has changed gradually. Only 16 of the top 25 banks as of January 1, 1992 stayed in the top 25 on December 31, 1996. In 1991, four banks (NationsBank, PNC, Fleet, and Corestates) were in the top 10 in the world, while they lost their position in 1996. The new banks in the top 10 are there due to mergers; but their competitors also made ready use of the merger weapon. By December 31, 1997, Fleet and PNC had been kicked out of the top 10 by other banks' mergers, notably that of First Chicago and NBD; and Corestates was in the process of being taken over by First Union. In 1998 and 1999, six of the top ten end-of-1997 banks merged into three via megamergers – BankAmerica merged with Nationsbank, First Chicago NBD with Banc One, and Norwest with Wells Fargo (Rhoades, 2000).

Since 1997, large banks tend to merge with domestic banks. Megabanks (BankAmerica, Chase, Citigroup) have acquired investment banks, insurance companies, and brokerage houses. They tried to enlarge their ranges of financial

services. Their branches provide more financial services than deposit-taking and loan-making. In this way, they can raise their revenues and decrease earnings variability by offering two or more financial products more cheaply than their competitors (Dymski, 1999).

To expand business, merging banks focus not only on the domestic banking market, but also on consolidating with nonbanking firms. In April 1997, Bankers Trust concentrated with Alex Brown, a Baltimore investment bank. This movement was considered as the practical end of the Glass-Steagall Act. In the same year, both BankAmerica and NationsBank bought San Francisco investment-banking firms.⁴ BankAmerica, Robertson Stephens for \$540 million; and NationsBank, Montgomery Securities for \$1.2 billion. These banks were in 13th and 14th place in underwriting common stock before merging and both of them were eager to enter the booming business of underwriting and arranging mergers. In April 1998, Citicorp merged with Travelers Group, the insurance giant, a \$70 billion deal generating the world's largest financial services firm. Although these merged companies have tried to market both insurance policies and savings accounts, or to provide business customers with both traditional bank loans and share underwriting, few of them were successful. Cross-selling motor insurance or emerging market mutual funds to credit-card holders is easy in theory, but turns out to be hard in practice (*Economist*, April 11, 1998).

The mergers after 1997 involved mergers by large megabanks with banking

⁴ Robertson Stephens, Montgomery Securities, Alex Brown and Hambrecht & Quist are four subsidiaries of San Francisco investment-banking firms. In the 1980s and early 1990s, they handled the major Silicon Valley deals.

firms and mergers by large megabanks with non-banking firms. These mergers blurred the lines between the services offered by brokerage houses, by investment banks, and by commercial banks. Some non-bank firms have responded actively to banks' plans of moving into non-banking financial services. These firms have started to provide banking or bank-like services to the retail customers. However, some large non-bank financial firms followed a different strategy. They overtook the retail banking market. They tend to make a global consolidation instead of competing with banks (Dymski, 1999).

The expansion of large banks continued after 1991. Nationsbank, which had \$116 billion in assets at the end of 1991, had \$264 billion at the end of 1997, and then with the injection of BankAmerica, \$680 billion by June 2000. Citibank, a \$216 billion bank in 1991, grew to \$310 billion by 1997, and because of its merger with Travelers Group, \$791 billion by June 2000. Chase, with 1991 assets of \$98 billion, had been up to \$365 billion by 1997 mostly because of its merger with Chemical; by June 2000 it had reached \$396 billion (Dymski, 2000).

3. Why banks want to merge

One way to gain insight into the nature of the potential gains and losses associated with bank mergers is to analyze the motives behind mergers. A variety of motivations have been offered for bank mergers.

Financial factors are believed to be a major motivator in bank mergers. Stewart (1991)'s merger motivation theory⁵ shows this. Cost savings or increases in revenues are the two ways of increasing operating profits. Cost savings are considered the main drive behind bank merger activity. Generating technological efficiencies can result in cost savings from mergers. In addition, Stewart's merger motivation theory of financial benefits also explains the merger from a debt capacity angle. The capital base of the banks will be enlarged after the merger, so their combined lending ability increases. However, some authors consider that bank mergers don't improve the financial performance of the combined banks (Baradwaj, Dubofshy, and Fraser, 1992; Palia, 1993; Hawawine & Swary, 1990; Toyne & Tripp, 1998; Madura and Wiant, 1994). While other authors hold the opposite view about this (Cornett & De, 1991; Chong, 1991; Cornett and Tehranian, 1992; Subrahmanyam, Rangan, & Rosenstein, 1997).

Another reason for bank acquisitions may be to diversify both the funding sources and the earnings of the acquiring banks. Large acquiring banks that depend on

⁵ The financial part of Stewart's merger motivation theory consists of: (1) increase financial performance (net operating profits), (2) financial benefits through borrowing against the seller's unused debt capacity or against an increase in the consolidated debt capacity (lending capability for banks), and (3) tax benefits derived from expensing the stepped-up basis of assets acquired or from the use of otherwise forfeited tax deductions or credits.

purchased funds may have interests in buying banks that have important core deposit funding bases. They will be highly valued after the merger, for they gain greater stability related to purchased funds. To shareholders, they will gain from a bank's diversification of its funding sources, because banks that increase their dependence on core deposits are less likely to experience a disruptive bank run. Besides, shareholders, particularly the investors whose all stocks are in the acquirer and whose portfolios are not well diversified, also can benefit from the diversification of the loan portfolio. To the public, it is hard to say whether they will gain from the diversification associated with mergers (Hunter and Wall, 1989).

Regulators have considered that if banks depended on core deposits more than on purchased funds, the banking system would be more steady. While an argument arised that if a bank faces financial problems, it is natural for the bank to withdraw purchased funds. Thus, these banks can still suffer riskier crises than banks which depend on purchases funds, although banks that rely on core deposits may be more steady. At the same time, the benefits of asset diversification in decreasing a personal bank's credit riskiness are widely accepted. However, a banking system with a few large organizations may be more uncertain than one with a large number of smaller organizations. Losses that happen at one bank would not make another independent bank to fail but could cause their joint failure if the two were merged (Shaffer, 1989).

Bank mergers make the bank itself more competitive by economizing on fixed costs through branch closures and through the focus on particular products or customer groups (niche players). This competition challenges the existing full-service

banking firms in two respects. First, niche players will figure out the products or services that are currently being over-charged compared to stand-alone costs. For example, if banks charge no specific fees for ATM use, customers who make little or no use of the machines subsidize other customers who are frequent users. Second, niche players stimulate the existing banks to go even further than they already have in evaluating the actual cost of each independent service or product offered and in charging based on that cost (Mathewson and Quigley, 1997).

To increase market power and reduce competition is an undisputed motive behind bank mergers. For the acquirers, reduced competition will result into high profits. However, consumers will pay more for bank products and services.

Advanced technology makes some bank branches redundant. Part of traditional transactions which used to be made in bank branches are made through alternative means, such as ATM machines, the telephone, and the Internet. These channels develop very swiftly for two reasons. First, the new technologies are more convenient for consumers in terms of economizing on transportation costs and time. Second, new technologies can reduce banks' costs by reducing the number of branches and the number of employees. Third, with advances in computer technology (such as systems, software) and communications, it is possible to make an ever-larger number of transactions at a single back-office site. It is also possible to integrate the operations performed by branches and subsidiaries all over the world through the use of standard software (Pattison, 1996).

Geographic diversification is accepted as an important motive for bank mergers.

The bank's market is wider after geographic expansion, reducing risk. In the U.S., before the Riegle-Neal Interstate Banking and Branching (IBBF) Act of 1994, which permitted bank holding companies to acquire banks in any state after September 29, 1995 and permitted mergers between banks located in different states after June 1, 1997, banks were not permitted to extend to outside of the state. After the Riegle-Neale Act, banks are free to acquire out-of-state banks in order to expand geographically across state lines and to diversify geographically. The merger rate has risen since the IBBF Act, confirming the geographic motive for mergers (Morgan and Samolyk, 2003)

Some researchers consider the "TBTF" (Too Big to Fail) argument as crucial to understanding the mergers of the 1990s (Benston, Hunter, and Wall, 1995; Hunter and Wall, 1989; Boyd and Graham, 1991). "TBTF" is the U.S.'s policy used to solve the crisis involving the Continental Illinois National Bank and Trust Company in May 1984. It means that uninsured depositors will be protected in full at insolvent banks that are considered TBTF by the FDIC (Federal Deposit Insurance Corporation) Act of 1991, while uninsured depositors may suffer losses at smaller banks. If a large bank fails, it might bankrupt the banking industry's insurance fund, which may cause panic throughout the nation. After the "TBTF" was adopted, banks were eager to enlarge, because they thought regulators would not allow banks of a certain size to fail (Fiedor, 1998).

Overall, mergers may occur to improve the financial performance, to diversify the acquirer, to enhance niche competition, to increase the acquirer's market power,

or to provide benefits relative to advanced technology, geographic diversification and larger size.

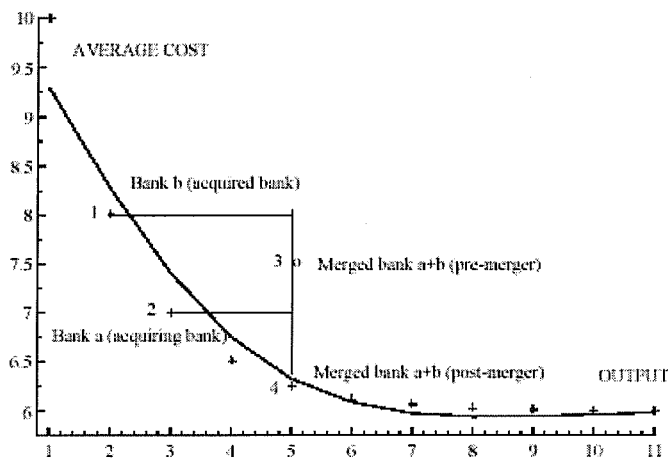
4. Benefits of mergers

Bank mergers can bring significant direct and indirect benefits to the economy. The main benefits are economies of scale, international competition and job creation.

4.1 Economies of scale

The banking industry often presents scale economies as a justification for mergers. The following figure illustrates the argument.

Figure 4.1.1 Economies of scale



Source: Humphrey (2003)

Bank b is the acquired bank, while Bank a is the acquiring bank. Point 3 shows the aggregation of all premerger data on banks a and b before the merger. Point 4 represent the merger. Comparing points 3 and 4, output is the same, but average cost is significantly lowered by the merger (Humphrey, 2003).

Numerous authors have examined whether economies of scale exist in bank mergers. Studies have taken two different approaches: the “profit” approach, which

uses profits as a measure of whether small or large banks are more efficient; and the “cost” approach, which examines operating efficiency by bank size. Most formal studies of economies of scale have taken the cost approach.

In the early studies, Benston (1965, 1972) and Bell and Murphy (1968) consider that there are significant scale economies for all banks following a merger, no matter how large the bank is. Namely, if banks double their size, a reduction in average costs of about 5% to 8% ensues (all else held constant). Unfortunately, these conclusions ignore economies of scale in three respects.

First, the Cobb-Douglas cost or production function specified in these early studies is restrictive. It can only indicate one of three possible outcomes — decreasing, constant, or increasing average costs for all banks. When studying a U-shaped average cost curve, we can see that small banks have a decreasing average cost, medium banks have a constant average cost, and large banks have an increasing average cost. These differences cannot be captured by the Cobb-Douglas function.

Second, because the samples used were mainly composed of small banks, the procedure of fitting a Cobb-Douglas functional form to the data almost forced the scale economy results of smaller banks to be extended to all banks. That is, because there are scale economies in small banks, then all banks are supposed to yield the same result.

Third, the differences between scale economies of the average branch office and scale economies of the overall bank are forgotten. If banks maintain additional offices in order to offer convenience to customers, and make up the costs of these

offices on the earning side, then there may be scale economies at the branch office level but diseconomies at the level of the bank itself. Here, only scale economies at the branch office level are considered, and economies at the level of the whole bank are not computed. (Benston et al., 1982; Berger et al., 1987 ; Berger and Humphrey, 1991).

Later, scale economy studies have tried to remedy these defects. More flexible functions were used, e. g. translog, spline and Fourier functions. These functions can display a U-shaped average cost curve. Besides, large banks (over \$1 billion in assets) are included in the research. In addition, scale economies are determined at the level of the bank instead of at the level of the average bank branch. Mester (1987), Clark (1988), and Berger, Hunter, and Timme (1993) agree that the average cost curve for all banks is U-shaped, while medium-sized banks' curves are flatter, which shows that they are more scale efficient than large or small banks. Further, only small banks have the potential for scale efficiency on the order of 5% or less.

Authors have tried to find the scale-efficient point for different sizes. Berger et al. (1987), Berger and Humphrey (1991), and Bauer et al. (1993) found that the point is somewhere between \$75 million and \$300 million in assets. They used banks with under \$1 billion in assets, banks of all sizes, and/or banks of over \$100 million in assets as separate samples. Other studies have used different thresholds. Noulas et al. (1990) found the cutting point to be between \$2 billion and \$10 billion for banks with over \$1 billion in assets. The difference between the two results may be due to the fact that large banks have a greater variety of products (e.g. off-balance sheet activities), different technologies, or a greater degree of cost dispersion. In spite of the

different locations of the scale-efficient points, it is accepted that there are no apparently overall scale economies from increasing bank size beyond a certain value. Actually, such increases may create slight scale diseconomies when the bank becomes very large. Nevertheless, it is difficult to draw strong conclusions about the exact nature and existence of these diseconomies because the data on large banks are so scanty.

There are some problems with the studies described above. First, most data used are from the most efficient banks. Second, scale economies are evaluated in terms of marginal changes in output. Third, nonparametric methods are supposed to be fit for examining scale economies. In fact, large and small banks are not representable by the same parametric cost function. The translog function limits large and small banks to a U-shaped (or possibly flat) ray average cost curve. In this way, if there are strong scale economies for the smallest banks and flat average costs for larger banks, scale diseconomies for the largest banks would be evaluated wrongly by the translog form. Besides, because large banks may have different product mixes from the average, while the translog approximation behaves poorly away from the mean product mix, problems will be generated in measuring scale efficiencies. Nonparametric estimation methods use spline or Fourier functions, in which shapes other than U-shape can be chosen for the average cost curve. Fourth, financial scale economies associated with risk reduction are not considered. Loan portfolios of banks become more diversified when banks become larger. Decreasing the amount of equity capital which is necessary to limit the risk exposure of the bank's creditors at a certain level will generate a financial scale economy (Berger, 1994).

In spite of the above problems, the basic findings remain valid. For the first

problem, Berger and Humphrey (1991), Bauer et al. (1993), McAllister and McManus (1993), and Mester (1993) consider that there is only a small difference between efficient banks and inefficient banks in scale economies measurement. For the second problem, Berger (1993, 1994) consider that scale economies and scale efficiencies are within a few percent of each other in most cases. Mitchell and Onvural (1992) and McAllister and McManus (1993) consider that because scale economies are mainly significant for the smallest banks, the use of nonparametric methods will not have much influence on the results. Finally, as for the third problem, McAllister and McManus (1993) indicate that the combination of financial scale economies from risk reduction increases evaluated scale economies only slightly for small banks. In all, only smaller banks have scale economies, while the farther expansion by the larger banks does not result in a significant reduction in average costs. According to Clark (1998), economies of scale exit in banks with total assets of less than \$100 million, but fail to show in banks with assets in excess of \$100 million.

4.2 International competition

As world banking has undergone sweeping changes, more Canadians have come to notice that the Canadian banking system faces not only domestic competition, but also international competition. Mergers are believed in an effective way of achieving international competitiveness. Two views on bank mergers in Canada arise.

The side against bank mergers considers that Canadian banks are large enough to show their capacity to compete on the world market. The Toronto-Dominion Canada

Trust Bank has been able to set up their discount brokerage operation through lots of acquisitions, and is now the third largest global discount broker.⁶ The Royal Bank has entered Europe and the United States, and has the largest presence of any Canadian bank in Europe.⁷ Besides, the five main Canadian banks have international operations in the U.S., parts of Latin America, the Caribbean, and Asia (providing about 33% of their 2001 revenues).⁸ According to this view, Canadian banks don't need to merge to compete internationally.

The side in favor of bank mergers views that Canadian banks will be eroded so badly by foreign competition and will lose their competitive edge to larger, more efficient global competitors such as GE Capital and MBNA, the giant credit card company. In addition, they use three measures to show that Canadian banks are not large enough for an effective international presence in banking.⁹

International banking is the first measure. Canada's financial system was in the fifth place out of 53 developed countries in terms of competition in 1997, which is still four places behinds their neighbor, the U.S.. Table 4.2.1 shows the ranking for Canada and the United States in detail.

⁶ TD Bank Financial Group Continues Momentum with Solid 3rd Quarter Earnings, TD Bank Financial Group Third Quarter 2000 Report to Shareholders, July 31, 2000

⁷ Proposed Mergers between the Royal Bank of Canada and the Bank of Montreal, and the Canadian Imperial Bank of Commerce and the Toronto-Dominion Bank Report to the Minister of Finance.

⁸ Federal Department of Finance, Canada's Banks

⁹ Background Paper #1. Competition, Competition, and the Public Interest. 1998. p.114

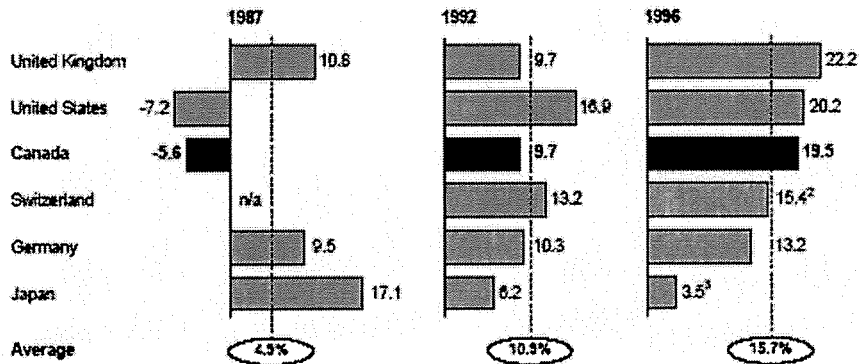
Table 4.2.1 Canadian and U.S. financial sector global competition rankings

Characteristic	Canada's Rank	U.S. Rank
Degree of overall sophistication	4	2
Supply of venture capital	5	1
Degree of competition from foreign banks	41	10
Soundness of banking system	1	15
Low loan deposit interest spreads	7	3
Stock markets as good source of capital	2	1
Well developed bond market	2	3
Adequacy of regulation	2	10
Ease of entry into the banking industry	39	10
Market determined interest rates	7	13

Source: Task Force on the Future of the Canadian Financial Services Sector. Background Paper # 1, *Competition, Competition, and the public Interest*. 1998. p 68

The overall profitability of a country's banks is another measure to check a country's ability to compete on a world scale. From Figure 4.2.2, we can see that Canada's profitability was in the third place in 1996. Although Canadian banks perform better on this measure, they are still behind that of the United Kingdom and the United States.

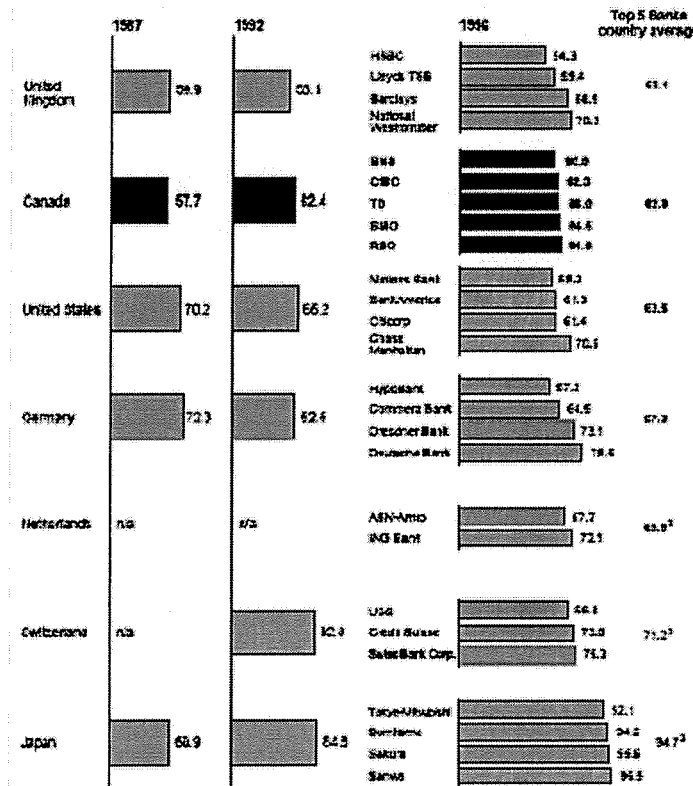
Figure 4.2.2 Profitability of banks - Net income/Total revenues



Source: Task Force on the Future of the Canadian Financial Services Sector. Background Paper # 1, *Competition, Competition, and the public Interest*. 1998. p. 112

Efficiency is the third indicator of international competition. It is the ratio of non-interest expenses to total income. From figure 4.2.3, we see that Canadian banks are in the sixth place out of the top seven countries with an efficiency measure of 62.8%. Besides, the efficiency measure for Canadian banks has been slowly decreasing over time.

Figure 4.2.3 International comparison of bank efficiency ratios



Source: Task Force on the Future of the Canadian Financial Services Sector. Background Paper # 1, *Competition, Competition, and the public Interest*. 1998. p. 114

To withstand international competition, mergers can be a good solution. Bank mergers increase the capital base and array of products & services, which in turn

allows them to become more competitive. In August 1999, the merger between the Toronto Dominion bank (TD) and Canada Trust make the small TD (compared to the other four big banks in Canada) bigger. The post-merged TD owns more assets and customers, which makes it more competitive in the domestic markets. Some observers think that if the five large banks in Canada merge, they will be more competitive in international markets. However, they have to wait until June 30, 2004, the date of the announcement of whether the domestic banks are allowed to merge or not (Walker, 2003).

One way of increasing the global competitiveness of Canadian banks is to merge with foreign banks. Although merging with foreign banks may imply different regulatory requirements and the need to adapt to the different business cultures, the benefits of foreign participation are well known. Foreign service offers enhance domestic competition, first and foremost. They bring knowledge of the latest products and risk management techniques. They upgrade workers' skill. They offer high quality financial services at lower cost. And they diversify a country's financial system, both in terms of choice of products and the way these are delivered. In spite of the advantages of foreign competition, it is not easy for foreign banks to enter a domestic market. This can be seen in the World Competition Survey ranking Canada 41st out of 53 in terms of foreign competition. However, restrictions for foreign banks entering the Canadian market are expected to be looser, when the proposed mergers of the five big banks are approved (Dobson, 2000).

4.3 Job creation

Bank mergers can have some positive effects on employment, although the increase can in no way compensate for overall reductions.

Some sectors in the banking industry have seen their employment grow after mergers, such as stockbroking, mortgage broking, credit card administration and insurance broking and dealing. The growth in financial services in Australia is a good example. From 1991 to 1996, the increase in job opportunities in the subsector of financial services was about 36%, with a further gain of 14% from 1996 to 1997. Similarly, in the United Kingdom, the City of London merchant banks have raised their staff by more than 20% from 1999 to 2000.¹⁰

In Japan, the value of all mergers and acquisitions deals jumped from \$17.5 billion in 1998 to \$150 billion in 1999, which caused an expansion in banking services and employment. Since 1997, Merrill Lynch has raised its staff in Japan from 670 to 3,650. During the same period, the number of employees in Goldman Sachs has increased from 600 to 1,200 (Conyon, Girma, Thompson and Wright, 2000).

In the merger of the Central Pacific Bank and City Bank, the company indicated that some duplicative branches will be closed, but the savings will be used to open branches in parts of the states that neither bank now serves. Although there is a job loss because of branch closures, new jobs will be created in new branches.¹¹

¹⁰ *Financial Times*, 8 May 2000

¹¹ Howard Dicus (2003), 'Central Pacific promises no layoffs after merger', *Pacific Business News*, December 8

In Canada, the four big banks also indicated the creation of job opportunities if the proposed mergers are enforced. The CIBC and Toronto Dominion Bank had claimed that because the services are expanded, more jobs will be created within a few years, in spite of an initial reduction of 10% in employment. The Bank of Montreal argued that the new bank would eventually have a positive employment impact of between 5 and 10% after a transitional period. There were projections of an expansion in the number of branches of the combined operation from 2,540 to about 3,010 –branches that would employ staff, though not necessarily perform traditional branch functions (Mathewson, Frank and Quigley, 1998).

In addition, as remote access to bank services (internet and telephone banking) develops very fast these days, the high quality jobs, such as IT and call centers, have increased. These occupations employ a better educated workforce, and provide a better salary. Some employees who lose their jobs go back to school, or retrain by themselves. After polishing themselves, they fill the new positions again.

In all, as the propensity for mergers increases, more services will appear in the banking industry. Besides, geographic expansions and the application of new technologies have generated some job opportunities.

5. Do banks benefit from mergers?

While technological progress and heightened competition are typically thought to be good for the public, the banking merger trend has been greeted with anxiety by some people. Attention has focused on such fears: job losses, branch closure, price increases, and cultural conflict.

5.1 Job losses

In bank mergers, little consideration is given to the fate of employees. A number of bank employees may be a 'collateral damage' in mergers, for they will lose their job because of the closure of branches or elimination of duplication. Job cuts are not just in one country, or one area; they are a worldwide phenomenon.

In the U.S., bank mergers often implied staff reductions. In 1992, Bank of America's acquired Security Pacific. It was expected to result in 11%-13% of the positions of the merged entities being eliminated. However, other evidence suggests that the loss would be as high as 17.5%. Integra Financial Corp., born from the merger between Union National Bank and Pennbancorp in 1994, resulted in 12% staff cuts. The 1995 merger between Chemical Bank and Chase Manhattan led to the elimination of 12,000 jobs of a total of 75,000 in the combined bank. Similarly, the 1998 acquisition of the Bank of America by Nations Bank included plans for the lay-off of 18,000 workers by 2002 (Rhoades, 1998).

In Canada, one detailed study¹² has shown what the employment impact would have been had the proposed mergers involving four of Canada's largest chartered banks – CIBC, Toronto Dominion Bank, Bank of Montreal and Royal Bank been allowed. The Royal Bank and Bank of Montreal acknowledged possible initial job losses of 10% which could be implemented via attrition.

Table 5.1.1 shows employment in the banking sector for Canada in the last 10 years.¹³ In the 1980s, because new technologies were introduced, new services and products appeared, and employment rose. However, after 1990, employment fell, mostly because of the mergers and the takeover of trust companies, such as the merger of the Royal Bank and Royal Trust.

Table 5.1.1 Chartered bank employment in Canada

Year	Bank employees in Canada	% of labor force in Canada
1985	162,163	1.24
1986	162,667	1.22
1987	162,850	1.19
1988	164,417	1.18
1989	169,246	1.2
1990	172,484	1.2
1991	173,090	1.2
1992	172,776	1.19
1993	170,808	1.16
1994	N/A	N/A
1995	161,346	1.08
1996	160,104	1.04

Source: Canadian Bankers Association: *Canadian Bank Facts* (various years).

¹² Study prepared by P. Dungan of the University of Toronto's Institute for Policy Analysis for the Canadian Bankers Association, 1997.

¹³ The data indicates the workforce of the five largest chartered banks published by the Canadian Bankers and includes permanent full-time and part-time employees.

Bank mergers also have an indirect effect on employment in other industries. The study¹⁴ concluded that there are 190,400 people directly hired by the banking sector in Canada, while 46,050 jobs were created by the banking industry indirectly. If proposed mergers among Canada's big five banks are passed, some out of these 46,050 positions will disappear.

In European Union countries, bank employment has been in gradual decline since the 1990s because of mergers and acquisitions. Table 5.1.2 illustrates this.

Table 5.1.2 Bank employment patterns in European Union countries

Country	1980 (thousands)	1990 (thousands)	1994 (thousands)	% change 1980-90	% change 1990-94
Belgium	68	79	76	16.2	-3.8
Finland	42	50	36	19.0	-28.0
France	399	399	382	0	-4.3
Germany	533	621	658	16.5	6.0
Italy	277	324	332	17	2.5
Netherlands	113	118	112	4.4	-5.1
Norway	24	31	23	29.2	-25.8
Spain	252	252	245	0	-2.8
Sweden	39	45	42	15.4	-6.7
United Kingdom	324	425	368	31.2	-13.4
Total	2,011	2,344	2,274	16.6	-3.0

Source: A. Tickell: "European financial integration and uneven development", forthcoming in R. Hudson and A. Williams (eds.), in *Uneven development in Europe* (London, Sage).

From 1986 to 1995, there were 431,000 bank staffs who lost their jobs involuntarily in France. Similarly, the entire financial services sector (including savings banks, mutual institutions and consumer credit specialists) of French credit

¹⁴ Study prepared by P. Dungan of the University of Toronto's Institute for Policy Analysis for the Canadian Bankers Association, 1997.

institutions saw a decline of 26,000 jobs from 1986 to 1997.¹⁵

In Switzerland, UBS (Union Bank of Switzerland) and SBS (Swiss Bank Corporation) forecast about 7,000 jobs out of 13,000 in the group worldwide will be eliminated. In September 2000, the data released by UBS indicates that 1,282 employees lost their jobs between June 1998 and June 2000. Although the two sources give different numbers, the decline in employment is undisputed.¹⁶

In 1999, SocGen, BNP and Paribas in France made an effort to merge, but they failed although they tried for a long time. However, two of them formed the new BNP-Paribas. According to the bank's chief executive, there were 3,600 positions that would be eliminated over three years.¹⁷

Germany's Deutsche and Dresdner banks suggested to merge in March 2000 (the merger was finally suspended). If the two banks had merged, there would have been 800 branches closures and 16,300 job losses. After the merger failure, Dresdner Bank declared a reorganization plan, which consists of the elimination of 5,000 jobs and the closures of 300 branches over two to three years.¹⁸

In Japan, Sakura Bank and Sumitomo Bank merged to form the world's second largest bank – Sumitomo Mitsui Banking Corporation on April 1st 2001. The merger is expected to result in 6,300 job losses and the closure of 183 branches (including 32 outside Japan), although it is promised that the reductions will not happen until

¹⁵ *Mergerwatch*, Edition 6, February, 2003

¹⁶ Agreement on the job reduction process in connection with the merger of *SBS* and *UBS* signed in Basel and Zurich on 30 Jan. 1998.

¹⁷ BFI - Economic Research Department(2002), 'France: Unemployment rate unchanged at 9.6% in February', 31 March #04 - 145

¹⁸ Deutsche Welle (2002), 'German Banks Continue Slide Into Crisis', 26 July

2006.¹⁹

The merger plans of Asahi and Tokai banks (finally aborted) predicted that reorganization would take four years. During the process, 4,000 jobs (or 17 per cent of personnel) would be cut and 70 branches in Japan and ten abroad would be closed.²⁰

In Latin America, the united workforce of Banco Itaú, BFB, Banerj and Bemge was 63,895 in 1994. The staff declined to 44,699 (a 30% reduction) after Banco Itaú had taken over the other three in 1999.²¹ Similarly, after Unibanco acquired Banco Nacional in 1995, the total number of employees decreased from 31,743 to 19,000 by 1999.²²

Job losses following a merger derive from eliminating redundancy in head offices and duplication in bank branches. Table 5.1.3 illustrates the job cuts due to bank mergers in different countries.

¹⁹ OECD (2000), 'Highlights of recent trends in financial markets Highlights of recent trends in financial markets', *Financial Market Trends*, No. 76, July

²⁰ Ibid.

²¹ Annual report 1999 (1999), Financial statement

²² Annual report 2002 (2002), Financial statement

Table 5.1.3 Job cuts due to bank mergers in different countries

County	Year	Merger	Situation	Job losses
USA	1992	Bank of America's and Security Pacific	Success	11-13%
USA	1994	Union National Bank and Pennbancorp	Success	12%
USA	1995	Chemical Bank and Chase Manhattan	Success	12,000
USA	1998	Bank of America and Nations Bank	Success	18,000
France	1999	SocGen, BNP and Paribas	Success	3,600
Switzerland	1997	UBS and SBS	Success	7,000
Germany	2000	Deutsche and Dresdner banks	Suspended	16,300
Japan	2001	Sakura Bank and Sumitomo Bank	Success	6,300
Japan	N/A	Asahi and Tokai banks	Aborted	4,000
Brazil	1994	Banco Itaú, BFB, Banerj and Bemge	Success	19,196
Brazil	1995	Unibanco and Banco Nacional	Success	12,743

5.2 Price increases

One concern is that banks will charge excessive fees for certain services following the merger. A merger broadens the market share of the merged banks, increasing market power, reducing competition and leading to price increases (Perry and Porter, 1985; Farrell and Shapiro, 1990). In the U.S., the service fees for deposits have gone up about 42% for all banks, and about 66.5% for the largest (Broadus, 1998). In Canada, the price increases from bank mergers are compelling: it is harder

to get loans in local markets after a merger and it definitely comes at a higher price.²³

As coalition spokesman Duff Conacher said: “All the evidence shows bigger banks charge higher fees and provide worse service”.

To increase profits merged banks not only increase their service fees, but also decrease the deposit rates. Many authors, including Berger and Hannan (1989a), Calem and Carlino (1991) as well as Neumark and Sharpe (1992) indicate that the relation between market concentration and deposit rates (e.g. money market deposit accounts (MMDAs), short-term certificates of deposits (CDs)) is negative after studying different U.S. data sets.

Focarelli and Panetta (2001) find that the deposit rate will decrease in the first few years after bank mergers in Italy, and then will go up. In a dynamic setting, Prager and Hannan (1998) find that merging banks tend to reduce the deposit interest rates during the twelve months prior to and the twelve months after a merger. However, according to Akhavein, Berger and Hannan (1997) and Praeger and Hannan (1998), the larger mergers have adverse affects on deposit rates, e.g. local MMDA and NOW (negotiated order of withdrawal accounts) rates significantly, but not on three month CD rates.

Several studies, including Hannan and Berger (1991), Neumark and Sharpe (1992), Hannan (1994), Jackson (1997), and Rosen (1998) analyze how banks modify consumer deposit rates. Their research shows that deposit rates change more slowly in more concentrated markets, that is less competition results in less adjustment in

²³ *Consumers assess mergers among big banks.* The Consumers' Association of Canada to the Honorable Ralph Goodale Minister of Finance 2003-12-31.

deposit rates.

To some extent, the deposit market mirrors the small business and consumer loan markets. To increase profits, the bank either reduces the amount of credit available to small businesses or increases the loan rates. Different sized banks have different approaches to reductions in small business lending. Because large banks don't have a lot of small business lending, the purchases of smaller banks by large banks tend to lessen the small business loans that flow through commercial banks. However, if the consolidated bank is mostly made up of small and medium sized banks which held a relatively substantial amount of small business loans, it is plausible that the consolidated bank tends to view small business loans as a more attractive investment. So the merger may in fact stimulate small business lending (Walraven, Nicholas, 1997).

If a merger shifts banking assets to larger banks and the larger banking organizations tend to allocate a smaller share of their funds to small business lending, the reduction in small business lending from consolidation could be substantial under the "consolidation hypothesis." (Berger, Kashyap and Scalise, 1995). Similarly, Peek and Rosengren (1996) find that, in the New England states, the purchase of a small bank by a large bank results in a decline in small business lending by the combined organization.

Although Strahan and Weston (1996) do not agree with the "consolidation hypothesis", their finding of a reduction of small business loans is consistent with that hypothesis. They observed a sample of banks involved in mergers and compare the

small business lending of the banks pre- and post-merger to a sample of banks not involved in mergers. They found that the decrease in the percentage of small business loans-to-assets is greater among banks not involved in mergers.

Later, Peek and Rosengren (1998) studied the relationship between bank mergers and small business lending. They found that the acquiring banks tend to make the small business lending share of the merged institution move to its previous share. The sheet of post-merger portfolio adjustments shows that the small business lending declines following the merger. In Europe, Sapienza (2002) finds that merged banks tend to shrink the credit line to small businesses.

Some other economists consider that although banks lend less to small businesses following the merger, this effect is neutralized either by existing rival banks extending a credit line to small businesses, or by the entry of new banks. Berger, Saunders, Scalise and Udell (1998) find that to gain market power, the rival banks tend to increase small business loans. Goldberg and White (1998) think that in the late 1980s and early 1990s, many new chartered banks appeared with the merger wave. They evaluate that the new banks took a larger share of small business loans on their balance sheets than the existing banks.

In a new line of research, Berger, Rosen and Udell (2001) discuss how market structure affects small business loans. To their surprise, small businesses may have more chances of getting a credit line in a market composed of many large banks than in a market consisting mostly of small banks, although larger borrowers will still more probably go to larger banks. The advantage of their study is that they could observe

the size of the borrowers directly, and don't need to approximate it by loan size. That's why they reach a different conclusion.

Evidence shows that not all banks tend to reduce their lending to small businesses. Some banks tend to increase the loan rate to get more profits. Using data from the 1980s, Berger, Demsetz, and Strahan (1999) indicate that bank mergers in the Metropolitan Statistical Area (MSA) are associated with higher rates for small business loans and lower rates for retail deposits. Besides, they conclude that local market concentration and deposit interest rates are not connected as tightly as before, but the connection of concentration and small business loan rates remains strong.

However, the loan interest rates have a tendency to fall in mergers between banks with small market shares. Sapienza (1998) discusses the influence of mergers on business lending using data on loan agreements between Italian banks and borrowing companies. She indicates that interest rates on business loans tend to decrease after mergers between small banks. Besides, she also finds that interest rates decrease less when the market share of the merging banks is larger.

5.3 Cultural integration

Cultural conflict is a common problem in bank mergers. Different banks have different values and norms. e.g. what is acceptable behavior. Hence, integration constitutes a challenge for the managers of the new bank.

Most management consultants suggest clearly identifying these different cultural features and putting them on the table for open discussion before the merger. The

challenge for the leadership is to communicate and demonstrate by personal behavior the values which will represent the post-merger bank. Means of changing action, such as compensation structures and retention payments play an important role (Cartwright, Sue and Cary, 1992).

The study of over 30 bank mergers by Davis (2000) shows that different cultures of the parties to the merger is a common phenomenon. Entrepreneurial holder-owned banks, value vs. profit oriented, customer vs. product driven – all increase the uncertainty and expectations of change triggered by the declaration of a merger. In the merger between BCP and BPA, even though some of BCP's high management had spent a good part of their earlier careers with BPA, the cultural differences were an key problem.

Sometimes, the conflict is at the personal level. The conflict in the merger between Banco bilbao and Banco Vizcaya was from the senior executives. Many of these executives had been friends since childhood in the Basque region and went to the same Deusto University in Bilbao. Later the power struggle was solved by the intervention of the Bank of Spain.

Cultural conflict can never be completely resolved before mergers. Good communication in the new organization often requires the intervention of high management. Hence the complications arising from conflicts within high management. In the merger between Bank One and Forst Chicago, management of First Chicago had a strong belief in customer service, while Bank One emphasized profit. Although both of them have strong Mid-west roots and common values of honesty and

diligence, an outside consultant was needed to bridge the gap between the two banks' cultures (Cline and Kenneth, 1998).

Time is needed for the cultural integration to take place. Even after the merger, cultural differences will persist. After the merger of Citigroup with Travelers, the cultural differences were still apparent, especially relative to the objective of cross-selling. Travelers had grown a highly refined marketing culture built around selling diversified products to its retail clients, while Citibank's culture was well known for engaging in a given unit's own bottom line (Felman, 1998).

Cultural differences between nationalities are another source of conflict. For example, there is a sharp difference in cultural profile between U.S. and European banks. In the U.S., everything is determined by a main partner, while in Europe the banks compromise a lot.

The merger between Meritaand and MeritaNordbanken brought together the largest Finnish and fourth largest Swedish banks to create what could become the first true Nordic financial institution. However, language was a major issue, although Finland was part of Sweden for over 700 years. Besides, the merger turned out to be a multi-cultural challenge. The relationship between Finland and Sweden has never been an easy one as they have always been competitors. The Swedes have been considered by Finland as the large, wealthy partner, hence the Finns worry that the Swedes are taking over, but these worries didn't materialize. The two banks are trying to work together and form a new corporate culture (Kroll, Karen M., 1998).

The Deutsche Bank acquired Bankers Trust Company in 1999 in order to gain

strength in investment and corporate banking as well as enter the U.S. market. The potential cultural clash is obvious, because the Deutsche Bank's German military precision and size are far from the Bankers Trust "loosy-goosy" style (Davis, 2000).

6. Measures to facilitate mergers

From the above discussion, we can see that price increases, cultural conflict, job losses, and branch closures are side effects of bank mergers. To make mergers more efficient, measures must be taken to solve these problems or at least minimize the negative effects.

For price increases, the market effective countermeasure would be to increase competition in order to put downward pressure on prices. It is the role of Competition authorities to determine whether a merger is desirable from the point of view of competition.

For job reductions, there are three types of solutions. (1) Early retirement can help by lessening the pressure on job cuts. However, some difficulties related to early retirement will arise. Firstly, the cost of early retirement for public pension systems makes governments reverse their support for early retirement plans. As public pension systems are changed to reverse this tendency in policy, compensation measures will affect the benefits of retirees, for instance, their full pension entitlements will decrease. Secondly, early retirement has an implicit cost in terms of the valuable experience of older workers.²⁴

(2) Working time reductions is another alternative strategy to control job losses. They also can generate new jobs in a situation where new recruitment in the financial services sector has been limited by reorganizations.

(3) Re-training of existing staff for new positions in expanding sectors of the

²⁴ European Monitoring Centre on Change (2000), 'The Impact of Mergers and Acquisitions in the Banking and Insurance Sector'

business is also being adapted by some banks although it is not applied widely.²⁵

For cultural conflict, there are three possible solutions. The first solution is the adoption of decentralized federation, which eschews the issue for a certain time. This diversity is a plus for the merged bank. For instance, *ING* (Internationale Nederlanden Group) has already grouped the different institutions successfully. They didn't impose strict directions in many areas, instead, they tried their best to support local marketing and delivery, with more than 30 different brands in the group. Basically, they believed in the value of maintaining local autonomy.

The management of Kapital Holding in Denmark has the same view. Three operating units of the institute - a savings bank, payments specialist and mortgage lender - have their own systems and operating identity, and only at the central level is there a common bond (Salomon, 1992).

The second approach is to impose the culture of the dominant entity. The management of Fleet Boston considered that workers had to adopt a common culture as soon as possible. In the merger of Svenska Handelsbanken with Stadshypotek, Svenska Handelsbanken holds a main position and there is no cultural inter-change in the merger process. Svenska Handelsbanken has a decentralized and profit-oriented culture. After the merger, they provided the Stadshypotek staff with many seminars on Handelsbanken's culture, which is called massive brainwashing.²⁶

²⁵ European Monitoring Centre on Change (2000), 'The Impact of Mergers and Acquisitions in the Banking and Insurance Sector'.

²⁶ Brainwashing means that remove the ideology which exists in the pre-merged bank.

In 1995, Lloyds acquired TSB, which is Lloyds' stockholder value-driven approach to expansion. TSB was focused on customer satisfaction. The meritocracy of TSB wins the conversion of its management to Lloyds's way. Lloyds maintained its uniquely powerful commitment to a stockholder-value oriented culture. TSB's management and Lloyds's culture fitted well together (Davis, 2000).

The third way is to build a new culture which is notably different from those of the merged banks. When performing this strategy, a bank will struggle with a host of internal and external challenges. Sometimes, staff in a new bank will try to maintain their old habits. In 1997, Erste Bank merged with GiroCredit. At the beginning of the merger, the conception of a new bank - the leading privately-owned large financial institution in Australia are emphasized. GiroCredit had a loose management structure, while Erste was a retail banking machine. The idea of a new bank has helped a lot in the merger process.

The merger between Norwest and Wells Fargo indicates that an agreement in sufficient detail on philosophy is needed before the merger. Norwest is a 'high touch'²⁷ culture while Wells Fargo has 'high tech' values. It is not easy to blend these two cultures together. Achieving agreement, the old Wells' Internet and supermarket banking capability and much of Norwest's traditional stores and approach to community banking were put together beneficially (Houston and Joel 1996).

However, two similar cultures can indeed generate more conflict than different ones. Cartwright and Cooper (1992) point out that two main cultures want to keep

²⁷ Norwest mainly do business person in person.

their dominant position following the merger. Nevertheless, putting one in dominant position while the other in the second place is considered a way to achieve a successful merger.

7. Conclusion

The Canadian financial industry is now facing the challenge of competing in global markets. Bank mergers are considered an effective way to counter the competition from abroad. In this paper, we discussed the history and the motivation of bank mergers. Bank mergers have many advantages, such as economies of scale, international competitions, and job creation. However, bank mergers create some side effects. There are cost-cutting exercises, involving job cuts and branch closures, higher fees, and cultural conflicts. Given that mergers create benefits and losses, and that each merger has different characteristics, approval should be decided on a case by case basis.

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