Panelist Paper on

Consolidation in the Financial Sector
Implications for Efficiency and Stability

By

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The purpose of this note is to discuss and comment on the discussant paper by Professor McFetridge on the impact of information technology (IT) on Consolidation in Financial Sector. For the purpose of this symposium, my objective is not to discuss the substantive issue but to focus on prioritizing research topics and approaches.

Let me begin by giving a summary of Professor McFetridge’s paper (2002). The first section discusses the implications of information technology for the efficiency consequences of consolidation in the financial sector. This is followed by a discussion of some of the empirical results in the literature and their implications for Canada. Finally, Professor McFetridge responds to four, out of a total of nine, issues or questions raised in the issue paper authored by the Steering Committee of the National Research Program in Financial Services and Public Policy (2001); he also suggests four research areas without explicitly listing their priorities.

As a panelist, part of my responsibility is to comment on the issue areas prioritised by Professor McFetridge. To be quite frank, my main area of research is free banking. Bank mergers is only a recent addition to my research portfolio as a result of my success in obtaining a SSHRC-funded project to examine the impacts of bank mergers and banking regulation on economic growth in Canada. The approach of my research project is essentially based on macroeconomic and time-series analysis, trying to examine economic growth in Canada under different regulatory regimes. It is distinctively different from the conventional approach in the literature on bank mergers currently dominated by microeconomics, industrial organization and financial economics. Given my background, I believe I have little, if any, value added by directly commenting on Professor McFetridge’s paper, which has done an excellent job in identifying the major issues in financial consolidation and succinctly explaining them from the perspective of an industrial economist. Instead, I choose to identify what research projects or issues in financial consolidation are of high priority from the view of a monetary economist.

As Professor McFetridge correctly points out, the issues and research suggestions a researcher regards as interesting are to some extent a matter of taste; and their rankings are subjective. Here, my comments, suggestions and rankings are by all means subjective and reflect my own preferences. Needless to say, the four research areas suggested by Professor McFetridge are all important and interesting. Based on my own interest, however, I would prioritize them in the following order:
(1) the nature, magnitude and social value of the profit efficiencies from mergers of financial firms;

(2) the operation of the market for corporate control in the financial services industry;

(3) the sources of X-inefficiency; and finally

(4) the extent and nature of vertical disintegration in the financial sector in Canada.

My impression of Professor McFetridge’s paper is that it focuses more on the impacts of mergers of financial institutions on efficiency but less on their impacts on financial stability. In contrast, I am more interested in the financial stability issues arising from financial consolidation, simply because financial stability or banking panics has a long history of being one of the major areas of research in macroeconomics. This, of course, does not imply that macroeconomists are not interested in efficiency issues.

As a monetary economist, I am more interested in financial or banking efficiency from a macroeconomic perspective than from a microeconomic one -- profit efficiencies as suggested by Professor McFetridge’s paper. The questions of interest to me are: Does consolidation of the financial sector improve efficiency? And if so, how? By efficiency here I mean the efficiency of the banking or financial sector in:

(i) encouraging aggregate savings of the economy; (ii) mobilizing savings into investment; (iii) allocating resources into productive investment projects; and (iv) diversifying and reducing risk, among other economic functions (see, for example, Levine 1997 for details). Ideally, an efficient financial sector would take up less real resources in channelling savings into investment, and hence resulting in higher real per capita GDP growth in the long run than its inefficient counterpart. That is why I agree with Professor McFetridge that the nature, magnitude and social value of the profit efficiencies from mergers of financial firms is an interesting research issue.

However, a puzzle I have is whether there is a direct relationship between efficiency at the firm or industry level and efficiency at the aggregate level. And I believe this puzzle is also an interesting and important research topic. Let me illustrate my point with a hypothetical example. Suppose two financial institutions, say banks, merge. For the sake of argument, further suppose these two banks achieve economies of scale or efficiency gain after the merger. In a conventional structure-conduct-performance paradigm, the conduct and performance of other banks in the industry could change as a result of the merger because the industry structure might have changed after the merger. This is somewhat a Lucas critique story (Lucas 1976). The possibility of an adverse impact of the merger on the cost structure of other banks should not be entirely ruled out. Therefore, it is unclear, at least to me, that the efficiency gain of the two merged banks would necessarily lead to an overall net increase in financial efficiency, as defined in the previous paragraph, at the aggregate. My theoretical conjecture may be wrong. In practice, however, small businesses
often complain about difficulty in obtaining loans and advances from large banks. If such complaints truly reflected what actually happened and also if small enterprises were the main engine for economic growth, then bank mergers might mean less resources were allocated to productive investment projects. The validity of this conjecture is unlikely to be resolved until empirical evidence is provided.

As far as this efficiency issue is concerned, I would like to add that an issue raised in the Steering Committee’s issue note is also of interest and importance. This issue is: What is the likely effect of technology on the cost structure of financial service providers? Obviously, this issue is closely related to the efficiency issue just mentioned above. Do technology improvements lower the cost of financial intermediation and hence promote economic growth in the long run? Or has the financial sector become less efficient than before as it absorbs more real resources due to its need to catch up with the latest technology?

Recently there is a proliferation of empirical studies indicating that financial development “causes” growth (see, for example, King and Levine 1993, Beck et al. 2000, among many others). Yet how financial consolidation affects growth needs to be further explored. The cross-country empirical studies in the finance-growth literature, I believe, can be fruitfully extended to see what lessons Canada can learn. For example, APEC (2001) has provided some evidence showing the importance of banking efficiency in promoting long-term economic growth in APEC economies. However, we still need to further explore this finance-growth nexus in order to have a better understanding of the role of financial consolidation in the growth process.

Let me now turn to the issue of financial stability. Among Professor McFetridge’s suggested research areas, I rank the operation of the market for corporate control in the financial services industry high. A main reason is that it is closely related to my research interest in free banking. Apparently this choice is highly subjective. I am particularly interested in whether market discipline is able to maintain stability of the financial system. If so, what are the possible mechanisms? And how do they function?

As far as financial stability is concerned, the Steering Committee’s issue paper has raised a number of interesting questions regarding mega-mergers and financial stability:

(1) Is bigness per se (i.e. beyond competition related issues) a legitimate policy concern?

(2) Can an institution be too big to fail? If so, at what point does it become such? And

(3) What can be done to limit potential distortions consequent upon a policy, or perception of a policy, of too-big-to-fail?

In my opinion, bank size remains a legitimate public policy concern, even though there may not be such thing as too-big-to-fail.1 The failure of a large bank can be very disruptive to the

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1. In 1894, there were a total of three banks in Newfoundland and two of them (both were large in terms of loons and
payments system. More importantly, the notorious moral hazard problem associated with the perception, or misperception, of a financial institution being too-big-to-fail, tends to erode market discipline, encourage excessive risk-taking and, as a result, increase the systemic risk of the financial sector. If this is the case, then financial consolidation does not necessarily mean that the financial sector becomes more efficient in diversifying and reducing risk.

All these are important questions and research topics that deserve investigation. Despite the voluminous literature on financial stability and related issues such as deposit insurance, empirical studies are relatively few and their findings remain mixed and controversial. As pointed out by Professor McFettridge, the operation of the market for corporate control in the financial services industry is not easy to research in Canada. Unfortunately, I have to agree with him. This is particularly the case with respect to the too-big-to-fail doctrine. Nevertheless, the relationship between mega-mergers and financial stability merits empirical investigation. A possible solution is to carry out historical or case studies to see what Canada can learn from other countries’ experiences.
References


