



The impacts of Gramm–Leach–Bliley bank diversification on value and risk



Darren Filson^{a,*}, Saman Olfati^{a,b,1}

^a Robert Day School of Economics and Finance, Claremont McKenna College, Bauer Center 325, 500 E. Ninth Street, Claremont, CA 91711, United States

^b College of Business & Public Management, University of La Verne, 1950 3rd St., La Verne, CA 91750, United States

ARTICLE INFO

Article history:

Received 31 October 2013

Accepted 17 January 2014

Available online 27 January 2014

JEL classification:

G21

L25

G14

G28

G01

Keywords:

Financial Services Modernization Act

Bank mergers

Bank diversification

Financial conglomerates

Event studies

ABSTRACT

Combined abnormal returns from U.S. bank holding company acquisitions during 2001–2011 suggest that diversification into investment banking, securities brokerage and insurance under the Gramm–Leach–Bliley Act of 1999 creates value. Exceptional returns depend on contributing factors; the most robust are that the acquirer is large and has experienced negative returns over the prior year (characteristics consistent with models of optimal diversification). Results are inconclusive on whether the impact of acquirer size is a too-big-to-fail effect, but acquirer characteristics are associated with adverse consequences: large size is associated with increasing systematic risk, and falling acquirer values are associated with increasing idiosyncratic risk.

© 2014 Elsevier B.V. All rights reserved.

0. Introduction

In the aftermath of the 2008 financial crisis, many have called for the repeal of the Financial Services Modernization Act of 1999 (also known as the Gramm–Leach–Bliley Act and referred to as the GLBA in what follows).² The goal of these efforts would be to prevent bank holding companies (BHCs) from participating in

investment banking, securities brokerage, and insurance activities.³ The ongoing policy discussion makes it particularly urgent to provide insight into whether such reforms would enhance social welfare.⁴

A complete policy analysis of the GLBA would compute the expected net present value of the welfare impact on all consumers and firms in the economy and also assess distributional consequences. Such an analysis would be complex and assumption-dependent. We pursue a more modest goal: we estimate the

* Corresponding author. Tel.: +1 (909) 607 6796; fax: +1 (909) 621 8249.

E-mail addresses: dfilson@cmc.edu (D. Filson), solfati@cmc.edu, solfati@laverne.edu (S. Olfati).

¹ Tel.: +1 (909) 957 5942; fax: +1 (909) 621 8249.

² Several bills have been introduced to attempt to restore Glass–Steagall restrictions. The most recent effort involves a bipartisan group of senators. See “Senators Warren, McCain, Cantwell, and King Introduce 21st Century Glass–Steagall Act” July 11, 2013 (http://www.warren.senate.gov/?p=press_release&id=178). For a summary of prior attempts see <http://larouchepac.com/glass-steagall>. For a summary of what the GLBA involves, see Barth et al. (2000). For additional background information and an introduction to the debate on whether the GLBA was responsible for the crisis, see White (2010) and the sources cited there.

³ Currently, the term “bank holding company” includes holding companies focused mostly on commercial banking (Bank of America and Wells Fargo, for example) but also applies to regulated financial holding companies focused mostly on other activities (Goldman Sachs and MetLife, for example).

⁴ The question is also of long-standing interest. A large literature prior to the GLBA explores the possibility of universal banking in the U.S. (Benston (1994) provides an overview). Universal banking could go beyond the GLBA to permit BHCs to operate nonfinancial firms or permit nonfinancial firms like Walmart to own commercial banks. The Volcker Rule in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 imposes a narrower version by restricting BHC involvement in hedge funds, private equity funds and proprietary trading.

impacts of GLBA diversification on the value and risk of the diversifying firms. Our approach is much simpler than a complete policy analysis, and it provides two potential shortcuts. First, if GLBA diversification does not create value for the diversifying firms, then it is unlikely that such diversification enhances social welfare. The diversifying firms should be able to appropriate some of the social returns to their diversification if the social returns are positive. Second, if GLBA diversification does create value, then further investigation can reveal circumstances in which it does so (and by extension, circumstances in which welfare might be enhanced). This should narrow the search for potential welfare benefits of the GLBA. Of course, private value creation could be at the expense of society. This might be because institutions become too big to fail. Beyond this possibility, systematic risk might rise, and even an increase in idiosyncratic risk could be cause for concern due to the possibility of bank failure. We explore these issues below.

Our empirical approach exploits the fact that GLBA diversification typically occurs through mergers and acquisitions (DeYoung et al., 2009). Given this, we use event studies of merger announcements to estimate the impact of GLBA diversification on firm value. We estimate the combined cumulative abnormal returns (CARs) from 168 U.S. BHC acquisitions during 2001–2011 and assess the impacts of the mergers on systematic and idiosyncratic risk. To measure the degree of GLBA diversification of a firm, we isolate the components of noninterest income that pertain to investment banking, securities brokerage and insurance, and we compare income from these sources to the sum of net interest income and total noninterest income. If the ratio is higher for the target, GLBA diversification is projected to increase as a result of the merger; otherwise it is projected to decrease.

Mergers projected to increase GLBA diversification generate mean combined CARs that are almost double those of other BHC mergers, and mergers that increase GLBA diversification more have higher CARs. However, several factors appear to have critical impacts on whether GLBA diversification is associated with exceptionally high CARs. For example, when tested in isolation, CARs associated with GLBA diversification are particularly high during the financial crisis year of 2008. The factors that survive horse races that test potential contributing factors against each other are that the acquirer is large and has experienced a declining market value over the prior year.⁵ These factors are consistent with theoretical models of value-creating diversification (Matsusaka, 2001; Maksimovic and Phillips, 2002; Gomes and Livdan, 2004): firms diversify when they outgrow or otherwise exhaust opportunities in their current lines of business (traditional banking activities in our case). We find that size leads to exceptional CARs only when mergers involve GLBA diversification, which suggests results are not just due to too-big-to-fail effects. However, we cannot completely rule out such effects because the largest few entities in the sample emerge from GLBA diversifying mergers. In any case, there are adverse impacts associated with acquirer characteristics: when mergers are GLBA diversifying, large acquirer size is associated with increasing systematic risk, and low acquirer returns over the prior year are associated with increasing idiosyncratic risk.

1. Prior literature

Much of the prior literature suggests that U.S. bank diversification destroys value (DeLong, 2001; Stiroh, 2004, 2006; Stiroh and Rumble, 2006; Schmid and Walter, 2009). Negative results are

not confined to the U.S.; Laeven and Levine (2007) analyze 43 countries and find a diversification discount.⁶ However, most of this literature explores the long-run movement away from interest generating activities toward non-interest generating ones. Given this, authors use broader notions of diversification than the one we focus on (comparing all non-interest-generating activities to interest-generating ones, for example), and much of the time period analyzed also predates the GLBA. When we use a broad measure, our results also suggest that diversification destroys value. However, as we discuss further below, almost all of BHC diversification into non-interest generating activities has not involved GLBA diversification, so broad measures are not ideal for assessing whether GLBA diversification creates value. Further, results from Europe, which has permitted GLBA-type diversification for longer than the U.S. (since the Second Banking Directive in 1989), suggest that such diversification might not be associated with a discount, at least under some conditions (Baele et al., 2007; van Lelyveld and Knot, 2009). Sanya and Wolfe (2011) find that bank diversification enhances profitability in emerging economies, and Elsas et al. (2010) find evidence against a conglomerate discount using data that includes the 2001–2008 period.

Much of the prior work that focuses more directly on the GLBA finds positive impacts. Several authors estimate the impacts of events leading up to and including the passage of the GLBA on the value of firms in the finance sector (Johnston and Madura, 2000; Akhigbe and Whyte, 2001; Carow, 2001; Carow and Heron, 2002; Czynnik and Klein, 2004; Mamun et al., 2004, 2005; Yildirim et al., 2006). Authors generally find positive abnormal returns, and they also conclude that large firms benefit more. In contrast, authors that use accounting data to examine GLBA diversification after the passage of the act do not find positive impacts (Yeager et al., 2007; Akhigbe and Stevenson, 2010; Elysiani and Wang, 2012). Earlier results using Section 20 subsidiaries are somewhat mixed.⁷ Bhargava and Fraser (1998) find that the initial decision by the Federal Reserve Board to allow BHCs to engage in investment banking through Section 20 subsidiaries generated positive abnormal returns for banks, but subsequent decisions resulted in negative effects. Cornett et al. (2002) find that accounting measures of performance improve when a bank adopts a Section 20 subsidiary.⁸ No

⁶ This literature builds on Lang and Stulz (1994) and Berger and Ofek (1995), who find diversification discounts in nonfinancial firms. Subsequent work (also focusing on nonfinancial firms) attributes the apparent discount to selection problems (firms decide whether to diversify or not) and difficulties with measuring diversification (see Matsusaka (2001), Campa and Kedia (2002), Graham et al. (2002), Maksimovic and Phillips (2002), Gomes and Livdan (2004), and Villalonga (2004a, 2004b)). Recent event-study evidence from almost 5000 mergers during 1950–2006 compiled by Akbulut and Matsusaka (2010) also suggests the absence of a discount. Recent work on U.S. financial conglomerates (including Laeven and Levine (2007) and Schmid and Walter (2009)) attempts to control for selection effects but still finds discounts. Klein and Saldenberg (2010) argue that corporate structures that tend to be employed by diversified firms have important impacts on the estimated effects of diversification.

⁷ Bhargava and Fraser (1998) and Cornett et al. (2002) describe Section 20 subsidiaries. Section 20 of the Glass-Steagall Act was originally interpreted as prohibiting Federal Reserve member banks from being affiliated with any organization engaged in underwriting or dealing in securities. In 1987, prompted by several court cases during 1963–1987, the Federal Reserve Board changed its interpretation of Section 20 to allow banks to own subsidiaries to earn revenue from certain “bank ineligible” securities as long as revenue from such securities did not exceed 5% of the subsidiary’s revenue. Over time, the set of permissible securities was expanded and the revenue limit rose. By the late 1990s (just prior to the passage of the GLBA) the revenue limit was 25%.

⁸ In related work, Cornett et al. (2006) find that while industry-adjusted operating performance of merged banks rises after the merger and large mergers produce greater gains, activity focusing mergers produce greater gains than diversifying ones. Their measure of focusing vs. diversifying is based on the preannouncement correlation in the merging firms’ stock returns, which is another example of a broad measure of diversification.

⁵ Cash-only financing also survives in the horse races, but we consider this to be a control variable. Andrade et al. (2001) show that, in general, cash financing is associated with higher CARs.

Download English Version:

<https://daneshyari.com/en/article/5088949>

Download Persian Version:

<https://daneshyari.com/article/5088949>

[Daneshyari.com](https://daneshyari.com)