THE WALL STREET JOURNAL.
WSJ.com

BUSINESS | SEPTEMBER 30, 2008

Industry Is Remade in a Wave of Mergers

By ROBIN SIDEL and DAMIAN PALETTA

The notoriously fragmented American banking system is going through a decade's worth of consolidation in a matter of weeks, with the U.S. government often acting as matchmaker.

At the end of last year, the three lenders that are now the largest in U.S. banking -- Bank of America Corp., J.P. Morgan Chase & Co. and Citigroup Inc. -- collectively held 21.4% of all U.S. deposits. Now, with this month's government-backed sales of the banking assets of Washington Mutual Inc. to J.P. Morgan and of Wachovia Corp. to Citigroup, the Big Three instantly have a combined 31.3% of U.S. deposits.

For more than a decade, banking experts have predicted an industry that is shaped like a "barbell" -- a few big banks at one end, thousands of tiny ones at the other and little in the middle. But that trend played out slowly, because many middle-tier banks were able to stay independent thanks to a robust economy. Now, with the financial crisis spreading, that middle tier of banks is starting to disappear.

"The consolidation is a natural part of credit cycles," said Sheila Bair, chairman of the Federal Deposit Insurance Corp. "This is what happens when you get into credit turmoil."

The consequences of this warp-speed consolidation will likely reverberate for years. For customers, it means less choice and the potential for higher fees as the big banks get more pricing power, further pressuring smaller rivals. For the economy and government officials, the very size of these banks means they should be better insulated from big shocks because their business lines are so diverse. But it also means these banks now may be seen as too big to fail. That notion could lead banks to take big risks if they think they'll be bailed out if they fall on hard times.

Supercompressed

The deals of the last two weeks are a supercompressed version of the events that happened over 10 years in Japan. More than a decade ago, Japanese banks were damaged so badly from loan problems caused by reckless lending to property developers and a plunging stock market that the government spent nearly $440 billion in tax money to bolster them, and nationalized the sickest ones to prevent a panic in the financial market. The government prodded various banks to merge but the process took years. Now, these banks are bigger and healthier. In a twist of fate, one of the creations of the forced consolidation in Japan, Mitsubishi UFJ Financial Group, clinched a deal Monday to acquire 21% of Morgan Stanley & Co.

In the U.S., consolidation still has a long way to go and could be painful if smaller banks fail to attract much-needed capital to stay independent.

"There are still more than 8,000 banks in this country and many of them have emerging issues in commercial real estate and commercial lending," says Charles Wendel, who runs Financial Institutions Consulting Inc., a Ridgefield, Conn.-based firm that advises banks. He predicts that as many as 1,000 banks will cease to exist -- through acquisition or failure -- over the next two years.

A slew of regional banks saw their stock prices get crushed Monday as investors worried about their prospects. National City Corp. of Cleveland, which earlier this year received a $7 billion capital infusion led by private-equity firm Corsair Capital LLC, tumbled 63% to $1.36 in 4 p.m. composite trading on the New York Stock Exchange. Sovereign Bancorp Inc., a mid-Atlantic lender that has been hit hard by its expansion into new markets, fell more than 72% to $2.33 a share. Fifth Third Bancorp, a regional lender based in Cincinnati, fell $7.05, or 43.6%, to $9.11 on Nasdaq.

The Best Hope

The best hope for many banks is for healthy institutions to snap up those that are struggling. Wells Fargo & Co., which has historically eschewed acquisitions, pored over the financial records of Wachovia and is now viewed as being on the prowl. Other regional players that are considered to be buyers are U.S. Bancorp of Minneapolis and PNC Financial Services Group of Pittsburgh. Representatives of Wells Fargo, PNC and U.S. Bancorp couldn't immediately be reached for comment.

"Any bank with a halfway decent board has to take the initiative. It's almost too late for some of them," Mr. Wendel said.

The shift of more deposits into the hands of the banking behemoths is already drawing ire from the nation's smaller players, which contend that the government is helping their bigger rivals at the expense of smaller institutions.

"If this latest crisis hasn't taught the policy makers anything, it should have taught them that big isn't better, and that if you create institutions that are too big to regulate and too big to manage, you are going to threaten the American taxpayer directly," said Camden Fine, chief executive officer of Independent Community Bankers of America, an industry trade group.

Some banking industry officials have begun calling for the government to temporarily raise deposit insurance limits, particularly at smaller institutions, because of fears about more depositors withdrawing cash quickly in what regulators are calling "silent runs."

'Systemic Risk'

At an emergency board meeting Monday at 6 a.m., the FDIC took the unprecedented step of citing "systemic risk" to intervene and assist Citigroup's acquisition of Wachovia Corp. The government entered into a loss-sharing agreement with Citi that will put the government on the hook for losses if the value of certain risky mortgages deteriorates precipitously.

The FDIC doesn't expect the collapse of WaMu or the near-collapse of Wachovia to cost the government money, but it establishes a growing pre-emptive regulatory philosophy that seeks to act quickly and prevent the escalation of the domino effect already occurring among financial institutions.

"The FDIC has always had an effect on the private sector by what it does," former FDIC Chairman William Seidman said. "You can say it picks winners and losers, that's true. It's inherent in its job."

The banking industry had undergone a wave of consolidation since the 1980s for several reasons, dating back to the savings-and-loan crisis and then picking up again after in-state banking laws were loosened last decade. In 1987, there were 17,345 federally insured banks and thrifts. In 1997, there were 10,924. Last year, there were just 8,534. But the most profound difference is that the consolidation appears to be happening only at the top of the industry -- and only in dire scenarios.

Mr. Seidman said the FDIC's action with Wachovia will only embolden investors or other banks that want government assistance in acquisitions.

House and Senate lawmakers are planning to redraw the regulatory landscape of the banking industry next year, and one issue that's likely to come under close scrutiny is the cap that prevents any bank from holding more than 10% of the nation's deposits after certain types of acquisitions. With three big banks now hovering around that cap and smaller banks needing saviors, it's conceivable that the longstanding resistance to the cap could evaporate.

Fallout for Consumers

That could result in some fallout for consumers. With fewer players, those banks will have more power to control prices that are paid for deposits. WaMu, for example, had been wooing new customers for months with unusually high rates on certificates of deposits. The thrift was still offering 5.00% on a one-year deposit as of Monday, according to BankRate.com. By comparison, J.P. Morgan, which typically doesn't chase deposits with aggressive rates, was paying 2.25%.

"WaMu had to pay above-market interest rates to attract deposits recently, but that strategy won't be necessary anymore," said a J.P. Morgan spokesman.

"Any time you see a large player in the field be acquired or go under, the effect on the consumer tends to be negative," says William McCracken, chief executive officer of Synergistics Research Corp., an Atlanta-based firm that conducts market research on the financial-services industry.

Small banks that competed with WaMu are already girding for competition from J.P. Morgan. Although J.P. Morgan is unlikely to match WaMu's CD rates, the big New York bank is expected to woo new customers with a slew of offerings that smaller institutions don't provide, such as wealth management.

Carol Kobuke Nelson, chief executive officer of Cascade Financial Corp., says she was deluged with questions from WaMu customers at a dinner party last weekend. The community bank based in Everett, Wash., competed head-to-head with WaMu and plans to emphasize its customer services and community activities when J.P. Morgan bursts into town.

"They certainly offer a broad array of products that we don't offer, but there's definitely a niche for community-banking services that we are trying to take advantage of," she said. Among other things, Cascade is hoping to attract former WaMu customers with its interest-bearing checking account.

Write to Robin Sidel at robin.sidel@wsj.com and Damian Paletta at damian.paletta@wsj.com