

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

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*Mergers and Consolidation Between Banking and Financial  
Services Firms: Trends and Prospects*

Walter W. Eubanks, Government and Finance Division

August 29, 2006

**Abstract.** In the 109th Congress, the Financial Services Regulatory Relief Act of 2006 (S. 2856), which is in conference with the House version of this bill, may have an impact on the concentration of financial services providers. It includes provisions that address the risks that large, complex banking/securities firms must confront in the new GLBA environment. The dynamics of consolidation combined with the commingling of financial services have made risk management more difficult for the services providers and their regulators.

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## **Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects**

**Updated August 29, 2006**

Walter W. Eubanks  
Specialist in Economic Policy  
Government and Finance Division

<http://wikileaks.org/wiki/CRS-RL30516>

# Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects

## Summary

Competitive, legislative, and regulatory developments in financial services in the United States have all contributed to significant industry changes. The landmark financial services legislation, the Gramm-Leach-Bliley Act (P.L. 106-102, GLBA) has been speeding ongoing changes in the U.S. financial services industry. Overall, it allows providers flexibility in responding to economic trends. Global and especially technological advances continue to affect the financial services industry in ways yet unforeseen. Such factors are part of the larger picture reflected in recent mergers among large banking organizations in Europe and Japan as well, and expanding or contracting product lines of domestic financial institutions.

Mergers of very large banking organizations in Europe and Japan move the size of single organizations to new heights. American providers of financial services are similarly growing through combinations, as exemplified by the fusion of J.P. Morgan into the Chase Manhattan companies, and the joining of Wachovia and First Union, not to mention the increasing span of Citigroup. BankAmerica acquired FleetBoston, to form the largest banking company in America and the second largest in the world.

Increasing diversification of financial services within single entities in the United States is occurring through acquisitions and internal development of new businesses. GLBA allowed new affiliations among banks, insurance, and securities firms and increased diversification within individual financial organizations. In response to this increased flexibility, many institutions have taken advantage of expanded organizational arrangements. Some have done so to marked advantage, while others have retreated from their diversifications. The most prominent backer of GLBA, Citigroup, has shed the insurance businesses it went to great lengths to acquire and validate through that law, and was cautioned in 2005 by the Federal Reserve on future expansions.

Specific changes for policy consideration depend on the predominant ways in which the financial system unfolds. GLBA clearly ended the isolation of the investment banking business from the commercial banking businesses through its repeal of the Glass-Steagall Act of 1933. The financing of Enron, WorldCom, Parmalat, and other questionable corporations through both securities and loans from prominent financial holding companies has called the commercial and investment banking combination of businesses into some question.

In the 109<sup>th</sup> Congress, the Financial Services Regulatory Relief Act of 2006 (S. 2856), which is in conference with the House version of this bill, may have an impact on the concentration of financial services providers. It includes provisions that address the risks that large, complex banking/securities firms must confront in the new GLBA environment. The dynamics of consolidation combined with the commingling of financial services have made risk management more difficult for the services providers and their regulators.

This report will be updated as developments warrant.

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# Mergers and Consolidation Between Banking and Financial Services Firms: Trends and Prospects

Two types of structural trends affecting banking and financial services firms have been prominent. First, there have been amalgamations of financial companies, including banks, into ever-larger entities generally within the same industries. Second, there has been increasing diversification of financial services offered within single entities, whether through acquisitions or internal development of new businesses, crossing industry lines. Ultimately, these size and product changes will shape the performance of the domestic and international financial systems. As nations gain experience with these changes, legislative and regulatory bodies in the United States and elsewhere will be maintaining oversight to evaluate possible effects. Volatility in the insurance and securities sectors adds impetus to changes in financial acquisitions as well. Problems of corporate governance in nonfinancial sectors have come to have a large role in the evolution of financial companies.

## Consolidation Worldwide

Consolidation is occurring not only in the United States, but worldwide. Varied factors are contributing. In Japan, a dominant factor is the belief that the nation requires larger institutions to ease recovery from serious financial difficulties. In Europe, the business philosophy is that cross-boundary transactions are increasing within the European Union, now with a largely common monetary system and set of business practices, and with former communist countries. The belief driving change in the United States is that organizations containing diversified financial services should have a place alongside compartmentalized financial services firms.

Much of the change, not only domestically but worldwide, is taking place through holding companies, which “hold” controlling stock positions in banks and other financial companies through two forms of absorption: merger and acquisition. Technically the term “merger” denotes one corporation purchasing another and absorbing it entirely into its own structure, while “acquisition” means one (holding) company buying another to “control” it. In this country, most financial fusions of large size take the form of an acquisition. Canada, too, has moved toward a holding company-based framework of financial firms’ acquisitions.

In the increasingly international financial economies of a computerized world, new institutions spring up while existing institutions, feeling threatened, assemble in defensive reaction. Prominent observers believe that large bricks-and-mortar providers of services and small, niche providers are the most likely to survive the onslaught of their new and more nimble competitors. Those in the middle, in size or

technology, might seem less likely to succeed in a volatile world of rising energy costs and interest rates. Changes under way in European Union financial regulation, including Financial Conglomerate and Investment Services Directives, are likely to increase pressures to consolidate across border geography and industry lines within the Union. Resistance to external acquisitions of financial firms in France, Germany, and Italy is dwindling, suggest that deals within the European Union will continue.

## The Biggest Mergers Worldwide

The government-sponsored fusion of Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan made the resulting trillion-dollar group nominally the largest banking organization in the world by assets. It and another Japanese firm created by merger as an alternative to collapse, Mitsubishi Tokyo, have kept that nation's institutions at the top of asset sizing. Japanese super-giants, and the European ones to a lesser extent, have emerged as the result not of strength but of weakness. Japanese banks, in particular, keep vast quantities of severely overvalued bad loans and investments on their books, calling into question their actual asset sizes and making them fall behind in operating results and market value. American institutions resulting from acquisitions are among the world's largest, as they were years ago. The U.S. companies Fannie Mae and Freddie Mac have grown to dominate their mortgage market without major acquisitions, however, by relying on governmental support. General Electric and Berkshire Hathaway, often treated as "nonfinancial" entities, appear among the largest businesses doing financial services as the result of acquisitions.

It is hard to compare the "sizes" of financial business that result from corporate deals and internal growth, when they are so varied. Banks, historically sized by assets, have become more interested in revenue-generating nonlending activities. Insurers share many of the assets-on-hand features of banks, except in their health lines, yet are subject to payouts on policies and thus might be sized by assets or revenues. Transaction-based firms such as securities broker/dealers and mortgage bankers try to minimize their own assets at risk, and thus are generally stratified by revenues or profits. Financial analysts often analyze businesses of any kind, including financial entities, by the value of their enterprise in the marketplaces for stocks and bonds: what investors believe the firm's activities are "worth." Multinational operations of every large financial company worldwide can move it up or down in comparative ranking when exchange rates shift. Thus, a variety of standards are used to construct **Table 1**, which is an approximation of the "sizes" of the world's largest financial firms.

Not all mergers succeed. One prominent example, called off before it happened, was of Deutsche Bank and Dresdner Bank in Germany. That proposed merger would have created a banking organization that would then have become the largest anywhere. Dresdner instead sold itself to the Allianz insurance firm in mid-2001, in a transaction that weakened the new buyer. Other mergers, here including that of Citigroup noted below, and abroad, which observers had anticipated would become successful have not worked out. Such marketplace downside phenomena do not raise

public policy questions if bankers accomplish the mergers within acceptable guidelines and do not cause national or international economic problems.

**Table 1. The World's Largest Financial Services Firms, 2004**

Name	Headquartered In	Principal Business(es)
Citigroup	USA	Banking/Securities
General Electric	USA	Industrial/Financial
American International	USA	Insurance
HSBC Group	United Kingdom	Banking
ING Group	Netherlands	Banking/Insurance
UBS	Switzerland	Banking/Securities
Royal Bank of Scotland	United Kingdom	Banking
JP Morgan Chase	USA	Banking/Securities
Berkshire Hathaway	USA	Insurance/Investments
BNP Paribas	France	Banking
Barclays	United Kingdom	Banking
Fannie Mae	USA	Mortgages
AXA Group	France	Insurance
Wells Fargo	USA	Banking
Credit Suisse Group	Switzerland	Banking/Securities
Morgan Stanley	USA	Securities
HBOS	UK	Banking
Allianz Worldwide	Germany	Insurance
Wachovia	USA	Banking
Mizhuo Financial	Japan	Banking
Societe Generale Group	France	Banking
Freddie Mac	USA	Mortgages
Merrill Lynch	USA	Securities
Banco Santander	Spain	Banking

**Source:** Adapted by CRS from Forbes.com data known as “The Forbes Global 2000.”

**Note:** Ranking is based on a composite metric for sales, profits, assets, and market value.

Should institutions grow so large as to become instruments of national policy, or pose systemic risks to their economies, however, they are “too-big-to-fail”: governmental intervention will almost certainly occur to assure their survival in case of difficulty. This is the financial situation of Japan. Its government has propped up enormous bad loans and investments in the financial system, consequentially encouraging mergers of banks and other financial companies through deposit insurance, tax, and regulatory mechanisms.

## **Mergers of Large Financial Institutions in the United States**

As for banking-based entities, fusions of U.S. institutions beginning in the mid-1990s significantly changed the country’s financial institutions both in size and diversification of services. The buoyant economic environment, with its richly valued stock prices, encouraged corporate deals of all kinds, including in finance.

U.S. banking law changed to encourage large amalgamations by market extension across America, coast-to-coast or regionally. Major financial legislation: the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328) envisioned these mergers. That act provided the statutory authority and set the framework for bank holding companies to acquire banks outside their home states and for banks to secure branches on an interstate basis. As a result, the share of industry assets of the ten largest U.S. banking organizations essentially doubled in the decade ending in 1999, before a major statutory incentive noted below. Meanwhile, financial industries remain much less concentrated than many others.

In notable deals, the most prominent was the formation of Citigroup, which uniquely mixed domestic and international financial services of many kinds. It anticipated P.L. 106-102, discussed in more detail below, in its combination of banking, securities, and insurance businesses into one holding company. Its formation predated enactment of that law that would ratify all of its deals, because it had received a special regulatory exemption from the Federal Reserve. Citigroup also expanded by acquisition along traditional lines, including recent deals for European American Bank, Golden State Bancorp in California, and Banamex in Mexico, and into the securities and insurance businesses. The complex formation of J.P. Morgan Chase included the former Chemical taking over Chase Manhattan, several securities businesses, and then J.P. Morgan before changing its name. Name change also occurred after Wachovia absorbed First Union, the latter having been on a value-destroying path of multiple acquisitions. Insurance companies, too, are engaging in mega-mergers, most notably the acquisition of American General by American International Group and of Lincoln Re by Swiss Reinsurance Co.

Bank of America startled the world of finance by announcing fusion with FleetBoston Financial to create a banking company holding 10% of U.S. banking deposits. The expanded institution is a truly nationwide bank, along lines envisioned in the Riegle-Neal Act of 1994, and yet touching upon that law’s national deposit share limit of its 10%. Its announcement sparked a wave of mergers among smaller



bank-based companies, as well as of J.P. Morgan Chase buying Bank One. Deal flows of this, as most, industry sectors have accelerated into early 2005.

Such mergers are important steps in the evolving deregulation of the traditionally tightly limited commercial banking and insurance industries, even while finance began shifting away from bank loans and deposits to securities throughout America. Investment banking and other securities firms have become perhaps even more important than traditional commercial banking to acquirers. Antitrust concerns over geographic concentration of traditional banking products remain, however: the Justice Department has required divestiture of branches as a condition of some recent banking fusions. Antitrust concerns embody societal views that banks should provide customer services in an atmosphere of some competition: customers ought not to be charged much more for or be discouraged from financial services because of declines in numbers of providers. Many believe that financial fusions have disadvantaged individuals and small businesses upon creation of large, complex financial organizations lacking a community orientation. Securities and insurance companies might siphon funds away from localities even further, in that view.

## **Expanding Lines of Business for U.S. Financial Companies**

Industry observers expected a wave of growth and diversification among United States institutions following ongoing application of legislation enacted in 1999: the Gramm-Leach-Bliley Act (P.L. 106-102, GLBA). That law eases affiliations among banking, insurance, and securities firms in the U.S., including those owned by foreign parties, and increases diversification within individual financial organizations. Most prominently, GLBA followed the fusion of Travelers Insurance with the bank holding company Citicorp, which would eventually would have to dissolve unless legislation would allow the combination of banking with insurance under one roof. Responding to the increased flexibility in GLBA, institutions have been rapidly making new organizational arrangements.

GLBA has several provisions easing diversification by financial services companies. Structurally, companies subject to bank regulation may expand their array of financial products through several options. GLBA provides for a financial holding company option and a financial subsidiary option. A new mechanism is also in place for the Federal Reserve and the Department of the Treasury to decide what is an appropriate financial activity, besides activities authorized by name in GLBA.

Companies wishing to expand services through a holding company framework have more latitude to do so post-GLBA. In that measure, Congress repealed provisions of the 1933 Glass-Steagall Act that had long precluded the affiliations of banks and securities firms, and parts of the 1956 Bank Holding Company Act that formerly precluded affiliations of banks and insurance underwriters. Bank holding companies wishing to become financial holding companies (FHCs) file notice of their election to choose new status with the Fed, as do foreign banks under a modified procedure. FHCs have since grown to prominence. More than 600 domestic and foreign financial firms of all sizes have become FHCs. Securities-

based investment bank holding companies, such as Merrill Lynch, have similar potentials under Securities and Exchange Commission regulation.

Another way for commercial banks wishing to expand product lines directly is through the creation of financial subsidiaries (FS). This arrangement allows banks to own companies doing financial activities that the banks may do, directly, or more significantly, activities that banks may not otherwise engage in directly. Banks wishing to do so follow the certification and notification procedures prescribed by their primary federal regulator, most prominently the Office of the Comptroller of the Currency, which charters and regulates national banks. The Federal Reserve and the Federal Deposit Insurance Corporation govern FS of state banks. An institution's chartering authority, whether the OCC or a state, must also permit contemplated activities. Many FS are insurance agency subsidiaries.

An unforeseen aspect is that despite GLBA's encouragement, fusions of insurance and banking companies have not been going on rapidly. Volatile, often low, returns on many lines of insurance underwriting (policy-writing) and investments deter bankers. The property-casualty sector in particular remains unattractive for most FHCs not only following the events of September 2001, but also because it lacks a nationally uniform system of regulation such as depository institutions enjoy. The prototype FHC, Citigroup, reversed its course to exit the property-casualty underwriting business by divesting Travelers Insurance. In contrast, profits in the insurance field are generally greater and more predictable in the sales or agency capacity that banks often undertake through subsidiaries, because policy losses do not negatively affect sales commissions.

Insurance companies themselves have been moving very slowly into the banking field following the example of MetLife becoming a FHC in 2001. Securities firms are, conversely, taking on full-service banking, especially Merrill Lynch, which has come to have major deposits in the banks it controls under GLBA. Momentum may be gathering for both nonbanking industries increasingly to fold banks into their operations, especially if economic uncertainties keep the attractiveness of federally insured deposits as safe assets high in comparison with securities.

Competition measured as numbers of providers nationwide seems likely to continue its decline. Overcapacity in financial businesses became reduced over time before GLBA through consolidation. In sectors except securities, the top ten firms have increased their share of assets since the mid-1990s while the number of participants shrank. The number of commercial banks fell from about 25,000 before World War I to less than 8,000 recently. Securities brokers and dealers numbered more than 9,500 in 1987 and have likewise declined in number. (Investment "firms," however, if defined to encompass investment advisors, asset managers, mutual funds, hedge funds, etc. have grown over time.) Life insurance underwriters fell from about 2,200 in 1985 to less than 1,600 in 2000. Today's approximately 3,000 property-casualty insurers are generally expected to fall by perhaps one-third. Most U.S. savings and loan associations vanished years ago, through waves of supervisory mergers — like the Japanese mode that increasing size can paper over bad loans — as well as by collapse. Fewer than 1,500 such "thrift institutions" remain.

Customers generally believe that enough providers to serve them, at least for transacting business across political boundaries such as many insurance and securities companies have historically done. Even for mortgages, the historical major and locationally limited products of savings and loan associations, a national market developed through brokers and other parties for this financial product — even though the number of associations shrank sharply because of losses and failures of firms.

Simultaneously, nonfinancial providers offer new customer choices relating to financial services. Consumers may use financial services through software products offered by nonfinancial providers. While Internet-only banking has not been a great success to date, offerings of online access to bricks-and-mortar financial institutions have proven viable. Various kinds of businesses are also linking their products to other services, directly for advertising revenues or for a slice of transactions as “agents.” Such new products are increasing competition for business in this sense.

In other expansions into non-traditional businesses, banking companies have taken on trading in the kinds of derivatives that Enron marketed. UBS Warburg, a unit of diversified banking company UBS of Switzerland, beat out Citigroup to take on Enron’s failed trading operations. The Office of the Comptroller of the Currency has allowed a large national bank to initiate trading in energy derivatives. The Federal Reserve has allowed FHCs to enter further into agricultural and energy-related commodities derivative businesses. Using a provision of GLBA known as “merchant banking,” which allows FHCs to invest in nonfinancial businesses, Bank One acquired the camera and imaging businesses of the failed Polaroid Corporation.

Restructuring and growth for its own sake in a revitalized economy seem to characterize many transactions. Financial business transactions remain prominent. **Table 2** presents the year-to-date industry rankings of the ten largest industry sectors involved in merger activity, in which financial business deals appear. (General merger and acquisition activity remains far below its crest in 1999, however.)

**Table 2. Top Ten Industry Line Merger and Acquisitions, Year to Date 2005, by Number and Value of Deals**

Classification	Number of Deals	Value of Base Equity Price, \$ Billion
Household Goods	8	\$54
Communications	106	42
Retail	75	23
Computer Software, Supplies and Services	385	22
Oil and Gas	29	20
Drugs, Medical Supplies, and Equipment	81	16
Miscellaneous Services	232	13
Broadcasting	117	12
Insurance	69	12
Banking and Finance	59	11

**Source:** Mergerstat.com proprietary data.

**Note:** Figures are as of April 4, 2005 and change weekly.

Regulators are already implementing a mode of containment of risks that may arise from new financial activities, such as limits on direct investments of banking companies via merchant banking. That practice involves taking a direct equity position in businesses as part of financing them, a Wall Street/venture capital practice allowed for FHCs in GLBA. Similarly, the Federal Reserve's clarification of "firewalls" that define proper transactions inside FHCs that banks can make with riskier nonbank parts of the same organization, in "Regulation W," may restrain both risks and returns from diversification within FHCs. Insurance interests have contested GLBA's bank insurance sales provisions in court filings recently, while other insurance provisions and interactions between depository institutions and commercial firms remain open.

In the 109<sup>th</sup> Congress, financial holding companies' activities were a critical focus of the Financial Services Regulatory Relief Act of 2005 (H.R. 3505) and the Financial Services Regulatory Relief Act of 2006 (S. 2856). Both bills were passed by their respective houses, and a conference is in the process of ironing out their differences. The provisions of these bills address the interactions between depository institutions and commercial firms, and reaffirm the regulatory authority of state insurance supervisors. Another bill, H.R. 111/S. 98, seeks to keep bankers from moving into the field of real estate.

Two "mega-mergers" in the commercial banking sector increased concentration of industry assets in America as a whole. They are Bank of America purchasing FleetBoston Financial, and J.P. Morgan Chase purchasing Bank One. Both were presented to stockholders, regulators, and customers as improvements in providing bank-related financial transactions across America, spreading the businesses into many new states, and increasing the sizes of the firms for efficiencies. Some questioned their effects on localities and smaller clients, however.

**Table 3** presents pre- and post- acquisition amounts of corporate assets, and shares of total industry assets of these three largest U.S. banking entities. Data are presented of the third quarter of 2003, before parties announced the first of these transactions. Measures of economic concentration in general analytical use include, among others, this "three-firm seller concentration ratio." (Antitrust analysis brings additional, more complex, measures into determining anti-competitiveness from mergers.) **Table 3** shows actual figures, and summed results as if the deals had occurred at the time. When bankers consolidate, they typically close branches and lay off employees. In reaction to such cost-saving contraction, many customers seek other financial providers. Post-transaction assets will thus be less than the sum of both partners' resources.

**Table 3. Top Three Bank Holding Company Assets, as Reported for the Buyer Alone and After Adjustment for Deals**

Company	Total Assets, \$ Billions		Share of Assets of Bank Holding Companies, %	
	Before	After	Before	After
Citigroup Inc.	\$1,208	\$1,208	13.9%	13.9%
J.P. Morgan Chase and Co.	792	1,083	9.1	12.5
Bank of America Corp.	737	933	8.5	10.7

**Source:** “Bank and Thrift Holding Companies with the Most Assets on Sept. 30, 2003,” *American Banker Online*, January 29, 2004; “Report on the Condition of the U.S. Banking Industry, Third Quarter, 2003,” *Federal Reserve Bulletin*, Winter 2004, p. 51; computations by the Congressional Research Service.

**Note:** The aggregate bank holding company asset series used as a divisor for the last two columns excludes very small companies.

Of the \$8.7 trillion of such bank holding company assets on September 30, 2003, the largest three firms held 31.5%. Adjusted by summing assets, disregarding customer loss, these firms would have collectively held a 37.1% national asset share. That figure represents a significant increase in the asset concentration of banking services nationally. Industry rankings remain the same when adjusted.

Observers believe that these mega-mergers will encourage a wave of consolidation and, thus, increase resource concentration in banking. For example, Regions Financial announced its deal for Union Planters a few months later, seeking to create a peer FHC. This sector remains more competitive than most others in the economy, however, if viewed through the lenses of other antitrust criteria because of its many providers and the many financial services available from nonbank providers and over the Internet.

## Risk Management

The dynamics of consolidations combined with the commingling of financial services have made risk management more difficult for the services providers and their regulators. In the GLBA framework, where services such as banking, insurance, and securities trading are provided by a single institution, the responsibilities of regulating financial institutions are more complicated because the regulators no longer have the separation of the lines of businesses that they had in the past. Driven by technological advances and competition among providers, new products have helped to erase the traditional lines of demarcation in financial services that the regulatory structure and markets were built upon. Bank regulators, for example, continue to lower barriers to bank entry into commodity futures and options businesses, and insurance has become a popular bank product. Rules and regulatory requirements concerning these products often fall under the supervision of multiple

regulators. As bankers have gotten more involved in the securities business, the business has changed, causing risk management issues to fall under the jurisdiction of bank regulators and the Commodity Futures Trading Commission (CFTC). But, most regulatory changes have occurred after the risks have risen sufficiently to show the deficiencies. Consequently, regulators are now placing great emphasis on improving credit-risk management, developing and improving their methods of measuring risk on a transaction-by-transaction basis. These methods are attempts to better quantify risk and establish more formal and disciplined processes to recognize price and manage risk.

## Banking

To ensure compliance to federal regulators' risk management requirements, bank regulators have been moving from the traditional regime of periodic examinations to in-house examiners. The Office of the Comptroller of the Currency, and the Federal Reserve System, for example, have placed resident examiners in the 24 largest national banks. These examiners, and specialists in areas such as commercial and retail credit, capital markets, bank technology, and asset management, provide the regulators with real-time risk management information. In addition, the federal regulatory agencies are in the rulemaking stage of implementing the Basel II capital accord as well as modifying the existing capital accord, Basel I, to make them more sensitive to the changing risk in banks' portfolios. Under the Basel risk-based system, each asset's probability of default is estimated in each line of business, such as mortgages, consumer loans, credit card, and automobile loans. Given the probability of default, the agencies require the banks to keep the appropriate level of capital on hand. A similar methodology is set up for commercial paper as well as derivatives, equities, and bonds.

## Insurance

Banks and insurance and securities firms sell deferred annuities, term life insurance and property-casualty, to individuals and commercial entities. Consequently, most of these financial services providers have become proficient at managing the risk inherent in these products. Consolidation is taking place within each sector as banks general merge with banks and insurers with insurers. However, risk management in the insurance business has evolved along similar form in both the banking and insurance sectors. For example, risk sharing is a common risk mitigating technique used by bankers and insurers. The institution finances its risks, either directly or through an insurer or reinsurer, by selling bonds to institutional investors. The payment of interest or principal depends on the occurrence or severity of the insured event. Finite risk insurance is an established risk management tool. These are multi-year, multi-peril, and/or multi-trigger coverages that combine self-financed reinsurance protection and an agreement that the reinsurer will not cover losses above a specified amount. This risk management tool reduces earnings volatility for the insured and limits the reinsurer's exposure. In addition, insurers and bankers are active in the credit risk transfer market, where insurers are net protection sellers and banks are net protection buyers. While these instruments may enhance the efficiency and stability of credit risk, they tend to be complex and lack transparency. Consequently, supervisory authorities have been introducing more complex requirements to make these transactions more transparent.

## Securities

Like the insurance industry, with the exception of exchanges, significant consolidation has not taken place in the securities industry. However, the development of financial instruments that incorporate characteristics of banking and insurance products has also complicated risk management in the securities industry. Furthermore, over-the-counter instruments such as swaps, caps, collars, and floors are increasingly popular alternatives to exchange-traded instruments. Exchange-traded instruments are standardized contracts for a fixed amount, delivered at a specified date at a particular location. Over-the-counter instruments are custom designed to reflect specific needs of the participants. These instruments are one-on-one arrangements, with a fee-earning broker who could be attached to a securities firm, an insurance company, or a bank. Many of these instruments are not transparent, have default risk exposure, and have limited risk protection, and they are legally enforceable contracts.

Risk management — defined as the limitation of the risks faced by an organization due to its exposure to changes in financial market variables — has been a significant force behind recent changes in the business pursuits of a number of the firms. For example, a number of firms have significantly increased their involvement in proprietary trading or trading for their own accounts, wide ranging trading that can range from domestic equities, to derivatives, to foreign securities. Some firms have also significantly boosted their presence in the private equity market by taking direct investment stakes in worldwide enterprises. In the last few years, a number of firms have become brokerage intermediaries for hedge funds. And in an attempt to lure back the institutional investor trades, a number of securities firms have become increasingly willing to commit their own capital to help facilitate the institutions' large block trades. Recently, the New York Stock Exchange and the NASDAQ Exchange each merged with a electronic-based securities trading rival. And due in part to concerns that the consolidations could provide the two exchanges with an opportunity to boost their trade transaction fees, a number of Wall Street firms have acquired stakes in smaller, rival regional stock exchanges to reduce the risk of higher transaction cost from the larger exchanges.