No Denying Dodd-Frank's Role in Bank M&A

Donald J. Mullineaux

What's the relationship between increased financial regulation and industry consolidation? In his March 31 commentary in *American Banker,* J.V. Rizzi contends that there is none. Contrary to the evidence provided in a recent Harvard Kennedy School working paper, Mr. Rizzi suggests that the Dodd-Frank Act — and regulation in general — does not underpin merger and acquisition activity. Rather, he says, banking acquisitions are primarily driven by economies of scale.

This is a bit like arguing that cigarette smoking does not cause cancer, since we have evidence that exposure to the sun and other forms of radiation are cancer-causing agents. Just as there are many causes of cancer, banks have multiple motivations for mergers.

Empirical studies of the link between regulation and mergers must try to account for all of the relevant causal factors, which is quite a difficult exercise. As researchers love to say, more work needs to be done to unravel the relationship between regulation and M&A. But there is no case for ruling out regulation as a prospective driver.

Mr. Rizzi also fails to appreciate that the imposition of new regulations like those engendered by Dodd-Frank can actually be a source of economies of scale. The reason why is that some of the costs associated with regulatory compliance are fixed costs, meaning that they do not vary with the activity level or size of the bank. Spreading fixed costs across a larger asset base is a common rationale for the existence of scale economies.

Federal Reserve governor Daniel Tarullo recognized this point explicitly in a May 2014 speech at the Federal Reserve Bank of Chicago. "Any regulatory requirement is likely to be disproportionately costly for community banks, since the fixed costs associated with compliance must be spread over a smaller base of assets," he said.

Governor Tarullo has been equally vocal about the economic costs associated with the potential demise of community banks, stating in the same speech that "community banks are of special significance to local economies" and that "the disappearance of community banks could augur a permanent falloff in this kind of credit [small-business loans], at least a portion of which may not be maintained in the more standardized approach to lending, characteristic of larger banks."

Much ink has been spilled in academic journals trying to explain the phenomenon of "merger waves," in which M&A activity clusters during well-defined time periods, only to erode at later dates. Once again, there are multiple possible explanations for this occurrence. But a leading candidate for the cause of waves is an "industry shock."

Such a shock can be defined as an unanticipated development or event that significantly alters the cost and or revenue structure in a particular industry. The most frequently mentioned shocks in the literature relate to technology, regulation, and deregulation.

It's hard to argue that Dodd-Frank was anything other than an unforeseen banking industry shock. Therefore, the law contains the potential to continue producing a substantial volume of new mergers.

Donald J. Mullineaux is chairman of the board of the Federal Home Loan Bank of Cincinnati and emeritus duPont chair of banking and financial services at the University of Kentucky's Gatton College of Business and Economics.