Coleman Fung Center Grant Proposal:

Will BHC Mergers with Nonbanking Financial Firms Generate Risk Reduction and Failure Reduction Benefits for TBTF Institutions?

Konstantin Magin, Principal Investigator

Haas School of Business, University of California, Berkeley

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1. Project Summary

In 1999 the United States Congress lifted many restrictions prohibiting mergers between commercial banks, investment banks, brokerages and insurance companies, thus partially repealing the Glass-Steagall Act of 1933. The motivation behind the reform was clear: to make financial institutions safer and more profitable by allowing them to diversify across activities. But some argue that this deregulation is at least partially responsible for the recent financial turmoil. They support, for example, the implementation of the Volcker Rule, prohibiting banks from (among other activities) engaging in proprietary trading.

This research is focused on modeling and quantifying the potential effect of the reform both on risk and on the probability of bankruptcy of newly diversified financial institutions for the period of 1998-2012.

The financial landscape has changed dramatically since 1999. The largest bank holding companies (BHCs) are no longer pure commercial banks as they used to be. Most of them have moved into nonbanking services, including securities and insurance brokerage. So methodologically it is no longer possible to use pure commercial banks as an approximation for BHCs, since most of the existing BHCs are now diversified financial institutions. At the same time, some of the nonbanking financial institutions became BHCs. So it is hard now to isolate pure commercial banks, investment banks, securities brokerages and insurance brokerages. Surprisingly, however, with few exceptions, there is relatively little involvement of BHCs in insurance underwriting. Therefore, it is possible to isolate pure insurance companies and to calculate the variance of their return on assets (ROA) and their covariance with BHCs. I will use simulated merger methodology and individual firm data to pair existing diversified BHCs' with life insurance companies and casualty insurance companies. This project will calculate risk-minimizing and probability-of-bankruptcy-minimizing institutional weights for life insurance and casualty insurance underwriting using data for 1998-2012 to see if there are still unexplored diversification opportunities. My working hypothesis is that BHC mergers with insurance companies will generate risk reduction and failure reduction benefits for TBTF institutions.