On the Existence of Synergies in Universal Banking

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Abstract

The existence of synergies between different banking activities is subject to research and controversy within the financial industry. Analyzing a global sample of 230 banks, we find a strong and robust negative effect of income diversification on value creation in banking. Moreover, we show that universal banks suffer from a significant and persistent conglomerate discount, which implies that the value creation within universal banks is less than if the different banking activities were conducted separately. Therefore, we conclude that the potential synergies arising from the combination of different banking activities do not compensate for agency costs associated with universal banking.

JEL-Classifcation: G21, G24, G32, L21, L25
Keywords: Universal banking, conglomerate discount, bank diversification

Executive Summary

Problem

The majority of the world's leading banks offer a wide range of financial services. The purpose of this so-called *universal banking* model is to realize synergies between different banking activities. However, while some banks become diversified universal banks, other banks compete successfully by focusing on one banking activity.

The existence of synergies between different banking activities is subject to research and controversy within the financial industry. So far, research on the benefits of combining different financial services within universal banks provides ambiguous answers depending on the underlying methodology. However, we identify two major weaknesses of the existing studies:

- The existing studies use similar variables to measure value creation and diversification as studies on non-financial companies and thus neglect bank-specific characteristics. Moreover, accounting distortions are in general not taken into account.
- Due to data constraints, business portfolios of universal banks are not analyzed based on the common definition of universal banking.

Hypothesis

The main goal of this thesis is to provide an answer to the question of whether synergies actually exist on an aggregate basis by improving the existing models. The resulting hypothesis to be tested in this thesis is the following:

- *On an aggregate basis, there exist no synergies between the different banking activities in universal banking portfolios.*

Thus, the focus of this paper is not on analyzing all individual benefits of combining different financial services, but rather to concentrate on the net gains of universal banking.

Methodology

To answer this question, we analyze the value creation of a global sample of 230 banks over the period from 2002 to 2010 using accounting and market data obtained from *Bloomberg*. We apply bank-specific accounting adjustments in order to better reflect the economics of banking and to correct for distortions. Moreover, we calculate the corresponding banking portfolios using revenue segment information provided by *Bloomberg*. The underlying assumption of our model is that, *ceteris paribus*, a higher value creation of universal banks compared to focused banks implies net benefits (i.e. aggregate synergies) resulting from the combination of different banking activities.

Results

First, we find a strong and robust negative effect of income diversification on value creation in banking. Thus, our results contradict the findings of Elsas, Hackethal and Holzhäuser (2010), who find a positive impact of revenue diversification on bank profitability. This discrepancy can be attributed to our improved approach in calculating banking portfolios and to our bank-specific accounting adjustments.

Second, we show that universal banks suffer from a significant and persistent conglomerate discount, which supports the findings of Laeven and Levine (2007). These results imply that the value creation within universal banks is less than if the different banking activities were conducted separately.

Moreover, we find indications that universal banks exhibit negative financial synergies, as measured by the cost of equity. However, because of data limitations and the strong assumptions that underlie our model, these findings should be interpreted with caution, hence only providing a direction for further research.

Conclusion

We conclude that the synergies arising from the combination of different banking activities do not compensate for agency costs associated with universal banking. Thus, after improving the existing models, our hypothesis can clearly not be rejected.

However, as argued by many advocates of universal banking, it seems compelling that there are *some* synergies between different banking activities. Therefore, for bank shareholders as well as for researchers, the main focus should be on identifying and efficiently mitigating conflicts of interest between shareholders and managers, and consequently on minimizing the agency costs arising from universal banking.