What should regulators do about merger policy?

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Abstract

I argue that merger policy needs to be driven by different considerations in Europe, Japan and the United States. In Europe the main challenge is to set up a system so that efficient consolidation can occur once the single currency is established. In Japan the policy ought to be directed towards trying to attract foreign institutions to acquire under-capitalized domestic institutions. Japan does not seem to be taking this route. In the US consolidation it is already occurring and the current policy should be continued. © 1999 Elsevier Science B.V. All rights reserved.

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The policy challenges for bank regulators in the late 1990s are very different in Asia, Europe and the US. Indeed, perhaps the biggest challenges right now are in developing countries in South East Asia. But to keep the discussion from going too far afield, I will confine my discussion to the issues relevant to the developed countries whose firms dominate international banking.

Japan’s situation is the most serious of these countries. The Japanese financial system is in deep trouble and at this point I believe that the merger
policy is partly to blame. I see three salient facts about Japan’s banking crisis. First, Japanese banks remain the largest in the world. For instance, the most recent data that I can find (which comes courtesy of the American Banker and pertain to year-end 1996) suggest that seven of the 10 largest banks in the world are Japanese. While size alone is hardly a cause for concern, it does become a problem when the largest institutions are not profitable.

The second key fact about Japanese banks is that they are amongst the least profitable in the world. For instance, in 1996 there were 69 banks in the Fortune Global 500. All of the Japanese institutions in the list rank in the bottom half of the distribution in terms of profitability; most are in the bottom quartile. With each passing quarter the profit outlook in Japan looks even bleaker. It is not clear how much further things can deteriorate but as of mid-1998 no one thinks we have reached the bottom yet.

Finally, and most problematically, it is not clear how or why the situation will improve. Put bluntly, the large Japanese banks appear to have no major areas of comparative advantage vis-à-vis other major global banks. Indeed, when I have asked senior Ministry of Finance officials what they see as a source of comparative advantage for the largest Japanese banks, the answer that I have been given is “taking deposits from Japanese savers and making loans to Japanese firms”. While putting numbers on something like comparative (or competitive advantage) is difficult, it is hard to think of a single important product line where the major Japanese banks are the world leaders.

To sum up I see Japanese banks as holding a dominant position in the Japanese financial sector, but they are stuck with extremely low levels of profits and there is little evidence to suggest that there is any easy path for recovery available. To me this implies that some exit from the industry is inevitable. The fear is that Japan’s financial problems will persist until some of the assets in the system are redeployed. I am unaware of any other examples where the dominant firms in an industry lost their profitability and comparative advantage but did not eventually shrink.

Unfortunately, I believe that the current merger policy in Japan seems driven by the desire to avoid such adjustment. To an extent this is true that the current policy is seriously misguided. The costs to the Japanese economy of delaying the rationalization of the financial sector are not known with any precision. But there are reasons to believe that the poor health of the banking system is one of the main causes of the nearly seven years of anemic aggregate growth in Japan.

My first piece of advice to policymakers is that the money that has been pledged to buy preferred share in Japanese banks ought to be redirected. The first priority ought to be making sure that depositors are completely assured that they will not lose any funds. The next priority ought to be making sure that no more money is wasted trying to protect the managers and shareholders of the poorly run institutions. Indeed, the regulatory energy that is being...
expended to keep all the major institutions a float ought to be refocused to trying to engineer a smooth transfer of assets out of the system.

The most obvious mechanism for an orderly transition would be a set of sales to foreign financial institutions. Fortunately for Japan the combination of a relatively weak Yen and a buoyant US stock market has made such acquisitions feasible. The good news is that there have already been some deals of this type involving the securities firms. I see the agreements between Merrill Lynch and Yamaichi Securities and the Travelers Group and Nikko Securities as two examples demonstrating that foreign buyers remain quite interested in Japan.

The bad news is that these agreements take two firms that conceivably could have been tapped to help recapitalize the banks out of the pool of potential bidders. There is certainly a limited number of firms that have both a strategic interest in building a Japanese presence and the financial resources to pay a premium to enter the market. For the banks to become attractive targets there must be a commitment by the regulators to move to a more transparent set of rules and to stop trying to manage market forces. In particular, the regulators would have to be willing to let a foreign owner shed employees and lines of business for an acquired bank. It is hard to say how long the the exchange rate and stock market levels permit these opportunities to continue. It would be the last and perhaps most costly in a series of blunders if this opportunity is passed up because the Ministry of Finance is unwilling to face the realities of the current situation.

Turning to Europe, I see a different set of challenges. With the impending monetary union I believe there will be intense pressure for banks around Europe to become more competitive. There are still wide differences in the efficiency of banks across the different “European” countries. In the short-run, I think there will be enough headaches with the shift to EMU that some differences can be papered over for a little while. Over the course of several years, however, I think consolidation and a transfer of assets towards the more efficient institutions is also inevitable in Europe.

To the extent that European banking consolidation involves many cross-border transactions, I see potential political problems. More specifically, given the pressure to protect local markets I anticipate considerable tension arising as the efficient institutions try to takeover and reorganize some of the more poorly managed banks. I wonder whether the politicians will be willing to step back and watch a set of large-efficient European banks to develop if doing so means that in some countries the leading banks will all be foreign.

As a benchmark, the city of Chicago (and state of Illinois) stood on the sidelines and watched as essentially all of its major financial institutions were acquired. There was relatively little political carping over this transformation. Can you imagine the French or Italians letting the same thing happen?

Moreover, there is some very intriguing recent empirical work by Sapienza (1998) that suggests that this type of transition justifiably will generate some
controversy. Sapienza analyzes a unique Italian data set that looks at individual banks and customers. Using this micro data she is able to trace the impact of a merger on the path of credit flows going to individual customers of the acquired bank.

While there are many noteworthy findings in her paper, perhaps the most interesting for these purposes is what she finds when a large bank enters a new market by taking over a smaller bank. Her results imply that the customers of the smaller bank see reductions in credit flows that are not warranted purely on the basis of their riskiness. In particular, she finds that the small firms that are the customers of a small bank which is acquired are significantly more likely to see a disruption in credit than are customers of banks involved in other types of mergers. Her regressions attempt to control for the borrowers creditworthiness, so the findings suggest that certain customers are systematically squeezed during mergers.

While the full welfare-effects of these results are yet to be determined, the results do suggest that there is likely to be a great deal of protest from small businesses if a merger wave gets started. The fact that Sapienza’s careful empirical work suggests that these objections may be partially justified is bound to give some politicians cover in trying to block the mergers. I therefore encourage policymakers to commit funding and make data available to researchers who are trying to determine the total costs and benefits of these kinds of acquisitions. In particular, the kind of micro data used by Sapienza also exists in other European countries. We have enough time for the research community to generate some results in advance of the debate if the resources are committed now.

Finally, turning to the US I see that the main challenge for merger policy is to get out of the way. It seems clear now that the idiosyncratic geographic restrictions on diversification are gone, that more consolidation will occur in the US. It is also pretty much settled that we will let this continue; I certainly believe that this is correct policy.

As I see it the more interesting policy question for the US is how do we regulate a banking system which is simultaneously populated with a number of huge, global institutions and 1000s of tiny financial intermediaries? Unfortunately, these organizations are both called banks and are bound by the same rules. I think the challenge is to design a system that mimics the discipline that would be imposed by a market but deals with the reality that what makes sense for $100 billion banks may not make sense for $100 million dollar banks.

One might be tempted to say who cares about keeping close tabs on the small banks. The problem is that there are other pressures that are blurring the line between banking and other financial services. So we are slowly seeing a convergence in many of the products being offered by different organizations. We have to be careful to not set up incentives for other firms to take advantage of loose rules for banks with low levels of assets. The last thing we want is to
encourage firms to set up banks to engage in non-traditional banking activities, just because of a regulatory arbitrage opportunity. While I see this as a difficult policy question, it really is much broader than the topic of merger policy.

References