EFFECTS OF BANK MERGERS AND ACQUISITIONS ON SMALL BUSINESS LENDING

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The opinions expressed do not necessarily reflect those of the Federal Reserve Board or its staff.
A SIMPLE QUESTION

• Are bank mergers and acquisitions (M&As) good or bad for lending to small and medium enterprises (SMEs)?
  – Do they increase or decrease credit availability?
• Seems like a simple question, but it is not.
  – Generated 100s of research studies, more in process.
• Answer differs by types of banks, SMEs, countries, etc.
  – In some cases, have fairly solid research results.
  – In other cases, have to extrapolate somewhat.
• Key tool in analyzing the findings is a conceptual framework that is supported by the research.
  – Framework helps draw conclusions with different degrees of certainty in different circumstances.
OUTLINE OF DISCUSSION

• Research evidence on mergers and acquisitions (M&As) on lending to small and medium enterprises (SMEs).
  – Whether they increase or decrease credit availability for these firms.

• Focus on key results in the literature.
  – Not enough time to review individual studies or all the findings.

• Give references for some papers on which the presentation is based for more details.
OUTLINE (2)

- Discuss the conceptual framework used in reviewing the research.
  - Framework is itself a product of the research.
    - Based on theoretical and empirical evidence on what banks and firms do in different economic environments.

- Framework also helpful for formulating questions that are likely to give the most informative answers about the effects of M&As on SMEs.

- In addition to whether M&As increase or decrease credit availability for SMEs, we ask:
  - Which types of banks are involved in M&A?
  - Which nation?
  - Which types of SMEs?
  - Responses of other banks?
OUTLINE (3)

- Brief “view from afar” of some important Asian nations.
  - China, India, Japan.

- Less is known than about U.S. & Europe, but extrapolate using the conceptual framework.

- Two important cautions!
  - 1. I am not an expert on Asia.
  - 2. Reminder: Opinions are not those of Federal Reserve!
CONCEPTUAL FRAMEWORK

- Ownership type and size of bank in the M&A matters.
  - Foreign, private domestic, or state-owned.
  - Large versus small bank.

- Nation’s lending infrastructure matters.
  - Accounting standards, creditor protection, regulation.

- Type of SME matters.
  - Firms with strong or weak financial statements.
  - Firms with or without access to good collateral.

- Other banks in the market matter.
  - May respond to M&A by supplying more or less SME credit.
  - May respond with more or less de novo entry.
DETAILS OF FRAMEWORK

• Lending technologies for SMEs differ primarily by the information used in the bank’s loan decisions.
  – Hard, quantitative data versus soft, qualitative and judgmental information.

• Financial statement lending based on strong financial statements (hard).

• Fixed-asset lending based on equipment, motor vehicles, or real estate taken as collateral (hard).

• Relationship lending based on qualitative information (e.g., owner’s character and reliability) gathered over course of bank-borrower relationship.
  – Other hard and soft technologies not shown here.
DETAILS OF FRAMEWORK (2)

• Different types of banks have comparative advantages in different lending technologies.
  – *Large* versus *small* banks,
  – *Foreign* versus *domestic* banks,
  – *State-owned* versus *private* banks.
DETAILS OF FRAMEWORK (3)

• Large banks have comparative advantage in hard-information lending technologies.
  – Economies of scale in processing hard information like financial statement data, values of fixed-asset collateral.

• Small banks have advantage in soft-information lending technologies.
  – Diseconomies of scale in processing soft information.
  – Easier for small banks to “know” SMEs, their owners, and local communities.
  – Difficult to transmit soft information like the quality of the SME owner through the communication channels of large organizations.
DETAILS OF FRAMEWORK (4)

• Foreign banks have comparative advantage in hard-information lending technologies in developing nations.
  – Better access to and experience in hard-information lending technologies than domestic banks.
    • Citicorp technology, experience versus local bank in developing nation.

• Advantage is reversed in developed nations.
  – Little difference in technologies and experience than large, domestic banks.
  – Added problems of distance, multiple economic, cultural, language, and regulatory environments.
    • Citicorp versus large, domestic banks in Paris, Berlin, or Tokyo.
• State-owned banks appear to be generally poor at providing credit to SMEs.
  – Lack of market discipline due to access to government subsidies.
  – Political pressures to misallocate credit.
  – State-owned banks only extensively studied in developing nations.
  • Poor performance also likely holds in developed nations, given findings for state-owned enterprises in other industries, such as telecommunications.
DETAILS OF FRAMEWORK (6)

• Comparative advantages are important for analyzing M&As because M&As often transform bank type:
  – Small banks into large banks,
  – Domestic into foreign banks,
  – State-owned into private banks.

• Individual SMEs may be efficiently served using only a subset of the lending technologies.
  – May not have strong financial statements;
  – May not have fixed assets to pledge as collateral.
  – May gain or lose credit availability from M&A, depending on whether the advantages in the firm’s efficient technologies are enhanced or destroyed.
DETAILS OF FRAMEWORK (7)

• Nation’s *lending infrastructure* also important:
  – Rules/conditions affecting bank lending, competition.
    • Accounting/information environment,
    • Legal, judicial, and bankruptcy environments,
    • Social environment,
    • Regulatory environment.

• Infrastructure affects feasibility/profitability of using technologies.
  – Financial statement lending requires accurate financial statements.
  – Fixed-asset lending requires strictly enforced creditor rights to seize collateral.
  – Relationship lending requires social norm of honesty.
DETAILS OF FRAMEWORK (8)

• Lending infrastructure also affects market shares of banking industry.

• Restrictions on foreign bank entry.
  – Reduces market shares of foreign banks.
    • May reduce SME credit availability for firms most efficiently served by foreign banks.
  – May also reduce competitive threat for domestic banks.

• Government ownership of banks.
  – Increases market shares for state-owned banks.
    • May reduce SME credit availability generally, given the poor performance of this bank type.
RESEARCH RESULTS

• **Conventional M&As**: M&As of private domestic banks.
  – Transforms small banks into large banks.
  – No change in ownership type.

• **Net gain for SMEs efficiently served by hard-information lending technologies** (e.g., financial statement lending, fixed-asset lending).
  – Large banks better able to serve them because of scale economies in processing hard information.

• **Net loss for SMEs that must rely on soft-information lending technologies** (e.g., relationship lending).
  – Large banks suffer scale diseconomies in processing soft information, may discontinue relationships.
RESEARCH RESULTS (2)

• For all M&As, the response of other banks matters, but often not included in the research.
• In the U.S., this has been studied for conventional M&As.
• The overall net effect of conventional U.S. M&As on SME credit availability is approximately zero!
  – Total SME credit by the merging banks declines.
  – Approximately equal increase in supply by other banks.
    • Incumbent banks in the market increase their SME lending.
    • De novo entry of new small banks that tend to make many SME loans.
  – These types of responses likely also occur in other nations, but they are probably much smaller because lending infrastructures are less competitive.
RESEARCH RESULTS (3)

• **Foreign takeovers**: Purchase of a domestic bank by a multinational banking organization, usually a large domestic bank.
  – Transforms domestic banks into foreign banks.
  – Size of bank in the nation unchanged, but increases total size of the organization.

• Results differ for developing and developed nations.
RESEARCH RESULTS (4)

• Foreign takeovers in developing nations:
  – Net gain for SMEs efficiently served by hard-information lending technologies.
    • Foreign banks have better access to and experience in these technologies.
  – Unclear for SMEs that rely on soft-information lending technologies.
    • May have loss because foreign banks are poor at these technologies.
    • May have gain if foreign banks import hard-information technologies that may be efficiently applied for these firms (e.g., credit scoring).
  – Overall empirical results for developing nations show net gain in credit availability when foreign market share is higher.
  – Even stronger positive effect for removal of restrictions on foreign entry, suggesting positive effects of competition on domestic banks.
RESEARCH RESULTS (5)

• Foreign takeovers in developed nations:
  – Possible slight negative effect on SMEs.
    • Likely little change in SME operations of large banks they acquire.
    • Foreign banks at a disadvantage in both hard- and soft-information lending technologies for these firms.
    • Distance, regulatory differences, strong competition from domestic large banks.
RESEARCH RESULTS (6)

• Privatizations: Sales of state-owned banks to domestic private or foreign banking organizations.
  – Transforms state-owned banks into private domestic or foreign banks.
  – Size of bank unchanged.
  – Increases total size of the organization if foreign sale.

• Developing nations:
  – Many types of SMEs likely gain in the long run, given poor record of state-owned banks.
  – Short run empirical results show small amount of progress.

• Developed nations:
  – Not much evidence on banks, but likely positive effects based on other industries.
VIEW FROM AFAR OF ASIA

• Less is known than about U.S. & Europe, but we extrapolate using the conceptual framework.

• I am not an expert – I am on my first working papers on China, India, and Japan.

• Reminder: Opinions are not those of Federal Reserve!
CHINA

• Chinese banking dominated by “Big Four” state-owned banks, many others are partially or fully state-owned.
• Started to partially privatize many of the banks, including the Big Four, and sell minority shares to major foreign banking organizations.
• Preliminary research suggests that the efficiency benefits of partial privatizations are high.
• No current evidence on their SME credit availability.
  – However, the efficiency evidence, plus extrapolation from the conceptual framework and experience of other developing nations, suggest positive long-run effects of the partial privatizations.
India similarly has very large state-owned banks with large market shares.

Has a small foreign shares and explicit barriers to expansion of foreign banks.

Some evidence that state-owned banks are poor at SME lending relative to private domestic banks.

Extrapolation from the conceptual framework and experience of other developing nations suggests would have positive long-run effects of privatizing the state-owned banks and removing explicit barriers to foreign banks.
JAPAN

- Japan also has a small foreign bank presence.
  - Probably makes little difference to SME credit availability because Japan is a developed nation.
    - Framework suggests foreign banks at a disadvantage in all technologies for SMEs in developed nations.
- No state-owned commercial banks, but Japan Post controls large share of deposits.
  - Press accounts of the battle over privatization last year suggest that funds mostly are invested in government bonds to finance public projects, rather SME loans.
  - Extrapolation from conceptual framework would also suggest long-run increase in SME credit availability from privatization.
  - However, I would certainly not make policy suggestions when I am the least informed person in the room!
PAPERS ON WHICH PRESENTATION IS BASED

Conceptual framework.

PAPERS (2)

U.S. applications.

PAPERS (3)

European applications.


PAPERS (4)

Latin American applications.


Asian applications.

- Berger, A.N., L.F. Klapper, M.S. Martinez Peria, R. Zaidi, Bank Ownership Type and Banking Relationships, working paper.
- Berger, A.N., C.H.S. Bouwman, H. Uchida, Bank liquidity creation in the U.S. and Japan: Different countries, different policies, different outcomes, working paper in progress.
THANK YOU!

• Thank you to the conference organizers for inviting me and thank you to the audience for listening.

• I hope that this has been informative.