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‘Too systemically important to fail’ in banking – Evidence from bank mergers and acquisitions

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A B S T R A C T

In this paper, we examine the systemic risk implications of banking institutions that are considered ‘Too-systemically-important-to-fail’ (TSITF). We exploit a sample of bank mergers and acquisitions (M&As) in nine EU economies between 1997 and 2007 to capture safety net subsidy effects and evaluate their ramifications for systemic risk. We find that safety net benefits derived from M&A activity have a significantly positive association with rescue probability, suggesting moral hazard in banking systems. We, however, find no evidence that gaining safety net subsidies leads to TSITF bank’s increased interdependency over peer banks.

1. Introduction

Bailouts of large financial institutions, in particular banks, have always caught the attention of the public due to their high social and economic costs (Stern and Feldman, 2004; Giannetti and Simonov, 2010). The term ‘too-big-to-fail’ (TBTF) was first used in a US congressional hearing in 1984 to justify the decision to bail out Continental Illinois National Bank (incurring a $1.1 billion expense to the Federal Deposit Insurance Corporation – FDIC) and also to 10 other large US banks that would have been rescued in the event of failure (Carrington, 1984).

The recent financial crisis between 2008 and 2009 provides a timely case study for TBTF effects in EU banking sectors. Large scale banking rescues occurred in all major EU economies and those rescued banks appear as natural candidates for a TBTF study as their failures would have posed systemic risk to

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the real economy (Petrovic and Tutsch, 2009). In addition, European banking markets have experienced far-reaching structural changes over recent years as part of the process of European integration which could have exacerbated TBTF effects. These changes are reflected in greater product and geographical diversification (Barros et al., 2005; Laeven and Levine, 2007) facilitated by mergers and acquisitions (M&As) between banks and other financial institutions that have become commonplace (ECB, 2000; Goddard et al., 2007).

However, as banks can grow substantially via merger and acquisition (M&A) (Hawkesby et al., 2007), deals undertaken by these large EU banks may not only increase their market value but can also offer evidence for the existence of safety net subsidies associated with TBTF (e.g. Carbó et al., 2011; Penas and Unal, 2004). There are also concerns that these EU banks' mergers can affect financial stability (Hagendorff et al., 2012b). First, systemic risk may increase as institutions become more interdependent due to similar business lines, investment portfolios, and common exposures after consolidation. Due to such interdependency, when a large bank fails, its problems may be contagious and rapidly infect counterparties; in turn, this may pose a threat to the stability of the economy. Second, when banks engage in M&As they can become more complex (i.e. bancassurance or conglomerates) and this may lead to greater opacity posing challenges for regulators (Carbó et al., 2011). Larger and more complex banks may find it easier to exploit regulatory loopholes without being monitored appropriately. Finally, cross-border M&As within the EU may also complicate issues further as uncertainties regarding the jurisdiction of national safety net arrangements and coordination problems between regulators may arise (Hagendorff et al., 2012a). Evidently, all of the three pan-European banks that failed in the crisis (Dexia, Fortis and ING) received some form of financial assistance from different EU member state governments.[1]

While the term TBTF may appear a misnomer - in some cases bailed-out banks have not been particularly large (Kaufman, 2003), from a regulatory perspective a bank's systemic importance, in other words, the complexity of the business model, connectivity to others as well as size, is the main consideration in a bail-out rather than size *per se* (Bank of England, 2009; IMF/BIS/FSB, 2009). To avoid confusion in terminology we will use the term TSITF in the remainder of this study, broadly encompassing TBTF and 'too-systemically-important-to-fail' institutions. We present an overview of the literature in Table 1, grouped according to the type of TSITF measure employed (asset size, market capitalization, market shares, rating and so on). The more recent reflect on the insights gained from the 2008–9 crisis and consequently consider a wider range of attributes such as business complexity, wholesale banking activities, substitutability of services, in addition to size when assessing systemic importance.

This paper contributes to the literature in two important ways. First, we develop an innovative approach to extract a measure of safety net subsidies from an auxiliary regression model, which examines the determinants of bank merger premiums. Previous M&A studies either fail to disentangle other incentives to consolidate (efficiency gains, enhanced market power, reduced agency costs) from potential safety net subsidies (Pennacchi, 2000), or only test the safety net subsidy effects associated with one specific factor such as size and ignore other factors that may explain such subsidies including phenomena such as: political clout, managerial opportunism, relaxed market monitoring and organizational flexibility (Kane, 2010).[2] Our approach, however, is capable of stripping out safety net subsidy gains broadly defined in M&As. Second, although the literature has documented a gradual increase in systemic risk in the EU over the past decade or so (Hawkesby et al., 2003, 2007; Brasili and Vulpes, 2005; Gropp and Moerman, 2004), Kane (2010) suggests that typical measures of systemic risk, namely indicators of interdependency between TSITF banks, have not enabled regulators to diagnose the root cause of financial distress correctly. In other words, regulators have been unable to effectively

[1] Dexia was rescued for the second time in September 2011 by a support program coordinated between French, Belgium and Luxembourg authorities.

[2] For example, Brewer and Jagtiani (2007) relate banking merger premiums to acquiring banks' size change dummy variables. They argue that the amount of premiums paid for reaching certain size thresholds reflects the perceived benefits of safety net subsidies. Some, however, propose that acquiring banks will obtain safety net subsidies when they pay more for targets that have greater covariance with their own profitability (as well as higher profit variance) (Hagendorff et al., 2012a; Benston et al., 1995). These studies, however, find no evidence to support this hypothesis.

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