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Too big to succeed? Banking sector consolidation and efficiency

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ABSTRACT

This study examines the effect of banking sector consolidation on bank profit and cost efficiency using data from Japan. Our analysis shows that bank merger events have little impact on profit efficiency, but significantly lower cost efficiency. This suggests that government-coordinated consolidation of banks, especially in a post-crisis environment, results in less cost efficient entities, although the bottom line of profit efficiency is maintained. Our analysis of changes in banking sector competitiveness over the same period suggests that these merged banks are able to maintain their "bottom line" due to increased market power.

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1. Introduction

With the global banking sector more consolidated than ever in the wake of the 2008 global financial crisis, the question of how banking sector consolidation affects efficiency is more important than ever. Research suggests that there are strong incentives for banks to consolidate. For example, U.S. banks

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that are "too big to fail" enjoy higher credit ratings (Morgan and Stiroh, 2005) and banks are willing to pay a premium for mergers that place them in that category (Brewer and Jagtiani, 2011). But there is some evidence that large banks tend to be less efficient than small banks (Berger and Mester, 1997; Bonin et al., 2005; Matousek, 2008; Papadopoulos, 2010; Sufian, 2010). Size considerations aside, the role of regulators in arranging mergers may be a significant factor. In the United States in the 1980s, for example, Peristiani (1997) found that FDIC-assisted mergers tended to reduce cost efficiency. In response to the wave of bank consolidation following the global financial crisis of 2008, regulators worldwide are openly discussing whether and how to limit banks from becoming "too big to save" (The Economist, 2011). This study aims to inform the policy debate by providing empirical evidence on how commercial bank mergers affect banking sector profit and cost efficiency.

This study addresses this question using the case of Japan in the wake of its own financial crisis in the late 1990s. The efficiency of Japan's banking sector has been explored in work by Altunbas et al. (2000), Assaf et al. (2011), Drake and Hall (2003), Drake et al. (2009), Harimaya (2008) and Uchida and Satake (2009), but investigations on the effects of bank mergers on efficiency have focused on small credit associations (Yamori and Harimaya, 2010) or mutual banks (Yamori and Harimaya, 2009). This is the first comprehensive study to investigate the question of how commercial bank mergers affect bank profit and cost efficiency in Japan.

Japan's experience with banking sector consolidation may be relevant to other economies affected by the 2008 crisis because Japan is one of the few developed economies with a large presence in the global banking sector to have experienced a banking crisis in recent history and many of the policy responses taken in Japan bear similarities to those of U.S. policy makers in the aftermath of 2008 (Hoshi and Kashyap, 2010). Like the mergers of the U.S. banks in 2008, the rapid consolidation of the Japanese banking sector after Japan's banking crisis in the late 1990s was helped along, implicitly or explicitly, by regulators.

The rest of this paper is organized as follows. Section 2 describes some of the institutional detail of Japan's banking sector before and after its concerted consolidation around 2000. Section 3 presents the methodology and data used to measure the profit and cost efficiency of each bank. Section 4 reports our main empirical results and Section 5 presents additional analysis of banking sector competitiveness to help interpret those results. Section 6 concludes.

2. The Japanese banking sector, 1996–2009

Table 1 overviews Japan's banking sector during the period 1996–2009. One thing evident from Table 1 is that the Japanese banking sector has experienced considerable change since 1996.

In 1996, the original ten city banks,[1] combined with Japan's seven trust banks and three long-term credit banks made up the famous "top 20 large banks" which dominated the banking sector, accounting for nearly 70% of total bank assets. But while the city, trust and long-term credit banks dominated in size, by far most of the banks fell into the smaller regional or regional II bank categories. In 1996 the regional and regional II banks accounted for more than 80% of the total number of banks in Japan, but only 30% of the market as measured by total assets.

Since that time, the total number of banks has shrunk by 21% (31 banks out of a total 148 in 1996). Nearly a half of that total has been bank failures. The changes seen in Table 1 are not all failures, and also reflect considerable merger activity and turnover. Old banks, including the specific cases mentioned above, often failed or were nationalized, but were then absorbed into existing banks or merged into completely new banks. Many of the failed regional II banks were absorbed by the other regional banks.

While the total number of banks has been steadily falling, the total assets of the banking sector has been relatively stable, leaving Japan's banking sector even more concentrated than it was at the start of the sample. Reflecting some of the structural changes discussed above, the market share of small banks, those with total assets of less than 1 trillion yen, has gradually shrunk over the sample period.

[1] Changes in the banking sector are eroding the meaning of such divisions, but with rare exception banks in Japan still fall into five distinct categories: trust banks, long-term credit banks, and three kinds of commercial banks – city banks, regional banks and regional II banks.

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