

Chapter V

The effects of consolidation on efficiency, competition and credit flows

1. Introduction

The liberalisation of financial markets and the accelerating development of information technology have increased competition both within and across industries. In particular, the lowering of geographical barriers and the increasing integration of financial markets pit against each other banks, insurance and asset management companies that used to operate in segmented markets. In response to this process, financial institutions attempt to improve the efficiency of existing operations and to expand into new markets, trying to build a competitive advantage in a new environment.

Mergers and acquisitions (M&As) allow financial institutions to rapidly increase their size and to improve their knowledge of new products and markets, thereby allowing them to attempt to exploit economies of scale and scope, to preserve falling margins by increasing market share and to attract new customers. M&As on the scale witnessed by the financial sector in the last decade have profound effects on the firms involved, their competitors and their customers, in particular households and small firms, for whom changing providers of financial services is more costly.

M&As can result in larger and more diversified firms; however, this does not necessarily mean that these firms are run more efficiently. In order to assess the impact of consolidation on the performance of financial institutions, the first section of this chapter defines what is meant by efficiency improvement; it then examines the evidence available regarding the effect of consolidation on the efficiency of financial institutions in the G10 countries.

Consolidation might increase the market power of financial institutions, thus leading to prices above (and volumes below) those prevailing in a hypothetical situation of perfect competition. The effect of consolidation on competition depends on several factors, such as the characteristics of the deal (eg in-market or out-of-market), the type of customers (local or international) and the degree of contestability of the markets involved. In the second section, the possible effects of consolidation on competition are analysed. Particular attention is given to ongoing fundamental developments in financial markets that have raised questions about the continued importance of the geographic markets identified under traditional antitrust policies. Existing empirical research is examined in order to assess the impact of M&As on competition. In addition, the main features of actual antitrust policy in the G10 countries are reviewed and a few relevant case studies are presented.

In many countries the process of consolidation of the banking system has involved a large number of small banks, raising fears that the reduction in the number of these institutions may affect the availability of credit to small firms that traditionally rely on bank credit. When consolidation occurs, the larger bank resulting from the merger is able to expand its lending capacity with respect to larger borrowers, and it may restructure its portfolio, discontinuing credit relationships with smaller borrowers.

In the section on the effects of consolidation on the availability of credit flows, the relative importance of small firms for G10 countries is briefly examined. After discussing why consolidation may adversely affect credit flows to small businesses, the existing empirical

evidence is reviewed. The effects of changes in size and organisation that result from consolidation on the propensity of participating banks to make small business loans are analysed, as is the behaviour of other market participants that might provide financing to the borrowers that have been rejected by the banks involved in M&As.

2. Consolidation and efficiency

The financial services sector is transforming itself in response to fundamental changes in regulation and technology. Financial institutions respond by attempting to improve their efficiency and by searching for new customers, increasing the range of products they offer and their geographical reach.

M&As are one way of implementing these strategies; however, the effect of consolidation on the performance of the institutions involved is not always clearly positive. After defining what is generally meant by efficiency improvement, the impact of consolidation on the performance of financial institutions is gauged on the basis of a review of the evidence available for G10 countries regarding the effect of M&As on the efficiency of financial institutions.

How do we measure efficiency?

Efficiency is a broad concept that can be applied to many dimensions of a firm's activities. According to a narrow technical definition, a firm is cost-efficient if it minimises costs for a given quantity of output; it is profit-efficient if it maximises profits for a given combination of inputs and outputs. These definitions take size and technology as given and focus on how production factors are combined; they both measure managerial efficiency (the optimisation of existing resources), as opposed to the more comprehensive concept of technological efficiency.

Technological efficiency considers scale and scope economies: an efficient firm is one that reaches the optimal size for its industry (scale) and that produces the optimal mix of products given the prices of their production factors (scope). The minimum efficient size and optimal product mix vary with technologies, regulations and consumers' tastes. Therefore, there should be wide variations in firm structure across time, industries and countries if firms fully exploit scale and scope economies.

The definitions call for different measurement methodologies. The simplest approach consists of comparing balance sheet ratios that describe costs (eg operating costs over gross income) and profitability (eg return on assets or on equity). However, this methodology does not fully take into account the complexity of the financial industry. More complex analyses measure managerial cost and profit efficiency by comparing firms to the best practice of the industry, as determined by statistical methods, taking into account for each institution its inputs, outputs and the prices it faces. A frontier (a combination of the factors just mentioned) along which all efficient firms would operate is estimated, then the distance of each actual firm from the frontier is taken as a measure of its (in)efficiency.¹⁷⁹

In order to evaluate economies of scale and scope, the shape of the frontier, given by the existing technologies, is investigated: if the performance of firms on the frontier (ie firms that optimally combine the existing resources) would improve by changing their size or product mix, then there is still room for exploiting economies of scale or scope.¹⁸⁰

¹⁷⁹ This method should be considered with a certain degree of caution, given that it is based on the presumption that the residuals of the estimated frontier (usually thought of as what cannot be explained) are highly correlated with the managerial inefficiency of the banks.

¹⁸⁰ For a review of estimation techniques, see Berger and Mester (1997).

The impact of M&As on firm-level efficiency can be gauged by comparing firms along different dimensions. For example, several studies investigate the relationship between size and cost efficiency. The results provide indirect evidence on the effects of mergers: if larger firms are more efficient, then presumably mergers will improve performance. This methodology suffers, however, from a weakness: it assumes that merged institutions are largely comparable to other larger firms; but the fact that some firms are involved in a merger while others are not is an indication that they may be different in several (possibly unobservable) ways. Analyses that focus on the performance of merged institutions compared with the performance of the non-merged ones are more reliable and provide direct evidence on the relationship between M&As and efficiency.

The two approaches are complementary; both provide information on the consequences of the consolidation process on competition and efficiency. Research has usually been conducted by analysing indirect evidence, mainly because of problems of data availability.

Finally, for firms listed on a stock exchange, efficiency gains can be measured on the basis of stock market performance: a firm is thought to be doing well when its shares outperform a given benchmark (the industry average or an index of firms of comparable size). The overall efficiency gains from a merger are evaluated in terms of the sum of the market values of the bidder and the target: if the sum increases, the deal is supposed to create value, and vice versa if it decreases.

Differences in regulations, institutions and market structure across countries mean that conclusions drawn from the analysis of one country should be generalised to others only very carefully. This also means that common patterns that might eventually emerge from an international comparison are particularly informative for a policy debate.

Commercial banks

Before analysing the empirical evidence, a few warnings on the commercial banking industry should be given. First, the industry really consists of two markets, retail and wholesale banking; retail banking is oriented towards households and small firms, while wholesale banking caters to larger firms and other financial institutions. Of course, many banks provide both services, but this only adds to the complexity of the analysis. In general, research has not distinguished explicitly between retail and wholesale banking, although the focus is implicitly on retail banking, where policy issues regarding competition, regulation and consumer protection are more relevant. The remainder of the section is mainly concerned with retail banks.

Second, in countries with a heavily bank-oriented financial system, the banking industry may evolve differently than in countries where there is more scope for securities markets, both in terms of products offered and risk management. This should be kept in mind when comparing cost and revenues structures and economies of scale and scope. In countries with well-developed financial markets, banks provide more services than just loans and deposits and are more able to offload risks, thus maintaining more liquid balance sheets; they may behave differently from banks that rely more on the traditional intermediation business.

Finally, because of differences in regulation, in some countries commercial and investment banks are (or have been in the past) strictly separated, while in others they can operate jointly as universal banks and even have cross-shareholdings with industrial companies. These differences make for different market structures and internal organisations, again hampering international comparisons. All these warnings notwithstanding, the banking industries in G10 countries do share some structural features that emerge from a careful analysis.

As most, although not all, M&A activity has taken place so far within country borders, the large majority of research is carried out at the domestic level. Most papers deal with efficiency, scale and scope issues indirectly, by comparing firms of different size; a few papers look directly at the evidence on mergers, analysing ex post improvements in performance. The following

summary of the aggregate data introduces a review of empirical papers that deal with issues of consolidation and technical and managerial efficiency for commercial banks.

Aggregate data

Similarities and differences among North American, European and Japanese banks emerge from the comparison of simple balance sheet ratios. The relationship between the cost structure and size of North American and European commercial banks shows some similarities: the ratio of operating costs to gross income is higher for smaller banks (with total assets below USD 5 billion) and it decreases from over 60 to around 55% for banks with assets between USD 20 and 50 billion (see Table V.1).

Table V.1
Size and performance of commercial banks

Area	Variables	< USD 5bn		USD 5-20bn		USD 20-50bn		> USD 50bn	
		No	Average	No	Average	No	Average	No	Average
Europe	Non-int. income (% of gross income)	539	19.2	169	24.6	50	20.2	64	30.8
	Operating costs (% of gross income)	543	63.1	183	61.6	55	55.6	63	65.5
	Return on equity	559	7.1	185	7.4	48	7.2	58	8.2
North America	Non-int. income (% of gross income)	266	21.5	97	29.2	29	28.2	19	53.4
	Operating costs (% of gross income)	266	60.9	96	59.8	29	55.4	19	67.8
	Return on equity	266	11.2	97	13.5	29	13.5	19	14.1
Japan	Non-int. income (% of gross income)	15	0.4	63	9.2	29	8.9	26	30.0
	Operating costs (% of gross income)	17	76.9	63	69.5	29	67.9	26	60.4
	Return on equity	17	1.3	63	0.1	29	0.5	26	3.2

Source: Fitch-IBCA data for commercial banks of G10 countries; banks are ranked by assets in USD billions. All variables are averaged over the 1994-97 period; the distribution is truncated at the top and bottom 10%.

The largest banks, with assets greater than USD 50 billion, present the highest costs (more than 65% of gross income). This pattern points to the existence of economies of scale up to a certain size, followed by diseconomies for very large banks. However, profitability rises with total assets: for North American banks the return on equity increases from 11 to 14% from the first to the fourth class; for European banks it increases from 7 to 8%.¹⁸¹ Higher operating costs are

¹⁸¹ Return on equity, unlike return on assets, is influenced by the capital structure of the bank; however, given that the capital structure is endogenously determined by the bank's management, it can also be considered as part of the measurement of efficiency.

compensated by a lower ratio of equity to total assets, probably an indirect benefit of increased diversification, and by a higher share of non-interest income (more than 50% of gross income for North American banks, more than 30% for the others). For Japanese banks the picture is more straightforward: the ratio of operating costs to gross income decreases as firms become larger; profitability is low or negative because of the deteriorating economic and financial conditions of the country in the mid-1990s.

As for managerial efficiency, the dispersion of cost and profitability ratios is a good proxy for the distance between the best and the worst performers. In North America, among banks with less than USD 5 billion of assets, the costs of those in the top quartile represent 55% of gross income and the return on equity is above 15% (Table V.2).

Table V.2
Dispersion of performance measures of commercial banks

Area	Variables	< USD 5bn		USD 5-20bn		USD 20-50bn		> USD 50bn	
		Best quarter	Worst quarter	Best quarter	Worst quarter	Best quarter	Worst quarter	Best quarter	Worst quarter
Europe	Non-int. income (% of gross income)	23.7	14.2	32.1	15.1	31.9	13.3	37.3	23.9
	Operating costs (% of gross income)	57.5	68.7	53.4	70.4	34.4	69.3	58.0	73.8
	Return on equity	8.8	5.4	9.7	4.7	9.0	5.6	9.9	4.8
North America	Non-int. income (% of gross income)	26.2	25.3	34.2	24.4	35.7	22.6	74.5	38.1
	Operating costs (% of gross income)	55.1	65.7	55.5	64.5	55.2	64.5	63.6	74.1
	Return on equity	15.2	7.7	17.4	10.1	16.5	11.2	15.5	13.0
Japan	Non-int. income (% of gross income)	13.6	3.5	11.2	7.0	9.8	7.3	41.3	24.9
	Operating costs (% of gross income)	68.2	75.8	66.8	72.2	63.1	71.3	55.8	64.7
	Return on equity	3.2	-9.8	3.6	-4.0	3.7	-0.3	-2.0	-4.3

Source: Fitch-IBCA data for commercial banks of G10 countries; banks are ranked by assets in USD billions. All variables are averaged over the 1994-97 period; the distribution is truncated at the top and bottom 10%.

For banks in the bottom quartiles of the cost and profitability distributions, costs are above 65% of gross income and the return on equity is less than half that of the best performers; the results are qualitatively the same for European and Japanese banks. The heterogeneity of results among banks of roughly the same size is an indication that there is room for large efficiency gains. For the largest banks, with assets above USD 50 billion, there is less heterogeneity, at least in North America (except for the share of non-interest income, which varies widely, perhaps due to the simultaneous presence of traditional intermediaries and more innovative banks). This could be due to the fact that the largest banks largely operate in wholesale markets where there is more

competition and less room for complacent behaviour. For European and Japanese banks, the differences between the top and bottom quartiles are similar to those recorded for the smaller banks; again, heterogeneity indicates room for efficiency improvement.

Cost and profit efficiency

Most studies of cost efficiency find that retail banks operate on average at between 10 and 20% below the efficient cost frontier, ie their costs are higher by 10 to 20% than those of the best institutions.¹⁸² This result holds across countries, suggesting that the gap between the best and the average practice is fairly stable. Efficiency is almost always measured relative to a domestic benchmark, as international comparisons are difficult (because the best banks of each country operate with different technologies that are not directly comparable). A study of 2000 European banks covering the period 1993-97 (ie after the implementation of the European Union's Second Banking Directive of 1988 and the adoption of the Single Market of 1992) shows that, on average, costs could be reduced by 16%;¹⁸³ in the period examined, some countries – such as Italy, the Netherlands and the United Kingdom – achieved rapid cost efficiency improvements, while in other countries – such as France and Germany – banks have yet to start slimming down.

Estimates of profit efficiency are more dispersed, averaging around 50% (ie the average bank could be twice as profitable); however, they are also more sensitive to the specification used to measure them and are thus less robust. On average, this dispersion suggests that profits are more driven than costs by firm-specific factors such as management quality or unobservable characteristics of local demand.¹⁸⁴ Therefore, there is a high potential for improving the overall performance of an inefficient target by reducing costs or increasing revenues.

The studies that analyse the direct effect of M&As on banks' efficiency have been performed on the basis both of balance sheet ratios and of multivariate cost and profit functions. The evidence on the effects of the deals on cost efficiency varies by country. For the United States there is little evidence of any improvement in cost efficiency following a merger, although a few studies that use more recent data show that there are some gains.¹⁸⁵ The evidence for European banks is broadly consistent with these results: one study finds that domestic mergers among banks of equal size improve cost efficiency, but this result does not hold for all countries; cross-border acquisitions are associated with a reduction in the costs of the target, while no effect is found for domestic M&As.¹⁸⁶ The difficulties in improving cost efficiency are related to the obstacles encountered, especially in continental Europe, to reducing banks' labour forces. In fact, personnel reductions, one of the main sources of savings, are hardly an option in countries with rigid labour markets.

As for profit efficiency, research performed on US banks finds an improvement, due mainly to an increased diversification of risks.¹⁸⁷ Larger banks have more diversified loan portfolios; this may also be due to the recent lift of the ban on interstate transactions, which allowed banks from different states, each with geographically concentrated portfolios, to merge and thus

¹⁸² See for example Berger and Humphrey (1997) for the United States and Altunbas, Molyneux and Thornton (1997) and Schure and Wagenvoort (1999) for Europe.

¹⁸³ See Schure and Wagenvoort (1999).

¹⁸⁴ See Demsetz and Strahan (1997).

¹⁸⁵ See Berger (1998), Peristiani (1997) and Rhoades (1998).

¹⁸⁶ See Altunbas, Molyneux and Thornton (1997), Focarelli, Panetta and Salleo (1999) and Vander Vennet (1996).

¹⁸⁷ See Akhavein, Berger and Humphrey (1997), Berger, Hancock and Humphrey (1993), Berger, Humphrey and Pulley (1996), Berger and Mester (1997) and Clark and Siems (1997).

diversify their holdings.¹⁸⁸ The reduction in risk allows them to lend more per unit of equity, thus earning higher returns. In Europe, more efficient banks tend to acquire institutions in worse shape. Mergers have a positive impact on profitability, mainly driven by improvements in operational efficiency; however, deals that consist of the purchase of the majority of the voting shares of the target do not appear to result in significant improvements.¹⁸⁹ One study finds that Italian banks merge in order to change their business focus towards providing financial services and thus increase their non-interest income, rather than to obtain efficiency gains;¹⁹⁰ the increase of profitability that is observed after M&As is related also to a more efficient use of capital.¹⁹¹

The direct evidence on how M&As affect banks' performance is mixed. In general, better banks acquire banks in worse shape; there is then some improvement, especially on the revenue side and for the deals of the last decade.¹⁹² However, the gains are probably not as large as those advertised by practitioners; more time is needed to fully assess the effects of the more recent transactions, including those involving very large institutions.

Scale and scope economies

Perhaps the most commonly quoted source of potential gains from M&As is the exploitation of scale economies. Banks that significantly increase their size by merging with others may have the opportunity to access cost saving technologies or to spread fixed costs over a larger base, thus reducing average costs and improving profitability. Notice however that many of the same gains could be achieved by outsourcing typical back office functions.

Most research on the existence of scale economies in retail commercial banking finds a relatively flat U-shaped average cost curve,¹⁹³ with a minimum somewhere around USD 10 billion of assets, depending on the sample, country and time period analysed.¹⁹⁴ This suggests that efficiency gains from the exploitation of scale economies disappear once a certain size is reached and that there might be diseconomies of scale above a particular threshold, presumably due to the complexity of managing large institutions.

This result is fairly robust and holds again across countries, but it relies mainly on data from the 1980s and early 1990s; it might have to be revised due to recent technological changes that imply large fixed costs and thus have the potential for scale economies even for larger banks.

Probably the second most quoted reason for M&As is the exploitation of synergies, or economies of scope: by merging with institutions specialised in different market segments, it is claimed that banks can improve their production process and cross-sell their products to a larger customer base. Measuring the existence and extent of economies of scope is especially difficult,

¹⁸⁸ Berger and DeYoung (2000) find that some banking organisations are efficiently managed on a cross-regional basis.

¹⁸⁹ See Vennet (1996).

¹⁹⁰ See Focarelli, Panetta and Salleo (1999).

¹⁹¹ Haynes and Thompson (1999) find significant cost cutting and profitability gains from mergers.

¹⁹² See eg Berger and Humphrey (1992), DeYoung (1997), Linder and Crane (1993), Peristiani (1997), Rhoades (1993 and 1998) and Srinivasan (1992).

¹⁹³ For the United States, see eg Berger, Hanweck and Humphrey (1987), Berger and Mester (1997), Hughes and Mester (1998), Hunter, Timme and Yang (1990) and Noulas, Ray and Miller (1990); for Europe see Altunbas and Molyneux (1996), Salleo (1999) and Schure and Wagenvoort (1999). For a fairly comprehensive review on scale and scope economies, see Berger, Demsetz and Strahan (1999).

¹⁹⁴ For Europe, scale economies are somewhat higher for savings banks, but for all categories of banks they are much lower than the cost reduction that can be obtained by improving the quality of management. See Schure and Wagenvoort (1999).

given that, in theory, the benchmark should consist of single-product firms. The lack of such firms casts doubts on the reliability of results in this particular field.

The analysis of universal banking, conducted on European data, searches for complementarities between loans and investment-related services; there is no strong evidence either in favour or against the joint provision of different services, but this might be due to measurement problems involving economies of scope.¹⁹⁵ In fact, the true test might be about to come, when a fully unified European market will see specialised and universal banks compete against each other.

Scale and scope economies are usually mentioned as the main drivers of M&As, but the available evidence, although indirect, seems to confirm that there are tangible benefits only for smaller banks. However, changes in technology and market structure might soon render these results obsolete.

Shareholder value

The last indicator of efficiency gains is the stock market performance of merging banks. The main finding of the event studies looking at share prices around the time that a deal is announced is that, on average, total shareholder value (ie the combined value of the bidder and the target) is not affected by the announcement of the deal, since, on average, the bidder suffers a loss that offsets the gains of the target. Therefore, M&As imply a transfer of wealth from the shareholders of the bidder to those of the target.¹⁹⁶

For US banks, one study finds the combined gains to be higher when there is significant overlap between institutions, consistent with a market power hypothesis, according to which higher market share leads to higher profits. Another paper finds, consistent with a diversification hypothesis according to which geographical diversification leads to a lower variability of income, that it is out-of-market transactions that create value for shareholders.¹⁹⁷ In both cases, the market value of the two banks combined should be higher than the sum of their values as separate entities.

Higher market concentration created by consolidation is likely to lead to an increase in prices for retail financial services, leading in turn to an increase in profits. However, it is also true that firms operating in more concentrated markets are generally found to be less efficient: this might offset the gains from an increase in market power and thus leave unchanged the market value of the bank.

A merger could also result in a bank with a different risk profile. Changes can come from many sources: larger banks could develop more sophisticated financial strategies or have more diversified assets and liabilities. Most gains would come from geographical diversification or from combining banks with other financial institutions such as securities and insurance companies; all this would influence the market value of merging banks. In general, M&As do not seem to generate significant shareholder value; at the moment it is hard to identify patterns that result in successful deals.

Conclusions

In conclusion, M&As do not significantly improve cost and profit efficiency and, on average, do not generate significant shareholder value. There is evidence in favour of exploiting scale

¹⁹⁵ See Allen and Rai (1996) and Lang and Welzel (1998).

¹⁹⁶ See Hannan and Wolken (1989) and Houston and Ryngaert (1994 and 1997); Cornett and Tehranian (1992) found positive overall returns from banking M&As. Cybo-Ottone and Murgia (2000) is the only event study of the European market. For a survey of event studies, see Pilloff and Santomero (1998).

¹⁹⁷ See Houston and Ryngaert (1994) for the market power hypothesis and Zhang (1995) for the diversification hypothesis.

economies in retail banking up to a certain size (well below that of the most recent very large deals). Economies of scope are harder to pin down; there is no clear-cut evidence of their existence.

Investment banks

M&As involving investment banks, as well as joint ventures and strategic alliances, are increasingly common, especially between continental European commercial banks and British and American investment banks. Firms are using M&As to establish a global presence. Cross-industry M&As involving investment banks and securities dealers have been plentiful, because within the financial services industry the latter is perceived to be a growth business.

There is little analytical evidence to draw on in analysing the impact on efficiency resulting from the consolidation process as it relates to investment banks. There are some results from the securities portion of the industry, but there is little evidence looking at this industry segment as a whole. Some evidence is also available from case studies that have been carried out on high M&As.¹⁹⁸

As a cautionary note, these results are based on US financial data from the 1980s. This is due to the lack of research on investment banks in other countries and to the fact that, where universal banking is allowed, investment banks are often divisions of commercial banks with no readily accessible separate balance sheets.

Cost and profit efficiency

Unfortunately, there are no studies that look rigorously at the question of the cost and profit performance of investment banks before and after mergers. A survey of case studies of recent consolidation transactions involving investment banks suggests that globalisation is the main force underlying consolidation. Customer demand is driving the process as businesses are looking for comprehensive services and solutions from their financial institutions as they expand across borders. In this environment, efforts to sustain profitability are leading to the globalisation of the market segment. Quotes from merging entities suggest that mergers create business synergies in areas of product offerings, product development, distribution and service. Earnings growth is often cited as an important reason for mergers, as is the need for global industry knowledge and global distribution, which demands global products, services and intelligence.

In case studies, the sentiment is often expressed that in this industry “size matters”, as it is believed to be closely related to prestige. Large organisations with a recognisable brand name appear to be trusted and to enjoy levels of demand for their services that generate profits even in the presence of inefficient cost structures. In addition, some commentators have pointed to the increasing size of deals in recent years and suggested that investment banks need to be large in order to win business and participate in various large loan syndications and equity and debt underwriting.

Scale and scope economies

Analytical research is available only for the securities industry. The results indicate that economies of scale do exist among smaller securities firms, but are exhausted when the firm reaches between USD 14 and 36 million in total revenue and at about USD 40 million in assets and USD 4 million in equity.¹⁹⁹ Larger firms demonstrate scale diseconomies. It appears,

¹⁹⁸ See Pearson (1998).

¹⁹⁹ See Goldberg, Hanweck, Keenan and Young (1991).

therefore, that only very small firms can expand their product mix and level of output, in the aggregate, and lower costs.

Similarly, on the question of economies of scope, research suggests that smaller speciality firms exhibit economies of scope while large multi-product firms exhibit diseconomies of scope. The overall conclusion, however, is that economies of scope do not appear to be important in the securities industry. Neither diversified nor speciality firms of minimum optimal scale operate at a cost disadvantage.

The results outlined above might be outdated in the foreseeable future, given the tremendous amount of change that has occurred in this sector in recent years. As a consequence, the efficient scale values found in past research, particularly for securities firms, are likely to change. However, the pattern of economies of scale to a relatively small size threshold appears to hold, as in the case of commercial banks.

Asset management companies

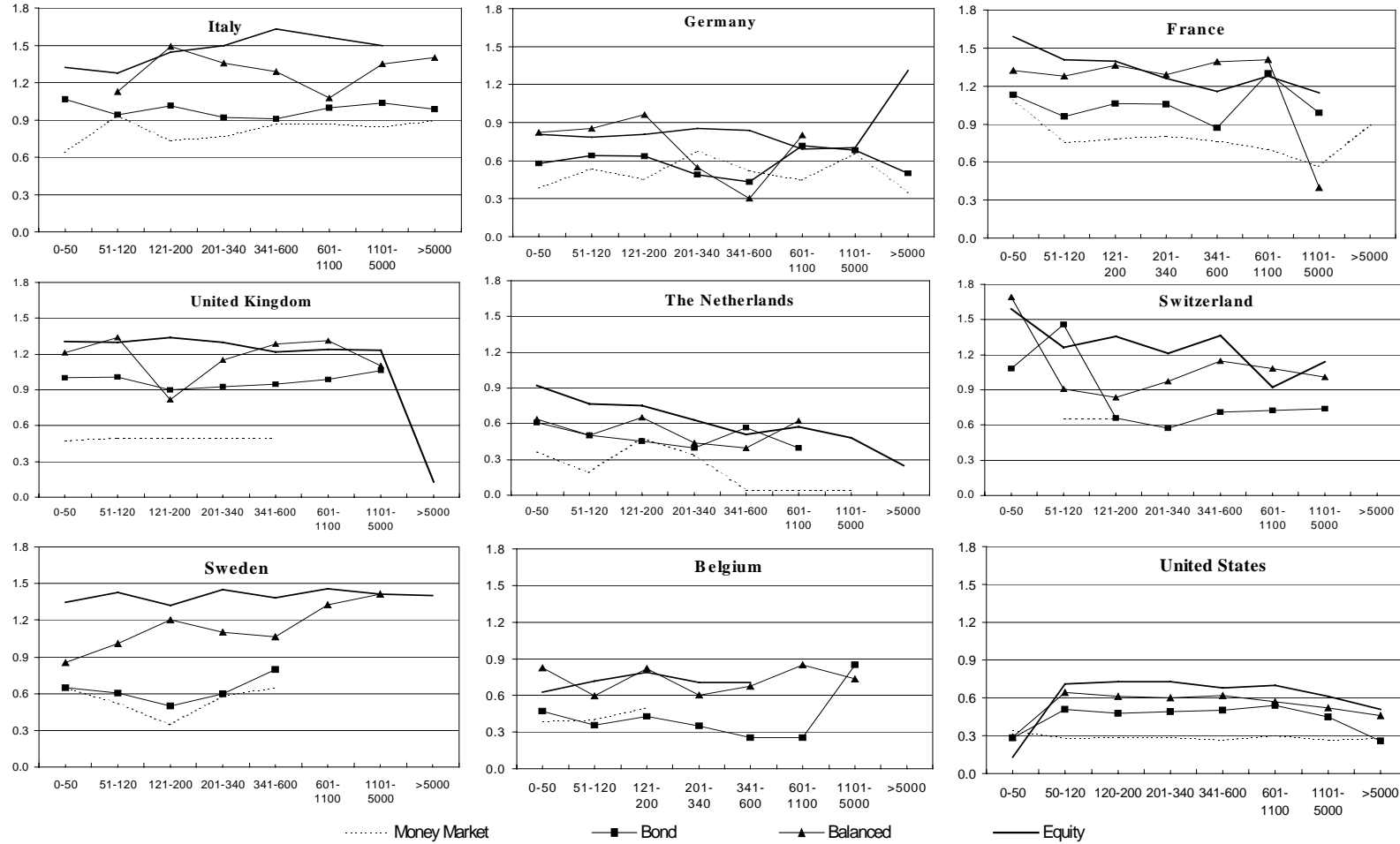
The wave of consolidation in the asset management industry has been widely driven by round-the-clock trading, the internet, globalisation and other technology-driven advances.²⁰⁰ Consolidation is also resulting from consumers' desire for the convenience of one-stop shopping. Japan and Europe are expected to be growth areas in the future because they have lagged behind the US institutional asset management industry.

Surveys indicate that many mutual fund investors do not know mutual funds charges, which are the price paid for asset management services. Investors' ignorance of fees is most likely attributed to double digit returns seen during good economic times. However, the issue of mutual funds' income and expenses will probably become more important during unfavourable conditions in capital markets. As a consequence, the mutual fund industry is likely to undergo some restructuring in the future as individual fund companies start to compete not only in performance but also in cutting fund charges.

At first glance, there is no strong correlation between fees charged by mutual funds and their size, measured by assets under management (see Chart V.1). In the United States, fees are generally low and slightly declining with the increase in the size of the funds, suggesting mild economies of scale passed on to customers (this, of course, assumes that the industry is highly competitive, ie that mutual funds do not exert much market power). In Europe patterns are not as smooth: equity funds are generally more expensive than money market, bond and balanced funds, as in the United States. Although in many countries the largest funds charge less than the smallest ones, the trend in the relationship between assets under management and fees is not as clear as in the United States; in fact, it is often funds of intermediate size that seem to offer the best conditions to customers.

²⁰⁰ See Barbash (1998).

Chart V.1
Management fees and net assets of mutual funds*
 (percentage points and millions of USD, at December 1999)



* Source: Lipper. Management fees are simple averages of maximum charges. No account is taken of charges scaled to fund size.

Economies of scale and scope

The expansion of shareholder services in the 1980s and 1990s, along with growth in new industries and foreign markets, placed upward pressure on the funds' expense ratios, because of the increased complexity in investing and managing risk. However, in spite of these developments, operating expenses have decreased, with larger reductions generated by funds with more assets under management (and thus with a higher probability of offering new services at an additional cost).

When the scale of activity of a mutual fund expands, a less than proportional increase in costs may be recorded both in the area of portfolio management (information technology and security turnover) and in that of shareholder servicing (record keeping and distribution). However, this can happen only if asset growth is not accompanied by a huge increase either in the variety of securities in the portfolio or in the number of accounts.²⁰¹

For a sample of US mutual funds, economies of scale at the management group level are significant, especially for smaller groups. However, if a fund's size is measured by the number of accounts, then scale economies are far smaller holding assets per account constant.²⁰² In general, there are scale economies in administering mutual funds in all size categories and the average cost curve of a typical mutual fund is downward sloping over the entire range of fund assets.²⁰³ For the United States, the relationship between fund assets and operating expenses, related to the management and administration of funds, declines steadily as assets grow and reaches a low of 70 basis points for the group of funds with over USD 5 billion in assets.²⁰⁴ In general, large equity funds display significantly lower operating expense ratios than small funds; the reductions in fund expenses from efficiency and productivity gains are passed on by service providers as they expand the scale of their operations. These results are partially consistent with those found for a sample of French open-end mutual funds, for which significant scale economies are detected only for small funds, while larger institutions tend to exhibit diseconomies of scale.²⁰⁵

There is also some limited econometric evidence on the presence of economies of scope in mutual funds. These results are qualitatively the same as those presented above for scale economies, with one difference noted in the study of French open-end mutual funds. In that case, economies of scope were found to be significant for both small and large firms.²⁰⁶

The evidence in favour of the existence of scope economies squares with the latest developments in the industry. Asset management services are often distributed jointly with other types of financial products, in order to reap the benefits from cross-selling: in Europe mutual funds are sold by bank branches, while in the United States fund distribution is concentrated in broker-dealers and discount brokers.²⁰⁷ Also, life insurance companies tend to have a competitive advantage as well as other more specialised firms that have established cost-effective channels of distribution by using electronic means. In order to gain access to distribution, fund management expertise and a greater international presence, a number of cross-border M&As involving asset management firms have occurred in recent years (eg Mercury

²⁰¹ See Baumol (1995).

²⁰² See Baumol, Goldfeld, Gordon and Koehn (1990).

²⁰³ See Latzko (1999).

²⁰⁴ See Rea et al (1999).

²⁰⁵ See Bonanni, Dermine and Röller (1998) and Dermine and Röller (1992).

²⁰⁶ See Bonanni, Dermine and Röller (1998).

²⁰⁷ See Walter (1999).

Asset Management of the United Kingdom was purchased by Merrill Lynch in 1997). As an alternative to M&As, many mutual fund firms have opted for strategic alliances with banks, securities broker-dealers and insurance companies.

To summarise, there is little analytical work available that directly addresses the issue of efficiency gains from consolidation in investment banking and asset management companies. Some results from the securities portion of the investment banking industry suggest the presence of economies of scale, but only for smaller securities firms, while there is limited evidence for the existence of scope economies. With regard to asset management firms, the scarce evidence available suggests that larger mutual funds tend to be more efficient than smaller ones; however, economies of scale and scope are probably significant only up to a certain size threshold.

Insurance companies

The insurance industry remains heavily regulated, both in its life and non-life segments; this could be a restraining factor for the consolidation process, decreasing the possibility of reaping economies of scale and diversification by discouraging consolidation, in particular cross-border deals. Differences in social security systems could also contribute to the international segmentation of the life insurance industry, if firms differentiate themselves in such key variables as the age of retirement or the model of funding (defined benefits or defined contributions). Furthermore, despite a trend towards deregulation, “cross-border trade in insurance services is limited by differences in culture, consumer protection laws, taxation, and the need to establish a local presence to process claims and handle administration.”²⁰⁸ However, at least within domestic markets, there is a potential for economies of scale and scope, in particular with other financial products, such as those offered by banks. These benefits may be obtained through joint ventures or through the combination of banks and insurance companies, a growing trend especially in Europe. Finally, the proposition that there could be efficiency gains by letting the best firms take charge of the others is even more true in a sector protected, at least to an extent, from outside competition. The following sections discuss the available evidence on the insurance industry, distinguishing between the two main lines of business – life and casualty/property.

Aggregate data

The insurance industry seems to exhibit economies of scale, at least judging from a cursory examination of firms’ balance sheet ratios. In the North American life insurance segment, management expenses as a fraction of net premiums written decrease from 16% for the smaller firms to 11% for the larger ones; in Europe the ratio decreases from 9 to 4% (see Table V.3).²⁰⁹ As for the non-life segment of the industry, the ratio decreases from 18 to 16% in North America and from 17 to 8% in Europe. In terms of profitability, the same pattern emerges: larger firms are more profitable than smaller ones. In North America, the return on equity increases from 3 to 13% for the life segment and from 7 to 10% for non-life firms; in Europe, it increases from 1 to 12% for life insurance companies and from 7 to 11% for the non-life firms.

²⁰⁸ See OECD (1998).

²⁰⁹ The difference in cost levels between North America and Europe might depend on different definitions of the variables. Because of the low number of Japanese firms in the available sample, they are not included in the analysis.

Table V.3
Size and performance of insurance companies

Area	Variables	Life insurance companies by asset size					
		< USD 500m		USD 500-2000m		> USD 2000m	
		No	Average	No	Average	No	Average
Europe	Management expenses (% of net premiums written)	76	8.6	86	5.0	142	4.4
	Return on equity	99	1.3	76	10.6	134	11.8
North America	Management expenses (% of net premiums written)	72	16.2	102	14.0	134	10.9
	Return on equity	71	3.4	104	10.6	135	13.0
Area	Variables	Non-life insurance companies by asset size					
		< USD 100m		USD 100-500m		> USD 500m	
		No	Average	No	Average	No	Average
Europe	Management expenses (% of net premiums written)	117	16.6	156	10.8	144	7.8
	Return on equity	263	7.2	183	9.3	145	11.2
North America	Management expenses (% of net premiums written)	254	17.9	364	15.9	216	15.5
	Return on equity	269	7.2	373	9.2	217	9.5

Source: Fitch-IBCA data for insurance companies; firms are ranked by assets in millions of US dollars. All variables are averaged over the 1994-97 period; the distribution is truncated at the top and bottom 10%.

If the dispersion of cost and profit measures is used as a proxy of efficiency, then North American insurance companies appear to differ substantially in their performance: for each class size and each segment of the industry, the costs of those in the worst quartile are more than double those in the best quartile and profitability is half as high (see Table V.4). The European industry reflects more or less the same pattern, suggesting that insurance companies in general could benefit from a consolidation process that would allow them to exploit scale economies and transfers of high-quality managerial skills. Of course, if the consolidation process goes too far, offsetting costs due to market power may arise (see below).

Table V.4

Dispersion of performance measures of insurance companies

Area	Variables	Life insurance companies by asset size					
		< USD 500m		USD 500-2000m		> USD 2000m	
		1st quarter	4th quarter	1st quarter	4th quarter	1st quarter	4th quarter
Europe	Management expenses (% of net premiums written)	3.4	12.9	2.5	6.7	3.0	5.6
	Return on equity	6.7	0.0	13.9	6.2	16.2	6.7
North America	Management expenses (% of net premiums written)	10.8	20.6	8.9	17.8	6.5	15.2
	Return on equity	10.6	0.0	14.7	6.6	17.3	9.1
Area	Variables	Non-life insurance companies by asset size					
		< USD 100m		USD 100-500m		> USD 500m	
		1st quarter	4th quarter	1st quarter	4th quarter	1st quarter	4th quarter
Europe	Management expenses (% of net premiums written)	10.0	23.2	4.4	16.1	1.8	12.7
	Return on equity	13.3	0.0	13.2	5.2	14.8	8.2
North America	Management expenses (% of net premiums written)	13.3	22.2	12.7	18.2	12.5	18.5
	Return on equity	10.1	4.4	12.9	5.5	12.5	6.1

Source: Fitch-IBCA data for insurance companies; firms are ranked by assets in millions of US dollars. All variables are averaged over the 1994-97 period; the distribution is truncated at the top and bottom 10%.

Cost and profit efficiency

A study performed on the insurance industry in the OECD countries finds that the increase in productivity observed for insurance companies in all countries is due to technical progress.²¹⁰ However, efficiency scores vary widely by country, the US firms being, on average, the most efficient. Efficiency seems positively correlated with the reinsurance rate and negatively correlated with the share of life insurance; this can be explained by the national characteristics of the life insurance market, which deters foreign entry and thus decreases competition, allowing domestic firms to grow complacent.

US non-life insurance companies operate at an efficiency level that varies from 80% of the best practice assessed for the medium-sized companies to 90% for the large ones, suggesting that competition keeps them from becoming too inefficient and that improvements from M&As are likely only for the firms in worst conditions.²¹¹ The average inefficiency level in the life

²¹⁰ See Donni and Fecher (1997).

²¹¹ See Cummins and Weiss (1993) and Gardner and Grace (1993).

segment of the insurance industry is higher, between 35 and 50%.²¹² Given that M&As improve the efficiency of targets,²¹³ the foreseeable consolidation process will be beneficial to the industry by, for example, rationalising the agency distribution system.

The evidence for other countries points towards a larger gap between the best practice firms and the rest of the industry: the average efficiency level is around 50% for France and Belgium,²¹⁴ around 50% and growing in Germany²¹⁵ and a little higher in the British life insurance industry.²¹⁶ Given that efficiency seems to be higher in countries where the regulatory burden is lower, deregulation could help close the efficiency gap by introducing more competition.

The insurance industry is still very fragmented because of regulation and the specificity of some of its products (for example, claims settlements). The dispersion of efficiency levels that results from these barriers to entry could probably be reduced if the better managed firms took over the weaker ones,²¹⁷ but the lack of evidence for the past and the rapid changes foreseeable in the future make it hard to assess the potential efficiency gains from M&As.

Economies of scale and scope

Scale economies in the US insurance industry have been studied extensively. For property/casualty insurance companies, there is evidence of scale economies for the small and intermediate size firms; this suggests that consolidation among them may reduce average costs.²¹⁸ On the other hand, larger firms seem to exhibit diseconomies of scale, while there is no evidence of scope economies at any size level.²¹⁹ As for the life insurance industry, scale economies are found up to USD 15 billion of assets, but it is unclear whether the result holds for larger firms.²²⁰

The evidence for European markets is more mixed, but in general it is in favour of the existence of scale and scope economies.²²¹ However, most studies refer to data of the early 1990s; the sweeping changes in regulation and technology that took place in recent years might have deeply affected the cost and revenue structure of the industry. Past results, therefore, should be considered with caution. For Japanese insurance companies there seems to be a consensus on the existence of scale economies, at least for the life industry.²²²

As in other financial industries, scope economies are more elusive; the coexistence of specialised life and non-life insurance companies within insurance conglomerates probably

²¹² See Yuengert (1993).

²¹³ See Cummins, Tennyson and Weiss (1999).

²¹⁴ See Delhousse, Fecher, Perelman and Pestieau (1995).

²¹⁵ See Mahlberg and Url (2000).

²¹⁶ See Rees and Kessner (1999).

²¹⁷ As long as concentration is not so high that firms become complacent or enjoy substantial market power.

²¹⁸ See Cummins and Weiss (1993).

²¹⁹ See Hanweck and Hogan (1996).

²²⁰ See Yuengert (1993) and Cummins and Zi (1998); Grace and Timme (1992) find evidence of scale economies throughout their sample, but they do not control for differences in the output of small and large companies.

²²¹ See Focarelli (1992) and Prosperetti (1991) for Italy; Focarelli (1992) also finds evidence of scope economies for the life and non-life segments. Fecher, Perelman and Pestieau (1991) find significant scale economies for the French industry, both life and non-life; Mahlberg and Url (2000) find significant scale economies for the German market; and Kaye (1991) finds them for the British life insurance companies.

²²² See Fukuyama (1997).

means that there is no single winning strategy (diversifying versus specialising). Diversification may be more suited to some firms and countries, while specialisation may be better for others.²²³

Just as for banks, the smaller insurance companies could probably reduce their costs by taking advantage of the potential economies of scale, however the benefits are likely to disappear after a threshold that is well below the size of the largest firms. The existence of economies of scope with other financial institutions is debated.

Cross-industry and cross-border consolidation

Research on the efficiency effects of M&As across financial industries and across national boundaries is scarce, largely because there have been relatively few such acquisitions to date. The primary difference between within- and across-industry M&As is the greater possibility of scope economies in mergers across industry lines – for example, through sharing physical inputs, information systems, or databases, or through consumption complementarities. There is also greater room for scope diseconomies – for example, from senior management straying far from its area of core competence.

There is very little research on the revenue scope efficiency effects of universal type consolidation. Some inference may be taken from the research on firms producing a single category of financial services. Such research shows that the evidence is ambiguous.²²⁴

There are factors that may make the efficiency consequences of international consolidation different to those for domestic M&As. First, there may be some barriers that inhibit foreign financial institutions from operating efficiently and competing against domestic institutions. These barriers may include differences in language, culture and regulatory or supervisory structures, and explicit or implicit rules against foreign competitors. In some cases, the organisational diseconomies of operating or monitoring from a distance may be exacerbated by having to manage institutions many time zones away.

Second, the market conditions and policies of the home nation may affect cross-border efficiency. In particular, the home market conditions (eg the degree of competition, the market for corporate control, or securities market development) and home market policies (eg banking powers, prudential regulation and supervision, and safety net guarantees) may affect the efficiency of national institutions abroad.

Studies of cross-border efficiency have usually found that domestic banks are significantly more efficient than foreign-owned banks.²²⁵ In particular, one study found that institutions headquartered in the United States tended to be more efficient than other institutions both at home and in other nations.²²⁶

Summary

There seems to be a general consensus that consolidation in the financial industry is beneficial up to a certain (relatively small) size in order to reap economies of scale. Although the evidence

²²³ See Berger, Cummins and Weiss (1999) and Berger, Cummins, Wiess and Zi (2000).

²²⁴ Berger, Humphrey and Pulley (1996) found little or no revenue scope economies between bank deposits and loans. Berger, Cummins, Weiss and Zi (2000) found revenue scope diseconomies on average from providing life insurance and property-liability insurance together. Berger, Hancock and Humphrey (1993) and Berger, Cummins, Weiss and Zi (2000) found that joint production is more efficient for some types of firms and specialisation is more efficient for others.

²²⁵ See eg DeYoung and Nolle (1996) and Mahajan, Rangan and Zardkoohi (1996).

²²⁶ See Berger, DeYoung, Genay and Udell (2000).

is more mixed, there is also little in the way of gains from economies of scope or of improvements in managerial efficiency due to the transfer of skills from the bidder to the target.

There is no clear evidence that M&As result in cost reduction. The most recent studies suggest that consolidation may enhance revenues, although results vary with the countries and deals analysed; moreover, the gains appear limited in magnitude. Stock markets also seem sceptical of M&As: on average, at the announcement of a transaction, the combined value of the firms involved does not vary much, as it should if significant benefits were expected.

Ex post results of M&As seem to contradict the motivations given by practitioners for consolidation, which are largely related to issues of economies of scale and scope and to improvements in management quality. However to a certain extent this might be a puzzle in appearance only. The following explanations have been put forward: (i) practitioners consider cost reductions or revenue increases per se to be a success, without also taking into account industry trends as a benchmark; (ii) there might be a “denominator effect”: a 20% reduction in operating costs seems larger than an equivalent 0.4% reduction as a fraction of total assets; (iii) the fact that there are no improvements, on average, means that some institutions do better and some do worse; given the inside knowledge of their firm and the arm’s length knowledge of competitors, managers might be justified in believing that their institution might be among the ones that would benefit from a merger or acquisition; and (iv) deals done in the past might have suffered from stricter regulation (eg labour laws) that prevented firms involved in M&As from reaping all of the benefits of the deal.

How innovation will affect the financial industry

The lack of clear-cut results on the efficiency of merged institutions could be traced back to the motivations for M&As. If they are not entirely driven by profit-maximising strategies (see Chapter II), M&As might well turn out to produce mixed results, in accordance with the fact that they were not all meant to increase profits in the first place. Other factors that potentially affect all participants might blur the picture, if their effect is large enough to overshadow the direct effect of M&As.

The opportunities presented by advances in payments technology, the development of internet banking and financial-engineering products should benefit all institutions (to the extent that they can be outsourced), but they are generally more easily exploited by large institutions that are able to invest up-front, postponing returns for longer. These firms also have more complex asset and liability structures that can benefit from sophisticated risk management strategies.

The development of outsourcing might have significant external effects on the financial industry. If the functions involved are those that exhibit clear economies of scale (eg processing credit card transactions), there might be a small number of firms performing them and offering lower rates to all financial institutions; this might, in turn, lower the threshold above which the smaller firms become viable, by decreasing their costs. The need for a larger size may be counterbalanced for some products by network economies, such as joining a nationwide ATM system, that can be obtained even by small banks.

Sales of mutual funds will be influenced even more heavily by branding, advertising and distribution channels. These developments will probably lead to internal, external and inter-sectoral competition in the asset management industry, promoting market efficiency and lower fees for consumers. The simultaneous presence of many, diverse institutions should benefit consumers and improve the dynamic efficiency of the financial industry by fostering competition and innovation.

A general warning with regard to these conclusions should be made, due to the importance of innovation itself in shaping firms and markets. On the one hand, innovation may reduce the cost of accessing the new technology, and therefore decrease the need for larger size in order to make its adoption profitable, so that even small intermediaries could handle tasks that today are out of their reach. On the other hand, there might be cases in which new systems are profitable

only if applied on a large scale, for example in the field of risk management. In the latter case, the differences between large and small institutions might increase; policymakers and regulators should carefully differentiate their action on the basis of products and markets rather than by categories of institutions.

3. Consolidation and competition

Consolidation affects competition because it increases market concentration, with the final effect dependent both on the likelihood of market entry and on firm behaviour. Market entry may be limited, for example, by regulation, and oligopolistic behaviour may intensify when concentration becomes higher, possibly leading to non-competitive levels of prices (or interest rates) and volumes. In this section these theoretical issues are discussed. Then, existing empirical research is examined in order to assess the practical relevance of the various theoretical propositions. Since empirical analysis is inevitably based on the past and the financial landscape is changing quickly, the relevance of foreseeable future trends is assessed. Finally, actual antitrust policy is reviewed and some relevant case studies are presented.

Theory

The theoretical analysis starts with two subsections that review the ways in which consolidation may affect competition. First, the potential of market entry is discussed in order to assess the effect of consolidation on concentration. Second, firm behaviour is discussed because it may determine how concentration affects competition. These subsections are followed by a short discussion of the trade-off between competition, efficiency and financial stability. The final subsection discusses the issue of market definition, which is relevant for antitrust purposes.

Market entry

Assuming a well-defined market, the standard literature on industrial organisation implies that the ease of market entry determines the link between competition and market concentration. In a contestable market, due to the threat of profitable entry, active firms are not able to exploit market power.²²⁷ However, contestable markets are an extreme theoretical benchmark: in fact, the conditions that are required for a market to be fully contestable do not hold in the real world. In such a market environment, concentration would increase as a result of consolidation, but there would be no effect on competition.

In the case of the financial industry, contestability fails to hold as a result of three conceptually different types of entry barriers: (i) those that are directly caused by regulation, (ii) those inherent in firms' cost structures, and (iii) those that result from (relatively) inelastic customer demand. Regulatory barriers include specific subsidies or public guarantees. For example, commercial bank deposits are generally insured by the government and may lower banks' capital costs. This gives commercial banks a relative advantage in products markets where non-commercial banks such as investment banks and insurance companies also compete. Another example would be national or state differences in legal frameworks and in their applications, such as differences in the jurisdictional status of contracts in different countries; this is particularly relevant for the insurance industry. Finally, imposition of host country regulations on foreign competitors can create barriers to entry. For example, foreign institutions may be required to establish a physical presence in a particular country before authorisation for servicing customers is given.

²²⁷ Baumol et al (1982) introduced the concept of market contestability as an extreme example of the concept of potential competition introduced by Bain (1956).

Entry barriers due to differences in firms' costs arise where entry requires significant sunk costs that have to be earned back. This can reduce competitive pressures, at least in the short run. Economies of scale or scope or the necessity to set up a network of branches may create barriers to entry for firms that do not have the necessary size to be economically viable. In addition, unequal access to production technology, production factors, or infrastructure can confer market power on favoured firms. Such situations may be difficult to detect because they may involve non-financial industries. For example, a financial institution might be affiliated vertically with a telecom enterprise, until lately usually a monopoly, that in turn restricts its services to this institution.

The third cause of the lack of contestability is a relatively inelastic customer demand, a cause that may be most significant for retail markets. For example, when customers find it convenient to buy all their financial services at a single financial service provider, they may become locked in and as a result less inclined to switch to other providers in response to favourable price offers by competitors. Cross-sector consolidation may foster the bundling of products, thus increasing switching costs and the rigidity of demand for financial products. In the case of banking, for example, the lack of a legal requirement that account numbers as well as the associated transaction data in an electronic bank account be transferable to another bank may increase barriers to entry by making it more cumbersome for customers to switch banks. Another source of rigidity of demand is the complexity of products, which may increase the difficulty of comparing the services of different providers.

Market behaviour

The effect of concentration on competition depends, among other variables, on whether firms compete on quantities or prices. In the first case, it is straightforward to show that the market outcome is closer to the monopoly result the smaller the number of firms. In the second case, the effect depends on the heterogeneity of products; the more heterogeneous the products are, the greater is the market power of firms. Firms tend to adopt niche strategies, in order to differentiate products beyond their essential characteristics. This may ultimately lead to mass customisation, whereby technology improvements allow firms to tailor their standardised products to the specific needs of individual customers.

There might be instances in which the financial industry presents the characteristics of a natural monopoly, with the regulatory consequences emphasised by the traditional industrial organisation literature. For example, with respect to payment services of banks, there may be network effects, possibly implying natural monopoly or oligopoly (see the following chapter), with the potential to set prices at non-competitive levels.²²⁸ Concentration of payment services in a non-contestable market environment increases the probability of market power abuse.

Linked oligopoly theory hypothesises that firms that compete simultaneously in many markets may recognise their interdependence and determine that aggressive behaviour in one market may lead to retaliation in the others; as a consequence firms may reduce competition in the affected markets. Multi-market contacts may lead to higher prices and lower quantities than the competitive outcome.²²⁹ By increasing contact points among firms, cross-border and cross-sector consolidation in the financial services sector may reduce competition.

The theories on relationship lending emphasise the crucial role of financial institutions in financing customers that do not have direct access to capital markets. Such theories focus on the screening and monitoring function of financial institutions and hypothesise adverse effects of competition on users of financial services. These arise, among other reasons, because of the

²²⁸ See McAndrews (1995).

²²⁹ Linked oligopoly theory was introduced by Edwards (1955) and was developed theoretically by Bernheim and Whinston (1990) among others.

inability of financial firms to subsidise new firms at the expense of established borrowers.²³⁰ It may be the case that bank loans to small firms are better available in more concentrated markets than in competitive markets. However, as will be discussed extensively in the section on Consolidation and the availability of credit flows, consolidation may be detrimental to small business lending.

Does consolidation create a trade-off between efficiency and financial stability?

In general, in a competitive environment only the most efficient and innovative firms survive, thus ensuring that the industry remains healthy and that firms pass on the benefits of competition and innovation to their customers. However, for the financial sector there might be instances in which competition may have a negative impact on stability, as the least efficient firms may have an incentive to increase their risk in order to reach the industry profitability level (the so-called incentive to “gamble for resurrection”). If these firms are large, financial stability may be threatened (see Chapter III).

The role of consolidation in altering the balance between competition and stability is ambiguous; M&As among large banks create institutions whose failure is potentially more threatening to the stability of the industry. However, if the new entities are managed more efficiently or if they benefit from economies of scale or scope, there should be both benefits for the consumers (to the extent that the improvements are passed on) and no particular negative effect on financial stability.

Prudential supervision and regulation, in particular liquidation procedures and coordination among supervisors of different industries and from different countries, should ensure that the stability of the financial industry is not threatened by the external effects of competition.

Market definition

The preceding discussion assumed that the relevant market was already defined, but empirical work must start with a workable market definition. This subsection investigates the theory behind the definition of markets for purposes of antitrust regulation.

One may define a relevant product market as a market that comprises all products and services that are viewed by consumers as similar or equivalent because of their properties, price and purpose. The relevant geographic market is the territory including the firms that impose competitive constraints on each other. For example, one definition of a market used in antitrust analyses is “a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximising [monopoly] firm, not subject to price regulation ... likely would impose at least a ‘small but significant and non-transitory’ increase in price.”²³¹ A second, closely related definition that emphasises market structure more than conduct, is: “The relevant geographic market comprises the area in which the undertakings concerned are involved in the supply and demand of products and services, in which the conditions of competition are sufficiently homogeneous and which can be distinguished from neighbouring areas because the conditions of competition are appreciably different in those areas.”²³² In some countries, the relevant geographic markets are identified by the antitrust authorities with administrative areas (eg regions or provinces; see Annex V.1).

In defining product markets, the substitutability of different products may vary across buyers of that product. For example, commercial bank transactions accounts and investment bank money

²³⁰ For an overview, see Boot (2000).

²³¹ See US Department of Justice and Federal Trade Commission (1992), p 7.

²³² “European Commission Notice on the definition of the relevant market for the purpose of Community Competition Law”, Official Journal of the European Communities, Series C, no 372, 9 September 1997.

management accounts have many similar features that may make them part of the same market for some consumers. On the other hand, bank accounts may be insured by government, while investment bank accounts typically are not insured. This may place these products in separate markets in the view of more risk-averse customers. Product market definitions also depend on the extent to which different goods are complements that are purchased together. In addition, convenience considerations may lead consumers to bundle their purchases of different goods or services. The extent of such clustering, and the resulting scope of the relevant product market, is an empirical question.

The geographic market indicates the extent to which consumers will travel to complete a transaction. This depends on the size of travel costs and other transaction costs relative to the utility gained from purchasing the product. As a generalisation, low-value goods that are purchased frequently tend to have smaller geographic markets than expensive goods that are purchased only rarely. Thus, wholesale markets will generally cover larger geographic areas than retail markets, and non-fiduciary financial services (such as mortgages) generally will have larger geographic markets than fiduciary services (such as deposits).

Empirical evidence

This section analyses the existing studies that have examined the extent to which the consolidation of financial markets has affected competition. The first empirical issue addressed is the empirical definition of the relevant markets. Subsequently, the main findings of the empirical studies on the effect of consolidation on competition are discussed. It is important to be aware that this literature uses data that do not represent the most recent technological developments.

Market definition

A recent examination of the suppliers of financial services shows that individual US firms are supplying more and more products over broader geographic areas.²³³ The fact that firms have increased both their product selection and their geographic reach does not necessarily imply, however, that markets have expanded. Firms often operate in many different markets. Also, some traditional financial business processes are now split into functions that can be offered in separate markets. An example is lending, where origination, securitisation and interest rate or foreign exchange swaps split the lending process into separate components that may be conducted by different firms. In addition, on the demand side, some claim that consumers of financial products want bundled products to a lesser extent than they once did.

In research and policy analysis, markets are defined in terms of products and geographical areas. In the first respect, surveys of household and small-business bank customers show evidence of clustering around the principal transactions account, but credit cards, mortgage and other loans, and other financial services are often purchased elsewhere.²³⁴

Insurance product markets tend to be defined more narrowly, as developing expertise in any product line implies substantial costs, even for producers that are already active in other business segments.²³⁵ In the non-life sector, customers generally feel that insurance products for different types of risks (health, property and casualty, travel etc) are not substitutable. Moreover, legal rules are often structured by type of risk, licensing for new types of risk is

²³³ See Berger, DeYoung, Genay and Udell (1999).

²³⁴ According to Kwast, Starr-McCluer and Wolken (1997), households tend to cluster the following products with their checking account: savings accounts, MMDAs, lines of credit and certificates of deposits. For small businesses, the clustered products are savings accounts, lines of credit, mortgages and cash management services.

²³⁵ See Chidambaran, Pugel and Saunders (1997).

generally a slow process, and certain combinations of risk may be legally prohibited.²³⁶ Therefore, the products of non-insurance firms are usually not included in the market definition of non-life insurance products.²³⁷

As an example of a stance taken by an antitrust authority, the European Commission in several cases has had to decide whether credit insurance in the areas of domestic use and export of capital goods can be considered a substitute for banking services such as factoring and letters of credit. While acknowledging that certain banking products are increasingly entering the market as competitors of credit insurance products, the Commission has concluded, on the basis of product characteristics and prices, that credit insurance and factoring are still different product markets.²³⁸

With respect to life insurance, it has to be noted that products generally carry a large savings component. Therefore, the relevant market may also include non-insurance companies (eg pension funds) that offer long-term savings products.²³⁹ As insurance products compete little or not at all with each other, the empirical literature tends to treat each of them as a separate market, even if they are offered jointly by the same companies.²⁴⁰

Turning to the geographic market definition, markets for some bank products appear to remain local, while others are national or international in scope. Among the latter are the markets for large commercial loans and credit card loans, secondary loan markets and other wholesale markets, while the local markets include household and small-business transactions accounts, small business lending and some types of consumer lending.

In empirical research, local markets are usually approximated by areas such as provinces, rural counties, cantons or metropolitan areas.²⁴¹ For the United States, this assumption is supported by survey evidence indicating that both consumers and small businesses overwhelmingly procure banking services from suppliers located within a few miles of the customer. It is still rare to bank with institutions that can be reached only via the telephone or internet. In fact, some recent articles in the popular press suggest that firms that have attempted to stress internet-based banking are retrenching.²⁴² Thus, on the demand side, markets for some bank products appear to be local.²⁴³

Retail bank product markets are also local in Europe.²⁴⁴ Despite the development of electronic banking and other advances, “there are still high ‘transport costs’ in retail banking and this

²³⁶ One of the major barriers to entry for firms that want to expand their insurance activities is the often limited availability of knowledge on loss statistics. This should be properly taken into account when defining relevant markets for competition purposes.

²³⁷ The factors that induce the fragmentation of the non-life insurance market are only partially mitigated by the similarities between the technologies used by banks and insurance companies (information processing, risk management, etc) that imply the possibility of including a broader range of institutions in the market definition.

²³⁸ Case Comp/M. 1082 - Allianz/AGF, OJ C 246/4; 6.8. 1998; case Comp/M. 1101 - Hermes/Sampo, OJ C 212/6, 8.7. 1998; case Comp/M. 1661 - Crédit Lyonnais/Allianz-Euler/JV, OJ C 285/6, 7.10. 1999.

²³⁹ See Table 4 in OECD (1998).

²⁴⁰ For example, Cummins, Tennyson and Weiss (1999) split the industry into five product markets.

²⁴¹ See Egli and Rime (2000) for Switzerland; MacKay (1998) for Canada; Rhoades (1996) for the United States; Sapienza (1998) for Italy; and the Wallas Committee (1997) for Australia.

²⁴² See Costanzo (2000), Day (2000), Julavits (2000a and 2000b), Snel (2000) and Toonkel (2000).

²⁴³ See Kwast, McCluer and Wolken (1997).

²⁴⁴ See Dermine (1999).

means that entry into foreign markets must be based largely on the opening (or acquisition) of a branch network.”²⁴⁵

Also, on the supply side there is evidence that some banking markets are local. The number of bank branches in most countries continues to increase despite a consolidation process that has reduced the number of independent banking organisations and legal changes that have largely removed legal constraints on bank geographic expansion. This indicates that firms continue to feel the need for a local presence.²⁴⁶ Continental Europe has a greater density of branches than English speaking countries, an indication of local markets and that technology has not yet led to a reduction in the number of branches.²⁴⁷ While cross-border banking is growing, it is still at a low level.²⁴⁸

For wholesale banking products, the introduction of the euro has increased the geographic scope of the European market since it has eliminated foreign exchange risk. Bond markets have tended to be national in scope, but have expanded with the adoption of the euro; cross-border competition should also increase for services like correspondent banking. The geographic scope of the activities is national or international also in the case of financial markets, and in particular money market trading, foreign exchange trading, derivative trading and asset management.²⁴⁹ On the contrary, for other services in the corporate banking sector – especially those provided in connection with exports – the Commission has found that the activity is predominantly national in scope, since it usually requires a close relationship between a bank and its customers in order to meet the particular needs of the clients.²⁵⁰ Investment banking services, which usually require a knowledge of national corporate law and the company structure as well as of accounting principles and the local market habits, are also considered to be national in scope.²⁵¹ In general, while acknowledging that many M&As are cross-border, the Commission has distinguished between the activity, which may be international in scope, and the service provided, which is mainly national in scope and may require that the principal advisor be physically established in the country where the target company is situated.

Geographic markets for most insurance and securities activities appear to be national in scope (or statewide for the United States). For example, for products like automobile insurance, consumers generally search only within the state or nation and the degree of regulation varies substantially across states and countries.²⁵² Nevertheless, some argue that barriers to entering geographic markets are low relative to the barriers to entering different product lines.²⁵³

²⁴⁵ See Gual (1999) and Vives (1999).

²⁴⁶ Local geographic markets for banking are not universally accepted. Hannan and Strahan (2000) find that geographic markets for certain banking products under a certain size limit may be broader than the typically local market. They find that, in most cases, markets that correspond to US states explain price variations better than local markets.

²⁴⁷ See Barth, Nolle and Rice (1997) and European Central Bank (1999).

²⁴⁸ See White (1998).

²⁴⁹ See European Commission, case M. 597 - Swiss Bank Corporation/S.G. Warburg, OJ C 180, 14.7. 1995, and case no IV/M 1043 - B.A.T./Zurich.

²⁵⁰ Case No IV/M. 596 - Mitsubishi Bank/Bank of Tokyo.

²⁵¹ See case Comp/M. 319 - BHF/CCF/Charterhouse, paras 6 and 9.

²⁵² See Bajtelsmit and Bouzouita (1997).

²⁵³ See Chidambaran, Pugel and Saunders (1997).

How consolidation affects prices

Banking

In general, competition in the banking industry has increased in the last few years due to deregulation and technological innovation.²⁵⁴ Consolidation might affect prices, especially in local markets that witness significant increases in concentration, but these might be unusual cases given the decisions of antitrust authorities that have blocked altogether mergers that would have sharply reduced competition (eg Canada) or demanded compensatory measures such as the sale of branches in markets where the increase in market share resulting from the deal would have been threatening to consumers (see Annex V.1). In fact, the pre-emptive action of antitrust authorities limits the possibility that merging intermediaries could take advantage of their increased market share, thus reducing ex ante the incentives to merge in order to exert market power.

In the United States, for example, four bank mergers have been denied on competitive grounds in the last decade, and branch divestitures have been negotiated in more than 50 cases. In Italy, the Bank of Italy (the antitrust authority for the banking sector) demanded in 10 cases the sale or closing of branches as a condition to allow mergers. In the case of the Bank Austria-Creditanstalt merger, undertakings were required by the European Commission before authorising the deal. The Swiss Federal Competition Commission authorised the UBS merger conditional on some limitations, among them the divestiture of 25 branches (see Annex V.2). In Canada in 1998, proposed mergers involving four banks accounting for 70% of bank assets were rejected; one concern cited in the rejection was that the mergers would have led to a substantial lessening of competition that would have caused higher prices and lower levels of service. In January 2000, the acquisition of Canada Trust by TD Bank was approved, but the divestiture of 13 branches and the Canada Trust MasterCard portfolio were conditions of the approval. In addition, in each country an unknown number of merger proposals have been aborted due to competitive concerns raised by antitrust authorities.

The effects of consolidation on competition can be evaluated indirectly in cross-sectional studies comparing markets with different degrees of concentration at a point in time. Alternatively, they can be examined directly, by studying markets that have experienced consolidation. Studies using the former, indirect approach with European data generally find that higher concentration leads to less favourable conditions for bank customers.²⁵⁵ The US evidence is consistent with that for Europe, indicating the existence of market power in connection with prices for small business loans and retail deposits.²⁵⁶ Studies using data from the 1990s indicate that the connection between concentration and retail deposit rates has dissipated somewhat relative to the previous decade.²⁵⁷ Examination of fees instead of interest rates shows that the degree of market power for retail deposits and payment services is relatively low.²⁵⁸ Nonetheless, there is some empirical evidence which finds that competition

²⁵⁴ For example, Angelini and Cetorelli (1999) show that the Italian banking system has become highly competitive in the 1990s. For similar studies see also De Bandt and Davis (1999) and Shaffer (1994).

²⁵⁵ De Bonis and Ferrando (1997) find a positive relationship between concentration and interest rates on loans in Italy. A similar result is obtained by Egli and Rime (2000) for Switzerland. Swank (1995) finds inverse relationships between concentration and price-competitiveness in Dutch markets for savings deposits and mortgages.

²⁵⁶ See Berger and Hannan (1989) and Hannan (1991).

²⁵⁷ See Hannan (1997) and Radecki (1998).

²⁵⁸ See Hannan (1998).

has not been offset by consolidation even though an increase in concentration has been observed.²⁵⁹

Indirect evidence on cross-sector competition can be drawn from the change in banks' behaviour when their borrowers become listed on a stock exchange. A study of IPOs in Italy finds that after being listed, firms pay lower interest rates, receive more credit and increase the number of banks that lend to them.²⁶⁰ This means that the availability of diverse sources of financing (in this case because of listing, but this might be also true in the case of competition from other players, including non-banks) causes banks to react, to the benefit of their customers.

Direct studies confirm that M&As may influence market prices. In the United States, a reduction in the interest rate on deposits is detected in markets that have been affected by consolidation.²⁶¹ A study of Italian M&As finds that loan rates increase when the market share of the acquired bank is large.²⁶² Estimates of the impact of mergers on prices for the Swiss retail banking market indicate that concentration may have a negative effect on prices.²⁶³

In conclusion, the empirical evidence suggests that there are entry barriers for banking markets and that market structure affects prices. While legal barriers to entry have been reduced over the last few decades, economic barriers such as economies of scale (although minimum efficient size is relatively small: see the section on consolidation and efficiency), switching costs and informational asymmetries remain important. Tests of the multi-market contact hypothesis do not find significant evidence of collusion among firms that compete against each other in different geographic markets;²⁶⁴ competition issues seem limited to in-market behaviour.

Investment banks

The investment banking industry is highly internationalised: among the largest firms in each geographic area are institutions from the United States, the United Kingdom, Japan, France, Germany, the Netherlands etc. This indicates that the market is international in scope. However, the same firms dominate product markets in most geographical areas: in equity underwriting, the top five firms consistently have a market share above 50%, be it initial public offerings (IPOs) or secondary offerings (see the tables in Chapter I). Moreover, the top ten firms, although with different rankings, come up in almost all "league tables", confirming the general impression that the industry is in fact highly concentrated, even at a supranational level. The same can be said of M&As advisory services, both for the United States and the European markets (see the tables in Chapter I). The US syndicated loan market and the debt underwriting market are less concentrated (see the tables in Chapter I), mainly because of competition from commercial banks.

There has been almost no analysis on competition for the investment banking sector. In Italy a thorough examination was performed by the antitrust authorities; it concluded that even though the market for investment banking was dominated by a small number of firms, there was no evidence of abuses.²⁶⁵

²⁵⁹ In Fuentes and Sastre (1998) for Spain, using the dispersion of interest rates as a proxy for competition, it is found that consolidation has not negatively affected the heightening competition which has developed in Spanish bank markets during the nineties.

²⁶⁰ See Pagano, Panetta and Zingales (1998).

²⁶¹ See Prager and Hannan (1998) and Simons and Stavins (1998).

²⁶² See Sapienza (1998).

²⁶³ See Egli and Rime (2000).

²⁶⁴ See De Bonis and Ferrando (2000) for Italy and Pilloff (1999) for the United States.

²⁶⁵ See Banca d'Italia and Autorità Garante della Concorrenza e del Mercato (1997).

A study of the US market for IPOs found that underwriting commissions cluster at 7% for issues below USD 100 million, while they are lower by half in other countries.²⁶⁶ A possible explanation is that investment banks recognise that if they undercut each other they would collectively end up with lower profits; this behaviour is only possible if they have some form of market power, due, for example, to barriers to entry.²⁶⁷

One analysis of the US market for corporate securities underwriting finds that entry of commercial banks has significantly reduced underwriter commissions in the corporate debt market.²⁶⁸ The reduction is strongest in those market segments in which banks' market share was larger. This suggests that entry of banks into the corporate securities market has significantly enhanced competition relative to the previous situation, in which only investment banks were active.

There is little or no research on the effects of M&As on prices and availability of investment banking services. However, the indirect evidence mentioned above suggests that in-market consolidation among important players might result in a significant increase of market power, thus harming customers. In fact, the sector is highly concentrated, and research for the United States – the largest world market – suggests that in some segments firms may already be exerting significant market power. Moreover, barriers to entry are likely to survive the technological developments foreseeable in the near future, as they are mainly due to the importance of reputation and to the placing power of underwriters.²⁶⁹ However, at the moment, the consolidation process involving investment banks is mainly cross-sector, aiming at creating financial conglomerates with commercial banks, asset management and insurance companies, so that it may not represent a clear threat of anticompetitive behaviour.

Insurance companies

Two studies of insurance markets in the United States find higher prices in more concentrated markets. A study of a cross section of state markets for automobile insurance finds higher premiums in states with more concentrated industries.²⁷⁰ An examination of a cross section of 18 types of insurance finds higher premiums in those insurance lines with higher four-firm concentration ratios.²⁷¹

The last few years have witnessed considerable consolidation in the insurance industry, particularly in the United States and Europe, including large mergers between banks and insurance companies. Nonetheless, according to an OECD report,²⁷² the insurance market is competitive, although the extent of competition seems to vary significantly from product to product and from country to country.

²⁶⁶ See Chen and Ritter (2000).

²⁶⁷ This case is similar to that of market-makers in stock markets. In 1998, NASDAQ market-makers agreed to pay a large fine in a settlement that followed the suspicion that they were colluding in fixing the bid-ask spreads. Although the issue did not involve consolidation, it is still suggestive of behaviours that might intensify as M&As reduce the number of players in reputation-sensitive industries.

²⁶⁸ See Gande, Puri and Saunders (1999). The study finds that the reduction in underwriting spreads has not been compensated by higher yield spreads; on the contrary, yield spreads have also declined.

²⁶⁹ There is some evidence that a security's features and the underwriter's reputation influence the level of underwriting commissions. See Carow (1999).

²⁷⁰ See Bajtelsmit and Bouzouita (1998).

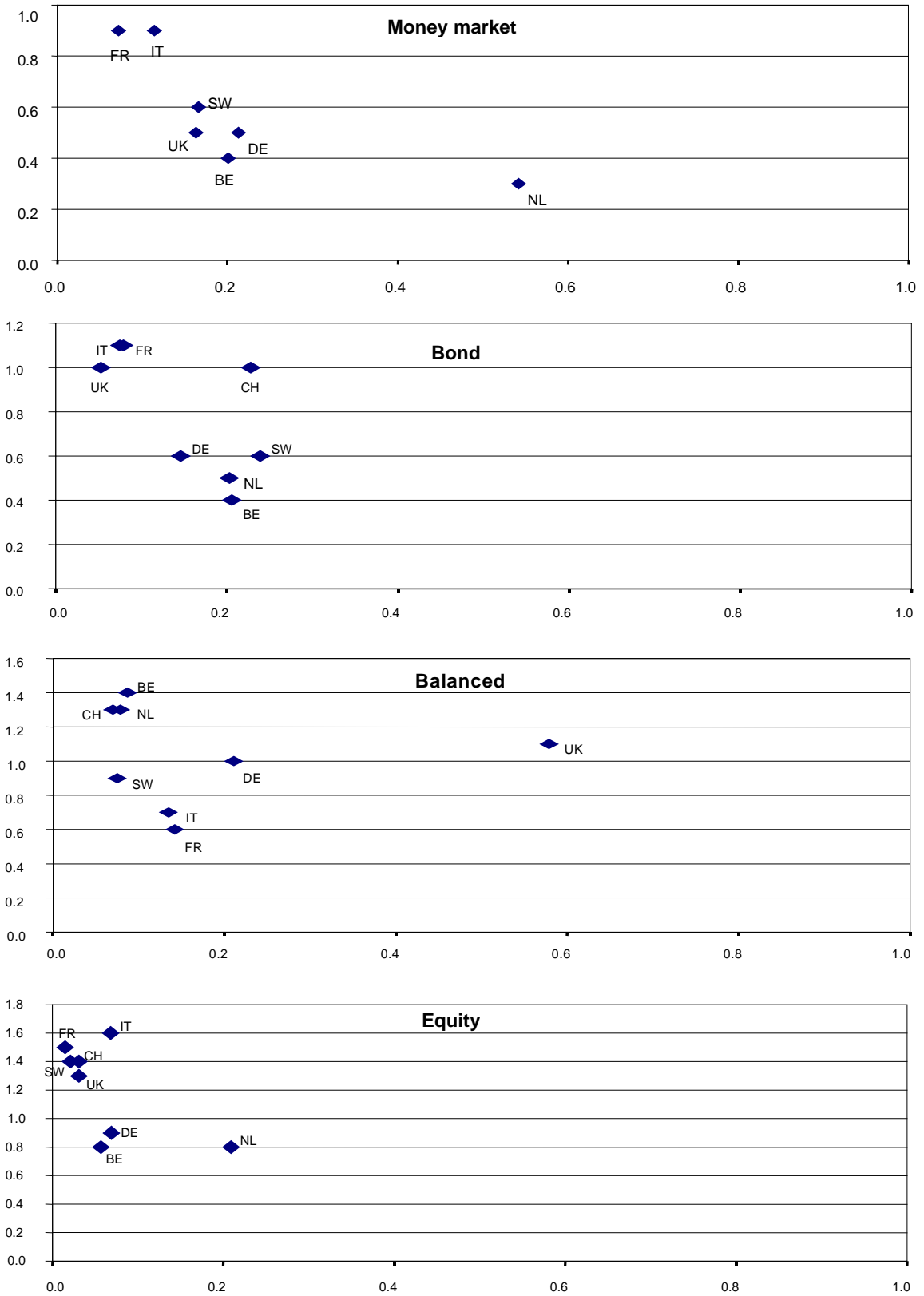
²⁷¹ See Chidambaran, Pugel and Saunders (1997).

²⁷² See OECD (1998).

Mutual funds

At first glance, there seems to be a negative relationship between market concentration and fees in the European mutual funds industry, in particular for money market, bond and equity products (see Chart V.2). This suggests either that market power is not a relevant issue in this industry, or that the possible existence of market power is more than offset by efficiency gains or scale economies that are passed on to consumers. However, given that most countries have similar levels of concentration but different average fees, the explanation for the cost and revenues structure might be country-specific for each segment of the mutual funds industry.

Chart V.2
Management fees and concentration in mutual funds industry
 (percentage points and Herfindahl-Hirschman index)



Source: Lipper. Management fees (vertical axis) are simple averages of maximum charges. The Herfindahl-Hirschman index (horizontal axis; monopolistic market=1) refers to market shares of the ultimate parent companies of fund management groups.

Conclusion

Overall, the evidence favours the hypothesis that more concentrated markets are less competitive and that large in-market mergers may significantly increase market power, thus harming customers, especially in retail banking markets and markets for some investment banking services. However, technological changes and product innovations may alter the results based largely on data from a few countries and referring to the early 1990s or earlier.

The future impact of technology

The diffusion of the internet and of electronic commerce could have major implications for the geographic market definition and therefore for the relationship between M&As and competition. Although electronic finance is not yet widespread, forecasts suggest a rapid growth in the near future; the penetration of online banking in Europe is projected to grow from 8% in 2000 to 22% in 2003; in the United States it should grow from 15 to 33%.²⁷³ If financial services can be purchased or supplied effectively by electronic means, geographic limits to market expansion may disappear, increasing the competition from firms located in other areas. Developments in electronic technology could also reduce entry barriers by reducing search costs for consumers, for example by facilitating the development of third-party information brokers. Language barriers may become more significant than entry barriers due to geographic distance. On the other hand, technology could increase barriers to entry due to the large fixed costs of adopting many new computer technologies.

The short- and medium-term impact of e-finance, however, should not be exaggerated for several reasons. First, it is still relatively costly for consumers: the need for a personal computer or mobile telephone to access the internet, and the ability to use these tools still constitute a barrier to its diffusion. Second, electronic banking does not reduce information costs for products where the bank has to rely on information about local markets. Furthermore, new entrants may be forced to back up their internet entry with massive advertising outlays before they can effectively compete. Finally, for some products, customers may demand more than online contracts, however customised. Examples are high-value, infrequently bought items such as life insurance and mortgages, for which one might research terms and conditions online but may wish some personal advice before buying them.²⁷⁴ These reasons may induce customers to keep using local suppliers, even if some services can be purchased electronically from a distant firm.

The picture might change considerably if intermediaries that operate exclusively on the internet emerge. Such firms may be able to offer more attractive conditions than those offered by traditional firms, since they do not need to support a branch network. At the moment, however, the legal framework for such firms is missing, in particular with regard to consumer protection and money laundering. Moreover, in many countries, a customer still has to show up personally in order to open a bank account. In addition, in their lending activity banks may want to continue to rely heavily on local information in the future, as offering some products (eg mortgages) on the internet is considered highly risky.

However, there are also reasons for which the development of e-finance may reduce, rather than increase, competition. The typical financial institution increasingly operates in multiple markets, partly in an attempt to sell bundles of products to customers. Due to technological progress,

²⁷³ A forecast of the penetration of online financial services in Europe in 2003 shows that around 20% of mutual funds and credit cards will be acquired online, while less than 10% of mortgages and life and pension products will be, even though internet users will represent more than a third of the total population. See JP Morgan (2000), p 29 and 37.

²⁷⁴ JP Morgan (2000), p 6 and 25.

these bundles may become increasingly customised for a large number of customers. As a result, switching costs would increase and customers may become locked in to their existing suppliers, thereby reducing potential market entry. Finally, due to technological advances, new ways of distributing financial services may be created which might only be exploited by vertical consolidation of financial institutions with non-financial partners such as telecom and media enterprises. From this perspective, competition in non-financial markets may also become relevant.

Antitrust policy

In this subsection, the antitrust rules that are applied in cases of financial sector consolidation, as well as experiences with their implementation, are described for a sample of G10 countries. The regulatory record on antitrust regulation of financial markets is not complete. In many countries, antitrust concerns have not played a prominent role in regulating mergers to date.

All of the countries covered by this study examine both the structural effects of proposed mergers and the behavioural aspects that may mitigate the anticompetitive effects of structural changes. Large countries with many local banking markets tend to have specific structural rules that serve as screens to determine whether a proposed merger might be anticompetitive in a particular market. If the structural effects of a merger exceed that screen, the merger is examined more closely and behavioural aspects are taken into account.

Smaller countries and countries in which there is not a long history of mergers among financial institutions, such as Japan and most European countries, do not have structural screens for processing mergers. Because of a lower volume of mergers, each proposed merger in these countries can be examined more intensively. An annex to this chapter contains the details of the rules and implementation of antitrust policies in individual countries.

Consolidation in the European Union is an example of the problems that might arise for antitrust authorities if financial institutions continue merging across borders and sectors. Of the decisions taken concerning the banking sector, the only case which gave rise to potential difficulties was the merger between Bank Austria and Creditanstalt.²⁷⁵ The merged entity would have become not only the leading supplier of banking services in Austria, but also the only bank with significant market shares in all relevant product segments. However, Bank Austria gave undertakings to the European Commission that eliminated the competitive concerns relating to the proposed merger.

Other banking cases reviewed by the European Union did not present competitive concerns for one or more of the following reasons. First, for wholesale banking or financial services related to capital markets, there are large numbers of international suppliers – that is, the market in general is not highly concentrated and market shares are rather fragmented. Consequently, customers have had sufficient choice and, barring unlawful collusion, there are no concerns as to restrictions of competition. This conclusion was drawn for example in the merger between Schweizerische Bankgesellschaft and Schweizerischer Bankverein to create UBS, at the time the largest banking institution in Europe. Second, several banking consolidations assessed by the Commission have involved companies which had no activities or only limited activities in the European Economic Area (eg Kyowa/Saitama or BankAmerica/Nationsbank). Finally, in a number of cases (such as the Deutsche Bank/Bankers Trust merger) the operations in question were largely complementary in nature, since there were no substantial overlaps in the activities of the companies.

²⁷⁵ All other banking M&As of which authorities were notified were cleared within the statutory four-week period.

4. Consolidation and the availability of credit flows

Consolidation in the banking industry has raised concerns of a reduction in the availability of credit to small and medium-sized enterprises due to the decrease in the number of small banks that specialise in this type of lending.

There are two sets of arguments as to why this may occur. According to the first, larger and more complex credit institutions have a lower propensity to lend to small firms. Hence, if the industry moves towards a structure with a small number of large banks, credit flows to small borrowers may be reduced. The second argument emphasises the dynamics of consolidation, which may cause a permanent disruption of credit relationships. To the extent that credit relationships between banks and small firms are characterised by soft information, which is less transferable than hard information such as balance sheet and income statements, small firms could face difficulties in finding credit from other sources.

When assessing the effects of M&As on credit flows to small firms, it is necessary to analyse also the behaviour of other market participants, since borrowers that are dismissed by the merging banks may be served by other banks or financial institutions. The effect of the spread of new technologies should also be taken into account because it may have an impact on the lending practices of banks, large or small, and provide new ways of dealing with the information asymmetries that are a fundamental aspect of lending relationships with small firms.

In this section, the relative weight of small firms for G10 countries is briefly examined. After discussing reasons why consolidation may adversely affect credit flows to small firms, the existing analytical evidence is summarised.

The importance of small business credit

Small and medium-sized enterprises (SMEs) make a substantial contribution to national output and job creation. In 1996, on average, they accounted for 66% of total employment in Europe (Table V.5), ranging from 57% in the United Kingdom to 80% in Italy. SMEs are also very important in the United States and Canada, although slightly less than in Europe, as they still represent more than 50% of the labour force. In Japan, SMEs appear to have the highest relative weight in all sectors of the economy compared to the United States and the 15 nations of the European Union, but the data are distorted by the fact that the national statistics are based on establishments rather than enterprises or enterprise groups.

Table V.5
Share of employment accounted for by SMEs

		Industry and energy	Construction	Trade, hotels, restaurants	All sectors
Belgium	1995	55.9	93.7	90.4	72.6
Canada	1994	44.3	89.3	75.6	52.1
France	1995	51.2	84.9	81.3	65.9
Germany	1995	37.6	87.1	73.3	57.7
Italy	1994	74.1	95.2	94.8	79.9
Japan	1993	66.9	95.4	83.9	76.5
Netherlands	1994	49.9	85.2	77.9	66.4
Sweden	1995	46.8	70.9	79.5	60.9
Switzerland	1995	62.2	90.4	76.7	68.8
United Kingdom	1995	47.9	88.2	58.1	56.8
United States	1993	37.5	88.9	58.5	52.9
<i>EU 15</i>	<i>1995</i>	<i>52.6</i>	<i>87.7</i>	<i>78.9</i>	<i>65.7</i>

Source: Eurostat; Enterprises in Europe. For an enterprise to be classified as an SME it must have no more than 249 employees, its annual balance-sheet total must not exceed ECU 27 million, no more than 25 percent of the capital of the enterprise must be controlled by one or more other enterprises, and its annual turnover must not exceed ECU 40 million. Only enterprises with at least one employee are included.

Economic performance may benefit from the presence of SMEs because they tend to be more flexible than larger firms, thus reducing the costs of organisational changes and innovation. Moreover, SMEs are characterised by high rates of entry and exit: failing enterprises are more quickly replaced in sectors where small businesses are widely represented. Thus, a sound small business sector, especially during downturns, may contribute substantially to the process of job creation.

SMEs tend to rely more on debt financing relative to large firms (see Chart V.3) with the exception of the United States, where firms face fewer difficulties in accessing equity markets and where the venture capital industry is more developed.²⁷⁶ Another explanation could be that the aggregate data reflect the sectoral composition of SMEs in each country, as different industries have different financial needs in terms of the mix between equity and different kinds of debt financing.

Breaking down financial debt by source shows that SMEs are mainly financed by banks (Table V.6) and hold a share of bank credit that is significantly higher than that of large enterprises. The only countries that are exceptions to this rule are Japan, where large firms have strong ties with credit institutions, and Belgium. Small firms are very highly dependent on banks in Germany and Italy.

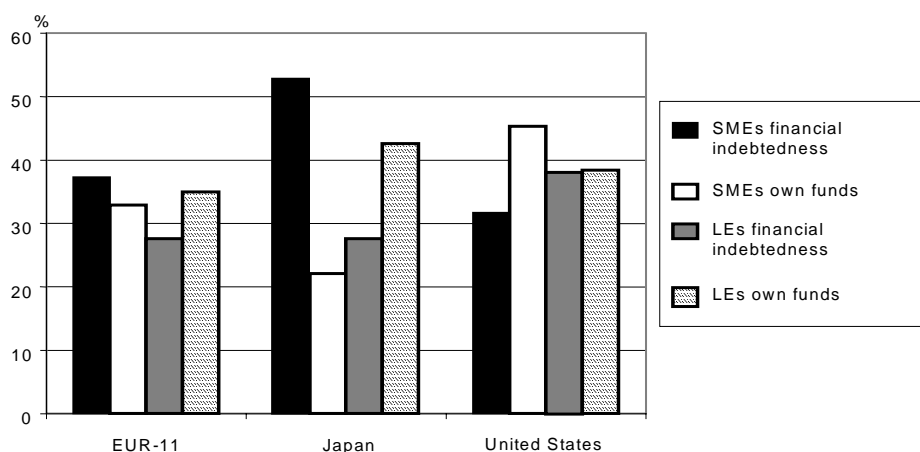
In conclusion, bank credit flows to SMEs appear to be very important in all G10 countries, particularly in Europe. Currently, SMEs are highly dependent on banks but the total availability of funds for them depends not just on consolidation but on all future developments of the

²⁷⁶ For example, in the European Union or Japan, the concept of stock markets specialising in SMEs is a rather new phenomenon, whereas the American Nasdaq was created in the early 1970s.

financial sector. The costs of accessing capital markets and the availability of other sources of financing might change in the future, but demand for traditional forms of bank financing is likely to remain substantial.

Chart V.3

Financial indebtedness and own funds ratio for small and large firms



Definitions: Financial indebtedness = ratio of short-term loans and amounts owed to credit institutions to total liabilities. Own funds = ratio of own funds less unpaid share capital to balance sheet total. LEs = large enterprises.

Source: DGII, BACH.

Table V.6

Share of bank debt to total debt for small and large firms

Country	Bank debt/total debt	
	Small	Large
Belgium (1998)	42.2	50.1
Canada (1996)	53.1	n.a.
France (1998)	44.3	21.2
Germany (1998)	64.1	29.9
Italy (1998)	64.6	27.3
Netherlands (1998)	54.9 ^a	35.9
Japan (1995)	28.2	33.2
United States (1995)	40.9	7.9 ^b

Note: Small firms have sales less than EUR 7 million; large firms have sales greater than EUR 40 million.

^a Also includes medium-sized firms. ^b The figure refers to medium-sized firms, as no information is available for large firms.

Source: BACH; for Canada: "What's New in Debt Financing for Small and Medium-sized Enterprises", The Conference Board of Canada, 1997.

Why consolidation may (not) reduce credit flows to small firms

The impact of consolidation on small business lending

Consolidation increases the size and complexity of the credit institutions involved. There are several arguments as to why this may reduce the provision of credit to small firms.

Smaller banks are constrained in lending to large firms, while large banks have access to a wider pool of borrowers and to a different mix of assets and financial products.²⁷⁷ Once the size constraint is eased, banks might shift their portfolios of loans in favour of larger borrowers or even shift their assets composition away from traditional lending activities.

A second reason could be that in providing credit to small borrowers, characterised by large information asymmetries, small banks enjoy a cost advantage over other banks both in loan origination and monitoring. Therefore, once small banks are replaced by larger ones, a decrease in small business credit may be observed because loans that were profitable are no longer so.

Small firms are considered significantly more opaque than larger ones; since they do not have traded securities on public markets and the requirements on their financial statements are looser, their quality may be more difficult to assess. Banks develop relationships that allow them to overcome asymmetric information problems because detailed knowledge of the firms is gained over time through contact with them.

Small banks may have a comparative advantage in issuing relationship-based loans and in monitoring small firms' activities. Due to their knowledge of the community in which the firm operates, they may have access to soft information on the entrepreneur and on local market conditions. As banks consolidate, their organisational structure tends to become more complex, and the lending decisions may be made at corporate headquarters located at a distance from the firms' activities. It may not be efficient to combine the provision of retail services to small customers with the provision of wholesale capital market services to large customers.²⁷⁸

Moreover, M&As usually involve deep restructuring and changes of branch managers. The reassessment of the loan portfolio by new managers who might not possess this soft information may imply the interruption of some of the existing relationships. Borrowers demanding relationship-based credit will find it difficult to convey their quality to other banks, due to adverse selection problems, and may end up being rationed.

On the other hand, there are reasons why these concerns may be unjustified and small firms might not face problems due to the creation of larger and more complex banking institutions and may even benefit from them. Larger banks or bank holding companies may act as efficient internal capital markets and allocate financial resources to their best use (although internal administrative allocation has problems of its own). In addition, having access to greater diversification opportunities, they can fund a larger number of small and riskier firms. Moreover, during periods of financial stress, large and diversified financial institutions may be stronger and more able to keep providing services to their customers than small, non-diversified local banks. Therefore, the ultimate effect of M&As on small business lending has to be evaluated on empirical grounds.

²⁷⁷ In most countries there are regulatory limits on loan concentration; even in the absence of such limits a bank would not issue loans that account for a high proportion of its capital.

²⁷⁸ See Berger and Udell (1996b).

The impact of changes in the degree of competition

Consolidation may also influence the provision of credit to small firms if it changes the degree of competition in the banking sector. Two opposite mechanisms are likely to be relevant.

Abstracting from informational asymmetries, a less competitive banking system should increase the cost and decrease the supply of credit for all categories of borrowers, thus resulting in less favourable conditions. As small firms make extensive use of bank credit, a decrease in competition may generate significant problems.

An alternative view, which takes into account information asymmetries, suggests that a more competitive banking system may be detrimental to borrowers, such as new and small firms, for whom “soft information”, as discussed above, is likely to be of significance.²⁷⁹ The reason is that a highly competitive environment may discourage intermediaries from investing in long-term relationships, which requires a degree of market power. If the bank expects to be able to extract rents in the future, it will offer lower rates to a borrower facing temporary credit problems. Hence, a reduction in market power of banks in these circumstances may lead to a reduced availability of credit to small firms or new borrowers.

How competitors react to mergers and acquisitions

The total change in the supply of small-business credit resulting from M&As also depends on the reactions of other lenders and on broader developments in the financial sector. Even if a bank reduces its supply of relationship-based loans because it faces diseconomies associated with supplying transaction-based services, other banks that are not burdened by these diseconomies may expand their own supply.

The development of new banks, which are a source of borrowing for small firms, should also be considered. Since de novo banks are small, they issue business loans to small firms. In addition, these new banks may have been created by loan officers who have left consolidating institutions, taking some of their relationship-based loan portfolios with them, or who believe that they possess above average screening capabilities based on knowledge of the local market.

Of course, it may be the case that even if borrowers dropped by consolidating banks are picked up by other lenders, the conditions they will face may be worse (ie higher rates or more collateral). Moreover, the possibility of finding another lender is likely to be influenced by the structure of the banking industry: if the industry is highly concentrated it may be difficult for a small business to find alternatives. If, instead, there are many banks even after the consolidation, it may be relatively easier to shift.

The overall impact on small firms of changes in the supply of bank credit resulting from M&As will also depend on the availability to these firms of non-bank sources of funding. These include equity finance, trade credit and funding by non-bank financial institutions. The access to these alternative sources of finance may vary with the earnings profile of the firm and the category of business in which it operates. Small firms in high-growth, high-risk sectors are more likely to obtain external private equity (ie “angels” and venture capitalists), while firms with steadier income flows and tangible assets more easily obtain external debt finance from banks and other financial institutions because they have collateral.

In countries with particularly concentrated banking sectors (eg Australia, Canada and the Netherlands) consolidation may raise particular concerns for marginal small business borrowers

²⁷⁹ See Sharpe (1990) and Petersen and Rajan (1995). According to this view, the relationship between competition in banking and the availability of credit to new firms is likely to be affected by the informational structure of the market: the ability of banks to obtain information about their clients’ creditworthiness, the extent to which that information is appropriable, the presence of credit rating agencies, and the degree of heterogeneity of borrowers and their ability to signal their creditworthiness.

that may be too risky for some, but not all, financial services providers. For many small businesses seeking financing, there is value in having more rather than less choice. Having a wide range of alternatives for bank financing, credit advice and a variety of other services offered by the banks is particularly important to marginal borrowers because it increases the probability that they will be seen as an attractive business opportunity by at least one service provider. For these borrowers, the question of the availability of financing options is not only a matter of obtaining competitive rates but a question of enhancing the chances of getting a loan at all. In these countries, leaving decisions on credit allocation in the hands of even fewer, larger institutions raises serious concerns that go beyond the issue of competition to the availability of credit at any price.

In Canada, for example, in 1998 four banks accounting for 70% of bank assets announced their intention to merge into two firms. One of the concerns cited in the rejection of the proposals was that the range of remaining alternatives for bank financing and banking services (especially for marginal small firms) would be reduced. The government felt that the question of the availability of financing options is not just a question of competitive rates but a question of enhancing the chances of getting a loan at all.²⁸⁰ Unlike in the United States, the emergence of local small business lenders to fill the gap left by a merger among traditional small business finance providers may not be likely.²⁸¹

The impact of technology

A consideration of increasing importance for banks' propensity to lend to small firms is the impact of technological change. Large banks are increasingly able to use credit scoring to make small-business loans and to process applications using automated and centralised systems. Scale economies allow these banks to generate large volumes of small-business loans at low cost, and improved technology and marketing, which change the delivery of financial services to small customers, make this possible even in areas where they do not have branch offices.²⁸² Credit scoring may also encourage more small-business lending because it gives banks a tool for pricing risk more accurately and makes the securitisation of these loans more feasible than in the past.²⁸³

A key issue, however, is that information technology is expected to reduce the cost of processing hard information. Therefore, it will benefit mainly "transaction-type" loans, which, like credit card loans, do not need much information-intensive credit evaluation beyond what is done in a credit scoring model based on quantitative data. It will not necessarily reduce the cost, and indeed may increase the relative cost, of processing the sort of information typical of relationship lending.²⁸⁴

An important implication of this is that small customers with strong financial statements and valuable collateral should not experience a reduction in credit availability. On the other hand, small borrowers who do not qualify for a sufficiently high credit score will continue to depend heavily on small banks, which offer traditional relationship-based loans. Hence, they may face an increased cost of funds or a reduced availability if credit scoring practices become dominant in the industry.

²⁸⁰ Statement by the Honorable Paul Martin, Minister of Finance, Ottawa, Canada, 14 December 1998.

²⁸¹ See McFetridge (1998).

²⁸² See Mester (1999); see also Berger, Saunders, Scalise and Udell (1998).

²⁸³ The securitisation of small-business loans has usually been limited, not least because of their heterogeneous nature. Credit scoring will tend to increase the standardisation of loans.

²⁸⁴ See Petersen (1999).

The empirical evidence

Empirical research on consolidation and small-business lending has followed two approaches. The first one infers indirectly the effects of M&As in the financial industry by analysing the relationship between firm size and bank size, using both market-level and bank-level data. The second one examines directly the changes that occur in small-business lending by the institutions involved in M&As. The majority of the existing literature is based on US data; some evidence exists for Italy.

Indirect evidence: bank size and small-business lending

Evidence shows that larger banks have a lower share of small-business loans to total loans. This is usually interpreted as evidence that consolidation may harm small-business lending.²⁸⁵

The effects of bank size on small-business lending have also been studied employing market-level data. The relative weight of small banks in local credit markets has not been found to influence the probability of a small firm having a line of credit from a bank. Some short-run disruption may occur, but firms in areas with fewer small banks do not appear to be more credit constrained.²⁸⁶

The hypothesis that increased organisational complexity may negatively affect the propensity to lend to small firms has found some support in the empirical literature. Results from investigating loan contract data suggest that larger banks tend to issue many fewer loans to these borrowers, although they charge lower rates and require less collateral. A similar result holds for banks with greater organisational complexity, as measured by proxies of the holding company structure.²⁸⁷

Direct evidence on M&As and small-business lending

Consolidating banks often reduce their total small-business lending. Several explanations have been suggested for this result. A first explanation is that the bidder tends to drive the share of small-business lending in the portfolio of the merged bank towards the share that the bidder held prior to the merger.²⁸⁸ Since the bidders are usually larger than the targets and hence have a smaller share of small-business loans, on average, M&As tend to reduce the availability of credit to small firms.

A study on the effects of bank M&As in Italy finds that banks involved reduce their share of credit to small firms.²⁸⁹ The reduction does not seem to be associated with organisational problems, because it follows M&As that generate differing levels of complexity for the integration of the banks involved. It does not appear to be related to loss of information either, because M&As are not followed by a reduction in the number of employees. In fact, the reduction of the share of credit to small firms seems part of a broader strategy of asset allocation that changes the composition of the loan portfolio towards larger, less risky borrowers and reduces credit to low-quality firms. This is consistent with the results of another study which finds that small borrowers who maintain their relationship with the consolidated bank are those least harmed by increases in interest rates.²⁹⁰ At the local (provincial) level the temporary

²⁸⁵ See Berger, Kashyap and Scalise (1995).

²⁸⁶ See Jayaratne and Wolken (1999).

²⁸⁷ Berger and Udell (1996a) test whether large and complex banks supply less credit to small business borrowers relative to smaller, less complex banks.

²⁸⁸ See Berger, Saunders, Scalise and Udell (1998), Peek and Rosengren (1998) and Walraven (1997).

²⁸⁹ See Focarelli, Panetta and Salleo (1999).

²⁹⁰ See Sapienza (1998).

reduction in lending to small firms is comparable in size to the reduction of lending to all firms, thus confirming that consolidation determines a general revision of the loan portfolios; borrowers in good standing (including small ones) do not appear to be negatively affected by consolidation.²⁹¹

Overall, the evidence discussed above suggests that consolidating banks do adjust their small-business lending strategy after consolidation. The direction is generally towards a reduction, but there are cases in which the change is in the opposite direction, as in the case of a small bank buying a larger one. Therefore, from a policy standpoint, the main finding of the papers summarised in the previous sections cannot be used as an accurate predictor of what will occur in the future and in different countries, since the impact of M&As on small-business lending depends crucially on the motivations of the deal and on the type of banks involved. Moreover, what is relevant is the total availability of credit to small borrowers; accordingly, some studies (discussed below) do not focus exclusively on consolidating banks but extend the analysis to the behaviour of other institutions in the same markets.

The reaction of competitors

Even if consolidation involves the interruption of some relationships, if the borrowers are able to find other lenders at the same cost there would be no effect on total lending. Other banks or other providers of financial services may pick up small-business loans dropped by merging banks, if these loans are profitable.

Some evidence on a positive reaction by the competitors of consolidating banks that reduce small-business loans has been found in US data.²⁹² One study examined the effect of M&As on the small-business lending of other banks in the same local markets and found that they tend to offset the reduction in the supply of credit to small firms by the consolidating banks. Another study employing market-level data finds that in markets where consolidation reduces small-business lending other institutions tend to increase it.²⁹³

Finally, de novo banks tend to lend more to small firms than other banks of similar size,²⁹⁴ so entry may be another source of substitutes. However, de novo banks are generally small; therefore, their effect is likely to be felt in the long term. Consolidation may be itself a determinant of entry in local markets as the structure of the banking sector changes; lending to small firms may shift across different categories of banks.²⁹⁵ One problem with the existing studies is that only the quantity of credit issued is examined but no information is available on rates and other contract terms.

Impact on birth rates of firms

As discussed previously, consolidation changes the competitiveness of the banking sector, thus indirectly influencing credit allocation. Several studies have investigated the relationship between the degree of competition and the availability of credit to small firms.²⁹⁶

In more concentrated banking markets commercial loan interest rates tend to be higher, especially for small firms that face higher switching costs.²⁹⁷ Other research has found, instead,

²⁹¹ See Bonaccorsi di Patti and Gobbi (2000).

²⁹² See Berger, Saunders, Scalise and Udell (1998).

²⁹³ See Avery and Samolyk (1999).

²⁹⁴ See DeYoung (1998) and Goldberg and White (1998).

²⁹⁵ See Berger, Bonime, Goldberg and White (1999).

²⁹⁶ See Petersen and Rajan (1994).

evidence of the positive effect of market power described by the theory on relationship lending: young firms in concentrated markets receive more credit than do similar firms in competitive markets, but such difference tends to disappear as firms become older.²⁹⁸

Concentration has been found to have a strong negative effect on the aggregate rate of birth of firms. Another study has found that in local banking markets the relationship between concentration and the rate of birth of firms differs across industries. Specifically, concentration appears to be relatively beneficial (or less unfavourable) for firms in highly opaque industries, as these industries have relatively higher rates of firm birth.²⁹⁹

Conclusions

Empirical evidence suggests that consolidation may have diverse effects on small-business lending. Although there are reasons for concern that the reduction in the number of smaller institutions may harm small-business lending, there is no evidence on the quality of borrowers that are discontinued credit. What appears to be most relevant is how permanent changes in market structure affect the competitiveness and efficiency of the industry, and how these factors will affect allocative choices of banks across different segments of borrowers. In addition, there is little evidence yet on how technology and the blurring of boundaries across financial products change relative costs and revenues from servicing different types of borrowers.

5. Policy issues

Competition policy

Policymakers and regulators should take into account how competition is affected by the ongoing consolidation process and changes in technology, in particular with regard to the evaluation of the benefits to the consumer and the burden laid on the industry.

There is little evidence on the benefits of consolidation (if any, they seem to be smaller for larger firms) and there are concerns about possible abuses of market power, especially by investment banks and by providers of local bank products such as small-business lending and financial services for households. Therefore, when proposing transactions, supervisors of financial institutions should carefully examine claims of efficiency improvements (mainly cost reductions to be passed on to consumers) that firms believe they will generate. This is especially important in cases in which a merger could raise significant issues of market power, such as for markets with significant economic or regulatory barriers to entry, or that are highly concentrated.

The impact of consolidation on competition can be assessed only by using an empirically supported definition of the relevant product and geographical markets. For example, electronic commerce and electronic banking may increase competition by enlarging the markets geographically; on the other hand, they could facilitate consumer lock-in by increasing switching costs, thus changing the definition of the relevant bundle of products to be analysed. Since financial markets are constantly changing, their definition has to be scrutinised regularly, taking into account the differential impact on different classes of consumers, such as households, small and large firms etc.

²⁹⁷ See eg Hannan (1991).

²⁹⁸ See Petersen and Rajan (1994 and 1995).

²⁹⁹ See Bonaccorsi di Patti and Dell'Araccia (2000).

In particular, the impact of technological changes could be more powerful for households than for small firms, since standardised techniques such as credit scoring models are more suited to the former. The analysis of the relevant markets for antitrust purposes should focus less on institutional categories, such as administrative boundaries (provinces, counties etc) or classes of firms (banks, insurance companies etc); it should take more into account changes in the geographic and the product dimension as well as changes in demand. In any case, the goal of antitrust authorities should be to maintain competitively structured markets.

In order to increase competition in an environment subject to mergers that significantly reduce the number of providers of financial services, obstacles to the mobility of customers should be removed. This could be done for example by setting and enforcing transparency rules regarding products and prices, or by simplifying the process of changing providers, eg by allowing customers to keep their account numbers and by enforcing the transfer of historical transaction information between intermediaries. Better flows of information between customers and financial institutions could also decrease the asymmetric information problems between small firms and banks; this in turn would limit the probability of credit rationing and relax one of the constraints set by regulators on M&As.

Alternative sources of finance

The problems faced by small firms in funding their projects might be alleviated if alternative sources of finance, both in terms of providers and products, are developed. This is particularly relevant for countries where firms rely more heavily on bank finance; the diversification of firms' financial structure could be encouraged, for example, by moving towards fiscal neutrality between debt and equity, by increasing the protection of minority shareholders, by fostering the development of equity markets or by decreasing the costs of being listed.

Alternative sources of finance, which include venture capital, private equity markets, specialised financial institutions and stock markets for small firms, may become more available as information generating and storing costs decrease and expertise in this field becomes more widespread, especially in Europe and Japan. Policies that encourage transparency and promote awareness of financial markets (such as, for example, incentives for individual pension plans and the diffusion of ratings) would be helpful in this respect.

Cross-industry competition may be beneficial to consumers both indirectly, by improving their outside options, and directly, by competing with existing products and by offering new products that increase consumers' choice. Eliminating policies that limit cross-industry competition would have a beneficial effect. In countries with particularly concentrated market segments, however, the costs and benefits associated with cross-industry M&As would have to be evaluated with special care.

Adequacy of data flows

Antitrust policy needs data on market shares, prices, and volumes of activity in key financial services business lines in order to be enforced efficiently. The financial services industry already regularly provides some of the relevant data; however it would be advisable to enrich the available information, especially at the firm level. The burden of these added reporting requirements should be minimised; authorities should explore ways to encourage financial institutions to contribute the needed data on an ongoing basis, possibly by publishing in return the aggregate data they collect for policy purposes.

In order to limit unjustified costs to the industry, authorities could focus on collecting data only in areas where the consolidation of the financial sector is likely to have significant effects, such as small-business lending and retail branch banking services. In some countries it might be possible to rely on sample surveys of financial institutions rather than having the entire financial services industry report data.

In general it is important to consider what kind of information should always be readily available so that the impact of M&As can be quickly assessed. In the area of small-business lending, for example, it is essential that governments and regulators be able to assess the impacts of financial sector consolidation on the availability of credit for small firms. At the moment, in many countries there is a lack of specific data on small-business lending and other forms of debt financing such as leasing, as well as little information on the availability of equity financing (eg venture capital).

Technology and consolidation

Technological progress is changing the landscape of the financial industry. It may increase the importance of economies of scale and scope, raising the minimum efficient size for financial institutions. This means that larger institutions could achieve cost reductions and pass them on to consumers, as long as markets remain sufficiently competitive. However, technological progress can also decrease competition by contributing, for example, to locking in consumers through increased switching costs. In this case, larger, more technologically sophisticated institutions could take advantage of their customers. Antitrust authorities should therefore focus on anticompetitive behaviour at least as much as on changes in market structure and on efficiency gains when analysing the potential effects of M&As.

Annex V.1

Antitrust rules and their implementation in specific countries

Australia

Rules

Competition policy in Australia is governed by the Trade Practices Act of 1974. The Act prohibits M&As that have the effect, or likely effect, of substantially lessening competition in a market. The Australian Competition and Consumer Commission (ACCC) is responsible for administering the Act.

Implementation

To determine whether a merger breaches the Act, the ACCC must define the relevant market and judge whether the merger would substantially lessen competition.

In defining a market, the ACCC takes into account the availability of substitutes, the geographical area over which an individual firm could exercise market power and the length of time that it may take other suppliers to develop substitutes for the merged firm's products. In its assessment of recent applications for banking mergers, the ACCC has indicated that it considers markets for wholesale banking (such as corporate fund raising and derivatives trading) to be national in scope; however, a more narrow, regional or state-based market has been applied to retail banking.

In assessing whether a proposed merger would substantially lessen competition, the ACCC takes into account such factors as market concentration, import competition, barriers to entry, the presence of vigorous and effective competitors, and the pace of product innovation in the market.

In assessing market concentration, the ACCC considers both the merged firm's market share and the share of the four largest institutions in the market. If the post-merger combined market share of the four largest firms is 75% or more, and the merged firm's share is 15% or more, the ACCC will need to consider other factors before permitting the merger. If the merged firm's market share exceeds 40% (regardless of the market share of the four largest firms) this also prompts further scrutiny by the ACCC.

In addition to the requirements set out in the Act, the Commonwealth Government has indicated that mergers amongst the four largest banks will not be permitted until competition in the financial industry, particularly in small-business lending, has substantially increased.

Belgium

Rules

Since 1991, the protection of economic competition in Belgium has been based mainly on theoretical foundations identical to EU competition law. According to the law of 5 August 1991 on the Protection of Economic Competition, as changed in 1999, three authorities oversee its application: the Commission of Competition (advisory body on general competition policy), the Service of Competition (the public administration charged with inquiries and the follow-up of the law's application) and the Council of Competition (an administrative judicial body that ensures the law's application and sanctions offences). They are the competent authorities for all economic sectors; for the financial sector, there is an ex ante authorisation of the Commission of Banking and Finance (CBF), the supervisory authority for the banking and financing sector. Under articles 30 and 31 of the law of 22 March 1993 on the establishment and supervision of

financial institutions, by and large all M&A operations in the financial sector must ask for this prior authorisation.

Implementation

In the recent past, Belgium has experienced a number of large M&As in the financial sector. The CBF has only three months to investigate a case and is presumed to approve any operation unless otherwise stated. It is also restricted in its disapproval to the evaluation of the sound and prudent management of the financial institutions concerned. The CBF has never refused its approval. Neither has the Council of Competition found any infringements, though this may be due in part to a difficult working situation, culminating in its temporary resignation from office in 1997, and a changing legal framework.

Canada

Rules

Generally, mergers are not challenged on the basis of concerns relating to the unilateral exercise of market power where the post-merger market share of the merging parties would be less than 35%. Mergers are not challenged on the basis of concerns relating to the interdependent exercise of market power where the share of the market accounted for by the four largest firms in the market after the merger would be less than 65%, and the merging parties would hold less than 10% of the market.

Implementation

First, the Competition Bureau, a federal agency within the Department of Industry, defines the relevant product and geographic markets. Second, it examines the parties' market shares and overall industry concentration. Third, the Bureau assesses key evaluative factors listed in Section 93 of the Competition Act, such as foreign competition, availability of acceptable substitutes, barriers to entry, change and innovation, removal of an effective competitor, business failure and exit, and the effectiveness of remaining competitors. All of these are used to determine the likelihood that prices will rise or service decline after the merger. Finally, efficiencies are examined if it is concluded that the merger results in a substantial lessening or prevention of competition. The Competition Act provides that a merger may proceed if (i) these efficiencies represent cost savings that would not be attained if a remedial order against the merger were made, and (ii) the cost savings represent real savings in economic resources. The analytical framework used by the Competition Bureau is described in the Merger Enforcement Guidelines as Applied to a Bank Merger released on 15 July 1998.

European Union

Rules

The approach of the European Community to merger control is part of a competition policy that has developed separately from equivalent national policies. It has been designed not only to ensure the objective contained in the Treaty of Rome that competition "in the common market is not distorted", but also as an instrument to facilitate integration and the development of the internal market. The Merger Regulation, which came into force in September 1990 and was modified in 1997, extended and clarified the Community's responsibilities concerning merger control.

The Merger Regulation gives the European Commission exclusive responsibility to control mergers with a Community dimension. The procedure is initiated by mandatory notification by the parties concerned. Smaller mergers remain in principle under the control of national authorities. The division of responsibility is made on the basis of the turnover of the enterprises

involved. The starting point for establishing whether a consolidation is considered to have a Community dimension is that:

- the aggregate worldwide turnover of all the undertakings concerned is more than EUR 5 billion; and
- the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than EUR 250 million, unless each of the undertakings concerned achieves more than two thirds of its aggregated Community-wide turnover within one member state;
- A concentration that does not meet the above-mentioned thresholds has a Community dimension where: (i) the combined aggregate worldwide turnover of all the undertakings concerned is more than ECU 2,500 million; (ii) in each of at least three member states, the combined aggregate turnover of all the undertakings concerned is more than ECU 100 million; (iii) in each of at least three member states included for the purpose of point (ii), the aggregate turnover of each of at least two of the undertakings concerned is more than ECU 25 million; and (iv) the aggregate Community-wide turnover of each of at least two of the undertakings concerned is more than ECU 100 million, unless each of the undertakings concerned achieves more than two thirds of its aggregate Community-wide turnover within one and the same member state.

In the context of exclusive Commission responsibility for dealing with mergers with a Community dimension, the Regulation states that no member state can apply its national legislation on competition to such cases unless it is to protect legitimate interests, which are defined as public security, plurality of the media and prudential rules.

Implementation

The Commission adopted over 160 decisions on mergers in the financial sector (including banking, insurance and pension funds) between January 1991 and mid-May 2000. Almost all of those examinations have been of cross-border operations, involving companies from at least two different EU member states or companies located in third countries, generating a certain turnover within the European Union. This relatively low number of decisions reflects the fact that, to date, most mergers in the financial sector have been domestic and have lacked a Community dimension, so that the examination has been left to the member state concerned. The trend towards cross-border consolidation is stronger in smaller member states, in particular in the Benelux countries. Of the 90 Commission decisions on banking mergers, for example, 20 cases concerned Belgian and 12 Dutch firms. A similar trend can be observed in the Nordic countries.³⁰⁰ This may be explained by the fact that credit institutions in smaller markets are more dependent on international expansion to achieve a critical mass. Language and cultural similarities may also be a factor.

France

Rules

For M&As among banks which do not fall under European Community regulation, and in the present state of French competition legislation (which is not completely clear on this subject), takeovers in the banking sector seem to be out of the jurisdiction of competition authorities, although some aspects of financial competition are within their jurisdiction.

³⁰⁰ These include, for example, Royale Belge/Anhyp, Kredietbank/Cera/Fidelitas/ABB, Paribas Belgique/Paribas Nederland, Merita/Nordbanken, Merita Nordbanken/Unidanmark and Föreningssparbanken/FI-Holding/FIH.

On the financial legislation side, there is no explicit disposition in the Banking Act that gives financial authorities the responsibility for monitoring concentration. However, a bank willing to take over another bank has to obtain authorisation from the Comité des établissements de crédit et des entreprises d'investissement (CECEI), which checks the compatibility of such an operation with the smooth functioning of the banking system and the safety of the customers. Therefore, when the CECEI approves a deal, it takes into account, in some way, its consequences on competition. However, the CECEI would not base a refusal on competitive considerations alone.

Implementation

In 1998, when CIC was privatised, five institutions were candidates for the takeover. The authorities examined the market shares that would result in each case. In four cases, the expected market shares of the new entities were quite significant in some market segments, but were deemed acceptable. In 1999, during the BNP-SocGen-Paribas affair, the CECEI looked closely at the effects of the proposed operations on the market shares of the resulting entities.

Germany

Rules

In Germany, the act prohibiting barriers to competition (Gesetz gegen Wettbewerbsbeschränkungen) provides the legal basis for regulating mergers. The essential criterion for a merger is met if a controlling entrepreneurial, or competitively significant, influence on the target enterprise would be attained through the acquisition of capital. Such influence may even be exercised through a minority stake if this is accompanied by special rights to information, co-determination or control on the part of the acquiring party.

The Federal Cartel Office (Bundeskartellamt) is primarily responsible for monitoring corporate mergers. It intervenes in mergers if the enterprises involved have reached certain turnover thresholds and merger control does not fall within the jurisdiction of the European Commission. Thus, mergers are generally subject to domestic supervision only if all the enterprises involved have achieved a total prior-year turnover of at least DEM 1 billion and if at least one of them has recorded a turnover in Germany of more than DEM 50 million for the preceding year. In the case of credit institutions, the total amount of receipts less the taxes that are paid directly from this source is used instead of turnover. The domicile of the enterprise is immaterial.

Implementation

The enterprises involved must report an intended merger to the Bundeskartellamt prior to the actual merger (preventive merger control). On receipt of notification, a preliminary procedure begins in which the Office decides within one month whether the merger is unobjectionable or whether it will proceed to examine the merger (main examinational procedure). During the main examinational procedure, the Office decides within four months whether it will allow the merger to proceed (possibly, subject to certain conditions), or prohibit it.

The Bundeskartellamt will prohibit a merger if it is expected to constitute, or bolster, a position of market dominance on the part of the enterprises involved. In examining market dominance, the relevant market first has to be defined and then market concentrations are determined based on the market structure (actual and potential competition from domestic and foreign rivals).

Italy

Rules

Italian antitrust regulation was introduced with the law number 287 in 1990. The objective of the law is to guarantee the functioning of the competitive process by prohibiting: (i) agreements that have the goal or effect of impeding, restricting or distorting competition; (ii) the abuse of dominant positions; and (iii) operation of consolidations that create or strengthen a dominant position which eliminates or substantially reduces competition.

The application of the law, which has to be carried out in accordance with the principles of the EEC regulation in the same domain, is the responsibility of the *Autorità Garante della Concorrenza e del Mercato* (AGCM). An exception is the banking sector: the law attributes to the Bank of Italy the application of the antitrust regulation to banks. The Bank of Italy adopts its own decisions after having heard the opinion (which is not binding) of the AGCM; an agreement was signed in 1996 on the means and terms of cooperation between the two authorities. Another exception is the insurance sector. The AGCM adopts its decisions after hearing from ISVAP, the supervisory authority for insurance companies.

Implementation

When the competent authority finds a potential violation of the antitrust law, a file is opened. From the approval of the law in 1990 to May 2000, the Bank of Italy, in its antitrust function, has opened 33 files: 16 were on consolidations, five on abuse of dominant positions, and 12 (plus one currently under examination) on anticompetitive agreements.

As far as consolidations are concerned, the main element for the assessment of the impact on competition is the definition of the relevant market, both geographically and in terms of products. The Bank of Italy usually defines the province as the relevant market for deposits and the region for loans. In many of the files on consolidation, the Bank of Italy has imposed compensatory structural measures, such as the sale or closure of branches in the local markets affected. Also, behavioural measures have been imposed in certain cases, for example, prohibiting the banks involved, for a given period of time, from opening new branches in the markets believed to be critical from the competitive point of view.

Growing importance is given to the control of anticompetitive agreements and abuses of dominant positions. The files opened until now by the Bank of Italy on agreements have been related to the behaviour of individual banks and business associations. The Bank has investigated agreements that could harm competition by fixing prices or other sales conditions of given products, and agreements on the territorial sharing of markets. The Bank of Italy has opened five files on the behaviour of the Italian Bankers Association with regard to the definition of uniform tariffs, specifically in the payment system area, and the suggestion of uniform mechanisms for the definition of pricing strategies on exchange rate fees. Recently, a fine of ITL 30 billion was imposed on 13 large banks that had agreed to exchange proprietary information and fix prices of given banking services, thus distorting competition.

Japan

Rules

The Anti-Monopoly Law prohibits any consolidation where “the effect of a merger may be to substantially restrain competition in any particular field of trade”. This is determined by the position of the merging companies in an industry (as measured by their market shares, ranks, the extent to which they compete etc) and by market conditions (as measured by the number of competitors, degree of concentration, entry, competition from imports, and the financial condition of the firms).

Implementation

The Japanese Fair Trade Commission is in charge of Japanese competition policy. The Commission implements the Anti-Monopoly Law and formulates guidelines for its implementation in order to make the law more transparent. The Commission also reviews government regulations and exemptions from the Anti-Monopoly Law. In practice, antitrust law works in tandem with efforts to deregulate the economy in order to increase competition in Japanese markets.

Netherlands

Rules

The antitrust legislation of the European Community overrides Dutch legislation if a particular intended consolidation has a “Community dimension” (see above). The Dutch legislation only applies to consolidations above a particular size (firms with a global turnover higher than NLG 250 million, of which at least two have a turnover of at least NLG 30 million in the Netherlands).

Consolidation is prohibited between firms (financial and non-financial), without giving prior notification to the Dutch competition authority, the Nederlandse Mededingings Autoriteit (NMA). The NMA subsequently determines whether concentration may pose a threat to competition and if it does, research is undertaken by the NMA, ultimately resulting in rejection, acceptance or the start of licence procedure (see below).

After notification is received, the NMA has a maximum of four weeks to determine whether a licence is required; if nothing happens, the consolidation may proceed. During these four weeks, the NMA investigates whether there is a chance of unacceptable market power as a result of the consolidation. If this is the case, a licence procedure is started, lasting a maximum of 13 weeks. The NMA investigates the nature of the relevant market, the market shares of the firms involved, the possibility of new entry and the degree of dependency of external stakeholders (suppliers, clients). This research determines whether or not a licence is issued and whether conditions will be attached. In exceptional cases the Ministry of Economic Affairs may override a rejection by the NMA, if the “general good” is endangered.

To deal with particular, financial sector specific situations, two exceptions to the procedure above are allowed. First, an exception has been created with respect to this notification procedure in case a consolidation would prevent bankruptcy of a financial institution, and thereby avoid severe consequences. In such a case, the relevant financial supervisor(s) and the NMA investigate, confidentially and without loss of time, whether consolidation between the problem institution and another would solve the problems without harming competition. In case the NMA disagrees with the preferred solution of the financial supervisor(s), the Minister of Economic Affairs may be asked to give a decision.

Second, when a consolidation, valid according to the NMA, would threaten the goals of financial regulation, the Minister of Finance, after consulting the relevant financial supervisor(s), may block the concentration.

Implementation

The rules as listed above have only been effective in the financial sector since 1 January 2000; for the non-financial sector, they have been effective since 1998. Since that time, there have not yet been situations in which the NMA has been actively involved in financial sector consolidation.

Spain

Rules

Spanish legislation, which is only applicable to consolidations that do not have a Community dimension (see Rules of the European Community in this annex), is laid down in Competition Law 16/1989 of 17 July 1989 (Articles 14 to 18), which contemplates the existence of two specialised administrative bodies: the Competition Service, which is responsible for initiating proceedings and implementing decisions, and the Competition Court, which submits reports and proposals to the Government. Both bodies cooperate with the European Commission in Community proceedings.

Implementation

Consolidations in excess of given thresholds, based on a definition of concentration similar to that laid down in Community legislation, are required to notify the Service. These thresholds are set according to market share (25% of the national market or of a distinct geographical market within a member state) and sales volume (aggregate amount of ESP 40 billion and ESP 10 billion in each of at least two of the undertakings concerned). The Service shall be notified of consolidations prior to, or not more than one month after, the conclusion of an agreement to combine, though notifications shall not imply the suspension of the operation. Whenever the Service considers that the consolidation may impede competition, the Government shall request a non-binding report of the aforementioned Court and may decide, within three months of the date of receipt of the report, to attach conditions to the consolidation or to impose appropriate measures to restore effective competition, including a reversal of the merger. The decisions of the Government may be brought before the Spanish Courts of Justice.

Sweden

Rules

According to the Competition Act, the Competition Authority must be notified of any merger if it creates an entity with a turnover greater than SEK 4 billion and the acquired firm has a turnover greater than SEK 100 million. A merger may be challenged if it results in a dominant market position or further strengthens an already dominant market position. Mergers may also be challenged on the basis of concerns regarding the resulting market concentration (collective market dominance). In general, mergers in the financial sector are treated in the same way as those in any other industry.

Implementation

When it is notified of a merger, the Competition Authority makes a preliminary investigation to determine whether there is cause for concern regarding the resulting market power or market concentration. If this is the case, the Competition Authority initiates a full investigation addressing issues regarding the possible effects on efficiency, competition, prices, quality of services etc. If necessary, the Competition Authority might then challenge the merger in civil court.

Switzerland

Rules

The Federal Competition Commission must be notified of a merger if the situation reaches the following thresholds during the financial year preceding the merger: (i) the aggregate worldwide turnover of the companies concerned amounted to at least CHF 2 billion or the aggregate turnover of the companies within Switzerland amounted to at least CHF 500 million, and (ii) the

aggregate turnover in Switzerland by each of at least two of the companies concerned amounted to at least CHF 100 million. For banks, turnover is replaced by 10% of total assets, and for insurance companies, the thresholds are calculated with reference to aggregate annual gross premiums. In addition, the Federal Competition Commission must be notified if a participating firm holds a dominant position in a market in Switzerland and if the merger involves either that market, a related market, or an upstream or downstream market.

Implementation

Merger control is governed by the Federal Law on 'Cartels and other Restrictions of Competition' of 1995. The law is applied by the Federal Competition Commission and its Secretariat. The Secretariat investigates proposed mergers and the Commission determines whether they should be allowed. Banks are basically treated like other industries, with the exception that the Swiss Federal Bank Commission takes the place of the Competition Commission if a merger is seen to protect the interests of creditors. This is expected to be the exception and has not yet occurred since the Act entered into force.

On receipt of the notification, the Secretariat starts a preliminary investigation by examining whether the merger might create or strengthen a dominant position liable to eliminate effective competition. If so, the Commission initiates a regular investigation. The duration of the preliminary investigation is limited to one month, that of the regular investigation to four months.

The main patterns of the examination are (i) the relevant markets, (ii) current competition in these markets, (iii) potential competition, and (iv) countervailing powers of customers.

United States

Rules

The competitive effects of all mergers and acquisitions are reviewed by either the Department of Justice (DOJ) or the Federal Trade Commission. The DOJ has traditionally had jurisdiction over mergers among financial services providers.

The DOJ applies a structural screen to mergers and closely examines those mergers that violate this screen. The screen is stated in terms of the level of the Herfindahl-Hirschman index (HHI) and the change in this index resulting from the proposed merger.³⁰¹ In most industries, mergers are examined closely if they would increase the HHI by more than 100 points to a level above 1000 or by more than 50 points to a level above 1800. In banking, the DOJ applies a more lenient standard, requiring an increase in the HHI of over 200 to a level above 1800 to conduct a more thorough review. This relaxed standard for banking is meant to reflect the competition banks face from non-bank financial institutions that are not included explicitly in the HHI calculation. US antitrust authorities define banking markets as clusters of services offered by banks to all customers (Federal Reserve Board) or to small businesses (DOJ).³⁰² It is implicit in these definitions that markets for products supplied to large businesses are geographically larger. These wholesale markets may also be narrower in product space since large firms may find it easier to purchase individual products from different suppliers. US antitrust authorities have not actively challenged mergers in the securities or insurance industries, and thus have not taken a formal position on the product or geographic markets in these industries. There is no exemption for mergers among firms under any size threshold.

³⁰¹ The HHI is the sum of the squares of the market shares of all firms in the market, with the market shares measured as percentages.

³⁰² See Amel (1997).

Mergers among banks are also subject to review by federal bank regulators and by state governments. The three federal bank regulatory agencies tend to use the same structural standards as the DOJ, though they differ in the weight they give to factors that may mitigate the structural effects of mergers. State Attorneys General rarely challenge mergers among financial institutions.

Implementation

Most large US bank mergers have involved both expansion into new geographic regions and in-market, horizontal effects in some local banking markets. In most cases, the merging parties have been willing to divest branches in those local markets in which structural changes would be so great as to cause concerns to antitrust enforcement agencies. Thus, structural effects of large bank mergers generally have not been so large as to cause competitive effects in local banking markets. In those rare cases in which smaller mergers have substantially increased concentration, there have been adverse effects on prices.³⁰³

³⁰³ See Prager and Hannan (1998).

Annex V.2

Case studies

The UBS merger

The merger was announced on 12 January 1998. On 2 February the Federal Competition Commission decided to open a regular investigation. On 20 April the Commission cleared the merger subject to some conditions.

The Commission investigated the markets for mortgage loans and commercial loans. It reached the conclusion that the merger would not affect competition in the mortgage loan market since the new UBS was expected to face strong competition from either local banks or Credit Suisse. For the commercial loan market, the Commission restricted the investigation to loans of up to CHF 2 million.

Considering the geographic market, the Commission defined the markets for loans to small and medium-sized firms as regional markets, which roughly coincided with Swiss cantons. The Commission focused its investigation on eight regional markets where the new UBS market share would be above 30% and found that the countervailing power of customers was weak in those markets. Furthermore, it was possible that the merger could lead to a collusive dominant position. Thus, the Commission imposed the following remedies to stimulate competition: (i) UBS had to divest, upon approval by the Commission, 25 branches distributed over Switzerland as well as two subsidiary banks; (ii) Corporate credit facilities cumulated in the new bank but not exceeding CHF 4 million had to be maintained until the end of 2004; and (iii) UBS was not allowed to give up membership in several joint ventures with other Swiss banks for several years.

The sale of branches turned out to be difficult. No single buyer could be found. Eventually, Migros Bank and Coop Bank (two banks belonging to the two major food and non-food retailers) each bought 11 branches, and three other branches were sold to three regional banks.

The merger of Banco Bilbao with Telefonica

In February 2000, the Spanish Banco Bilbao Vizcaya Argentaria (BBV) announced an alliance with Telefonica, the largest Spanish telecom company, in order to develop online banking and e-commerce services for the Spanish-speaking world. This alliance covers a series of joint ventures linked to internet-based financial services. The move is similar to recent “new-technology” alliances between AOL and Time Warner and Vodafone, AirTouch and BSCH.

The Spanish antitrust authority has investigated the case and required that the new group restructure, amongst others, its media holdings.

BSCH/Champalimaud

On 3 August 1999, the European Commission approved an agreement by which Banco Santander Central Hispano (BSCH)³⁰⁴ would have acquired control over the Portuguese financial group Champalimaud. The Portuguese authorities had opposed the planned concentration by a decision taken on 18 June 1999, based on the need to protect national interests and strategic sectors of the national economy.

³⁰⁴ Banco Santander Central Hispano is the leading Spanish bank. It was created through the merger of Banco Santander and Banco Central Hispano at the beginning of 1999.

The Commission was concerned that the decision of the Portuguese authorities was not justified on prudential grounds and therefore violated EU rules on freedom of establishment and the free movement of capital. It decided therefore to open formal infringement proceedings against Portugal. It also took action against the Portuguese measures by two decisions based on the EC Merger Regulation that grants the Commission exclusive powers to assess consolidations having a Community dimension. With the first decision of 20 July 1999, the Commission requested the suspension of the decision by the Portuguese Minister of Finance to oppose the operation and the measures deriving therefrom, such as the suspension of voting rights of BSCH and Champalimaud in Mundial Confiança, because the Portuguese authorities had failed to notify their decision to the Commission. With the second decision adopted on 20 October, the Commission indicated that the measures of the Portuguese authorities could not be regarded as protecting legitimate interests within the meaning of the Merger Regulation and were thus incompatible with Community law. The Portuguese authorities challenged both Commission decisions before the Court of Justice and did not comply with the Commission's request to suspend their decision to oppose the acquisition.

Subsequently, BSCH and Champalimaud concluded a new agreement which replaced the previous one and according to which BSCH acquired Banco Totta & Açores and Banco de Crédito Prédial Português belonging to the Champalimaud group. This new agreement was reported to the Commission on 29 November 1999, and authorised by the Commission on 11 January 2000, and was not opposed by the Portuguese authorities.

The Champalimaud case is important for Community law and the business community as it reaffirmed the exclusive jurisdiction of the Commission for mergers having a Community dimension. This case also raised the question of the application and interpretation of "prudential rules" in consolidations in the banking sector. Under the Second Council Directive 89/646/EEC of 15 December 1989, on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, a potential buyer of a qualifying holding in a credit institution has to inform the competent authorities of the member state. The competent authorities have three months to oppose such a plan if, in view of the need to ensure sound and prudent management of the credit institution, they are not satisfied as to the suitability of the potential acquirer. In the Champalimaud case, the Commission made clear that any intervention by member states concerning mergers that have a Community dimension and therefore fall within Commission jurisdiction, has to be reported to the Commission and has to be based on one of the recognised "legitimate interests" (public security, plurality of the media and prudential rules) mentioned in the Merger Regulation. The Portuguese authorities were considered to fall short on both of these accounts.

CGU/Norwich Union

The merger of the two British-based insurance companies was announced on 21 February 2000 and reported to the European Commission on 15 March 2000. After examination, the Commission cleared the merger on 13 April 2000, concluding that the reported agreement, which had a Community dimension, was compatible with the common market and with the functioning of the European Economic Area agreement.

CGU provided all classes of general insurance and life insurance throughout the world. The main activities of Norwich Union were the provision of general insurance, life insurance and pension and investment products. Both had activities in the United Kingdom, Ireland, continental Europe, North America and Australia. However, the only member states in which either party had a significant market presence and where there was a significant overlap between the parties' activities were the United Kingdom and Ireland, where the new entity would have become the largest insurer in the general insurance sector.

The Commission practice of defining the relevant product market in the insurance sector is to make a distinction between general insurance, life insurance and reinsurance. General and life insurance can be divided into as many product markets as there are different kinds of risks

covered. However, in the assessment of this case as on several other occasions, the Commission did not deem it necessary to define conclusively the relevant product and geographic market. This was possible because the Commission concluded that, even when applying the narrowest market definition, the consolidation would not have created or strengthened a dominant position as a result of which effective competition would have been significantly impeded.

Having examined the various market segments of the United Kingdom and Irish general insurance sector, the Commission concluded that the combined entity would face strong competition across all lines of business from a significant number of well established competitors with comparable financial strength including Allianz, AXA, Royal & Sun and Eagle Star (Allied Zurich). Moreover there would also be a number of strong companies, in particular brokers and financial institutions, active in the distribution channels, creating competitive pressures for insurers.

Fortis/G-Bank

On 24 June 1998, the Commission cleared the acquisition by Fortis group, the Belgian-Dutch insurance and banking group, of the whole of Generale Bank, the largest Belgian bank also active in life and non-life insurance.

The integration of Generale Bank and Fortis would create an international conglomerate active in banking and insurance and operating mainly in Belgium and the Netherlands, with relatively high market shares in Belgium. However, the Commission authorised the deal, taking into consideration that there would remain strong competitors in Belgium both in banking (BBL/ING, Kredietbank, Bacob) and in insurance (Groupe Royale Belge, AXA, Assubel/AGF, SMAP).

In its assessment of the merger, the Commission regarded the relevant geographic market as being national in scope for retail banking and for small and medium-sized corporate clients, and international for large corporate clients and for financial markets. Nevertheless it considered that certain assets of the merging companies, such as the strength of their distribution network, needed to be analysed at a smaller level, that is on a regional or local level. As strong market overlaps existed in Belgium, the Commission examined the network effect of the merger in all the Belgian provinces and regions. Even though the new entity would have the strongest market network in Belgium, the Commission concluded that this would not confer on it a dominant position since consumers would have sufficient competing banking outlets at hand. In its assessment, the Commission also ruled that the existence of electronic cash dispensers, electronic banking and telephone banking minimised the effect of any strong position in this respect.

Generali/INA

On 12 January 2000, the Commission cleared, subject to a number of commitments given by the parties concerned, the proposed acquisition by Generali, a company active in the insurance sector both in Italy and abroad, of INA, one of the largest Italian insurers. According to the commitments, Generali would divest its controlling stakes in three subsidiaries active in the life insurance sector, its shareholding in Fondiaria and INA's controlling interests in BNL Vita and Banco di Napoli. Moreover, Generali would eliminate the interlocking directorships between the Board of Directors and Executive Committee of INA and reduce significantly those between its own Board and Executive Committee.

In investigating this case, the Commission cooperated closely with the Italian Antitrust Authority and with ISVAP, the Italian surveillance authority in the insurance sector. As regards the substantive aspects of the case, the Commission found that the consolidation, as originally proposed, could have led to the creation or strengthening of a dominant position in the Italian life insurance sector. The combined entity's market power would have been fostered by the strength of its distribution network, which is the main driver of competition in the insurance

sector. The new group would have been stronger than its competitors in the most important distribution channels, ie in the agency and banking channels. As regards the latter, the Commission's preliminary investigation indicated that this channel has grown rapidly in the last few years. About 70% of new policies concluded in 1999 were estimated to have been sold through banks. The merged entity would have controlled approximately one quarter of the existing bank outlets in Italy.

Bank Austria/Creditanstalt-Bankverein

On 11 March 1997, the Commission approved the acquisition of Creditanstalt-Bankverein by Bank Austria Aktiengesellschaft, following undertakings given by Bank Austria that eliminated the identified competitive concerns. Bank Austria and Creditanstalt were both universal banks that had their main focus of activity in Austria. Measured by the balance sheet total, the new entity would have been approximately five times larger than the next largest Austrian bank.

In assessing the implications of the proposed consolidation, the Commission found that, after the merger, the new entity would not only have been the leading supplier of banking services in Austria, but also the only bank with significant market shares in all relevant product segments. The Commission also found that, both in consumer and business customer banking services in Austria, the parties (together with GiroCredit, in which Bank Austria had a major holding) would have attained significant market shares. These would have been several times higher than those of the next largest competitor in a number of product segments, including credit business, stocks and shares and deposits. In addition to the high market shares, the Commission considered that Austrian banking markets were characterised by market access barriers that, in retail banking in particular, resulted from the need to be present locally through an extensive network of branches. It held that consumers usually maintained a link with only one bank because they incurred both information and transaction costs when changing banks. The mobility of bank customers was considered to be further reduced by the fact that maintaining several banking links, and dividing deposits between banks, reduces the chances of getting a loan. The Commission also considered that the foreign banks active in Austria had, despite many years' presence in some cases, achieved only very small market shares and were collectively too insignificant to be able to exert a decisive competitive influence in the medium term. Further competitive concerns stemmed from the addition of the holdings of Bank Austria and Creditanstalt in the specialised banks Österreichische Kontrollbank (OeKB) and Österreichische Investitionskredit AG, two institutions active in the public interest (ie export insurance, financing and processing and subsidised lending). The Commission thought therefore that there was a risk of the creation or reinforcement of a dominant position.

In order to meet the competition concerns expressed by the Commission, the parties offered certain commitments. Bank Austria agreed to sell its stake in GiroCredit. In addition, it undertook to reduce the global participation of Bank Austria and Creditanstalt in OeKB to the level of participation that Bank Austria and GiroCredit held together prior to consolidation. Furthermore, Bank Austria agreed not to extend its influence in Investkredit beyond the level of influence that it had, together with GiroCredit, prior to the concentration. These undertakings were considered appropriate to completely resolve the competitive concerns raised by the Commission and led to the approval of the proposed merger in its modified form.

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