The Impact of Mergers and Acquisitions in the Banking and Insurance Sector

Table of Contents

Executive summary 2
The impact of M&As on employees, staff representatives and their unions 2
The impact of M&As on consumers 3
The impact of M&As on shareholders 5

The impact of mergers and acquisitions on employees in the financial services sector (Tina Weber) 6
Introduction 6
Trends in employment in the financial services sector 6
Table 1: Employment in Financial Services, EU, 1992 and 1998 7
Trends in the nature and quality of employment in the financial services sector 8
The nature of restructuring in the financial services sector 9
The impact of restructuring and mergers on working conditions and the industrial relations climate 10
The role of employee representation in mergers and restructuring 11
Recommendations 13

Financial services mergers and acquisitions: Consumer impacts (Andrew Leyshon) 15
Introduction 15
Service provision in retail financial services 16
Impact on smaller and larger consumers 18
Reactions by consumers to mergers 20
Conclusions 21
References 21

The performance of banking mergers: Propositions and policy implications (Hans Schenk) 24
Abstract 24
Introduction 24
Methodology 25
The empirical evidence: event studies 27
Table 1: Assessment of the 50 largest bank mergers, 1990-1999 28
Figure 1: CAR (%) of 87 foreign acquisitions by large Dutch firms, 1990-1995 30
The empirical evidence: ex-post studies 31
Table 2: Selected banks ranked by asset size, 1999 36
Figure 2: Typical long-range average cost curve 37
Purely strategic (bank) mergers: a bit of theory 37
Effects of purely strategic (bank) mergers and some policy suggestions 39
Conclusions 41
References 42

The Impact of Mergers and Acquisitions in the Banking and Insurance Sector

Executive Summary

In January 2000, UNI-Europa Finance commissioned three experts to produce papers on the impact of Mergers and Acquisitions (M&As) in the European Banking and Insurance sector to complement its own internal survey "Mergers & take-overs in the finance sector – Report of a UNI-Europa survey". One of the papers focuses on the impact of M&As on employees, a second assesses the impact on consumers and the third paper looks at the outcome of M&As on shareholders. This paper summarises the key findings of these papers and highlights the fact that all experts point to the negative impact of M&As in the finance sector.

The impact of M&As on employees, staff representatives and their unions

The paper argues that the European financial services sector is currently undergoing a period of major restructuring, which started in northern Europe in the early 1990s and slowly moved southwards, only reaching the southern European countries more recently. It brought with it a greater diversification of activities and the use of new working methods in order to make savings in efficiency in the light of increasing competition.

Data from Eurostat show that there has been a significant decline in employment in the European financial services sector in all member states (although some countries have suffered more than others). These figures have to be regarded with some caution because of uncertainties over the defining framework applied by Eurostat and over the extent to which outsourced functions are taken into account in the calculation of employment. The UNI-Europa survey estimates that 130,000 jobs have been lost in the last 10 years as a result of mergers and take-overs alone.

On the whole it is often difficult to separate the impact of mergers and the impact of other competitive pressures or the introduction of information and communication technology. What is clear, however, is that these factors are often linked and that merger decisions provide an impetus for workforce restructuring. The announcement of a merger or take-over is often linked with the announcement of job losses. It is not always clear to what extent pre- or post-merger announcements are an accurate reflection of what will happen in reality, as they are clearly produced with an audience in mind.

Recent years have also brought about a change in the nature and quality of employment in the sector. Job cuts have in particular affected traditional branches and back office jobs. This has particularly affected older workers and women with traditional banking skills. These are skills which are not easily transferable to the new centralised functions, such as those required in call centres. The standardisation of products has allowed functions to emerge, which can deal with a high volume of clients without requiring training in traditional banking skills. Where jobs have been created, these often require managerial, IT or other specialist skills.

Another significant trend, which has affected employment, is the increasing incidence of the outsourcing of functions, such as IT, cleaning or maintenance. Working conditions in outsourcing companies often differ from those of directly employed staff and workers are often covered by inferior collective agreements. Mergers often lead to higher workloads being placed on remaining staff, with companies requiring greater flexibility, in terms of working hours, mobility and skills. Such requirements

by companies are rarely matched by a commitment to greater flexibility for workers and increased training provision.

The most common way in which companies have sought to effect reductions in employment is through early retirement schemes. However, as these are proving increasingly costly to companies, the public purse and other employees themselves, alternatives such as working time reductions needs to be considered.

M&As provide management with the opportunity to renegotiate terms and conditions, which leads to a destabilisation of the social climate of the company. This is further aggravated by the uncertainty relating to employee information and consultation arrangements in the new merged company. As mergers often lead to organisational changes involving the break-up of established bargaining units, such collective bargaining arrangements often have to be re-negotiated.

The paper argues that current legislation is often insufficient to provide employees' information and consultation bodies enough power and resources to be able to effectively address crisis situations such as mergers and take-overs. Evidence shows that workers are often informed very late or even after the event in the case of a merger or take-over.

A review of national and European legislation in this area is therefore urged and it is argued that much could be learnt from disseminating good practice from companies which have experience in dealing with such situations. The UNI-Europa trade union strategy on mergers is making a significant step in this direction.

The impact of M&As on consumers

The paper argues that mergers in the finance sectors are largely the result of destabilisation in the competitive environment for financial services, which was brought about by the national deregulation of markets and the increase in new methods of dealing with customers. In particular, the growth in electronic networks open up the financial services market to an increasing number of competitors, who are no longer reliant on a traditional branch network in order to attract custom.

On the whole, it is argued that it is difficult to assess the impact of mergers and acquisitions on consumers, not only because this aspect is not usually considered in popular or scientific analysis, but also because it is often difficult to disentangle the direct impact of M&As from the impact of other factors such as increasing global competition or technological change. Bearing in mind these considerations, the paper reaches the following conclusions:

Looking at the impact of M&As on product provision, choice and the cost of products, it is argued that in general, the number of products on the market has increased significantly in recent years, offering more choice at reduced prices, as most new market entrants are seeking to compete on the basis of price. They are able to do this because new information and communication technology allows them to save costs by operating with fewer branches – or without a traditional branch network. New products and providers are also argued to offer many clients more time flexibility, as they no longer have to rely on branch opening hours to conduct their business. Traditional providers have responded to this trend - in order to meet consumer need, but also to cut running costs - by closing branches.

It is argued that recent trends in the financial services, including mergers and acquisitions, have had a varying impact on different clients. While the majority of larger, wealthy and "standard" clients (i.e. those without problems of bad credit histories etc.) have benefited from the increase in product choice and

the proliferation of information and communication technology based services (such as Internet banking), a significant minority of individuals are detrimentally affected by this trend as they lack access to the required information and communication technology or the knowledge to use it, while at the same time losing access to local branches. It can be argued that this trend has served to increase social exclusion, as the groups detrimentally affected by these developments tend to already suffer from educational, social and economic disadvantage. Research, for example, shows that branch closures tend to be located in the poorer areas.

Branch closures and the loss of many other backroom functions as a result of proliferation of information and communication technology have led to significant job losses. While job losses were in evidence prior to the current merger wave, in the majority of cases, a merger accelerates branch closure programmes and the transfer of backroom functions. As a result, the level of physical, local service provision is reduced, requiring consumers to travel greater distances to receive a personal service. While a significant number of consumers welcome the ability to conduct their financial business at any time of day through, for example a call centre or an Internet service, others regret the loss of more personal, local, face-to-face interaction. Such consumers argue that recent developments have lowered the quality of financial service provision by bringing a degradation of the relationship with the financial service provider.

As mentioned previously, the increasing technological distance between client and service provider tends to disadvantage those individuals, who are excluded from access to transport or information and communication technology. The paper argues that in some areas the disappearance of mainstream alternatives has opened the door to predatory financial service providers offering lower quality, more expensive services to those most in need.

The paper argues that increasing merger activity is serving to restrict competition and will therefore in the long run be a disbenefit to consumers. In fact, it is argued that restriction of competition is very often the raison d'être of merger activity as it serves to counteract competitive pressure.

Another key process, which is currently underway in many countries, is that of demutualisation of financial service providers. While in the short-run this may appear to bring benefits to consumers in the form of windfall payments, studies show that in the long run, demutualised companies offers lower quality services at higher prices.

Finally, the paper argues that it is difficult to assess the impact of M&As on consumer loyalty, as such information is generally sensitive and is rarely released by companies for public scrutiny.

The impact of M&As on shareholders

The paper argues that mergers in the financial services are part of a larger merger wave, which engulfed the economy in the 1990s, with an annual deal value of $1,000 billion. In the EU alone, 760 financial service mergers took place between 1986-1995. This process has hotted up further recently, with 490 mergers being effected in the banking sector in the first quarter of 1998 alone. At the same time the size of mergers has also increased substantially.

Mergers take up a considerable amount of the executive's time, and the paper therefore seeks to assess what they actually deliver to shareholders and the economy. In assessing the impact of mergers on share value, the paper looks at two types of scientific studies, which have been conducted over the decades to assess the performance of mergers. One type of study seeks to assess the reaction of the stock market to merger announcements and the impact of share prices in different timeframes from the merger announcement, while filtering out the impact of general share price movements (so called event or ex-ante studies). Another type of study looks at company accounts after the merger to assess its performance (ex-post studies). Despite the latter sometimes being complicated by companies' use of creative accounting methods, both types of study indicate a largely negative outcome of merger decisions, particularly on the acquiring company.

All evidence from ex-ante studies indicates that the impact of merger announcements on the share price of the acquiring company is negative in the medium and long-term, while the impact on the share price of the target company is positive. Ex-post studies are consistent with these pessimistic assessments of the impact of M&As on company profitability. From as far back as the 1950s, data show declines in profitability of around 15% of merged companies. A large US study showed that acquired companies, which did well prior to the merger, deteriorated after the event. Acquired companies which did badly in advance of merger went from bad to worse. Furthermore, it is found that between 19-47% of all acquisitions were disinvested within 10 years of acquisition.

Over the years, academic studies have consistently shown that only 15% of mergers are successful and over 60% have negative results.

In trying to assess why, despite this evidence, mergers do indeed happen, the paper reaches the conclusion that much can be attributed to "bandwagon mergers" based on a so-called "minimax" strategy. In the minds of company executives this strategy is aimed to minimise regret as far as is possible. Therefore, when they observe other companies around them being involved in merger activities, it is considered whether the level of regret would be greater if they sat tight and did nothing and saw other ventures succeed or become an acquisition target themselves, or whether regret would be greater if a merger was initiated which eventually failed. As the latter would be the experience of a majority of their peers, regret would be minimised.

The impact of mergers and acquisitions on employees in the financial services sector

Tina Weber, ECOTEC

Introduction

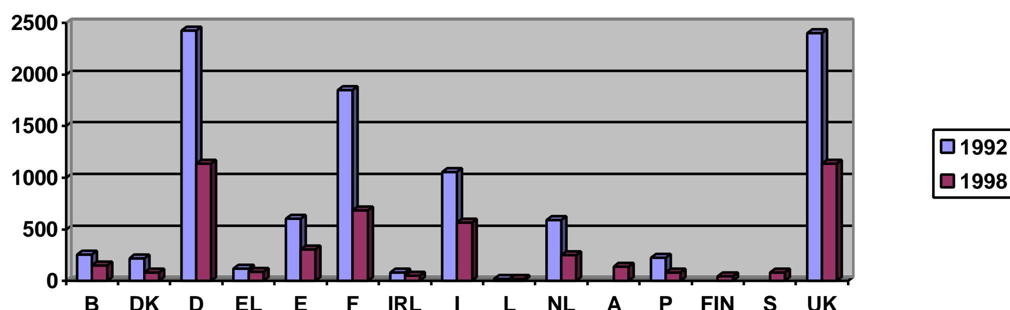
The process of restructuring in the financial services sector has been gathering pace since the early 1990s, in Europe as well as world-wide. Within the European Union, this process started in Northern Europe and is continuing to spread southwards. It is a trend, which started in banking and is now increasingly engulfing the insurance sector. Initially, purely national restructuring was often followed by restructuring involving companies and employees from different EU countries and beyond. In its totality it has significantly changed the profile of the financial services landscape in the European Union, with a concentration among larger providers of general banking and insurance services, increasing specialisation among smaller institutes, the emergence of "bancassurance" and mixed provision and the proliferation of new distribution channels such as telephone and the internet.

The main aim of this paper is to look at the impact of mergers and acquisitions on employees in the financial services sector. It will assess the overall impact these processes have had on the number of individuals employed in the sector in the EU. In doing so, it is important to distinguish between the impact of the general global restructuring process and the impact of mergers and acquisitions in the financial services in particular. This paper seeks to highlight how these processes are interlinked. It goes on to describe how recent changes in the sector have affected the occupational and skills profile of jobs in the sector. The way in which companies in the financial services sector have effected restructuring will also be assessed and the question will be asked whether any efforts have been taken by companies to limit the impact of restructuring and mergers and acquisitions on employment. The paper seeks to establish to what extent working conditions and workers' rights have been affected by mergers and what impact these events have had on the industrial relations climate. The role played by trade unions and employee representatives in this process, and the level of involvement of European Works Councils in transnational merger processes, which are likely to have a significant impact on the workers they represent, are of particular importance and will be analysed in this paper. Finally, the paper develops some recommendations on trade union strategy in dealing with mergers and acquisitions.

Trends in employment in the financial services sector

Data from the Eurostat Labour Force Survey show a significant decline in the employment in the EU financial services sector between 1992 and 1998. However, such data needs to be viewed with caution, the precise delimitation of the sector by Eurostat is unclear. National data sets are also sometimes different in relation to whether they count all employment or only full-time equivalents. Furthermore, it is unclear to what extent outsourced activities are captured by these figures. Nevertheless, the data provided shows a significant drop in employment, which is in line with the findings of the UNI-Europa survey.

Table 1: Employment in financial services, EU, 1992 and 1998



Source: Eurostat, Labour Force Survey, 1999

The survey estimates that 130,000 jobs have been lost in the last 10 years as a result of mergers and acquisitions alone in the financial services sector. On the whole, job losses in banking have been more severe than in insurance, as the restructuring process began earlier in the banking industry.

It is clear that not all job losses in the sector can be directly associated with the fall-out from mergers and acquisitions. Other factors such as technological innovations and the globalisation of systems of production and labour have also clearly played their part. For example, the increasing automation of data processing has led to the disappearance of a number of back office functions. Advances in technology and the globalisation of the economy have also allowed many companies in the sector to outsource tasks, such as claims handling, to locations outside the European Union, such as the Indian sub-continent, where labour is cheaper. The increasing use of call centres and the internet for sales and customer services functions has led many banks to reduce the number of branch offices and has reduced the market share of insurance intermediaries.

Having said that, it is clear that the global restructuring of the economy and the resulting increasing competitive pressures are among the causative factors for the current "merger mania" in the financial services sector. In the early 1990s mergers primarily took place at the national level, as companies strove to achieve competitive advantage over other national or European rivals. In recent years, mergers and acquisitions have increasingly become global as the market place has expanded geographically. Coupled with this process, mergers and acquisitions have become increasingly diverse, not only geographically, but also in terms of the nature of businesses involved, as many financial services companies have sought greater diversification in the services they can offer to the client. Thus, whereas mergers originally largely took place between banks and other banks, such deals now increasingly involve banks and insurance companies.

While technological change and global restructuring have contributed to the increasing occurrence of mergers in the financial services sector, mergers themselves are also accelerating the process of restructuring and technological change, as merged companies seek to capitalise on newly established synergies and strive to reach the cost savings targets set in merger plans for the benefit of their shareholders. Indeed, pre-merger announcements of staff cutbacks are very often associated with rises in the share prices of the companies involved.

It could be argued that the precise impact of mergers and acquisitions on job losses could be monitored by studying such pre- and post-merger announcements. For example:

- In France, the adaptation plan presented following the merger between BNP and Paribas and covering the period between 2000-2002 calls for the elimination of 6,200 jobs in France (of which 1,400 are directly attributed to the merger) and 2,000 jobs abroad (mainly in Great Britain and Asia).
- In Great Britain, the merger between National Westminster Bank and Royal Bank of Scotland is to cost 18,000 jobs.
- In Great Britain, following the merger of CGU and Norwich Union, the elimination of 5,000 jobs was announced (4,000 of which in Great Britain).
- As a result of the AXA/Guardian Royal Exchange merger, 2,500 jobs were to be eliminated in Great Britain and 800 in Germany.
- In the merger between Royal and Sun Alliance, the company originally announced the loss of 4,000 jobs (3,000 in the UK). Actual figures subsequently rose to 4,000 in the UK alone.

However, as some of these examples show, pre-merger announcements in particular are often an unreliable source to future merger-related job losses, as they are often targeted at shareholders, rather than reflecting precise post-merger strategies. Post-merger announcements, on the other hand often under-estimate the number of actual job losses. Such pronouncements can therefore only be taken as an indication of the employment impact of mergers.

It is similarly difficult to distinguish between the employment impact of a merger and the impact of a take-over on jobs, although it has been argued that the latter is potentially more likely to cost more jobs. The question of the employment impact of inter-bank mergers versus bank and insurance mergers is a similarly complex one, with the latter on balance likely to have a more limited impact on employment, as it generates less duplication of activities.

On the whole, it should therefore be noted that there are significant difficulties in distinguishing between the precise employment impact of a merger or take-over and that of the process of global restructuring. The two trends are clearly interlinked and together exert significant pressures on employment in the financial services sector. Before looking at the impact of these processes on the nature and quality of employment in the sector, it is worth noting that in some cases, mergers have been identified even by the trade unions representing workers in certain companies as the only way of keeping the companies alive. According to the UNI-Europa Survey on *Mergers and Take-overs in the Finance Sector* (2000), this was seen to apply in case of the merger between United Friendly and Refuge Assurance.

Trends in the nature and quality of employment in the financial services sector

As mentioned above, the process of automation, which may not have been directly caused, but is often advanced by the merger process, has led to the disappearance of a number of low-skilled administrative functions. In addition, many labour intensive services have been outsourced to the low wage economies of the African and Indian sub-continent. Outsourcing has been one of the most significant trends in employment not only in the financial services sector, but also in the economy as a whole. This is in many cases also true in the merger process, as companies seek to reduce their fixed costs. Outsourcing initially primarily affected companies' so-called "non-core" functions such as cleaning, catering, maintenance and IT. However, in more recent years, outsourcing is also increasingly being used to provide a number of core functions such as customer services. Customer services and sales functions are today more likely to be provided by call-centres, which handle high volumes and generally operate with low-skilled, low-paid staff. As a result job satisfaction in call centres is generally low and staff turnover rates are high, which necessarily has an impact on the quality of service provided. Other industries have seen examples of call-centre facilities being used because of a high

level of customer complaints. Another concern about the increasing use of call centres in the financial services sector is the low level of unionisation among the workforce in these facilities. The outsourcing of services in general often leads to affected workers being covered by a different, less favourable collective agreement and in some cases no collective agreement at all. An example of this was given by SBC of Portugal in the UNI-Europa survey.

Crucially, the elimination of low skilled jobs through automation, the outsourcing of non-core functions (with the exception of IT) and the low levels of pay and working conditions in call centres primarily affect female staff in the sector.

Among employees remaining within the direct employment of financial services companies, demands for the handling of higher workloads, the requirement for higher level skills and greater flexibility are increasing. This particularly relates to the requirement of a higher degree of computer literacy and higher professional competence allowing for multi-tasking. The demands placed on staff for higher skills and greater flexibility, is often not matched by a similar commitment among companies for improved in-house training facilities and more flexible working conditions to meet their employees' requirements for the achievement of a more satisfactory work-life balance. This is particularly true in the case of mergers, where the need to make cost savings often affects expenditure on training. There are also examples of companies going back on commitments to introduce more flexible working time arrangements made prior to a merger announcement. The UNI-Europa survey provides an example from France, where prior to the merger between AXA and UAP, trade unions at AXA had been at the point of signing an agreement on the reduction of working hours. Since the signature of the merger agreement, reduced working hours are to be imposed by law and unions are in the process of negotiating the details. However, no such agreement has been foreseen at UAP.

The nature of restructuring in the financial services sector

This section examines the question of how companies have handled the restructuring process and job reductions following mergers or acquisitions and looks at whether measures have been taken to limit the negative impact of these processes on employment.

As mentioned above, outsourcing is one of the ways in which companies have sought to reduce their fixed employment costs. However, the most common way of achieving reductions in employment has been through the use of early retirement. This was either encouraged through company early retirement schemes, through national measures available to encourage early retirement or through a combination of both.

Early retirement is widely considered to be the most "socially responsible" way of achieving job reductions and this process is often part of a negotiated settlement with works councils. In AXA, for example, early retirement was offered at age 52 on 70% of an employee's previous salary.
In Germany, "Model 55" allows an older employee to enter early retirement at the age of 55, upon which he or she receives 90% of his/her salary until age 60.

However, a number of question marks need to be raised over the large scale pursuance of such a strategy. Firstly, it is unclear to what extent early retirement is really voluntary in the light of limited alternatives. Secondly, the cost of early retirement on public pension systems is increasingly leading governments to seek to reverse their support for early retirement strategies, which date back to the 1970s and early 1980s, when they were introduced to deal with high levels of youth unemployment. As public pension systems are changed to reverse this trend in policy, compensation measures for older workers affected become increasingly less favourable and in many cases, their full pension

entitlements are reduced as a result of taking early retirement. Thirdly, there is an issue of the drain of valuable experience from companies, which cannot be replaced, Fourthly, the trend towards early retirement has been widely argued to have contributed to discrimination by employers towards older workers, as they are increasingly perceived to be incapable of adapting to new business requirements and learning new skills. Finally, the question raises itself, as to the shock which will be experienced as mergers and restructuring continues and the early retirement route is increasingly precluded as this age group is no longer represented in the company age profile.

Without the development of alternative strategies by companies and trade unions, companies will at this time be forced to increasingly rely on redundancy measures. Alternatives such as working time reductions should therefore be considered not only to limit job losses, but also to create new jobs in a climate where new recruitment in the financial services sector has been limited by restructuring.

Another alternative would be the re-training of existing staff for new roles in expanding sectors of the business. In other industries (and particularly in Scandinavian countries) there are examples of companies offering those affected by restructuring the option of early retirement or company funded re-training, either for a role within the company or for a new profession. There are examples from Sweden, Portugal and Luxembourg of the use of retraining and re-deployment, but the extent to which these have been applied has generally been limited, although they were widely demanded by trade unions.

Where a merger brought about a geographical move in operations for some staff, assistance with transport costs was often given for a transitional period and higher skilled and paid staff were often entitled to re-location packages.

The impact of restructuring and mergers on working conditions and the industrial relations climate

As in other industries and sectors, the announcement of a merger necessarily created a high degree of anxiety among the workforce, as individuals begin to fear for their jobs and the security of their working conditions. The UNI-Europa survey shows that in many (though by no means all) cases such fears are well founded. Merger processes often provide an opportunity to revise and re-negotiate regulatory frameworks and working conditions.

Mergers often lead to the revision of business units and therefore collective bargaining units. It is not uncommon for employers to seek to use the need to renegotiate agreements to revise levels of pay and working conditions in their favour, particularly if this goes hand in hand with the outsourcing of certain functions. Alternatively, as in the French example given above, mergers can lead to previously agreed points being reneged.

In some cases trade union representative structures can suffer serious blows as a result of a merger, although in many countries, the possibility for re-negotiation of trade union and employee representative structures is restricted by law. In Finland, for example, where the banking sector has a unionisation rate of 90%, every bank is covered by a collective agreement negotiated between the bank union SUORA and the employers' organisation. Under labour legislation, every bank has to follow the agreement as a minimum requirement. While negotiations of interpretations of the collective agreement are possible, these cannot lead to lower levels of pay and conditions. This example clearly shows the importance of strong collective agreements and national legislation to protect terms and conditions and employee representative structures post-merger.

The UK was until recently one of the few countries which had no legal structures underlying trade union recognition (this has changed with the introduction of the Employment Relations Act in 2000) and highlights the importance of such legislative or policy-based underpinning. Ireland provides a strong example of the power of inclusive national policy strategies on industrial relations, which can filter down to impact on the industrial relations climate. In the UNI-Europa report, the IBOA reports a significant improvement in industrial relations as a result of the national "Partnership Agenda", which emphasises the importance of social partnership in policy making as well as in the workplace.

The industrial relations climate therefore often suffers as a result of mergers, although this is clearly not true in all cases. Following the merger of United Friendly with Refuge Assurance in 1996, the MSF union actually reported an increase in employer-union dialogue. As the new management took on some of the more positive elements of the human resources management inherited from United Friendly, industrial relations were seen to have improved. The UF/RA merger example is clearly more likely to be an exception rather than the rule as the experiences of other mergers have shown:

- Following the merger of Midland Bank with HSBC in 1992, HSBC, which had its own staff association, did not recognise BIFU (now UNIFI) in the UK. In 1996, Midland Bank, which had previously recognised BIFU, subsequently de-recognised the union for managerial grades.
- In Ireland, trade unions have reported a significant worsening in the industrial relations climate following the take over of Northern Bank by National Australia. The new company witnessed a series of national strikes in 1995 and a subsequent virtual de-recognition of the union.

These examples show, that problems are often most severe, where global mergers bring a strong clash of cultures and industrial relations regime types.

The role of employee representation in mergers and restructuring

In order for trade unions and employee representative structures to play an informed part in merger or take-over decisions – either by offering alternatives, or through being involved in the negotiation of the implementation and outcome of the merger process in relation to the workers they represent – it would be necessary for them to have access to timely and accurate information on merger intentions, the rationale behind them and prospective outcomes to allow them to develop, and if necessary to co-ordinate a response between different sites and employee representative structures.

However, the UNI-Europa survey clearly shows that companies planning a merger or take-over rarely consulted or informed their workforce on their upcoming plans. The trade unions concerned were even less likely to be consulted. Very often, staff first hear of merger plans in the media or in the workplace after the event. Where consultation did take place, it was generally very shortly before the merger decision was to be taken and did not give the union or staff representatives the final power of veto over any decision taken by the company.

Some differences in the level and quality of information and consultation taking place prior to the merger can clearly be found to result from the availability and enforceability of strong national legislation relating to the information and consultation of staff before decisions are taken, which are likely to have a significant impact on the workforce. The overall industrial relations climate and the level of unionisation in the sector and at company level can also be shown to have played a part. In Finland, for example, where legislation is in place and the single trade union representing workers in banking has a 90% unionisation rate, negotiations over the impact of mergers on employers are obligatory for the new employer after a merger or take-over. If there are job losses, a minimum time limit is set for these negotiations. Nevertheless, it is argued by the trade unions that decisions are usually already

taken before employees are consulted and these negotiations are therefore no more than window-dressing.

Similarly, in Germany, where rights to information and consultation exist for the supervisory board and the central works council, such information is often not given in good time contrary to legal requirements. For example, it was only in March 1999, four months after the announcement of the take-over of Banker's Trust by Deutsche Bank, that the works council was officially informed of this development.

Thus, with few exceptions, the procedures for information and consultation on mergers and acquisitions are insufficient or are not sufficiently applied and enforced. This is true both at the national and at the transnational level in the case of European Works Councils. The role of the latter is seen by many to be crucial in cases of mergers and acquisitions, which involve companies with European operations. Within the European Works Councils Directive and its national implementation in the member states, there is clearly some provision for workers to be informed before an event which is likely to influence a significant number of workers in more than one member state. However, the UNI-Europa survey shows that the level of effectiveness and activity of the European Works Councils varies widely from country to country. Indeed, in many cases, EWC agreements have yet to be established. Where they are in place, management often only pay lip-service to these structures. Experience has show that EWCs have generally not receive prior information of any merger intentions and have not had any involvement in consultations on post-merger strategy. A new agreement taking account of the revised structure after a merger or take over is not always entered into, even where both undertakings involved had previously had individual EWC agreements.

Together with the barriers which remain in relation to the understanding of different countries' industrial relations systems and the language barriers, the reticence of employers to make EWCs active fora for exchange and consultation at transnational level is currently limiting the effectiveness of EWC where mergers and acquisitions are concerned.

Recommendations

It is clear that current legislation and employee representative structures are insufficient to ensure that trade unions and employee representatives can play an effective role in the process of change, which is currently engulfing the finance sector as a result of restructuring resulting from technological advances, the globalisation of the economy and the wave of mergers and acquisitions. Current provisions do not always allow trade unions to effectively fulfil their role in ensuring that workers' rights and working conditions are protected in merger and take-over situations.

A number of steps can be taken by trade unions to seek to improve this situation:

Legislation

Trade unions must play their part in national and European level negotiations and re-negotiations of legislation governing the rights of employee representatives to be informed and consulted about merger and take-over decisions in a timely fashion. This can be done through national and transnational social dialogue channels and lobbying. It is particularly timely in the framework of the renegotiation of the EWC Directive, ongoing discussions on European legislation on national information and consultation and employee representation in the European Company.

Where legislation already exists, but companies fail to implement it, they should consider exploring whether legal action can be taken to penalise employers for not respecting such provisions. Relevant legislation includes:

- Directive on information and consultation (European Works Councils Directive)
- Directive on collective redundancies
- Directive on transfer of undertakings

Preparation and national and transnational co-ordination

The unions represented in UNI-Europa have already taken steps at transnational level to formulate a trade union strategy on mergers and acquisitions. This strategy builds on the work of the European social dialogue in the banking and insurance sector and the links established between participating national unions. With regard to taking legislative action against errant employers, the strategy recommends that unions in Europe discuss the establishment of a network of lawyers in different countries working on cases relating to mergers and acquisitions on their behalf. This would allow unions to benefit from each other's experience and to exchange information.

UNI-Europa already plays an active role in the preparation and negotiation of European Works Councils agreements in the sector and will continue to do so. Unions are urged to exploit the terms and conditions of the Directive in order to obtain as much detailed and regular information as possible from management on a merger or take-over. The Trade Union Guidelines set down in UNI-Europa's merger strategy document provide trade unions involved with a list of key questions to ask management. EWC members can (as much as any confidentiality agreements allow) use their links with national trade unions to provide information and seek to develop a common response.

In order to be able to prepare more effectively for the impact of mergers and acquisitions on employees, trade unions need to study the impact of past mergers more closely, in relation to their impact on employment, working conditions and pay, but also on quality for the consumer and outcomes for shareholders. This information should be widely shared and can allow unions to provide a stronger response to employer claims on the economic necessity and wisdom of mergers and acquisitions. National and transnational exchange of information is clearly the key to the establishment of a strategic response in the case of merger announcements.

Financial services mergers and acquisitions: Consumer impacts

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Introduction

Mergers and acquisitions are an important part of the European retail financial services landscape, and will continue to be so for the foreseeable future. They are indicative of a re-scaling of financial service activities within Europe as organisations endeavour to expand and diversify their operations across financial services markets, regions and countries. Mergers and acquisitions are a means by which firms are able to increase market share and capitalise upon scale efficiencies within an increasingly competitive market for financial products and services.

There is a strong case for arguing that mergers and acquisitions within the European financial services industry are better seen as a consequence of, rather than a direct cause of, competitive change within the European financial services industry. In other words, the growth in merger and take over activity may be interpreted as an outcome of the destabilisation of the competitive environment for financial services over the last 25 to 30 years or so. The market for financial services has become more competitive over this period, for at least two reasons. First, successive rounds of national and European re-regulation have removed the 'structural' regulatory barriers that previously kept firms corralled within narrow parts of the financial system, and which has encouraged firms to expand into new financial markets so raising levels of competition within them. Second, successive rounds of financial innovation have also raised levels of competition, which have changed the bases upon which firms compete with one another for customers and market share. Perhaps the best example of this is the growth of electronic databases as a means of sorting and managing customers. The use of relational databases in combination with automated credit-scoring and 'forensic' marketing systems has reduced the dependence of established financial services firms upon their traditional branch networks, which are an expensive way of distributing products and services to customers.

The ability of firms to contact and discriminate between customers 'at a distance' through the use of these technologies has encouraged extensive branch closure programmes and the growth of alternative distribution channels, such as telephone call centres and, more recently, internet-based financial services. This development has delivered short-term benefits for financial services firms, because such delivery systems produce significant efficiency savings in the provision and processing of customer services. However, it has also increased the level of competition within the industry as a whole, and has emerged as a real threat to the long-term survival of many established financial services firms. In the past, the requirement to have an extensive network of branches to be able to participate in many financial services markets was a fairly effective barrier to entry. However, the growth of electronic information systems and alternative distribution channels means that it is now far more cost effective for firms without a branch network to enter financial services markets. As a result, a host of non-financial services firms have entered the European retail financial services market, increasing levels of competition still further for established firms, and adding further pressures for consolidation through merger and acquisition. This circular process of competition will be given a further spin by the growth of electronic banks offering services over the Internet.

The remainder of this report is divided into four parts. Part 2 reviews the impact of recent changes upon levels of service provision to customers. Part 3 considers the impacts on different types of customers. Part 4 reviews the reactions of consumers to these changes. Finally, Part 5 provides concluding comments.

The report draws upon the author's research into the reorganisation of British and European retail financial services over the last decade, and from a desk-based review of a range of media and other reports on the recent history of the European retail financial services sector. It should be noted that most accounts of merger and acquisition activity within the retail financial services sector tend to gloss over the impacts on consumers in favour of a focus upon employees and shareholders. This is understandable, in that the impacts upon employment levels and share values are more immediate and quantifiable, whereas any impacts upon consumers tend to be observable only over the medium- to long-term. Moreover, and to reiterate the argument made earlier, it is important to see the impacts made on consumers by mergers and acquisitions as part of a wider process of reorganisation within the financial services industry more generally. It is difficult to disentangle the direct impacts that mergers and acquisitions have upon the consumers of retail financial services, although they may well exacerbate and amplify existing trends and processes.

Service provision in retail financial services

What has been the impact of mergers on levels of product provision/choice/cost?

The numbers of financial products available to consumers has increased markedly over the last decade or so. This has been brought about by a number of related developments. First, by the growth of competition between financial services firms referred to earlier, which has included competing on the number and range of products offered. Second, the number of financial products has increased as financial services firms have increasingly sought to provide investment and insurance products that substitute for welfare services that have been degraded or even withdrawn by governments in areas such as pensions, health and education. Third, and finally, changes in regulation across Europe have made it easier for firms to enter new geographical and product markets.

In addition to greater choice, there are grounds for arguing that the cost of such products for the majority of financial consumers has also fallen in real terms. Many new entrants to financial services markets have chosen to compete on the grounds of price, particularly through the use of virtual or 'at-a-distance' distribution methods such as telephone call centres. This can be seen in the case of mass insurance markets, such as car and household insurance, and for products such as credit cards. In addition, such services give consumers greater time flexibility. Firms using such systems are able to undercut more traditional competitors through efficiency savings, as it is more cost effective to deal with customers through technologies such as call centres than through a branch, but also because such firms actively discriminate in favour of certain types of customer and against others. Therefore, while most customers have benefited from such developments, through a proliferation of choice and the increase in price competition, a significant minority of financial services consumers have lost out. The losers are consumers who are seen to be particularly bad risks or insufficiently well off for financial services firms to justify the costs of servicing them as customers. These individuals and households also lose out in another way too. The financially excluded tend to be those with low levels of literacy and educational attainment and experience difficulty in navigating their way through the increasingly complex world of retail financial services. They face problems of decision-making even when they are presented with the opportunities to make choices about the purchase of financial services.

Therefore, the landscape of European retail financial services provision is increasingly complex, but increasingly divided. There is very little evidence of the impact that mergers make on product provision, but one would suspect that they do not necessarily lead to the disappearance of products. Indeed, given the current climate for product innovation, it would be more likely that mergers might be motivated by a desire to expand the product range.

Have staff reductions decreased standard of service?

A clear motivation for merger and acquisition activity within retail financial services is to reap efficiency savings. The most effective way to do this is to close branches, as firms are able to economise on staff, property and equipment costs. It should be noted that financial services firms have been undertaking extensive branch closure programmes from at least the late 1980s onwards. UK banks and building societies closed 20% of their branches between 1989 and 1995, largely independent of merger and acquisition activity. However, programmes of branch closure tend to accelerate in the wake of mergers. For example, the British banks, Lloyds and TSB plc, were already pursuing their individual strategies of bank branch closure ahead of their merger in the late 1990s. The merger meant that even more branches were closed as the new bank, Lloyds-TSB, began to eradicate branch overlaps. A similar acceleration of branch closures will occur following the merger between NatWest and the Royal Bank of Scotland. However, in some cases the reverse can happen. For example, Midland Bank began a major branch closure programme in the late 1980s, but which ended when the bank was purchased by HSBC. The drastic closure programme had in large part been driven by Midland's severe financial problems, but which were resolved when the bank was bought in the early 1990s.

The closure of branches has undoubtedly reduced the level of physical service provision for some customers. Most customers have to travel further to use a branch, and this disproportionately affects those who are less mobile, either for reasons of low income or physical disability. This development has also had negative impacts upon those with low levels of financial literacy, for it makes it more difficult for consumers to be able to engage in face-to-face discussions with branch staff, which can help clarify confusions in financial services publicity material and documentation. While the growth of 'remote' service facilities, such as ATMs and telephone banking, are more than adequate substitutes for branches for many customers, they may not be equivalents for disadvantaged groups who are less likely to have access to a telephone. This growing physical, social and technological distance between the most disadvantaged members of society and the formal financial services industry has encouraged the growth of 'predatory' financial services providers, such as money-lenders, who charge high prices for debt-products but who also provide a 'door-to-door' service and offer cash-based service and the possibility of irregular repayments.

Have mergers restricted competition/created monopolies?

One of the major motivations of merger and acquisition activity in all industries is to counteract competitive pressures by pooling and redistributing market share. In that sense, the *raison d'être* of much merger and acquisition activity is precisely to counteract the effects of competition upon the organisations concerned. It would seem that the danger of monopoly within the retail financial services sector is very strong. This is partly a legacy of decades of financial regulation within Europe that was designed to encourage 'stability' within the financial services industry for fear that too much competition would lead to a crisis which, through a process of contagion, would then spread to the rest of the economy. As a result, for most of the post-war period many financial services firms have been able to develop dominant market positions without intervention from government agencies. Therefore, although there has been a growth in competition and product availability in recent years, this has taken place from a low base. This state of affairs was acknowledged by a recent government report on competition in UK banking that recommended any future bank merger be referred to the Competition Commission because the tendency towards monopoly in the industry would be counter to the consumer interest (*Competition in UK Banking: a Report to the Chancellor of the Exchequer*, HMSO, London: www.bankreview.org.uk).

What has been the impact on quality of products?

It is very difficult to isolate the impact of mergers and acquisitions upon the quality of products. As indicated earlier, the range of products offered by retail financial institutions has increased. Moreover, the industry insists that its move to an 'at-a-distance' mode of service provision is demand-led. From the industry's perspective, branch closures are as much a product of consumers opting to use ATMs and telephone banking facilities in place of branches, for example, as it is the fact that remote facilities are more cost-effective for financial services firms. For example, Barclays Bank claims that less than 40% of its customers now use branches due to the availability of cash machines, telephone and internet banking (20,000 of its 13,000,000 customers - 0.15%) registered for internet banking in one week. However, there is also some anecdotal evidence to suggest that not all customers are happy with the introduction of centralised enquiry systems, whereby telephone enquiries to branches are fielded by operators in centralised call centres, and only routed through to branches if the enquiries cannot be dealt with remotely. Some customers feel that this represents a degradation of the relationship they have with their financial services provider. Moreover, as the financial services industry becomes more competitive, so the danger of firms selling inappropriate or bad products to customers increases (as in the case of the pension selling scandal in the UK).

Does the impact on consumers differ depending on the nature of the merger/take-over?

Mergers of financial services firms serving professional markets (such as investment banks, for example) will have only indirect effects on consumers, whereas mergers of retail financial services firms will have more direct impacts. There is insufficient evidence to be able to make a more precise qualification of this statement.

Impact on smaller and larger consumers

Have mergers deepened social exclusion, e.g. through branch closures, increasing use of new technology such as Internet banking?

Mergers between financial services firms have not necessarily deepened social and financial exclusion. However, as indicated earlier, a significant minority of people do not have access to basic financial services, and these individuals and households tend to be geographically concentrated. Research undertaken by the author has revealed that bank branch closures tend to be disproportionately concentrated within the poorest parts of towns and cities. Because these individuals and households tend to be the most economically marginal members of society they are the least able to make personal investments in the kinds of basic infrastructure needed to participate in developments such as telephone-based financial services or Internet-based services. For the latter, customers would need not only to be connected to a telephone service but also be able to afford an expensive personal computer and accompanying software. In some of the poorest parts of European cities significant proportions of the population are unable to afford a telephone.

Social and financial exclusion may well be deepened by parallel developments in the area of credit scoring. Increasingly, diagnostic software programmes determine the potential profitability of customers through analyses of information provided on application forms for various products and services. Financial services firms use these programmes because they reduce bad debt and increase profitability. But credit scoring systems may also prevent some consumers from gaining access to financial services because they have certain social and financial characteristics that mean they will not gain approval and be offered services or products (see Leyshon and Thrift, 1999).

Has there been a differential impact on larger and smaller consumers/investors?

New technology and the increased ability of financial institutions to offer a wider range of products and services have benefited those with the means to access them. Consumers with a regular income and a good credit history are able to borrow money more readily and cheaply than ever before, although this has often lead to widespread debt encumbrance. Consumers of retail services with more restricted incomes, with poor credit histories or unstable social backgrounds, are finding it more difficult to get access to the mainstream financial services sector traditional banking services.

Have consumers benefited from windfall payments?

A process that has run in parallel to that of merger and acquisition activity within the financial services sector has been that of 'demutualisation'. Insurance companies and building societies have been prominent mutual organisations, which are effectively 'owned' by their members, that is, by consumers who held policies or debt products and who have the right to vote on policy and other matters at Annual General Meetings.

In recent years, there has been a wave of demutualisation as building societies and insurance companies have converted to public limited companies, effectively buying the ownership off members in the form of 'windfall payments', of up to several thousands of pounds each, based on the level of business that customers did with the organisation. These payments have undoubtedly enriched many individuals and households in the short-term. Moreover, they have the capacity to do so over the long-term too, to the extent that customers retain shares that continue to rise in value, or where customers have used the money from the sale of shares to invest in other long-term investments. However, set against these benefits is the calculation that products offered by public limited companies tend to be more expensive over the long-term because products have to be priced at a level that generate sufficient profits to allow dividends to be returned to shareholders. Thus, it has been calculated that over the life of an average mortgage or life insurance policy products purchased from a public limited company are more expensive than those purchased from a mutual organisation. There is some anecdotal evidence to suggest that some customers take advantage of the windfalls but then move their financial services business to another mutual organisation. Whether this is due to a preference for cheaper long-term financial services or merely in anticipation of a short-term gain from yet another demutualisation is impossible to determine from the evidence currently available.

Several demutualised organisations have subsequently been bought by large European financial services firms, and have so provided further momentum to the wave of merger and acquisition in the financial services industry.

Reactions by consumers to mergers

What has been the impact on consumer brand loyalty (e.g. Evidence of client moving to or away from the new company as a result of the merger)?

Again, it is virtually impossible to determine the exact impacts of specific mergers and acquisitions on levels of customer loyalty from the available evidence. This kind of information is highly sensitive, and is not easily released by firms. However, it is generally known that the industry sees declining levels of customer loyalty as a problem, although levels of customer mobility vary markedly between sectors. Levels of mobility are relatively high in price-sensitive sectors such as car and household insurance, whereas it is lower for more complex products such mortgages and lower still for banking services.

In all product areas a growing number of consumers are prepared to move their business from one firm to another. Although on the whole financial service customers tend to be highly conservative, it tends to be the more affluent and financially literate customers that are most prepared to shop around for products and to relocate their financial activities if necessary. This is seen less as a boon and more of a burden for the financial services industry. Such developments add to the marketing costs of the industry as firms seek to develop attractive brands and retain and attract customers through advertising. In addition, while these are exactly the kinds of customers firms would like to attract from other firms, as they are more likely to buy additional financial products, they are also the customers firms would least like to lose from their own customer rosters. The problem is complicated by the fact that in the case of products such as current accounts, customers rarely engage in activities as clear and precise as closing one account and opening an alternative, substitute account elsewhere. Rather, they tend to open additional accounts to run alongside their existing service and move their business across gradually, while maintaining the original account, to provide maximum flexibility and to leave open the possibility of reversing the account transfer should they need to in the future. This adds costs to the banking sector as a whole, as additional accounts have to be serviced without a net addition of capital to the system. This contradictory development is exacerbated by the development of packages to encourage and facilitate the movement of business from one account to another as firms agree to take responsibility for transferring items such as direct debits and standing orders.

Perhaps the clearest evidence of customers abandoning firms in protest at strategic decisions made by financial services firms may be seen in the case of protests against bank branch closures in the UK. As banks have closed branches in communities, many individuals have 'voted with their feet' and moved their accounts from the 'runaway' branch to the branches that remain. However, in some cases, individuals and households in particularly marginal or remote communities have sometime moved their accounts from one branch to another only to find themselves in a similar situation when their 'refuge' bank subsequently makes a similar decision to abandon that particular community.

Conclusions

The main conclusions to this brief overview are as follows:

- It is difficult to discern specific impacts made on consumers from merger and acquisition activity within the European retail financial services sector.
- Merger and acquisition activity should be seen as an outcome and a response to the intensification of competition across the retail financial services industry.
- Increased competition is a product of wider regulatory changes and a reduction in the entry barriers to retail financial services. This has involved a move away from a dependence upon collecting and utilising face-to-face knowledge accumulated within branches towards the use of electronic databases which can be used to discriminate between and communicate with consumers 'at-a-distance'.
- Retail financial services markets are becoming increasingly polarised, as a result of processes of financial inclusion and financial exclusion. This process will intensify with the growth of Internet banking which will increase choice and reduce costs to those consumers who buy their financial services on-line.
- The problems of finding readily accessible information on consumer responses to changes suggest the need for a more effective system of monitoring the social accountability of the European retail financial services market. Within the United States, for example, it is possible to determine the impact of bank mergers on consumers because of the existence of regulation that requires banks to disclose information on the markets they serve (the Community Reinvestment Act) and the outcomes of decisions on applications for home mortgages (the Home Mortgage Disclosure Act) (see Dymski, 1999). Legislation such as this has enabled communities and unions to monitor the impact of mergers and take-overs within the banking sector and to mobilise objections to mergers that might produce socially regressive lending outcomes. There is a clear need for parallel legislation to require disclosure within the member states of the European Union.

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The performance of banking mergers: Propositions and policy implications [1]

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Abstract

Using both ex-ante and ex-post methodologies, this paper discusses the performance of mergers in banking. The discussion is set against a more general background and concludes that it is unlikely that mergers among large banks, as well as take-overs of small banks by large banks, are able to create much economic wealth. Also, it is found that such mergers and take-overs do not generally create positive shareholder returns. The generality of this finding is demonstrated by a discussion of findings on non-financial mergers. Since the ubiquitousness of ill-performing mergers is at odds with both conventional wisdom and economic theory, the paper discusses briefly why then such mergers and take-overs take place at all. It is suggested that especially large banks may be incapable of checking value-destroying strategies because of the incidence of so-called minimax-regret behaviour both among their large clients and among themselves. The paper touches upon some wider effects on economic efficiency and comes up with several policy implications. It is argued that competition policies should address issues of productive efficiency along with issues of allocative efficiency and that industrial policies should improve the access of retail clients to investment funds.

Introduction

The 1990s have seen a merger and acquisition (M&A) wave with unprecedented peaks in both the United States and Western Europe (traditionally, and with around twenty times fewer mergers, Japan was only a very distant third). With more than 1,000 billion US dollars in annual deal value during much of the second half of the 1990s, and roughly double this number during 1999, this fifth merger wave of the century easily outpaced the size of investments in equipment, machinery and corporate R&D. While a considerable, and towards the late 1990s rising share of merger activity consisted of the getting together of firms that were already large thanks to earlier mergers, a substantial number of mergers concerned the take-over of small, innovative firms. When regarded from the wider perspective that a wave spanning more than half a decade allows, all industries, be they young or mature, seem to be affected. Banking mergers would therefore merely seem to be part of a larger phenomenon. By implication, in order to understand why mergers occur in banking, it would be helpful to understand why merger waves occur at all.

To get a feeling for the importance of bank mergers, consider the following observations. During the 1980s, more than 5,000 US banks lost their independence due to take-over, followed by the disappearance of another 3,000 during 1990-1997, implying that almost half the number of banks in existence in 1980 had been acquired twenty years later. American banks spent in excess of $65 billion to acquire other banks in 1997. In the EU, 760 financial services mergers took place between 1985 and 1995 (of which more than 65% were between domestic players). During the first quarter of 1998, the number of banking mergers in the EU (excluding Germany) amounted to no less than 490. EU banks spent around $100 billion in 1998, which was up from $70 billion in 1997 and an average of $15 billion during 1994-1996. During the first quarter of 1999, EU banks expended in excess of $65 billion on mergers and acquisitions. As a result, the number of credit institutions in the European Union has

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decreased from 12,256 in 1985 to 9,285 in 1997. Interestingly, the average size of mergers outside as well as within banking has increased starkly both within the US and the EU. The number of so-called banking "supermegamergers" (involving institutions with assets of over $100 billion each) increased markedly. In the US for example, based on market values, four of the ten largest mergers in any industry ever, prior to 1999, involved banks (Citicorp/Travelers; BankAmerica/Nations Bank; Banc One/First Chicago; and Norwest/Wells Fargo). European banks knew how to hold their own as well, with such mergers as between UBS and Swiss Bank Corp., Deutsche Bank and Bankers Trust, Royal Bank of Scotland and NatWest, and BNP-Paribas. Still, most mergers in the US are between very large banks acquiring smaller institutions while a similar pattern is evolving in the EU.

Clearly, mergers in banking and elsewhere take up considerable amounts of managerial time and talent (perhaps as much as fifty per cent at the level of top-executives). Since they usually require enormous funds to get done, or vast offerings of paper, it is therefore of great importance to know what they deliver to the economy. Is all this time and money spent well? In this paper, I will review the evidence for banking mergers. I will do so, however, by referring explicitly to non-financial mergers as well. Although many studies of banking mergers have been undertaken there are still many questions left. Looking into the effects of non-financial mergers may therefore be helpful in establishing an overall view on the issue.

In order to give the reader some feel for the approaches and procedures that were adopted by the studies to be reviewed, I have chosen to add some explanatory methodological notes (section 2) as well as to discuss some of these studies a bit more extensively rather than just tabulating their findings (sections 3 and 4). Since it will become clear that the general result of these studies is quite paradoxical, I will also discuss why so many firms, including banks, pursue mergers so vigorously (section 5). A discussion of some implications for the wider economy is then followed by some policy suggestions in section 6. Section 7 wraps up the thrust of the paper.

Methodology

The performance effects of mergers can be estimated in several ways, but two of these have received prominence with dozens of applications having been published over the last two decades:

- studies which try to assess merger performance indirectly by analysing the reactions of the stock market to merger announcements, so-called event studies or ex-ante studies, and
- studies that pursue a direct assessment by analysing the effects of mergers on real firm performance in as far as this can be gauged from internally generated accounting data, so-called ex-post studies.[2]

In most of the studies the underlying assumption is that improved stock performance (ex-ante studies) or improved profitability (ex-post studies) are best indicators of true performance increases, i.e. increases in productive (or internal) efficiency (say, productivity) and/or increases in dynamic efficiency (i.e. process and product innovation), in short, increases in the creation of economic wealth. Although this latter criterion is the only one that makes sense when assessing mergers from a social point of view, it is evident that mergers and acquisitions (M&As) may well be beneficial to certain stakeholders (shareholders, managers, employees) and thus welcomed by them even if no economic wealth has been (or will be) created. The most conspicuous example would be a merger that increases profitability as a result of the creation of (additional) market power. In this case, wealth is merely redistributed from

[2] Other types of merger assessment include questionnaire studies (these are less appropriate due to likely response bias) and case studies (which, though very illuminating, may not have general value).

consumers to producers instead of created (in economic jargon we say that allocative efficiency has deteriorated). Other examples of merger advantages that are not related to the creation of wealth include increased bargaining power vis-à-vis suppliers of inputs, and tax advantages. For example, the take-over of AEG by Daimler-Benz brought tax savings of approximately 1.9 billion Deutsche Mark (approx. 1 billion Euro) which was several hundred million DM more than the purchase price paid (Bühner, 1991). Whereas it is currently debated whether tax advantage seeking mergers should be of concern to public authorities, it is widely accepted that mergers which merely lead to a transfer of wealth from consumers (clients) to producers (banks) should in principle be prohibited.

Since it is unlikely that a merger *reduces* market power, post-merger profits would normally not be smaller than pre-merger profits. If it is observed, that profits have decreased after a merger nevertheless, then it can therefore be safely concluded that this merger has had negative effects on productive or dynamic efficiency.

Ex-ante studies. Ex-ante studies, commonly found in the finance literature, define the announcement of a merger (or sometimes its consummation) as an event in the stock price history of the merging firms. The effect of this event is estimated by assuming that changes in the share prices of the merging firms, after controlling for movements in the market in general and the systematic risk of the firms concerned, represent the value of the event. In a substantial number of cases, one uses some variant of the capital asset pricing model (CAPM) or the market model (MM) to calculate the expected returns for the firms in question. Systematic changes in the residuals ('abnormal returns') from these models around the event will then show the effects of a merger. When estimating the effect of mergers beyond a single case, the residuals are averaged over all the firms in a sample for various days or months before and after the event and subsequently accumulated over a period to give the cumulative average residuals, or CARs. Using the CAPM or some variant makes it necessary to assume that the capital market is efficient, meaning that stock prices are a true reflection of the present value of the underlying assets, including all future cash flows.

A merger announcement contains new information, which will be assessed by investors on its promises for future earnings. Stock prices of both acquirer and target will rise if investors estimate that the merger will lead to positive additional future earnings.

Ex-post studies. Ex-post studies usually compare, occasionally for very large samples, profitability data for merging firms with a control group of less acquisitive or non-merging firms and/or with the history of the merging firms themselves. Some studies have gathered data on real resource effects, others on market share and R&D outputs. In as far as these studies have focused on data that have been generated by the merging firms themselves, they are not without pitfalls either. For one, it is well known that firms can use an impressive arsenal of creative accounting techniques so that published accounts may not give a true and fair reflection of these firms' financial position. For example, the incorporation of the acquired firm's profits in the year of merger and the handling of the premium paid by the acquiring firm are notorious for the extent to which they can be manipulated (Smith, 1992). In addition, mergers and acquisitions can be accounted for by means of purchase accounting or pooling of interests accounting. The two methods lead to fundamentally different profit ratios while both can have a depressing effect on calculated post-merger profits.[3] Besides, it may be very difficult to define a

[3] Under purchase accounting, the assets of the acquired firm are recorded at the effective purchase price paid, while under pooling of interests accounting, they are recorded at their pre-merger book values. If a premium is paid over the acquiree's book value, an addition will be made to the acquirer's good will account under purchase accounting while it will be debited to the acquirer's equity account in the case of pooling of interests accounting. Both profit/assets and profit/sales ratios will be lower under purchase accounting than under pooling of interests accounting. Under either method, the net worth of the merged firms is increased upon

comparable control group, especially since most acquisitive firms have become quite diversified (at least since the mid-1960s) and their diversification patterns may differ substantially. Also, many acquisitive firms undertake several acquisitions in succession, so that the effects of a specific acquisition may be hard to isolate. Finally, since the typical acquired firm is several times smaller than the acquiring firm, its contribution to profits may be overwhelmed within the much larger compass of the new parent's operations.

The empirical evidence: event studies

Turning now to the evidence, it can be concluded that event studies lead to quite sobering inferences. In a study of bank mergers consummated during 1987-1997, which was done by management consultants Mitchell Madison (see *The Financial Times* of 10 August 1998), 60% under-performed controls in terms of shareholder returns for acquirers, sometimes by as much as 17%. This concurs with a survey of Rhoades (1994) who reviewed twenty-one event studies of US banking mergers. He finds that only three studies conclude that a merger announcement had a positive influence on the returns to stockholders of the bidding firm. In contrast, eight out of nine studies that analysed effects on the target bank's share performance find a positive return to shareholders. Especially the studies that had been done since 1989 were found to undercut the hypothesis that the financial markets expect mergers to improve bank performance.

A recent study of 54 relatively large European mergers undertaken during 1988-1997 came up with comparatively positive findings (Cybo-Ottone and Murgia, 2000). When compared to a general market index, about half of the acquiring banks in the sample showed positive CARs. The average post-announcement abnormal gain to acquiring shareholders was in the area of 1.4 per cent whereas target shareholders gained on average more than 12 per cent. However, the study only investigated merger effects for rather tight event windows, stretching to only 20 post-merger days at the most.

Bain & Cy. investigated the development of shareholder value for 50 of the largest bank mergers of the 1990s for much longer time periods (see Weimer and Wisskirchen, 1999). The assessment covered various event windows, ranging from three days before the announcement to legal completion; from legal completion to one year after; from one year after legal completion to two years after, from two to three years after, and for the full period. Unfortunately, only the results were published and not the research methodology. Moreover, in private communication, the authors informed me that they had used several other indicators, among them "qualitative factors and client insights" to complement their event study but were not at liberty to reveal the details. Thus, it is not possible to assess the merits of the study. More in particular, client opinions are likely to be biased in favour of mergers so that the study may overstate the positive effects of these mergers.

Still, the results seem worthwhile enough to replicate here (see Table 1). Whereas Bain & Cy. have made a distinction between mergers that were consummated before 1998 and newer deals, these have been combined in the table. Clearly, the assessment of the newer deals relies more fully on short term stock market evaluations. It can be seen that roughly 30 per cent of these mergers would 'probably' have to be qualified a success. Seventy per cent are, therefore, likely not to be a success, or in other words likely to be a failure in the sense that they could not or are unlikely to realise any economic gains (in as far as these can be inferred from stock valuations).

Interestingly, these findings are not much different from those found in studies that apply to non-

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consolidation to reflect current market values, and this results in the creation of a larger asset base and additional depreciation expenses. The effect of this is that the calculation of post-merger profitability may be biased downward relative to pre-merger profitability.

financial industries. Reviewing 29 studies from different countries and time periods, Mueller (1996) confirmed earlier reviews to conclude that target firm shareholders enjoy substantial gains. Beginning around two months before the event, the target firm's share prices start to rise until they outperform their CAPM-predicted returns or the returns of the control group at or immediately after the event.[4] For the studies reviewed, the median gain to acquired firm shareholders amounted to 20.6 per cent. The median gain to acquirers in Mueller's review is only 0.2 per cent, but in the light of studies not covered in the review even that result would seem upwardly biased. Reviewing ten studies that have measured CARs over a tighter event window (within 5 days before or after the event), Sirower (1997) finds that average acquirer's CARs in US mergers undertaken during the 1980s range from -3.35 to at best -0.85 per cent with only about 35% of acquisitions being met with positive stock market returns on announcement.

When event windows are expanded to the medium term (a half year to three years after the event), the returns to acquiring firms usually appear to deteriorate significantly. Mergers are typically consummated six months after their announcement. Out of 25 studies that have estimated the returns as of that date, 19 come up with negative abnormal returns (with a median value of -6.8% for all 25). Magenheim and Mueller (1988) who estimated the performance of 78 mergers for an event window of [-3, 36] with a pre-event CAPM benchmark came up with CARs of between -15.7 and -42.2%.

Table 1: Assessment of the 50 largest bank mergers, 1990-1999

Probably a success	Neutral	Probably a failure
• ABN-Amro	• ABN/Amro-Banca Real	• B. Central-B. Hisp. Americano
•Ass. First Cap.-His. Avca Fin.	• Ambroveneto-CARIPLO	• B. di Roma-B. Santo Spirito/Cassa di Roma
• Ass. Generali-B. della Swizzera	• B. de Bilbao-Banco de Vizcaya	• Banc One-First Chicago
• B. de Santander-B. Central Hispano	• B. Bilbao Vizcaya-B. Excel Economica	• Crédit Agricole-Banque Indosuez
• Banco de Santander-Banesto	• Bank Austria-Creditanstalt	• First Union-Core States
• Bayer. Vereinsbank-Hypobank	• Bank of Tokyo-Mitsubishi Bank	• Fleet Fin. Corp.-Sanwa Bus. Cr.
• BCP-BPA	• CCB-CLF	• Monte del Paschi di Siena-Banca Agricola Montava
• Chase-Chemical	• Credito Italiano-Unicredito	• Realkredit-BG Bank
• Cred. Italiano-Credito Romagnolo	• Crédit Suisse-Winterthur	• St. George Bank-Advance Bank Australia
• Deutsche Bank-Bankers Trust	• Dresdner Bank-Kleinwort Benson	• Sun Trust-Crestar Fin. Corp.
• Dt. Verkehrsb.-Long Term Credit	• First Bank-US Bancorp	• Washington Mutual-HF Abmanson
• Lloyds-TSB	• IB San Paolo di Torino-IMI	• Wells Fargo-First Interstate
• Nordbanken-Merita	• ING-Barings	
• Star Bank Corp.-Firstar	• Merrill-MAM	
• Travelers-Citicorp	• Morgan Stanley-Dean Witter	
	• Nat. Australia-Michigan National	
	• Nations Bank-BankAmerica	
	• Norwest-Wells Fargo	
	• Rabobank-Robeco	

[4] The pre-event rise could be due to insider knowledge and trading, to the acquirer building up a toehold, or to strategic buying (i.e. to investors having spotted that the firm must be a prime candidate for acquisition).

• SBC-UBS

• Société Générale-Crédit du Nord

• Travelers-Salomon Broths.

Source: Bain & Cy.

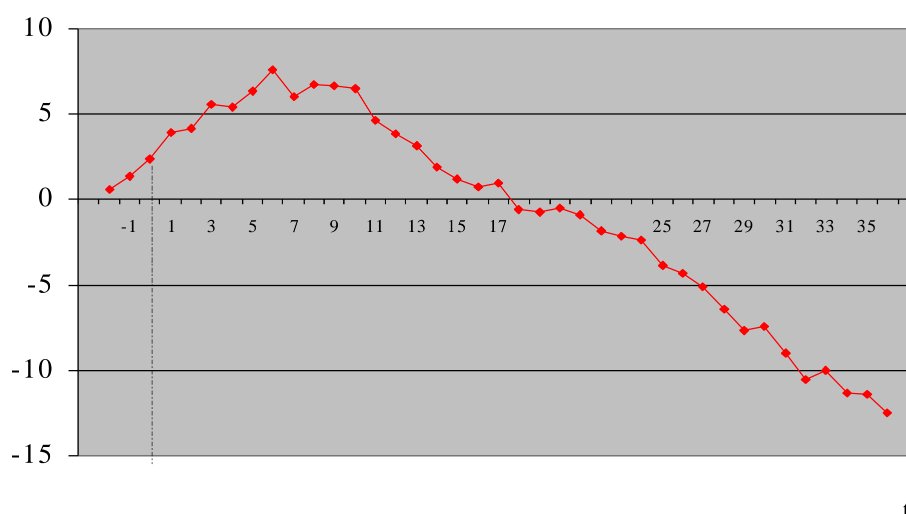
The studies discussed have not made distinctions between purely national and cross-border mergers and take-overs. Since the latter category has increased in importance especially during the late 1980s and 1990s, a team at Erasmus University decided to study shareholder returns for cross-border mergers and take-overs exclusively (see Schenk, 2000c). Moreover, the team focused on returns to acquiring shareholders only, on the assumption that returns to the owners of acquired firms are more likely to benefit from bidding process peculiarities instead of economic fundamentals.

The sample included 87 foreign acquisitions by 63 Dutch firms undertaken during 1990-1995. It included services firms (trading and retailing) as well as firms from construction industries but no financial services firms. The predicted (normal) returns were calculated using the market model over an estimation window stretching from 38 months to 3 months prior to the event. In order to capture both short term and long term returns, an event window was taken stretching from 2 months prior to the event to three years after it. Figure 1 clearly shows the stock market reaction to these mergers to be negative in the long run though positive in the short run, i.e. until about six months following the merger announcement. For the period as a whole, shareholder value of these acquiring firms dropped with more than 12 per cent.

These findings are corroborated by a recent study of KPMG management consultants (KPMG, 1999). For a sample of 107 firms taken from a list of the 700 largest cross-border deals by value completed between 1996 and 1998, it found that only 17 per cent of the deals had added shareholder value to the lead firms relative to industry matched controls. As many as 53 per cent actually destroyed value whilst the remainder produced no discernible difference.[5]

Figure 1: CAR (%) of 87 foreign acquisitions by large Dutch firms, 1990-1995 [-2, +36 m]

[5] Interestingly, of the board members of the firms investigated 82 per cent believed (or at least said that they believed) that the mergers had been a success. Less than half of the lead firms had carried out a formal review process.



In conclusion, it is evident that the majority of event studies that have tried to capture the results of merger in banking or elsewhere for the acquiring firms show negligible payoffs or small losses at announcement and significant negative returns thereafter. Since acquirers usually appear to be outperforming the market prior to the event, this implies that they become worse off as a result of mergers and acquisitions. However, the returns to target shareholders are significantly positive. To some this latter finding is sufficient evidence to conclude that mergers and acquisitions create wealth. They would argue that an efficient market would bid away any potential gains to acquirers during the process that leads up to the consummation of the merger so that the target shareholders' gains are the net increase in economic wealth. This of course would need to be quite unsettling to the shareholders of the acquiring firm as they would see their agents spend much time and financial resources in a market of high risk and, at best, a predicted gain of approximately zero.

More fundamentally, however, there are two issues that deserve to be discussed. The first concerns the sources of any positive evaluation by investors. Positive results may be explained by expectations that the management of the acquiring firm will be able to raise the productive and/or dynamic efficiency of the target. This explanation is normally embraced by those who claim that the market for corporate control is an efficient market (such as Jensen, 1988). However, positive returns might equally well be explained by expectations that the new firm will have more market power. In both cases, future profits may rise thus justifying the premiums paid. Ex-ante studies cannot tell us which of the two is the real source. In fact, it has been demonstrated that the stock prices of rivals of merging firms rise as well upon announcement which suggests that investors may be expecting increasing chances for collusion which would benefit their firms too.[6]

Even more fundamentally, the question is whether equity prices are unambiguously (rationally) related to economic fundamentals. Since many studies have found that stock prices are sensitive to new information (i.e. that they react promptly and swiftly to news events) and that investors cannot systematically outwit the market, it would seem evident that this relationship is real. However, Summers

[6] The stepped-up appreciation of rivals' shareholder value may also be due to shareholders perceiving a larger probability of these rivals becoming take-over targets now that other mergers have taken place.

(1986) has pointed out that these findings in themselves are not sufficient evidence to accept the hypothesis that capital markets are efficient: they would be consistent, too, with a hypothesis that claims that market valuations include large persistent errors. Summers' alternative formulation would be consistent with several important findings both experimental and empirical. On the experimental side, Tversky and Kahneman (1981) have found that subjects overreact to new information in making probabilistic judgements (see Schenk, 2000b, for further discussion). Shiller (1981) has shown empirically that financial markets display excess volatility and overreact to new information. Clearly, the capital market can easily be the victim of 'fads' or fad-like behaviour by investors (see also Shiller, 2000). Moreover, if targets are desired by multiple bidders, bidding wars may easily result in economically unjustified premiums.

These findings do not exactly boost one's confidence in ex-ante studies. In fact, it would seem that such studies do not have the systematic power to tell us anything more than that target shareholders are able to gain substantially, and that the market for corporate control requires the payment of significant premiums. Whether these gains and premiums are systematically related to economic fundamentals, instead of being the result of investors having overlooked the stock so that it was undervalued or of acquisitive managers who have overvalued it, is uncertain to say the least. Rather one would have to rely on additional information, which is why we will now discuss the most important findings of ex-post studies.

The empirical evidence: ex-post studies

Given the measurement problems mentioned above, and the various ways in which they have been tackled, it is somewhat surprising, but at the same time reassuring that ex-post studies have produced very consistent results.

These results paint a pessimistic picture. It appears that failure is widespread, mediocrity considerable, and success only occasional. This time, let me start with a review of the most important studies of non-financial mergers. Meeks (1977) selected 233 British mergers and acquisitions undertaken in the period 1964-1972 so as to give normalised profitability data for at least three years before, and up to seven years after the merger. He found that the acquirers significantly outperformed their industries pre-merger, but that performance declined subsequently, except for the year of merger. As suggested by Meeks, the relative performance improvement during the first year might well be explained by accounting manipulations and/or some sort of 'window dressing' in order to reassure shareholders of the fruits of the merger. A similar study done by Kumar (1985) on 350 mergers and acquisitions in the UK during 1967-1974, again showed significant profitability declines that were persistent over several post-merger years. When taken together, these two studies reveal that approximately 62% of all mergers and acquisitions showed negative results in comparison to their proxy counterfactuals.

More recently, Dickerson, Gibson and Tsakalotos (1997) investigated whether there is a permanent shift effect on performance following a firm's first acquisition and whether there are differential returns to acquisition growth and internal growth. Their study utilised a large panel of UK-quoted firms over the period 1948-1977 and, in an effort to capture long-term performance, included only those companies for which there was a minimum of ten years of data. This implied that they had 2,941 companies with an average of 18 years of data on each; just under 30% of these companies were present in the sample for the whole duration of 30 years. Out of the almost three thousand firms, 613 (21%) made at

least one acquisition for a total of 1,443 acquisitions. Thus, the study allowed comparing companies once they had made an acquisition with their previous performance as well as with non-acquiring firms. Moreover, it allowed to take account of changing levels of mergers and acquisitions activity over time thus eliminating any period-specific bias. Dickerson *et al.* find that acquisitions have a systematic detrimental impact on company performance as measured by the rate of return on assets. Not only is the coefficient on acquisition growth much lower than that on internal growth, but there appears to be an additional and permanent reduction in profitability following acquisition as well. More specifically, for the average company, the marginal impact of becoming an acquirer was to reduce the rate of return relative to non-acquirers by 1.38 percentage points (i.e. in the year of the first acquisition). Taking all subsequent acquisitions into account, acquiring firms experienced a relative reduction of 2.90 percentage points per annum. Since the mean return across all non-acquiring firms was 16.43%, this translates into a shortfall in performance by acquiring firms of 2.9/16.43, which is around 17.7% per annum. When decomposing growth into acquisition growth and internal growth the study shows that if a company were to double its rate of growth through growing internally, then its profitability would rise by almost 6.9% in the long run. If the same growth rate were to be realised by acquisition, then profitability would only rise by 0.2%.

Arguably the most exhaustive and ambitious study of post-merger performance thus far, applying to—unfortunately, only non-financial—mergers and acquisitions undertaken by American firms was done by Ravenscraft and Scherer (1987). They examined no less than 5,966 mergers and acquisitions by 471 corporations in the US between 1950 and 1977 as well as 900 divestitures in the period 1974-1981. The results were subsequently tested on fifteen case studies of acquired and later divested firms. The econometric analysis is based on the Federal Trade Commission's Line of Business data set which provides a uniquely detailed collection of information on US manufacturing over the period 1974-1977. The unique character of the Line of Business data set, as its name implies, is that it provides company information that has been broken down according to 261 manufacturing industry categories. Apart from explicit information on merger accounting methods used, the data set includes information on depreciation methods, plant asset age, inventory accounting methods, growth rates, R&D and advertising intensity. Thus, most of the objections that one may have against internally generated company data were invalidated. Moreover, the data set allowed Ravenscraft and Scherer to perform analyses at the divisional level of firms so that the results of acquisitions that are small relative to the acquiring firm could be tracked as well. Besides, the high degree of disaggregation made it possible to form sharply focused control groups (divisions can be matched more easily than firms). Finally, the data set included, unlike most of the studies discussed so far, smaller and privately held companies.

Again, the findings of this project are quite unsettling. First, acquired firms did not appear to be systematically less profitable than other firms. Indeed, companies which were privately held before acquisition may even have been more profitable than industry and size matched non-acquired firms. Secondly, the financial results of the mergers investigated were generally poor. On pooling of interest acquisitions without systematic asset revaluations, profitability was barely above control group levels. Even in the best year, 1977, it was much lower than the average acquired unit's pre-merger return. Purchase acquisitions underperformed their controls, at least in part, but not entirely because of asset revaluations. Only mergers involving roughly equal firms ('mergers of equals', i.e. mergers between firms that differed from one another in size by not more than a factor of two) had a positive effect on post-merger profitability, but such mergers were extremely rare (69 out of a total of almost 6,000). Third, Ravenscraft and Scherer did not find any evidence to support the hypothesis that R&D was

stimulated by the parent-subsidiary relationships following merger.[7]

In an effort to answer the counterfactual question of whether profits would have declined as much had merger not occurred, Ravenscraft and Scherer drew a special control sample of 261 'independent survivors' that had similar size and operating income/assets ratios to a subsample of 69 acquired lines. The 179 firms that qualified for the regressions appeared to have kept up their profitability much better than the acquired firms. Although the acquired firms' average growth rate of 8.9% per year was higher than that of their home industries, all of the independent survivors grew even more rapidly, at 13.1% per year. Evidently, the profitable firms that chose to remain independent were not deprived of growth capital relative to the firms that became a subsidiary of another firm and that by doing this enabled themselves to tap an internal corporate funds market.

Summarising, Ravenscraft and Scherer's investigation of divestitures leads to the following conclusions:

(a) the units acquired and later sold off were on average in robust good health at the time of their acquisition, but became gravely ill thereafter;
(b) in those cases where acquired units were doing badly already before take-over, then the problems tended to get worse after it;
(c) sold-off units fared much better after sell-off than before;
(d) between 19 and 47% of all acquisitions were eventually divested, with an average lag of nearly ten years;
(e) the problems preceding sell-offs were most serious following conglomerate acquisitions.

Further insights consistent with the Ravenscraft-Scherer evidence come from a number of studies which will only be briefly summarised. Using similar methodologies, as far as possible, a team supervised by Mueller studied mergers in Belgium, Germany, France, The Netherlands and Sweden alongside British and US mergers. On the whole, the project concluded that "no consistent pattern of either improved or deteriorated profitability can (...) be claimed across the seven countries. Mergers would appear to result in a slight improvement here, a slight worsening of performance there" (Mueller, 1980a: 306). Copeland *et al.* (1994) report on a McKinsey & Cy. study of 116 acquisition programmes, undertaken by firms that were represented in either *Fortune*'s list of the 200 largest US industrials or the *Financial Times*' top 150 UK industrials between 1972 and 1983. Only 23% were successful in terms of the acquiring company being able to earn back its cost of capital or better on the funds that had been invested in the merger. A study of German mergers (Bühner, 1991) covered 110 transactions undertaken by the largest 500 manufacturers in the period 1973-1985. Only those mergers were included for which at minimum data for three pre-merger as well as three post-merger years were available. Both horizontal and diagonal mergers registered a decline in return on equity as well as return on assets over pre-merger values while the effects were strongest for diagonal mergers, a result which was upheld when six instead of three post-merger years were studied.

Searching for their effects on R&D inputs as well as outputs, Hitt *et al.* (1991) studied 191 US acquisitions that were completed from 1970 to 1986. R&D inputs were defined as total R&D expenditures divided by total sales, corrected for industry influences ('R&D intensity'). R&D output was

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[7] In interpreting these findings, it should be noticed that an important number of acquisitions were eliminated from further analysis as they were sold off before 1975, suggesting that the profitability results for the remaining firms may have been biased upwards.

measured by dividing the total number of patents a firm held by its annual sales ('patent intensity'). After size, leverage, return on assets and liquidity were controlled for, it appeared that an acquisition variable was a significant, negative predictor of R&D intensity. Acquisitions also negatively affected patent intensity, primarily to the extent that they increase the degree of diversification. Hitt *et al.* concluded that their study found no support for the proposition that mergers and acquisitions created synergistic gains from economies of scale or scope in R&D activities. More recently, a repeat study was done on a sample of 250 industrial US firms drawn from a frame of 776 firms for which R&D expenditure data over 1985-1991 was available (Hitt *et al.,* 1996). Again, it was found that acquisition intensity had a significant, negative effect on internal innovation. The evidence also indicates that the take-over of innovative SMEs in particular has a rather dramatic negative impact on the performance of these firms, from which they can normally only recover after having been spun off again (Chakrabarti *et al.*, 1994; Thompson *et al.*, 1993).

Mueller (1986) studied changes in the post-merger market shares of acquiring companies on the proposition that a deterioration in efficiency or product quality would have to show in a loss of market share. His sample consisted of all companies that were among the largest 1,000 of 1950 and were acquired by a firm among the 1,000 largest in both 1950 and 1972. In effect, 209 firms qualified (with a total of 123 acquiring firms), and their market share history was compared with that of a size and industry matched control group of non-merging firms. Exploiting detailed line of business data, he found that firms that were acquired between 1950 and 1972 retained a significantly smaller percentage of their 1950 market shares than non-merging firms, and that the decline in their market shares occurred after they were acquired. For conglomerate acquisitions, the loss in market share was nothing less than impressive. Whereas a non-acquired firm retained 88.5% of its 1950 market share in 1972, an acquired firm retained but 18%. In a previous study of 133 mergers between 1962 and 1972, Mueller had found a significant decline in the growth rate of the acquiring firms in the five years following the mergers compared with both a matched control group and their industries (Mueller, 1980b).

Although banking mergers appear to perform slightly better—mainly due to the fact that banks appear less rationalised yet than manufacturing firms—these results for industrial mergers are reflected in almost all studies of banking mergers. Tichy (2000) who has reviewed some twenty-five studies of mergers among mostly US banks concludes that roughly a third have reported positive effects in terms of either rising returns, declining costs, increasing profits or greater efficiency. Neutral effects were reported in slightly more than half of the studies whereas 16 per cent reported negative effects. Thus, about two-thirds of the banking mergers investigated in these studies were unsuccessful. However, the positive effects for the remaining cases were typically much smaller than expected.

Another survey by Van Rooij (1997) concludes that even when acquirers are relatively (cost) efficient ex ante–which should create a potential to transfer efficiency to targets–there is hardly any evidence of such opportunities being realised after the merger. Relative to non-merging banks, mergers do not show significant efficiency improvements. Similarly, Akhavein *et al.* (1997) recall that banks have costs that are typically 20-25% above those of the observed best-practice banks which would suggest that cost efficiency could be considerably improved by merger. Again, however, they notice that such potentials are not systematically realised in practice.By and large, the consensus is that bank M&As at best lead to very little improvements in internal efficiency. Exceptions exist, of course, but they mostly pertain to mergers among very small, locally active banks. Although this cannot yet be fully substantiated, the findings look like suggesting that the larger the merging banks, especially when their

size is beyond a still quite limited asset size of $10 billion, the smaller are the chances for cost improvements. Indeed, as Tichy (1990) already concluded, for the largest banks in Europe as well as elsewhere, there is no significant relationship between size and profitability, which indicates either absence of market power and efficiency effects or, more plausibly, a compensation of market power gains by decreasing returns to scale (also see De Jong, 1993). Upon reflection, this is what one would expect on the basis of estimates of minimal optimal (or efficient) scale (MOS) in banking. Repeatedly, such estimates have ranged between, say, $1 billion and $10 billion and, more recently (i.e. with regulations becoming looser and looser), $25 billion. In Europe, Van der Vennet (1996) has reported that optimal banking size from a cost-efficiency point of view would be in the range of Euro 10 to 100 billion in assets. Clearly, the difference with actual practice is enormous (see Table 2).

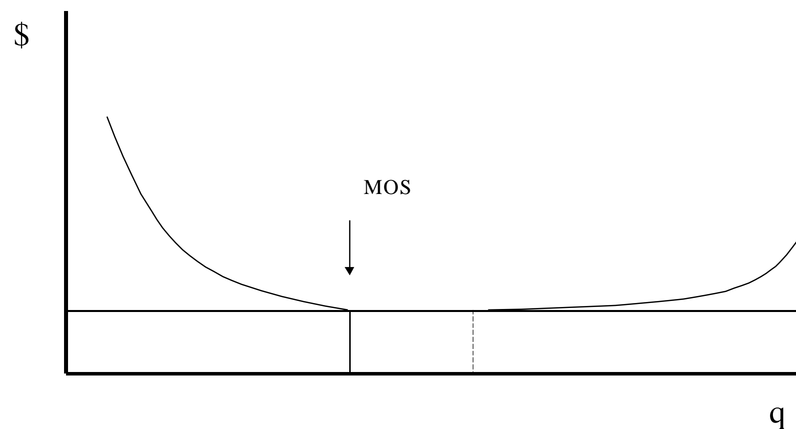
Table 2: Selected banks ranked by asset size (cUS$), 1999

Bank	Assets
IBJ/Fuji/DKB (Japan)	1200 bln
Deutsche Bank (Germany)	700 bln
UBS (Switzerland)	700 bln
Citigroup (US)	700 bln
BNP-Paribas (France)	700 bln
BankAmerica (US)	600 bln
Bank of Tokyo-Mitsubishi (Japan)	600 bln
HSBC (UK)	500 bln
HypoVereinsbank (Germany)	500 bln
ABN-Amro (Netherlands)	475 bln
Crédit Suisse (Switzerland)	475 bln
Société Générale (France)	440 bln
ING (Netherlands)	315 bln
Canadian Imperial Bank of Commerce (Canada)	180 bln

Recent deregulation in both the EU and the US will probably push MOS upwards while technological advance will, as usual, exercise a downward pull, but since the typically found average cost curves are only weakly U-shaped, this is not likely to make the future much different from the past (see Figure 2 where q is output size).

Some studies of banking efficiency have recently introduced a distinction between internal (or X-) efficiency and profit-efficiency. As a result of merger, a bank may be able to find superior product combinations, for example by moving into higher-valued products like loans instead of securities. Such profit-efficiency effects have only been studied by Akhavein et al. (1997) for US 'megamergers' undertaken during the 1980s (where these mergers are defined as transactions involving firms with assets in excess of $1 billion each) and by Berger (1998) who focused on the early1990s. Though the evidence therefore is much less definitive, and it remains uncertain in how far merging banks generally proceed to a different output mix, their results suggest that the average output mix changes such that profit-efficiency is increased by a few percent. Notice, however, that both samples virtually excluded "supermegamergers" (Berger et al., 1999), a category that has increased in importance recently.

Figure 2: Typical long-range average cost curve



Of course, several methodological criticisms may be brought against some of the established types of merger performance studies (see e.g. Calomiris, 1999). Yet, since the evidence—as we have seen—appears quite consistent with the findings for non-financial mergers as well as time periods, it would seem evident that many bank mergers miss the economic mark, although it remains difficult to state precisely by how many.

Purely strategic (bank) mergers: a bit of theory

On balance, it is clear that the findings of ex post studies strongly suggest that mergers and acquisitions cannot usually ameliorate the performance of the firms implied—to put it mildly. Indeed, the weight of the evidence suggests that efficiency is reduced on average following merger, especially, but—as evidenced in particular by non-US mergers—certainly not exclusively when there is a substantial difference in size between acquirer and acquiree and when the merger is of the diagonal (conglomerate) type. Looking across all available studies, an educated guess would be that only around fifteen to twenty per cent of mergers could be qualified a success—the remainder being either a waste or an outright failure. Since many mergers are not able to elicit support from the acquirers' stockholders either—as has become evident from the ex ante studies—it would seem that shareholders in at least a substantial number of cases are right in guessing what the prospects of merger are.

These findings beg two questions. First, if so many mergers fail then why do they occur at all? Second, what may be the consequences of the ubiquitousness of inefficient mergers? In this section, I will spend some time explaining why economically unproductive mergers may be so omnipresent. Section 6 will then be devoted to some potential larger effects of this phenomenon.

Assuming that players are well-informed, Schenk (1996) has developed a minimax-regret model that makes such mergers strategically, though not economically, rational if there is a high degree of interdependence among players and much uncertainty with respect to the prospects of individual actions. Especially when shareholders are likely to use peer grading in assessing their agent's performance, it appears that bandwagon mergers are likely.[8] When regret is defined as the loss of

[8] Notice that Milbourn *et al.* (1999) have developed a model that leads reputationally sensitive CEOs

pleasure due to the knowledge that a better outcome might have been attained if a different choice had been made then, under conditions of uncertainty, the minimax-regret routine selects that strategy which minimises the highest possible regret. Given a particular action of firm A that is sufficiently important to be monitored by her strategic peer—i.e. a merger or an acquisition—firms B,..., *n* (*n*=small) will have to contemplate what the repercussions for their own positions might be. Suppose that there is no way that firms B,..., *n* can tell whether A's move will be a successful one. A's move could be genuinely motivated by a realistic expectation that her cost position will improve or that her move will increase her ratings with stakeholders or even her earnings. That is, A's competitiveness position vis-à-vis her peers may be ameliorated as a result of that move, say in terms of a first mover advantage. But then again, it may not. For example, A's move might be purely motivated by the pursuit of managerial goals, or it may simply be a miscalculation caused by hubris. What should firms B,..., *n* do?

Leaving out, for simplicity, all firms but B, suppose that A's move will be successful, but that B has not reacted by imitating that move herself (which we call scenario *α*). To what extent will B regret not having reacted? Alternatively, suppose that A's move will not be successful but that B has imitated it solely inspired by the mere possibility of A's move being a success (scenario *β*). To what extent will B regret this when the failure of A's move—and thus of her own move—becomes apparent? Within a minimax-regret framework, it is likely that B's regret attached to scenario ***α*** will be higher than the regret attached to scenario *β*. For in scenario ***α***, B will experience a loss of competitiveness, while in scenario *β* her competitive position vis-à-vis A will not have been harmed. Moreover, in scenario ***α*** firm B's reputation will suffer, while in scenario *β* it will be able to share any blame of its stakeholders with A. Thus, under conditions of uncertainty, a strategic move by firm A is likely to elicit an imitative countermove by her rivals.

As Bikhchandani *et al.* (1992) have shown, this sort of imitation may easily develop into a cascade. In a sense, mergers and acquisitions have then become "taken-for-granted" solutions to strategic interdependence. It implies that firms may have become locked into a solution in which all players implicitly prefer a non-optimal strategy without having ready possibilities for breaking away from it.

Even if some firms do not adopt minimax-regret behaviour, it will be sensible for them to jump on a merger bandwagon too. For, an M&A cascade implies that the likelihood of becoming an acquisition target increases. Since relative size is a more effective barrier against take-over than relative profitability firms may therefore enter the M&A game for no other reason than to defend themselves against its effects. By doing so, however, they will simply help amplify a merger wave that has just started.

In conclusion, it would seem quite possible that the high incidence of non-wealth creating mergers, outside or within banking, is not the result of failed implementation techniques as many management consultants would like one to believe. Rather the existence of strategic interdependence under uncertainty, conditioned by the availability of funds, may compel management teams to undertake mergers even if it is known that it is very unlikely that these will increase real performance.[9] With multi-market oligopoly omnipresent, and given the increasing weight assigned to stock market performance

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into herd behaviour, i.e. into imitating first movers, as well.

[9] Perhaps, this explains why so many mergers remain virtual. Indeed, just like has previously been found for manufacturing mergers, there is in fact little evidence that overlapping bank operations and branches are discarded post-merger (Peristiani, 1997).

appraisals — which to a large extent are reputationally determined — the ultimate result will be an economy-wide merger boom.

Mergers with these properties are dubbed here as "purely strategic mergers". These are mergers that are intended to create strategic comfort rather than economic wealth (or, for that matter, monopoly rents). It will be clear, that a minimax-regret game can only be played if market mechanisms are insufficiently potent to block it. The repeated occurrence of non-wealth creating mergers, however, is sufficient proof of this possibility. Put differently, one implication of the minimax-regret game is that firms instead of being disciplined by the market for corporate control mechanism are perverting just this mechanism: they use it to prevent it from operating efficiently.

For the special case of banking, we should probably add to this that banks, being institutions that fulfil a servicing task, would by strategic necessity have to go along when their clients are becoming bigger and bigger. As a matter of fact, this motivation is frequently invoked by bank CEOs when asked for the logic of their mergers. Indeed, the evidence that we have seems to point out that economy-wide merger waves are only rarely started in services industries.

If, indeed, many mergers are strategically motivated instead of economically, then it becomes almost superfluous to ask why so many mergers fail. Still, it is obvious that the following factors will add to the difficulties of realising wealth-creating mergers: expenses paid to banks, consultants and legal experts; the costs of changing operating procedures; the high level of premiums necessary to seduce target shareholders to sell; and the diversion of managerial attention from other important activities, particularly long-term investments such as developing and bringing new products to the market and the optimisation of attendant production processes. In this latter respect, Hoskisson *et al.* (1994) have suggested that target firms are likely to enter a state of 'suspended animation' in which decisions requiring long-term commitments such as investments in R&D are postponed, pending the outcome of the acquisition negotiations. Apparently, if there are any gains from consolidating branches, computer operations, payment systems, etc, then these will often in practice be offset by control losses due to larger size, conflicts in corporate culture, or problems in integrating especially electronic systems.

Effects of purely strategic (bank) mergers and some policy suggestions

An obvious implication of so many mergers being unproductive is, of course, that much managerial time and talent as well as significant funds are simply being wasted. It would seem that the prevalence of strategy considerations leads to significant opportunity costs from an economic point of view. In other words: our economies would have (even) better performed if all those resources would have been spent productively. Yet, as long as the game is being played, no party to it can withdraw until its effects become clear in a real sense. By that time, however, large firms in manufacturing and banking may have sown the seeds of a serious recession. For it seems quite likely that economic actors cannot indefinitely pursue such strategic behaviour with impunity. In the short run, the bill will be, and have to be, footed by consumers, clients and investors, but in the long run the economy as a whole will suffer since merger-active firms, be they in manufacturing or in banking, have become so big that their investment behaviour directly affects the fate of our economies. It could be argued that the billions that are fruitlessly expended on mergers do not vanish from the economic process. Indeed, it may be so that shareholders at the receiving end instead of creating a consumption bubble, or overindulging themselves in Veblen-type conspicuous consumption (Veblen, 1899), will reinvest their newly acquired pecuniary

wealth in investment projects that do create economic wealth. If so, then we would merely have to worry about a retardation effect. Still, such an effect may be significant, especially following a merger wave, i.e. a time period during which one retardation follows the other. Indeed, Mueller (1999) has suggested that the vigorous pursuit of what he calls 'unprofitable' mergers may be one of the factors that contribute to the decline of nations. When professional managers as well as a whole industry of investments bankers, stock analysts, lawyers 'and even economists' are occupied with transferring assets instead of creating them, when cash flows get used to buy existing plants, offices and new economy facilities rather than improve their performance or build new ones, then decline is almost inevitable. Noticing that, indeed, all previous merger waves were followed by years of economic distress and restructurings, it would therefore seem unjustifiable at the least to neglect the importance of the productive and/or dynamic losses that result from mergers.

Evidently, the fact that so many unproductive mergers can occur at all, and recurrently, indicates that neither capital nor product markets are strong enough to discipline firms into economically efficient behaviour. This suggests that many firms, within or outside banking, must presently be able to exercise market power. From a competition policy point of view unproductive mergers should therefore be challenged. However, present policies would seem ill-equipped to handle those forms of anti-competitive behaviour which do not have as an effect that prices are raised above competitive levels, or above long-run average costs. This means that if firms raise prices because operating costs have increased to all of them as a result of widely spread inexpedient behaviour they will escape sanctions. Elsewhere (Schenk, 2000a), I have therefore suggested that competition policies should adopt what I call a 'Full Efficiency Test' (FET), i.e. a procedure in which a proposed merger is not just tested for allocative effects but for productive and dynamic effects as well.

In comparison to the problems just observed, some effects of banking mergers in particular would seem to be quite unimportant. Whereas traditionally banks in more concentrated markets charge higher rates on loans while paying lower rates on deposits, this relationship seems to have dissipated somewhat during the 1990s. However, the relationship between such concentration and small business loan pricing still appears to be strong (Berger *et al.*, 1999). Thus, in local markets, but in small national markets as well, the retail segment, i.e. individual households and SMEs, may be landed with the costs of purely strategic banking mergers. Indeed, consumer's organisations during the 1990s have stepped up their criticisms of bank pricing behaviour, arguing that inefficiency forces banks to continually increase prices and cut services in claimable components (*Consumentengids*, 10, 1998). Moreover, the most common finding of US studies is that consolidation of large banking organisations tends to reduce small business lending to a greater extent than can be offset by other banks in the same local market, especially if transaction costs are relatively high as in relationship-based banking; similar results were obtained in a study of Italian bank mergers (Berger & Udell, 1998; Berger *et al.*, 1999; Schenk, 1995). For the Netherlands, Van Bergeijk *et al.* (1995) have estimated that the direct costs of banking concentration may have been as high as 400 million DGL (then approx. 200 million Euro) in 1992, to which perhaps as much as 180 million DGL in terms of indirect costs should be added.[10] Since large, multinational firms are in a better position to negotiate favourable terms, not in the least because they can shift much of their capital needs directly into international capital markets, it is likely that much of these costs are mainly borne by SMEs and other retail clients. It is perhaps indicative that a recent

[10] Direct costs increase investment costs without impairing investment activity as such. Indirect costs are the costs to society that arise when firms abandon their investment plans because of excessively high costs.

survey in US banking found that customer satisfaction had declined significantly over even such a short period as 1994-1997: whereas in the earlier year, 3% of customers was dissatisfied, and 65% very satisfied, by 1997 these percentages had changed to 8% and 54% respectively (Booz-Allen & Hamilton research, cited by Kolesar *et al.*, 1998).

The apparent neglect of SMEs by large and/or externally growing banks is problematic especially as these firms, on average, are relatively innovative and/or efficient with respect to innovation (see e.g. Nooteboom and Vossen, 1995) and venture capital firms have not endeavoured to compensate for this effect (see Mason & Harrison, 1995; Bygrave & Timmons, 1992). Since the access to public stock markets is precluded to many SMEs too because of the high fixed costs involved, it follows that the infrastructure of the capital market should be geared more to the needs of SMEs than is presently the case. More in particular, the ability to raise equity capital on the stock market at low transaction cost should be seen more as a critical component of this infrastructure. Elsewhere, I have therefore advocated the support of stock exchanges that are fully located on the Internet (Schenk, 1998).

Conclusions

Evidently, too many mergers, inside as well as outside the banking industry, are to be qualified as economic failures. It is in society's interest—even in the long-term interest of shareholders—to prevent such mergers as much as possible. Since we would not want to throw out the baby with the bath water by prohibiting all mergers that involve at least one big player, it is desirable to reconsider the ways and means of current competition policies. In this respect, this paper has suggested to incorporate a Full Efficiency Test in these policies. Meanwhile, it would be desirable to restructure the capital market in such a way that SMEs would no longer be required to foot the bill that is presented by excessively merger-happy banks. The paper has therefore suggested supporting the creation of stock exchanges that are fully located on the Internet.

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