This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Financial Sector Development in the Pacific Rim, East Asia Seminar on Economics, Volume 18

Volume Author/Editor: Takatoshi Ito and Andrew K. Rose, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38684-8

Volume URL: http://www.nber.org/books/ito_07-2

Conference Date: June 22-24, 2007

Publication Date: February 2009

Chapter Title: Comment on "Consolidation of Banks in Japan: Causes and Consequences"

Chapter Author: Hiro Ito

Chapter URL: http://www.nber.org/chapters/c0399

Chapter pages in book: (309 - 312)

Yamori, Nobuyoshi, and Kozo Harimaya. 2004. Governance of shinkin banks and choice of mergers (in Japanese). Paper presented at the symposium on the Governance and Contemporary Meaning of Cooperative Financial Institutions at Hokkaido University, Sapporo, Japan.

Yamori, Nobuyoshi, Kozo Harimaya, and K. Kondo. 2003. Are banks affiliated with holding companies more efficient than independent banks? The recent experience regarding Japanese regional BHCs. *Asia Pacific Financial Markets* 10 (4): 359–76.

## Comment Hiro Ito

Before the 1990s, bank mergers were hardly seen in Japan except for a very few cases of rescue mergers. Even those rare mergers were initiated by the Ministry of Finance (MOF) with help of keiretsu-related companies and banks of the rescued bank. At present, bank merger is no longer uncommon in Japan. In retrospect, two events led to a significant increase in bank mergers in Japan. One is a series of deregulation/liberalization policies in the financial sector that started in the early 1980s, and the other is the 1990s recession.

Deregulation/liberalization policies contributed to thinning profit margins, which used to be guaranteed by the government through financially repressive policies, and thereby intensifying market competitions for the financial institutions. The recession that started in 1991 hurt financial institutions' balance sheets through severe asset deflation and weakened loan demand. Inevitably, in the early 1990s, merging with other institutions started to be viewed as one of the means to survive the severe conditions in the Japanese financial industry. In the aftermath of the banking crisis of 1998, which broke out with several major bank failures, as the Japanese banking industry became fluid, so did the number of bank mergers drastically increase.

With this background, this chapter investigates a fundamental question pertaining to banking consolidations in Japan: "What motivates banks to decide to merge?" More specifically, the authors investigate whether banks decide to merge so as (1) to increase market power; (2) to improve cost efficiency; (3) to merely follow government's financial stabilization policy; or (4) to build a managerial empire. The authors categorize the first two views as the "value maximization view" because these two consequences can lead to increasing the value of shares and the last two as the financial stabilization view and the managerial empire building view.[1]

Hiro Ito is an associate professor of economics at Portland State University.

1. As Andy Rose pointed out at the presentation, I also agree that points one and two should not be considered to be one view. Although both of the two points may lead to in-

With these questions in mind, the authors conduct an empirical analysis on what kind of premerger conditions motivate banks, either acquirers or acquirees, to merge, and on what bank consolidations could do to the merged banks in terms of cost efficiency, profitability, and healthiness of the financial conditions.

There is no question that this chapter investigates an interesting question. When bank mergers started becoming more commonplace in the late 1990s, many discussions arose both within the policy community and in the general public about the efficacy of bank consolidations. Many wondered if bank mergers merely mean big amalgamations of feeble banks or the creation of slimmer and more efficient banks. While there are very few studies on mergers and acquisitions (M&A) in the Japanese banking industry—simply because it is only recently that they started appearing in the Japanese banking scene—this chapter nicely fills the void.

Using a sample of major banks, regional banks, and *shinkin* banks for fiscal year 1990 to 2004 (fiscal year 1990 to 2001 for *shinkins*), the authors find empirical evidence as follows. As for the premerger determinants of bank mergers, efficient banks, among major and regional banks, but not *shinkin* banks, tend to acquire inefficient ones. The authors argue that this result is in line with the value maximization view. They also find that large, but unhealthy regional or *shinkin* banks tend to acquire small and unhealthy ones, which they believe is suggestive of the government's stabilization efforts. As for the postmerger conditions, they find that merged banks tend to experience a short-term decline, but a long-term gain, in their return on assets (ROA) in the aftermath of consolidations. Merged banks also tend to raise loan rates, which they believe evidence that merged banks exert more market power but also are more likely to fail to increase the capital-to-asset ratio or to decrease the volume of nonperforming loans (NPLs). They also find that merged banks tend to experience loan growth.

This chapter presents an interesting set of results and adds important information to the debate on the efficacy of bank consolidations in Japan. It should help financial administrators as well as bankers in Japan to self-evaluate their policies. However, because of its potential policy implications, this chapter deserves careful scrutiny. Let me make three comments on the estimation of the premerger determinants of bank mergers and one on the postmerger estimation.

First, on the premerger estimation, the authors may need to be more careful about theoretical interpretation of the estimation results. When empirical findings are analyzed, the authors often argue whether the estimated coefficients are indicative of banks' market-driven motivations (i.e., the "value

creasing the value of shares, these points are about completely opposite issues in terms of the competitiveness of market conditions. That is, while point one indicates an increasing markup for a bank, that is, more gains from less-competitive market conditions, point two refers to more-competitive conditions for the bank.

maximization view") or reflecting the government's stabilization efforts. However, these two views are by no means mutually exclusive, especially in the case of Japanese banking industry where, historically, the MOF has heavily intervened with the industry. Although a series of deregulation/ liberalization policies and the creation of the Financial Services Agency (FSA) have lessened the government's meddling since the late 1990s, it is still the case that bank consolidations in Japan are a function of what the government or FSA thinks. In other words, political-economic factors play an important role in banks' decision makings about potential mergers regardless of the type and size of the banks. Hence, the value maximization view and the government stabilization view are not an *either/or* issue and, therefore, the empirical results should not be interpreted one way or the other. That said, from a different angle, it may not be sufficient to have only economic factors as explanatory variables for the estimation as the authors have done. They may need to include some political variables to incorporate the political-economic factors of the decision makings.

Second, the timing of the dependent and explanatory variables appears to be questionable. To avoid bidirectional causality, the authors lag the explanatory variables by one year. However, lagging the right-hand-side variables by one year may not capture appropriately the effects of the determinants of bank mergers. In other words, conditions in one year before a merger may not properly reflect the motivations on the side of merging banks. This concern arises due to the following two reasons. First, it usually takes a long time, possibly more than a year, for Japanese banks to implement a merger after its announcement. Hence, in the year prior to a merger, it is often the case that the merging banks are preparing and working toward the merger, not determining the merger. Therefore, the business or economic conditions in one year prior do not represent as the determinants of the merger. Second, using one-year lagged variables for the explanatory variables may involve a risk of capturing moral hazard behavior. That is, a bank that is to be acquired by a relatively healthy or bigger bank may behave on contrary to the benefit of the future shareholders of the merged bank by taking unnecessarily risky investment. Especially, if a to-be-acquired bank is riddled with severely weakened balance sheets, it may as well take the long-bomb strategy—gamble on high-risk, high-return investment to improve balance sheets—because it has small net worth to lose anyway. The U.S. savings and loan crisis witnessed such moral hazard cases. One cannot rule out the possibility for Japanese mergers and acquisitions. In this sense also, lagging the explanatory variables for one year may not be appropriate to examine the motivations for Japanese banks' mergers.

Last, on the premerger estimation, the results of the determinants of bank mergers (shown in table 8.3) are generally not that significant. The weakness in the results is suspected to be due to multicollinearity. In the es-

timation, the authors attempt to incorporate different aspects of banking business, namely, cost performance, size, and healthiness of the banks, and include several variables for each aspect as explanatory variables. For example, the ROA and the cost ratios are included to capture the market efficiency levels of the banks, whereas the capital-to-asset ratio and the asset growth rate are to capture their size. However, one can suspect that these variables for each aspect of banking business are highly correlated. Furthermore, these different aspects of banking business can also be highly correlated with each other. Either or both of cost performance and the operation size of banks usually affect the healthiness of the banks, or vice versa. At the very least, the authors may need to be careful about the choice of variables and avoid unnecessary multicollinearity.

Finally, on the postmerger estimation results, the authors find that merged banks tend to raise loan rates and interpret that as evidence that merged banks strengthen their market power. However, this result can also be interpreted as that newly merged banks tend to implement more stringent risk management and, therefore, charge higher rates on their loans. It has been discussed that a merger plan is often approved—implicitly or explicitly—by the MOF or FSA with a condition that the new bank will improve balance sheets and capital adequacy. If that is the case, it is not surprising that a newly merged bank implement more stringent risk management and charge higher loan rates.

After all, this chapter can convey important messages to financial administrators and bankers. For that purpose, careful interpretation of the empirical results and some refinement in the model construction may be necessary. It seems that the NPLs problem is finally history; as of the spring of 2007, among the six major city banks, the ratio of NPLs to total loans is around 1.5 percent, a significant fall from 8 percent in 2002. As the NPL problem is over, fluidity in the banking industry may end as well. However, given the current M&A boom and ample liquidity on the global scale, restructuring of Japanese banks may not end soon. Given that, the implications this chapter presents can be quite significant.

## Comment Barry Williams

I appreciate the opportunity to discuss this chapter as it provides an insight into the merger process in a country I do not make a focus of my research. Thus I found the chapter both informative and interesting. I do have a few comments to make that I feel can possibly improve the chapter.

Barry Williams is a professor of finance and head of the Department of Finance at Bond University.