CROSS-BORDER BANK MERGERS & ACQUISITIONS AND INSTITUTIONAL INVESTORS

The last few years have seen significant cross-border bank mergers and acquisitions (M&As) activity in the euro area. At the same time, institutional investors – investment funds, insurance corporations and pension funds – have become the main collectors of households' funds and important shareholders of firms and banks. This article analyses these two phenomena – first separately and then by looking at how they are related, emphasising the possible consequences for financial integration and financial stability. The presence of institutional investors as large shareholders affects corporate governance in general and the occurrence of M&As in particular. In addition, the results of the empirical analysis presented in the article suggest that the presence of foreign institutional investors as shareholders of banks facilitates cross-border M&As.

1 INTRODUCTION

The integration of the European financial market is important for the conduct of monetary policy, for financial stability and for economic welfare. The integration of certain segments of banking is somewhat less advanced than the integration of other euro area financial markets (for instance, wholesale money and bond markets).[1] Reducing barriers to cross-border banking integration is one of the policy priorities for the completion of the single market for financial services and for enhancing economic growth in the euro area.

Banks with significant cross-border activity play a key role in the process of banking integration. Cross-border banking is very often the result of cross-border M&As. However, there are a number of barriers to cross-border bank M&As. Some have to do with legal and regulatory requirements and others are more related to greater difficulties in acquiring information from different markets and from afar. While in the euro area the former have mostly been eliminated, barriers related to information costs are still present and seem to be particularly significant in the banking sector.

Institutional investors involved in international activities can be pivotal to removing these barriers and thus contributing to the process of financial integration. Institutional investors are, together with banks, the most important financial intermediaries. They are defined as professional asset management institutions with discretionary control over assets that invest funds from small investors in order to achieve a specific objective in terms of acceptable risk, return maximisation and maturity of claims. The most important institutional investors are mutual funds, pension funds and insurance companies.[2]

Institutional investors are significant shareholders in listed corporations and in banks. Their presence as shareholders, especially if they are large shareholders, may affect corporate governance, i.e. the management of potential conflicts arising within a firm between different shareholders, and between the shareholders and managers of a firm, with significant consequences vis-à-vis the profitability of the firm involved. The presence of institutional investors as shareholders in a company seems to affect corporate governance and, in particular, the occurrence of M&A activity, which puts corporate governance to the test.

Following this reasoning, Section 2 reviews the process of bank M&As in the euro area, highlighting the importance of cross-border activities. Section 3 describes the significance of institutional investors in the euro area. Section 4 analyses how the strengthening of foreign institutional ownership may affect corporate governance in general and the process of

1 ECB (2008), Financial integration in Europe, April.
2 This definition is widely used in the literature: see, for instance, P. Davis and B. Steil (2001), "Institutional investors", MIT Press and ECB (2007), "Corporate finance in the euro area", May. Hedge funds are not included in the category of institutional investors in this article. The first reason is that it focuses on the impact institutional investors have on the corporate governance of listed firms, while the size of corporate shareholdings of hedge funds is small compared with other institutional investors. Moreover hedge funds tend to have a short-term orientation. A second reason is that these intermediaries are unregulated or loosely regulated funds and thus data on their active strategies may be more difficult to obtain.

cross-border M&As in particular. In fact, the empirical evidence presented in this article suggests that institutional ownership may positively affect cross-border bank M&A activity. Finally, Section 5 concludes.

2 THE INTEGRATION OF BANKING MARKETS

This section reviews the impact of cross-border banking activity on the economy in order to understand the related benefits and costs. It then describes the recent trends in cross-border bank M&A activity in the euro area.

BENEFITS OF CROSS-BORDER BANKING

Banking markets encompass interbank (or wholesale) activities, capital market-related activities and retail banking. Data on these activities reveal that while the euro area interbank (or wholesale) market and capital market-related activities show clear signs of increasing integration, retail banking continues to be fragmented.

Cross-border banking is important for financial integration and economic growth. The basic consideration in this regard is that cross-border activities provide a major tool for banks to realise their optimal size, to reap economies of scale and scope, to diversify activities, and to spread risk and increase revenues. This, in turn, enables banks to improve resource allocation and risk management, and also to increase profitability. Through the international expansion of banking groups and interbank competition, these beneficial effects are expected to spread to the euro area banking sector as a whole, fostering closer convergence towards better and more efficient banking practices, deeper integration, and greater breadth, depth and liquidity of markets.

Ultimately, progress in the development and integration of the banking sector will also have a positive effect on macroeconomic performance. Numerous empirical studies have provided evidence for the close link between more integrated and efficient banking markets and enhanced economic performance.[3] This link is particularly strong in the euro area, given the central role of banks in the financial system.

Cross-border banking also has an impact on financial stability in two important respects. On the one hand, cross-border banking fosters the overall resilience at the euro area level as larger and more diversified banking systems are better equipped to absorb economic shocks. On the other hand, cross-border banking opens up additional channels for the transmission of instabilities across borders, both via ownership links and credit exposures.[4] The potential transmission or spillover of financial risk across jurisdictions is more likely in this context and, as a consequence, systemic risk becomes more complex. This also implies that with a view to safeguarding financial stability in more closely integrated banking markets, it is important to ensure that cross-border risks are adequately monitored and properly managed.

Cross-border banking activity can be enhanced in two different ways, either directly through "greenfield" investment or branches, or indirectly through cross-border M&As – deals where the acquirer and the target banks are located in different countries. Cross-border bank M&As may increase the efficiency of the banks involved as long as they are able to achieve synergies and exploit economies of scale at the group level. However, this can often be challenging, owing, for instance, to obstacles in the standardisation

3 See P. E. Strahan (2003), "The real effects of US banking deregulation", The Federal Reserve Bank of St. Louis Review, 85, pp. 111-28; and P. Hartmann, F. Heider, E. Papaioannou and M. Lo Duca (2007), "The role of financial markets and innovation in productivity and growth in Europe", ECB Occasional Paper No 72.

4 See R. Ferguson, P. Hartmann, F. Panetta and R. Portes (2007), "International financial stability", Ninth Geneva Report on the World Economy, Chapter 6, November. For evidence on contagion based on credit exposures, see R. Iyer and J.-L. Peydró-Alcalde (2008), "Interbank contagion at work: evidence from a natural experiment", University of Amsterdam Working Paper.

of banking products and IT systems across countries.[5] Furthermore, there might be negative externalities for banks' customers if bank M&As reduce banking competition. In the euro area, given the relatively low level of cross-border integration, the overall effect of cross-border M&As is likely to be positive.

There are relatively few cross-border M&As in banking compared with M&A activity in the manufacturing sector, which may reflect the existence of several barriers.[6] These barriers are related to (geographical) distance, language, culture and markets (information costs). In particular, the higher opaqueness of bank assets relative to other sectors implies that there are important information barriers between banks that operate in different countries and markets which further reduce cross-border bank M&As.[7] In addition, other barriers are related to different regulatory and supervisory structures which may impede or make it very difficult to finalise cross-border M&As and, therefore, may offset some of the efficiency gains from banking consolidation.

The improvement of regulation in a domestic banking system has an indirect effect on international merger decisions. For instance, regulation that enhances transparency facilitates the assessment of efficiency gains from international bank mergers. In countries with increased transparency banks become more attractive targets of international bank mergers. Moreover, banks in more developed countries (which are presumably more efficient) tend to take over banks in less developed countries. In more homogeneous countries, for example euro area countries, the relative profitability of banking systems has little explanatory power for bank merger activity.[8] This suggests that differences in profitability are not large enough to outweigh the costs of factors such as distance, common language, and a common legal and banking system.

Public policies have an important role to play by providing a legal, regulatory and supervisory framework conducive to the efficient operation of cross-border entities, promoting a level playing-field in the European Union (see the box). While barriers to consolidation linked to regulatory and legal requirements can eventually be removed, barriers related to information costs may remain, even in legally integrated markets.[9] In this regard, institutional investors can play an important role, especially those with the scope and resources to overcome information barriers.

5 There is empirical evidence that cross-border bank M&A increase the efficiency of the banks involved. See Y. Altunbas and D. Marqués-Ibáñez (2008), "Mergers and acquisitions and bank performance in Europe: the role of strategic similarities", Journal of Business and Economics 60, 3, pp. 179-290. See also J. M. Campa and I. Hernando (2004), "Shareholder value creation in European M&As", European Financial Management, 10(1), pp. 47-81, J. M. Campa and I. Hernando (2006), "M&A Performance in the European financial industry," Journal of Banking and Finance 30(12), December, pp. 3367-92, and F. Pasiouras, S. Tanna and C. Gaganis (2007), "What drives acquisitions in the EU banking industry? The role of bank regulation and supervision framework, bank specific and market specific factors", Coventry University Working Paper.

6 See D. Focarelli and A. F. Pozzolo (2001) "The patterns of cross-border bank mergers and shareholdings in OECD countries", Journal of Banking and Finance 25, pp. 2305-37. They find that in the 1990s cross-border mergers accounted for only 13% of merger activity within the banking industry compared with 35% within manufacturing and 24% within all sectors on average.

7 See D. P. Morgan (2002), "Rating banks: risk and uncertainty in an opaque industry", American Economic Review, Vol. 92(4), pp. 874-88, September and M. J. Flannery, H. Simon and M. Nimalendran (2004), "Market evidence on the opaqueness of banking firms' assets", Journal of Financial Economics, Vol. 71(3), pp. 419-60, March.

8 See C. M. Buch (2003), "Information or regulation: What drives the international activities of commercial banks?", Journal of Money, Credit and Banking, Vol. 35, pp. 851-69.

9 See A. N. Berger, R. DeYoung, H. Genay and G. F. Udell (2000), "Globalization of financial institutions: Evidence from cross-border banking performance", Brookings-Wharton Papers on Financial Services 3, pp. 23-158, and A. N. Berger, R. DeYoung and G. F. Udell (2001), "Efficiency barriers to the consolidation of the European financial services industry", European Financial Management 7, pp. 117-30.

Box

OBSTACLES TO CROSS-BORDER M&As

Cross-border M&As can be challenging, both during the transaction phase and subsequently when delivering the envisaged operational synergies. Several important factors which have an impact on this process lie beyond the remit of public authorities, as obstacles to cross-border M&As include geographical distance, differences in culture, language, markets and consumer preferences. Nevertheless, public authorities have a role to play in enhancing the policy framework for cross-border banking consolidation by reducing prudential, legal and fiscal obstacles that could dissuade prospective acquirers.[1]

Prudential obstacles to cross-border M&As relate to the supervisory approval process for acquisitions as well as to the various prudential rules by which cross-border banks have to abide. Both issues have attracted increased attention at the EU level: in September 2007, Directive 2007/44/EC, aiming to improve legal certainty, clarity and transparency of the supervisory approval process for acquisitions in the financial sector, came into force, and EU Member States must comply with it before 21 March 2009.[2] In addition, enhancing supervisory convergence and cooperation has progressed with the adoption of the revised framework for home/host cooperation under the Capital Requirements Directive and the related work of the Committee of European Banking Supervisors. The enhancement of the Lamfalussy framework currently under way is expected to provide further impetus in this respect.

Legal obstacles pertain to incompatibilities in national company laws that can render cross-border mergers and takeovers problematic or even impossible and insufficient legal harmonisation; the latter has two-pronged effects. Differences in the rules for consumer protection, liability and bankruptcy, for example, inhibit the standardisation of products and related IT systems on a cross-border basis, affecting in particular the provision of retail financial services. Furthermore, insufficient legal harmonisation could affect corporate restructuring and especially the transformation of foreign subsidiaries into branches. Incompatibilities in national company laws are expected to be diminished following the full implementation by Member States of Directive 2005/56/EC on cross-border mergers. Finally, the European Company Statute includes a legal framework for corporate restructuring; however, market participants have suggested that it involves a number of practical difficulties and thus interest to adopt this corporate form has so far been very limited.

Finally, fiscal obstacles involve gaps or lack of clarity in national tax rules regarding the treatment of cross-border M&A operations, the possible application of exit tax on capital gains and the value added tax (VAT) treatment of the transfer of financial assets. In addition, lack of clarity and harmonisation on issues such as VAT charges on intra-group services, transfer pricing and the treatment of cross-border losses impede the operational efficiency of cross-border banks. With regard to VAT, a legislative initiative has been launched by the Commission by adopting a proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax, as regards the treatment of insurance and financial

1 For more information, see ECB (2007), "Financial integration in Europe".

2 For more information, see S. Kerjean (2008), "The legal implications of the prudential supervisory assessment of bank mergers and acquisitions under EU law", ECB Legal Working Paper Series No 6.

services[3] and the related Council Regulation laying down implementing measures for Directive 2006/112/EC.[4] This Directive aims at modernising and simplifying the complex VAT rules for financial and insurance services and securing a level playing-field in the pan-EU market for these services as far as VAT is concerned. Reducing the impact of hidden VAT in costs of insurance and financial service providers is one of the objectives of the above proposals.

3 COM (2007) 747.
4 COM (2007) 746 final.

BANK M&A ACTIVITY IN THE EURO AREA

Since the introduction of the euro there have been many banking M&A deals, although the number of such deals has declined somewhat over the last few years (see Table 1). However, the value of bank M&As has increased, reflecting the higher valuation of banks' equity as well as the involvement of larger banks.

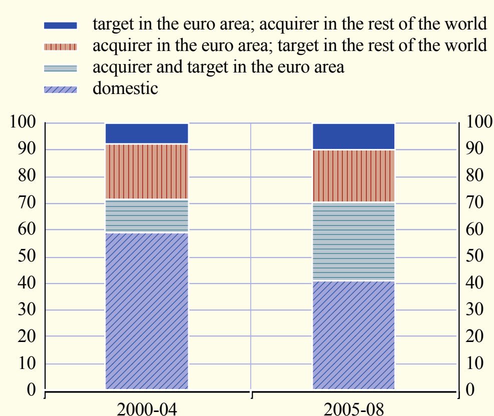
Table 1 Bank M&As in the euro area

	2000-04	2005-08
Value of deals (EUR billions)	182	269
Number of deals	485	274

Sources: Zephyr, Bureau van Dijk and ECB calculations.
Notes: All acquisition transactions are taken into account provided that the resulting stake in the target bank is above 10% of its capital. 2008 data are related to the first half of the year.

Chart 1 Domestic and cross-border euro area bank M&A activity

(percentages)



Sources: Zephyr, Bureau van Dijk and ECB calculations.
Notes: Domestic deals comprise M&A deals where the acquirer and the target bank are located in the same euro area country. All acquisition transactions are taken into account provided that the resulting stake in the target bank is above 10% of its capital. 2008 data are related to the first half of the year.

Concerning the geographical location of the deals, not only have cross-border deals increased relatively more than domestic transactions, but also the values of cross-border M&A deals have recently been significantly larger than domestic deals (see Chart 1). Moreover, intra-euro area cross-border M&A deals – where both acquirer and target banks are located in different euro area countries – have increased the most, which may also be the result of both the euro and ongoing policies aimed at reducing barriers to banking market integration in the region.

There was also significant cross-border bank M&A activity between euro area banks and banks located outside the euro area. In particular, over the last few years, cross-border bank M&A activity has been significant for outward deals – where a euro area bank acquires a bank located outside the euro area – and, also, for inward cross-border M&A deals, where a euro area bank is targeted by a bank located outside the euro area.

3 TRENDS IN OWNERSHIP OF INSTITUTIONAL INVESTORS IN THE EURO AREA

In developed countries, households hold the majority of their financial assets indirectly via financial intermediaries. Indeed, only in the United States does the direct holding of securities, in particular shares, constitute a significant part of households' portfolio. Among the various intermediaries, MFIs (mainly banks)

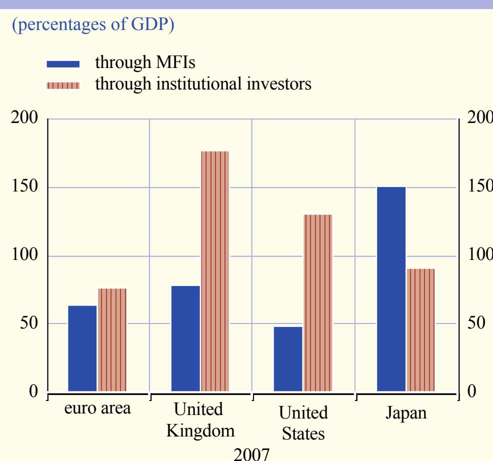
collect a larger part of these funds, compared with the assets managed by other institutions. Nevertheless, despite differences existing across countries, the funds flowing through institutional investors have been consistently high over the past few years and have grown slightly in the major developed economies as a ratio of GDP. For instance, in terms of magnitude, the value of financial assets held by euro area households through financial intermediaries – both through MFIs and through institutional investors – was around 140% of GDP at the end of 2007, compared with 130% at the end of 1999.

The latest data show that a little under half of the total financial assets in the euro area are invested through MFIs, while the rest go to institutional investors (see Chart 2). In the United States and the United Kingdom, funds flowing through institutional investors as a percentage of GDP are significantly larger, mainly reflecting investment in pension funds, presumably as a consequence of the differences in public pension schemes compared with those in euro area countries. Households in Japan hold many more assets in banks than in other developed countries, although they still invest significant amounts in insurance and pension funds.

Households have also increased the percentage of their assets invested via institutional investors in the developed economies. This is more likely the result of significant developments in global financial markets, with a notable increase in the range of products and services offered to the public. At the same time, global demographic trends – in particular population ageing across the developed economies – have placed a large burden on public social security systems and have triggered pension reforms. The resulting reduction in benefits has supported investment in private pension funds. This has been the case in the euro area, where the overall increase in capital flowing to investment funds has been the result of larger funds being available to the pension fund industry, which nevertheless remains underdeveloped in most countries.[10] By contrast, the percentage of assets invested via mutual funds has declined since 1999 across euro area countries.

Chart 2 Household holdings of financial assets

(percentages of GDP)



Sources: ECB, Eurostat, Bank of Japan and Federal Reserve Board.
Notes: Financial asset holdings through MFIs include currency and deposits. Financial asset holdings through institutional investors include mutual fund shares (for Japan, investment trust beneficiary certificates and trust beneficiary rights) as well as insurance and pension fund reserves.

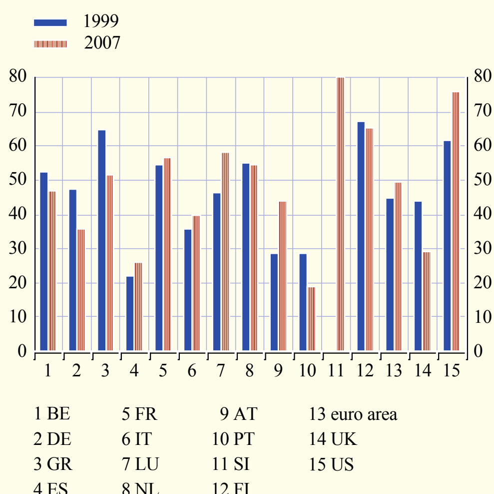
Owing to the large size of assets under management, institutional investors play a key role in global financial markets. They generally hold diversified portfolios, although the various types of institutional investors tend to allocate their portfolios differently, for example to respond to different investment horizons, as is the case for pension and investment funds. At the same time, portfolio allocation strategies differ across countries, partly as a result of regulatory requirements.

In general, institutional investors place a significant share of funds in equity. Investment funds in the euro area have increased the percentage invested in equity over the last few years to reach almost 50% by end-2007. This percentage remains significantly lower than in the United States but higher than in the United Kingdom, where equity investment has decreased substantially since 1999 (see Chart 3). However, there are considerable differences across euro area countries. With the exception

10 See the article entitled “Demographic change in the euro area: projections and consequences” in the October 2006 issue of the Monthly Bulletin.

Chart 3 Investment fund holdings of equities

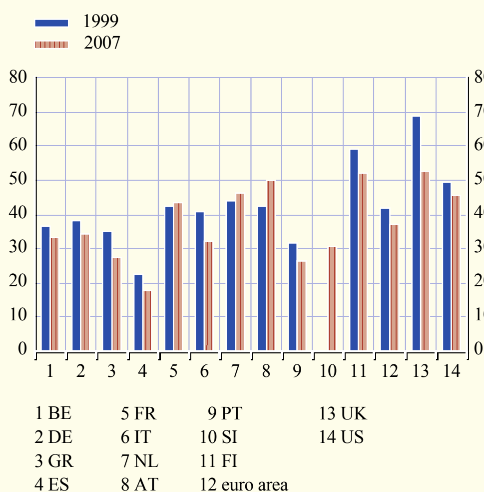
(percentages of total assets)



Sources: ECB, Bank of England and Federal Reserve Board.
Notes: For the euro area countries and the United Kingdom data refer to holdings of "shares and other equity", which include mutual fund shares; for the United States data refer to "corporate equities".

Chart 4 Insurance corporations and pension fund holdings of equities

(percentage of total assets)



Sources: ECB, Bank of England and Federal Reserve Board.
Notes: For the euro area countries and the United Kingdom data refer to holdings of "shares and other equity", which include mutual fund shares; for the United States data refer to "corporate equities" and mutual fund shares. Latest available data for Finland relate to 2006. Data for Luxembourg are not available.

of Germany, Italy, Spain and Portugal, investment funds in other euro area countries hold more than 40% of their portfolio in equity. The ratio of investment in equity is over 60% in Finland and over 80% in Slovenia.[11]

The differences are somewhat less pronounced for the portfolio allocation of insurance corporations and pension funds (ICPFs), which on average tend to hold less equity, reflecting regulatory constraints. In the euro area, only in Austria, Finland, France and the Netherlands is the percentage of the portfolio invested in shares relatively close to that in the United Kingdom and the United States, while in the other euro area countries pension funds tend to hold a more diversified portfolio by type of instrument (see Chart 4).[12] ICPF investment in equity shows a slight decrease in 2007 compared with 1999.

Other financial intermediaries (OFIs), of which investment funds constitute a significant part,[13] have increased the percentage of their portfolios invested in shares over the last few years at the expense of investment in other kinds of securities (mainly bonds) (see Chart 5). The low levels of bond yields over the same period are likely to have affected this trend, prompting investment fund managers to move towards more aggressive strategies, especially when facing a significant net withdrawal of funds. The investment in equity of ICPFs has decreased slightly since 1999, while investment in securities has increased over the same period (see Chart 6).

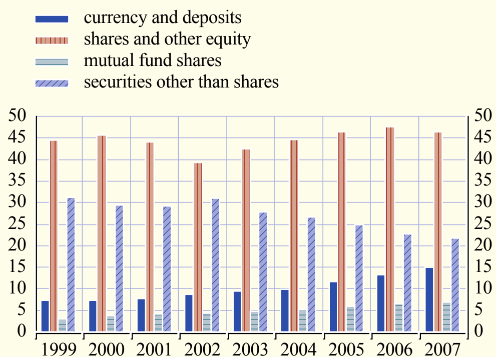
11 This peculiarity in Slovenia results from the conversion of three investment companies into equity funds, which at the end of 2006 held 23% of the total assets of the country's mutual funds. See Bank of Slovenia, Financial Stability Review, May 2007.

12 For some euro area countries, notably Austria, the ICPF's holding of mutual fund shares outweighs that of other categories of shares.

13 Other financial intermediaries are defined as corporations or quasi-corporations (other than insurance corporations and pension funds), such as investment funds that are engaged mainly in financial intermediation by incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional entities other than MFIs. These OFIs also include those entities engaged primarily in long-term financing, such as corporations engaged in financial leasing, financial vehicle corporations created to be holders of securitised assets, financial holding corporations, dealers in securities and derivatives (when dealing for their own account), venture capital corporations and development capital companies. See also http://www.ecb.europa.eu/stats/pdf/eaa/EAA_Glossary.pdf.

Chart 5 Portfolio allocation of euro area OFIs

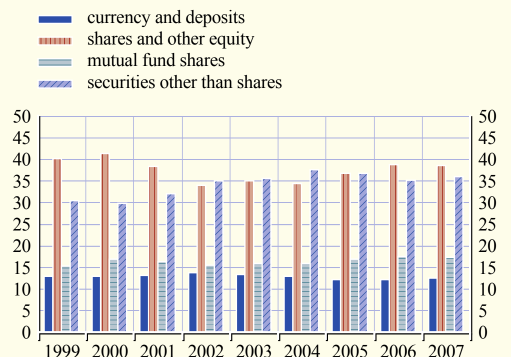
(percentages of total assets)



Source: ECB.
Notes: The portfolio allocation refers to the balance sheet of OFIs. "Shares and other equity" includes mutual fund shares.

Chart 6 Portfolio allocation of euro area ICPFs

(percentages of total assets)



Source: ECB.
Notes: The portfolio allocation refers to the balance sheet of ICPFs. "Shares and other equity" includes mutual fund shares.

4 INSTITUTIONAL OWNERSHIP, CORPORATE GOVERNANCE AND M&As

The previous sections have described the process of cross-border bank M&A activity and the increasing importance of institutional investors. The aim of the following sub-sections is to analyse the relationship between institutional ownership, corporate governance and cross-border M&As.

CORPORATE GOVERNANCE AND OWNERSHIP

The aim of corporate governance is to avoid, and eventually manage, potential conflicts arising between shareholders and firm managers and between different classes of shareholders. Corporate governance is related to the main characteristics of the financial system in place, such as corporate law, but it is also linked to the ownership structure of firms.

One important factor affecting differences in financial structures and corporate governance around the world is the degree of ownership concentration.[14] Corporate governance may be weak if ownership is too dispersed. A small shareholder does not have any incentive to monitor a firm since he or she cannot benefit from the positive externalities of monitoring while bearing the related costs. As a result, the lack of some degree of ownership concentration in publicly owned companies tends to weaken shareholders' monitoring incentives, thereby leading to agency problems between owners and managers.[15] Large investors, who have more incentives to monitor, and also more power, typically strengthen corporate governance, especially in systems where legal arrangements give relatively less power to minority shareholders. In the euro area, fundamental steps are being adopted to enhance corporate governance mechanisms. The directive on the exercise of shareholders' rights, which Member States are due to implement by July 2009, is of particular relevance in this respect.[16]

Large shareholders often enjoy a close relationship with a company's management

14 See R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1999), "Corporate ownership around the world", Journal of Finance Vol. 54 (2), pp. 471-517.

15 See J. Tirole (2007), "The theory of corporate finance", Princeton University Press.

16 Directive 2007/36/EC. The main features of this Directive are the reduction of the minimum notice period for most general meetings where shareholders can vote also by electronic means from 21 to 14 days; furthermore they must disclose the voting results on their website. The Directive also sets standards granting shareholders the right to ask questions and requiring companies to respond. In addition, it gives shareholders the right to put items on the general meeting agenda and table resolutions. Finally, the Directive bans share blocking and abolishes constraints on the eligibility of people to act as proxy holders.

structure and have an incentive to monitor the firm's activities. However, their interests may not always coincide with those of all the shareholders. This can result in conflicts of interest among different categories of shareholders, which may also affect corporate policies. There is some evidence that ownership concentration and profitability are not always positively linked.[17] For instance, a higher proportion of shares gives a higher incentive to monitor a firm, but if the level is too high, larger shareholders may pursue policies that benefit the person or group in control (like "empire building" through M&As) but which may not be beneficial to the other shareholders.[18]

In this context, the identity of these large shareholders seems to be important as well. Large shareholders may be families, non-financial corporations, banks or even the state, but they can also be institutional investors with possibly conflicting interests and different investment horizons. This may have implications for corporate structures, investment choices, dividend policies and more broadly for corporate governance and the way firms are run. For example, in the case of banks, whether or not the biggest shareholder is a non-financial corporation or an institutional investor may be relevant for corporate governance. A non-financial company may exploit its close relationship with the bank's managers to obtain funds in an economic crisis or may oppose a change in control (e.g. a cross-border M&A) to preserve this close relationship. An institutional investor, on the other hand, would aim to achieve the highest return on equity to retain its investors, which may be good for the general shareholder but may sometimes bring too much "short-termism" to the company, which could have a negative impact on its long-term profitability.

THE EFFECT OF INSTITUTIONAL OWNERSHIP ON CORPORATE GOVERNANCE

The significant growth in the role played by institutional investors is one important recent development in the financial structure of Europe. From a corporate finance perspective this has at least two main consequences. First, institutional investors ease direct financing of non-financial corporations by buying corporate bonds and equity. Second, by having significant corporate ownership participations in the euro area, they can impose market discipline and influence the behaviour of (financial and non-financial) corporations.[19]

As indicated earlier, shareholders with large investment stakes – often institutional investors – are the most likely monitors of publicly traded companies.[20] In such companies, shareholders effectively delegate decision-making responsibility to managers whose interests can diverge from those of their shareholders. The board of directors has a significant role in controlling such agency problems arising from its fiduciary obligation to shareholders, which includes the responsibility to recruit, dismiss, compensate and monitor top management. When the board of directors fails to perform these tasks, shareholder activism may arise in response.

The fact that common stocks are bought and sold in a market place is an initial remedy for suboptimal management by incumbent boards. Precisely because investors can sell their shares to the highest bidder, there is a market for

17 See A. Shleifer and R. W. Vishny (1986), "Large shareholders and corporate control", Journal of Political Economy 94, pp. 461-88.

18 A large shareholder with control has the power to appoint directors and managers and to make major corporate decisions that normally require the approval of a certain proportion of shareholders.

19 Note that this disciplining behaviour in corporations is not limited to non-financial corporations but can also be applied to financial corporations (e.g. banks) themselves.

20 See, for instance, M. C. Jensen and W. H. Meckling (1976), "Theory of the firm: Managerial behavior, agency costs, and ownership structure", Journal of Financial Economics 3, pp. 305 60. See also J. A. Brickley, R. C. Lease, and C. W. Smith (1988), "Ownership structure and voting on antitakeover amendments", Journal of Financial Economics 20, pp. 267-91; G. A. Jarrell and A. B. Poulsen (1987), "Shark repellents and stock prices: The effects of antitakeover amendments since 1980", Journal of Financial Economics 19, pp. 127-68; B. Holmstrom and S. N. Kaplan (2001), "Corporate governance and merger activity in the United States: Making sense of the 1980s and 1990s", Journal of Economic Perspectives 15, pp. 121-44; G. B. Gorton and M. Kahl (2006), "Blockholder identity, equity ownership structures, and hostile takeovers", NBER Working Paper No W7123; and A. R. Admati, P. Pfleiderer and J. Zechner (1994), "Large shareholder activism, risk sharing, and financial market equilibrium", Journal of Political Economy 102, pp. 1097-1130.

corporate takeovers – a "market for corporate control" – that gives competing management teams, as well as active investors, the ability to gain control of companies, thereby circumventing ineffective managers and boards. But even in cases where there appear to be no bidders, the stock market performs an inherent monitoring role, pressuring managers and boards to make decisions increasing equity value.[21]

When investors are dissatisfied with certain aspects of a company's management or operations, they can try to promote change with or without a change in control, in the former case through a M&A. Through their initial purchases and subsequent decisions to hold or sell, shareholders are expressing their views on the corporation's performance. In extreme cases investors initiate takeovers and leveraged buyouts aimed at achieving fundamental corporate changes. Between these extremes are intermediate points that include, for example, blockholders who purchase equity minority stakes with the intention of influencing managerial decision-making. Dissatisfied shareholders can also simply "vote with their feet" by selling their shares. Theoretical arguments and empirical evidence show that while having disciplinary effects on companies, the act of selling shares can lead to changes in governance as well.[22]

The role of institutional investors and the way in which they exercise their activism has been the topic of a large empirical literature. First, institutional investors are more likely to collect other shareholders' votes and push for corporate governance reforms.[23] For example, when institutional investors have larger ownership in a firm, shareholder-sponsored governance proposals tend to obtain more votes. Similarly, pension funds seem to be more successful at monitoring and promoting changes in firms at which they target their activism.[24] Second, there seems to be a relationship between institutional ownership and compensation policy. For instance, empirical evidence suggests that institutional ownership may increase the sensitivity of executive compensation to performance and may also reduce the level of compensation.[25]

Furthermore, institutional ownership may affect the likelihood of M&As. Firms with a higher number of institutional investors as shareholders are less likely to agree or vote for measures aimed at preventing takeovers.[26] In addition, different types of institutions, for example with different investment horizons, may have different implications for the M&A process. Firms with prevailing short-term shareholders have more chances of being targeted to receive a takeover bid.[27]

INSTITUTIONAL OWNERSHIP OF BANKS

A consequence of the increasing predominance of institutional investors is that they are becoming relevant shareholders of banks (see Chart 7). Therefore, institutional investors can more significantly affect corporate decision-making and governance. The latter aspect may be particularly important in systems where shareholders' rights are less developed.[28]

21 As B. Holmstrom and J. Tirole (1993), "Market liquidity and performance monitoring," Journal of Political Economy 101, 4, pp. 678-709 have argued, the stock market may be the most reliable monitor of managerial performance because stock prices incorporate a variety of information about future performance and value that cannot be found in financial statements alone. See also E. Fama and M. Jensen (1983), "Separation of ownership and control", Journal of Law and Economics 301-25.

22 For analyses of the effects of selling shares on corporate governance, see A. R. Admati and P. Pfleiderer (2005), "The Wall Street walk as a form of shareholder activism", Stanford University working paper; and R. Parrino, R. W. Sias and L. T. Starks (2003), "Voting with their feet: Institutional ownership changes around forced CEO turnover", Journal of Financial Economics 68, pp. 3-46. See also A. Hirschman (1971), "Exit, voice and loyalty: responses to decline in firms, organizations, and states", Harvard University Press, Cambridge, MA.

23 See S. L. Gillan and L. T. Starks (2000), "Corporate governance proposals and shareholder activism: The role of institutional investors", Journal of Financial Economics 57, pp. 275-305.

24 For general evidence see, for example, D. Del Guercio and J. Hawkins (1999), "The motivation and impact of pension fund activism", Journal of Financial Economics 52, pp. 193-340.

25 See, for instance, J. C. Hartzell and L. T. Starks (2003), "Institutional investors and executive compensation", The Journal of Finance 58, pp. 2351-74.

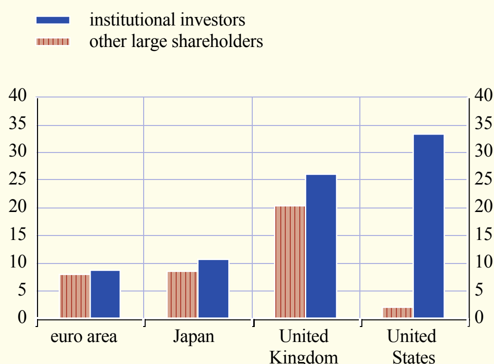
26 See J. A. Brickley, R. C. Lease, and C. W. Smith (1988), "Ownership structure and voting on antitakeover amendments", Journal of Financial Economics 20, pp. 267-91 and G. A. Jarrell and A. B. Poulsen (1987), "Shark repellents and stock prices: the effects of antitakeover amendments since 1980", Journal of Financial Economics 19, pp. 127-68.

27 See P. Matos, J.-M. Gaspar and M. Massa (2005), "Shareholder investment horizon and the market for corporate control", Journal of Financial Economics, Vol. 76 (1), pp. 135-65.

28 See ECB (2007), "Corporate finance in the euro area", May.

Chart 7 Institutional investors as large shareholders in major banks

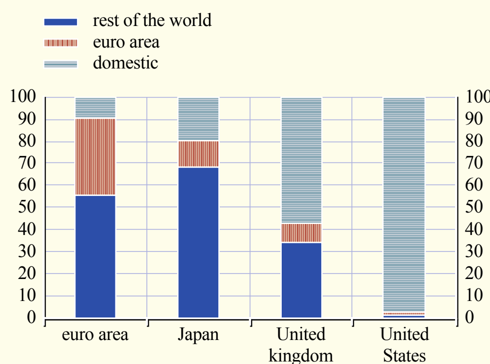
(percentages of total shares)



Source: Reuters.
Notes: Data retrieved in 2008. Data refer to the three largest banks in terms of market capitalisation.
Shareholding rights are the cumulated sum of rights held by the largest investors in each bank. Data are provided for the largest 20 stockholders in the pension fund and insurance corporations sector and for the largest 30 stockholders in the mutual funds sector; non-institutional investors are represented by the largest five shareholders in this category. For each geographical area, the indicator is calculated as an average of the shareholding rights by type of investor across banks, weighted by the market value of the banks concerned.

Chart 8 Domestic versus foreign institutional investors as shareholders in major banks

(percentages)



Source: Reuters.
Notes: Data retrieved in 2008. Data refer to the three largest banks in terms of market capitalisation.
Shareholding rights are the cumulated sum of the largest investors for each bank. For each geographical area, the indicator is calculated as the average of the domestic versus foreign residency of the largest 20 stockholders in the bank and insurance corporations sectors and the largest 30 stockholders in the mutual funds sector.

The effect of institutional ownership on the corporate governance of banks can be more important than in other industries since bank debt holders (very often including many small depositors) may not have strong incentives to monitor banks. Conversely, institutional investors have the incentives and the power to strengthen the corporate governance of banks.[29]

Foreign institutional investors are also becoming important shareholders in euro area banks with the largest market capitalisation (see Chart 8). In fact, the institutional ownership of these banks is, by and large, foreign, with an important presence from other euro area countries. This picture is similar in Japan, where non-resident investors represent the majority of the largest institutional stakeholders. On the contrary, in the United Kingdom domestic institutional investors in the major banks are predominant compared with non-resident investors. Finally, the major banks of the United States also attract almost exclusively domestic institutional investors, reflecting their importance and their size in the US financial system.

Investors' nationalities also affect the monitoring of banks' activities. Foreign investors (i) may not benefit so much from (domestic) public policies (e.g. a bailout when there is excessive bank risk-taking), or (ii) may have a more distant relationship with local corporations, thereby implying that domestic institutional money managers are more likely than foreign money managers to have business ties to local firms and be more sympathetic to the incumbent.[30] Furthermore, when

29 C. Hadlock, J. Houston and M. Ryngaert (1999), "The role of managerial incentives in bank acquisitions", Journal of Banking and Finance 23, pp. 221-49, confirm that banks with higher levels of managerial ownership are less likely to be acquired while Y. Brook, R. Hendershott, and D. Lee (2000), find in "Corporate governance and recent consolidation in the banking industry", Journal of Corporate Finance 6, pp. 141-64, that higher levels of outside block-holder ownership and a more independent board increase the probability that a bank will be acquired.

30 See L. S. Gillan and L. T. Starks (2000), "Corporate governance proposals and shareholder activism: The role of institutional investors", Journal of Financial Economics 57, pp. 275-305; G. F. Davis, and E. H. Kim (2007), "Business ties and proxy voting by mutual funds", Journal of Financial Economics, pp. 552-70; and M. Ferreira and P. Matos (2008), "The colors of investors' money: The role of institutional investors around the world", Journal of Financial Economics 88, pp. 499-533.

institutional investors own significant equity in their associated banks, they will not act independently from the management of the bank, thus weakening its corporate governance. On the contrary, foreign institutional investors are likely to be more independent shareholders and may, therefore, enhance corporate governance.

INSTITUTIONAL OWNERSHIP AND CROSS-BORDER M&As

Foreign institutional ownership and cross-border M&As are important mechanisms for financial integration. An important way of improving risk-sharing, and hence welfare, is to invest a proportion of the wealth overseas in assets with different risk characteristics. Consumers normally achieve this through institutional money managers (i.e. foreign institutional ownership). As explained before, the reduction of home bias and the growing importance of institutional investors go hand in hand.[31] The process of reducing the home bias and the increase of overseas portfolio investment improve financial integration.

Foreign institutional ownership and cross-border M&As can, in principle, complement or substitute each other as important mechanisms for financial integration. The presence of foreign investors as shareholders of corporations could, on the one hand, make it less necessary for corporations to make acquisitions overseas since a firm can access global finance even in the home markets. This argument would suggest that investors' international portfolio diversification may substitute for corporate internationalisation. On the other hand, a greater presence of foreign investors with a better knowledge of foreign markets can increase cross-border M&As by reducing information barriers between firms in different countries and markets.

Institutional investors – especially if active at an international level – may promote cross-border bank M&As by building bridges between banks, owing to their knowledge of foreign markets. Foreign institutional investors are generally very active internationally and, therefore, have a better knowledge of the different banking markets. As outlined above, the information barriers in banking markets are high, given the greater opaqueness of banks compared with other sectors. Hence, cross-border bank M&As may be more difficult, which could explain why there have been fewer cross-border M&As in the banking sector than in non-financial sectors. Institutional investors that operate in international markets can help to reduce these information barriers thanks to their monitoring ability and their knowledge as global investors.

Another reason why foreign institutional investors may be important for influencing cross-border deals is that domestic investors may be more reluctant to support cross-border M&As. For example, if cross-border M&As were to result in higher banking competition, domestic institutional investors associated with the domestic banks could try to oppose such cross-border deals in case their profits were eroded by the increased competition. Similarly, domestic non-financial large shareholders could also try to block such operations because of the potential loss of connection with the bank.

Indeed, a simple econometric analysis of bank M&As involving euro area banks over the 2002-06 period suggests that the degree of foreign institutional ownership in banks affects the likelihood of cross-border bank M&As (see Table 2). In particular, both target and acquirer banks with a higher proportion of foreign institutional ownership have a higher probability of being involved in a cross-border M&A than in a domestic M&A. By contrast, domestic institutional

31 The home bias literature suggests that informational constraints or information asymmetries cause investors to allocate too much of their portfolios to domestic stocks and too little to international stocks. See, for example, R. Stulz, M. Dahlquist, L. Pinkowitz and R. Williamson (2003), "Corporate governance, investor protection, and the home bias", Journal of Financial and Quantitative Analysis, Vol. 38(1), pp. 87-110.

Table 2 Cross-border bank M&A and institutional ownership

Size of target bank	-0.210
Size of acquirer bank	-0.010
% of domestic institutional investors in target bank	-0.240
% of foreign institutional investors in target bank	0.130**
% of domestic institutional investors in acquirer bank	0.039
% of foreign institutional investors in acquirer bank	0.100***
Adjusted R-Square	0.320
Number of observations	22

Sources: Zephyr, Osiris and Bankscope, from Bureau van Dijk; ECB calculations.
Notes: This table presents the results of an econometric analysis in which the choice of a cross-border versus a domestic bank M&A is analysed. In particular, a Probit model is used and the choice variable takes the value of 1 if the merger and acquisition is cross-border, and 0 if domestic. This choice variable is explained with a measure of institutional ownership and bank size indicators. The institutional ownership measure is the total percentage of institutional ownership in the target or the acquirer bank, disaggregated between domestic and foreign institutional ownership. The sample includes bank M&A deals between 2002 and 2006 in which both the target and the acquirer banks belong to the euro area. M&A deals are selected following the criteria: (i) the transaction involves the majority of the shares of the target bank (the ownership percentage sought after the deal is above 50%); and (ii) the deal is completed by the end of the sample period. Leveraged buyouts, spin-offs, recapitalisations, self-tender offers, exchange offers, repurchases, minority stake purchases and privatisations are excluded from the analysis. A positive coefficient in the table implies a higher probability that a merger and acquisition is cross-border, whereas a negative coefficient means that a domestic merger and acquisition is more likely. *** and ** imply statistical significance at 1% and 5% respectively.

ownership does not seem to affect the decision as to whether the M&A is cross-border or not.[32]

These findings have some implications for financial integration and regulation. An environment favouring foreign institutional ownership (both in terms of holding shares and being “activist” investors) could promote financial integration through cross-border M&As. This is all the more important as the legal barriers among euro area countries have been reduced substantially and mostly only information barriers remain present. In addition, more cross-border banking and more foreign institutional ownership increase the scope for cross-border and cross-sector contagion and systemic risk. Thus, it is important that the cooperation among the authorities responsible for banking supervision and regulation in Europe follows a clear set of common principles on crisis management, procedures and practical arrangements, which would ensure a timely and effective response.[33]

5 CONCLUSION

Cross-border bank M&A activity in the euro area has been significant over the last few years. At the same time, institutional investors – investment funds, insurance corporations and pension funds – have become the main collectors of households’ funds and important shareholders of firms and banks. These two phenomena appear to be linked, since institutional ownership affects the occurrence of M&As.

The results of the empirical analysis reported in the last part of the article suggest that institutional ownership is important and that the presence of foreign institutional investors as shareholders of banks facilitates cross-border bank M&As.

Financial integration is a highly dynamic process, in which market developments and policy action are intricately linked. While market forces have the primary role of shaping the single market for financial services, policy-makers can further support these efforts by

32 These results are not affected by the inclusion of different types of control variables, such as bank characteristics (e.g. bank size, capital, liquidity, risk, profitability or presence in foreign markets), specialised banks such as commercial, investment and mortgage banks, dispersed ownership variables, country and time-fixed effects, and country variables related to the legal system and banking regulation. Only evidence for M&A deals in which all banks belong to the euro area is presented. However, the results are very similar when the sample refers to the OECD countries. Other research provides evidence that foreign institutional ownership may increase cross-border non-financial firm M&A deals, whereas other variables, like the corporate law environment, play an important but smaller role in M&As (M. Ferreira, M. Massa and P. Matos (2007), “Shareholders at the gate? Cross-country evidence on the role of institutional investors in mergers and acquisitions”, INSEAD Working Paper). There is also evidence, however, to suggest that target firms are located, on average, in countries with poorer investor protection than their acquirer firms’ countries, suggesting a convergence in governance standards (see S. Rossi and P. Volpin (2004), “Cross-country determinants of mergers and acquisitions”, Journal of Financial Economics 74, pp. 277-304; and A. Bris and C. Cabolis (2008), “The value of investor protection: Firm evidence from cross border mergers”, Review of Financial Studies, pp. 605-48).

33 See Memorandum of Understanding on Cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability, June 2008.

providing an adequate framework for the cross-border expansion of financial institutions and activities.

This article has analysed the barriers to cross-border bank M&As. Barriers related to the legal and regulatory environments have been significantly reduced in the euro area over the last few years. However, other kinds of barrier, linked to information costs, remain significant and affect the probability of the occurrence of M&As. The presence of institutional investors, especially those which are active internationally, can have a beneficial impact, since these may reduce information barriers and act as bridges between countries and firms. In this context, public policy can play an active role in helping to remove the obstacles to cross-border ownership of banks, which are nowadays mainly linked to the presence of information barriers. Cross-border bank M&A activity is likely to remain high, which, in turn, will require the strenghtening of cooperation among financial supervision authorities in Europe.