

Banks, regions and development *

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1. Introduction

From the 1980s onwards, banking sectors in all the industrialised countries have been experiencing intense restructuring, aggregation and consolidation, radically changing their ownership structures and geography. These processes are particularly significant both in absolute terms (due to the number of mergers and acquisitions – M&A – new branches and the value of the assets involved in such operations), and in relative terms. In the past 20 years the number of banks in the USA has fallen by 34% while in Europe, between 1990 and 1999, the number of banks fell by 45% in France and Spain, 33% in Germany and 24% in Italy (European Central Bank 2000).

Various reasons lie behind these ongoing processes.¹ Some of them are of a general nature. First we have the revolution in communication and information technologies, which has led to the development of sophisticated risk management, borrower screening and monitoring techniques, and standardisation in many financial products, thereby encouraging competition and allowing banks to enter into markets geographically (and culturally) far-removed from their headquarters and core business. Second, widespread financial deregula-

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¹ For a broad survey of the literature on the causes and effects of banking systems integration, see Berger, Demsetz and Strahan (1999); Berger *et al.* (2000); White (1998).

tion has broadened the operating areas available to banks and reduced transaction costs.

Other reasons are of a contingent nature, such as the economic and banking crises of the early 1990s, which were handled by the monetary authorities so as to safeguard the stability of banking systems,² limiting as far as possible the cases of banking failure by favouring M&A operations, and the privatisation of state-owned banks.

Finally, there are the reasons of a corporate nature: the search for scale and scope economies, the acquisition of market power and managerial power and the possibility of reaping tax advantages.

Although the majority of aggregations has so far occurred at the national level, more recently bank aggregations have also taken on international dimensions. For instance, in Europe the ongoing construction of a single monetary and financial system is now occurring through *cross-border* operations (Berger *et al.* 2000, Buch and De Long 2001) and agreements between banks and other financial institutions (mainly insurance companies).

Whatever the reasons behind such restructuring processes, and aside from their actual effectiveness in improving profitability and efficiency in the banks involved,³ the globalisation of the credit markets, the consolidation of banking structures, the removal of barriers to the free location of banks and their penetration of peripheral markets pose at least the following four main questions. Will integration of the banking systems lead to a narrowing or a widening of the development gap between regions? What relationship will there be between financial centres and the periphery, and how will financial labour be divided between national (international) banks and local (regional) banks? Is it possible for the supervision authorities to influence these processes, and would it be beneficial for market efficiency and economic growth for them to do so? In the affirmative case, how should they intervene?

² For example, in Italy, according to Tasca (1998), in the period between 1985 and 1996, of the 90 cases of official banking crises only one, that of the Banco di Tricestino in 1990, concluded with definitive liquidation. Moreover, in many countries the changes in the control ownership structure of banks may often be attributed to formal or informal interventions of the supervision authorities (see Prowse 1997).

³ The evidence on this point is far from conclusive, often highlighting the fairly small effects of mergers and acquisitions on the profitability of the banks involved. For the USA, see Berger, Demsetz and Strahan (1999) and Rose (1999); for Europe, see Vennet (1996); for Italy, Focarelli, Panetta and Salleo (1999).

These questions are relevant in many countries, including most definitely Italy. Here, the process of banking system integration has developed in the presence of severe areal imbalances and proceeded in one direction only, from the advanced regions of the North and Centre to those of the South, where the independent banks have seen drastic reduction in number. However – and this is the decisive question to pose – is it reasonable to imagine that for vast and backward geographical areas like the Italian Mezzogiorno, the objective of autonomous, self-propelling development may be attained relying solely on outside-owned banks?

2. Two approaches to integration of the banking systems

The answers most frequently given to these questions have followed two contrary lines, one that we might define as ‘optimistic’, the other ‘pessimistic’.⁴ For the optimists,⁵ liberalisation and globalisation of credit markets bring certain advantages to backward regions. Competition on local credit markets increases banking efficiency and credit availability, and reduces interest rates. Bank consolidation gives rise to more diversified institutions or banking groups, thereby reducing the risk of banking crises. The small local banks will either be able to match up to the levels of efficiency of large outside banks or they will disappear, in either case with evident advantages in terms of social welfare. It is recognised that there may be adverse effects in the short run, in particular on the credit granted to small firms which would tend to be reduced due to the scarcer availability of information for outside banks and the low propensity of the large banks to work with small borrowers. However, these would only be temporary effects, that would tend to disappear once due account was taken of the reactions of other local banks and the start-up of new banking institutions – which would be ready to exploit all the opportunities left by the large banks – and once the time had elapsed necessary for the reorganisational efforts of the new entrants to take effect.

⁴ See Alessandrini (1996).

⁵ Of the most decisive in this sense, see the Commission of the European Communities (1990), Mishkin (1998), Zimmerman (1995).

By contrast, for the 'pessimists'⁶ such difficulties would be anything but momentary. Rather, financial integration and the entry of national banks in peripheral regions would trigger a perverse process of cumulative causation making it increasingly difficult for firms operating in these regions to access the credit market. It is acknowledged that the microeconomic efficiency of banks could increase, but this, it is argued, would only enhance the overall profitability of the banks to the detriment of the local economies. The credit market would become more concentrated; the distance from decision-making centres and the standardisation of customer evaluation procedures would make it very problematic for outside banks to gain a proper appreciation of the development potential of small local firms. At the same time, financial resources would be drained from the peripheral economies to more developed regions. Local savings would be directed towards financial centres both directly – as they would be attracted by the greater stability of the more developed economies, the lower systemic risks and the better opportunities to diversify risk-performance combinations that the institutions in financial centres would be able to offer – and indirectly, as the outside-owned banks would use savings collected in the peripheral regions elsewhere. In such regions, the flows of funding would thus become scarcer and above all more volatile. The local banks would necessarily be the losers in competition with large outside banks and, at most, could occupy some marginal market niches, not so relevant to the development of the local economy.

Now, as Huveneers and Steinherr (1992) noted, when reading such statements it is hard not to sense that we are essentially in the realm of conjecture, acceptance or refutation of which could only be made on the evidence of hard facts and an in-depth analysis both of the characteristics, the constraints and the incentives of the actors involved, and of the ways in which the processes of financial integration and competition on the credit market proceed. However, as we shall see in the following sections, as soon as we turn to theories and facts, pessimism and optimism are forced to give way to more prudent, more circumspect attitudes.

⁶ Of these, cf. Dow (1994), Martin (1995), Chick and Dow (1997).

3. Integration of banking systems: theoretical analysis

Theoretical reflection on the effects of banking systems integration and consolidation upon the functioning of credit markets has been very broad in scope. This literature has dealt with many aspects including the issues of market structure, fixing of interest rates, credit availability, information production, customer relationships, credit allocation and economic growth. The conclusions reached in this literature are far from concordant, clearly demonstrating that banking integration is a complex, heterogeneous process which may offer opportunities and create difficulties according to the ways in which it unfolds and the degree of development of the economies.

For the sake of presentation, we can start by distinguishing between two possible forms of integration of credit markets: *i*) integration by flows and *ii*) integration by structures.

3.1. *Integration by flows*

When referring to the integration of banking systems we mean a situation in which there are no geographical segmentations in the credit market, or in other words a situation in which an agent, given his/her characteristics and the characteristics of the business that he/she intends to pursue, is able to obtain a certain amount of credit, at a certain cost, irrespective of where he/she operates. In principle, therefore, credit markets could be perfectly integrated, even to the extreme degree of all the financial institutions being concentrated in a single financial centre and from there distributing their services locally to customers through financial flows.

With integration by flows, local credit markets tend to become increasingly contestable, the hit-and-run competition on the part of outside institutions being a credible threat to incumbent banks operating on each market. The very distinction between local bank and national bank would tend to disappear and, at most, banks would be differentiated by their size (Papi 1994, Mishkin and Strahan 1999). In terms of bank-firm relationships, there would no longer be either a fi-

nancial centre or a periphery. In other words, perfect integration in flows would constitute the 'end of financial geography'.⁷

Naturally, a necessary condition for there to be integration by flows is that transaction costs and information barriers be low. This extends the geographical operating area of each bank and allows customers access to geographically distant banking institutions, making the location choices of the two agents less and less meaningful for bank-firm relationships. Integration by flows thus arises and develops together with technological innovations concerning information transfer and treatment. Rapid progress in this direction has considerably lowered contact and search costs, also for the smaller clientele. Casual observation and the scant evidence available for the USA (Berger and De Young 2002, Petersen and Rajan 2002, Radecki 1998) suggest that physical proximity is becoming a less important factor on the retail deposit and credit markets. However, this evidence is not borne out in all countries (Buch 2001) and, above all, it indicates only a trend towards a weak geographical extension of the field of action of bank branches, without showing any existence of a single national retail market and the disappearance of local credit markets (Kwast, Starr-McCluer and Wolken 1997; Cyrnak and Hannan 1998).

However the integration of credit markets by flows encounters technological, or rather, *logical* limits. Indeed, to the extent to which the very existence of banks is justified by the presence of information asymmetries between savers and investors, and to the extent to which, *ceteris paribus*, such asymmetries grow along with geographical distance, the importance of the location of banks and their offices for the good or bad functioning of local credit markets is inevitable (Zazzaro 1998).⁸ In other words, from the logical point of view, the 'end of financial geography' could only occur jointly with the 'end of banks'.

⁷ See O'Brien (1992). It is worth emphasizing that with integration by flows, the end of geography would concern only bank-firm relationships and accessibility to markets, while financial centres would not necessarily disappear. Other reasons concerning, say, the availability of human capital, the more rapid diffusion of financial innovations or the existence of scope economies could indeed continue to make one location more attractive to banks than another.

⁸ On this point, it may also be interesting to recall the words of the Governor of the Federal Reserve, Alan Greenspan, who observed that "the newer technologies may be awesome but human nature does not change and we still appreciate a face across the desk more than a computer screen" (quoted from the mimeographed version by Petersen and Rajan 2000, p. 9).

3.2. *Integration by structures*

Geographical integration of credit markets thus also requires a process of integration and consolidation in banking structures. Although the presence of the same banking institution in several regions does not imply, *per se*, the absence of geographical credit market segmentation, it undoubtedly leads to more uniform prices and lending criteria across regions.⁹ The large national and international banks, in order to simplify administrative practices, reduce agency problems with branch managers, facilitate communication with their customers and establish a reputation for impartiality and correctness, often prefer to apply similar credit conditions, even when faced with differing market structures (Berger *et al.* 2000).

However, integration by structures may have very different effects on the functioning of local credit markets according to whether it occurs through the opening of banks and/or branches or rather by acquiring stakes in local banks and, in the latter case, whether the acquiring bank is one already operative in the area (i.e. an inside bank) or a new bank seeking to enter the market (i.e. an outside bank), or whether the stake acquired is an absolute majority or relative majority holding.

3.2.1. *Integration in structures by opening banks and branches*

When banking systems integration leads to the establishment of new banks or the opening of new branches, competition on local credit markets increases, with beneficial effects both on interest rates and the amount of credit granted locally (Economides, Hubbard and Palia 1996; Zazzaro 1997; Calem and Nakamura 1998; Buch and Golder 1999). When depositors' and borrowers' mobility across regions and banks is sufficiently large, bank interest rates tend to be more regionally uniform (Calem and Nakamura 1998) and the quality of the

⁹ In this respect, some evidence concerning the deposits market in the US economy may be found in Radecki (1998) and Heitfield (1999). For Italy, Galli and Onado (1990) show that the average loan interest rates practised by banks with head offices in the regions of central-northern Italy are more uniform geographically than those practised by banks with head office in the south of Italy (on average lower and locally concentrated compared with the former. On this point, see also Zazzaro 1998 and Alessandrini and Zazzaro 1999).

services offered by each bank tends to be higher due to the considerable probability of multiple contacts with its own customers and with its rivals (Mester 1987).

However, in the presence of information asymmetries and opaqueness in screening criteria, an increase in the number of banks could trigger winner's curse phenomena, leading to a rise in the interest rates practised in the region. Indeed, each bank would take account of the fact that the probability of the same application being *correctly* rejected by its competitors increases with the rise in the number of these competitors, which explains why it would be willing to lend only at higher interest rates (Broecker 1990, Riordan 1993, Shaffer 1998).

At the same time, increase in the number of banks operating in the local credit market and reduction in the degree of monopoly of incumbent local banks make the switching of borrowers from one bank to another more straightforward and less costly, and thus reduce the banks' share of profit (current and future). This, in turn, may reduce the banks' incentives to carry out in-depth borrower selection and monitoring (Cetorelli 1997, Chiesa 1998, Gehrig 1998, Cetorelli and Peretto 2000), and to be involved in long-term customer relationships and relational financing¹⁰ with new firms or firms in crisis (Petersen and Rajan 1995). Moreover, the higher the number of banks, the higher is the risk of moral hazard behaviours on the part of borrowers in that their reputation costs tend to reduce (Hoff and Stiglitz 1997). All these phenomena lead to a rise in interest rates, reduction in the average quality of firms funded and a drive towards short-termism on the part of banks and firms.

The counter-argument, however, is that the entry of outside banks and increased competition also tend to reduce profitability for the more traditional forms of funding not based on specific relations between bank and firm (known in the literature as arm's length financing or transaction-based lending). Taking this into account, it cannot be ruled out that increased market competition may make forms of transaction lending even less profitable than those of relational lending, thereby increasing the engagement of local banks in

¹⁰ According to the definition of Aoki and Dinç (2000, pp. 20-21), "*relational financing* is a type of financing in which the financier is expected to make additional financing in a class of uncontractible state in the expectation of future rents over time".

the latter activity (Aoki and Dinç 2000, Boot and Thakor 2000, Hauswald and Marquez 2002). In more concrete terms, the entry of national and international banks on local markets could drive the local banks to occupy a market niche with small local businesses, making it worthwhile to undertake, towards them, the functions of a *Hausbank*.

3.2.2. Integration in structures by mergers and acquisitions

However, it is precisely the information advantages at the disposal of local banks that may in some cases, especially on the more peripheral markets, constitute a formidable barrier to entry for outside banks (Gehrig 1998; Dell'Araccia, Friedman and Marquez 1999), thus leading to more indirect forms of integration through mergers and acquisitions (Dell'Araccia 2000).

With M&As, if the merging or acquiring bank is already active in the region, the number of banks operating in the area decreases and the variance of market shares tends to rise, thereby raising the level of concentration in the credit market.¹¹ Should the banks behave as Cournot competitors,¹² this, in turn, will lead to an increase both in their market power and in the interest rates applied in the region, together with a reduction in credit granted locally, unless the efficiency of the new banking structures arising from M&As is so much greater (that is, their marginal costs are so much lower) than that of the individual banks operating previously as to overturn the effect of increased market power upon prices (Farrell and Shapiro 1990). However, if the competition between the banks is over prices, or if each bank's conjecture about their opponents' reaction differs from no reaction, the relation between the concentration and market power becomes ambiguous, as does the effect of consolidation processes upon interest rates. Moreover, when M&As concern banks operating on the same market, there is no dispersal of the information heritage or cus-

¹¹ For a survey of the determinants of market structure, see Jacquemin (1987), Martin (1993) and, with reference to the banking market, Cetorelli (1999).

¹² On the type of strategic variable actually employed by the banks in competition the evidence is mixed: Gollop and Roberts (1979) and Berg and Kim (1994) reject the hypothesis of competition over quantity (*à la* Cournot), while Neven and Roeller (1999) find that this hypothesis is well suited to describing the behaviour of banks in Europe.

tomers relationships accumulated over time, which may have a positive, or at least non-negative, effect on loan price and non-price conditions.

When M&As concern banks operating on different geographical markets, the benefits of efficiency deriving from scale economies are generally limited, while the scope economies may be considerable. By contrast, the losses in terms of information and knowledge of local economic environments may be very great. Nevertheless, following on the entry policies of new banks and the greater difficulties in establishing collusive agreements with new actors, competition on local markets could also increase in the immediate future.

Of course, the effects of banking consolidation on competition are not felt uniformly in all customer segments. For large and for small businesses, financial integration leads to fairly limited changes in the structure of the reference market. For the large firms it remains more competitive since they already look towards national and international credit markets and borrow from more than one bank. In the case of the small businesses, the market structure remains essentially monopolistic, as small businesses are to a great extent already informationally captured by local banks, often their sole suppliers of credit.

3.3. Financial integration and credit allocation

The entry of large national or international banks in peripheral regions affects not only prices and quantities but also the allocation of credit among firms and industries.

First of all, due to greater diversification in their portfolio, large banks are generally less risk-averse and hence more inclined to finance new initiatives and innovative projects. Yet precisely because they are more diversified, large banks may find customer screening costly and monitoring less worthwhile (Winton 1999). Furthermore, in peripheral regions the large banks actually operate through their branches and local management, very often represented by managers who are in the region only temporarily, being posted to the branch for a limited

period,¹³ and whose remuneration and career possibilities depend on the current profitability of the branch. Moreover, the local management usually performs only the preliminary screening of loan applications, while the ultimate decision on credit disbursement is made by the head office. Thus the local branch managers of out-of-market owned banks may end up taking a very cautious attitude, preferring to finance low-risk projects, characterised by short-term returns and hard information easily communicable, rather than support uncertain long-term projects which are difficult to appreciate from the head office, even if the latter may be crucial for the development of local entrepreneurship and economy (Palley 1997, Stein 2002).

Secondly, the existence of organisational diseconomies (Williamson 1988, Berger, Demsetz and Strahan 1999) may force large banks to abandon some market segments, like start-up lending or, more generally, small business lending, which would require very different skills and organisation structures from those needed to operate with large and mature firms.

Thirdly, to make up for the lack of specific information on local investors and limit the agency problems with local branch managers (Nakamura 1993 and 1994, Ferri 1997), the large out-of-market owned banks are led to standardise customer relationships at a local level by using statistical methods such as credit scoring.¹⁴ These have the great merit of reducing selection costs and time, facilitating access to credit for small firms (Berger, Frame and Miller 2002). Moreover, they tend to make the selection process more objective and limit cases of credit being granted to ailing firms. At the same time, however, the use of rigid statistical selection procedures based on past hard-information from balance sheets or other publicly available sources may well increase the cases of non-acceptance of profitable loan applications. This

¹³ For evidence on this point, see Ferri (1997). According to Ferri (1997), the frequent turnover in local management is explained by agency problems between branch and head office managers. According to others (Saraceno 1970, Zazzaro 1998), mobility represents a key element in a manager's career, which is why it is often requested, rather than passively experienced, by managers of peripheral branches.

¹⁴ As shown by Akhavein, Frame and White (2001) and Frame, Srinivasan and Woosley (2001), in the USA the adoption of credit scoring systems is widespread among large-size banks. For a useful analysis of credit scoring methodologies and their merits, see Mester (1997). For some interesting considerations on possible negative consequences for local economic development of the use of statistical methods for customer selection, see Brusco (1999).

type of error may be more frequent just in backward regions, where corporate 'accounting quality' is unlikely to exceed the 'average' criteria established in credit scoring procedures.

Although the informational advantages of local banks, stemming from their historical roots and 'cultural affinities' with the local community, allow for sounder assessment of local firms, they do not ensure that credit is always allocated as best suits local economic development. Indeed, for various reasons, local banks operating in peripheral regions could find it worthwhile to finance mature firms operating in traditional industries rather than new and innovative firms. In the first place, in-depth exclusive knowledge of a single economic environment may reduce a bank's capacity to react to novelties from the world of production. Examining the merits of a new firm producing in a new (for the region) sector often requires skills and experience which local banks cannot be in possession of, regardless of the amount of private information available on the entrepreneur and the local economic environment (Dosi 1990, Zazzaro 1997).

Secondly, long-term, exclusive ties with local firms may drive local banks to limit the entry of new firms and the financing of highly innovative businesses. Indeed, if such businesses were successful, they could create serious difficulties for the solvency of the existing firms and their capacity to honour their debts, which are largely contracted with the same local banks (Zazzaro 1998 and 2001). This type of attitude on the part of local banks would not only check the entry of innovative firms, but would also end up reducing the innovative efforts of existing firms which, 'protected' by the local banks, would have less incentive to introduce innovations (Zazzaro 2001 and 2002).

Lastly, in backward areas, liquidity costs may also discourage local banks from financing innovative businesses (Zazzaro 1993 and 1997). By definition, local banks concentrate most of their deposit collection and lending activity in limited geographical areas. Thus, for such banks the reflux of deposits resulting from the granting of a loan will depend crucially on where the money lent will be spent. If borrowing on the interbank market is more costly than deposit collection, then the larger the amount of credit granted locally, the lower will be the cost of liquidity for the local banks (Moore 1989). Of course, by definition, in peripheral areas the firms that pay incomes locally are precisely the less innovative ones, operating in non-dynamic industries.

4. Integration of banking systems: the empirical evidence

If the theoretical literature on financial integration and banking consolidation does not allow definitive conclusions to be drawn on the side of either the optimists or the pessimists, the empirical evidence is no less uncertain. Here we shall refer essentially both to evidence from the US economy – which is in fact the object of most of the research into the ‘real’ consequences of banking systems liberalisation and consolidation – and to the Italian economy. The latter is known to have a very dispersed social, productive and financial web, made up of many local and regional banks, a large number of small and medium firms and many cities and towns, each of which has its own well-defined cultural identity. This is why Italy is an important case study for assessing the possible effects of banking integration processes on the economy.

The empirical literature on the subject may be divided into four main avenues of research: *a*) the effects of banking systems integration and consolidation processes on both the degree of competition of the banking industry and credit conditions; *b*) the effects of bank mergers and acquisitions on small firms (SFs) financing; *c*) the role of local banks (LBs) in financing local development; and *d*) the effects of banking systems integration on economic growth.

4.1. *Concentration, competition and interest rates*

The first question to be tackled is whether the deregulation, integration and consolidation of banking systems have caused an increase or a reduction in concentration on the local credit markets.

Evaluation of the concentration of credit markets naturally varies with the geographical area and the type of financial products considered. While at a national level the main effect in all European countries has been reduction in the number of banks with a considerable increase in concentration (Messori 2002), at the local level, in Italy as in the USA, the concentration has fallen or at most remained stable, being more greatly affected by the regional expansion strategies of national and interregional banks through the opening of new branches (De Bonis and Ferrando 2000, Black and Strahan 2002, Calcagnini and

Hester 2002). Indirectly, this confirms that banking market integration in Europe has so far been mainly a domestic phenomenon and has only marginally concerned relations between countries. Moreover, in many European countries – Austria, Belgium, Finland, France, Italy and Spain, for example – the concentration tends to be greater on the deposit markets (especially savings deposits) than on the loan markets, and more for mortgages than for short-term loans (Corvoisier and Gropp 2002).

However, whatever the effect upon credit market concentration, what matters more is to establish to what extent banking systems consolidation and integration have affected competition and credit conditions.

The contributions addressing this point fall into two categories. First of all, we have a number of contributions proposing direct assessment of the banks' competitive behaviour by estimating the Lerner index. Angelini and Cetorelli (2000) apply this method to the Italian banking system and find that subsequent to adoption of the Second Banking Directive of the European Union (1993) the banks' behaviour has become more competitive, especially in the case of banks operating in the Northern regions. The Lerner index also showed a considerable reduction in the case of banks involved in mergers and acquisitions, in line with the trend observed over the whole system. Parallel with this increase in competition in the macro-areas of Italy an increase in the degree of concentration (measured by the Herfindhal index) also occurred, suggesting that the greater competitive behaviour within the credit market should be ascribed to both the opening of new branches and the current negative economic situation, which has led banks to squeeze their *mark-up*.

Other contributions follow a more indirect approach, analysing the consequences that banking systems integration has had on the amount and conditions of credit on local markets. Here we can further distinguish two analysis strategies: one of a static type – with the focus on relations between concentration measurements and price and quantity variables –, the other dynamic – with the focus on the effects of mergers, acquisitions and the opening of new branches on prices and quantities.

The works of the first type tend to show, albeit with varying intensity, that in more concentrated credit markets banks usually charge higher interest rates and grant less credit (D'Amico, Parigi and Tri-

filidis 1990; Hannan 1991; Jappelli 1997; Jayaratne and Strahan 1998; Sapienza 2002).¹⁵ However, as regards the credit volumes granted, and in accordance with the theories that underline the positive role of market power on the management of information problems within bank-firm relations, Bonaccorsi and Gobbi (2001) found that, in the Italian provinces, the negative effect of concentration on the volumes of credit granted holds only for large firms, while for SFs, those which have less transparent information, it is positive. Moreover, where the concentration is greater, the amount of non-performing loans is appreciably higher, suggesting less commitment or a lower capacity of banks to select and monitor customers carefully.

The differentiated effect of concentration in the credit market is confirmed in many other studies. Bonaccorsi and Dell'Araccia (2001) and Black and Strahan (2002) find respectively that in the Italian provinces and in the US states, where concentration of the credit market is greater (and deregulation has been swifter), the start-up of the more informationally opaque firms proceeds at a lower rate. Similarly, again with reference to the USA, Cetorelli (2001 and 2002) finds that job creation on the part of new firms and the degree of competition in the industry both decline when concentration of the credit market is higher.¹⁶ However, on less competitive markets the entry of new firms occurs to a relatively greater degree in industries for which information problems are more serious.¹⁷

We also find mixed results on turning to dynamic analysis. Focarelli, Panetta and Salleo (1999) found that the overall volume of loans granted in Italy tends to increase for banks involved in mergers, while it decreases when consolidation occurs through acquisitions. However, the result is overturned when we take account of the banks' size involved in mergers and acquisitions, the banks acquired being

¹⁵ The results of the empirical evidence on the structure-conduct-performance model also seem to be banking product sensitive. For instance, with regard to European banking systems, Corvoisier and Gropp (2002) found that the structure-conduct-performance model is well suited to describing the behaviour of banks on the loans and checking accounts markets, but may not be applied to the market for savings deposits and mutual funds.

¹⁶ Interestingly, Cetorelli (2002) interprets this result as evidence of the phenomena of creative destruction mentioned in Section 3.4, on account of which LBs might not find it worthwhile to encourage the start-up of new firms.

¹⁷ Bonaccorsi and Dell'Araccia (2001). Similar results in a cross-section analysis among countries and industries were obtained by Cetorelli and Gambera (2001).

those that increase lending, while the banks created by a merger tend to reduce it (Bonaccorsi and Gobbi 2001). By contrast, Sapienza (2002) found that if mergers and acquisitions take place between small banks operating on the same market, the lending rates tend to decrease; conversely, when the banks involved are large, after consolidation the banks' market power becomes stronger and *all* the banks operating locally tend to raise their lending rates, especially for medium-size enterprises. However, when consolidation involves banks operating on different markets, their lending rates increase, while those charged by rival banks decrease.

Finally, as for non-performing loans, Focarelli, Panetta and Saleo (1999) find that mergers have no significant impact on the loan portfolio quality, while for acquired banks non-performing loans initially increase, but then tend to decrease over time. Clearly, this may either mean that the acquiring banks have performed an efficient clean-up of the balance sheets of the acquired banks by writing off dubious credit or, alternatively, it might indicate the application of more restrictive selection criteria for new SFs which may be riskier but remain important to stimulate the process of economic growth.

4.2. Mergers, acquisitions and small firm financing

The drawback most often mentioned by those wary of credit market integration is the reduction in financing experienced by new SFs, especially those operating in peripheral and less developed areas.

There is now robust evidence that, on the one hand, SFs are more dependent on bank credit than large firms¹⁸ and, on the other, that the larger banks tend to allocate a smaller share of their assets to loans for SFs than the smaller banks¹⁹ (Berger and Udell 1996). Hence mergers and acquisitions should bring about a reduction in bank loans to SFs and penalization of those firms unable to satisfy the minimum financial and asset criteria required by large banks to grant loans.

In reality, the available evidence presents a much more complex picture, in which consolidation effects depend significantly on the

¹⁸ For a complete updated survey of the problems of small firm financing, cf. Berger and Udell (1998).

¹⁹ Although the relation between bank size and the volume of loans to SFs is not strictly monotone; cf. Strahan and Weston (1998).

type of institutions involved. US and Italian empirical evidence (Peek and Rosengren 1998, Strahan and Weston 1998, Sapienza 2002) shows that consolidations occurring between medium-large banks or those in which large banks have incorporated a small bank have actually led to a reduction in loans to SFs. Conversely, mergers and acquisitions involving small banks have led to a bigger share of loans to SFs. Moreover, loans to SFs in dynamic (stagnant) regions are less (more) affected by size when the bank acquired becomes part of a national banking group (Houston, James and Marcus 1997; Houston and James 1998).

However, besides the different behaviour of banks involved in consolidation processes, the reaction of other banks operating on the same market must also be considered. This reaction often produces a positive effect that more than compensates for the negative effect of size.²⁰ In other words, mergers and acquisitions would drive other banks (some already in existence, others established after the merger) to cover the market segments left uncovered by the new bank spawned by the merger and limit the reduction of (or even increase) the amount of credit granted overall to SFs.

Whatever the case may be, it should be pointed out that reduction in lending to SFs would represent a loss in terms of social welfare only to the extent to which firms that had had their credit lines cut undertook profitable investments. If it were not so, we would only be faced with the elimination of inefficient credit lines retained by inefficient banks (Berger, Kashyap and Scalise 1995). Unfortunately, in this case, too, the available evidence takes us nowhere in this respect. However, the fact that *i*) loans to SFs from competing banks increase, *ii*) the probability of SFs borrowing from target banks being dropped by the consolidated bank is higher than the same probability for SFs credited by acquirer banks, even after verification of borrower quality (Sapienza 2002), and *iii*) the probability of an acquisition occurring (both on the part of another bank operating on the same market, and on the part of an outside bank) does not depend on the volume of loans granted from the acquired bank to SFs (Moore 1997), suggests that the reduction in loans to SFs might not be simply the result of

²⁰ Cf. Berger *et al.* (1998); Berger *et al.* (1999); De Young, Goldberg and White (1999). Evanoff and Örs (2002) recently presented evidence for the positive effect that, in the USA, market deregulation and the entry of new banks from outside have had on cost efficiency (not on that of profits) of banks operating on local, urban and rural markets.

more efficient credit markets, but rather might represent a possible social welfare loss.

4.3. *Local banks, small firms and local development*

Behind the 'pessimistic' views, there is implicitly the idea that localism (of banks and firms) is a key factor for the development of peripheral economies. LBs are better equipped and more interested in assessing the growth prospects of small local firms, on which the development of local economies greatly depend. The idea is that their regional rootedness and the 'cultural affinities' that tie the management of such banks to the local community produce comparative advantages. These local characteristics *i*) mitigate the information problems and allow banks to select and monitor clients better; *ii*) facilitate forms of interlocking transactions and mutual control among firms; and *iii*) increase the cost of social sanctions, making *enforcement* of debt contracts more stringent and discouraging firms' opportunistic behaviour.²¹

While there are no doubts as to the 'quantitative' importance of LBs for financing SFs, there is little evidence of their efficiency in customer selection and capacity to stimulate the growth of local economies, and moreover this little is, to our knowledge, limited to the case of Italy.

Historically speaking, the LBs have not always thrown themselves into the functions of a *Hausbank* for SFs. By the beginning of the 20th century the LBs had already become entrenched in many areas of Italy. In particular, in the north-eastern and central regions, where the later industrial districts have spawned, the LBs clearly had a more considerable presence than elsewhere (Conti and Ferri 1997). However, from Conti's reconstructions (1997) it also emerges that, with the exception of the silk-producing district of Como, only rarely did bank-firm relations manage to evolve along the lines of the *Hausbank* model. In Veneto, as in the Marche and other regions, there already prevailed multiple lending phenomena, which reduced the

²¹ On the importance of interlocking transaction phenomena, mutual control and social sanctions, cf. Bell (1988), Stiglitz (1990) and Besley and Coate (1995). For an application of this literature to financial problems of industrial districts, cf. Dei Ottati (1995), Conti and Ferri (1997).

availability of information on local firms and confined relations with local firms to a purely arm's length type. Moreover, customer selection depended mainly on the branch manager's personal acquaintance with the customer (Gigliobianco 1997) and his/her relations with the leading citizenry, whose signature was often materially required, acting as a form of guarantee. The impression is that personal acquaintance represented at that time what is now represented by credit scoring, namely a way of selecting customers at low unit cost. Whether the former was (is) more efficient than the latter depends, as noted by Gigliobianco (1997), on the type of knowledge that each manager considered important for granting credit, a definitely less controllable factor than the variables used in the credit scoring method.

Moving on to the present day, recent surveys on credit availability within industrial districts have shown that firms located in industrial districts pay lower lending interest rates. However, it is uncertain whether such firms experience more or less stringent financial constraints than firms operating outside the industrial districts.²² At any rate, lower lending rates seem due to a 'district effect' rather than any privileged relations the firms might establish with the LBs. This seems to be indirectly borne out by the results of Angelini, Di Salvo and Ferri (1998) and Ferri and Messori (2000). The former authors find that, for SFs, customer relations with banks lead to a reduction in lending rates only when cooperative banks are involved and only for firms that are members of a cooperative bank. In other words what counts is the cooperative form and not being a local bank. By contrast, Ferri and Messori (2000) show that, although relationship banking predominates in both the industrial district areas and the less developed Southern areas, it has a positive effect on credit allocation only in the North-East and Central regions of Italy.

Finally, as regards the effects that the presence of LBs has on economic growth, the results are once again inconclusive, depending mainly on the geographical unit chosen for analysis and the other fi-

²² Baffigi, Pagnini and Quintilani (1999) show that the investments of firms located in industrial districts are more sensitive to cash flow. However, Finaldi Russo and Rossi (1999), using a *probit* model in which the dependent variable is given by the ratio between the credit used and the credit agreed which assumes the value of 1 when the ratio exceeds 90% and 0 in other cases, found that firms operating in industrial districts are slightly less constrained from the financial point of view compared with other firms.

nancial variables considered. At the regional and provincial level, Luchetti, Papi and Zazzaro (2001), Ferri and Mattesini (1997) and Cosci and Mattesini (1998) find that the presence of LBs can positively affect economic growth. By contrast, Angelini, Ferri and Vacca (1998) find that at the individual town level the relation is no longer statistically significant. Similarly, in the only study to our knowledge devoted to the US economy, Collander and Shaffer (2003) did not find any clear evidence of LBs influencing short- and long-term growth rates in local economies (identified in the so-called *metropolitan statistical areas* and *nonmetropolitan counties*) differently, in terms of quality and quantity, from the outside banks working in the area.

4.4. *Local banking systems and economic growth*

What has so far emerged is an extremely complex picture, from which it is difficult to draw precise conclusions. Theoretically, there are good reasons for seeing banking systems integration both as beneficial process for the economy and as a factor increasing the gap between 'advanced' and peripheral areas. We thus have to rely on the empirical evidence to determine case by case what its concrete effects are. The empirical literature not only confirms that the various situations are different and that banking systems integration generates mixed effects, but above all shows that the results depend enormously on many different aspects like the indicators considered, the control variables used, geographical frameworks, actors and periods of time examined. As the possible combinations of all such elements are clearly infinite and as it is very difficult to reach a definitive conclusion even for a specific case, we may reasonably wonder whether the geographical organisation of the banking system and the efficiency and degree of development of local financial systems have any permanent effect on local economies taken together, or whether their effect is only temporary and limited to certain actors.

All in all, the response to this question seems to be positive both for the US economy and for Italy. Jayaratne and Strahan (1996) find that the rate of growth of US states significantly increased in the years following the deregulation of branch opening, even after considering the volume of loans granted and local tax policies. According to these two authors, the improvement recorded in the quality of the loans

granted after deregulation should be attributed to better credit allocation rather than a swifter accumulation process. A similar result is reached by Collander and Shaffer (2003), who show that deregulation and the degree of competition on credit markets has favourably affected the short- and long-term growth rates of local systems in the USA.

Again with reference to the USA, Samolyk (1994) found those areas in which banks show better balance sheet indicators are also those where growth rates are higher. This result is even more clearly confirmed for the Italian economy. Lucchetti, Papi and Zazzaro (2001) constructed a measure of the inefficiency of regional banking systems based on the microeconomic cost inefficiency of individual banks, weighted for the respective share of bank branches in the region, and inserted this measure in a panel convergence regression. Even after considering several control variables (overall loan volume granted, presence of LBs, transport costs, human capital, efficiency of the local legal system and regional and temporal dummies), the authors found that the inefficiency of the local banking systems has a significant negative influence on regional GDP growth rates. Guiso, Sapienza and Zingales (2002) reached the same conclusion through a study on Italian provinces, where as an indicator of the degree of development of the local banking system they use the individuals' probability of obtaining credit in each area. From their analysis it emerges again that the degree of development of local banking systems is linked to higher growth rates of local economies, lower average firm sizes and higher probability for individuals to succeed in launching their own firms.

5. Conclusions: problems and proposals

The theoretical and empirical literature on banking integration surveyed above leads to no clear-cut conclusion. There is no reason to support either of the two main approaches examined above, to the exclusion of the other: neither the theory we labelled as 'optimistic', which relies on competition to select the most efficient banks, nor the theory we defined as 'pessimistic', which fears the risks of integration

governed by large banking institutions unable to adapt to the specific needs of peripheral areas.

There are three levels of proposals that may be advanced to make the links between banks, regions and development more effective.

The first level is essentially methodological and concerns the need to adopt an eclectic approach to banking integration, open to identifying every possibility that allows both to improve the efficiency of banking structures and to enhance the different development potentials of local economies (Alessandrini 1996, Alessandrini and Zazzaro 1999). Two kinds of efficiency need to be considered. The first is 'operational-efficiency', which focuses attention on banks as firms operating on different financial markets in a regime of competition, and therefore oriented towards opting for more efficient organisational solutions and more profitable operative choices. The second is 'development-efficiency', which focuses on the regions as a set of local systems, differentiated in their economic and social configurations, where the banks contribute together with manifold other actors to determine their development. From this standpoint the bank assumes an institutional role as local development agent.

Our opinion is that both levels of efficiency should be taken into consideration for sound appraisal of banking consolidation processes and to select possible corrective interventions. Of course, in the more developed local systems a virtuous combination is created between banks and firms that allows the banks to achieve this two-fold efficiency. In backward regions it is more difficult to achieve such a winning combination, but it is at the same time more necessary. There is no point having efficient banks if they do not contribute to local development. It is essential to distinguish parasitic local banks, run with a *rentier* rationale, from those that take on the responsibility of keeping the market and local businesses buoyant, even in the most difficult situations and also to the detriment of the solidity of their own finances. For such banks, operational-inefficiency has an 'environmental' justification and the concept of development-efficiency must include the support given to the local economy, even when there are no evident spin-offs in terms of actual development.

The second level of our analysis focuses attention on the aim of accelerating development in backward areas so as to contribute to reducing gaps between regions. The present attitude is to make the less

developed credit markets more competitive, allowing the entry of outside banks through both branch liberalization and acquisitions of local banks. This is considered a necessary and sufficient condition to disrupt inefficient equilibria between banks, firms and local economy. However, it is fundamental to monitor and critically appraise what is done – how, where and to what effect.

First of all, it must be ascertained whether achievement of a greater operational scale for banks has actually increased competition in peripheral economies. The risk to be avoided is that monopolistic rent simply changes hands from the local bank to the acquiring outside bank. Moreover, it should be verified whether competition in credit allocation leads to the take-off and consolidation in less developed regions of a critical mass of solid, competitive firms, which are consequently more reliable and less risky. Experience shows that this is not automatic and that it is illusory to think that mergers and acquisitions provide tangible results in terms of both operational and development efficiency in the short term.²³ This does not mean that outside-owned banks should abandon efforts to allocate credit efficiently and cease to assess business and market risks. The responsibility for contributing to development where it is most needed requires adaptability to various local contexts – a capacity also necessary to the large banks or large banking groups. Strategic importance should be given to the need to invest in peripheral regions, especially in qualified staff able to carry out in-depth examination allowing the more promising and innovative firms and entrepreneurs to be selected. Such investments are far-reaching in terms of social consensus and regional rootedness and pay dividends in terms of profitability, albeit in a medium-long time horizon.²⁴

²³ Similar concerns emerge in relation to the impact on less developed peripheral regions of the rationalisation of management functions and operative techniques to achieve the benefits of economies of scale. Firstly, the concentration of management functions causes not only a reduction in the decisional autonomy of local banking structures, but also a shift of highly-skilled professionals from the periphery towards the bank's headquarters. Secondly, standardisation of the evaluation techniques for creditworthiness leads to uniform criteria being adopted in profoundly different realities. The effect achieved is the opposite of what would be required: in less developed regions credit for firms becomes a more costly resource and is more difficult to obtain, as has been found up till now in Southern Italy (Busetta and Sacco 2001, Giannola 2002).

²⁴ From this point of view, it is precisely the large intermediation structures that would benefit, if they so wished, as they manage to operate in several areas and could

The obvious difficulty encountered when tackling the issue from the normative standpoint is that, while in the case of operational-efficiency we are in the traditional field of policies to improve market and business efficiency, in the case of development-efficiency its defining characteristics represent typical externalities.

As is the case for all externalities, they can be corrected only by changing the objective function of the actors generating them (that is, through public ownership) or by creating conditions whereby they generate monetary effects on such actors (that is, through explicit or implicit taxes or subsidies, regulations, redefinition of property rights). As also in the case of policies in favour of investments and new industrial sites, we thus need to identify suitable incentives to encourage the local establishment and development of banks in certain disadvantaged regions and direct towards them credit flows additional to those that the market forces would spontaneously produce. However, in the case of banks, current policy trends in all the industrialised countries have actually rejected both solutions and taken a diametrically opposed path, setting their sights on privatisation and prudential regulation to guarantee both the efficiency and stability of the banking sector. In particular, the model of prudential regulation relies on stringent asset requirements that take no account of development-efficiency but, rather, encourage less risky commitments with immediate profitability. This not only fails to help internalise the externalities of 'creating development', but also makes it more costly to operate in backward regions.

Without necessarily introducing explicit ways of improving development-efficiency, the bank supervision authorities could still resort to their action of moral suasion, encouraging or discouraging individual aggregation operations.²⁵ On this point, once again in the

thus afford a long wait for positive results on investments in areas to be developed, as they can count on a current flow of profits obtained in more developed areas.

²⁵ This has already occurred in the past. For example, in Italy, after the Second World War, the Banca d'Italia under the direction of Donato Menichella strongly supported the local banking system in the knowledge that it would have been hard for an acephalous banking system to favour the autonomous, self-propelling development of peripheral areas. Moreover, it is currently occurring in the case of *cross border* consolidation operations. Here there has been a certain schizophrenia in appraisal on the part of many observers who, while considering the maintenance of a national banking industry fundamental, consider the maintenance of a system of local banks for developing regions much less important.

comments and current choices of policy makers, there seems to be an unjustified asymmetry of opinion. On the one hand, there is repeated talk about industrial development from the bottom up and of local development policies as the only course to be pursued to redress regional disequilibria while, on the other hand, there has been an attitude of 'benign neglect' *vis-à-vis* the disappearance of autonomous local banks, which is considered an inevitable toll to pay for market efficiency and economic growth.

Such considerations bring us to the third level of our proposals, which concerns the selective reinforcement of local banks. They should not be considered solely as passive actors, fated inexorably to disappear under the blows of global competition. While it is desirable that parasitic, inefficient local banks be absorbed by other banks, the case of the more responsible and active local banks is different. They have accumulated a capital of knowledge and skills directly rooted to the local economy that should not be lost. These banks must be able to improve their operational-efficiency, but not at the expense of their deep-rooted development-efficiency. Moreover, we know all too well that, especially when there are weak bank owners, the sale of local banks is often dictated not so much by the pursuit of questionable economies of scale as by the acquisition of private advantages for local management (Bliss and Rosen 2001). The managements of local banks are often far more attracted by the flattering prospect of entering the gilded halls of finance than by painstaking development governed from within.

The question must be seriously posed as to whether the progressive loss of autonomy of the more responsible local banks in the less developed regions corresponds to an effective development policy. Their finances could reflect the weakness of the economy to which they have lent their support but not the set of knowledge and expertise accumulated within their region,²⁶ which should be capitalised and relied upon as agents of local development. We should not underestimate the strategic importance of encouraging some of these banks to remain independent and grow from within. Where this is possible, concrete foundations are laid to reduce lags in development.

In the presence of a strong, competitive local bank, there would be greater guarantees of local credit markets being less conditioned by

²⁶ Also in their case we may speak of "little giants", quoting the expression used by Padoa-Schioppa (1994).

the strategies of outside-owned banks, which in turn would be induced to compete on specific local objectives.²⁷ The benefits are not limited to competition, but extend to the social impact that training and the settling in of a local managing class may have. This feature is not given the importance that it deserves – an importance that should be recognised within the context of successful interactions between investment in training, quality of human capital and qualified professional functions, which underpin endogenous development in an area and also apply to the banking system. This must be the aim of policies. Otherwise, the vicious circle checking development and widening regional gaps cannot be broken.

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²⁷ While attempts have been made to evaluate the effects that the entry of new outside banks has had on local bank efficiency (Evanoff and Örs 2002), to our knowledge no contribution has sought to measure the effects that the presence of efficient local banks has on the behaviour of outside banks.

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