

**Perspectives of macrofinance regulation of banking consolidations
in the context of the international reform of banking regulation**

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Abstract

Mergers and acquisitions (M&A) in the banking industry pose serious threat to post-crisis recovery amid the increasing interconnectedness of credit institutions. Yet M&A remain one of the least manageable contributors to minimization of systemic risk, should post-M&A process run short of objectives and synergy. Financial markets externalities and adverse scenarios of macro-level dynamics put additional challenges to post-M&A alignment, while shortage of macroprudential policy tools fails to empower regulators in designing a roadmap towards minimization of systemic risks built in the M&A processes. Guided by ultimate objective of global regulatory reform (Basel III) we pioneer a principally new idea extending risk-centered regulation over M&A specifics aiming at integrity of banking consolidations that is highly relevant and material for financial stability. We also propose a single conceptual platform of M&A-related rulebook as well as an M&A risk matrix that would further shape the mechanism of systemic risk alarmism.

The issue of banking regulation may appear quite irksome and even daunting amid tightening regime of the post-crisis regulatory paradigm and the increasing global financial interconnectedness. Yet there is a regulation-free area that, however, links regulated environments. This regulatory gap may wipe out corporate value, destroy industry dynamics, and destabilize markets. What is meant here is about M&A deals in the banking sector.

On the other hand, the banking industry critically depends on macroeconomic dynamics. To survive in an uncertain and volatile environment and to maintain competitive advantage, banks have nothing but to strategize efficient performance and higher productivity by applying a mechanism of M&A. However, macroeconomic instability and market imperfection exacerbate risk of post-M&A value deficiency through to non-accomplishment of the M&A deals. According to field experts, M&A deals failure ranges between 60 to 80% (McCarthy and Dolfsma, 2013, p. 2; Lewis and McKone, 2016). In turn, highly interconnected and fragmented global financial markets put additional challenges to national and global consolidation movements due to ripple and contagion effect for the banking industry, market, or economy at large implying that under certain circumstances

M&A may run beyond control and ruin all the efforts of all parties in the case of value-deficient post-M&A outcome. At the same time there is no noticeable evidence that perils of organizational consolidations discourage global M&A movement; rather, M&A waves that mostly coincide with economic upward appear to play a positive role and be driving force of the post-crisis recovery thus not only shaping financial markets optimism but also sparking systemic risks.

The odds of adverse selection of M&A targets and adverse scenarios of M&A processes bring to the forefront the issue of M&A-related risk management at both micro- and macro-levels aiming at minimize of the hostile macroeconomic externalities when designing M&A processes and tailoring their outcome. In fact, criticality of risk managerism in the M&A-making is oftentimes understated due to the lopsided focus on primarily micro-level aspects of the M&A transactions and excessive prioritization of quantitative post-M&A benefits in an as much shorter time horizon as possible. A number of qualitative aspects of the consolidation processes are simply undervalued or even ignored; however, their role in exacerbation of systemic risks and risk contagion can hardly be overestimated. After all, failing to balance the “trilemma” between value-drivers of quantitative and qualitative aspects and short-termism may ultimately erode fundamentals of the M&A process, especially in its integration phase.

Post-M&A value creation, or synergy, has always been at higher risk in the banking sector, partly owing to deregulation that was dominating the banking industry for more than 30 years up to the Great Recession. Now, in the framework of the sweeping overhaul of financial regulation, the existing regulatory gap contrasts with tougher prudential requirements imposed on pre- and post-M&A banks. Logically, new paradigm of banking regulation calls for the alignment of all areas organically linked to it. After all, synergy is one of the key indicators of successful deals and sustainable growth (Dzhagityan, 2014).

Bank consolidations are excessively sensitive to systemic and endogenous risks. Empirical studies found that M&A in the post-crisis period are mostly associated with rescuing banks from underperformance (Molyneux, Schaeck, and

Zhou, 2014), while banks' homogenous behavior during crises (Calmès and Théoret, 2014) is another indication of their sensitivity to macroeconomic shocks, let alone increased vulnerability of consolidation processes to exogenous and endogenous risks of lesser caliber. Moreover, the acquiring and target banks are differently affected by M&A (Du and Sim, 2016) notably those that have their homes in countries with different economic systems (Shirasu, 2018), while there is still poor awareness as to how and the extent to which M&A in the emerging economies are affected by current financial markets dynamics (Lebedev et al., 2015). In other words, the more bumpy and humpy the M&A deal, the less its ability to synergize value thus ensuring deal consistency and risk minimization and the more it is prone to the risk of failure (Dzhagityan, 2014).

Combination of adverse economic and behavioral¹ aspects may spark lasting adverse externalities for post-crisis recovery and severely downplay burgeoning market optimism. M&A fallouts in cross-border deals inhibit internationalization of regulatory reform and “encourage” regulatory arbitrage thus contaminating critical aspects of financial interconnectedness exposing them to crisis developments. Moreover, fragility of M&A is exacerbated by their opaqueness: Their details are still deficient to public. Needless to say that lack of transparency stretches limits of short-termism known for its pivotal role in igniting 2007–09 economic meltdown. To overcome multidimensional drawbacks and risks inherent to M&A deals, banking consolidations should receive multidisciplinary approach² that would treat the extent of interconnectedness of M&A-undergoing banks not only within their financial sector but beyond: This will not only expand our awareness about sources, diversity, and variety of systemic and idiosyncratic risks but also enhance objectivity, integrity, and accuracy of risk assessment together with how to maintain risk-free environment (or at least to the limits that would be free from any causal effects destroying M&A transactions and post-M&A value

¹ There is evidence of the souring environment of banking competition in the EU following the recent financial crisis (Apergis, Fafaliou, and Polemis, 2016).

² More about multidisciplinary approach in M&A and its implications for post-M&A integration and for meeting strategic objectives see: McCarthy and Dolfmsa, 2013.

creation). In fact, lack of understanding as to how systemic risks affect banking industry multiplies inability of regulators in securing stress-resilient, market-tolerant and growth-sustainable banks as a product of M&A deals.

Another matter of M&A-related concern is post-consolidation synergy that is critically important for both bank managers and bank owners and other stakeholders whose welfare depends on the extent of synergy generation. Nevertheless, extant academic literature demonstrates conflicting findings on measuring post-M&A synergy while scarcely illustrating how M&A-related risks could be mitigated using macroeconomic instruments. Lack of linkages between M&A deals in the banking industry and macro-level parameters and dynamics do contribute to exacerbation of systemic risk. This happens when bank size is relatively large compared to the size of the given national economy (Vallascas and Keasey, 2012). At the same time the issue of macroprudential regulation of the M&A processes appears in its weakest and most incomplete agenda, if not at all ignored or underconceptualized, among other critical aspects of the new regulatory paradigm. Some core M&A aspects like operating and financial synergy³⁾ and their contribution to post-M&A value creation as well as any relevant links to regulation and dependence on macroeconomic parameters are still missing their understanding and measurement thus preventing assessment of their contribution to systemic risk. Moreover, findings are short of unbiased and comprehensive consideration of the other factors that may put additional challenges to the post-M&A entity. This academic gap coupled with fragmentary and episodic research of the M&A-driven forces (Larsson and Finkelstein, 1999, pp.1, 3) triggers indetermination and misconception of risk-originated factors underlying M&A that are critical for post-crisis recovery and financial stability, although some experts conclude on no significant relationship between M&A and financial stability (Ijtsma, Spierdijk, and Shaffer, 2017). On the other side, dearth of relevant

³⁾ Post-M&A operating synergy is defined by the accounting-based performance measures and is expressed by profitability of the resulting institution that exceeds profitability of each of the pre-M&A institutions taken together. Post-M&A financial synergy is defined by market capitalization of the resulting institution that exceeds market capitalization of each of the pre-M&A institutions taken together.

theoretical basics and bases further diminish synthesis of various academic foci in the field (Haleblian et al., 2009) thus not only refraining their validity for organizational settings and banking industry regulators but also missing linkages with macroeconomic policy.

1. M&A and systemic risk

Despite the fact that banking industry dynamics is highly vulnerable to systemic risk while remaining its main source and contributor, this phenomenon has received scarce academic attention. Its significance for stakeholders is proved by high (20-30%) contribution to corporations' aggregate return (Chatterjee, Lubatkin, and Schoenecker, 1992, p.139; Demsetz and Strahan, 1997, p.301), deficiency of which may seriously weaken post-M&A integration process. Academic discussions in the field are ramified by proponents of related M&A (Palepu, 1985; Hoskisson et al., 1993) as the only platform for 'M&A-making' in the banking industry that can sustain systemic risk, and unrelated consolidations with their resilience to macroeconomic uncertainties (Chatterjee, 1986; Chatterjee and Wernerfelt, 1988). Other scholars doubt the capability of conglomerate corporations to minimize detrimental effect of systemic risk (Templeton and Severiens, 1992; Demsetz and Strahan, 1997).

All the discussions and findings above reflect interrelatedness between systemic risk and horizontal (homogenous) M&A. Regulatory liberalization before the global financial crisis raises criticality of conglomerate M&A for sustainable growth of the financial sector and their implication for financial stability. Supported by evidence from the unrelated M&A wave in the U.S. banking industry in the first decade of the 21st century, recent investigations into conglomerate banks capture more plausible results: unrelated M&A decrease systemic risk due to less erratic profit fluctuations and incongruous revenue cycles that are front line factors securing continuous liquidity, cost-efficiency, and competitiveness (Bösecke, 2009). Moreover, acquirers with heterogeneous operating models receive comparatively higher synergy than their peers from horizontal M&A (Ng,

2007). Among these findings one of the most interesting that supports the advantages of heterogeneous operating models is that banks' penetration to insurance sector reduces shareholders' risk through economies of scope contributing to lesser risky environment (Bajtelsmit and Ligon, 1996). While some academic studies hesitate about effective exposure to non-bank activities (Boyd, Graham, and Hewitt, 1993), there are conclusions that are further strengthened by specific methodology linking risk measurement to market-based, and not to accounting-based, indicators (Brewer, 1989). At the same time other observations substantiate reduction of total risk and enhanced performance ensuing conglomerate M&A (Obi and Emenogu, 2003) that corroborates other findings suggesting positive 'conglomerate M&A – risk reduction' linkage by evidence from 13 conglomerate deals, which manifested post-M&A returns 2.7 times higher of non-conglomerate M&A deals of S&P500 companies from 1965-1983 (Ravenscraft and Scherer, 1987).

However, many experts associate the Great Recession with regulatory liberalization that paved the way to (and even encouraged!) M&A between banks and non-bank financial institutions, which eased risk transmission among segments of financial sector. Their concern was ultimately materialized in some provisions of Dodd-Frank Act⁴ that has imposed certain restrictions on banks' conglomerate M&A. However, strategizing synergies generated from different financial market segments or different economic branches seems to remain as a strong platform in effective immobilization of systemic risks; in other words, conglomerate banks mitigate adverse effect of systemic risk through cross-border diversification and enhanced capability of resource redeployment (Amihud and Lev, 1981). However, that was the case of comparatively homogenous regimes of banking regulation across national jurisdictions. In today's volatile dynamics of the global financial markets scarcity of regulatory instruments overseeing inorganic growth of credit institutions may diminish the completeness of M&A deals thus discouraging M&A continuum, on the one hand, and becoming a source of systemic risk, on the other.

⁴ Also known as the Wall Street Reform and Consumer Protection Act of 2010.

While synchronization of M&A risks with M&A efficiencies seems to be a micro-level reality (Crane, 2011), systemic risk, its multiplication and transmission in financial markets remains the main threat to financial stability, while the main threat to the post-crisis regulatory paradigm is regulatory weakness and failure to assess the effect of systemic risk on behavior of financial sector actors and financial sector dynamics. Regulatory transformation has affected almost all aspects of policy and regulatory elements of prudential banking supervision (Dzhagityan, 2016a, 2016b). However, M&A in the banking industry still remains unaddressed despite higher vulnerability of consolidation process to systemic risk and despite increased contribution of consolidation process to systemic risk.

Criticality of regulatory focus on M&A processes is associated with higher interconnectedness and interdependence of global systemically important banks (G-SIBs) that are active participants of cross-border consolidations given that the post-M&A bank is subject to different regulatory regimes. This, in turn, may exacerbate systemic risks in the financial sector of the national jurisdiction with more stringent regulation regime compared with countries that have comparatively loose regulatory requirements. Another source of systemic risk comes from heterogeneity of operating models of either acquiring or target bank that taken together or on a stand-alone basis not only may provoke instability at national level but also may destabilize global financial markets.

Nevertheless, objectives of new regulatory paradigm in restoring banks' role as driving forces of sustainable economic growth and financial stability still remain inconsistent with underestimation of the their role, place, and importance as the key actors of economic modeling and as the key elements of macroeconomic models (Werner, 2016). Even central banks and banking industry regulators overlook banks' effect on macroeconomic dynamics thus actually invalidating own efforts over mitigation of systemic risks and minimization of the scope of risk contagion during economic uncertainty and crisis developments. Such a fallacy undermines the concept of contemporary banking regulation taking into consideration interconnectedness of G-SIBs and other systemically important

financial institutions (SIFIs) not only within the perimeter of financial system but with macroeconomic level as well. As a central point of Basel III such a fallacy may further destabilize economic environment by M&A thus rising concern over microeconomic dynamics. Lack of consistent, comprehensive, and comparative links between M&A in the banking industry and key parameters of the macro-level dynamics diminishes the validity of macro-finance area and aggravates usability of instruments of the macroprudential policy.

Rigor of prudential regulation urges banks to more cautiously strategize M&A-making. Among the main disincentive factors are miniaturization⁵ and clusterization⁶ of regulatory standards, on the one hand, and further restrictions of banking operations that are associated with higher risk (but still remaining more profitable), on the other hand. Lowering the probability of bank failures is an ultimate and apparent objective of the contemporary banking regulation; however, the issue of the costs related to the lack of post-M&A synergetic effect to M&A failures remains without supporting regulatory instruments (Llewellyn, 2013) that diminishes M&A resolution approaches, techniques, and toolkits.

Indeed, there remains little space of optimization of relationship between banks and their regulators and macro-finance hierarchy/management, and it seems that the “supervisory gap” in the M&A framework will mount the number of “white spots” in the integration phase, missing of which will most probably deplete the balance between post-M&A objectives and capabilities of credit institutions entered into M&A deals. Unless this regulatory gap is filled with rational determination to ensure close links between prudential standards and M&A-centered regulation, M&A in the banking sector will remain dependent on unforeseen circumstances of macro-level dynamics and uncertainty thus being one of the principal generators of systemic risk. Besides, unawareness of the links, relationships, and dependencies between specifics of the banking M&A and

⁵ Decomposition/atomization of regulatory standards/components attributable to particular aspects of banking regulation and applicable to prudential banking supervision.

⁶ For example, groups of related standards of capital adequacy, liquidity, recommendations on corporate governance, etc.

financial stability may soon become one of the key obstacles of M&A thus remaining one of the key factors of “glocalization” of banking regulation that puts additional barriers to the promising perspectives of regulatory globalization.

2. M&A and macroprudential policy & regulation

It is quite obvious that systemic risk emanating from volatility of the M&A processes in the banking industry could not be mitigated using traditional approaches to the M&A deals, including instruments of prudential banking regulation. The matter is that due to the complex economics of the post-M&A realm, measurement of M&A processes should be subject not only to micro-level-related parameters but also to macro-level dynamics. Moreover, M&A involving SIFIs and G-SIBs are much more vulnerable to financial markets volatility and external shocks thus causing the risk of “domino effect” in the banking industry and triggering instability to the national economy.

However, linkages between M&A processes and macro-level parameters and their dynamics could first be tested applying macroprudential policy tools. Although this regulatory area is the least explored in terms of validity and soundness of its instruments, it is emerging as a comparatively reliable linkage between banking sector and macro-level, which underlies measurement of risks of individual banks’ insolvency as well as of whether the banking industry is sound and stress resilient enough to secure financial stability for the observable time horizon.

It is difficult to assess the capability and efficiency of macroprudential instruments due to short haul elapsed since their introduction into regulatory practice; however, certain findings confirm strong linkages between the power of macroprudential tools and bank risk-taking (Altunbas, Binici, and Gambacorta, 2018). The same reason is attributable to the lack of empirical models underlying not only M&A strategies but also the robustness of macroprudential concept at large. This raises the following questions: The extent to which functionality of the macroprudential policy and functionalization of its instruments will meet the

objectives of traditional banking regulation? Whether macroprudential methodology, tools and techniques are able to contribute to post-M&A synergy and to comprehend the objectives of post-M&A integration? How to unwrap “trilemma” involving M&A parameters and goals, macroprudential regulation, and financial stability?

The above questions suggest that “macroprudentialism” in the M&A deal-making is feasible but not sufficient in developing a roadmap towards minimization of systemic risks built in the M&A processes. Consolidations in the banking industry require more focused, even “customized” and an ad hoc regulatory concept/model that would accommodate higher robustness for M&A processes and stress resilience for post-M&A credit institutions. In other words, M&A require not only macroprudential focus but also another sort of macro-finance regulation that would help sailing M&A deals through multidimensional structure of the banking industry and uncertain dynamics of the global financial markets. Technology of M&A regulation should be based on principally new philosophy and instruments that would most effectively and efficiently adapt post-M&A banks to external shocks and challenges in order that M&A as an instrument of inorganic growth would also become a tool of equilibrium in the banking sector amid inconsistencies at macro-level. In these circumstances, macroprudential regulation seems to play mostly auxiliary role in maintaining M&A consistency through supporting their adaptation to macroeconomic cycles and through preventing their possible spillover effect over the banking sector and the economy at large. This role could be realized through:

- mitigation of systemic risks in financial sector and decrease of volatility in financial markets thus lowering risks of economic downturn and market pessimism, and
- identification and further conceptualization of risks and exposure to risks at economic hierarchies and financial market segments thus minimizing risk multiplication and transmission while ensuring sustainability of performance and sustainable growth of economic agents.

However, diligent objectives of macroprudential regulation do not mean credibility of application of the macroprudential policy tools to the most complex environment of consolidation processes. Arguments in favor of its validity should be based on recognized instrumentation and models delving into the validity of its measurement techniques and shedding light on the effects of financial and non-financial cycles on current and perspective dynamics of financial markets and consequently the behavior of economic agents. But along with that macroprudential policy is emanating from the task of sustainability of the banking sector and individual banks including those that are product of M&A, but not M&A itself. In other words, macroprudential regulation is applied to the known areas of traditional, microprudential banking regulation, leaving the gap between pre-M&A and post-M&A banks open.

Besides, it is still questionable the political economy of macroprudential regulation. Delegation of macroprudential policy making to central banks conflicts with independency of banking regulation. Institutionalization of macroprudential functions should not be predicated upon its close linkages with monetary policy, nor should it be determined by the objectives of financial stability implying its incorporation into the assigned authority of banking regulation. Unless institutional aspect of macroprudential regulation will not receive pragmatic solution, the limits of systemic risk will remain beyond accurate and unbiased assessment. As such, presently macroprudential concept of M&A is devoid of sound economic and institutional concept and therefore could not be adequately empowered in isolation from the specifics of M&A processes.

3. M&A regulation as an impending reality

Weaknesses in addressing systemic risk coupled with deficiency in understanding as to how the instruments of macroprudential regulation could become a reliable measure of consistency, completeness, and integrity of the M&A processes signify inevitability of imperfect markets if consolidations will not be supervised by independent regulatory authority. Interconnectedness of M&A

outcome with banking sector dynamics and the economy at large is increasingly, and even alarmingly, demanding the development of frontline elements that would structure M&A deals in a way to maximize synergy and simultaneously contain the contagion effect of M&A inconsistencies which may further deteriorate essential metrics of macro-level.

To avoid the odds of larger-scale disruptions during implementation and post-M&A integration (PMI), M&A need new model of governance based on its macro-regulation (macro-finance regulation) covering the distance from deal's launch till its finalization measured by completeness of PMI. Extreme circumstances need extreme, finer-tuned and tailored measures. M&A regulation (or simply, **mergulation** that is an acronym from the words “merger” and “regulation”) should be powered up by a designated regulatory institution in the form of federally/centrally/globally mandated, not-for-profit, and member-funded body/authority (Dzhagityan, 2014). Despite whether the regulatory authority is national or global, M&A regulatory rules and standards should be based on a single conceptual platform as a benchmark for all financial regulatory authorities in the framework of a separate rulebook (for example, Basel III,5 or as an integral part of Basel IV). The global governance of mergulation is urged by the fact that even national-level banks have linkages to global financial markets, while its active role in financial intermediation and interconnectedness will require mergulation of financial consolidations.

While it's too early to discuss conceptual framework of mergulation, it should definitely be risk alarmism-centered and risk management focused while supported by advanced tools and techniques for transition modeling including the advanced tools of macroprudential regulation (for example, stress-testing), comprehensive synergy assessment during PMI, control of sidewind spillover effects, matrix linkage between transition regulation and traditional regulation, just to specify a few. Like deposit insurance authority is responsible for deposited money safety, this authority's mission will be M&A safety through its “implementability” (as opposite to that of external consultants and auditors whose

responsibility is short cut by advising the deal and not by the deal's outcome). By addressing M&A's multiple aspects, mergulation will naturally administer more rigorous information disclosure requirements.

To fill up the regulatory gap between pre- and post-M&A banks requires model with heterogeneous variables which would address exogenous and endogenous M&A-related risk factors. Given that M&A processes in the banking sector depend on multiple economic aspects and dynamics, these variables could be grouped by core concept areas that contribute to shaping M&A deals and post-M&A landscape, covering the deal from initiation to completion to integration. Maximization of M&A-driven factors and their inclusion into the model will, to our strong belief, help understand as to whether mergulation could become the next macroprudential instrument ensuring M&A deals safety and how its credibility would embed the existing system of macroprudential tools, which tailor the roadmap towards financial stability.

Nevertheless, mergulation should not be mystified as a panacea from all the M&A headaches. Nor anybody should expect from it any instantaneous effect in both excelling during M&A-making and for ensuring financial stability. Rather, it may become a straightjacket for ambitious yet shortsighted dealmakers. The safety-net for mergulation is justified by level playing field in risk-taking (single risk-approaching methodology for all M&A deals complemented by specific, customized risk-sharing mechanism). The leveling will accommodate risk exposure to the limits of traditional and macroprudential regulation and as such, will minimize risk of PMI inconsistency and non-compliance. Furthermore, mergulation could make it possible to quantify systemic risks and to compose risk matrix that would facilitate unwrapping other, hidden nuances of risks. By comprehending risk issue mergulation will help alleviate PMI flaws and keep them at more or less acceptable level, as M&A will be more secured from managerial misperception and awkwardness. And last but not least, mergulation will ensure equal access for all banks to professional expertise and focused guidance during the deal. In fact, this one-size-fits-all approach will benefit smaller banks by

escaping them from paying big cheques of the external consultants of higher caliber (Dzhagityan, 2014).

Smooth run of M&A is one of the pillars of systemic risk alarmism and financial stability. Therefore, mergulation could become its risk management platform thus keeping M&A engines fuelled and functional till deal's accomplishment. Although M&A drawbacks ensued from tacit factors are virtually inevitable, with mergulation the extent of setbacks are expected to be less dramatic, M&A implementation – less erratic, and results – more pragmatic. It is believed that the effect of mergulation on M&A-making will be commensurate with that of micro- and macroprudential regulation in its significance in polishing resilience of the banks and policing positivism in the global financial arena.

This article is a first ever attempt to conceptualize regulation of the M&A deals in the banking industry. We tried to find valid approaches to why banking M&A should be regulated and what if organizational consolidations will remain unaddressed amid tightening regime of post-crisis regulatory paradigm along with challenging issues of interconnectedness of G-SIBs and SIFIs and their effect on the processes of financial globalization. Our further research will be centered around searching for the valid tools and techniques enabling to roadmap linkages between regulators and M&A processes, on the one hand, and between micro-level key performance indicators and macro-level parameters and dynamics, on the other hand.

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