

## RESEARCH BRIEF

# Are Bigger Banks Better? Firm-Level Evidence from Germany

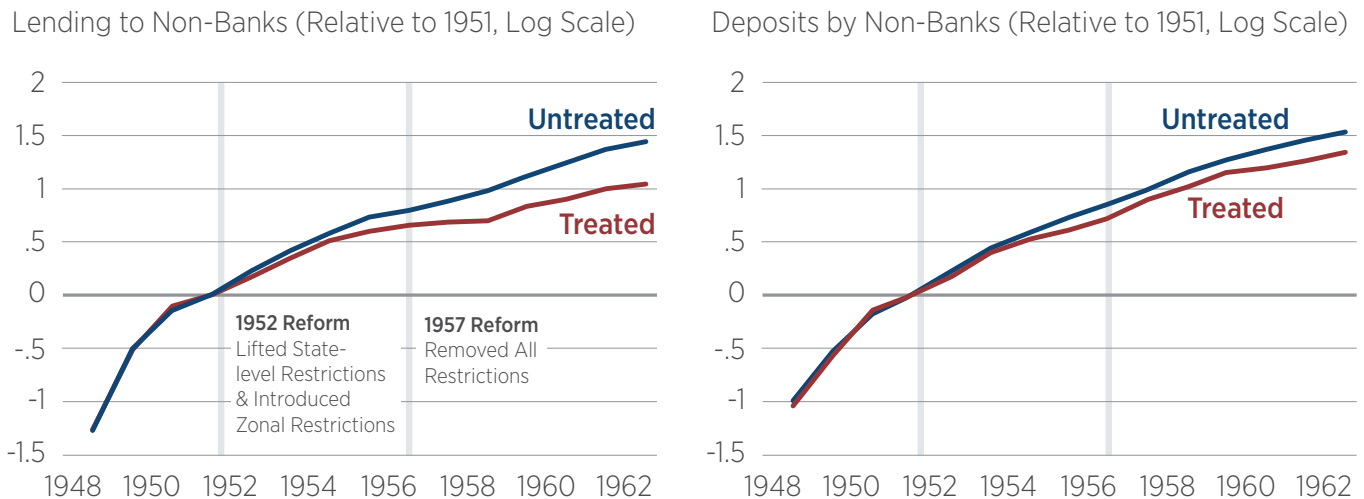
Based on BFI Working Paper No. 2020-172, [\*“Are Bigger Banks Better? Firm-Level Evidence from Germany,”\*](#) by Kilian Huber, Assistant Professor of Economics, Chicago Booth

### KEY TAKEAWAYS

- ✓ Scrutiny of large firms is on the rise, especially among high-tech firms.
- ✓ However, attention should also be paid to the continuing growth of very large banks.
- ✓ The impact of large banks has long been debated, with scale efficiencies weighed against systemic effects.
- ✓ This research reveals that bank size do not always deliver positive results and can actually lead to harm for some firms.

Politicians, policymakers, and consumer groups in the United States and Europe have recently turned their attention to the increasing size of large tech companies and the market share that those firms capture. While attention is focused on tech giants, another industry is experiencing a similar phenomenon: large banks keep getting bigger. Despite the supposed systemic risk that such institutions pose, large banks continue to grow in size and influence. Despite dispensing bailouts and other rescue measures during episodic financial crises in recent decades, government agencies continue to allow—and in some cases encourage—such growth.

**Figure 1 • Lending to Non-Banks and Deposits from Non-Banks**



Notes: The data are in real terms, for the December of the given year, and provided by the Deutsche Bundesbank. The treated group includes banks affected by the breakup and subsequent reforms. The untreated group includes all untreated commercial banks.

Are these large banks good? On the one hand, size implies efficiencies of scale and an improvement in the delivery of financial services, which benefits the economy. On the other hand, size may encourage risky behavior that not only threatens an individual bank's safety, but given the interconnected nature of large financial institutions, can put the entire financial system at risk.

In "Are Bigger Banks Better? Firm-Level Evidence from Germany," Kilian Huber addresses these and other issues—including the important consideration of the impact of bank size on borrower performance—that have challenged researchers for years. Huber analyzes a rare period in postwar Germany when banking reforms determined when certain state-level banks were allowed to consolidate into national banks. His findings cast doubt on the efficacy of large banks and offer important insights for policymakers and regulators charged with monitoring bank size.

### An Unnatural Experiment

Banks do not grow randomly. For example, a bank might strategically consolidate with another bank if it expects the borrowers of

the other bank to grow faster in the future. In such cases, one would observe a positive correlation between bank size and the growth of borrowers even if bank size has no causal effect on borrowers. Such phenomena proved empirically challenging for this research, but two features of the postwar German banking system aided Huber in his analysis. The first feature is the reliance of German firms on relationship banking. Due to asymmetric information, bank-borrower relationships were sticky, meaning that shocks to a given bank affected the cost of banking services for its relationship borrowers.

The second feature is the banking policy of the Allied occupiers in postwar Germany. The Allies believed that three banks with nationwide branch networks (Commerzbank, Deutsche Bank, and Dresdner Bank, which constitute this paper's treatment group) had contributed to the Nazi war effort. In other words, according to Allied occupiers, big banks were definitely bad. In 1947/48, the Allies broke up the treated banks into 30 independent state-level organizations and prohibited the new banks from branching outside state borders.

A first reform in 1952 permitted some of the state-level banks to consolidate with other state-level banks within three banking zones. This meant that the 30 state-level banks merged to become nine treated institutions, one for each former national bank in each banking zone. A second reform in 1957 permitted the reconsolidation of the three original, national banks. Hence, borrowers with a treated relationship bank experienced sharp increases in the size of their relationship banks in 1952 and 1957.

Under these reforms, increases in bank size had nothing to do with the performance of banks and their borrowers. Rather, bank size was wholly decided by outside, non-market, forces (in this case, a key driver was the improving relationship between the Allies and Germany in the wake of the Cold War). How did these managed consolidations affect bank operations? Huber's historical analysis revealed the following: The consolidations increased diversification, organizational complexity, and hierarchical decision-making; they enabled the banks to use internal capital markets and to spread out fixed costs; and they reduced the need for loan syndicates.

Banks are typically considered large, or systemically important, if their assets exceed roughly 1 to 2 percent of GDP, which no German banks attained during the breakup. However, after reconsolidation in 1957, the assets of each treated bank exceeded 1 percent of GDP. Hence, the repeal of the Allied legislation transformed the treated banks from 30 state-level lenders into three banks of systemic importance.

Before describing Huber's findings, it is worth noting one important contribution of this research: This paper presents the first digital micro-dataset on firms in postwar Germany. The data were hand-digitized from historical firm records and cover the postwar period until 1970. This data trove—which includes

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All told, Huber was able to estimate how changes in bank size causally affected firms in the real economy, and his findings were clear:

- There was no evidence that increases in bank size raised the growth of borrowers.
- Firms and municipalities with higher exposure to the consolidating banks did not grow faster after their banks consolidated.
- Small, young, and low-collateral borrowers of the banks actually experienced lower employment growth after the consolidations.
- Further, the consolidating banks themselves did not increase lending, profits, or cost efficiency, relative to comparable other banks.

These findings reveal that increases in bank size do not always generate improvements in the performance of banks and their borrowers; on the contrary, such growth in bank size might even harm some firms. In some instances, bigger banks might benefit real growth, for instance because they can use more advanced information technology. In general, however, there is no stable relationship that generates benefits for the real economy when banks consolidate or grow large.

## Conclusion

For policymakers, the impact of bigger banks remains a complex question that not only depends on whether a large bank operates efficiently, but on the net impact of other mechanisms, including the benefits and costs for borrowing firms. Huber's analysis reveals that beneficial mechanisms are not always powerful enough to outweigh harmful effects. Indeed, Huber finds no evidence that increased bank size improved the growth rate of borrowers.

To the point: Firms and municipalities with higher exposure to the consolidating banks did not grow faster after their banks consolidated; small, young, low-collateral borrowers actually experienced lower employment growth after the consolidations; and the consolidating banks themselves did not increase lending, profits, or cost efficiency, relative to comparable banks.

## CLOSING TAKEAWAY

These findings reveal that increases in bank size do not always generate improvements in the performance of banks and their borrowers; on the contrary, such growth in bank size might even harm some firms.

These results show that increases in bank size do not always generate improvements in the performance of banks and their borrowers, and might even harm some firms. Ultimately, the impact of large banks is a complex question that depends on the net impact of several mechanisms, some of which are beneficial and others that are harmful to borrower growth. As revealed in this research, the beneficial mechanisms are not always powerful enough to outweigh the harmful effects.

### READ THE WORKING PAPER

NO. 2020-172 · OCTOBER 2020

#### **Are Bigger Banks Better? Firm-Level Evidence from Germany**

[bfi.uchicago.edu/working-paper/2020172](https://bfi.uchicago.edu/working-paper/2020172)

### ABOUT OUR SCHOLAR



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