MOTIVES AND REASONS OF THE BANK MERGERS IN THE EU

Marek Badík
Silesian University in Opava
School of Business Administration
Univerzitní namesti 1934/3
733 40 Karvina
Czech Republic
e-mail: marekbadik@yahoo.co.uk
telephone: +00420 775128112

Abstract
Over recent years the European banking sector has experienced a rapid process of mergers and acquisitions (M&As). This paper provides an overview about motives, reasons and triggers of bank M&As in the EU banking industry during the past years. This study answers the following questions. Why do bank M&As occur? What is driving the recent merger wave? What factors lead management to adopt a decision to merge bank or acquire another bank? Is takeover activity connected with the developments in capital markets? Are there any specific characteristics of bank M&As in the ten new European Union countries? The paper is divided into three parts; the first part discusses the firm level motives, which are often cited as main drivers for M&As. The second part assesses external factors particularly; deregulation, technological advances and globalization that created pressures for change in the banking industry and might explain the recent pace of M&A activities. The last part describes the recent development in the new EU member countries.

Keywords: mergers, acquisitions, banking sector, European Union

JEL codes : G34

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1. Introduction

Mergers and Acquisitions (M&As) have become the driving force of the world economy and have played a significant role in the strategy of many banks in the last decade. Since 1990s, the European banking industry has experienced an unprecedented level of merger activity that has considerably influenced the sector’s structure. Therefore it is unsurprising that during the second half of the last decade, the most frequent words used in reports on banking were ‘merger’ and ‘acquisition’. Consolidation and integration have had a significant impact on the structure of the EU banking system and the concentration levels have been rising. It seems that consolidation is more advanced in the wholesale than in the retail sector, however, the recent increase in EU cross-border M&As has increasingly involved retail banks. At the end of 2005, there were 6,308 credit institutions in the EU, which is a decrease of 10.9% since 2001.

Table 1 Number of credits institution

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Source: ECB(2006)

It is known that M&As come in waves. According to Martychova and Renenbourg (2005) the current takeover wave started in mid 2003 as a result of the gradual recovery of economic and financial markets after the downturn that had begun in 2000. Although this merger wave has not finished and it is too early to draw conclusions on the triggers and driving forces, some trends and typical characteristics can be found. Martychova and Renenbourg (2005) argue that the next important factor of the increase in takeover activity is due to the transactions that were delayed due to the downturn of financial markets and the increased anxiety caused by the World Trade Centre terrorist attacks of 2001. The current growth in M&As is also very significantly spurred by cash-rich firms seeking opportunities to expand into new markets. Most bank mergers in the EU take place within a single country and cross-border mergers were exceptional, as acquisitions made by third country banks from outside the EU were particularly rare. However, the current trends in the global economy and deregulation in the EU banking sector have increased cross-border deals in the EU countries (see appendix 1).

\[2\] Sobek (2000)
This paper provides insights into the motives, reasons and triggers for M&As activity in the previous years. It is organized as follows: the first section describes the bank level theoretical motives and reasons for M&As. In the second section I investigate the external causes of merger activity observed by banking and financial professionals. The final section reviews the main determinants of takeover activity in CEE countries.

2. Reasons and Motives for Bank M&As in the EU countries

Considerable research in the area of M&As shows that the reasons for mergers are varied; therefore, studies typically do not find just one motive but several motives and reasons for mergers. The reasons and motives for M&As can be divided into two groups; the first set of motives includes firm level motives. Besides these motives and reasons which are aimed specifically at the maximization of the value of the acquiring firm, there are also the external factors such as; globalization, deregulation, technological progress, introduction of Euro to name a few, that significantly affected the structure of the banking sector, creating pressures for change in the banking industry, which might explain the recent pace of M&As activities.

Figure 1 Motives and Factors for M&As

Source: Pasourias at al. (2005)
**Firm level motives**

Generally, the underlying motives and reasons which lead managers to merge with or take over another firm can be classified as *value maximization* motives with the aim of increasing the value of the acquiring firm, which includes synergy (economic) motives and *non-value maximization* motives which arises in situations where there is separation of ownership and control between shareholders and management, and involves both agency (managerial) and hubris motives.

2.1.1 Synergy motives

Synergy is the most often cited motive for the decision to merge with another company according to many theorists. Synergy means that the combined entity is not just one larger company but two companies complementing each other, creating benefits that add to the value of the new organization. It is generally expressed in the form $1 + 1 = 3$.

According to efficiency theory, the gains through synergy are the main reason for M&As (Trautwein, 1990). The efficiency theory distinguishes three types of synergy, *operational*, *managerial* and *financial*. According to Sudarnam (1996), operational synergies, for example economies of scale and scope, can be achieved by combining activities, products and markets of the merging firms. Managerial synergies exist in circumstances where the bidder’s firm possesses superior planning and monitoring abilities (Trautwein, 1990). Therefore, there are some mergers which are motivated by the acquired firm’s management being replaced due to their inefficiency and a belief that the acquiring firm’s management can utilize the target’s resources better. According to Pasiouras at al. (2005) financial synergies are realized if the cost of capital of the merged entity is lower than that of the individual companies. Other important sources of financial synergy are tax advantages which may arise from either the merged company benefiting from tax laws or by using the net operating losses to cover revenue. If a profitable bank takes over or merges with a bank with net operating losses, it might use the losses from recent years to reduce the amount of tax they are liable for in the current year.

As stated above, a very important source of synergy is in creating economies of scale: the opportunity to produce a larger volume of output with lower costs per unit. The economies
of scale are most common in horizontal mergers (the merging firms operate in the same sector). There are many different ways of sharing and decreasing the expenses of a merged company. Cost savings involve; closing redundant branches, consolidating information systems and back offices, processing cheques, payments and card transactions, marketing and management sharing, production and distribution sharing, or the reduction of general and administration expenses.

The second most quoted motive for M&As in the financial sector according to Amel et al (2004) are economies of scope, which refer to the reduction of costs per unit through the production of a wider variety of goods or services. There are many ways that banks can achieve economies of scope and offer a greater array of products. Cross selling is regarded as a source of competitive advantage to an existing business and synergies. For example, a smaller bank can offer products already carried by a larger bank that could not be previously offered due to the smaller bank’s size. Therefore, such a merger allows the combined institution to offer a greater product range, increasing sales and in consequence the gross revenue. Bancassurance deals, between banks and insurance companies, are also motivated by the particular desire to cross sell different products to customers. There are significant benefits of combining banking and life insurance because banks have short-term liabilities and long-term assets whilst insurance institutions have the opposite. Another motivation for the creation of bancassurance groups is the optimization of the different distribution networks of the companies’ products. For example banks have a wide range of branches that insurance products can be sold within.

The next important factor which has boosted merger activity is risk diversification, which is the broadening of current product portfolios with the product ranges of unrelated businesses, which is easily facilitated by merging across industries (Sudarsanam et al, 1995, cited by Larsson and Wallenberg, 2002). The main argument here is that integration of two firms can bring lower risk and reduce the probability of bank failure, if the firms´ cash flow is not perfectly correlated (Pasiouras at al., 2001) Diversification can be divided into geographic and product diversification. The product diversification is a result of a changing environment in the form of increased competition and concentration. Banks have reacted to these changes by using proactive strategies with the aim of offering a wider range of bank services, for example non-income products. M&As have become very convenient means for product diversification. Banks find it easier to acquire an existing bank with a wide branch
network and large range of products than to develop new products and build their own network. It is more relevant for retail and SME banking.

Many banks are motivated to take over or merge with another bank due to requirements of financial regulators that require commercial banks to sustain minimum capital adequacy. Therefore, many banks either justify their mergers by stating that the resulting combined asset base would be larger and would enable the new institution to make loans that the companies would not have been previously able to offer, due to capital base lending regulatory restrictions. As a result, the achieved larger capital base allows the merged institution to offer new products, mainly loans, to existing customers or to attract additional customers through the new product offering.

While the motives stated above were relevant to domestic takeovers, cross-border M&As are largely motivated by the desire of banks to geographically diversify their risk or by a strategic choice to enter new markets in search of profit opportunities. Geographic diversification, meaning the spread of banking activities into new geographical areas, enables the acquiring bank to decrease its risk, and to increase its market power and profits in the long term. Another often cited reason in the development of cross-border M&As is the desire to overcome limited growth opportunities in local markets, particularly when domestic markets are mature or demonstrate a high degree of concentration.

2.1.2 Non-value maximization motives

The empirical evidence of merger success rates points to the fact that many mergers and acquisitions do not achieve their goals. The agency view assumes that instead of maximizing shareholders wealth, managers maximize their own wealth. Managers want to maximize their personal benefits such as compensation, power, wages and prestige. These benefits are often positively related to the larger company size and the growth rate of sales that can result from mergers. The hubris hypothesis, proposed by Roll (1986), suggests that managers incur errors of overestimating the value of target firms. Consequently they can engage in mergers when there are no synergies. The hubris hypothesis must not always mean that managers act against owners’ interests. However, when the interest of the managers is prioritized the acquisition might fail and even cause wealth losses for the shareholders. Besides long term benefits which have been discussed previously and are the drivers behind
many M&As, there are also some M&As that can be motivated by speculation. A perceived disequilibrium of a company’s securities prices (company is not correctly valued by the market), can make it financially advantageous for a company to acquire another. Shleifer and Vishny (2003) argue that M&A activity occurs due to agency conflicts when financial markets are bullish. The bull markets lead to the overvaluation of equities and acquisitions can be made by overvalued acquirers of relatively less overvalued targets.

2.2 External factors

Deregulation and liberalization of financial services, accompanied by technological advances, has changed the banking environment significantly. Regulatory provisions have been harmonized to reduce cross-border trade barriers and deregulate the domestic market. The process of financial liberalization and deregulation increased the overall level of competition in financial services. The most influential act for banks was the introduction of the Second Banking Co-ordination Directive, which provided “a passport” to offer services across the European Union. It enables banks to offer cross-border services or establish branches without further authorization, providing that the bank is already authorized to sell these kinds of services in its home state. The Second Banking Directive was specifically aimed at removing the obstacles for foreign entry into markets. The motivation was that the removal of regulatory barriers would lead to the integration of banking markets, enhancing efficiency and promoting competition. Therefore, these positive changes resulted in an increase in the number of cross-border M&As deals.

M&A activity is significantly driven by industrial and technological developments, especially the decreased computing costs and progress in telecommunication services. Technology, which is regarded as a catalyst of the recent wave in the EU banking sector, shaped the structure of the financial industry by decreasing the cost of collecting, processing and using information. Globalization has been characterized as a by-product of technology and deregulation. The challenges and benefits of globalization have increased the numbers of cross-border mergers and acquisitions which have become a key to achieving high performance of banks. The creation of the single currency has been a very important factor in the EU banking sector. Since the introduction of the Euro, it has increased the need for more European bank mergers to gain competitive advantages over other banks and cross-border activity has become more attractive. This merger boom has been supported by the integration
of the euro-area's financial markets. The fair economic environment has had a positive impact on M&A activities in recent years. In general, M&As occur in periods of economic recovery following a market crash, long term economic recession or economic depression caused by war or energy crisis. The current economic environment in the EU is characterized by stable economic growth, thus, has a positive effect on a bank’s decision to consolidate. M&As are also positively correlated with stock market prices which have been bullish in recent years. It is obvious that the increase of M&A activities usually coincides with periods of rapid credit expansion and booming stock markets. On the other hand, the takeover activity is usually affected by a sharp decline in stock markets.

3. Practitioner´s view on the bank consolidation

In this part I outline the most cited reason for and motives behind M&As, as seen by practitioners. While the previous drivers of M&As were observed and stated by researchers and academic scholars, this chapter offers the overview on reasons of bank consolidation undertaken by financial professionals.

According to The ECB Report (2006), small bank M&As are mostly being carried out for cost efficiency reasons, such as economies of scale. Larger bank M&As often have an element of strategic re-positioning and are also driven by considerations of economies of scale. Conglomerations are intended to diversify risk and to smooth income volatility. On occasion, the M&As are also targeted to acquire technological and other skills. The driving forces behind M&As have been identified in reports by the Banking Supervision Committee as being; information technology, disintermediation, the integration of international capital markets and creation of the single European currency.

Group of Ten (2004) reported on consolidation in financial services by surveying forty five experts in the field of banking from ten countries to acquire an understanding of their opinions about the consolidation of the banking and financial sector. In relation to within-country and within-segment mergers, the strongest motivating factor appears to be the desire to achieve economies of scale. Other important motivating factors according to the interviewees were revenue enhancements owing to increased size and increased market share. For within-country and across-segment mergers, the most important motive appears to be revenue enhancement due to product diversification. Finally, regarding cross-segment and
cross-border consolidation, revenue enhancement was also considered to be a strong motivator; however, increased market power was viewed as only slightly important.

Deloitte research (2005) reports that among important factors for cross border M&As also are; harmonizing legal systems and the fading of product nationalism. This contributed to cross border boundaries reducing in importance, as such national loyalty has faded while the appetite for more competitive banking has increased. The important driver of consolidation remains the pressing need to generate earnings growth and achieving of economies of scale.

Deloitte research (2007) regards globalization and consolidation as two mutually reinforcing trends. Globalization remains a basic trend, with the growing importance of off-shoring and the need to expand into new markets, not just to drive out competition but to also take advantage of new opportunities, especially in high growth emerging markets.

4. Additional reasons and motives for M&As in CEE countries

Positive global trends have had an impact on the CEE region and, therefore, the number of M&As has increased significantly in the CEE as well. After the transition from a centrally planned bank system, governments have opened up their banking sectors from the middle of the 1990s onwards and the many of the Western European and U.S. banks have turned their focus onto geographic expansion into the CEE countries. The result is a very high degree of foreign, especially Western European, ownership in almost all CEE countries. Besides the motives and reasons stated above, there are further reasons which have affected M&A activity in these countries. Many Western European and U.S. banks started to buy banks in the Central and Eastern European countries in order to gain attractive new business in these markets. M&As in the CEE countries in the 1990s took place mostly through the sale of banks in full or part state ownership to foreign owners, consolidation accelerated when the countries from this region joined the European Union in 2004. The concentration process has been going on and is due to the rising importance of the retail and SME banking, branch presence becomes an increasingly important topic in these countries. Vannet (2006) defines two hypothesis why the CEE banks are of the interest of the foreign bank. The first (efficiency) hypothesis states that efficient Western European banks target inefficient banks in
the CEE countries in order to transfer their superior technologies and management practices. The second (market power) hypothesis states that foreign banks aim to takeover large foreign banks so that they can increase their market share, even without a beneficial effect on efficiency or profitability. Vannet (2006) used multivariate regression analysis and did not find the positive relation between acquisitions and operational efficiency; on the contrary, he found the positive association between the market share and the probability of being targeted. His results indicate that Western European banks have targeted mainly established banks with large market share in order to increase their market power.

Conclusion

M&As occur due to various reasons. The main reason is connected with the maximization of firm’s value through synergy motives which are caused by economies of scale and scope to name a few. However, empirical evidence shows that most M&As were not successful and implies that there are other motives which are not linked to maximization of shareholders wealth as presumed in the neoclassic perspective. These motives stem mainly from the agency conflicts between managers and shareholders and hubris motives. All the firm level motives are significantly influenced by external factors, especially by deregulation, globalization, technological progress and liberalization. The fair macroeconomic environment and growing capital markets have had a positive impact on M&A activity as well. The structure of the EU banking sector has also been significantly affected by the introduction of the Euro. Motives and reasons for acquisitions of CEE banks were firstly linked to the transformation process in the 1990s. After the deregulation of domestic markets and joining the EU in 2004, the new EU countries’ banks have become acquisition targets, especially for the reason that Western European and U.S. banks desired to increase their market power and strengthen their position in the promising growth of the CEE markets.
References


[7] EUROPEAN CENTRAL BANK. *The euro and the banking secto.,* Speech delivered by Christian Noyer, Vice-President of the European Central Bank, 2000


Appendix 1

Number of mergers and acquisitions (M&As) in the EU banking sector

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ECB(2006)