ECONOMIC RESTRUCTURING IN BANKING AND FINANCE THROUGH MERGERS AND ACQUISITIONS

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ABSTRACT

The financial services sector is going through one of the most dramatic periods of restructuring ever undergone by a major industry - a reconfiguration whose impact has carried well beyond shareholders of the active firms in this sector as well as global competitive performance and economic growth. Financial services have therefore been a center of gravity of global mergers and acquisitions activity. The industry comprises a surprisingly large share of the value of merger activity worldwide.

This paper presents, in a comprehensive way, the reconfiguration of the financial services sector on the European market through mergers and acquisitions (M&A). This exposition will describe the underlying drivers of the mergers and acquisitions process itself and the efficacy of merger implementation - notably the merger integration dynamic.

KEYWORDS: *restructuring, M&A, integration, financial services sector, economic drivers*

Introduction

Apart from the uncertainty surrounding labor markets and consumer spending, financial stability remains a major issue in the Euro zone. With their heavy exposure to the struggling economies of Central and Eastern Europe, Western banks face the risk of further write-downs and erosion of their capital base. According to tabulations by the European Commission, banks from "old" member states of the European Union have claims of about €950 billion in "new" member states and other European emerging markets - accounting for around 82 % of total foreign claims. In absolute terms, the largest exposure is by banks from Austria, Germany, Italy, and France. In terms of GDP, cross-border banking exposure to the region accounts for 68 % of Austrian GDP, 27 % for Belgium, 23 % for Sweden, 17 % for Greece, and 14 % for the Netherlands.

With a forecast of -0.4 % growth in 2010, the Euro zone remains a laggard in the global arena. In other advanced economies, growth is expected to be flat to slightly positive by next year, while emerging and developing nations - especially in Asia - are expected to lead the rebound with growth rates between 3 and 6 percent. In the corporate sector, recovery is likely to come first to international companies positioned to benefit from this growth.

The financial services sector is going through one of the most dramatic periods of restructuring ever undergone by a major industry - a reconfiguration whose impact has carried well beyond shareholders of the active firms in this sector as well as global competitive performance and economic growth. Financial services have therefore been a center of gravity of global mergers and acquisitions activity.

This paper presents, in a comprehensive way, the reconfiguration of the financial services sector on the European market through mergers and acquisitions (M&A) by detailing the underlying drivers of the mergers and acquisitions process itself.

From a shareholder perspective, mergers are supposed to be accretive - they are supposed to add value in terms of total returns to investors. They almost always do that for the sellers. Often they do not succeed for the buyers, who sometimes find that the combined firm is actually worth less than the value of the acquiring firm before the merger.

What does the theory say?

Almost a half-century ago, Miller and Modigliani (1961) pioneered the study of the value of mergers, concluding that the value to an acquirer of taking over an on-going concern could be expressed as the present value of the target's earnings and the discounted growth opportunities the target offers. As long as the expected rate of return on those growth opportunities is greater than the cost of capital, the merged entity creates value and the merger should be considered. Conversely, when the expected rate of return on the growth opportunities is less than the cost of capital, the merged entity destroys value and the merger should not take place.

To earn the above-market rate of return required for mergers to be successful, the combined entity must create new cash flows and thereby enhance the combined value of the merger partners. The cash flows could come from saving direct and indirect costs or from increasing revenues.

Market extension

The classic motivation for M&A transactions in the financial services sector is market extension. A firm wants to expand geographically into markets in which it has traditionally been absent or weak. Or it wants to broaden its product range because it sees attractive opportunities that may be complementary to what it is already doing. Or it wants to broaden client coverage, for similar reasons. Any of these moves is open to *build* or *buy* alternatives as a matter of tactical execution. Buying may in many cases be considered faster, more effective, or cheaper than building. Done successfully, such growth through acquisition should be reflected in both the top and bottom lines in terms of the acquiring firm's P&L account and reflected in both market share and profitability.

Economies of scale

Whether economies of scale exist in financial services has been at the heart of strategic and regulatory discussions about optimum firm size in the financial services industry. Does increased size, however measured, by itself serve to increase shareholder value? And can increased average size of firms create a more efficient financial sector?

In an information- and distribution-intensive industry with high fixed costs such as financial services, there should be ample potential for scale economies. However, the potential for diseconomies of scale attributable to disproportionate increases in administrative overhead, management of complexity, agency problems, and other cost factors could also occur in very large financial firms. If economies of scale prevail, increased size will help create shareholder value and systemic financial efficiency. If diseconomies prevail, both will be destroyed. Scale economies should be directly observable in cost functions of financial services suppliers and in aggregate performance measures.

Unfortunately, studies of both scale and scope economies in financial services are unusually problematic. The nature of the empirical tests used, the form of the cost functions, the existence of unique optimum output levels, and the optimizing behavior of financial firms all present difficulties. Limited availability and conformity of data create serious empirical problems. And the conclusion of any study that has detected (or failed to detect) economies of scale or scope in a sample selection of financial institutions does not necessarily have general applicability. Nevertheless, the impact on the operating economics (production functions) of financial firms is so important - and so often used to justify mergers, acquisitions, and other strategic initiatives - that available empirical evidence is central to the whole argument.

Economies of scope

M&A activity may also be aimed at exploiting the potential for economies of scope in the financial services sector - competitive benefits to be gained by selling a broader rather than narrower range of products - which may arise either through cost or revenue linkages.

Cost economies of scope suggest that the joint production of two or more products or services is accomplished more cheaply than producing them separately. "Global" scope economies become evident on the cost side when the total cost of producing all products is less than producing them individually, whereas "activity-specific" economies consider the joint production of particular financial services. On the supply side, banks can create cost savings through the sharing of transactions systems and other overheads, information and monitoring cost, and the like.

Other cost economies of scope relate to information - specifically, information about each of the three dimensions of the strategic matrix (clients, products, and geographic arenas). Each dimension can embed specific information, which, if it can be organized and interpreted effectively within and between the three dimensions, could result in a significant source of competitive advantage to broad-scope financial firms. Information can be reused, thereby avoiding cost duplication, facilitating creativity in developing solutions to client problems, and leveraging client-specific information in order to facilitate cross-selling. And there are contracting costs that can be avoided by clients dealing with a single financial firm.

Cost diseconomies of scope may arise from such factors as inertia and lack of responsiveness and creativity. Such diseconomies may arise from increased firm size and bureaucratization, "turf" and profit-attribution conflicts that increase costs or erode product quality in meeting client needs, or serious conflicts of interest or cultural differences across the organization that inhibit seamless delivery of a broad range of financial services.

Operating efficiencies

Besides economies of scale and cost economies of scope, financial firms of roughly the same size and providing roughly the same range of services can have very different cost levels per unit of output. There is ample evidence of such performance differences, for example, in comparative cost-to-income ratios among banks and insurance companies and investment firms of comparable size, both within and between national financial services markets. The reasons involve differences in production functions, efficiency, and effectiveness in the use of labor and capital; sourcing and application of available technology; as well as acquisition of inputs, organizational design, compensation, and incentive systems - that is, in just plain better management - what economists call X-efficiencies.

Empirically, a number of authors have found very large disparities in cost structures among European banks of similar size, suggesting that the way banks are run is more important than their size or the selection of businesses that they pursue. Some authors found that the greater the overlap in branch office networks, the higher the abnormal equity returns in European bank mergers, although no such abnormal returns are associated with increasing concentration levels in the regions where the bank mergers occurred. This suggests that any gains in shareholder-value in many of the financial services mergers were associated more with increases in X-efficiency than with merger-related reductions in competition.

Impact of mergers on market power and prospective market structures

Taken together, the foregoing analysis suggests rather limited prospects for firm wide cost economies of scale and scope among major financial services firms as a result of M&A transactions. Operating economies (X-efficiency) seems to be the principal determinant of observed differences in cost levels among banks and nonbank financial institutions. Demand-side or revenue-economies of scope through cross-selling may well exist, but they are likely to be applied very differently to specific client segments and can be vulnerable to erosion due to greater client promiscuity in response to sharper competition and new distribution technologies. However, there are other reasons M&A transactions may make economic sense.

In addition to the strategic search for operating economies and revenue synergies, financial services firms will also seek to dominate markets in order to extract economic returns. By focusing on a particular market, merging financial firms could increase their market power and thereby take advantage of monopolistic or oligopolistic returns. Market power allows firms to charge more or pay less for the same service. In many market environments, however, antitrust constraints ultimately tend to limit the increases in market power. Managers of financial services firms often believe that the end game in competitive structure is the emergence of a few firms in gentlemanly competition with each other, throwing off nice sustainable margins. In the real world such an outcome can easily trigger public policy reactions that break up financial firms, force functional spinoffs, and try to restore vigorous competition. Particularly in a critical economic sector that is easily politicized, such as financial services, such reactions are rather likely, despite furious lobbying by the affected firms.

Asymmetric information, Know-How, and embedded Human Capital

One argument in favor of European mergers and acquisitions in the financial services industry is that internal information flows in large, geographically dispersed, and multifunctional financial firms are substantially better and involve lower costs than external information flows in the market that are available to more narrowly focused firms. Consequently, a firm that is present in a broad range of financial markets and geographies can find proprietary and client-driven trading and product-structuring opportunities that smaller and narrower firms cannot. Furthermore, an acquisition that adds to breadth of coverage should be value-enhancing by improving market share or pricing if the incremental access to information can be effectively leveraged.

A second argument has to do with technical know-how. Significant areas of financial services have become the realm of highly specialized expertise. An acquisition of a specialized firm by a larger, broader, more heavily capitalized firm can provide substantial revenue-related gains through both market share and price effects.

Closely aligned is the human capital argument. Technical skills and entrepreneurial behavior are embodied in people, and people can move. Parts of the financial services industry have become notorious for the mobility of talent, to the point that free agency has characterized employee behavior and individuals or teams of people almost view themselves as "firms within firms." Hiring of teams has at times become akin to buying small firms for their technical expertise, although losing them (unlike corporate divestitures) usually generates no compensation whatsoever. In many cases the default question is "Why stay?" as opposed to the more conventional, "Why leave?"

It is in this context of high-mobility of embedded human capital that merger integration, approaches to compensation, and efforts to create a cohesive "superculture" appear to be of paramount importance. These issues are discussed in high details today and take on particular pertinence in the context of M&A transactions, where in the worst case the acquiring firm loses much talent after paying a rich price to buy a target.

Diversification of business streams, credit quality, and financial stability

One of the arguments for European financial sector mergers is that greater diversification of income from multiple products, client-groups, and geographies creates more stable, safer, and ultimately more valuable institutions. Symptoms should include higher credit quality and debt ratings and therefore lower costs of financing than those faced by narrower, more focused firms.

Past research suggests that M&A transactions neither increase nor decrease the risk of the acquiring firm, possibly because risk-diversification attributes (such as cross-border deals) have played a limited role in banking so far.

It has also been argued that shares of multifunctional financial firms incorporate substantial franchise value due to their conglomerate nature and their importance in national economies. However, as practice shows, this guaranteed franchise value serves to inhibit extraordinary risk taking. There is substantial evidence that the higher a bank's franchise value, the more prudent management tends to be. Thus, large European banks with high franchise values should serve shareholder interests, as well as stability of the financial system and the concerns of its regulators, with a strong focus on risk management, as opposed to banks with little to lose. This conclusion, however, is at variance with the observed, massive losses incurred by European banks in recent years in lending to highly leveraged firms, real estate lending and emerging market transactions.

Conclusions

Assessing the potential effects of mergers or acquisitions in the European financial services sector is as straightforward in concept as it is difficult to calibrate in practice. The positives include economies of scale, improvements in operating efficiency (including the impact of technology), cost economies of scope, impact on market structure and pricing power, improved financial stability through diversification of revenue streams, improvements in the attraction and retention of human capital. The negatives include diseconomies of scale, higher operating costs due to increased size and complexity, diseconomies of scope on either the cost or revenue sides (or both). Bigger is sometimes better, sometimes not. It all depends.

In terms of the evidence reviewed in this article, the relevant management lessons appear to include the following:

- Don't expect too much from economies of scale.
- Don't expect too much from *cost* economies of scope, and be prepared to deal with any cost diseconomies that may arise.

- Optimize operating economies or *X-efficiencies* through effective use of technology, reductions in the capital-intensity of financial services provided, reductions in the work force and incentive-compatible compensation practices.
- Specialize operations using professionals who are themselves specialists.

If a strategic direction taken by the management a financial firm does not exploit every source of potential value for shareholders in M&A situations, then what is the purpose? Avoiding an acquisition attempt from a better-managed suitor, who will pay a premium price, does not seem as unacceptable today as it may have been in the past. In a world of more open and efficient markets for shares in financial institutions, shareholders increasingly tend to have the final say about the future of their enterprises.

All things considered, there is no substitute for good management in the strategic positioning and implementation process of financial services firms. That means (1) targeting markets that are large and growing and increasingly concentrated, where the firm has a shot at being one of the dominant players, and (2) knitting together those markets that extract the maximum value from scale and scope linkages that may exist. The reality shows that the first of these is substantially more important than the second. It also means paying careful attention to operating costs and risk control, both of which allow plenty of room for excellence as well as for error - especially with regard to developing and executing an integrated approach to the management of risk. And finally, it means intense and persistent attention to product quality and innovation. What shareholders are looking for is a highly disciplined and creative approach to the internal allocation of productive resources that appears to be more efficient than external markets and is likely to deliver sustainable excess returns on share capital.

Leadership of financial firms that is driven by these core objectives will find that the use of mergers and acquisitions as a strategic tool can be very rewarding indeed - the tendency to do the right thing and to do it right in an M&A context tends to grow out of the basic way the business is run. Everything else follows from that.

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