

Violetta Kałuzińska*

CONSOLIDATION PROCESSES IN THE EUROPEAN BANKING SECTOR

Introduction

Since 1990s the banking industry all over the world has been undergoing continuous restructuring processes, characterised by strong consolidation tendencies. The trend is often attributed to factors such as globalisation, deregulation, the technological progress and the development of capital markets. According to a report of the Bank of International Settlements (BIS), the consolidation of the European banking system is due to or was intensified by the gain of the efficiency followed by banks. Moreover, the Euro is believed to have accelerated the European financial market integration process and so to have encouraged the activities among EU member-countries. In consequence, the national and cross-border competition was strengthened, which led to the creation of numerous mergers and acquisitions in the banking industry¹.

The purpose of this paper is to present the nature of consolidation processes in the banking sector. Section one explains the concept and the rationale behind bank mergers and acquisitions. Section two presents gains and risks associated with the aforementioned trends, while section three gives a brief outline of the trends that have been observed in the Polish banking sector.

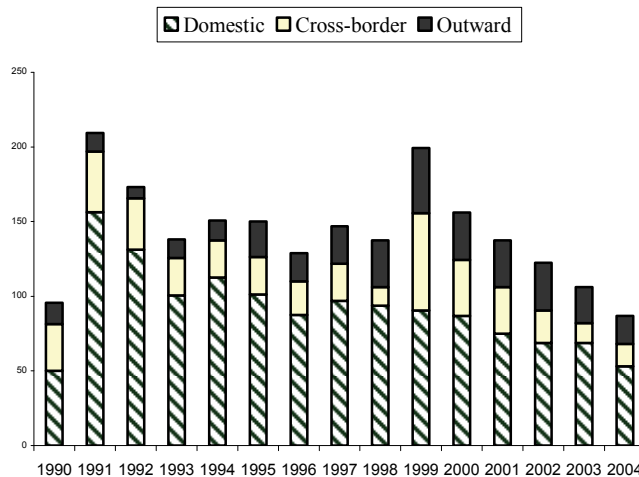
1. The trend towards consolidation

The European banking sector experienced a particularly rapid process of mergers and acquisitions (M&As) during 1990s. Figure 1 shows the development of this trend between the years 1990-2004.

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¹ J. Dermine, *European Banking: Past, Present and Future*, ECB Conference Paper, Frankfurt am Main, 2002.

Figure 1. The number of M&As in banking in the EU 15, 1990–2004.



Note: Cross-border M&As refer to transactions in the EU 15 involving a non-domestic acquirer, outward M&As refer to non-EU acquisitions of EU 15 banks. *Source:* R. Ayadi, *Assessing the Performance of Banking M&As in Europe – A New Conceptual Approach*, CEPS, Brussels 2007, p. 2.

The recent increase in banking sector consolidation began in late 1997, in Europe, by the move to merge two of Europe’s largest banks, United Bank of Switzerland and Swiss Bank Corp. The need to gain a competitive advantage on domestic market forced two English banks – Barclays and Woolwich – to merge. Another spectacular example could be the emergence of the biggest Nordic banking group – as a result of a successful merger between two Scandinavian banks: MeritaNordbanken and Unidanmark. In the United States the announced megamergers in 1998 included the \$73 billion Citicorp-Travelers merger, the \$59 billion NationsBank-Bank of America merger, the \$34 billion Wells Fargo-Norwest merger, and the \$26 billion Bank One-First Chicago/NBD merger². Later that year, German Deutsche Bank decided to takeover Bankers’ Trust. The trend swiftly spread to other countries (France, Denmark, Japan, etc.). Table 1 presents M&A deals signed between the very years 2001–2003.

² J.C. Soper, *What’s Next for Consolidation in Ranking*, Business Economics, April 2001.

Table 1. M&A transactions completed in 2001–2003 involving European banks

	Domestic	European cross-border	International cross-border
Within-sector	BoS – Halifax (UK) DG Bank – GZ Bank (Ger) Dexia – Artèsia (Be) San Paolo IMI – Cardine (It) BP Verona – BP Novara (It) Banca di Roma – Bipop Carire (It) CCF – Banque Hervet (Fr) Banco Sabadell – Banco Herrero (Sp) BP di Bergamo – BPCI (It) Crèdit Agricole – Crèdit Lyonnais (Fr) Bp di Vicenza – Cassa di Risparmio di Prato (It) DnB – Norlandsbanken (Nor) BP di Lodi – Banco di Chavari e della riviera Ligure (It) San Paolo IMI – BP Adriatico (It)	Deutsche Bank – Scudder (Ger/Sw) Sociètè Gènèrale – Komerčni (Fr/Cze) KBC – Nova Ljubljanska Banka (Be/Slovenia) Unicredit – Allianz – Zagrebacka Banka (It/Ger/Croatia) Erste Bank – Ceska Sporitelna (Au/Croatia) Unicredit – Zivnostenska Banka (It/Cze) Sanpaolo IMI – Intern europabank (It/Hung) Barclays – Zaragozano (UK/Sp)	SCH – Banespa (Sp/Mex) SCH – Banco Santiago (Sp/Chile) ING – Seguros (NL/Mex) BNP Paribas – Bank West (Fr/US) BNP Paribas – Union California Bank (Fr/US) RBoS – Medford Bankcorp (UK/US) Rabobank – VIBC (NL/US) HSBC – Household International (UK/US) RBoS – Cambrigeport Bank (UK/US) ABN AMRO – Sudameris (NL/Brazil) Sociètè Gènèrale – SSB Bank (Fr/Ghana)
Cross-sector	Allianz – Dresdner (Ger) CDC-Caisse d'Épargne Group (Fr) Natexis Banques Populaires – Coface (Fr) Crèdit Agricole – Finaref (Fr) BNP Paribas – Facet (Fr) ABN AMRO – KBC Private Banking (NL) RBoS – Churchill Insurance (UK)	SCH – AKB (Sp/Ger) BNP Paribas – Cogent (Fr/UK) BNP Paribas – Consors (Fr/Ger) DnB – Skandia AM (Nor/Swe) ING – Entrium (NL/Ger) Deutsche Bank – Rud Blass (Ger/Swi) Crèdit Mutuel CIC – Van Moer Santerre (Fr/Lux)	Dresdner Bank – Wasserstein Perella (Ger/US) Deutsche Bank – RREEF (Ger/US) Sociètè Gènèrale – TWC (Fr/US) Sociètè Gènèrale – HerzLease (Fr/US) SCH – Origenes (Sp/Argentina)

Source: R. Ayadi, G. Pujals, *Banking Consolidation in the EU – Overview and Prospects*, CEPS Research Report in Finance and Banking, No. 34, April 2004, p.12.

Dynamic consolidation processes in the European financial markets along with the prospects of joining it in the foreseeable future have naturally stimulated analogical processes in Poland. Since 1995 one

has been able to observe a sharp increase in the number of bank mergers and acquisitions, which resulted mostly from the need to keep or increase the market share (or – especially in case of cooperative banks – the need to meet capital requirements). As an example of consolidation in the Polish banking sector one could quote setting up Pekao S.A. Group (consisting of Bank PeKaO S.A., Bank Depozytowo-Kredytowy S.A. in Lubin, Powszechny Bank Gospodarczy S.A. in Łódź and Pomorski Bank Kredytowy S.A. in Szczecin), which increased the safety of each member bank and its deposits. Since 1996, on the other hand, foreign investors have become particularly active in the field, which incorporated the majority of banks operating in Poland into the international banking groups: AIB European Investments Ltd. – owned by Allied Irish Banks – came into possession of over 60% of the shares of WBK S.A., ING Bank bought nearly 55% of shares of Bank Śląski S.A., while Commerzbank became an owner of nearly 49% of the shares of WBK S.A.³. HypoVereinsbank became the strategic investor of BPH SA, Austria Creditanstalt Bank – of PBK SA, UniCredito Italiano invested in Bank Pekao SA⁴, to mention a few examples.

There are numerous factors driving the trend towards banking consolidation in Europe: the imperative of value creation, financial globalisation, the deregulation of banking activities, technological and financial innovations, the introduction of the euro and the progress made towards the completion of an integrated European financial market, customer relationship or even managerial motives.

1.1 . Maximising–value explanations of M&As

Value-maximisation motive for M&As is believed to result from the strengthening of the shareholders' role, the increasing importance of institutional investors in banking capital (pension funds, mutual funds, private equity and hedge funds), the pressure from financial markets and new corporate governance rules⁵. An M&A allows the resulting company to obtain efficiency gains through⁶:

³ M. Buszko, *Konsolidacja sektorów bankowych w krajach rozwijających się – współczesne tendencje w zakresie fuzji i przejęć*, „Bank i Kredyt”, 2003, nr 3, p. 70.

⁴ M. Micek, *Teoretyczne podstawy konsolidacji w sektorze bankowym*, „Bank i Kredyt”, 2002, nr 8, p. 41.

⁵ R. Ayadi, *Assessing the Performance...*, art.cit., p. 6.

⁶ *Ibidem*, p. 6.

- cost reductions (or: cost synergies),
- revenue increases (or: revenue synergies),
- the exchange of best practices and/or
- risk diversification.

The typical strategy of cutting costs in the process of integration is by taking advantage of economies of scale and scope produced by vertical and horizontal integration of financial institutions on a domestic or cross-border basis⁷. Revenue synergies also derive from a better combination of production factors (such as: harmonisation of product ranges, the existing complementarities between activities, or cross-selling). Generally, efficiency gains are obtained by input and output adjustments in order to reduce costs, increase revenue and/or reduce risks so as to increase the value added.

The restructuring operations may also allow efficiency gains through the reorganisation of teams or the generalisation of “best practices” (so called *X-efficiency*⁸).

Apart from greater economies of scale and scope, efficiency can also be improved by a larger diversification of risks (both functional and geographical).

As to the value creation through increased market power⁹ as a factor stimulating M&A activity, it is believed to play a significant part at the local level and within the same sector (especially retail banking). Still the impact of concentration level on market power seems to be decreasing due to the opening up of markets and the appearance of new competitors¹⁰.

1.2. Globalisation

Globalisation is a broad term which is generally used to mean growing interdependencies between countries, relating to their exchange of trade and the flow of capital, technology and information. The process of

⁷ K. Liebscher, *Financial deregulation in EU – chances and challenges for financial stability*, Speech at the 5th Annual CSI Conference “New Agenda of WTO: Challenge and Contribution of the European Union”, Innsbruck, November 2005, p. 4.

⁸ *X-efficiency*- the managerial ability to decide on input and output in order to minimise costs or maximise revenues (R. Ayadi, *Assessing the Performance...*, art. cit., p. 9).

⁹ *Market power* – the ability to fix market prices as a result of a dominant position in a given market.

¹⁰ *Ibidem*, p. 11.

globalisation is one of the most prominent factors contributing to important changes in the economy, which influence the pace of the economic growth or the level of unemployment. That means that it brings about not only economic changes but social and technological ones as well¹¹. Financial services constitute a sector marked by the most dynamic advances. The term of financial globalization refers to a fast integration of separate domestic markets, running activities on a global scale, creating products and services intended for global markets, and growing interrelationships in the functioning of banking systems¹².

Financial globalisation manifests itself in the amount of cross-border financial flows and cross-border banking and it can be analysed from a number of perspectives. Firstly, consolidation processes within the banking industry have been forced by globalisation outside the banking sector. Companies operating on a global scale expect both – the same standard of banking services and the provision of integrated financial services. It is the increased global integration that has strengthened the natural tendency towards concentrated provision of infrastructural services (a tendency that is further accentuated in the context of the European single market)¹³. In order to retain increasingly globalised client relationships, the banking sector too tries to replicate the new economic structures¹⁴. Secondly, the surge in acquisitions results from the need on the part of the banks to better compete in the global marketplace with both financial and non-financial institutions¹⁵. While considering the influence of globalisation on consolidation processes in the banking sector, one should differentiate between globalisation of the financial markets (i.e. the integration of domestic financial markets) and the globalisation of banking systems (i.e. the increasing interdependence

¹¹ Z. Zawadzka, *Zagrożenia ...*, art.cit., p. 5.

¹² Ibidem, p. 5.

¹³ G. Tumpel-Gugerell, *Central banks, liquidity and a changing financial infrastructure*, European Central Bank conference on “Liquidity in interdependent transfer systems”, Paris, 2008.

¹⁴ S. Sankaran, *Banking Sector Consolidation*, Advantage-India, White Papers, 2002. <http://www.advantage-india.com/Banking.pdf>

¹⁵ e.g. Wall-Mart, the world’s largest retailer, has established a banking network to complement the retail reach that it already possesses. Net companies outside the existing banking sector have been trying to offer quasi banking services through the Internet. Thus the boundaries of the banking industries are becoming less and less clear.

of domestic financial institutions)¹⁶. Thirdly, the increased concentration has not been limited to market infrastructures. The emergence of key global players has also led to increased internalisation of payment flows in correspondent banks which perform payment and custody services for other banks. Correspondent banking therefore begins to blur the distinction between intermediaries and infrastructure providers¹⁷.

1.3. Liberalisation and deregulation

Banking markets in the early 1980s were characterized by severe fragmentation. Capital controls in many countries severely limited cross-border trade in banking activities¹⁸. Moreover, with the exception of Germany, the United Kingdom, the Netherlands and Luxembourg, the banking sector of most European countries was very much repressed with a large set of regulations constraining its activities. The list of regulations included¹⁹:

- control of interest rates,
- capital controls,
- stock exchange membership,
- branch restrictions,
- foreign bank entry,
- credit ceilings,
- mandatory investment requirements,
- restrictions on insurance.

All the regulations were imposed in an attempt to protect domestic banking sector. However, governments and central banks soon began to realize the negative effect of the interventionism, especially on such a large scale. And thus twenty years later a regulatory convergence toward a minimum set of regulations on banking license, capital, and large exposure limits marked the ending of “repressed” banking systems, contributing to the single market program. The main benefit of the latter was to launch a process of competitive deregulation among national regulatory agencies using their power to help banking industry²⁰.

¹⁶ M. Micek, *Teoretyczne podstawy konsolidacji w sektorze bankowym*, „Bank i Kredyt”, 2002, nr 8, p. 40.

¹⁷ G. Tumpel-Gugerell, art.cit., p. 2.

¹⁸ J. Dermine, art.cit., p.12.

¹⁹ Ibidem.

²⁰ Ibidem.

Liberalisation and deregulation of international financial markets have made it easier for the banks to enter and successfully operate on foreign markets (*single licence*), to consolidate with other banks or to converge with non-bank financial firms. Thus banking consolidation have often taken the form of a joint venture/strategic alliance, a merger or an acquisition within a single country, a cross-border merger or acquisition, a cross-sector merger or acquisition. The process did not only change the operating conditions for the banks but it also enabled companies from outside the banking sector to compete successfully on both domestic and foreign markets. As a consequence, the competition rose sharply. On the other hand, liberalisation of capital flows has made the market of share prices, exchange rates and interest rates much more volatile²¹. It is perhaps worth mentioning that nowadays a reverse trend is being observed, apparently stimulated by recent experiences with instability of the financial system problems: namely a growing amount of micro- and macro prudential regulations.

1.4. European financial integration

The integration of national financial markets aims at fuelling competition, reducing transaction costs and creating deeper, more liquid and more efficient markets. European financial integration, which began half a century ago, is still an ongoing process marked by the following milestones²²:

- the Treaty of Rome, signed in 1957, contained the basic principles for the creation of a single European market for financial services,
- in 1985, the Single Market Programme provided a general strategy based on harmonisation of standards, a *single licence* and the mutual recognition of a financial firm's licence obtained in one EU member state,
- in 1987, the Single European Act entered into force with the aim of establishing a single European market including free movement of capital,
- from 1999 onwards, European financial integration has been enhanced by the introduction of the euro and the Financial

²¹ Z. Zawadzka, *Zagrożenia...*, art.cit., 2002.

²² K. Liebscher, *Financial deregulation...*, art.cit., 2005.

Services Action Plan (FSAP); the adoption of the single currency eliminated currency risk for the Member States of the euro area and at the same time made it easier for borrowers and investors to take advantage of borrowing and investment opportunities within the euro area. The purpose of the FSAP was to provide the legal framework enabling the effective exercise of market freedom in financial services throughout the European Union;

- launched in 2000, the Lisbon Agenda gave further stimulus to the integration process by enhancing structural reforms in order to increase competitiveness.

The list is by no means exhaustive. A number of other steps have been so far and are still being undertaken to improve financial integration: the Green Paper on Financial Services Policy released in 2005, aiming at consolidating and simplifying the existing legislation (by 2010), as well as at effective and consistent implementation of the measures adopted under the FSAP at the national level; the White Paper containing the Commission's final policy program; efforts made to change national infrastructures into pan-European payments infrastructures, like: the introduction of TARGET 2²³ or the implementation of the Single Euro Payments Area (SEPA) project (improving the field of retail payments), to name a few.

In the EU, the elimination of entry barriers and the harmonisation of regulations intensified competition in financial markets. The introduction of the euro made capital allocation more efficient, since it eliminated the costs for foreign exchange transactions and hedging, and made prices easier to compare²⁴. No wonder then that since the introduction of the euro there have been numerous banking M&A deals. Although the number of the deals has declined over the last few years, the value of bank M&As has increased (table 2).

As to the geographical location, cross-border deals increased relatively more than domestic transactions, analogically to the values of cross-border M&A deals which were significantly larger than domestic deals (figure 2).

²³ TARGET 2 – a single technical platform replacing the decentralised payment system, which allows for the provision of a harmonised level of services across Europe.

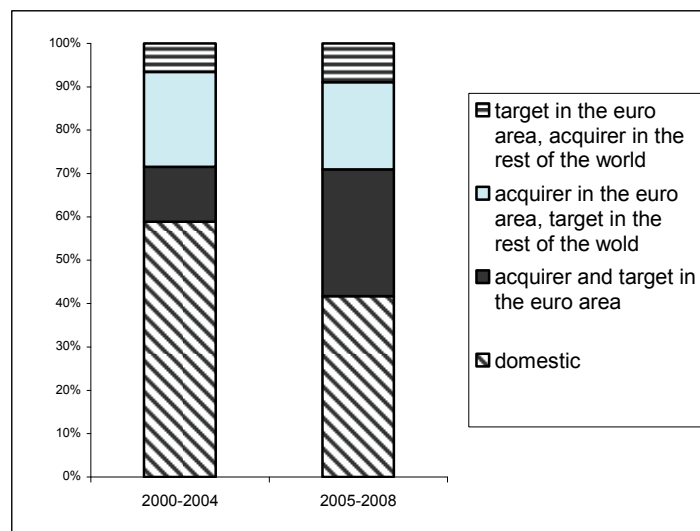
²⁴ *Ibidem*, s. 3.

Table 2. Bank M&As in the euro area

	2000–2004	2005–2008
Value of deals (EUR billions)	182	269
Number of deals	485	274

Source: *Cross-border bank mergers & acquisitions and institutional investors*, Monthly Bulletin, ECB, October 2008, p. 71.

Figure 2. Domestic and cross-border euro area bank M&A activity



Source: *Cross-border bank mergers & acquisitions and institutional investors*, Monthly Bulletin, ECB, October 2008, p. 71.

1.5. IT development

Rapid changes in information technology are believed to have played a crucial role in accelerating the pace of banking industry consolidation in recent years. The financial sector has experienced a tremendous amount of both technological and financial innovations. These have made banking services faster, more varied, more easily accessible. Advances in technology have allowed for the financial operations to be performed regardless of geographical or time zones. The introduction of real-time gross settlement systems with electronic book entries could serve as just one of the most prominent examples of state-of-the-art technology in financial services provision. Financial innovations have also triggered a

significant rise in the number of derivatives and the associated trading volume²⁵. Thus technological advances contributed to deep changes in the banking sector. On the other hand, they have also generated very high fixed costs which can only be profitably recuperated from large-volume operations²⁶. They stimulated globalization, securitization, the development of new products and ways of distributing them; they helped create new management methods and – last but not least – brought about changes in the “bank-customer” relationship.

1.6. Customer relationship

There is a perceptible change in banking philosophy from being rather product-oriented (and the need to sell it) to retaining long-term relationships. Banks need to offer a wider range of services to expand the relationship. It is a generally accepted belief that in order to meet their clients’ growing needs (be it individual or corporate clients), banks need to develop their products, work on the quality of their services, and keep competitive advantage by offering “everything under one roof”. A rising level of education, an easier access to IT or the ability to obtain information easily (through the Internet or a phone) made their customers more demanding as far as the price, range or the quality of banking services are concerned.

That is why in order to retain customers on a highly competitive market it is imperative for the banks to acquire or have strategic alliances with organizations that offer complementary products and services or possess different strengths²⁷.

The above list of factors fuelling the M&A process would be far from complete without mentioning the psychological aspect of the phenomena, such as managerial ego²⁸ (the *agency relation*), mimicry (“follow the leader” strategy), defensive reactions and the need to reduce uncertainty (acquire to avoid being acquired). As far as cross-border

²⁵ G. Tumpel-Gugerell, art. cit., p. 2.

²⁶ R. Ayadi, G. Pujals, *Banking Consolidation in the EU – Overview and Prospects*, CEPS Research Report in Finance and Banking, No. 34, April 2004, p. 15.

²⁷ S. Sankaran, art.cit., p. 2.

²⁸ When control and ownership are separated within the firm, managers may pursue their own objectives. In this case a merger or an acquisition – instead of being dictated by maximizing shareholders’ value or increasing profit – may be dictated by the power, prestige and/or higher remuneration that are related to the management of a larger firm. More: R. Ayadi, G. Pujals, *Banking Consolidation...* art.cit., p. 19.

consolidation practices are concerned, some authors also stress the importance of so-called *environmental factors* in M&A trend²⁹. Unfavourable environmental factors in the country of destination are believed to discourage foreigners to penetrate and limit M&A cross-border activity. “They increase the home field advantage and protect domestic banks, particularly when these banks are technically efficient. (...) legal and regulatory impediments, defensive moves from authorities and other institutional and cultural rigidities rank high in the list of discouraging factors for cross-border M&A activity”³⁰. Thus it is necessary that the driving forces of consolidation outweigh the negative impact of institutional and cultural impediments, for the M&As to occur.

Last but not least, liberalisation and deregulation enabled new organizations to enter financial markets, including *near-banks* (other financial intermediaries, such as insurance companies, investment funds, leasing companies, etc.), *non-banks* (some non-financial institutions, such as: car companies, mail-order companies, software and telecommunication companies, etc), and it also allowed for the creation of new products and services, which consequently increased competition and changed the conditions in which banks used to operate. Deregulation and securitization blurred the distinction between monetary and capital markets. There appeared new and more attractive investment opportunities (alternative to bank deposits) and new sources of capital (alternative to bank loans), which decreased the role of banks as financial intermediaries whose role traditionally was to accept deposits and offer loans – the process generally known as *disintermediation*. “In response to these environmental changes, European banking institutions have been obliged to attain a critical size by increasing their sphere of activity, in order to compensate for the erosion of their margins and to restore their revenues to remain competitive in the marketplace³¹”.

²⁹ See e.g. I. Hasan, A. Lozano-Vivas, J. T. Pastor, *European Bank Performance Beyond Country Borders: What Really Matters?*, “European Finance Review” No 5, Kluwer Academic Publishers, 2001; J.P. Abraham, P. Van Dijke, *European Financial Cross-Border Consolidation: At the crossroads in Europe? By exception, evolution or revolution?*, SUERF, Vienna 2002, etc.

³⁰ J.P. Abraham, P. Van Dijke, *European Financial Cross-Border Consolidation...*, art. cit., p. 18.

³¹ R. Ayadi, G. Pujals, *Banking Consolidation...*, art.cit., p. 15.

2. The expected gains and potential drawbacks of the consolidation and convergence

The liberalisation and globalisation are believed to accelerate the economic growth, the financial sector development and the increase of international competition. As it significantly broadens the range of potential investors, it also increases the markets' liquidity and makes even higher volume operations possible without heavily affecting the prices. The possibility to conduct operations on a broader and deeper market increases competition and positively influences the level of market transparency, which enables its participants to compare prices³². So in order to compete successfully on a global scale, banks (and other financial institutions) need to obtain market power which they may gain through consolidation and/or convergence processes.

2.1. The advantages of consolidation and convergence

The expected benefits of consolidation (with other banks) or convergence (with non-financial service providers, such as insurance firms, brokerages, and investment banks) include³³:

- revenue growth from a large customer base,
- efficiencies in operations,
- ability to spread fixed costs over a large customer base,
- diversification of income from both product and geographic area,
- stabilisation of asset quality,
- optimal deployment of excess capital,
- the search for higher value of common shares.

Having analysed the results of research done on M&A activity in the banking sector³⁴, Soper concluded that merged banks had enhanced

³² Z. Zawadzka, *Zagrożenia...*, art.cit., 2002, p. 5-6.

³³ J. W. Spiegel, A. Gart, *What Lies Behind the Bank Merger and Acquisition Frenzy?*, Business Economics, April 1996, p. 47-52.

³⁴ See for example: F. Furlong, *New View of Bank Consolidation*, The Economic Letter No 98-23, Federal Reserve Bank of San Francisco, July 1998; J. D. Akhavein, A. N. Berger, D. B. Humprey, *The Effects of Megamergers on Efficiency and Prices: Evidence from a Bank Profit Function*, Review of Industrial Organization, February 1997; A. Berger, *The Efficiency Effects of Bank Mergers and Acquisition: A Preliminary Look at the 1990s Data*, in: *Bank Mergers and Acquisitions*, Y. Amihad, G.

their output mix by shifting the composition of assets from securities to higher yielding loans. Merged banks also seem to have been able to lower the cost of borrowed funds, which could have been due to the reduction in risk through diversification (both in terms of geographic extent as well as product mix) and risk reduction through diversification of earnings (gained mostly by the increase of fee income relative to traditional interest income)³⁵. Kwan and Eisenbeis³⁶ list three reasons for the surge in acquisitions:

- achievement of cost savings and/or operational efficiencies,
- better ability to compete in the global marketplace,
- provision for the controlled exit from financial industry of inefficient competitors.

However, they also stress the fact that much touted earnings, efficiency, and other performance and earnings benefits of large bank mergers remain highly doubtful. De Long found that mergers that concentrate banks geographically or in product create value, while those that diversify them do not create value³⁷. Similarly, Havrylchuk³⁸ observes that although merged banks, which she analyzed in her research, have increased profitability and that the shareholders have also experienced positive abnormal results, the improvements in cost-efficiency were not so clear. She adds that acquisitions were less successful than mergers in transferring prudent banking practices to the target banks and were probably motivated by the quest for additional market power.

Campa and Hernado prove that target banks show substantial improvements in their return on equity and efficiency following their acquisition. However, the operating improvements observed after the

Miller (red.), Kluwer Academic Publishers, Amsterdam, 1998, or more recent ones: R. Ayadi, *Assessing the Performance...*, art. cit., 2007, etc.

³⁵ J.C. Soper, *What's Next for Consolidation in Banking?*, Business Economics, April 2001.

³⁶ S. Kwan, R.A. Eisenbeis, *Mergers of Publicly Traded Banking Organizations Revisited*, Economic Review, Vol. 84, No. 4, Federal Reserve Bank of Atlanta, 1999; quoted after: J. C. Soper, *What's Next for Consolidation...*, art.cit., 2001.

³⁷ G.L. De Long, *Stockholder gains from focusing versus diversifying bank mergers*, "Journal of Financial Economics", 59 (2), 2001, p. 221-252.

³⁸ O. Havrylchuk, *Consolidation of the Polish banking sector: consequences for the banking institutions and the public*, Department of Economics, European University Viadrina, Frankfurt, 2004.

merger are not correlated with the excess returns shareholder received upon the announcement of the deal, which lets the authors draw a conclusion that the ability to obtain such operating gains seem to be difficult to predict by financial markets³⁹.

Banks aim at obtaining *economies of scale* (as a result of specialising and offering the same products to a much larger number of clients) and *economies of scope* (as a result of diversifying their services, which helps minimizing costs per unit, and reduces likelihood of a bank failure). It is believed that higher size of assets/liabilities tend to be inherently diversified and thus minimize risk. By combining different, but often complementary services (e. g. commercial banking and investment banking), banks have a chance to exploit inter-sector synergies. Increasing the size of a banking institution may minimize the risk of its failure, as it makes it *too big to fail* or as it is also described: *too important to fail*. As the infamous example of Lehman Brothers showed, problems of a big financial institution pose a serious threat to the stability of the whole system (e. g. due to the *domino effect*). That is why governments and supervisory authorities do not eagerly let it declare bankruptcy, which – on the other hand – opens the possibility of *moral hazard*. Apart from the aforementioned revenue enhancement, stronger capital base, reduced costs, or business and geographic diversification, other important benefits resulting from M&As in the banking sector include: sharing of knowledge, technology, risk, and (at least theoretically) improved management. The last benefit, however, does not always appear to be reflected in practice⁴⁰.

Table 3 summarises the above disquisition by comparing the main motives of cross-border M&As with those of domestic deals.

³⁹ J.M. Campa, I. Hernado, *M&As performance in the European financial industry*, Documentos de Trabajo No. 0516, Banco de España, Madrid 2005, p. 26.

⁴⁰ Empirical data supports the intuitive conviction that big and complex organisations could prove more difficult to manage efficiently than smaller ones. That is partly because of the „human aspect” of the enterprise, which does not necessarily contribute to the smooth running of a multinational financial firm, which often needs to blend different cultures, values and reduce negative attitudes towards the consolidation idea. More in e.g.: A. Turnbull, *Banking Sector Consolidation*, November 2002, http://www.ceinet.org/download/sef_2002/38_Turnbull.pdf; J. C. Soper, *What's next...*, art.cit., 2001; T.A. Rad, L. van Beek, *Market valuation of European bank mergers*, European Management Journal, vol. 17, no. 5, October 1999, etc.

Table 3. The main motives and possible rationalisations for four types of M&A

	Between credit institutions	Across different sectors
Within one country	<p>Domestic bank M&A Economies of scale linked to costs are the main motive. Cutting distribution networks and administrative functions (rationalisation), including information technology and risk management areas.</p>	<p>Domestic consolidation Economies of scope through cross-selling are the motive. Risk and revenue diversification. Optimum usage of complimentary distribution networks. Possible rationalisations within administrative functions may lead to economies of scale linked to costs.</p>
In different countries	<p>International bank M&A Size, i. e. the need to be big enough in the market, is the main motive. Matching the size of clients and following up clients. Possible rationalisation within administrative functions.</p>	<p>International consolidation Economies of scope through cross-selling together with size are the main motives. Risk and revenue diversification. The M&A offer few rationalisations because institutions are in different countries and subject to different regulations and practices.</p>

Source: *Mergers and acquisitions involving the EU banking industry*, ECB, December 2000, p. 20.

What becomes apparent when analysing table 3 is the difference between motives in domestic and cross-border M&As, especially in regard to banking. In domestic transactions, it is cost reductions by economies of scale and rationalisation that prevail as main motives, while in cross-border activity the size motive comes to the fore, that is the need to increase market shares and market power outside the home market.

After outlining the rationale behind the consolidation and convergence in the banking sector, it is now time to counterbalance it by presenting some disadvantages (or even threats) connected with the process.

2.2. The disadvantages of consolidation and convergence

Apart from all the undeniable advantages of consolidation and convergence processes in the banking sector (both from the point of view of the institutions involved as well as their clients), there are also some serious drawbacks connected with the process.

Following the classification of M&A operations, in which at least one of the bodies involved belongs to the banking sector, presented in table 3, one can group the risk connected with mergers and acquisitions according to the same two criteria:

- location of the company which is being taken over or of the merger partner (domestic or international operation),
- sector (operations within the banking sector or cross-sector ones).

The risk connected with consolidation and convergence can be analysed either before the whole operation (*ex-ante*) or after it (*ex-post*). The least risky seem to be domestic M&As within the banking sector, while the most risky – international M&As going beyond the banking sector⁴¹.

Table 4. The risk of mergers and acquisitions

<p>Type I Merger or acquisition within a given country, within the banking sector <u>Ex ante</u>: risk of poor evaluation of the operation and strategic risk <u>Ex post</u>: operational risk and the risk of losing clients</p>	<p>Type III Cross-sector merger or acquisition within a given country <u>Ex ante</u>: risk of poor evaluation of the operation and strategic risk, increased by cultural differences; exchange rate risk <u>Ex post</u>: operational risk and the risk of losing clients; regulatory and fiscal risk</p>
<p>Type II Cross-border mergers and acquisitions within the banking sector <u>Ex ante</u>: risk of poor evaluation of the operation and increased strategic risk, possible frictions between managers <u>Ex post</u>: operational risk and the risk of losing clients, regulatory and fiscal risk; reputation risk in the medium – and long-term</p>	<p>Type IV Cross-border cross-sector merger or acquisition <u>Ex ante</u>: maximum risk; risk of poor evaluation of the operation and increased strategic risk, possible frictions between managers <u>Ex post</u>: maximum risk, operational risk and the risk of losing clients, regulatory and fiscal risk; reputation risk in the medium – and long-term</p>

Source: M. Iwanicz-Drozdowska, *Fuzje i przejęcia w sektorze bankowym*, „Bezpieczny Bank” 2001, no. 1/2, p. 79.

⁴¹ M. Iwanicz-Drozdowska, *Fuzje...*, art.cit., p. 79.

Table 4 outlines the types of risk which the consolidating institutions may have to deal with. It stresses the importance of careful planning and preparation at each stage of the enterprise, both as far as financial calculations, structural changes and/or informational campaigns for the workforce and clients are concerned. There are a number of issues, which the companies engaging in the M&A process need to overcome⁴², such as:

- unfamiliar markets,
- cultural differences,
- differing accounting, regulation and reporting standards,
- the risk of duplicating business activities and/or structures,
- IT compatibility (which may prove costly),
- the need to consolidate management and employees (and to overcome their reluctance),
- shareholder differences.

However, one must remember that the risk does not affect only and exclusively the parties involved, but that it also increases systemic risk by enlarging the size of the given institution and changing cross-border and cross-sector relationships⁴³. In fact, this seems to be the most frequently highlighted danger: the potential impact on the level of systemic risk in the overall market. The present regulatory apparatus proved inadequate to the task of overseeing and supervising the emerging megabanks and conglomerate financial service firms⁴⁴. Recent changes in

⁴² A. Turnbull, *Banking Sector Consolidation*, November 2002, http://www.ceinet.org/download/sef_2002/38_Turnbull.pdf

⁴³ The subject of the influence of cross-border and cross-sectional consolidation on the stability of the financial system – although both vital and interesting – is outside the scope of this paper. For more information see: M. Iwanicz-Drozdowska (red.), *Konglomeraty finansowe*, PWE, Warszawa, 2007; M. Iwanicz-Drozdowska, *Bezpieczeństwo rynku usług finansowych – perspektywa Unii Europejskiej*, Wydawnictwo AGH, Warszawa, 2008, etc.

⁴⁴The problem of coordination of home and host country banking supervision (*home vs host country problem*): the joint responsibility for supervision of a subsidiary is asymmetric in that the home country supervisor has the responsibility to view the subsidiary in the context of the entire institution, while the host supervisor focuses solely on the subsidiary itself. The degree to which the home country supervisor is obliged to share information about the bank is rather unclear. Potential for deficiencies in the sharing of information create scope and incentives for increasing the risk of host country subsidiaries. If a multinational bank as a whole is facing distress, it might shift risk to the subsidiary where it expects the greatest government support. If the subsidiary

the structure of the banking industry, due to both consolidation and convergence, call for different financial supervision regulations and solutions⁴⁵.

Other drawbacks include:

- the loss of domestic ownership in the financial sector (which may affect the stability of the financial system and the effectiveness of monetary policy),
- reduced competition and innovation (being one of a few global players may give a megabank a monopolistic position on the market),

goes bankrupt, it is the deposit insurance system in the host country which is responsible for providing support. This implies losses, which are borne by the local taxpayers. High banking concentration in a host country adds to the likelihood of a bail-out, because the government may not be willing to accept the failure of a subsidiary which constitutes a substantial part of the country's financial system. The subsidiary might then take increased risks in the host country. Furthermore, if the home supervisor can avoid responsibility for the bank's distress by forbearance regarding potential insolvency it may lead it to indulge the bank's transfer of risk to the subsidiary. For more information see: M. Iwanicz-Drozdowska, *Konglomeraty...*, op.cit. 2007; M. Iwanicz-Drozdowska, *Bezpieczeństwo...* op.cit., 2008.

⁴⁵ Appropriate steps have already been undertaken as far as EU is concerned. Currently, three committees exist at the EU level in the financial services sector, with advisory powers, the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR). These are often known as the "Lamfalussy level 3 Committees" because of the role which they play in the EU framework for financial services legislation, created following a report by a group chaired by Alexandre Lamfalussy. In January 2009 the Commission took action to strengthen the powers of these committees and proposed a financial instrument giving them a secure financial basis for their work. In February 2009 a report by a high-level group chaired by J. de Larosière recommended transforming the three Committees into European Authorities, with commensurately increased powers to, inter alia: co-ordinate the work of national supervisors, arbitrate between national supervisors in supervisory colleges in cases of disagreement on supervisory issues regarding a cross-border financial institution; take steps to harmonise national regulatory rules and move towards a common European rulebook; directly supervise certain pan-European institutions which are regulated at EU level, such as Credit Rating Agencies. On 27 May 2009 the the European Commission adopted a Communication on Financial Supervision in Europe which proposes a set of ambitious reforms to the current architecture of financial services committees, with the creation of a new European System of Financial Supervisors (ESFS), composed of new European Supervisory Authorities, and a European Systemic Risk Council (ESRC).

More: http://ec.europa.eu/internal_market/finances/committees/index_en.htm

- increased operating and managerial risk,
- the danger that the search for an increased market power leads to the creation of mega-banks, which – by altering effective competition – does not allow for any immediate profits for consumers because of dominant position abuses (cartel in banking)⁴⁶.

3. Banking sector in Poland⁴⁷

The present banking system in Poland has been built as a result of three major processes:

- transformation of the economy (from centrally – planned to market economy),
- legislative changes, and
- globalisation, liberalisation and deregulation processes affecting the flow of capital and financial services.

It is often stressed that the nature of consolidation processes of the banking sector in developed countries significantly differs from analogical processes in so-called *emerging* economies (like Poland). In developed markets mergers and acquisitions had as their primary objectives maintaining and/or increasing the competitive advantage by increasing efficiency, lowering costs, expanding the range of products and services. In *emerging* markets, however, the main aims of the transactions (at least during the first stage) were: privatisation, restructuring, protecting the banks from bankruptcy, and improving the financial condition of the sector after the crises⁴⁸. And it is in the last stage (from around 1999) that the consolidation processes of the banking

⁴⁶ R. Ayadi, *Assessing the Performance...*, art.cit., p. 11.

⁴⁷ As it is not the aim of this paper to present a detailed history and panorama of the Polish banking sector changing over the years, but merely to outline some general trends and to point out their similarities to the tendencies described in the previous section of this paper (observed in developed countries), AND as the motives for M&A operations in state banks, cooperative banks and banks operating as registered companies differ significantly, the considerations concerning banking sector in Poland have been mostly limited to the latter ones (i.e. banks operating as registered companies), even though the author realizes how it diminishes the cognitive value of the paper.

⁴⁸ M. Buszko, *Konsolidacja sektorów bankowych w krajach rozwijających się – współczesne tendencje w zakresie fuzji i przejęć*, „Bank i Kredyt” 2003, nr 3, Narodowy Bank Polski, Warszawa, p. 70.

sector in Poland seem most similar to the analogous processes in developed countries described in the earlier part of this paper (in terms of dominant motives and forms).

The introduction of market economy in Poland forced dramatic changes in the banking sector. The year 1989 when the Banking Law Act and the National Bank of Poland (NBP) Act were passed, marked the beginning of a continuous process of restructuring the sector⁴⁹. The most important factors driving the process included⁵⁰:

- the establishment of nine universal state banks (on the basis of 400 NBP branches) which took over the NBP's deposit-lending operations⁵¹,
- the development of a network of commercial banks with involvement of mixed capital, initiated by new regulations in this field,
- bank privatisation,
- the increase of foreign investor share in the development and ownership transformation of the sector,
- bank liquidations and bankruptcies as well as consolidation processes within the sector.

The privatisation process, which began in the 1990s, had as its primary objective building a modern commercial banking sector. According to the privatisation programme prepared in 1991, the rationale behind the trend could be summarized in a few main points⁵²:

- increasing the standards of the banks' activities (by transferring know-how),

⁴⁹ A very informative and detailed description of the changing structure of the banking sector in Poland in the 1990s can be found in *The Polish banking system in the nineties*, Polish Financial Supervisory Authority, December 2001.

⁵⁰ www.knf.gov.pl.

⁵¹ These banks included: Powszechny Bank Gospodarczy in Łódź, Powszechny Bank Gospodarczy in Warsaw, Wielkopolski Bank Kredytowy in Poznań, Bank Śląski in Katowice, Bank Zachodni in Wrocław, Bank Gdański in Gdańsk, Bank Przemysłowo-Handlowy in Cracow, Bank Depozytowo-Kredytowy in Lublin, Pomorski Bank Kredytowy in Szczecin. Initially these were state banks, equipped with capital (own funds) by the NBP and in 1991 they were transformed into sole state shareholder companies.

⁵² J. Kraciuk, *Procesy konsolidacji w polskim sektorze bankowym*, SGGW, Warszawa; <http://www.ekrol.sggw.waw.pl/publikacje/pdf/prst15/Ref.31.pdf>

- rationalizing the banks' ownership structure and management methods,
- increasing the effectiveness of capital allocation and human resources,
- strengthening the banks' capitals.

When a two-tier structure of Polish banking was established, the primary objectives of the Polish central bank became looking after the value of the national currency and guarding the stability of the financial system.

Important changes in this respect occurred after 1997. The new Constitution gave the National Bank of Poland a strong position among public institutions and made monetary policy the responsibility of a new NBP body – the Monetary Policy Council. Supervising the banks was entrusted to the Commission for Banking Supervision⁵³, and the General Inspectorate of Banking Supervision, an organisationally autonomous body within the structure of the NBP, was assigned the executive role.

Poland's accession to OECD (the Organization for Economic Co-operation and Development) in 1996 eliminated barriers for foreign banks to establish their branches in Poland and it was the influence of foreign capital that largely determined the structure of the Polish banking sector today. During the first period (between the years 1990 and 1992) a number of banks operating in Poland rose dramatically as economically weak banks were easy to purchase⁵⁴. Banks which were established at that time were undercapitalised, technologically backward, and inefficiently managed, which made them an easy takeover target. Acquisitions became the main way of sector consolidation and the main way of entering the market for foreign investors.

In the second half of the 1990s the importance of mergers grew gradually, as the main aim of consolidation shifted towards increasing the banks' competitiveness, raising their innovative character, and diversification of revenue sources. The majority of banks taking part in the operations at that stage – unlike in the first one – were in sound financial condition.

Finally, from around 1999 onwards a new trend could be observed, with the dominant role of foreign capital. Selling the

⁵³ Since January 1, 2008 – an independent body called Polish Financial Supervision Authority.

⁵⁴ After: M. Buszko, *Konsolidacja...*, art.cit., 2003, p. 76-77.

controlling block of shares of regional Polish banks to foreign investors was supposed to bring numerous benefits both for the banks as well as the whole sector. Access to modern technologies, IT systems and *know-how* were the most immediate of the expected advantages, and so was stabilising capital markets. It is often stressed, however, that the actual benefits in many cases were much less than expected, as foreign investors limited the development of local institutions or decided to get rid of well-known brands. Thus, although it is generally agreed that the presence of foreign capital was indispensable in the process of transforming and consolidating the banking system, it is arguable whether the way and the extent to which it was allowed to penetrate the Polish market was most optimal from the point of view of the national interest of the country.

Today foreign investors have a predominant position in the Polish banking sector, as presented in Table 5.

Table 5. The structure of the Polish banking sector

	2003	2004	2005	2006	2007	2008	2009
Number of banks	658	653	649	647	645	649	649
Staffing at banks	151 254	149 605	152 954	157 931	167 162	181 295	180 657
Bank offices, including:	12 324	11 754	11 987	12 562	13 468	14 698	14 842
– branch offices	4 394	5 005	5 085	5 184	5 605	6 118	6 344
– other	7 930	6 749	6 902	7 378	7 863	8 580	8 498
Share of particular groups of banks in total assets							
– commercial banks	94.8	94.1	93.3	90.7	89.6	89.2	89.1
of which: under foreign control	67.8	66.9	69.1	66.6	66.6	67.0	66.4
– branches of credit institutions	–	0.6	0.9	3.1	4.3	5.4	5.5
– cooperative banks	5.2	5.3	5.8	6.2	6.2	5.4	5.4
Share of particular groups of banks in loans to non-financial customers							
– commercial banks	92.9	91.9	91.6	90.1	89.9	89.6	89.8
of which: under foreign control	69.7	66.5	68.4	66.9	66.5	66.4	66.6
– branches of credit institutions	–	0.3	0.8	2.6	3.6	5.0	5.0
– cooperative banks	7.1	7.8	7.6	7.3	6.5	5.4	5.2
Share of particular groups of banks in deposits taken from non-financial customers							

– commercial banks	93.4	92.7	91.7	89.6	89.4	88.9	89.2
of which: under foreign control	62.6	62.4	66.1	64.7	65.5	64.9	63.6
– branches of credit institutions	–	0.3	0.6	1.8	1.9	2.7	2.8
– cooperative banks	6.6	7.0	7.7	8.6	8.8	8.4	8.0

Source: Polish Financial Supervision Authority, www.knf.gov.pl

Conclusion

Intense cross-border and cross-sector integration processes are changing the nature of the banking sector itself and the financial sector as a whole. Liberalisation and deregulation in the banking and financial services industries, supported by outstanding technological developments, have effectively allowed for the blurring of boundaries between different sectors of the financial market. Today it seems highly probable that financial conglomerates will continue to be dominant forms of organizations on the market. This will undoubtedly provide an on-going challenge to financial regulators to develop adequate regulatory structures, market supervision and policies.

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