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# Perspectives of the European Mergers and Acquisitions in Banking*

This short paper discusses the perspectives of M&A's in the European Banking industry. It starts off to characterise the industry, which leads to a number of reasons why consolidation will continue and caveats boggling M&A's in banking.

## Banking on Change

The banking industry is undoubtedly in the middle of an upheaval. At the heart of this upheaval stands the belief that bigger institutions are capable of reaping vast economies of scale and scope. The industry sees an unprecedented M&A transaction volume, as the quickest way to grow is simply to merge. Table 1 highlights this development: The transaction volume in Europe has doubled during the first nine months of 1999, compared to 1998. It should be noted, that only those M&A's were counted, whose transaction value was above 0.5 billion USD.

Table 1

M&A Transactions in banking in bill. USD (30.09.99)

| | Europe | USA | Others |
|---|---|---|---|
| 1993 | 3 | 12 | 1 |
| 1994 | 7 | 9 | 2 |
| 1995 | 26 | 55 | 29 |
| 1996 | 14 | 35 | 7 |
| 1997 | 76 | 120 | 4 |
| 1998 | 73 | 284 | 30 |
| 1999 | 155 | 79 | 15 |

Source: Die Bank 11/99, p. 758.

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From an industry perspective, one can predict easily, that the consolidation process among European Banks will continue and speed up in the countries, which lag behind this development. Although mergers between small banks continuously took place, it is the M&A activity among the bigger commercial banks, which attracts currently the attention. Table 2 compares the market share in their home market of the 5 biggest banks in a variety of European countries. Huge differences can be seen: whereas the 5 biggest Swedish banks have a market share of almost 90%, their German counterparts can only claim a share of 16.7% of the market. The prediction here is that consolidation will increase on the national level and speed up in the laggards Germany, Italy and France.

Table 2

Concentration among European Banks

| Country | 1990 | 1997 |
|---|---|---|
| Sweden | 70.00% | 89.70% |
| Netherlands | 73.40% | 79.40% |
| Austria | 34.50% | 48.30% |
| Spain | 34.90% | 43.60% |
| France | 42.50% | 40.30% |
| Italy | 19.10% | 24.60% |
| Germany | 13.90% | 16.70% |

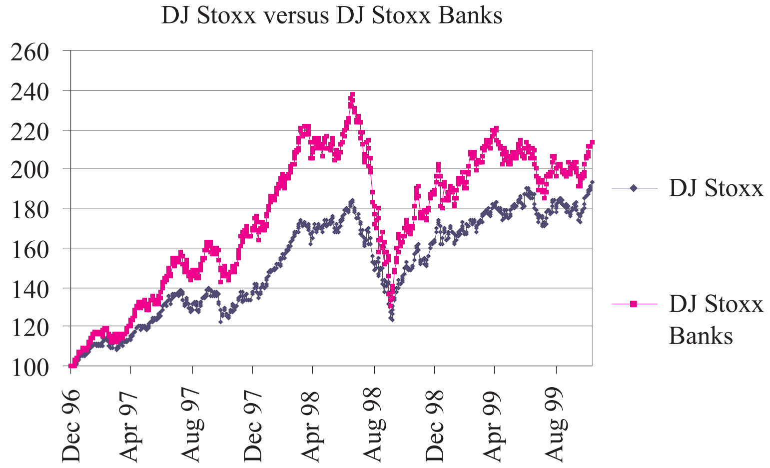
Bank assets of the five largest banks as a % of total bank assets.

Source: ECB and BHF-Bank.

It is interesting to note, that the sub-index Dow Jones Banks of the broad Dow Jones Stoxx index, started to outperform four years ago (Graph 1). It can be interpreted that the market anticipated a wave of mergers, viewing this consolidation process as highly positive, despite continuously falling interest rate margins. Furthermore, one can look at how the market judges individual banks and compare their market capitalisation to the size of their bank assets (Table 3). We see striking differences, how the market values these different banks. Especially German banks are seen very unfavourable, although some of them cought up recently. While Deutsche Bank is certainly the biggest bank, her market capitalisation places her on place 4. A similar fate is experienced by the other big German commercial banks (Dresdner Bank, HypoVereinsbank and Commerzbank): an institution with half their bank assets is valued higher by the market then they are.

Another interesting point is that German banks are still expensive in terms of the price/earnings ratio. One can see in Table 4 that German banks display above average P/E ratios. It is not so much that their price is too high, but that their earnings are too low. Their profitability of their retail clients and their elaborate

Graph 1




Source: Datastream Primark.

Table 3

Market capitalisation versus bank assets in mill.

| | Market cap. 30.09.99 | Ranking | Bank assets 31.12.98 | Ranking |
|---|---|---|---|---|
| UBS | 60775 | 1 | 586444 | 2 |
| Credit Suisse | 49791 | 2 | 405266 | 5 |
| ING | 48254 | 3 | 394925 | 6 |
| Deutsche Bank | 38698 | 4 | 626603 | 1 |
| BSCH | 35614 | 5 | 235917 | 12 |
| Fortis | 33037 | 6 | 337978 | 9 |
| ABN Amro | 30429 | 7 | 432083 | 4 |
| BNP (incl. 2/3 of Paribas) | 27966 | 8 | 324832 | 11 |
| BBV | 25744 | 9 | 133990 | 15 |
| Dresdner Bank | 24413 | 10 | 365375 | 8 |
| UniCredito Italiano | 22246 | 11 | 146615 | 14 |
| HypoVereinsbank | 21556 | 12 | 460735 | 3 |
| SG | 20101 | 13 | 383533 | 7 |
| Commerzbank | 18613 | 14 | 326211 | 10 |
| San-Paolo-IMI | 17037 | 15 | 158289 | 13 |

Source: BHF-Bank.

branch-network are poor. Analysts of BHF-Bank estimated that Deutsche Bank earns more with her wealthiest 300,000 clients than with the rest of her 7 million retail clients[1]. The conclusion is simply that this lack of profitability can only be countered by consolidation of the big commercial banks to decrease inefficiencies in their retail network. Cost reduction in the retail business can only be achieved by merging in the home market. Furthermore, the earlier one merges, the bigger are the potential savings. Investments in information technology, staff, the development of an online-bank, etc. all display synergies if two banks are combined in the home market. Table 5 gives an impression of the over-banked nature of the industry[2].

Table 4

P/E ratios of European Banks as of 11.11.1999

| Bank | P/E ratio | Bank | P/E ratio |
|---|---|---|---|
| **BAYER. HYPO-UND-VBK.** | **24.7** | BANCA DI ROMA | 17 |
| **DRESDNER BANK** | **24.7** | NAT. WSTM. BANK | 16.9 |
| NAT. BANK OF GREECE | 23.8 | BNC. ESPR. SANTO (BESCL) | 16.8 |
| **DEUTSCHE BANK** | **23.4** | ALLIED IRISH BANKS | 16.6 |
| BSCH | 23.4 | RYL. BK. OF SCTL. | 16.5 |
| HSBC HOLDINGS | 23.2 | ALLIANCE & LEICESTER | 16.4 |
| BNC. BILBAO VIZCAYA R | 22.9 | DEXIA | 16.4 |
| ERGO BANK | 22.4 | BANCA INTESA | 16.3 |
| BNC. PINTO & SOTTO MAYOR | 22.2 | SOCIETE GENERALE | 16.2 |
| **COMMERZBANK** | **21.9** | DEN NORSKE BANK | 15.2 |
| BANCA NAZ. LAVORO | 21.7 | ABBEY NATIONAL | 13.9 |
| ARGENTARIA | 21.2 | MERITA | 13.4 |
| BCP R | 20 | DEXIA FRANCE | 13.3 |
| BANK OF SCOTLAND | 19.9 | ABN AMRO HOLDING | 12.8 |
| BANCA MONTE DEI PASCHI | 19.1 | BNP | 12.4 |
| CREDIT LYONNAIS | 18.2 | ERSTE BANK | 12 |
| LLOYDS TSB GP. | 18.1 | BANK AUSTRIA | 11.6 |
| BARCLAYS | 18 | DEN DANSKE BANK | 10.7 |
| SAN PAOLO IMI | 17.6 | SEB ‘A’ | 10.7 |
| BNC. POPULAR R | 17.5 | BANK OF IRELAND (ISE) | 10.5 |
| NORDBANKEN HOLDING | 17.5 | CHRISTIANIA BANK | 10.3 |

Source: Datastream Primark.

[1] See BHF-Bank *Deutsche Großbanken, 1999.*

[2] An econometric approach to the excess capacity in the European banking industry can be found in de Bandt and Davis, 1999.

Table 5

Indicators of Excess Capacity as of Dec. 1997

| Country | No. of banks | No. of branches per 100000 inhabitants | No. of bank employees per 100000 inhabitants |
|---|---|---|---|
| **Germany** | **3578** | 57 | **916** |
| France | 1299 | 44 | 689 |
| Spain | 416 | **97** | 629 |
| Italy | 935 | 44 | 600 |
| Netherlands | 90 | 44 | 719 |
| UK | 551 | 32 | 901 |

Source: ECB and BHF-Bank.

The high number of banks in Germany is striking and we have to elaborate for a while on that. Table 6 shows the structure of German banking. The market is highly fragmented due to the existance of largely independent co-operatives (Volks- und Raiffeisenbanken) and locally owned savings banks (Sparkassen). Those co-operatives and savings banks merge among themselves, but it is impossible (so far) for a big commercial bank to buy them.

In the case of Germany, therefore, a consolidation among the four big commercial banks seems likely and necessary for further credible expansion strategies. The obstacles to that scenario are the political reaction and the negative and scaring example of the HypoVereinsbank merger.

The ironic implication of the high P/E ratios of the big German commercial banks is, that it seems unlikely that they will be bought by other banks.

Table 6

Market shares of the German banking sector

| | market share | branches |
|---|---|---|
| Commercial banks | 15.50% | 7.70% |
| Other private banks | 27.10% | 4.80% |
| Co-operatives | 12.80% | 28.50% |
| Savings bank sector | 36.20% | 33.10% |
| Others | 8.40% | 26% |

Source: Deutsche Bundesbank and BHF-Bank.

## Some Reasons and Caveats

Having identified excess capacity and costs as reasons for consolidation, one can now move to other reasons, why M&A activities are so predominant to date. The nature of banking and the framework in which banking takes place has fundamentally changed in recent years. Not intermediation seems to be at the heart of banking, but disintermediation. Banks are not so much credit institutions anymore, being exposed to credit risks. Banks are more and more engaged to pass the risks on to another party. Banks simply package risks differently and sell and pass them on to other clients. The old continental banking approach in becoming a stakeholder of industry has gone. In contrast to that banks package private equity or venture capital funds and earn provision income, not interest margins. It should be noted, that interest margins have declined substantially during the last few years, thanks to increased competition and the low level of interest rates. This of course puts pressure on the banks to innovate and develop new products, which yield provision income[3].

The advance of non-banks, moving into the domain of banks has increased the pressure on traditional banks. One of the trends in retail banking is to move towards customers. The supermarket chain started to offer banking services to their clients. What could be more convenient to consumers? Similarly new institutions are being created to fulfil niche-services. Here one could think about the BMW Bank, offering as the main product car leasing. However, offering slightly higher interest rates on customers accounts, the BMW Bank started to attract retail clients and it is believed right now, that one could expand even further into banking. Would you bank with Jil Sander? What about a sleek Jil Sander credit card? Consumers can and do shop around to fulfil their financial needs. Banks will therefore try to expand and deepen services to build (or re-build) a trusting relationship to draw on customer loyality. It seems likely, that this will only work in certain customer segments.

Globalisation is certainly the current catch-phrase. There are two aspects to globalisation in our context. Global players in industry need banks, which have the expertise, standing, and capacity – or network – to serve them. This global perspective cannot be learned by a national institution, it is the approach which matters. The disaster Deutsche Bank suffered with the take-over of the British investment bank Morgan Grenfell is a good example. The attitude and in-house culture of Deutsche did not correspond to the international style of Morgan Grenfell, and employees just walked away in dozens. Beside a brand name, banks only have employees to bank on. They have the knowledge, know the clients and innovate – or fail to do so. Acquisitions in Banking are therefore far more delicate than acquisitions in the manufacturing industry, for example. The technical language in engineering is the same wherever you are: the problems are

[3] Compare to Deutsche Bundesbank, Monatsbericht, Juli 1999.

technical, and so are the solutions. Banking, which connects technical issues and human-driven institutions such as markets or firms will always also need the human input and rely on some internal subjective culture. It will be extremely interesting to see, whether cross border M&A's do actually work. Will a cross-border Dutch, Swiss or Swedish M&A be more successful than a German, French or British? Are we economic agents as multi-cultural and global, as the world economy suggests? Even on a national scale different banking-cultures can be found[4].

A recent attempt to assess the successfulness of M&A's in banking arrived at very sobering results. The Consulting firm Baine & Company looked at 30 M&A's announced before the 1.1.1998 and twenty announced thereafter. While it is difficult to assess the more recent mergers, the earlier ones can very well be analysed. Baine & Company came to the conclusion, that a quarter of mergers were failures, half were questionable and only the last quarter of the sample seemed promising and successful. It should be noted, that two thirds of the mergers studied were on a national scale. This result should be taken as an indication only. The criteria used in assessing success and the weights attached to them are all highly subjective, so that one has to handle this result with care. However, the clear indication is simply the apparent difficulties of M&A's in banking and the very risky nature of this development. One gets the impression, that mergers have to happen, because someone else has just merged and companies follow like lemmings.

The other aspect of globalisation is that not only industry has become global, but financial markets have become more and more integrated, thanks to the liberalisation of financial markets. Banks can easily move into new markets, but have to face new competitors at home. The conclusion is rather straightforward: you either develop into a global player, or not. If you don't, you have to think about a successful niche-strategy to remain independent[5].

Another aspect driving consolidation in Europe is certainly the ongoing integration of the European Union and Euroland. All regulative barriers have been removed by the creation of the single market for goods and services in 1992 and the Second Banking Directive of 1993. The introduction of the common currency facilitates the expansion in Euroland even further. It should be noted, that consolidation would have taken place in any case, but that the European integration has provided one more argument and more pressure for banks to react. There are mainly two areas, which are most affected by the advent of the Euro: asset management and investment banking. As currency risk is eliminated in Euroland, the home market for asset managers has increased dramatically. The economies of scale are vast in that area. Whether one manages one million or 10 billion, the decisions the asset manager has to make and the costs associated with them are the same (mainly research costs). Given that there are no currency risks anymore,

[4] See Schuster 1999 in Siegwart and Neugebauer (eds), 1999.
[5] See the discussion in Schierenbeck, 1999, p. 281.

Table 7

Bonds issued in what is now Euroland in 1998

| Pos. | Manager or Group | Amt euro m | Iss. | % Share |
|---|---|---|---|---|
| 1 | Deutsche Bank | 3,270.21 | 16 | 9.33 |
| 2 | ABN AMRO | 2,884.09 | 12 | 8.23 |
| 3 | CDC Marches | 2,843.98 | 12 | 8.11 |
| 4 | Paribas | 2,662.30 | 9 | 7.59 |
| 5 | Warburg Dillon Read | 2,418.58 | 10 | 6.90 |
| 6 | Merill Lynch & Co. | 1,725.62 | 14 | 4.92 |
| 7 | Societe Generale | 1,699.75 | 14 | 4.85 |
| 8 | JP Morgan | 1,459.78 | 7 | 4.16 |
| 9 | Morgan Stanley & Co. Inc. | 1,320.69 | 10 | 3.77 |
| 10 | Banque Nationale de Paris | 1,311.06 | 10 | 3.74 |
| 11 | Credit Agricole Indosuez | 1,233.52 | 11 | 3.52 |
| 12 | Credit Suisse First Boston | 1,057.65 | 6 | 3.02 |
| 13 | Dresdner Kleinwort Benson | 1,000.89 | 5 | 2.85 |
| 14 | Barclays Capital | 986.63 | 3 | 2.81 |
| 15 | Lehman Brothers | 700.00 | 1 | 2.00 |
| 16 | Westdeutsche Landesbank Girozentrale | 690.24 | 2 | 1.97 |
| 17 | Caja de Madrid | 631.96 | 5 | 1.80 |
| 18 | Commerzbank AG | 548.56 | 5 | 1.56 |
| 19 | ING Barings | 499.16 | 3 | 1.42 |
| 20 | San Paolo IMI SpA | 464.81 | 4 | 1.33 |
| Total of issues used in the table | | 35,062.70 | 162 | 100.00 |

Source: Börsen-Zeitung.

a Spanish pension fund can invest on a par level into German or Dutch shares, managed, for example somewhere in France. This development affects of course the Euroland shares, volume traded and their liquidity. Furthermore, the single currency allowed the creation of a huge liquid market for government and corporate bonds. It is far easier now for corporations to satisfy their borrowing needs by issuing bonds, thanks to the depth of the Euroland market. This development replaces the old bank loans and restructures investment banking activities. It is startling to look at the bonds issued in Europe in 1998 and the volume issued in 1999. The Euro has in no time whatsoever established a huge, mature and liquid bond market. All the tables are inclusive of all international and domestic public bonds, corporate bonds (and government bonds issued via commercial banks), issued in Euro debt and exclude equity and equity-linked deals.

Table 8

Bonds issued in Euroland in 1999 (until November)

| Pos. | Manager or Group | Amt euro m | Iss. | % Share |
|---|---|---|---|---|
| 1 | Deutsche Bank | 11,511.40 | 39 | 9.15 |
| 2 | Merrill Lynch & Co. | 10,452.50 | 36 | 8.31 |
| 3 | Paribas | 9,808.17 | 36 | 7.80 |
| 4 | Dresdner Kleinwort Benson | 8,514.54 | 26 | 6.77 |
| 5 | Morgan Stanley & Co. Inc. | 7,629.79 | 46 | 6.07 |
| 6 | Warburg Dillon Read | 7,087.88 | 30 | 5.64 |
| 7 | ABN AMRO | 6,530.38 | 25 | 5.19 |
| 8 | Lehman Brothers | 6,340.83 | 15 | 5.04 |
| 9 | Salomon Smith Barney International | 5,867.33 | 25 | 4.67 |
| 10 | Banque Nationale de Paris | 5,308.33 | 13 | 4.22 |
| 11 | Credit Suisse First Boston | 4,940.00 | 25 | 3.93 |
| 12 | JP Morgan | 4,618.33 | 19 | 3.67 |
| 13 | Goldman Sachs & Co. | 4,210.83 | 17 | 3.35 |
| 14 | Mediobanca — Banca di Credito Finanziario SpA | 3,833.33 | 10 | 3.05 |
| 15 | Chase Manhattan Corp. | 3,050.00 | 12 | 2.43 |
| 16 | Donaldson Lufkin & Jenrette Securities Corp. | 2,287.50 | 6 | 1.82 |
| 17 | Barclays Capital | 2,207.63 | 7 | 1.76 |
| 18 | Banco Bilbao Vizcaya SA | 2,154.17 | 8 | 1.71 |
| 19 | Westdeutsche Landesbank Girozentrale | 2,133.33 | 7 | 1.70 |
| 20 | Caja de Ahorros y Pensiones de Barcelona | 1,779.17 | 4 | 1.41 |
| Total of issues used in the table | | 125,752.27 | 333 | 100.00 |

Source: Börsen-Zeitung.

We mentioned above the new role of banks. So, what type of banks will develop? It is often pointed towards the continental European universal banks in contrast to the Anglo-Saxon division between retail banking and investment banking (be it imposed by law, as in the USA or simply historically developed as in the UK). What would be the reasons for universal banks to split into an investment and a retail bank? Core competencies, profitability, focussing etc. can all be thought of. However, if one believes that banks will assume the role of repackaging risks and earn in the future mainly provisions, it is clear that certain retail channels will be of advantage. Products have to be placed and sold. This placement power draws from the retail base. It is therefore unlikely that continental European banks will start to split up. However, it is also true that the old way banking worked on the continent will expire in due course. A move towards efficient units, combined under one roof – the vision of Rolf Breuer, Chairman of

Table 9

Issues of corporate bonds in Euroland during the first 10 months of 1999

| | Amt. m (Euro) | Ave. m (Euro) | Pcnt. | Iss. |
|---|---|---|---|---|
| Austria | 250.00 | 125.00 | 0.32 | 2 |
| Belgium | 330.00 | 165.00 | 0.42 | 2 |
| Finland | 665.00 | 166.25 | 0.84 | 4 |
| France | 22,409.32 | 367.37 | 28.32 | 61 |
| Germany | 17,287.42 | 392.90 | 21.85 | 44 |
| Ireland | 375.00 | 187.50 | 0.47 | 2 |
| Italy | 18,530.00 | 545.00 | 23.42 | 34 |
| Netherlands | 4,237.42 | 423.74 | 5.35 | 10 |
| Portugal | 2,000.00 | 1,000.00 | 2.53 | 2 |
| Spain | 13,050.00 | 686.84 | 16.49 | 19 |
| Total | 79,134.16 | 439.63 | 100.00 | 180 |

Source: Börsen-Zeitung.

Deutsche Bank – seems most likely. It is questionable, whether there is place for an insurance under that roof. There is no apparent benefit of buying a bank from the perspective of an insurance. To the contrary, insurance companies have competitive advantages in terms of managing assets and move with their products in the domain of banks. Banks on the other hand can benefit from selling insurance products, without having the risk of owning an insurance company. There is thus no inherent need for banks and insurance companies to merge: where are the economies of scale or scope?

## Conclusion

It is almost certain, that M&A activities will increase in Europe. Although there will be even bigger units, there will also be more competition among banks, this should eradicate profit margins and thus benefit the consumers. Furthermore, while the number of national banks decreases, the market (Euroland) increased, offering thus more choice for clients. The level of service is likely to increase, as well as the number of products offered. It is also likely, that consumers benefit from niche-strategies of institutions, which deliberately or not – fail to become a global player. The main obstacles banks will face are human beings, or finding a management style, which allows a fruitful integration of the different banks. Banks from smaller countries, with less historical luggage to carry seem to benefit from this psychological fact disproportionately. Furthermore, those are also the countries, which have consolidated most in their home markets, being right now prepared to venture into cross-border acquisitions.

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