Alexandra MICU
Academy of Economic Studies Bucharest, Romania
Ion MICU
Academy of Economic Studies Bucharest, Romania

MERGERS AND ACQUISITIONS IN THE BANKING SECTOR DURING THE FINANCIAL CRISIS

Empirical study

Keywords
Financial crisis,
Banking sector,
Mergers,
Acquisitions,
Economy

JEL Classification
G34

Abstract

Focused on the banking sector, the article analyses the change in approach that financial organizations needed to embrace in order to overcome the difficulties of the recently passed financial crisis. In order to emphasize this difference, the article focuses on the negative effects of the financial crisis on the banking sector and as well on the reorganization measures taken post-crisis. Furthermore, the article discusses the evolution of mergers and acquisitions in the banking sector throughout the years, the financing method and the way the crisis affected the economy worldwide.

Introduction

Economists and experts associate the wake of the global financial crisis with the global collapse in cross-border bank flows as well as with the financial markets' fragmentation within the euro zone (Milesi-Ferretti and Tille, 2011). The need to restore profitability and strengthen banking systems has urged European and American banks to cut on their international operations. The global financial crisis had accelerated a number of structural transformations that globalised international banking system. European and American banks became the major drivers of global integration of financial systems (Claessens and Van Horen, 2014). Prior to the crisis, most experts in banking considered financial internationalization as solely beneficial (Kose, and Rogoff , 2010). However, the crisis revealed major risks given an unprecedented collapse in capital flows. Eventually, the crisis affected all countries; at that, emerging economies experienced a shorter-lived retrenchment compared to advanced economies (Lane and Milesi-Ferretti, 2012). Foreign banks from crisis-affected countries eliminated their local lending rates compared to domestic banks. Over 2007-2013, national banking systems went through major ownership transformations. This implies that financial crisis adversely affected the international expansion and investment decisions taken by the lead globally operating banks most of which located in crisis-affected countries. This made many players to retrench from foreign activities, whereas others grasped the crisis' implications as an opportunity for further expansion and increasing their market shares internationally. The increase of global presence was due the need for crisis-affected advanced country banks to solidify their operations abroad.

A merger is a proper means of establishing a banking alliance by synergising two or more existing structures into one. While each separate unit loses its identity, still banks opt for mergers to synergise their operating capacities, expand their presence on global markets, diversify their operations, grow, consolidate production capacities, and save on taxes. The issue of forming banking alliances through mergers and acquisitions (M&As) has been hot on the financial agenda aftermath a financial crisis. Even without adverse affects of global economic meltdown on financial industry, globalisation has served as a major driver that accelerates the competitive pressure on financial markets (Figure 1). Given such a highly challenging environment, banks opt for mergers and acquisitions as a best way to survive and compete with the rivals. Oftentimes, therefore, mergers and acquisitions in post-crisis environment serve as a means of last resort for many banks to keep aboard.

Global financial crisis has turned mergers, acquisitions and takeovers into rather popular business forms of banking alliances that assume critical corporate structural changes though they still are the only feasible way of survival on a competitive global market. There are various forms of business combinations by means of merger. Some banks do it through absorption by acquiring other bank that consequently loses its identity. Through consolidation, two or more banks establish a new joint structure wherein every unit dissolves and fully integrate into a new entity.

1. Mergers and acquisitions in the banking sector

The process of consolidation assumes that the acquired company transfers all its shares, assets and liabilities to the acquiring company by means of share or cash exchange. In its turn, acquisition assumes that the acquiring bank takes over ownership over other banks and combines all their operations within the framework of a sole new alliance. The process of acquisition assumes that two or more banks may operate as independent legal entities, though they are usually prone to corporate control changes. Finally, by means of takeover one bank obtains management control over another bank. Therefore, one bank acquires not less than 25% of the voting power in another bank. Mergers and acquisitions have become a necessity in a banking sector following the adverse effects of a global financial crisis. A huge number of international and national banks worldwide have engaged in mergers and acquisitions. This has enabled many banks to benefit from the opportunities of economies of scale, which they would not do by operating as independent financial structures. Banks take advantage of mergers and acquisitions by growing their operations and minimizing their expenses at considerable rates. Furthermore, the formation of banking alliances reduces a number of players on financial markets and therefore lessens competition in the banking industry (Hannan and Pilloff, 2009).

In the banking sector, mergers and acquisitions take a form of 'horizontal merger' assuming that the combined entities represent similar business and perform the same commercial activities. In case some non-banking financial institutions provide the same services as banks, they are also subject to merger with other banks. Mergers and acquisitions in the banking sector is the way for the banks to seek new opportunities and gain strategic benefits on financial markets, as well as extend their customer base. Most importantly, these business alliances enable the banks to grow and internationalize. While more structures combine their business within the framework of one entity, the latter grows dynamically and wins competitive edge over rivals. Such growth, known as 'inorganic growth,' is equally opted by state and private banks internationally. Regional and multinational banks apply to cross-border mergers and acquisitions as a popular way to win dominant positions in the global banking sector, garner market share, and achieve economies of scale. Most importantly, mergers and

acquisitions in the banking sector enable banks to ensure efficiency, synergize, grow shareholder value, and increase revenues. In a post-crisis financial environment, there are also financially distressed banks subject to mergers and takeovers resulting in financial monopolies. Such alliances occur due to liberalization of the banking sector, deregulation of the financial market, and post-crisis economic reforms. To save banking sector and financial markets from monopolies, governments assign apex financial authority to control and regulate banking operations (Cetorelli and Goldberg, 2011).

Over the past three decades, there has been a considerable decline of a number of banks. Mostly, the trend is due to voluntary mergers that help unaffiliated banks to form banking alliances. After the recession of 2007-09, the voluntary merging trend intensified and resulted in the lesser number of banks worldwide. At that, the acquired banks are naturally smaller with lower net interest income and return on assets, and higher non-interest expenses compared to non-acquired banks. Furthermore, the acquired banks are less given higher cash and deposit shares and lower loans. Next, the acquired banks are also in a worse economic position in terms of ratings, capital, assets and loans. The core features that differentiate acquired banks involve efficiency and profitability. Thus, most banks consider mergers as optimal means to enhance their efficiency. Consequently, with every successful merger, the banking system gets sounder while customers get wider access to credit at lower rates. Hence, mergers benefit local communities. On the other hand, mergers assume adverse effects by making local banking markets less competitive and shrinking customer access to credit and essential banking services. Governments, central banks and regulatory agencies supervise mergers to prevent uncompetitive banking markets.

2. M&A's evolution during 1985-2014

So far, aftermath the 2007 financial crisis, the number of mergers has overwhelmed the number of failures. At that, community banks are most prone to mergers while the mergers of the banks with capital over $10 billion are rare; 90 percent of the 1,500 mergers after 2007 involved banks with less than $1 billion in assets. Because of successful mergers over 2009-2011, the number of community banks decreased by 25 percent. Despite the fact that most mergers fell in 2009, the number of failures had never exceeded successful mergers. Since 2011, voluntary mergers between banks have set a prevailing trend in an international banking sector that led to considerable decline in community banks, as seen in Figure 2.

Banks merge because of business-related reasons and opportunities enabling them to increase the total value of their individual structures (DeYoung et al, 2009). The owners of less efficient and less profitable banks that anticipate financial problems in the near future seek to exit the banking industry by selling their banks. In their turn, efficient and profitable banks seek expansion opportunities (Hannan and Piloff; Jagtiani, 2008). By dynamically expanding its business, a bank increases its business and revenue by acquiring another bank. Thus, mergers allow bank owners to use the resources of an acquired bank to expand its business presence. The strategically important resources of an acquired bank might have been mismanaged or underused. This comes as a splendid opportunity for the acquiring bank to deploy excessive deposits and ensure stable source of funding expanding lending. Hence, the banks with high deposit shares and with a higher ratio of core deposits to assets are attractive targets to the acquirers who readily pay large premiums over book value, supporting this idea.

Horizontal mergers allow the acquirers to acquire a bank in the same market and with similar financial products and services allowing them to capitalize on expertise and grow its business at reasonable expense. The idea behind acquiring a bank suggests an opportunity for the acquirer to expand his client base and turn it into a target market for cross selling its main banking services and additional products. Further, acquisitions boost the merged entity's revenue by rising market share within a particular business line or geographic location. In addition, acquiring a bank enables to boost revenue growth providing that the acquired bank came from a market featured by solid economic activity. Finally, acquiring a bank also assumes generation of efficiency gains meaning that after acquisition the banks disseminate their costs within a larger asset base, eliminate branches, and save on employment. The main beneficiaries of mergers are the banks with similar geographical and business profiles. Business and location similarities allow merging structures to save on expenses required to implement their joint business purpose (Cornett et al, 2006). Owing to mergers, banks diversify their asset portfolios, eliminate their risks, operate funding sources, and perform activities that lead to fee generation.

On the other hand, acquiring a bank that does business with different lines or in different geographical markets assumes advanced diversification. In order to eliminate operational risk, the acquiring bank should fully comprehend all the features of the new market and inherent risks, as well as expertise specificities in new business lines. The acquired banks differ from the acquirers banks in size, profitability, and condition. Acquired banks are less profitable, smaller, weaker, and therefore less efficient. This is due to the lower levels net interest incomes and non-interest incomes, and comparatively high operating costs. While there are various ways of measuring a bank's condition, experts consider capital as the major indicator. The effects of financial crises assume considerable losses depriving the banks from

capital they would deploy to cover unexpected expenses. Financial losses also disable many banks from making new loans. Therefore, in times of financial crises and post-crisis periods, bankers use mergers and acquisitions (M&A) as the optimised means to advance their condition.

3. Trends in mergers and acquisitions

On a global scale, the banking M&A alliances are evolving at a rapid pace. The growing trend enables the banks to optimize their global presence. Increased consolidation within banking alliances enhances business opportunities for small and mid-sized banks. On the contrary, experts forecast that large banks will limit their M&A activities in the coming years. Still M&A will remain as a prevailing trend for most of the banks worldwide while they are seeking growth in emerging markets.

Regarding the first trend that assumes the optimization of banks' global presence, over the last few decades, banks tended to internationalize and serve global customers. The last financial crisis and unstable global economic conditions, however, have urged them to re-consider their internationalization strategies. Furthermore, stricter capital and liquidity requirements and tougher regulations posed serious challenges for international banks. Such regulations the Volcker Rule and Basel III altered risk-management costs and affected global operations of foreign banks. Many countries have changed their domestic tax regulations that complicated international operations of foreign banks. Given these conditions, banks are expanding their operations by concentrating on core services. Many large international banks like Citibank opt for restructuring given altered capital requirements. New post-crisis economic reality urges bank owners to seek consolidation within international banking alliances. Such mergers assume selling or buying specific portfolios. While large banks emphasize on local operations and avoid locations with strict regulations, the smaller and mid-sized banks tend to purchase the branches of larger banks sold at a relatively low price. For instance, Bank of America sold 51 retail branches to Washington Federal in 2013.

Regarding the second trend that assumes increased consolidation of small and mid-sized banks, in the conditions of post-crisis economy most regulatory authorities launched regulatory reforms that made national banking systems more transparent. In particular, Europe implements Basel III, while the United States implement Dodd-Frank and the Volcker Rule. These regulations assume strict requirements with regard to capital and liquidity. Thus, the banks improve their capital and liquidity conditions. Stricter regulations are often deterring large banks from further global expansion, while the operations of small and mid-sized banks suffer from stringent capital and liquidity requirements. Most US banks subject to the M&A operate less than $1b in assets. This provides great opportunities for further expansion of local large banks.

Given the third trend that assumes shortening M&A activities by large banks, aftermath the financial crisis the latter have become rather cautious. This relates to extended scrutiny imposed on M&A activities by public and government regulatory authorities. Considering this, the new regulations heavily affect large banks while in response they have re-shaped their operational strategies to be much more conservative. They are streamlining their businesses as the only way of risk aversion and maintaining their brand name and reputation on a competitive market. Given uncertain economic conditions in the developed countries, increased regulatory pressures and the risks of losing reputation, large banks emphasize on long-term planning rather than upcoming M&A combinations.

Taking into consideration the fourth trend that assumes the growth of banking business in emerging markets, banks are seeking new opportunities for growth after being challenged with the debt crisis in the United States and sovereign debt crisis in Eurozone over the past few years. (Figure 3)

By contrast, emerging economies of Asia-Pacific for example provide banks with stable economic conditions. Regardless of different rates of growth and dynamics, banking experts consider Asia-Pacific as the most promising economic region. Taking into account that banking industry is mature in developed countries, the rising middle-class expands current demand for banking products. Such trend assumes increased concern about banking services in developing regions that assume extensive opportunities of penetration for global banks. To make the banking industry stronger in emerging markets, regulatory authorities encourage consolidation into banking alliances. In the Philippines, for example, regulators apply incentives that boost inter-bank consolidation. Thus, M&A allow banks from mature markets to internationalize and set their footprint on the emerging markets.

Conclusions

Banking M&A alliances vary depending on a region due to the differences in the regional and national economies and industry policies. Aftermath the global economic crisis the conditions in the banking market improved. Meanwhile, the banking sector faced extra regulations. The necessity to comply with harsher regulations (including the Dodd Frank Act and Durbin Amendment) necessitated American banks to improve their capital ratios. Similarly, Canadian banks stuck with the increased number of regulations. Consequently, North American banks concentrated on the restructuring to comply with the new regulations. That has put their M&A priorities aback until they fulfill their reorganization plans. Meanwhile, the new regulatory rules

benefited small US banks with some concessions to somehow improve their disadvantageous positions on financial market. Nonetheless, the smaller banks will still require additional investments and that need urges them to seek consolidation opportunities with other, predominantly larger banks.

Asia-Pacific presents a rather perspective region while it is undergoing through economic expansion. This presents huge opportunities for foreign banks aiming to extend their global presence. The ROE of Asia-Pacific banks have topped the same indicator among European and American banks. By 2030, the same region will become home for two-thirds of the global middle class. Not surprisingly, the banking competition on the regional markets is fierce. Every bank owner wants to capture growing opportunities. At that, additional pressures will come from Basel III requirements that restrict foreign ownership policies. These additional regulations deprive many foreign banks to pursue the opportunities of growth and internationalization in Asia-Pacific. Bad news is also for regional banks due to tough financial regulations. Systematic financial institutions in China, for example, are subject to 11.5% capital adequacy ratio. Nonetheless, business commentators deem Asia-Pacific as a lead location for global banking M&A in the near future. They ground their arguments on relatively stable economy as well as growing middle class income. These growth opportunities are the main triggers attracting banks from mature economies. While foreign banks are ready to initiate more M&A transactions, the core deterrent is strict regulation on foreign investment. Banking experts also foresee the counter trend of large Asia-Pacific banks shifting to the mature financial markets westwards (Claessens and Glaessner, 1997).

Concerning Europe, the economies of 17 Eurozone economies boost regional economy. The core drivers of economic growth are Germany and France. Recent sovereign debt crisis urged many European banks to save on staff employment and sell assets to comply with tough Basel III regulations. Such conditions drive European banks to restructure and consolidate with their European peers. The banking industry is fragmented in across the emerging economies in Europe, indicating potential opportunities for banking alliances. In their turn, fast-growing and innovative European banks need more capital to facilitate their regional expansion and growth. This means that the European banking industry is prone to consolidation activities. In addition to consolidation among regional banks, there is an ongoing expansion of large Chinese banks onto the European market.

In Latin America, Brazil presents a strategically important banking market. Regional banks deploy conservative financial practices featured by tight regulation after the banking system survived financial crises in the 1990s. This means that Latin American banks are capable of adapting to changes in regulation policies. While comparatively stable Latin American economy is likely to attract foreign banks, new entrants will obviously face strict regulations as a major deterrent. Political risks present another huge concern slowing down the pace of potential M&A activities in the region. To enhance banking industry efficiency, regional regulators encourage the consolidation of small banks and advancement of their capital ratios. Therefore, consolidation will help domestic banks to further regional M&A. In their turn, foreign banks may wait for favorable political and regulatory environment. Vice versa, some Brazilian banks are considering entering Middle East and Asia-Pacific markets part of their globalization and growth strategy.

The Middle East banks are already sizeable leaving no prospects for consolidation among local banks. Given the unstable political situation in the Middle East, the capitalized regional banks are seeking outbound M&A in the regionally proximate growing markets. Africa’s banking penetration is rather slow that provides perspectives for potential M&A combinations. While banking penetration in Africa depends on individual country peculiarities, the banking industry in Africa is comparatively stable featuring high returns on equity and solid earnings growth. The banking industry is emerging in this perspective region while banks are pursuing domestic consolidation. Favorable banking regulations and high growth regional opportunities seem rather attractive to foreign entrants.

Africa’s banking penetration is rather slow that provides perspectives for potential M&A combinations. While banking penetration in Africa depends on individual country peculiarities, the banking industry in Africa is comparatively stable featuring high returns on equity and solid earnings growth. The banking industry is emerging in this perspective region while banks are pursuing domestic consolidation. Favorable banking regulations and high growth regional opportunities seem rather attractive to foreign entrants (Cyree, 2010).

Reference list

[1] Cetorelli, N., and Goldberg, L 2011, “Global Banks and International Shock Transmission: Evidence from the Crisis,” IMF Economic Review, 59, 41-76.

[2] Claessens, S., & Van Horen, N. 2014, “Foreign Banks: Trends and Impact,” Journal of Money Credit and Banking, 46(1), 295-326.

[3] Claessens, S., and Glaessner, T. 1997, “Are Financial Sector Weaknesses Undermining the East Asian Miracle?” Directions in Development, World Bank, September.

[4] Cornett, M.M., McNutt, J.J. and Tehranian, H. (2006). Performance changes around bank

mergers: revenue enhancement versus cost reduction. Journal of Money, Credit, and Banking, 38(4), pp. 1013 - 1050

[5] Cyree, K. 2010, “What Do Bank Acquirers Value in Non-Public Bank Mergers and Acquisitions?” *The Quarterly Review of Economics and Finance*, vol. 50, no.3, pp. 341-351.

[6] DeYoung, R, Evanoff, D., and Molyneux. P. 2009, “Mergers and Acquisitions of Financial Institutions: A Review of the Post-2000 Literature,” *Journal of Financial Services Research*, vol. 36, no.2, pp. 87-110.

[7] Hannan, T., and Pilloff, S. 2009, “Acquisition Targets and Motives in the Banking Industry,” *Journal of Money, Credit and Banking*, vol. 41, no. 6, pp. 1167-1187.

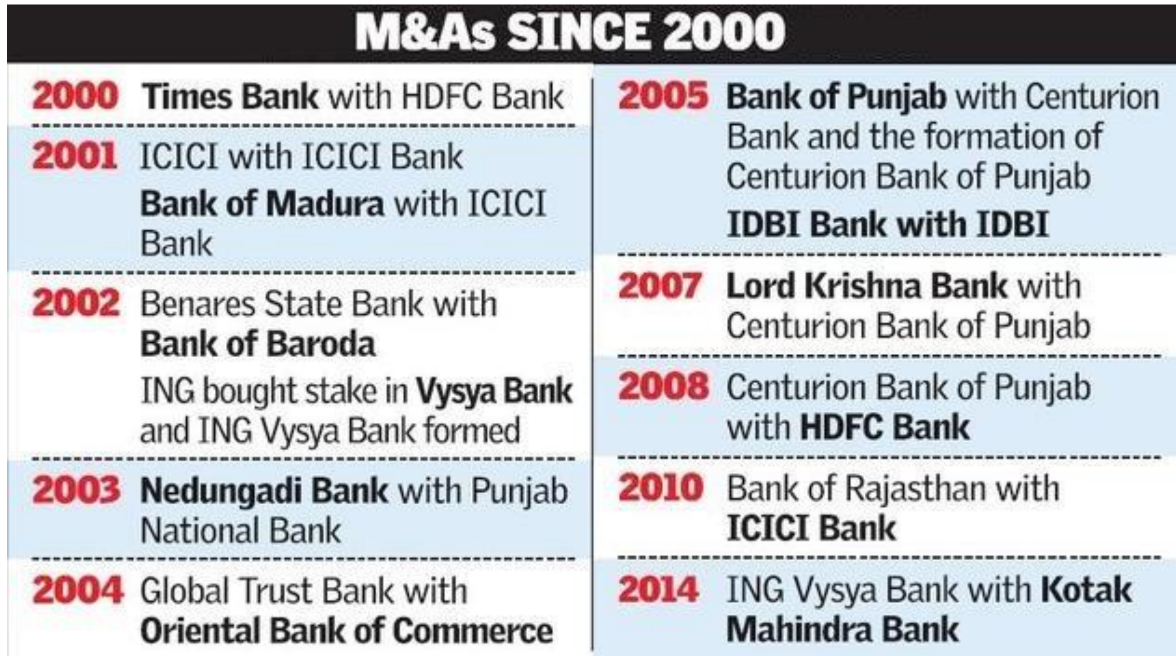
[8] Jagtiani, J. 2008, “Understanding the Effects of the Merger Boom on Community Banks,” Federal Reserve Bank of Kansas City, Economic Review, vol. 93, no. 2, pp. 29-48.

[9] Kose, M. Et al. 2010, “Financial Globalisation and Economic Policies,” in Dani Rodrik and Mark Rosenzweig (Editors), *Handbook of Development Economics*, Vol. 5, The Netherlands: North-Holland, 4283-4362.

[10] Lane, Philip R. and Gian Maria Milesi-Ferretti, 2012, “External Adjustment and the Global Crisis” Journal of International Economics, 88(2), 252-265.

ANEXE

Figure 1: Mergers and acquisitions between 2000-2014



M&As SINCE 2000

Year	Merger / Acquisition
2000	**Times Bank** with HDFC Bank
2001	ICICI with ICICI Bank **Bank of Madura** with ICICI Bank
2002	Benares State Bank with **Bank of Baroda** ING bought stake in **Vysya Bank** and ING Vysya Bank formed
2003	**Nedungadi Bank** with Punjab National Bank
2004	Global Trust Bank with **Oriental Bank of Commerce**
2005	**Bank of Punjab** with Centurion Bank and the formation of Centurion Bank of Punjab **IDBI Bank with IDBI**
2007	**Lord Krishna Bank** with Centurion Bank of Punjab
2008	Centurion Bank of Punjab with **HDFC Bank**
2010	Bank of Rajasthan with **ICICI Bank**
2014	ING Vysya Bank with **Kotak Mahindra Bank**

Figure 2: Mergers and acquisitions between 1985-2014

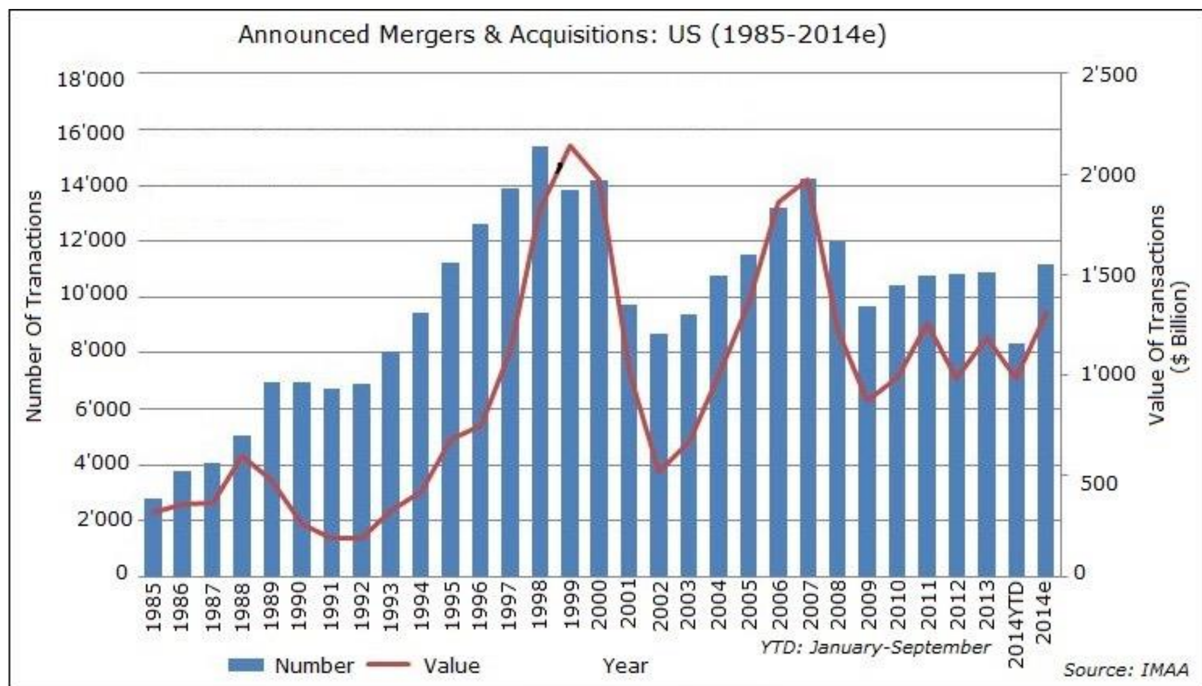


Figure 3: Evolution of financial crises between 1982-2011