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CROSS BORDER M&A IN BANKING SECTOR - FACING THE FINANCIAL CRISIS

Introduction

Since year 2007 the world has been facing the biggest financial crisis in the history. The tightly interconnected global economy cannot be unresponsive to the problems imposed by a huge number of companies collapsing one after another. Entities in banking sector belong to the most sensitive ones. When in 2007 it became known that US banks had problems the whole world economy started to shake. Some companies were in trouble, but others were in good condition because of their effective strategy. The former were looking for help, the latter had a chance to take advantage of this situation.

This article presents the role of the cross-border M&A in banking sector as a tool of surviving the financial crisis in years 2007-2009.

1. Cross border M&A as an effective market strategy

The main goal of a company is to increase its value as well as optimize the shareholders interest throughout its operating. A decision to expand to the foreign markets is one of the possibilities of reaching this goal. But it requires thorough strategic and financial analysis. If a company wants to be effective it should choose proper market entry strategy as this will have a huge impact on the company's results. In the portfolio of possibilities of expansion into foreign markets a company can choose between: exporting, licensing, joint venture or direct investment. The most effective and appropriate strategy for banking sector is direct investment through cross-border mergers and acquisitions (M&A).

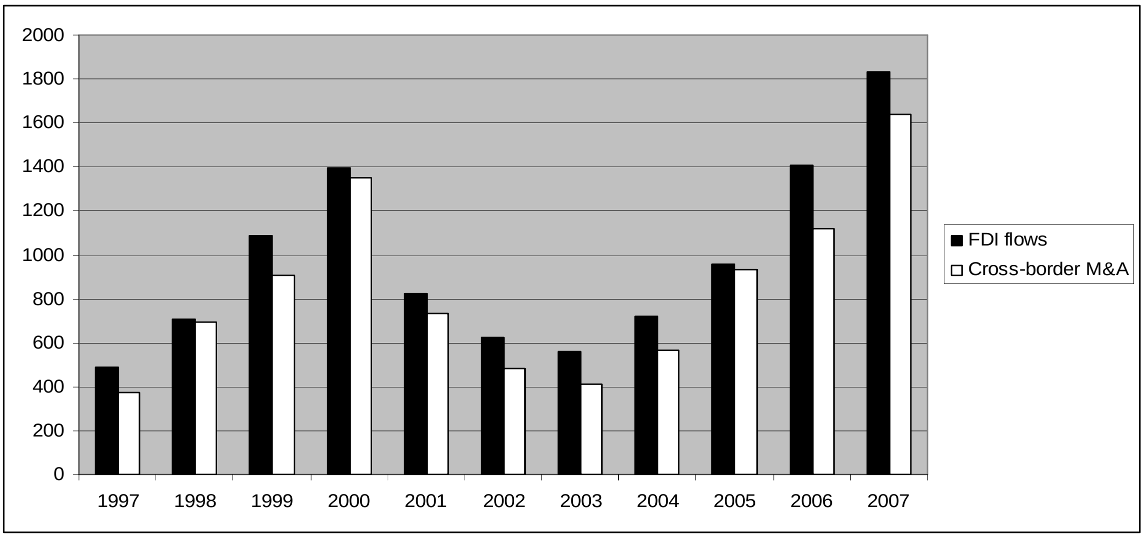
To make it clear we need to divide this combined concept and define it. Cross-border acquisition takes place when existing company is purchased by a direct investor and cross-border merger is a type of direct investment in which two companies form a new, larger entity[391]. Looking on this matter in a wider perspective

[390] Praca napisana pod kierunkiem dr Iwony Sobol, Instytut Handlu Zagranicznego, Wydział Ekonomiczny Uniwersytetu Gdańskiego.
[391] C.W.L Hill, *International Business*, McGraw-Hill, 6th edition, 2007, p. 429.

cross-border M&A could be taken into consideration by multinational enterprises (MNE) for two reasons: to solve past and present problems and (or) to look for market opportunities. In banking system it is especially effective with the liquidity or asset losses problem. Additionally taking part in M&A can provide better effectiveness in reallocating resources. We can also learn from our strategic partner about management and operation systems which can improve company's efficiency and competitiveness[392]. This significant type of foreign direct investment (FDI) has been increasing over the years as prime FDI flows as it is shown in table 1.

Table 1

World cross-border M&A in the whole FDI flows in years 1997-2007 in bn of



USD

Source: Own work on the basis on *Inward FDI flows, by Host Region and Economy, 1970-2007, Value of Cross-border M&A's by region/economy of purchaser*, UNCTAD 2008, http://www.unctad.org, 10.02.2009.

The data shows that cross-border M&A accounted for 89% of worldwide FDI in 2007[393]. Multinational enterprises could not go wrong choosing this strategy because it allows them to reduce competition and increase market power in foreign countries and there is a huge possibility of speedy entry and taking over a big part of the market.

Nowadays in the highly uncertain and volatile world we can observe high growth of cross-border M&A activities. This is particularly prominent in the financial sector, especially banking. Cross-border M&A presents a chance of recovery and (or)

[392] A. Mody, S. Negishi, *The Role of Cross-Border Mergers and Acquisitions in Asian Restructuring*, World Bank Institute, The World Bank, Washington D.C. 2000, p. 3.

[393] *Inward FDI flows, by Host Region and Economy, 1970-2007, Value of Cross-border M&A's by region/economy of purchaser*, UNCTAD 2008, http://www.unctad.org, 10.02.2009.

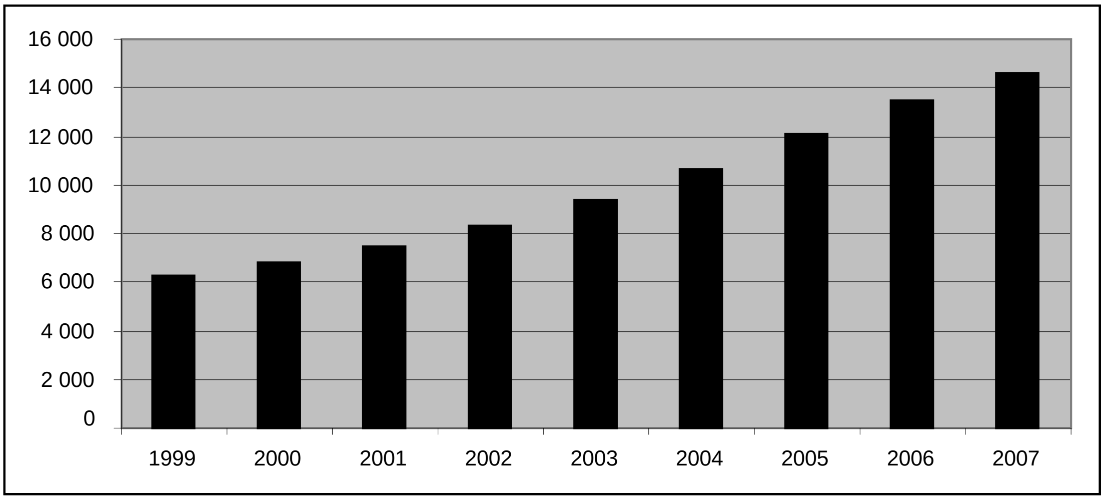
expansion when faced with a financial crisis. On the one hand it is a chance not to go bankrupt, but on the other one it is a very good moment to attack weak competitors.

2. Financial crisis overview

Nowadays crisis is the word which is on almost everybody's lips. Definition of a crisis can be found in every encyclopedia and it means a difficult moment, a turning point of something that is usually characterized by an unstable stage. To get a better idea how a crisis can develop let us have a look at what was happening in the mortgages market between years 1999 and 2007.

Table 2

Total mortgages market in all sectors in USA in years 1999-2007 in bn USD



Source: Own work on the basis on *Statistical Supplement to the Federal Reserve Bulletin*, The Federal Reserve Board, http://www.federalreserve.gov, 31.12.2008.

First signs of problems in the subprime mortgages market could be observed in the USA in 2005. This kind of credit accounted for 14% in whole mortgages credit market in the USA, which is a huge increase compared to year 2002 when it was only 3%. In the meantime whole mortgages market was growing systematically. In table 2 it can be seen that from 2002 to 2005 mortgage market growth was at the level of 45% (from 8 335 bn USD in 2002 to 12 101 bn USD in 2005).

Banks put stress on increasing the credit sales volume and gave loans to people with limited credit rating. What is more the financial crisis was not only the matter of low interest rates, which made the house price bubble, but it was also a matter of lack of caution from consumers which believed that the house prices will always be increasing. Banks were using minimum underwriting standards, credit agencies were giving too optimistic ratings on new products, regulators did not create a suitable legal framework on it and underestimated liquidity, investors were buying illiquid complex repackaged products without focusing on the underlying bank profit drivers. Also Enterprise Risk Management (ERM) which should be implemented very strictly especially in such organization like banks was forgotten at that time. The members of board of directors are the most important link in implementing ERM in a company and should be aware of company's risk appetite. Unfortunately they were blind and did not see the problems arise[394].

The subprime mortgages market went in very short time from the niche market to a meaningful element in the map of home financing[395]. The problems come when people cannot repay their loans, which is an even bigger problem when the economy goes down and the debtors lose their jobs and liquidity, and when the value of estates drops below the value of mortgage. This is a simple way of getting bad assets in the banking system. Possessing huge amount of bad assets at the time when the economy is in a bad condition causes less penchant for giving credits[396]. This in turn causes liquidity crunch problem with lending the money to other banks. With a very small level of trust on the unstable market in August 2007 central banks started to pump money into the system to prevent the bankruptcy of banks.

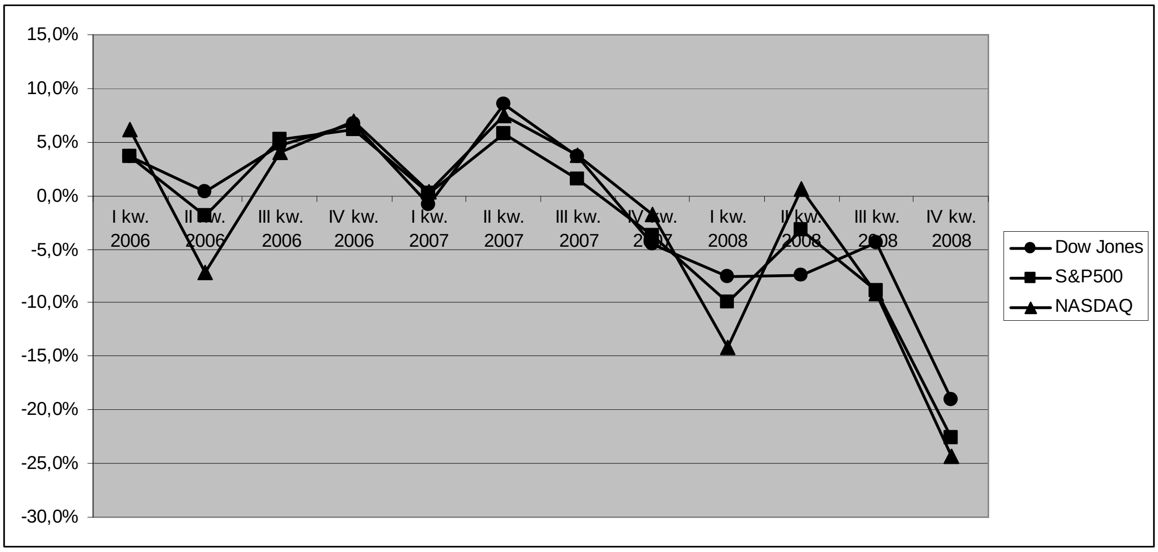
Banking system function all over the world and banks in different countries are connected like the blood vessels in a human body. Crisis started to spread worldwide because US financial institutions wanted to share the risk of subprime mortgages with other investors. They set up special funds to share the risk called Special Investment Vehicles which were issuing collateralized debt obligations bought by banks, investment and hedging funds. It was the simplest way to spread the risk all over the USA and different parts of the world. Due to the *contagion effects* other financial institutions were getting in trouble. In January 2007 losses were quoted at the level of 100 bn USD and year later three times more just in subprime mortgages market. The level of losses in the whole threatened financial market ranged from 600 to even 1000 bn USD. These markets have not seen such huge losses in the entire

[394] R. Rudnicki, *Subprime credit crunch – nieszczęścia na własne życzenie*, Przegląd Corporate Governance, nr 4/2008.
[395] E. Schloemer, Wei Li, K. Ernst, K. Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, Center for Responsible Lending, 2006, p. 7, http://www.responsiblelending.org.
[396] M. Muskal, *Understanding the financial crisis*, „Los Angeles Times", http://www.latimes.com, 10.02.2009.

history[397]. In addition to this it would be proper to write that it is not the first banking crisis, but it is the first global one. The bankruptcy of New Century Financial Corporation in 2007 – the biggest US moneylender – was the beginning of the collapses of a few smaller ones, also the insurance companies. The next shocking sign of the crisis was suspension of investment funds payments from the one of the biggest investment banks in the world – Bear Stearings. In the effect price of stocks in the whole world decreased. The most visible signs were visible on indexes like Dow Jones, S&P500 and NASDAQ. It was just a beginning of the decreases as can be seen in table 3.

Table 3

Dynamics of Quarterly Performance of Dow Jones, S&P500 and NASDAQ Indexes in years 2006-2008



Source: Own work on the basis on http://www.stooq.com, 10.02.2009.

Crisis in the US financial sector spread all over the world. After the troubles of the US banks and decreases on New York Stock Exchange we could observe how the crisis spilled out all over Europe. This crisis affected also another important feature of efficient and operative banking system – confidence. Lack of it leads usually to *bank run* and causes problems in the whole banking sector. Such a situation was observed in the United Kingdom in 2007 when Northern Rock was faced with such a problem[398]. Also German banks had problems with lack of confidence. IKB Deutsche Industriebank and SachsenLB almost collapsed when the subprime crisis on

[397] S. Sołtys, *Subprime – to nie jest zwykły kryzys*, Raiffeisen Bank Polska S.A., konferencja naukowa „Kierunki zmian w sektorze finansowym w Polsce i na świeci", Sopot 2008.
[398] P. Welfens, *Banking crisis and prudential supervision: a European perspective,* International Economics and Economic Policy, Springer 2007.

US market has become apparent and investors started to avoid almost all of the commercial papers issued by Special Investment Vehicles[399].

3. The cases of particular banks

The results of the global crisis such as bad credits, collapses of banks and insurance institutions all over the world, deep decreases on stock exchanges, bankruptcy of many companies and bad derivative investments have shown that the rule “too big to fail” did not work. For many financial institutions and governments it was unbelievable to see the collapse of such financial giant as Lehman Brothers. Also they were shocked by the milliards of dollars losses of Lloyds Banking Group, German’s Hypo Real Estate, problems of Fannie Mae, Freddie Mac and AIG, Bear Stearns, forced takeover of Merill Lynch, Dexia, Royal Bank of Scotland or finally the big pride of Belgian banking system Fortis which almost collapsed. These banks are just the top of the iceberg. But these examples show how the system has been affected by the crisis.

Weak conditions of the biggest world banks in the biggest economies had to cause problems throughout the whole global economy affecting various markets and countries. Weak financial system may cause the dig of credit crunch and push many national economies into deeper crisis. Governments of the affected countries have been aware of this problem. Without stable banking system no economy can work properly. The crunch in the system has been pushing national banks of various countries to intervene. Such a situation could be observed in the case of helping with takeover of Bear Stearns by JP Morgan. Also all of the institutions listed in the previous paragraph had to be nationalized. States conducted these operations to rescue collapsing banks and the entire system. The only exception to this rule was the case of Lehman Brothers. Fed decided not to support this institution. This was the sign given by Fed to eliminate the temptation of *moral hazard* so that banks will not be keen on taking bigger risks because of the state’s help[400].

The interesting thing about the present situation is the fact that these big players of global financial world are not so big anymore. The truth is that these banks still need to fight for their survival. Presently some of banks are still state banks but some of them have already changed their owners and the most of them will do so in

[399] Ibidem.
[400] C. Rękawek, *Świat z Lehmanem niekoniecznie byłby lepszy*, http://www.ft.onet.pl, 10.01.2009.

the future. The ways of saving these institutions are M&A at the national and international level. For these banks it is a way of not going bankrupt at the time of crisis. But where there are losers there are also winners. The crisis is the best time for strong entities to act and enlarge a market share.

At the beginning of the crisis there were opinions that cross-border M&A in the banking sector are rather the exception than the rule[401]. But then we could see on the banking sector stage such moves as Italian's UniCredit acquisition of Germany's HypoVereinsbank and Netherland's ABN Amro acquisition of Italian's Banca Antonveneta[402]. Advantages of such transactions are obvious. They help to drive up the market, which later can drive up more M&A deals because of increasing confidence and it has a positive influence on banking earnings. What is more such transaction can have a visible effect on the share prices of banks, especially investment ones[403].

The next important phase for cross-border M&A was in 2007 when consortium of three banks gave an offer of acquisition of ABN Amro. Royal Bank of Scotland, Spanish Santander Bank and Belgian Fortis Bank bought the Dutch bank for 101 bn USD and took over 86% of shares, which made it the biggest deal in the banking history. That year we could see the first serious results of US mortgage crisis. Barclays Bank, which was also interested in ABN Amro, resigned because its combined offer of cash and shares decreased in value due to the beginning of US mortgage crisis, which meant running a higher risk[404]. Time has shown that the winner was Santander which is one of the few banks that did not catch the bug of the crisis as other members of consortium did. Santander focused more attention on ABN's Brazilian operations which promised growth and deal with swiftly flipping to another buyer ABN Italian retail network. In such a way and thanks to Spanish regulations Santander avoided the subprime problem[405]. Santander also bought two British mortgage banks, Alliance & Leicester and part of Bradford & Bingley, which caused some liquidity problems with possessing bad assets in the bank's portfolio, but

[401] G. La Malfa, *Cross-border M&A does not suit most banks*, http://www.ft.com, 01.06.2005.
[402] *Financial Services M&A. Review of and Outlook for mergers and acquisitions in the European financial services market 2006*, PricewaterhouseCoopers 2006, http://www.pwc.com, 10.02.2009.
[403] L. Saigol, *M&A boosts banking shares*, http://www.ft.com, 28.11.2005.
[404] *Wielkie przejęcie banku za 71 mld euro*, http://www.money.pl, 09.10.2007.
[405] *Aftermath of a mega-merger. Three amigos, only one conquistador*, „The Economist", http://www.economist.com, 17.07.2008.

still in the whole of year 2008 Santander had a net profit of 13,6 bn USD[406]. In addition to this other Spanish banks like BBVA, which were not involved in the derivatives market in such a way as for example German or British ones, are looking forward to the cross-border M&A aims in the USA, especially the small banks in Florida.

And last but not least is an example of how a strong and healthy bank can make a great investment deal. The French biggest bank BNP Paribas, with 50 bn EUR self assets and assets in general at level 1800 bn EUR, bought the Belgian pride Fortis Bank in 2008. The deal was worth 14,5 bn EUR which included 75% of capital of the Fortis Bank and 100% of Fortis Assurance in Belgium, 67% and 16% correspondingly in Luxembourg. The spectrum and consequences of this cross-border acquisition was huge. Fortis Bank, first nationalized, was taken over by the French bank with its 1458 agencies in Belgium, Luxembourg, France, Poland and Turkey. What is more it took also its insurance business in Belgium, private banking and the consumer credit banking business. The most baffling problem – toxic assets – was also solved. Toxic assets of Fortis Bank worth 10,4 bn EUR were separated into a special *defeasence* fund.

BNP Paribas is nowadays considered to be the safest bank, because of the fewer amounts of toxic credits which are the most dangerous during the financial crisis. Acquisition of Fortis Bank was the one of the most correct hits in the banking sector in the world. Analytics estimated that synergy will bring about 500 bn EUR profit each year starting from 2011[407].

Unfortunately this acquisition is not finished yet. At the end of 2008 the Belgian government collapsed and presently BNP Paribas is still awaiting the confirmation of the transaction. What is more the first voting of Fortis Bank shareholders did not find a solution to this problem. Also, as Fortis Bank is a tidbit for a few interested parties there was a renegotiation of the deal. The changes are to be as follows: BNP Paribas will take only 10% of insurance business and it will take with the Belgian government a bigger part of the toxic assets. But there is also another player in the game – Chinese insurer which is Fortis Bank's biggest investor, which

[406] *Santander and BBVA. The Spanish derby*, „The Economist", http://www.economist.com, 12.02.2009.
[407] P. Błoński, *Fortis połknięty przez BNP Paribas*, http://www.rfi.fr, 06.10.2008.

might not agree on the deal[408]. For the time being shareholders have rejected twice the deal. But if BNP Paribas would strikes the deal it could be its great chance to take over a sizeable market share.

In the case of Belgian banking sector it is good to write about another big bank in this country: KBC. KBC is now the biggest bank in Belgium and it has not been faced with problems such as Fortis Bank was. Strategies of these two banks have made a huge impact on the ways of facing the financial crisis. KBC was involved mostly in Central and Eastern Europe. In these countries banks did not invest huge amount in the US subprime market. Also during the crisis it has been going back to the traditional banking model which is more deposit dependent, relies on: less securitization, stronger capital bases, increased risk controls and more regulations. This comparison highlights that banks with less aggressive strategies win nowadays and could be the potential threat to the not long ago big competitors and could even try to take over their market share.

What is more on the banking system horizon can be observed a lot of national M&A which have taken place during the financial crisis. In USA JP Morgan has bought Bear Stearns and Washington Mutual, Bank of America has taken over Merrill Lynch,

and in Germany Dresdner Bank has been taken over by Commerzbank[409]. Also problems of mother company could cause changes in the banks shareholders list in particular national banking sectors, for example in Poland there are possible acquisitions of Pekao, BRE Bank, BZ WBK and Millenium[410].

M&A on one hand can bring positive results to all sides, but on the other hand it could cause problems. Such a situation was with Lloyds Bank Group which took over HBOS bank. In February 2009 Lloyds Bank communicated 11 bn GBP loses which makes it almost impossible for Lloyds Bank to rise up after such a big blow[411]. This merger shows that there is a high probability of bad deals, especially when they are done in a hurry and under the pressure of the British government. So nowadays we are faced with the worldwide nationalization of banks and big M&A's.

[408] *Fortis. What a curve-up*, „The Economist", http://www.economist.com, 05.02.2009.
[409] Bień, K., *Kryzys wyłoni nowych właścicieli*, http://www.ft.onet.pl, 20.10.2008.
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Summary

The cross-border M&A is not the only strategy to overwhelm the market. But every year this kind of investment grows in value and the results show that it is worth trying. It can reduce competition and increase market power. But these days it gives additional advantage - it helps to survive the hard times of financial crisis. The players which were once the biggest are now often the weakest and dependent on others. Nationalization is the normal procedure, but another option is changing the owner. M&A can be the tool to help in this procedure. Such banks as ABN Amro, Fortis Bank, Lloyds, Bear Stearns, Dresdner Bank are the survivors in the crisis and are safe from bankruptcy but on the other side of the coin we have winners such as Santander, KBC, BNP Paribas which have employed the right strategy which will push them in the near future to the larger market share and higher profits.

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4) *Fortis. What a curve-up*, „The Economist", http://www.economist.com.
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12) Saigol L., *M&A boosts banking shares*, http://www.ft.com.
13) *Santander and BBVA. The Spanish derby*, „The Economist”, http://www.economist.com.
14) Schloemer E., Wei Li, Ernst K., Keest K., *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners,* Center for Responsible Lending, 2006, http://www.responsiblelending.org.
15) Sołtys S., *Subprime – to nie jest zwykły kryzys*, Raiffeisen Bank Polska S.A., konferencja naukowa „Kierunki zmian w sektorze finansowym w Polsce i na świecie”, Sopot 2008
16) *Statistical Supplement to the Federal Reserve Bulletin*, The Federal Reserve Board, http://www.federalreserve.gov, December 2008.
17) *Sześciu bankom grozi rewolucja*, http://www.bankier.pl.
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21) http://www.stooq.com.