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MERGER AND ACQUISITION IN THE FINANCIAL SERVICES INDUSTRY

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-Abstract-

The paper analyses the driving forces of the convergence in the financial sector, focused on banking and insurance companies, in terms of strategic cross-sector and cross-border mergers and acquisitions (M&As). New tendencies such globalization, integration, disintermediation and deregulation give the basis for new dimensions in the financial services industry. Based on the data, the banking industry has experienced an enormous level of consolidation as M&As. We find that the penetration process, so the entry into insurance services industry is mostly driven by banks. We analyse whether this risky strategic process is beneficial or necessary in the financial services industry.

Keywords: *merger and acquisition, bancassurance, horizontal integration, diversification, financial synergy*

JEL Classification: G21, G22, G34

1. INTRODUCTION

Due to the radical changes in the function and structure of financial markets and to the regulation reforms, the services provided by the financial institutions became reasonably different. In the last decade the most conspicuous change in the financial sector is the increasing convergence of banks and insurance companies. Nowadays many banks offer insurance while insurance company products compete with bank savings. This tendency is bordered by various concepts – bancassurance, allfinance, assurfinance, financial conglomerates.

As a consequence of the product range widens, the services becoming more complex, the regulation is liberalized and the merger wave of corporations, financial suppliers also became more complex and their activity structure became more diversified.

2. THEORETICAL FRAMEWORK

In recent decades, affecting all industries have become the elements of globalization, deregulation and liberalization trend. As a result, strategic groups, corporate giants have emerged, which became the focus for the operation of the increased risk reducing diversification. The strategic management literature has traditionally relies on four main strategies of diversification, as Ansoff (1957) outlined: horizontal, vertical, concentric and conglomerate diversification strategies.

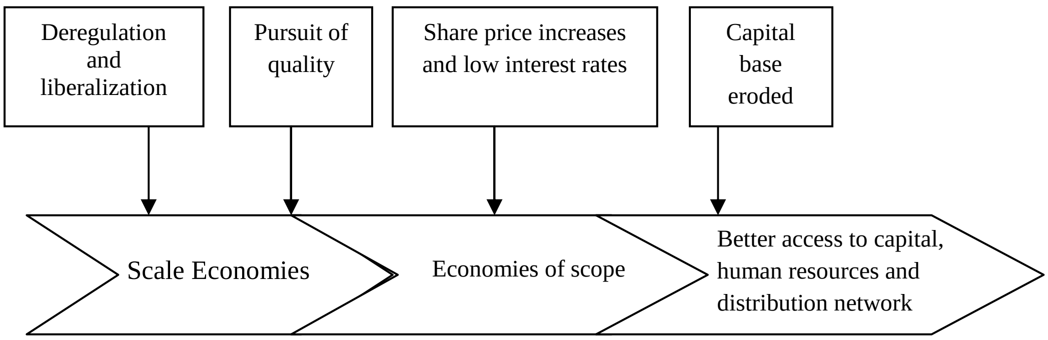
Horizontal integration can be defined as ownership or increased control over competitors' (David 1989). In most cases, this strategy is characterized by the merger or acquisition of the competitor. This position is concentrated as the existing products, markets, or both increases the level of corporate activities is included. In case of large firms, this strategy has limitations that may violate the Competition Act. The horizontal growth strategies can be defined as a strategy, by which is not related and/or unrelated products are sold to existing customers. David (1989) differentiates a horizontal integration, which includes the acquisition of a competitor, and one that the introduction of new products and services means. This second category does not include the acquisition or establishment of new units, but fully integrated into the existing company structure. Consequently banking and financial M&As are horizontal.

Vertical integration is defined as the company's business scale expansion, incorporating the activities of suppliers and customers. There are two types of vertical diversification. The first is a backward integration, which entails the acquisition or ownership of the company increased control over supply. The other type, the forward integration, means the control over distributors and resellers. This may involve the purchase of a distribution system, or to set up such a system internally. The main disadvantage of vertical integration is that the supplier is bounded to a single business, even though there may be cheaper producers in the market as well. Finally, by changing needs, in vertically integrated units may occur coordination difficulties (Hill-Jones, 1989). Despite of all this, the cost savings, cost avoidance in the market, quality control and applied technology can be the potential benefits of the strategy. The convergence in energy sector – which has the second largest M&A volume after financial sector – is vertical character integration. (Read more about the parallel of M&A in financial and energy sector in Deutsch (2011) and Deutsch-Pinter-Pinter (2011)).

The concentric diversification means that we give something new, but related product to the company's existing product line (David, 1989). The new product’s technology and marketing aspects are in synergic position with the company's current products. It can be seen that this group has many similarities to the horizontal integration (new but related products are not introduced), as well as vertical integration – regarding the inputs as new related products.

The conglomerate diversification strategies include a category for which there are no obvious technological or marketing synergies, or cross-selling opportunities. This strategy of the 1960s became well known, and is still often arise in the literature (Porter, 1985). Hill and Jones (1989), however, argued that unrelated diversification can bring greater benefit than the related, as the latter increases the organizing difficulties. The diversification strategy is a tool for mergers and acquisitions initiative. Figure 1 shows the driving forces of the application of mergers and acquisitions.

Figure 1: Forces of M&As



Enhancement of efficiency in:
- information technology,
- distribution
- asset management,
- R&D.

To be able to:
- aceess to external markets,
- use different distribution chanels,
- manage higher and more complex risks,
- expand product portfolio.

Increase:
- financial base,
- public recognition.

Decrease:
- the volatility of results,
- the cost of capital.

Source: DIBC (2003)

The main driving forces - economies of scale, choice, access to economic resources and efforts – can be completed by the following factors, which in theirselves are not turning up the merger-acquisition activity, however, help to create a favorable environment:

- market deregulation and liberalization
- move the customers' preferences for large service providers (search for quality)
- increase in stock prices and low interest rates
- eroded capital base.

When company executives announced a new merger or acquisition is their intention, the most commonly cited reason is that the newly created business unit, economies of scale provided by the realization of cost synergies will be able to. The reason is that the larger units can be more efficient for smaller ones. This is due to the fact that many of the cost of operation do not increase proportionally with the size of the company. Obvious examples are the brand and support structure, a highly specialized product development, information technology system to establish and maintain the distribution network and asset management. Typically, larger companies seem easier to attract adequate employee, equity capital and external funding. The larger companies re-configure more easily their business portfolio, ceasing product lines and activities that are making losses and are not part of the group's strategic thinking. In addition to economies of scale lead to the consolidation of the organizational profile of economy development as well. This may result from the fact that the combined business units are also able to continue to become a party goes beyond the individual profile. If the mergers and acquisitions are successful, - the efficiency increases - then the product or service mix improving, and have better access to customers, and all the shareholder value and return on equity increases (Welborn, 2004).(More about valuation of financial institutions in Takács (2009)). Furthermore, when a group diversifies the risks of diversified business lines, it usually reduces the volatility of profits, and thus the capital cost. In addition, if the groups are showing an intensive financial strength, this means they take a lot of advantage. They will be able to share capital, and obtaining other external sources for lower cost, to carry out easier investments and divestments.

Arising equity markets and low interest rates generate favorably environment for mergers and acquisitions. The recovery of stock markets blow up the capital base of undervalued companies is particularly favorable target for the expanding groups. Mergers and acquisitions integrate the know-how in one organization, but it can also cause major problems of integration. Any alternative costs occurring in acquisition, it should be compared with the costs that are occurring in the case of new entry. In many cases, new entry provides more flexibility in planning new services.

3. CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY

3.1. Merger and Acquisition Waves

Summarized the theory and completed with examples, we keep track of the historical merger waves. We analyse the driving forces, and impacts on several industries.

Table 1: Historical Merger and Acquisition Waves

Time Period	Driving Forces	Type of M&A Activity	Key Impact	Factors Contributing to end of Wave
1897-1904	Drive for efficiency, Technological change	Horizontal consolidation	Increasing concentration: metal, transportation, mining industry	1904 stock market crash, fraudulent financing
1916-1929	Entry into World War I., Post WW I. boom	Largely horizontal consolidation	Increased industry concentration	1929 stock market crash
1965-1969	Rising stock market, Sustained economic boom	Growth of conglomerates	Financial engineering and conglomeration	Increasing purchase prices, excessive leverage
1981-1989	Rising stock market, Economic boom, Underperformance of conglomerates	Rise of hostile takeovers	Break-up of conglomerates, Increased use of junk bonds to financial transactions	Recession, bankruptcies
1992-2000	Economic recovery, Booming stock market, Internet revolution, Lower trade barriers, Globalisation	Strategic mega-mergers	Record level of transactions (in numbers and prices)	Slumping economy and stock market
2003-2007	Lower interest rate, Rising stock market, Globalisation, Price-value disproportion	Cross-border transactions, Horizontal mega-mergers, private equity influence	Increasing synchronicity among the world's economies	Economic slowdown in industrial nations

Source: own source based on DePamphilis (2011)

Because of extent barriers, we highlight only the elements affecting the financial industry. By the middle of the 20th century the basis of the modern financial system evolved also in international directions with fixed exchange rates, convertible foreign currency and the widespread spreading of free-trade principles. The post-war reconstruction and the significant economic recovery went hand in hand with the rapid development of the financial services. By the 1970's the conditions became mature to replace the fixed exchange system with a flexible one and the regional and global liberalization of the financial system began. The ever increased international movement of money and capital sources, the raw material crisis, the debt crisis of the developing countries increased the risks engaged in the financial system. The flexible currency-exchange system, the fluctuation of interests, the financial innovation which created ever more newness, put the credit institutions, investment banks and pension funds from time to time to trouble. Risk became ever big and complex the effective treatment of which was unavoidable.

The flow of complex financial products and money between the banking retail and wholesale channels actually aimed at the more proportioned and more effective attainment of savings. The aim of financial suppliers is to make individuals to invest their money at them. However the persuasion create an intense competition in purchasing of savings, and accordingly in the encouragement of demand.

From the 1980's reintegration started, as a result of the two areas (banking and insurance) were trying to incorporate and practise each other's functions. This new development of financial services is the strengthening convergence of the banking and insurance branch on the financial services market.

The liberalised-deregulated financial regulation system allowed banks and insurance companies to cross the formerly strictly designated borders. However, this was preceded by the shrinking of the commercial banks' market share.

On one hand deregulation resulted in the declining market share of banks in the savings market, on the other hand it opened the way for banks to penetrate the insurance market. One way of the process is the merger and acquisition of banks and insurance companies. Consequently mergers and acquisitions are a risky way to grow business.

3.2. Mergers and Acquisitions in numbers

In the last decade M&A activity has fluctuated in all industry, especially in financial sector. Since the start of the financial crisis the risk perception has risen and the global M&A activity in financials has fallen, although the volume of the transactions is the largest in the sector. The expected growth ratio for 2011 in the financial industry is about 15%.

Table 2: Global M&A Volume By Top Industries (billion USD)

	Energy	Financials	Telecom	Healthcare	Materials	Utilities
2000	146.67	506.91	526.11	20.76	118.69	97.24
2001	139.62	408.24	140.81	17.37	94.75	108.89
2002	74.26	260.77	91.15	24.03	50.50	95.30
2003	73.59	347.89	105.64	52.29	63.81	47.01
2004	186.05	522.14	220.69	55.03	105.19	68.43
2005	215.18	581.61	269.44	90.48	149.37	123.95
2006	252.45	940.56	281.37	133.68	283.92	249.33
2007	279.54	1,016.80	205.93	118.66	296.35	304.52
2008	235.33	724.34	175.35	63.53	184.88	121.10
2009	223.14	422.55	98.40	25.96	81.73	103.01
2010	300.10	328.86	162.71	56.05	134.42	127.08

Source: Bloomberg (2011)

In the financial sector we analyse the cross-sectorial changes to estimate the motivation of financial institutions. The European banking has experienced substantial changes and new forces of changes have taken place such as structural deregulation and prudential reregulation, competition, technological developments, globalization have occured. M&A deals are one of the main responses to new force of changes in the banking sector (Table 3).

Table 3: Number of M&A transactions between European Financial Institutions (EU-27) in 2008

Target company's Industry	Acquirer company's Industry							
	AFI	AM	Banks	Broke-rage	OCI	DF	Insu-rance	OF
AFI	19	14	4	0	0	0	1	23
AM	28	148	63	30	4	0	33	67
Banks	2	17	182	6	5	0	4	31
Brokerage	6	17	24	47	1	0	12	32
OCI	4	4	21	6	24	0	3	20
DF	1	0	3	0	0	0	1	1
Insurance	13	21	25	1	1	3	317	53
OF	27	33	22	10	2	0	8	148
Total	100	254	344	100	37	3	379	375

AFI: Alternative Financial Investment, AM: Asset Management, OCI: Other Credit Institutions, DF: Diversified Financial, OF: Other Financials

Source: Thomson ONE Banker database, in: Fiordelisi (2009)

Table 4: Value of M&A transactions between European Financial Institutions (EU-27) in 2008 (in USD million)

Target company's Industry	Acquirer company's Industry							
	AFI	AM	Banks	Brokerage	OCI	DF	Insurance	OF
AFI	39.8	440.4	0.0	0.0	0.0	0.0	0.0	258.2
AM	393.2	3834.9	3131.4	413.4	56.0	0.0	5301.0	11460.3
Banks	0.0	3574.3	178507.6	14037.8	63.4	0.0	67.4	127519.1
Brokerage	59.8	21.2	2393.6	4590.5	0.0	0.0	45.2	5647.3
OCI	91.7	88.0	1855.5	1145.0	3420.7	0.0	1015.4	3153.0
DF	0.0	0.0	640.7	0.0	0.0	0.0	7.9	144.2
Insurance	479.0	1228.1	5222.5	125.4	0.0	0.0	45801.4	6451.5
OF	5620.7	9864.5	3880.2	199.9	181.0	0.0	35.7	8583.5
Total	6684.1	19051.4	195631.4	20,511.9	3721.1	0.0	52274	163217.1

Source: Thomson ONE Banker database, in: Fiordelisi (2009)

We realised before that financial suppliers needed to extend their activities to cope with the emerged competition in the financial services sector, but now we can support this theory with numbers. Banks have loosened their space against other non-bank supplier. Table 3 and 4 make clear that banks are motivated to defence the customer savings, so their sources, according to integrate insurance companies into their business.

After the detailed M&A transactions, the largest number of transactions is made by insurance companies and banks. It shows us a real heavy competition. In terms of deal value, banks play the major rule with 195 631.4 million USD, beyond the insurance sector's 52 274 million USD. By the reason of global financial crisis, there is an enormous transaction value in terms of inside sector M&A in bank sector, but the second largest deal value lead up to the insurance industry with 5222.5 million USD. It demonstrates the necessity of widening services and that banking and insurance services, or organisations can be complementary and not competitive alone. Recent statistics show a rising trend of M&A transactions since 2003.

4. CONCLUSION

Mergers and acquisitions are one of the main banks responses to higher competitive pressures in banking industry. New forces of changes are related to globalisation, structural deregulation, prudential reregulation and technology developments. It is a risky way to growth, but there are some factors give rise to the successful M&A strategy (Table 5).

Table 5: Factors give rise to mergers and acquisitions

Factors	Consequences, effects
1. Operating Synergy	
• Economies of scale	enhanced value, access human capital, capabilities, skills, enter new region
• Economies of scope	profil, expand product/service offering
2. Financial Synergy	cost efficiency
3. Diversification and market, product/service development	stabilizing returns New products/services – New markets, Current products/services – New markets, New products/services – Current markets
4. Increased market power	anti-competitive effects
5. Customer focus	distribution channel optimization ("under one roof"), better access to customers, segments

Source: own source based on Pintér (2007), DePamphilis (2011), Pilloff-Santomero (2007)

Banks need to broaden their activity to be competitive, but success depends on several factors, on aligning the people, organisational, cultural and financial assets.

In further research we are going to deal more detailed with cross-border merger and acquisition transactions and highlight the disadvantages of the diversification strategies to complete the M&A process valuation.

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