Banking on change

Executive summary

- The launch of the euro in 1999 was regarded as the catalyst for a high level of cross-border bank acquisition.
- Even bigger domestic and international deals are set to follow.
- The general view is that treasurers can afford to be relaxed at this stage.

GRAHAM BUCK EXAMINES THE EFFECTS OF BANKING CONSOLIDATION ON CORPORATES.

The tussle between Barclays and Royal Bank of Scotland for control of ABN AMRO may culminate in the latest flurry of cross-border deals within Europe's banking sector. According to a recent report by ratings agency Moody's on bank consolidation, the deals herald a new trend. The report notes that the launch of the euro in 1999 was regarded as the catalyst for a high level of cross-border bank acquisitions. Although the number of deals has not lived up to initial expectations, Moody's suggests there have still been more than many suppose. Over the past decade, European banks have been involved in around 500 merger and acquisition deals and the pace has recently picked up as the barriers to large cross-border transactions are removed. Europe now has one of the highest levels of foreign banking ownership in the world.

That said, the volume of deals is still considerably less than that of the US, where consolidation has resulted in the Big Three of Bank of America, Citigroup and JPMorgan. Nonetheless, the average European banking deal over the past three years has been around 10 times bigger than the average US merger and acquisition.

TREND TO CONTINUE Moody's report author Pierre Cailleteau expects consolidation to continue both domestically and across borders and even bigger deals to follow. The trend is helped along by the increasing assertiveness of shareholders – a prime example is hedge fund the Children's Investment Trust, which was instrumental in lobbying for a break-up or sale at ABN AMRO. In addition, banks may have to become predators if they are not to be the prey.

And as *The Economist* noted, unlike Europe's other industries "banks have largely been spared the embarrassment of hostile bids, private equity raids and needling shareholders". More recently, the credit crunch from US sub-prime mortgage loans and the resulting market could provide the impetus for another round of banking consolidation, with smaller-capitalised banks acquired and any problem loans on their books placed in a special purpose vehicle to ring-fence exposure.

M&A deals have three main goals: to increase the bank's market power, to enhance its market performance, and to pre-empt a strategic move by a competitor.

Has consolidation to date met these objectives? Moody's report suggests that the effect on ratings has been neutral to positive and Cailleteau believes it has allowed groups such as Santander and Royal Bank of Scotland to move from being regional operators to global players. But overall the jury is still out. In-market consolidations have generally proved more successful than cross-border deals, Cailleteau suggests.

Since the news broke in March that Barclays and ABN AMRO were in talks on a possible merger some of Europe's other major banks, which in the past have considered various combinations but not pursued them, have resumed negotiations.

SHOULD TREASURERS WORRY? There is a perception that consolidation makes it harder for small business borrowers to obtain credit. So should treasurers be alarmed by the prospect of more deals?

Probably not at this stage, suggests David Swann, Group Treasurer for British American Tobacco. He says his own group is hedged against consolidation as it is well banked. Nonetheless, he is closely following further developments in the sector if, as seems likely, the acquisition of ABN AMRO demonstrates that a cross-border deal can be successfully accomplished and encourages others to follow.

Bob Williams, Group Treasurer at Barratt Development, agrees that more deals should not cause too much concern: "I don't think, from a treasurer's perspective, it will be to the detriment of tailored services, reasonably efficient pricing and the like as there will still be a lot of players." However, one potential drawback is where two banks lending to the same company effect a merger. The total lending lines following the union will usually be less than the sum of the two individual lines available pre-merger.

There is a strong case for encouraging consolidation. Bank fees and the cost of many banking services are allegedly too high because the sector has been largely insulated from the effects of competition.

The evidence from North America, which has witnessed significant banking consolidation in recent years, is that it sometimes results in less choice, higher prices and credit being less freely available in some areas, but overall the drawbacks have been offset by the benefits of keener competition.

ENDING IN TEARS Another factor behind European banks' previous reticence to expand beyond their home country has been the experience of those that made acquisitions in the US, suggests Swann. A number of deals ended in tears and HSBC recently provided an example of the downside of US expansion, when the group's otherwise strong set of results was marred by problems experienced by its North American arm, Household.

National pride has also been a major factor in preventing deals on both sides of the Atlantic, says Williams. He says that Canada's bank sector was ripe for consolidation in the late 1990s but political considerations thwarted any deals. Williams thinks further consolidation is now inevitable.

Many banks are not under pressure to abandon their independence and disagreements over allocation of the top jobs continue to thwart some potential unions. Ye the trend towards further consolidation now looks unstoppable and further deals can be expected.

In May, Italy's UniCredit and Capitalia agreed to merge, creating Europe's second-biggest bank by market value. UniCredit has also been in talks with France's Société Générale on the possibility of creating a new European giant.

Meanwhile, France's newly elected president, Nicolas Sarkozy, appears ready to lift the state's long-held opposition to a union of Société Générale with BNP Paribas. The changed stance is apparently based on the belief that a combined SG-Paribas would be a national banking giant with the muscle to fend off bids from outside France. Similar thinking on France's energy sector saw Sarkozy apply pressure that resulted in the announced union early in September of state-owned Gaz de France with Suez.

BANKS HAVE LARGELY BEEN SPARED THE EMBARRASSMENT OF HOSTILE BIDS, PRIVATE EQUITY RAIDS AND NEEDLING SHAREHOLDERS.

JOINING IN Until recently, Germany provided the main exception to the consolidation trend. Small to medium-sized companies traditionally relied on regional, state-backed funding from the Landesbanken. But in the fallout from the US sub-prime loans affair, it has become evident that a number of public banks have limited credit facilities and need to consolidate. The revelation has already led to a bail-out of IKB Deutsche Industriebank and public sector bank Landesbank Baden Wurttemberg (LBBW) buying rival Sachsen LB.

LBBW now plans to bid for WestLB, which is actively seeking a partner and has hired strategic advisers ahead of a potential sale. A combination of LBBW and WestLB would create a group bigger than Commerzbank and second only to Deutsche Bank.

Outside of the Landesbanken, consolidation prospects for Germany's major banks are less certain. Deutsche Bank's Chief Executive, Josef Ackermann, has said that Deutsche Bank is primarily a global investment bank and that a mega-merger would not bring any benefit to that particular sector. He also doubts whether a non-German bank would willingly transfer its head office to Germany.

But Commerzbank's Chief Executive and head of the German banking industry association Klaus-Peter Mueller has said an ABN AMRO takeover will put pressure on Germany's banks to go on the acquisition trail. Jochen Sanio, President of Germany's financial regulator Bafin, says German banks will themselves be taken over if they fail to act.

A similar trend is under way in Scandinavia, where a potential merger between Nordea and Swedish rival SEB would create a banking group similar in size to Deutsche Bank, with a market value close to $70bn.

The positive view of consolidation holds that a blitz of mergers and acquisitions would be required before it started to seriously impact on competition and smaller companies began to find credit harder to obtain. Further unions would also help to rationalise overheads and lead to cheaper banking. The trend could even help to improve competition at the international full service banking level if it created more major players in the sector.

In fact, while bigger banks are consolidating, new players are coming into the market. One example is mid-market bank Alliance & Leicester, which in April launched a free business current account aimed at small and medium-sized companies.

The consolidation trend also promises to give some of the larger players more of an international presence. As Moody's notes: "Large banks are racing for global rather than European clout – hence the flurry of activity in China recently." And not only have international banks been purchasing minority stakes in Chinese lenders, but more recently, there have been indications that China itself might use some of its massive reserves to acquire stakes in overseas companies.

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