Economic Assessment of Selected Bank Mergers in the Central-East Europe Region in Comparison with Developed Countries

Tej Jakub[*], Ekonomická fakulta TUKE, Košice, Slovakia

ABSTRACT – My intention is to clarify the process of merging from the economic point of view, especially impact on financial results after the merger itself. Examine and analyze differences in financial results, measured by using various ratio indicators, market value of shares and capital adequacy in the region of Central and Eastern Europe in comparison with developed markets in the world.

KEY WORDS: economic situation, merger, the indicators of profitability, market value of shares, capital adequacy

Introduction

Nineties was characterized by a large number of mergers and acquisitions worldwide. This phenomenon belongs in the past decades to the preferred part of economic theory and practice. By the volume of capital bank mergers and acquisitions belong to highest rank of operations. They are closely linked with the globalization process and thanks to it very often cross national borders. Economic assumptions of mergers wave in last decade is the rapid development of information technology, reducing the cost of communication and transport, markets deregulation and privatization. In particular, acquisitions are an integral part of the restructuring process in transition economies.

Merger itself has not always met planned expectations. There is no guarantee of achieving economies of scale, risk diversification and improvement of solvency. To fulfill all positive effects, it is necessary to prepare in advance more than just a basic plan and strategy. It is necessary to include regional specificities and all other relevant variables.

Material and method

The intention of article is to clarify the processes of mergers from an economic perspective and impact on financial results after the merger itself. Based on data from annual reports, it examines and analyzes the impact of mergers on banks' financial results, measured by various ratios or market value of shares and capital adequacy in the region of Central and Eastern Europe in comparison with developed markets in the world.

---

[*] Address: Boženy Němcovej 32, Košice, Slovakia, e-mail: jakub.tej@tuke.sk

Achievement and discussion

Merger usually means the process of merging two or more separate economic entities, which occurs through direct connection to their net assets. The merger, in most cases means the merger of relatively strong and equally important subjects, which is reflected in many aspects. The merger must be decided by the General Assembly of all participating companies. As arguments for mergers and acquisitions is tend to be given many reasons. Separations of reasons in favor of the merger and against them are widely various, and what some studies have considered clearly positive, others resolutely refuse. As an example, we can use the impact of mergers on employment and the expected impact of mergers on the effectiveness of the newly created bank. But the problem remains that many mergers are justified economically inefficient. Analysis shows that the main problem is merging different corporate culture of companies. Only few projects, of mergers and acquisitions have more than a basic plan how to solve this problem. Others fail because of incorrect valuation of assets or hidden liabilities of the company [5, p. 243].

Complicated structure of conglomerates, which occur after the merger, very often requires more administrative personnel. The preserved remains specialized, however often mutually competing departments. On the other hand are after mergers and acquisitions expected savings from reductions in staff or expenses costs (Table. 1). These benefits would mean social costs in terms of increased unemployment. The problem in terms of social costs is also closing branches, usually associated with reducing supply of banking services, job cuts may not be the rule.

Table 1. Estimates of cost savings in bank mergers (in% of total costs)

SBC-UBS	**23**
Bank of Scotland-NatWest	22
Bank Austria-Credit Anstalt	18
BankAmerika-SecPac	17
Wells-First Interstate	17
Chemical-Chase	16
Swedbank-Forenings	15
Lloyds-Midland	14
Vereinsbank-Hypobank	14
Fortis-Generale	11

Source: Davis, S. I. 2007 [2, p. 97]

The most important argument for the merger is synergy. Synergistic effect is based on the premise that combining two formerly separate companies involves an increase effect on the coupling value that is added to the sum of the merging companies. It is known that such effects arise when combining two companies, for example, that in newly established company arise economies of scale, reduce some costs, lower distribution costs and marketing costs, disposal of surplus or unused assets, or just using them. We can say that the 90th were synergies reason and argument of many mergers in the financial sector. Acquisition of a

major market positions, or the emergence of oligopoly or even monopoly, should be reflected in the growth of the value of the bank and decrease the value of competing banks - however most of the studies decrease the value of rival banks didn't demonstrate [1, p. 135].

The motive for mergers and acquisitions may also be to circumvent quotas, tariffs and other restrictions in foreign trade, reduce dependence on foreign trade or invest in a safe and predictable environment. For successfully manage of merger is very important to make valuation of both banks, which want to merge. Financial valuation of bank aims to make its value by a sum of money. The potential of bank is then evaluate by cash equivalents. Valuation methods can be divided into these main groups [4, p. 12-13]:

1. methods based on income analysis,
2. methods based primarily on an analysis of current market prices,
3. valuation methods based on cost (the cost of purchasing the property).

Researched bank mergers were divided into groups according to the region in which they took place. The first group included the mergers in developed economies such as Japan, USA, GB, Spain and Republic of South Africa.

The second group included mergers acquisitions in transition economies of Central and Eastern Europe. The oldest is the acquisition of CSOB by Belgian KBC in 1999 in the Czech Republic. In it, KBC has acquired 65.69% stake for 40 billion CZK. Followed by series of Austrian ErsteBank acquisitions in the Czech Republic, Slovakia and Romania. The other from region are the acquisition of Komerční banka by French Societe Generale in 2001 in the Czech Republic, where there was a transfer of 60% of the shares for 40 billion CZK and fresh UniBanka merger with HVB Bank in Slovakia in 2007.

Table 2. The value of mergers under the merged total assets (EUR million)

Merging banks	Total assets		Total
Mitsubishi Tokyo FG + UFJ Holdings 2005 (Japan)	779 338	593 396	**1 372 734**
JP Morgan Chase + Bank One 2004 (USA)	955 077	269 512	**1 224 589**
Sumitomo + Sakura Bank 2001 (Japan)	500 886	414 775	**915 661**
Royal Bank of Scotland + NatWest 2000 (GB)	532 455	309 873	**842 328**
Barclays + ABSA 2005 (JAR)	785 852	51 009	**836 861**
Santander + Abbey 2004 (Spain)	504 704	248 857	**753 561**
SG + KB 2001 (Czech)	512 500	12 175	**524 675**
ErsteG + BCR 2006 (Romania)	181 703	13 519	**195 222**
KBC + CSOB 1999 (Czech)	156 218	6 557	**162 775**
ErsteG + SS 2001 (Slovakia)	80 114	4 643	**84 757**
ErsteG + CS 2000 (Czech)	54 935	12 410	**67 345**
UniBanka +HVB Bank 2007 (Slovakia)	1 504	2 178	**3 682**

*Source*: own calculations based on annual reports of banks

Capital adequacy

Sense of capital adequacy is based on the assumption that the larger the capital of financial institutions, the more resources shareholders put in. And the greater will be their

interest for the proper operation of the institution not to lose this money, but to maximize their value.

Graph 1. Capital adequacy ratio (%)
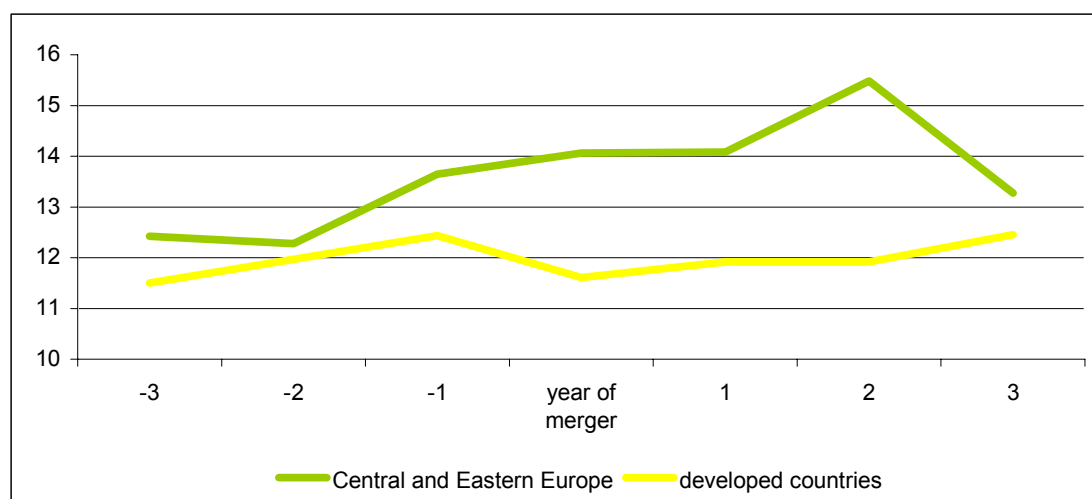
Source: author

In case of problems means lower value of capital adequacy for the shareholders and depositors a higher probability of loss. When bank will be successful in its activities, the lower value of the capital adequacy means for shareholders higher probability of evaluation invested investments, but for clients only their deposit interest. Raising capital adequacy means better security for clients, but on the other hand it means a reduction in institutions profit contributing to the unit of capital [9, p. 195].

From the previous graph 1 captivate an increase in capital adequacy of banks from Central and Eastern Europe. This can be explained by the some restructuring and reducing the risk before merger, or consistent acquisition partner selection. However, the level of the years after the merger seems to be overly cautious, since the recommended minimum threshold is at 8%. Conversely, banks from developed world economies reported relatively stable levels without significant trends at around 12%.
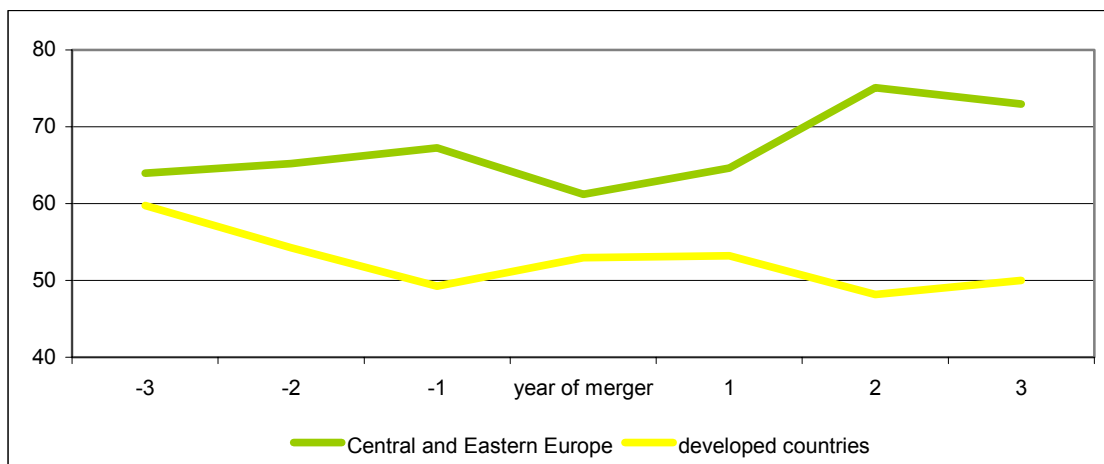
Profitability ratio indicators

From all of profitability indicators, each of which focuses on a different type of profitability, was included in the analysis one of representative from each category. Representations of the course are also most worldwide prevalent ROE and ROA.

Graph 2. shows the development of Bank's profitability ratio indicator R1 (net banking product * 100/ bank's business income) three years prior to the merger till period of three years after the merger. It is clearly visible that the group of banks from Central and Eastern Europe after the merger increased the share of net banking product up to 75%. In the second group of banks throughout the whole period a clear downward trend with small stagnation
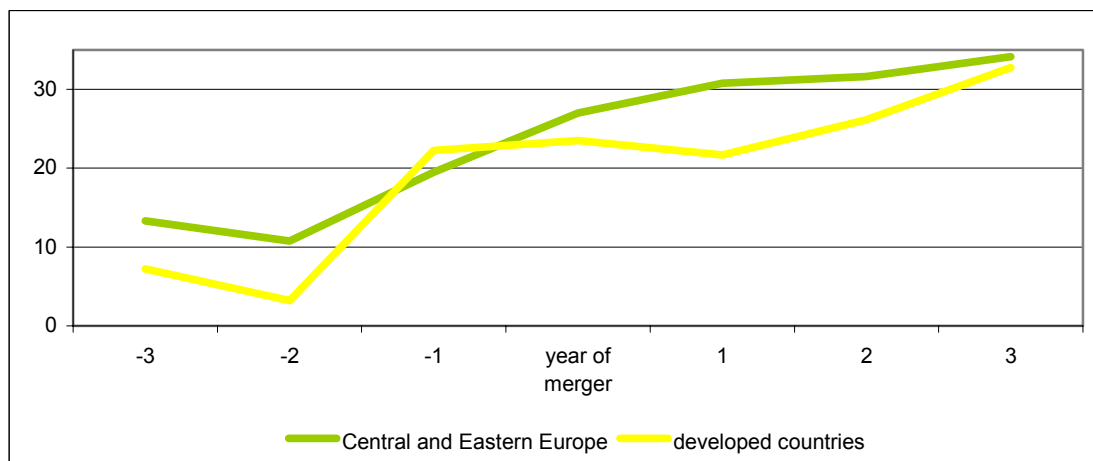
in merger's year, which means focusing on other areas, mainly on income from fees and commissions, or profits from financial operations.

Graph 2. Bank's profitability ratio indicator R1

Source: author

*Graph 3. Bank's profitability ratio indicator R3*

Source: author

R3 indicator works with net profit before tax (R3 = net profit before tax * 100 / bank's business income + operating income + other income) and thus eliminates any tax differentials in all countries. Already one year before the merger can be seen profit growth in both groups of banks, which continued also in subsequent years. So this indicator describes the merger as a great way how to increase net profit before tax.

Graph 4. Personal profitability R4
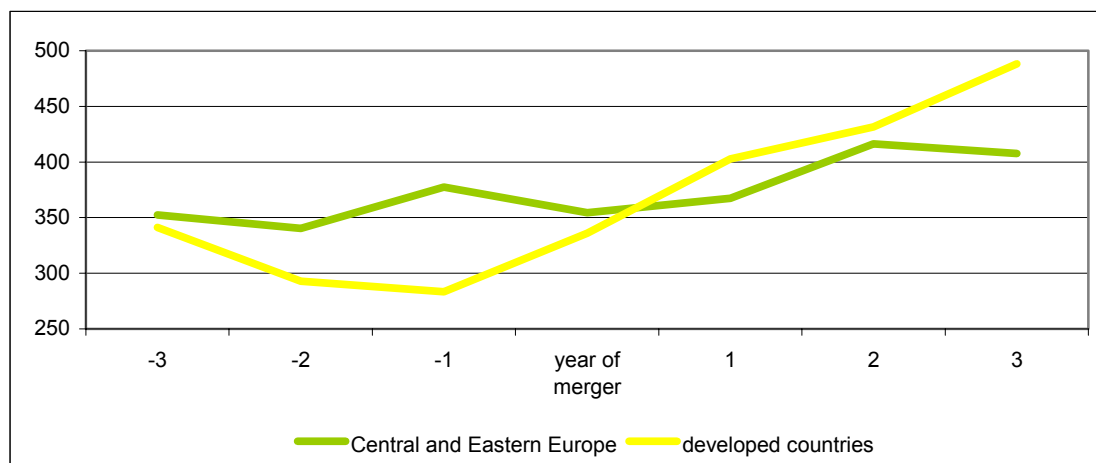
Source: author

Personal profitability ratio shows the effect which brings unit of labour in proportion to net banking product (graph 4). In international comparisons it is necessary to use net profit before tax due to different levels of taxation in different countries, and also apply profit to one employee. This comparison may indicate overstaffed banks or not very successful interbank organization, poor levels of technical equipment or in the extreme case low skilled and expertise of employees. Optimization of branch network and reducing the number of employees is among the core theme of mergers. One might assume that after the merger it comes just increase of this parameter. However, in a group of banks from Central and Eastern Europe was no bigger increase acting, even in the merger year there was a slight decline. And since labor costs were not growing by way to be able to explain this trend, mergers in this direction had not brought the desired effect. Conversely group of banks from developed economies, recorded an increase to almost twice its value from the year before the merger and the trend seems to be strong enough also for the future.

Graph 5. Return on equity – ROE
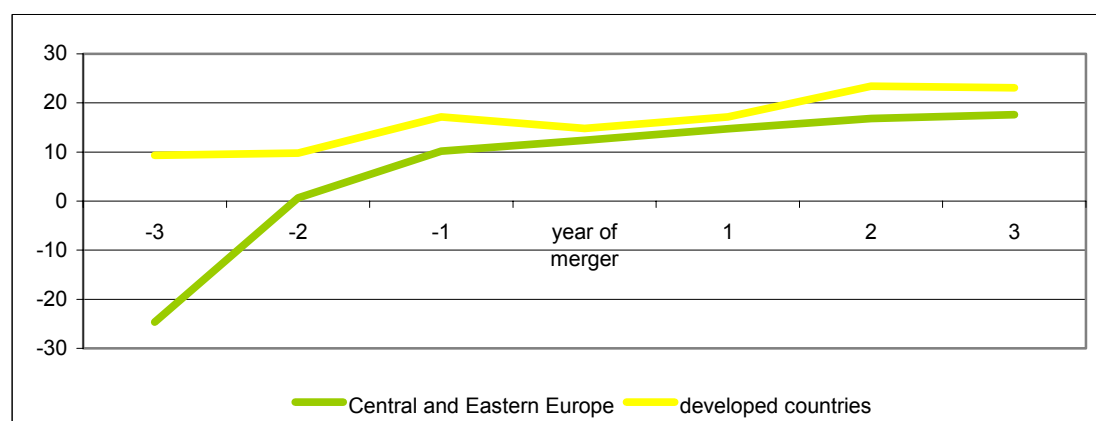
Source: author

Graph 5. shows the performance of banks as measured by ROE. It indicates to shareholders how effective their investments in shares are. Visible is a positive increase in banks in Central and Eastern Europe. Already one year before the merger they reached a significant positive value and growth trend is maintained until the end of the period. By contrast the group of mergers in developed economies has value of ROE still in the range 10 to 20% without significant changes in the merger's year. Thus the merger did not bring any significant effect to shareholders in the long run.

*Graph 6. Return on assets – ROA*
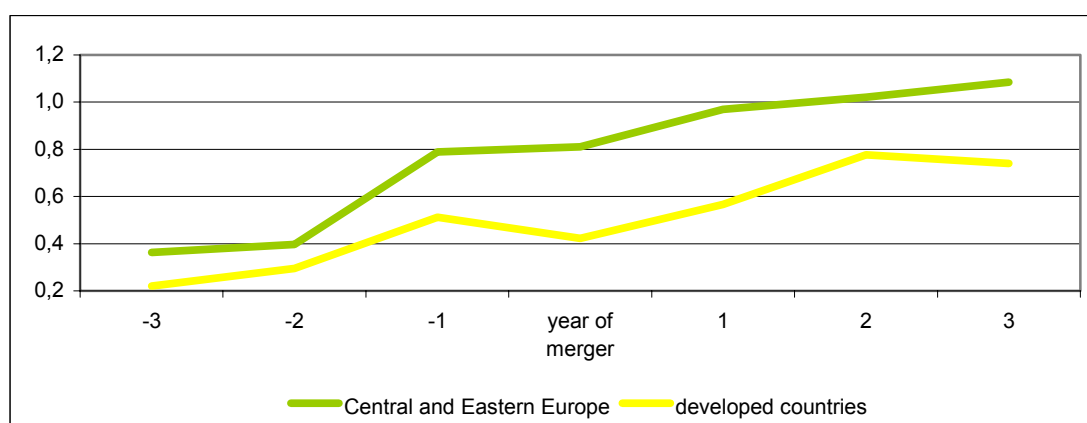
Source: author

The fundamental problem of the indicator ROE as the primary indicator of bank profitability, is that it does not take into account a possible leverage factor. The Bank may indeed very easily increase its ROE by increasing the total debt, namely use capital to cover a higher amount of assets. Therefore, the analysis must be considered simultaneously with the second indicator - ROA. Graph 6 - ROA shows how effectively assets are used to make a profit, then how much one unit of assets earns in average. The international standard is regarded as a value of 1.00 and as we can see, central European banks are reaching that point immediately one year after merger. In contrast with second group which are slightly below the standard and don't exceed value of 0.8 throughout whole period of time. The following shape of curve caused Japanese banks and their long-lasting crisis in its banking sector, which is marked by huge credit losses and overcapacity.

Market value indicator

The most important indicator from this category is now considered the market price of shares, which immediately takes into account all relevant information affecting their level and is a very important tool for investors (graph 7).

Graph 7. Market price of shares
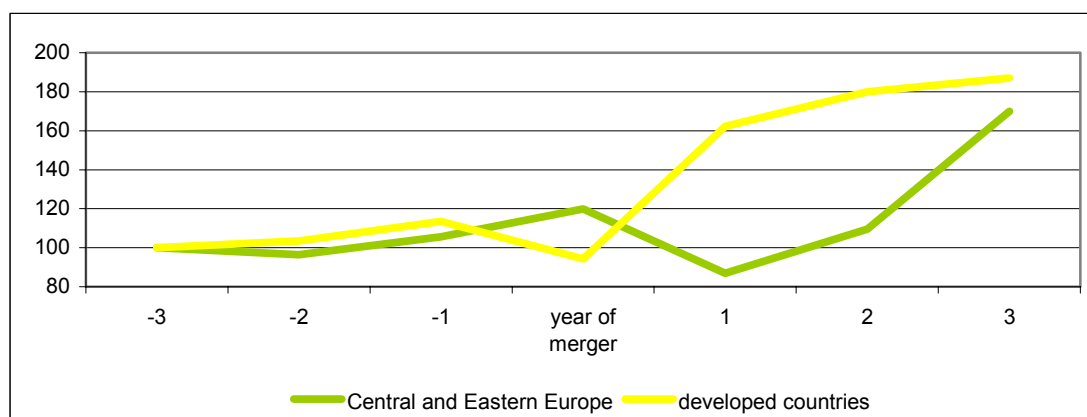
Source: author

Note except Slovenská sporiteľňa, BCR, HVB Bank and UNI Bank, which shares are not publicly traded.

One year after the merger took place as expected, fall in central banks stock prices, but it was already deleted the next year and a year later, the average price reached 170% of the initial value. The curve of banks from developed economies has fall in merger's year, but the following period was marked by a sharp strengthening price of shares up to 190% of initial value in the third year after the merger.
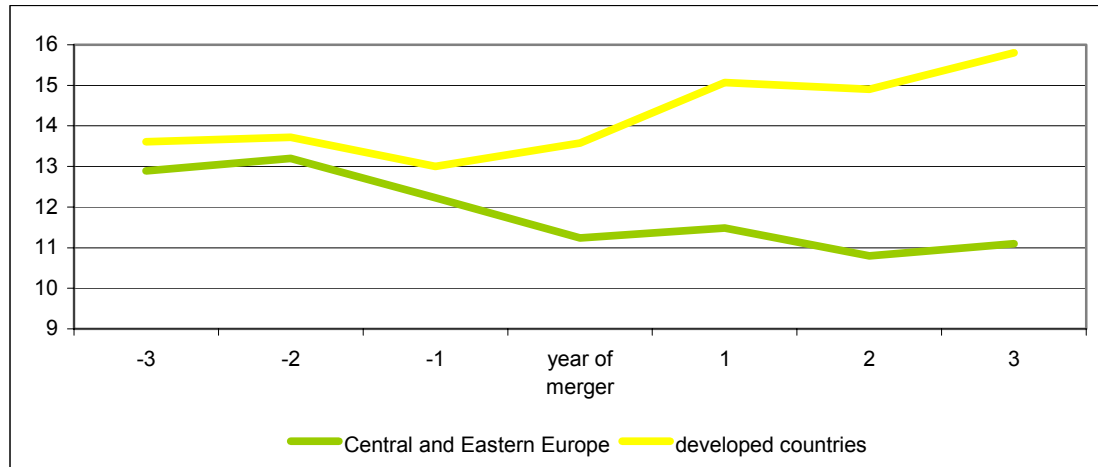
Graph 8. Total loans / total assets ratio
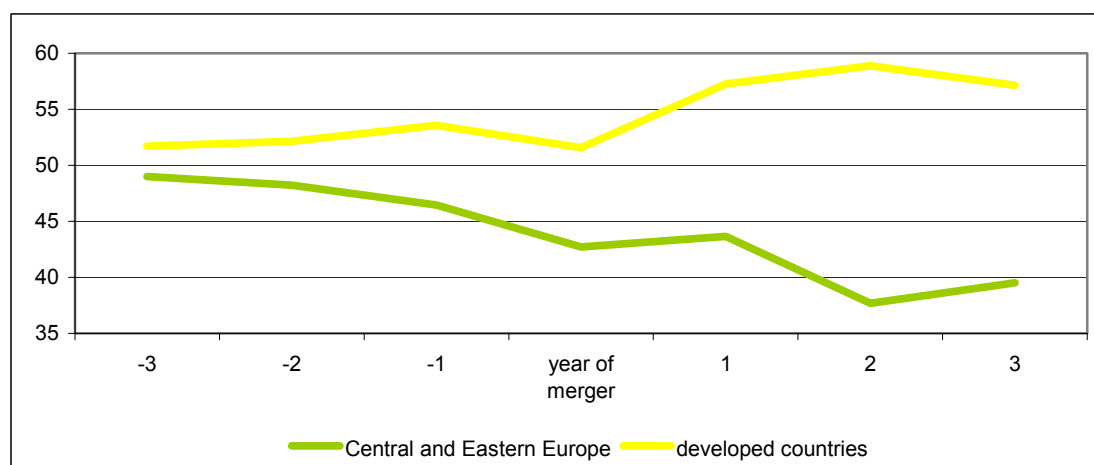
Source: author

One of the most important indicator for financing small and medium-sized enterprises (SME) belongs the volume of total loans to total assets (graph 8). Which are in the banking practice divided in loans to households and small entrepreneurs, large corporate clients, special funding and loans to SME's. Now we pay attention just to the last item which is drew in graph 9.

Economic Analysis (2010, Vol. 43, No. 1-2, 34-43)

Graph 9. SME's loans / total assets ratio

Source: author

The share of SME's loans to total assets has a very similar trend as total loans to total assets. We can observe a significant trend of divergence in two groups since year before the merger, which is getting stronger every following year. Mergers in the our region didn't contributed to a better allocation of loans for small and medium-sized enterprises, but commercial banks are now paying increasing attention to the segment of small and medium-sized enterprises [8]. Which do not provide such large volumes of transactions as large corporate customers, but better margins and future potential. This led in 2008 to increase of lending volume to this segment about the fifth, sometimes up to 30 %.

Conclusion

The success of the merger affects many factors. We could say most important are managing rationalization of operations, gaining access to new banking techniques, optimizing economies of scale, portfolio diversification, synergy, and not least the success of the merger determine choosing of financing method of the merger. Assessment of the merger success after several years of difficult, but most obvious way seems to be using different analytical methods and ratio indicators that can provide a fairly comprehensive view of economic performance following years after the merger compared to the years before the merger.

All indicators should be monitored and assessed in longer period of time and it should be noted that even slight changes in the indicator level may indicate changes in the range of customers or changes in the financial market. The capital adequacy is showing some differences between merger groups. Central and Eastern Europe region in the second year after the merger amounted value exceeding 15 %, so although in the eyes of clients were more secure, on the other hand, this meant reduction in institutions profit contributing to the unit of capital. Profitability indicators also speak in favor of the merger in Central and Eastern Europe region. Mergers in our region didn't contributed to a better allocation of

loans for small and medium-sized enterprises, but commercial banks are now paying increasing attention to the segment of small and medium-sized enterprises.

Better results of banks in transition countries in Central and Eastern Europe, is generally attributed to a significant restructuring and rationalization process, which took place before the merger itself to attract acquisition partners. To evaluate the impact of mergers on banks' financial results can be done not only with using these methods and indicators, but also in other ways.

Summary

The study gives an overview of the economic situation coupled with the merger of banks in the area of Central and Eastern Europe in comparison with developed markets in the world. It applies to different types of mergers of banks ratio indicators, the market value of shares and capital adequacy. Attention turns also to the issue of SME's loans measured by the range of indicators.

References

BALÁŽ, P., VERČEK, P. *Globalizácia a nová ekonomika*. Bratislava: Sprint, 2002, s.135. ISBN 80-89085-06-7.

DAVIS, S. I. *Bank Mergers. Lessons for the Future*. London: Macmillan 2000, s. 97. ISBN 978-0-312-23552-9.

KOTULIČ, R., KIRÁLY, P., RAJČÍNIOVÁ, M. *Finančná analýza podniku.* Bratislava: Iura Edition, 2007. - 206 s. - ISBN 978-80-8078-117-0.

MAŘÍK, M. *Určování hodnoty firem.* 1. vyd. Praha: Ekopress, 1998, s. 12-13. ISBN 80-7079-938-2.

POLOUČEK, S. *Bankovnictví.* 1. vyd. Karviná: SU v Opavě 2005, s. 243. ISBN 80-7248-264-5.

POLOUČEK, S. a kol. *Bankovnictví.* 1. vydání. Praha: C. H. Beck, 2006, s. 490. ISBN 80-7179-462-7.

RÁKOŠ, J. Základy finančnej analýzy. In: *Manažment projektov v regiónoch.* Prešov: Manacon, 2005, s. 83-100. ISBN 80-89040-27-6.

TEJ, J., BRECIK, M., KRASNODĘBSKI, A. *Small and medium enterprise - one of the aspects of the regional development.* In: Acta Agraria et Silvestria. Vol. XLIV/2: series agraria; sekcja ekonomiczna. - Kraków: Wydawnictwo Oddzialu Polskiej Akademii Nauk, 2005.

TEJ, J. ml., TEJ, J. *Ekonomické zhodnotenie fúzií vybraných bánk v regióne.* In: ANNO 2009. Prešov: PU v Prešove 2009, s.191-202. Dostupné na: http://www.pulib.sk/elpub2/FM/Kotulic10/index.html, ISBN 978-80-555-0005-8.