Cross-border M&A and efficiency in the European banking sector: risks and rewards

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Words:3560

Contents

Introduction

The banking sector's cross-border mergers and acquisitions are at the core of the European economy's growth (Vander Vennet & Gropp, 2002). As a result, issues about how cross-border bank mergers and acquisitions in Europe influence bank efficiency and risk-reward have gotten a lot of attention in discussions. For a long time, there has been debate over the link between bank efficiency and cross-border mergers and acquisitions in the European banking sector. Furthermore, some people are debating whether bank efficiency may be increased following cross-border mergers and acquisitions. This article examines the current literature to see if and how cross-border mergers and acquisitions in the European banking sector have influenced bank efficiency. In addition, this paper focuses on the risks and rewards for European banks following cross-border mergers and acquisitions. During the literature review, there are no studies have combined the efficiency and impact of cross-border mergers and acquisitions in the European banking sector, so the motivation of this research is to integrate the efficiency of cross-border M&A on European banks in recent years, to analyze the advantages and disadvantages of cross-border banks and to fill the research gap. The body of this paper is organized as follows. The academic and practical rationales, research questions, and literature evaluation will be presented in order, followed by an analysis and summary of the efficiency and risk-reward of cross-border mergers and acquisitions in the European banking sector.

Rationale

Academic rationale

Cross-border mergers and acquisitions are unavoidable in the banking sector as the financial system becomes more globalized (Lozano-Vivas et al., 2011).

It was stated that the banking sector has entered a new era of consolidation since the late 1990s, with cross-border mergers and acquisitions becoming more widespread throughout Europe (Lindblom & von Koch, 2002). Several studies have shown that cross-border mergers and acquisitions of European banks boost bank efficiency, particularly in terms of bank profitability and risk diversification (Duijm & Schoenmaker, 2021; Hassen al., 2016). Cross-border banking, on the other hand, has been claimed to have little role in risk reduction and return generation (Hayden et al., 2007).

Practical rationale

It must be acknowledged that cross-border M&A of banks is inextricably linked to European bank integration. Through analyzing and researching the efficiency and impact of cross-border M&A in recent years, it can help provide feasible directions for the future development of the European banking sector, and also learn from some of the risks and experiences that have arisen during the M&A process in the past, to prevent the risks that may arise in the future. Furthermore, the research and analysis can broaden the factors influencing the efficiency of European banks' M&A, highlight the importance of cross-border M&A to economic development in the banking industry, and provide some ideas for other banks and companies interested in understanding and developing their cross-border M&A strategies.

Research questions

The main question is "What are the efficiency and implications of cross-border mergers and acquisitions in the European banking sector?" and there are two sub-questions to this topic. The first one is "how do cross-border mergers and acquisitions in the European banking sector affect the efficiency of the banking sector?". It refers to the changes in the efficiency of the European banking sector following the cross-border M&A. The second one is "what are the risks and rewards of cross-border M&A for European banks?". It refers to the advantages and disadvantages of cross-border M&A for European banks.

Literature reviews

Background

Through the process of economic globalization, financial regulation is slowly being eroded in the financial sector. Cross-border mergers and acquisitions are increasingly common. In the fifth wave of M&A, cross-border M&A in the banking sector has been a major focus area (Lozano-Vivas et al., 2011). European countries have been actively involved in this wave of cross-border M&A to enhance profitability and market competitiveness. Furthermore, in the 1990s, the European Union's foundation and the euro's adoption led to the integration of European banks and a rise in banking sector internal rivalry. Consequently, cross-border mergers are becoming increasingly common in the banking sector.

According to statistics, cross-border mergers and acquisitions in the European banking sector are worth up to US$691.7 billion by 2020 and 2007 was the peak year for European mergers and acquisitions, with over 18,900 deals ("Value of European M&A deals 2000-2020 | Statista", 2022). There have been several notable cross-border mergers and acquisitions in the European banking sector, such as the acquisition of HVB Group AG by UniCredito Italiano, the Merger between DZ Bank and WGZ Bank and the large M&As took place in Sweden and Finland banks.

Motivations of cross-border mergers and acquisitions

In the European banking industry, the number of cross-border mergers has increased, which has contributed to increasing concentration on the European market (Kozak & Wierzbowska, 2021). This phenomenon has attracted the attention of many scholars. Since then, many studies have begun to examine the motivations behind cross-border mergers and acquisitions. There are two main motivations for cross-border M&A in the banking sector. One major motivation is the synergy effect of cross-border M&A. Synergy relates to the benefits of a merger between two companies that work towards a common objective and then generate 1+1 is greater than 2 (Arnold & Lewis, 2019). Synergies are mainly classified as operational synergies, management synergies and financial synergies. Among them, operational synergies refer to increasing revenue and reducing costs. On the one hand, companies use the company's existing resources for cooperation and production to reduce the cost of existing products and thus build economies of scale. On the other hand, it refers to the complementary nature of assets between companies to improve innovation and technological development.

Diversification is the second motivation. According to UNCTAD (2018), cross-border mergers and acquisitions are one of the fastest ways to enter new markets. In the banking industry, cross-border mergers and acquisitions can increase market share, provide customers and shareholders with more products and services, increase the market value of a company and give it a competitive edge. As a result of diversification, a bank's inherent risks are diversified and customer loyalty is increased, resulting in profits.

Bank efficiency and measurement methods

The definition of bank efficiency is the relation between the inputs and outputs, or the costs and benefits of a bank's business activities (Fiordelisi et al., 2011). It is possible to categorize bank efficiency into three categories: economies of scale efficiency, economies of scope efficiency, and X-efficiency. Bank efficiency is a crucial metric for cross-border bank mergers. Evaluating bank efficiency can be classified into two categories. The first approach is to use traditional financial analysis. A measure of bank efficiency can be calculated by comparing profitability, return on equity, and operating efficiency indicators before and after a merger (Pham & Marek, 2019). The second method is to analyze the data using data envelopment analysis (DEA), which is a non-parametric test developed based on relative efficiency evaluation (Titko et al., 2014).

- **The efficiency of economies of scale**

Economies of scale in the banking sector refer to the reduction of banking costs through improved resource allocation, management and the achievement of information sharing (Dijkstra, 2013) In the European banking sector, cross-border bank mergers have had a considerable positive influence on economies of scale. The creation of the EU has enabled banks to operate freely within the eurozone without legal or technical barriers, thus contributing to lower production costs. Although differences and barriers still exist between European countries, it is clear that it is easier and more convenient for European banks to consolidate across borders in other EU countries than in other regions, and that economies of scale can be achieved more easily.

Pham & Marek (2019) stated that cross-border mergers have accelerated the pace of consolidation in the European banking sector, creating economies of scale and improving bank performance. Furthermore, Increased market concentration following bank mergers helps banks to expand and achieve economies of scale. Kozak & Wierzbowska (2021) measured the relationship between market concentration and bank efficiency for bank mergers in selected EU countries from 2005 to 2019 and proposed that increased bank concentration has a huge impact on the efficiency of banks in EU countries. Dijkstra (2013) examined the sources of economies of scale for banks in the euro area from 2002 to 2011 and claimed that economies of scale and market concentration in the European banking sector are positively correlated.

However, it has also been argued that some cross-border M&A of large banks did not achieve economies of scale. ALTUNBAS & Molyneux (1996) in Europe argued that cross-border M&A between large banks does not fully realize economies of scale. It is also pointed out that there are diseconomies of scale between large bank mergers and acquisitions, arguing that it is not the case that the larger the bank, the easier it is to achieve the efficiency of economies of scale (Stimpert & Laux, 2011).

- **The efficiency of economies of scope**

Banking economies of scope refer to using the bank's numerous operations and institutions to increase the range of deposit products or loan products, such as check deposits, loans, and currency exchange, to broaden the range of financial services and boost the bank's profitability. The bank can then reduce risk and increase its ability to withstand it (Vander Vennet & Gropp, 2002). By merging across borders, European banks can effectively utilize their resources and reduce costs. Banking cross-border mergers allow them to broaden their risk portfolios and diversify their products. Banks with diversified loan portfolios are more likely to reduce the risk and costs of bank insolvency, and hence reduce the risk of bank failure. Shim (2019) conceded that European banks with diversified loan portfolios have a more stable financial position in the market. Furthermore, Dijkstra (2013) proposed that European cross-border banks have consistently exhibited positive economies of scope over the period from 2002 to 2011.

- **Cost efficiency and profit efficiency**

The influence of cross-border M&A on bank cost and profit efficiency has been a major topic of discussion. Some studies support that the impact of cross-border mergers and acquisitions on the cost efficiency of banks is positive and significant. Huizinga, H et al. (2001) found that mergers have a higher impact on cost efficiency than profit efficiency by examining efficiency data for cross-border merged banks in Europe. Furthermore, Long (2015) showed through an empirical study that the effect between cost efficiency and the stock value market of EU banks is positive. However, a contrary finding points to a limited increase in banks' profitability and no considerable cost reduction of banks following cross-border mergers (Pham & Marek, 2019). Furthermore, Lozano-Vivas & Weill (2009) argued that banks are less cost-efficient after cross-border mergers and that low-cost efficiency is linked to why less efficient banks are more likely to be acquired. Lozano-Vivas & Weill (2009) also conceded that those cost inefficiencies are due to the presence of trade barriers in cross-border bank mergers, while profit efficiency is influenced by many factors, such as changes in pricing models following bank mergers and improved market position following the merger and acquisitions. Coccorese & Ferri (2020) through the results of a case study of Italian banks, described that mergers and acquisitions only increase the cost efficiency of banks in the case of successive mergers.

It's worth mentioning that the acquirer's and acquiree's post-merger cost and profit efficiency differ, which is connected to the size, assets, and liquidity of the bank itself. Du & Sim (2016) pointed out that mergers and acquisitions tend to increase the post-merger efficiency of the target bank through an analysis of the data collected. By comparing the ROA and ROE of the merged European banks, it is shown that poorer profitability, less liquid and more cost-efficient banks tend to generate higher profitability post-merger and can improve existing internal problems through the merger, resulting in higher ROE than before. However, mergers between banks with better operating performance did not result in better efficiency or significantly higher profitability (Hassen et al., 2016).

Rewards of cross-border M&A

- **Improving bank performance**

Cross-border M&A of banks improves the performance mainly in terms of increasing the scale of production, sharing resources and thus reducing costs, and increasing the range of business areas and market share and thus increasing market competitiveness.

On the one hand, cross-border mergers can reduce labor costs, as banks make -internal redundancies after mergers. King (2017) pointed out that employees who remain within banks after cross-border M&A exhibit a potentially beneficial influence on work productivity and organizational efficiency in the long run. At the same time, cross-border mergers allow banks to share resources among themselves, increasing productivity and reducing production costs. This study confirmed the causal impact of mergers and acquisitions (M&A) on bank productivity (Q) in 23 EU countries, empirically demonstrating that the effect of M&A on productivity is effective in the long run (Aljadani & Toumi, 2019). Furthermore, cross-border M&A has more significant efficiency gains for banks compared to domestic M&A. By comparing the cost, ROA and ROE ratios of European cross-border M&A banks and domestic M&A banks, the study confirms that cross-border M&A banks are more efficient than domestic M&A banks, confirming the effectiveness of cross-border M&A in improving bank efficiency (Lozano-Vivas et al., 2011).

On the other hand, cross-border M&A facilitates the expansion of banks' service offerings, allowing for rapid entry into new market segments and lowering trade barriers. It is not only saving costs and expenses but also reducing the number of market participants in the market, increasing the market share of that bank and improving its competitiveness. Mergaerts &

Vander Vennet (2016) proposed that diversification following bank mergers and acquisitions can lead to higher profitability. Marques-Ibanez & Altunbas (2004) stated that cross-border bank mergers and acquisitions can improve bank performance and that M&A banks use differentiated lending and credit risk strategies to improve banks.

- **Expand technological innovation and achieve technological change**

Banks develop new technologies through cross-border acquisitions of fintech companies. Acquirer banks utilize the technologies and resources they acquire to gain a competitive position in the industry, develop their company, and increase the return on their technological investments. For example, in the case of Morgan Stanley's acquisition of E-Trade, the acquirer gained access to E-trade's digital technology and resources to improve the quality of its online services. By using E-trade's high technology in combination with wealth management channels such as financial advisors, workplace and self-service channels, the efficiency and effectiveness of wealth management were improved ("Morgan Stanley to Acquire E*TRADE | Morgan Stanley", 2022). performance.)

- **Risk reduction**

Cross-border M&A enhances asset diversification and geographical diversification of banks, which has a positive influence on reducing bank risk. Hayden et al. (2007) observed that geographical diversification improved the risk-return of low-risk banks, while loan diversification was inefficient only for high-risk banks. Cross-border mergers improve banks' ability to respond to crises by concentrating customer resources, improving inventory capacity and reducing insolvency risk. Duijm & Schoenmaker (2021) conceded that bank risk is reduced through cross-border banking, which decreases bankruptcy risk and generates a more predictable income profile. It has also been argued that various bank mergers can decrease the danger of an institution facing bankruptcy (CHOI et al., 2010).

- **Increasing shareholder benefits**

From the perspective of shareholders, cross-border mergers can also bring significant wealth to shareholders. On the one hand, cross-border M&A has a beneficial influence on shareholder value since it improves the bank's profit efficiency, resulting in enhanced shareholder rewards. Pham & Marek (2019) argued that the increase in profit efficiency of the merged bank has a positive impact on the increase in shareholder value. On the other hand, through cross-border mergers, the bank's insolvency risk is diversified and the bank can issue more debt to absorb capital, thus generating returns for shareholders (Aljadani & Toumi, 2019).

Risks of cross-border M&A

1. **Strategic risk**

Strategic risk is the risk that a merger will fail due to a mismatch between the size, culture, target market and growth strategies of the two parties. (Vander Vennet & Gropp, 2002). Although Viegas-Pires (2013) claimed that the multifaceted role of culture on the impact of merging firms has little impact. The majority of the literature demonstrates that cultural differences between merging firms have a significant impact on cross-border M&A. In cross-border mergers, cultural differences exist between two banks as well as between countries. If differences in corporate culture and development strategies cannot be overcome to achieve desired synergies (economies of scale and scope), mergers and acquisitions can be risky. Lee (2018) also asserted that cultural conflicts between firms are one of the reasons for the failure of cross-border M&A integration. Zvezdanović Lobanova et al. (2016) mentioned that organizational cultural differences can affect post-mergelaborgration and performance.

2. Integration risks

Cross-border banking does not provide a guarantee of bank performance. After a cross-border merger, if the bank does not integrate effectively with its resources, technology and systems, it may lead to a lack of management experience and innovation in human resources and internal management (Arnold & Lewis, 2019). Hyder & Osarenkhoe (2018) recognized that the failure rate of multinational mergers and acquisitions is extraordinarily high due to the acquiring company's insufficient integration processes. Marques-Ibanez & Altunbas (2004) confirmed that merged banks that fail to maintain consistency in the development of new technologies in terms of innovation and personnel management can negatively affect performance. It has also been argued that diversification of bank assets does not ensure higher performance or bank safety(Shim, 2019).

3. Legal and compliance risks

Laws and regulations vary from country to country. The complexity of cross-border M&A requires both parties to the acquisition to have a good understanding of the laws and related procedures of the other country. If one is not familiar with the relevant legal norms of the target country, one may have to bear the legal risks associated with the M&A, which may lead to a lower success rate of cross-border M&A. Pham & Marek (2019) pointed out that although the establishment of the EU has reduced trade barriers to some extent, legal risks still exist.

4. Credit and Operational risk

Cross-border mergers and acquisitions are often characterized by high risk and can be characterized by information mismatches that prevent the full valuation of the acquiring company, failing to realize its expected potential or significant financial losses. Lewis& Bozos (2019) suggested that information asymmetry is a key risk factor in international bank mergers and acquisitions. Cross-border mergers and acquisitions are not entirely profitable for shareholders and there are risks involved. CHOI et al. (2010) stated that additional risks may develop as a result of increased risk-taking tendencies among bank shareholders and executives after a merger.

5. Cross-border transaction risk

Cross-border transactions of European banks involve the risk of loss due to political and economic changes in the countries on both sides of the merger, or changes in currency or exchange rates. Changes in the political environment or the policies of foreign investors may increase the cost of projects and reduce their returns. Moreover, it has been identified that uncertainty over government policy is one of the risks for companies acquiring across borders (Lee, 2018). However, Amihud et al. (2002) suggest that cross-border acquisitions on average neither increase nor decrease the risk to the acquirer because the risks are offset.

Conclusions and recommendations

The primary purpose of this research is to examine and analyze the influence of cross-border mergers and acquisitions on the efficiency of the European banking industry, as well as to evaluate the benefits and drawbacks of cross-border M&A for European banks. It begins with an overview of the background and trends in cross-border M&A in the European banking sector, followed by a discussion of the major drivers of cross-border M&A in the European banking industry. When reviewing the literature on the impact of cross-border M&A on banks' economies of scale, economies of scope, cost efficiency, and profit efficiency, it is discovered that there are both economies of scale and diseconomies of scale, and that the impact of cross-border M&A on banks' cost efficiency and profit efficiency is also influenced by factors like bank size and asset liquidity. In the following section, the paper examines the returns and risks of cross-border bank M&A discussed in the literature. This study concludes that cross-border M&A improves banks' performance. Cross-border mergers and acquisitions encourage geographical diversification, enrich banks' products, increase technological innovation, and result in economies of scale and scope, thereby lowering costs and reducing and diversifying banks' insolvency and credit risks. Nevertheless, there are risks associated with cross-border M&A, including strategic risk, integration risk, legal risk, credit risk, and operational risk. This paper aims to provide guidance for cross-border M&A in the European banking sector as well as provide insight for European banks seeking to carry out cross-border M&A by analyzing the effect, risks, and rewards associated with cross-border M&A on the efficiency of European banks. This study has a limitation in that it examines only cross-border mergers of European banks and not global cross-border mergers. Furthermore, it is based solely on a review of previous relevant literature research and does not calculate data from primary sources to acquire a more precise numerical empirical validity. The study's findings do not give a full examination of international mergers' effects, risks, and rewards on bank efficiency. The future research study may examine the impact of cross-border mergers on bank efficiency in a wider geographic area, including Asia, Europe, and Africa.

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