The FDI Race in European Banking

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Abstract

This paper presents a brief overview of the European banking market in the 1990s and highlights various issues surrounding FDI in the sector. A varied literature covers the main factors influencing cross-border activity in banking and this suggests that regulatory, information and other barriers inhibit cross-border trade in banking services. This suggests that cross-border activity in banking is mainly characterised by horizontal FDI. Given that evidence points to the fact that domestic financial re-structuring has significantly outpaced cross-border activity during the 1990's it is possible to conceive of industry re-structuring as a two-tiered race both domestic and cross-border. In the latter case the FDI race may relate to expansion that seeks to broaden product range, markets, expertise in a host of different industry segments. Motives may relate to costs (scale, scope and X-efficiencies) or/and revenue enhancement. The race is really between firms in similar segments, like investment banks building asset management and private banking capabilities, retail banks adding to their customer bases and developing insurance services and so on. It remains to be seen whether European banks and other financial firms will continue to slowly build their cross-border operations or whether the current decade will yield an avalanche of further cross-border consolidation in the industry. Maybe this depends on restructuring trends outside the financial industry? Only time will tell.

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1. Introduction

This paper provides an overview of the European banking market in the 1990s and highlights the issues surrounding cross-border activity in the industry. A varied literature covers the main determinants of cross-border activity in banking and this suggests that regulatory, information and other barriers inhibit cross-border trade in banking services. This suggests that cross-border M&A in banking is mainly characterised by horizontal FDI. Nevertheless, various managerial motives such as follow the leader strategies and Hicksian 'Quiet Life' risk reduction strategies cannot easily be identified as features of either horizontal or vertical FDI. As such, it needs to be noted that while most bank cross-border M&A is likely to be motivated by a desire to avoid trade and other barriers there are various managerial motives that may also be important in explaining the motives for overseas expansion that do not fit easily into the FDI dichotomy. The latter part of the paper briefly investigates the financial features of banks engaged in domestic and cross-border M&A activity in European banking. There is also some evidence that domestic deals are motivated more by cost efficiency considerations whereas earnings diversification may be more important for cross-border bank deals. Given that evidence points to the fact that domestic financial re-structuring has significantly outpaced cross-border activity during the 1990's it is possible to conceive of industry re-structuring as a two-tiered race both domestic and cross-border. In the latter case the FDI race may relate to expansion that seeks to broaden product range, markets, expertise in a host of different industry segments. Motives may relate to costs (scale, scope and X-efficiencies) or/and revenue enhancement. The race is really between firms in similar segments, like investment banks building asset management and private banking capabilities, retail banks adding to their customer bases and developing insurance services and so on. It remains to be seen whether European banks and other financial firms will continue to slowly build their cross-border operations or whether the current decade will yield an avalanche of further cross-border consolidation in the industry. Maybe this depends on restructuring trends outside the financial industry? Only time will tell.

The paper is structured as follows. Section 2 examines various structural developments in European banking during the 1990s. The following Section 3 examines the main determinants of cross-border banking activity and Section 4 discusses the financial characteristics of domestic and cross-border bank consolidation in Europe in the second half of the 1990's. Section 5 assesses whether there has really been an FDI race in European financial services and Section 6 is the conclusion.

2 Structural Change in European banking

Technological developments, de-regulation at the EU level and the introduction of the single market for financial services, have all played there part in fostering greater competition (see Matutes and Vives 1992 and Vives 2000) and market contestability (see De Bandt and Davis 1999) in European banking throughout the 1990's. An outcome of the increased competitive pressure has been reflected in the decline in the number of banks in the market, normally as a result of mergers and acquisitions. This, in turn, has tended to increase the level of domestic market concentration. As Table 1 shows, a fall in the number of banks has been a shared tendency in all the largest European countries.

Table 1 Number of institutions in the banking and credit services of five European countries

Country	1985	1990	1995	1998	% Change 85-98
France	1952	2048	1445	1209	-38.1
Germany	4739	4170	3785	3403	-28.2
			970	921	-16.3

Italy	1101	1043			
Spain	695	696	484	396	-43.0
UK	655	624	578	527	-19.5

Source: Adapted from Eurostat (1999) .

Another indicator of changing banking sector capacity is the number of bank branches per capita. Table 2 shows that the number of branches per capita started to fall much later than the decline in bank numbers. This could be interpreted as an indication that the impact of competition on the efficient allocation of bank physical resources is a more recent phenomenon.

Table 2 Number of bank branches per 1,000 per capita

	1990	1995	1996	1997	1998
Germany	0.50	0.59	0.59	0.58	0.55
France	0.45	0.44	0.44	0.43	0.43
Italy	0.31	0.41	0.43	0.44	0.46
Spain	0.90	0.92	0.94	0.96	0.98
Austria	0.58	0.58	0.58	0.58	0.57
Belgium	1.35	0.76	0.74	0.72	0.70
Finland	0.66	0.38	0.34	0.32	0.31
Ireland	0.27	0.35	0.42	0.30	0.42
Luxemburg	0.78	0.85	0.92	0.95	0.92
Netherlands	0.54	0.44	0.44	0.40	0.39
Portugal	0.20	0.35	0.38	0.38	0.31
United Kingdom	0.38	0.30	0.28	0.28	0.27
United States	0.20	0.22	0.22	0.23	0.23
Japan	0.39	0.38	0.38	0.35	0.35

Source: ECB (2000), and Eurostat (1999)

The institutional background behind these figures comes from the fact that until the early 1990's, retail banking was relatively isolated from competition, either through formal or informal barriers to entry into the market, collusive agreements or regulatory capture. This situation appeared to occur in various European countries. In this sense (Molyneux et al. 1994), have suggested that between 1986 and 1989, banks in Italy and France earned revenues as if under monopoly or conjectural variations short-run oligopoly conditions. This lack of competition probably produced oligopolistic rents for stakeholders, not only for owners but also for employees and managers in the case of expense preference behaviour and the 'quiet-life-hypothesis'[1]. In general, the limited competitive environment led to substantial inefficiencies and low returns on equity throughout the industry during the 1970's and 1980's. Various banks were also protected through more lenient tax/regulatory treatment (IMF 2000).

The European Unions '1992' Single Market Programme (SMP), was a commitment to liberalisation intended to produce a substantial change in the competitive scenario of European banking (Vives 1991). The general view being that European banking has become more competitive and contestable (see, EC 1997 and de Bandt and Davis 1999) although various over capacity problems still persist (Bikker and Haaf 2001). The European Union is trying to address these issues through the implementation of a Financial Services Action Plan that started 1999. This regulatory programme includes a broad range of measures (to be adopted by all EU member states by 2005) aimed at promoting a more integrated and efficient European financial system. [2]

An important feature of the changing environment has been the increase in the number of bank M&A's as shown in Tables 3 and 4. The number of both domestic and cross-border M&A increased between 1995-2000. However, domestic deals dominate, accounting for more than the 80% of total M&A activity in the EU banking sector. Nevertheless, the number of cross-border deals also increased from 51 to 83 over the same period (62 in the first quarter of 2000).

According to a recent report by the (BIS 2000), the preference for national consolidation is that it offers clearer opportunities for reducing costs and fewer complications in terms of handling the merger due to a normally more homogeneous corporate culture. Besides firms try first to gain a stronger national presence so that they could be large enough to compete in a likely latter cross-country consolidation phase.

[1] See Hicks (1935).

2 See EU (1999)

The reasons for banks to merge as well as the potential benefits from mergers are not clear in the literature[3]. Focusing only on the Euro area, empirical studies tend to find that the main factors of competitive advantage are not economies of scale but rather improvements in X-efficiencies[4]. Yet, it is surprising that in reality mergers and acquisitions do not appear to offer improvements in either efficiency measures or better stock market returns [5].

Table 3 Number of Domestic M & A's between Credit Institutions

	1995	1996	1997	1998	1999	2000*
Belgium	6	8	7	6	6	0
Denmark	2	2	1	1	0	1
Germany	100	117	109	189	240	91
Greece	0	0	3	7	3	0
Spain	4	4	1	5	5	3
France	60	61	46	52	51	21
Ireland	1	1	0	2	1	0
Italy	68	56	45	52	64	30
Luxembourg	3	1	3	9	6	6
Netherlands	2	2	5	0	1	2
Austria	14	24	27	37	20	5
Portugal	5	5	1	1	0	6
Finland	7	6	5	5	2	3
Sweden	1	2	2	1	1	0

3 See Dermine (2000) for a comprehensive survey of the literature
4 See European Commission (1997), Van der Vennet (2002), Altunbas, Molyneux and Thornton (2001). See Altunbas, Evans and Molyneux (2001) for a study of ownership and efficiency issues in German banking.
5 Although according to Cybo-Ottone and Murgia (1998), abnormal returns can be expected associated with the announcement of domestic bank deals.

United Kingdom	2	4	15	16	14	4
Euro Zone	270	285	249	358	396	167
European Union	275	293	270	383	414	172

Source: ECB (2001) * First six months

Table 4 Number of Cross-Border M & A's between Credit Institutions

	1995	1996	1997	1998	1999	2000*
Belgium	0	1	2	1	5	3
Denmark	0	0	1	0	2	1
Germany	22	17	9	13	29	10
Greece	0	1	0	2	5	1
Spain	9	7	18	10	12	26
France	1	0	1	1	4	4
Ireland	2	3	3	1	1	0
Italy	5	3	0	3	2	0
Luxembourg	0	1	0	3	4	2
Netherlands	5	9	3	3	2	3
Austria	0	0	2	0	4	3
Portugal	1	1	1	4	2	3
Finland	2	0	0	2	0	2
Sweden	0	0	3	0	6	2
United Kingdom	4	7	6	8	5	2
Euro Zone	47	42	39	41	65	56
European Union	51	50	49	51	83	62

The reduction in the number of banks, due to the increased number of mergers and acquisitions, would also suggest an increase in concentration across European banking markets in recent years. In fact, when we compare the percentage of the banking and credit sector controlled by the five largest banks, measured in terms of total assets, we observe an increase in this figure for most countries. Tables 5 shows that the largest EU banking markets have experienced increasing[6] market concentration. Interestingly, activity among Europe's largest banks has accelerated recently, so that more than half of the 30 largest European banks are the result of recent mergers. As a consequence, the average size of the top five European banks in terms of total assets has doubled since 1995. The degree of concentration is particularly striking in the smaller Euro-area countries, where a very small number of banks dominate the national markets.

Table 5 Five-firm concentration ratio as percentage of total assets

								1st half	%-point change	
	1980	**1985**	**1990**	**1995**	**1996**	**1997**	**1998**	**1999**	**95-2Q99**	**97-2Q99**
SE		80.8	82.7	86.5	86.5	86.8	85.7	87.0	0.5	0.2
NL		72.9	73.4	76.1	75.4	79.4	81.7	82.9	6.8	3.5
DK	62.0	61.0	76.0	72.0	72.0	72.0	76.0	78.0	6.0	6.0
BE	54.0	48.0	48.0	51.2	52.2	53.9	72.5	75.8	24.6	21.9
PT	60.0	61.0	58.0	74.0	80.0	76.0	75.2	74.7	0.7	-1.3
FI	37.0	38.0	41.0	70.6	71.7	72.7	73.5	72.8	2.2	0.1
GR	n.a.	80.6	83.7	75.7	74.5	71.8	72.8	72.3	-3.4	0.5
ES	n.a.	35.1	34.9	47.3	46.0	45.2	44.6	50.8	3.5	5.6
AT		35.9	34.7	39.2	39.0	48.3	50.1	50.4	11.2	2.1
IT			29.2	32.4	32.1	30.7	38.7	40.2	7.9	9.5
IE	59.1	47.5	44.2	44.4	42.2	40.7	40.1	40.0	-4.4	-0.7
UK				28.3	29.1	28.3	27.8	27.6	-0.7	-0.7
LU	31.1	26.8		21.2	21.8	22.4	24.6	26.2	4.9	3.7
DE			13.9	16.7	16.1	16.7	19.2	19.4	2.7	2.7
FR		46.0	42.5	41.3	41.2	38.0	39.2			
Av.	37.9	52.8	50.9	51.8	52.0	52.2	54.8	57.0		

Source: ECB. (2000), Mergers and acquisitions involving the EU banking industry-facts and implications, pg.42. Where SE (Sweden), NL (The Netherlands), BE (Belgium), PT (Portugal), FI (Finland), GR (Greece), ES (Spain), AT (Austria), IT (Italy), IE (Ireland), UK (United Kingdom), LU (luxemburg), DE (Germany), FR (FRANCE).

This increase in concentration should be a regulatory concern as the increase in the size of the institutions can give raise to 'too big to fail' problems (TBTF) [7]. That is the fact that the central bank is more likely to bail out a large bank because its failure may disrupt the payments system and/or create a systemic collapse of the financial system. Large banks that have been actively promoted (and even created) by governments aimed at creating national champions may be subject to more lenient regulatory scrutiny than their smaller counterparts. They may be also allowed to

[6] The Herfindahl index, which is better proxy for market concentration as it takes into account the full population. As indicated in table 2.9, this figure also pointed towards shows an increase in concentration particularly over the last two years.

[7] In fact the TBTF problem appears to be quite present in Europe (Fernadez de Lys 2000).

operate on a lower than optimal capital base, as given the systemic risk implications of their failure, it is assumed by the institutions and other market participants that they would receive public support when faced with insolvency. Consequently, and due to TBTF considerations, domestic consolidation is likely to have implications for the capital positions of banks as it could increase incentives for a reduction in the capital positions of the largest banks. Table 6 provides a further snapshot of the consolidation trend in European banking showing recent activity between major financial groups.

Table 6 Recent M & A in European Finance 2001-2002

Name / Acquirer	Country	Name/Target	Country	Year	Type of Deal
Domestic M & A					
Dexia	BE/FR	Artesia BC	BE	2001	Acquisition
Banca Intesa	IT	Comit	IT	2001	Acquisition
Bank of Scotland	UK	Halifax	UK	2001	Merger
Unicredito	IT	Rolo Banco 1473	IT	2001	Acquisition announced
Allianz	DE	Dresdner Bank	DE	2001	Acquisition
Munich Re	DE	HVB	DE	2001	25.7% stake
San Paolo IMI	IT	Cardine	IT	2001	Acquisition
Sabadell	ES	Banco Herrero	ES	2001	Acquisition
CDC	FR	CNCE	FR	2001	Merger
BPI-SGPS	PO	Banco Espirito Santo	PO	2001	Merger
Abbey National	UK	Alliance & Leicester	UK	2002	Pending
Banca di Roma	IT	Bipop-Carire	IT	2002	Acquisition
Monte Paschi	IT	Banca Nazionale de Lavoro	IT	2002	Pending
Cross-Border M & A					
Svenska Handelsbanken	SE	Midtbank	DK	2001	Acquisition
Dexia	BE/FR	Kempen/Labouchere	NL	2001	Acquisition
Deutsche Bank	DE	Zurich Financial Services	CH	2001	Acquisition
Failed M & A					
National Bank of Greece	GR	Alpha Bank	GR	2001	Merger
Unicredito	IT	Commerzbank	DE	2001	Acquisition
LloydsTSB	UK	Abbey National	UK	2001	Acquisition
Abbey National	UK	Bank of Scotland	UK	2001	Acquisition
Sampo	FI	Storebrand	NO	2001	Acquisition
SEB	SE	Swedbank	SE	2001	Merger
Deutsche Bank	DE	Commerzbank/Dresdner	DE	2001	Acquisition/Merger

Notes: Non-exhaustive list

Source: Abraham and Van Dijcke (2002) p.28

So far \we have mainly focused on M & A Activity but another important dimension has been the trend towards an increased number of joint ventures and strategic alliances. According to the Group of Ten (2001) there has been a substantial increase in such activity in the European financial services industry during the 1990's. For instance, 823 joint ventures and strategic alliances were recorded between 1990 and 1999 in Europe, of which 487 were cross-border. The Group of Ten note that cross-border alliances and joint ventures were more common in Europe compared with the US and Pacific Rim countries. While joint ventures and alliances appear important, cross-border M & A activity in Europe was substantially greater in terms of number of deals (778 cross-border M & A's in Europe throughout the 1990's). This indicates that M & A activity is the preferred route for financial firm expansion in Europe.

3. Determinants of Cross-Border Activity in Banking

The aforementioned discussion has noted the rapidly changing features of the European banking industry including the trend towards greater domestic and cross-border consolidation. This begs the question as to the main motivating factors driving the trend towards greater cross-border M & A activity.

An extensive and disparate body of literature has examined these issues. This literature spans the economics literature on the determinants of FDI, studies on the strategic behaviour of international banks and empirical evidence on the performance features of cross-border bank mergers.

The theoretical and empirical literature on the determinants of FDI focuses on two main motives for overseas expansion - factor price differentials and trade barriers that inhibit exports. The former, known as vertical FDI, suggests that multinational activity occurs so that firms can take advantage of international factor price differences. As noted by (Slaughter 2002), headquarter services require substantial physical and human capital inputs whereas production is mainly manual labour intensive. Companies become multinational when they establish production in lower manual labour cost countries and headquarters where skilled labour costs are low. The alternative motivation for the existence of multinationals relates to trade barriers that make exporting costly. Where trade costs are high the firm establishes in countries to access markets and this is referred to as horizontal FDI. One can see that these two main motives for FDI derive from study of the real sector. In the case of banking, evidence would seem to suggest that horizontal FDI is likely to be a much more important motive for cross-border activity than vertical FDI. This really relates to the nature of banking business. (Casson 1989), for instance, notes that the strategic reasons for foreign bank expansion are based on advantages associated with 'internalizing' informational advantages as opposed to trading at arms length. Because the potential sources of economic rents in commercial banking stem mainly from the non-tradeable nature of information, it is difficult to find efficient markets for long-distance transactions, making foreign investment an important feature of the industry [8].

Regulations governing many areas of the financial services sector are country-specific. It still remains almost impossible to undertake cross-border activity without (physical) establishment. Even in the EU, where substantial progress has been made to create a single market, retail financial services are almost solely provided by banks and other financial firms (whether domestic or foreign-owned) located in the respective countries. Differences in tax treatments, consumer protection legislation, marketing rules, definition of products, investor protection and so on mean that the cross-border provision of many retail banking and other financial services products hardly exists. Banks that try to sell their retail services cross-border, therefore, are likely to have a substantial competitive disadvantage. In fact, globally, many jurisdictions prohibit the sale of retail financial services (or financial services to small and medium-sized companies) without establishment - a bank must have a physical presence before it can enter the market. These barriers may be less onerous when

8 See Williamson (1975) for a discussion of how the concept of internalisation is related to transaction costs and the implications for the growth and strategies of firms. Also see Coase (1937) for a seminal study on the rationale for firm existence due to internalisation benefits in contrast to market transactions.

banks operate in areas that have a more international dimension such as investment and international banking, although it is noticeable that even the world's largest investment banks typically have extensive physical market presence in many countries. In general, domestic regulations dictate that banks must have a physical presence in the country before they can access various markets - this, therefore, acts a substantial trade barrier facilitating both cross border establishment as well as M & A activity. Bringing together informational advantages associated with have a market presence plus the barriers brought about by domestic financial services regulation this means that cross-border activity in banking can mainly be characterized by horizontal FDI.

In addition to the FDI literature there is also an extensive strategy orientated literature that aims to identify the main motives for bank expansion and this is also related to studies that seek to analyze cross-border bank performance. From this literature one can distill some of the main motives for bank expansion overseas and see how the horizontal FDI motive predominates.

The following main motives for cross-border banking distilled from this disparate literature are as follows:

Customer Seeking Strategies - banks seek to undertake overseas expansion in order to obtain new customers or to follow established clients. The reason why banks are more likely to seek new customers through M&A activity relates to the barriers associated with the cross-border provision of services without establishment and also the costs associated with building a substantial customer base through de novo entry. (Khoury 1980) and (Kim 1993) have noted that the decision to invest overseas is associated with the higher costs associated with meeting clients needs from a distance as opposed to investment in the foreign market. (Sebastian and Hernansanz 2000) also note that Spanish bank expansion in Latin America has been motivated by various factors including the commercial opportunities afforded by a relatively underdeveloped banking market.

Obtaining a Foothold Strategy - foreign bank expansion can be motivated by the desire to establish a presence so as to test the market. (Casson 1995) notes that information can be obtained by making experimental foreign investment and overtime banks can decide on whether to expand or contract their activities. (Ball and Tschoegl 1982) found that Japanese banks tended to make small investments as precursors to larger deals in their expansion in the UK and US. In section 4 of this paper we also show that in Europe bidder banks tend to be much larger than acquired banks in cross-border compared with domestic M&A bank deals.

Follow the Leader Strategy - when a leading bank undertakes investment in a foreign market it may well encourage others to follow. (Choi, Tschoegl and Yu 1986) found evidence that large banks emulate their competitors cross-border strategy regarding investment decisions in the main financial centres. Anecdotal evidence also suggests that some form of herd instinct is apparent vis-à-vis the recent rush of commercial and investment banks to acquire asset management firms across Europe and the US, as well as Spanish bank expansion in Latin America (to give just a couple of examples). The follow the leader strategy may possibly be explained by the dynamics of bank FDI in that if all banks are subject to a common shock some will be first to move and others will follow. However, it may be that some form of oligopolistic competition explains why non-leader banks conjecture that the best behaviour is to emulate the industry leader.

Customer Following Strategies - banks in their home market have information advantages associated with their on-going client relationships. The nature of these relationships puts banks in a privileged position to follow their customers abroad. Various studies, such as (Goldberg and Saunders 1981), (Hultman and McGee 1989), (Grosse and Goldberg 1991) and (Fisher and Molyneux 1996) find that foreign bank presence in the UK and US are positively related to FDI and trade flows. As various industries become more concentrated (e.g. telecommunications, media, defense, motors and so on) then the financial services they demand become increasingly more complex and larger in scale. Big firms need big banks so they can meet their growing financing needs. The capital market, of course, can meet certain financing requirements of large firms - especially when markets are buoyant. When capital market become less accommodating then companies turn to their banks. In other words, when companies become larger and industries more concentrated, the banking industry will follow suit.

Performance and Efficiency Advantages - the most obvious reason justtifying foreign expansion is that it adds to overall bank performance and shareholder value. That is, returns generated from cross-border opertaions will add to group reurns, boosting ROE and ultimately adding to shareholder value. Given that a major strategic objective of banks is to generate sufficient returns to their owners one would expect that there is evidence to suggest that foreign operations add value in some way. Cross-border consolidation can therefore be expected to add value to the firm by 'improving the financial institutions efficiency and/or increase their market power in setting prices' (Berger et al 2000, p.10)

(Berger et al 2000) , however, find 'very few strong conclusions regarding the efficiency effects of cross-border consolidation' (p.25). There is little evidence that cross-border deals create scale, scope or product-mix advantages. They also note that the the X-efficiency literature provides little guidance as to whether foreign or domestic banks are more cost or profit efficient. In order to further analyse X-efficiency issues in cross-border US and European (France, Germany, Spain and the UK) banking they estimate cost and profit efficiencies for a sample of large banks during the 1990s. Disaggregating the results according to domestic and foreign banks according to home country origin they find that ' domestic banks may be more efficient than foreign banks from most foreign countries; may be about equally efficient with foreign banks from some foreign countries; but may be less efficient than foreign banks from one (the US) of the foreign countries' p.64. In other words, some foreign banks may have efficiency advantages over their domestic competitors but one cannot take as a stylised fact that foreign banks are more efficient. Another interesting finding from this study is that banks with the best domestic performance also perform well abroad, whereas poor performers tend to repeat their poor performace cross-border. This latter finding suggests that banks are not locating oversease to benefit from differential factor prices. Other emprical evidence provided by (Berger et al 2001) also suggests that a variety of efficiency barriers impede cross-border activity and therefore offset some of the gains from cross-border consolidation.

Considering the emprical evidence on the efficiency and performance features of cross-border banking there is little to suggest that banks locate oversease to benefit from differences in factor prices thus providing little support for the vertical FDI motive.

Managerial Motives - cross-border M & A may be motivated by managerial motives rather than the objective of shareholder value maximisation. Entrenched mangers may make cross-border investment decisions based on their own preferences for pay, perquisities, power, job security, a 'Quiet Life' and so on (Berger et al 1999). In general, cross-boder deals may 'either strengthen or weaken the hands of entrenched managers directly by affecting the market for corporate control or governance, or indirectly by changing the market power of the firm' nevertheless, ' The net effects of cross-border consolidation on the behaviour of managers in pursuing their own objectives directly through affecting corporate control or indirectly through affecting market power is unknown' (Berger et al 2000, p.34 -35)

Government Motives - it could be argued that a major factor that has motivated the cross-border consolidation trend in Europe (and the US) has been deregulation aimed at fostering a more competitive, innovative and open banking markets. In Europe the Single Market Programme and EMU have reduced barriers to cross border activity within Europe and the Euro zone with the objective to help facilitate cross-border activity. In the US the repeal of Glass Steagall and the Riegle Neal Interstate Banking and Branching efficiency Act 1994 has also fostered a more open and competitive banking environment. What is interesting is that the liberalisation that resulted from the Single Market Programme in Europe encouraged substantial domestic consolidation first and then this was later followed by cross-border expansion. (EC 1997). Consolidation came first in domestic markets as a strategic response of banks to protect their home market position mainly from the threat of foreign acquisition. (The largest banks in Italy and Spain, for instance, were perceived as small from a European perspective and so to protect their home market position there was domestic consolidation first followed later by overseas expansion). While the number of cross-border banking deals in Europe has increased, however, (Buch and DeLong 2002) note that as a proportion of total bank M&A activity they fell post-1992. (A similar result is also found for bank M&A in the US pre- and post- NAFTA suggesting that the creation of regional trading blocs may not be too successful in promoting cross-boder bank mergers). While the creation of trading blocs may have the impact of creating more domestic as opposed to cross-border M &A activity it is nevertheless the case that for nearly all European banking markets the end result has been more concentrated domestic banking markets and foreign bank presence has increased in nearly all European banking markets since the early 1990s. (Goddard et al, 2001). There is also anecdotal evidence to suggest that domestic governments within Europe (for instance in Italy) actively promoted and managed consolidaion in order to create domestic banks large enough to be protected from possible hostile acquisition by foreign banks.

Although the terminology and methods of analysis vary depending on whether one views the FDI, bank strategy or performance/efficiency literature the bulk of evidence points to the fact that regulatory, information and other barriers inhibit cross-border trade in banking services without establishment. This means that cross-border M&A in banking is mainly characterised by horizontal FDI. Nevertheless, various managerial motives such as follow the leader strategies and Hicksian 'Quiet Life' risk reduction strategies cannot easily be identified as features of either horizontal or vertical FDI. As such, it needs to be noted that while most bank cross-border M&A are likely to be motivated by a desire to avoid trade and other barriers there are various managerial motives that may also be important in explaining the motives for overseas expnasion that do not fit easily into the FDI dichotomy.

4. Financial Characteristics of Domestic and Cross-Border Bank M & A in Europe

As noted in (Goddard et al, 2001) prior to merger domestic bank M&A has usually been justified on the basis that such deals will result in cost savings resulting from the rationalisation of branches, headquarters and the integration of IT systems. While domestic mergers have mainly been motivated by the desire to reduce costs foreign deals have been justified on the grounds that an overseas acquisition will boost (and diversify) revenues - through the acquisition of a new customer base that will facilitate the cross-selling of services. Put crudely, the majority of domestic deals, therefore, have been cost driven, whereas cross-border deals are more revenue orientated. Given that the justification for domestic and cross-border deals are different it is interesting to analyse how or whether the financial features of banks involved in such deals differ.

This section covers some provisional finding from a recent study by (Altunbas et al 2002) where they investigate the strategic similarity between banks engaged in European merger activity. Following an approach similar to (Datta et al 1991); (Chaterjee et al 1992); (Bollenbacher 1993) and (Ramaswamy 1997), (Bahre et al 2002) they use a variety of financial indicators to define the strategic features of banks engaged in domestic and cross-border mergers. Their study investigates a sample of 178 bank merger and acquisitions (106 domestic and 72 cross-border) that took place in Europe between 1995 and 2000. [9]

The variables used in the analysis are shown in Table 7. A variety of these variables account for risk attributes - liquidity ratio, capital ratio and loan-loss provisions to net interest revenue. A higher liquidity ratio indicates that that the bank is in a stronger position to absorb adverse liquidity shocks but as liquid assets tend to be low-yielding a higher ratio implies (all other things being equal) lower earnings. The capital ratio (or to be more precise the equity-to-assets ratio) indicates the capital strength of the bank and its ability to absorb credit and or other losses. Loan-loss provisions to net interest revenue ratio provides a crude indication of the extent to which the bank has made provisions to cover credit losses. The higher the ratio the larger amount of expected bad loans are on the books, indicating higher risks, although these have been provisioned for. In addition to these risk indicators a number of other variables are included to account for the balance sheet features of the banks involved in M&A. These include the net loans to assets ratio which shows the proportion of the balance sheet dedicated to lending. In addition a loans to deposit ratio is also included to indicate the proportion of deposits lent out (this can also be considered a crude risk proxy - the higher the ratio then greater reliance of the bank on more costly bought in funds it needs to meet lending requirements). The study also includes a couple of cost variables - one a standard cost-income ratio that proxies for efficiency and a non-staff cost to total cost ratio which is used as an indicator for technology and other

9 Merger information was obtained from the Thompson Financials M & A database. Bank financial information was obtained from Bankscope.

investment spending. The extent of banks' involvement in generating non-interest income (fees, commissions and so on) is captured by the non-interest revenue to total revenue variable. Diversification of income streams are crudely captured by the off-balance sheet to total assets ratio. Finally, the ability of banks to generate revenue is indicated by the asset productivity measure (total revenue/total assets) and variations in tax is given by the taxation margin. The study uses differences in return-on-assets as the main performance indicator. While the choice of these variables seems somewhat ad hoc they are typical of the sort of variables that have been used in numerous studies that seek to analyse the determinants of bank performance (Goddard et al 2001)

Table 7 Definition of the Variables Used in the Analysis

Symbol	Definition	Formula (Ratio)
LQ/D	Liquidity ratio	Liquid Asset/Total Deposit
CIR	Cost income ratio	Total Cost/Total Revenue
E/TA	Capital ratio	Equity/Total Assets
NL/TA	Loan composition of Balance Sheet	Net Loans/Total Assets
LLP/NIR	Credit risk	Loan loss Provision/Net Interest Revenue
NIR/TR	Earnings Diversification	Non-Interest Revenue/Total Revenue
TR/TA	Asset Productivity	Total Revenue/Total Assets
OBS/TA	Exposure to Off-Balance Sheet Activity	Off-Balance Sheet Items/Total Assets
L/D	Loan-back ratio	Customer Loans/Deposits
OE/TC	Proxy for Technology and other Investment Spending	Non-staff Costs/Total Cost
TM	Taxation Margin	Pre-tax Return on Equity (ROE)/Post-tax ROE
ΔROA	Change in Performance	Two year post-merger Return on Assets (ROA) less two year Pre-merger ROA
PREROA_B	Pre-merger ROA of	Two year average Net Income/Average

	Bidder	Asset
RSIZE	Relative size	Total Asset of Target/Total Asset of Bidder

Table 8 provides descriptive statistics for the financial features of banks engaged in domestic consolidation. Overall, the table shows that bidders are substantially larger than targets. In fact, the mean relative size of a target was 75% of the bidder's size. The median figures for the relative size indicator (R Size) are also revealing as these show that that targets were only 19% the assets size of the bidder. It can also be seen that post merger profits (ROA) increased on average by 0.10%, although the median increase in returns at 0.03% is indicative of only small performance improvements. Bidders tend to be more cost efficient (in terms of the cost-to-income ratio) but also have higher operating costs (perhaps suggesting that they spend more on technology). Targets also tend to have higher equity ratios, loan losses, non-interest income ratios, lend-back ratios and asset productivity (total revenue/total assets). Bidders have higher OBS activities (surprisingly not reflected in greater non-interest income ratios) and pay more tax. Many of these features, of course, may be a function of size - that is bidders are larger and so tend to lend less (as a proportion of the balance sheet), have lower equity-to-assets ratios, do more OBS business and so on. At least the data are indicative of the broad financial features of banks engaged in domestic M & A in Europe in the second half of the 1990s.

Table 8 Domestic Mergers - Descriptive Statistics of Size, Performance and other Financial Features of Target and Bidder Banks

	Target			Bidder		
Variables(1)	**Mean**	**Median**	**Standard Deviation**	**Mean**	**Median**	**Standard Deviation**
Total Asset*	17,690	2,407	36,469	53,894	19,098	80,536
LQ/D	29.68	27.94	18.89	26.91	29	13.22
CIR	69.53	69.32	16.81	66.67	68.57	14.48
E/TA	8.73	5.44	12.51	5.444	4.54	3.48
NL/TA	53.54	53.63	19.8	51.29	52.1	15.85
LLP/NIR	23.76	17.95	33.71	21.14	14.01	34.21

NIR/TR	18.45	15.49	16.08	15.97	14.56	13.41
TR/TA	9.214	9.294	2.977	8.687	8.909	2.636
OBS/TA	19.38	11.07	28.02	39.7	14.5	206.8
L/D	104.6	65.6	199.2	85.4	66.6	116.8
OE/TC	68.13	68.87	15.14	73.23	72.24	14.75
TM	4.852	4.29	4.295	5.253	5.65	3.528
	Change in Profits and Relative Size			**Pre-Merger Profits**		
ΔROA	0.10	0.03	0.52			
RSIZE	71.54	19.50	120.38			
PREROA_B				0.43	0.38	0.57

(1) For definition of the variables refer Table 9. *Total Asset in Euro (millions)

Table 9 presents the descriptive statistics of size and strategic elements of target and bidder firms for the sample of cross-border mergers. In many respects the financial featues of bidders and targets engaged in cross-border deals are similar to domestic consolidation. The main differences relate to size and post-meger performance. Target banks tend to be much smaller in size relative to the bidder - the median asset size of a target is only 12% of the bidder. Cross-border mergers also exhibit small ROA improvement of 0.23%, on average, which is better than the improvement shown in domestic mergers although these performance improvements remain small. (It may well be worth extending the nalysis of performance comparisone by looking at changes in market capitalisation although few of the smaller banks in the sample are quoted).

Table 9 Cross-Border Mergers - Descriptive Statistics of Size, Performance and other Financial Features of Target and Bidder Banks

	Target			**Bidder**		
Variable(1)	**Mean**	**Median**	**Standard Deviation**	**Mean**	**Median**	**Standard Deviation**
Total Assets*	43,539	14,658	70,154	207,455	147,894	186,220
LQ/D	33.43	29.86	19.96	41.15	27.84	58.06
CIR	62.37	67.51	20.41	66.67	67.54	14.01

E/TA	10.59	5.86	17.79	5.38	3.61	10.48
NL/TA	45.97	48.93	20.29	43.39	48.99	16.63
LLP/NIR	13.28	15.61	30.82	16.6	15.18	10.04
NIR/TR	22.46	19.48	15.43	25.31	20.19	20.75
TR/TA	8.605	8.134	2.608	7.995	7.328	2.986
OBS/A	20.75	15.75	33.21	25.01	16.89	52.37
L/D	73.78	62.95	57.92	87.7	67.1	193.9
OE/TC	70.64	71.6	15.26	76.51	74.97	9.7
TM	4.376	3.789	4.254	5.516	5.109	2.711
	Change in Profits and Relative Size			**Pre-Merger Profits**		
ΔROA	0.23	0.13	0.48			
RSIZE	28.14	12.19	43.29			
PREROA_B				0.54	0.44	0.47

(1) For definition of the variables refer Table 9. *Total Asset in Euro (millions)

If one compares Tables 8 and 9 together a number of interesting features emerge as to the cost and revenue features of banks involved in domestic and cross-border deals. In domestic deals bidders are typically more efficient than targets (in terms of the cost-income ratio) suggesting that deals are predicated on the 'efficient' bidder passing on efficiency advantages/expertise onto the less efficient acquired bank. In the case of cross-borer deals bidders appear slightly less efficient than targets. This perhaps provides some, albeit limited, evidence that cost considerations are more important for domestic deals. Banks engaged in cross-borer deals also seem to have more diversified earnings. Bidders have higher non-interest revenue to total revenue compared with targets and both depend more on non-interest sources of income compared to banks engaged in domestic deals. This may suggest that banks engaged in cross-border activity are more focused on revenue generation from non-interest sources. However, other indicators of diversification (such as off-balance sheet items to total assets) and revenue generating capacity (total revenue to total assts) do not suggest major differences between cross-border and domestic deals.

(Altunbas et al 2002) highlight some interesting differences in the financial features of domestic and cross- border M & A in European banking. Unlike the bulk of the literature, they do find that mergers tend to increase performance but only slightly (in terms of ROA at least). They also highlight the importance of size differences in relation to bidder and target banks. Although not reported above, they also tend to find that, on average, deals between banks of more equal size tend to yield greater performance improvements. [10]

5. Has there been an FDI race in European Financial Services?

Given that the available evidence points to the fact that domestic financial re-structuring has significantly outpaced cross-border activity during the 1990's it is possible to conceive of industry re-structuring as a two-tiered race both domestic and cross-border. In the latter case the FDI race may relate to expansion that seeks to broaden product range, markets, expertise in a host of different industry segments. Motives may relate to costs (scale, scope and X-efficiencies) or/and revenue enhancement. The race is really between firms in similar segments, like investment banks building asset management and private banking capabilities, retail banks adding to their customer bases and developing insurance services and so on.

Having said this, the main re-structuring activity has really been in the domestic market where consolidation has sought to build strong national firms from which possible overseas expansion can follow. In countries that are constrained by their small size, excess concentration or other regulatory barriers (as in Scandinavia, Benelux countries and Switzerland) this has forced some of the larger financial firms to emphasise cross-border expansion. However, this sort of strategic focus, in general, has been much less important for banks and other financial firms operating in larger and less constrained markets.

10 Of course any comparison of pre- and post-merger financial data needs to be treated with caution due to the specific accounting treatment of M&A activity.

From a general perspective, European banks have been slow to develop strong multinational franchises although Table 10 shows that there are a number of European institutions that now depend heavily on foreign income to power their business.

Table 10 Ranking of banks according to assets outside their domestic base (2000/2001)

	Bank Name	Country	Foreign assets (%)	Foreign Income (%)	Staff Abroad (%)
1	UBS	CH	80.5	56.5	58
2	Standard Chartered	UK	80	90	95
3	Credit Suisse Group	CH	78.7	42.9	58.8
4	Deutsche Bank	DE	71.9	57.8	48.5
5	ING Bank	NL	64.1	44.7	61
6	ABN Amro Bank	NL	64	65.7	66.2
7	BNP Paribas	FR	61.6	37	38.8
8	HSBC*	UK	55.6	62.6	56.9
9	KBC Bank	BE	54.7	40.7	42.2
10	Allied Irish Bank	IR	52.9	56.6	68.8
11	SCH	ES	52.7	62.4	66
12	RZB Group	AU	47.3		77.5
13	Dresdner Bank	DE	43	33.2	17.3
14	BBVA	ES	41.4		68.8
15	Bank of Irealnd	IR	37.9	22.9	
16	Erste Bank Group	AU	37.7	35.9	71
17	Fortis Bank	NL/BE	37.2	56.2	46.5
18	Anglo Irish Banking	IR	36.5	46.7	39.9
19	Hypo Vereinsbank	DE	34.4	30	51.6

Notes: * Outside Europe

Source: Abraham and Van Dijcke (2002) p.26

The motives for cross-border expansion as we have already noted are varied and complex and as such it is difficult to view FDI expansion in the financial services sector in its totality as a race. While the 1990s have been an era where cross-border activity in the financial sector has come to the fore, in other sectors (such as in the motor industry, pharmaceuticals and electronics sectors) such industries have long pursued multinational strategies. These sectors have developed extensive networks of alliances, joint ventures and acquisitions that help facilitate in providing more optimal production, distribution and marketing capabilities. It could just be that the financial services industry is one (or two) steps behind their major corporate clients in formulating their transnational strategies. As noted in Abraham and Van Dijcke (2002) it remains to be seen whether European banks and other financial firms will continue to slowly build their cross-border operations or whether the current decade will yield an avalanche of further cross-border consolidation in the industry. Maybe this depends on restructuring trends outside the financial industry?. Only time will tell.

6. Conclusion

This paper provides an overview of the European banking market in the 1990s and highlights the issues surrounding FDI activity in the industry. A varied literature covers the main determinants of cross-border activity in banking and this suggests that regulatory, information and other barriers inhibit cross-border trade in banking services. This suggests that cross-border M&A in banking is mainly characterised by horizontal FDI. Nevertheless, corpoate governance issues relating to non-profit maximising managerial motives such as follow the leader strategies and Hicksian 'Quiet Life' risk reduction strategies cannot easily be identified as features of either horizontal or vertical FDI. As such, it needs to be noted that while most bank cross-border M&A is likely to be motivated by a desire to avoid trade and other barriers there are various managerial motives that may also be important in explaining the motives for overseas expansion that do not fit easily into the FDI dichotomy.

The latter part of the paper briefly investigates the financial features of banks engaged in domestic and cross-border M&A activity in European banking. There is some evidence that mergers tend to slightly increase performance and target banks in cross-border deals are much smaller than in domestic deals. There is also some evidence that domestic deals are motivated more by cost efficiency considerations whereas earnings diversification may be more important for cross-border bank deals.

Given that evidence points to the fact that domestic financial re-structuring has significantly outpaced cross-border activity during the 1990's it is possible to conceive of industry re-structuring as a two-tiered race both domestic and cross-border. In the latter case the FDI race may relate to expansion that seeks to broaden product range, markets, expertise in a host of different industry segments. Motives may relate to costs (scale, scope and X-efficiencies) or/and revenue enhancement. The race is really between firms in similar segments, like investment banks building asset management and private banking capabilities, retail banks adding to their customer bases and developing insurance services and so on. It remains to be seen whether European banks and other financial firms will continue to slowly build their cross-border operations or whether the current decade will yield an avalanche of further cross-border consolidation in the industry. Maybe this depends on restructuring trends outside the financial industry? Only time will tell.

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