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Banking Merger 2000

Master Thesis

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Abstract

This paper deals with the issue of mergers and acquisitions in banking. It views the issue of M&A in the light of the current wave of strategic restructuring ushered by the integration of the European market, and presents a qualitative approach to decision making. A starting point for the discussion is to articulate the purpose for the existence of the financial intermediary as an alternative to the capital market. This analysis draws on the Coase classical conception on the origin and the nature of the firm and applies it to the financial services sector.

Further, the paper considers the main evolutionary trends in the financial intermediation process as it dictates the institutional structure of the financial firm and gives what Coase calls " meaning to the question what do we mean by saying that the firm gets larger or smaller". In this manner the M&A issue is approached from organizational perspective. This approach is articulated in a client-product-arena organizational model which views M&A as a global strategic positioning.

One major advantage of this model is that it puts focus on adaptability and is suited to long term strategic decision making. Such approach suits the objectives of management planning as it copes with the changing global market environment. The model's organizationally oriented structure accommodates for the changing nature of the banking industry as it heads towards the new millennium. The paper illustrates the usefulness of the client-area- product matrix as a management tool by applying it in the discussion of the merger between the Swedish SEB and the Danish Codan bank. It argues that this cross border venture can serve as a typical example of management thinking in cross border expansion for the coming decade.

1. Introduction

Banks are financial intermediaries, whose importance stems from their power to create and manage currency, channel information and money flows of enormous size and effect large volume transactions. From the "money-changer's table" of 17th century Europe, they evolved into major institutions, shaping the economy's money supply system and directing the transfer of funds between economic agents both nationally and globally.

The speeded integration of the world markets, the intriduction of the single Euro currency, and the unprecedented escalation in large-scale restructuring activity across industry sectors during the 90ies, has put the financial industry in global, multidimensional perspective. Firstly, banks deal with new market dimensions as they expand beyond national borders and encounter new macroeconomic, regulatory and demographic environments. Secondly, banks deal with new products and new forms of competition, brought about by the advances in technology. Together those two factors define new demand patterns and new customer dimension, to which management has to continuously adjust. The globalization of the banking industry has increased complexity of decision making. With the current upsurge in global corporate restructuring management faces the need for a decision making suited for flexible, long-term oriented planning.

1.1. Objective

With this background in mind, the paper looks at the trends of west European banking, particularly after the introduction of the Euro currency, with the objective of articulating a decision making framework which considers the current complexity and the changing nature of the financial industry. The discussion that follows rests on the basic premise that articulation of such framework requires an understanding of the bank's role as a financial intermediary and of the factors that have lead to the changing

nature of financial intermediation during the last decades and which will likely influence it in the near future.

1.2. Approach to objective

The analysis starts by adopting the Coase theorem on the origin and the evolution of the firm. This concept views the firm as organization of transactions, which provides a more efficient alternative to the free market mechanism whenever such institutionalization reduces the cost of carrying out the transaction. This allows to look at the bank as an organization of intermediation functions which it can offer to its customers at a lower market cost. With changes in the market environment the role of banks change as well and management must continuously review its competitive positioning by incorporating or abandoning products and activities.

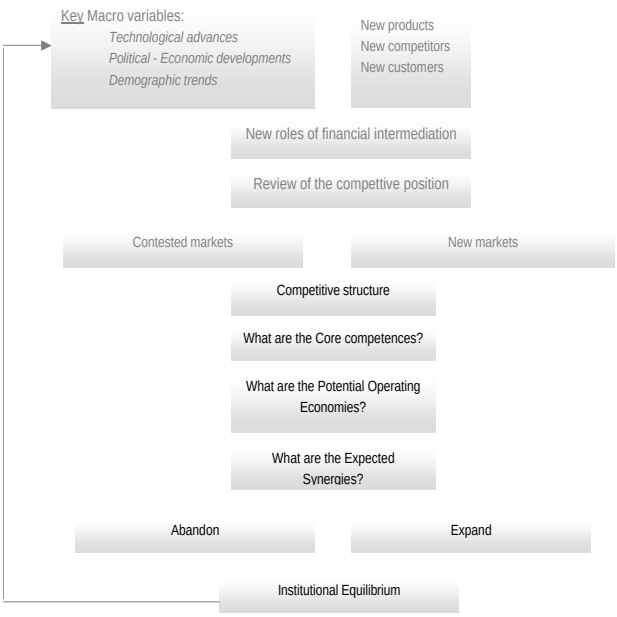
The paper relates this supposition to a client-arena-product (CAP) matrix which can be used to identify sources of competitive advantage and markets with profit potential. The firms may decide to abandon old activities and turn to markets in which it can benefit from operating economies and synergies (Fig 1.1). The CAP matrix can be helpful in charting an expansion path as illustrated through the case study.

2. The changing nature of the banking industry

2.1. The frontiers of the firm

The issue of the “optimal frontiers” of the firm raised here is not new. Earlier in the century the economist R. Coase attempted to answer this question in a classical writing, which dealt with the origins and the nature of the firm by using the economic analysis of margin and substitution. The fundamental usefulness of this approach lies in its ability to give what Coase called “scientific meaning to the question of what is meant by saying that a firm gets larger or smaller” (Coase 1937).

Figure 1.1



If the price mechanism of the free market economy provided the most efficient distribution of resources, then, the article asked, why do firms exist? Coase argued that it costs to use the price mechanism. Market cost include, among others, contracting cost and risk allocation, with the most obvious cost

being that of information, or “discovering what the relevant price are”. These costs could be reduced “by the emergence of specialists who would sell this information”. In this manner Coase looked at the firm as institutionalization of market functions, resulting in reduced (although not eliminated) market costs. The firm should expand if it can organize an additional transaction at a lower cost than the market. However the benefits of expansion are limited too, due to “diminishing returns to management”, or the rise of marginal organization cost as the firm expands. The firm reaches its equilibrium limit when the marginal benefit from a organizing additional transaction equals the marginal cost of carrying it in the open market.

Overall, Coase argued that firms tend to get larger

“a. the less cost of organizing and the slower these cost rise with an increase in the transaction organized.

b. the less likely the entrepreneur is to make mistakes and the smaller increase of mistakes with the increase of the transactions organized.

c. the greater the lowering in the supply price of factors of production to firms of larger size” (Coase 1937).

Most of these concepts have retained their basic validity in modern analysis, albeit under different names, such as “X-efficiency” which is essentially “the way firms are run” or the managerial skill of using resources and controlling costs. “Oprating economies”of scope and scale relate to the per-unit economic benefits of product volume and range expansion and have provided the main motivation for the globalization of the financial services industry. With this framework in mind the evolutionary trends of the banking industry can be viewed from the perspective of the changing role of banks as intermediaries, or what I.Walter calls “institutional microstructure of the financial intermediation process.”

2.2. Banks and capital markets

The transfer of funds between deficit and surplus units can take place either directly through the capital markets or through financial intermediaries, for a fee. In strictly capital market economies companies obtain funds by issuing and selling securities which investors prefer to purchase at their won risk in the expectation of a higher return. In efficient markets investors can purchase securities according to their the risk-return preferences by diversifying their portfolio. It has been widely argued that well-functioning capital markets increase the economy's efficiency, its investment level and real wealth as well as its capacity to absorb risk (Molineux 1992, p.28). In strictly bank oriented economies, bank take over the intermediary functions of the market. Companies rely for financing on bank loans, while banks themselves perform a wide range of financial services. economy t those securities bring together the ultimate borrowers and lenders. In this case the economy's overall risk is determined mainly by the owners of productive resources and by banks.

2.2.1. "The lowest paying business in town"

Until the second half of the 20th century banking business involved mainly old fashioned intermediation: banks obtained short term funds from depositors and lent them long term to the industry sector. Their intermediation function focused mainly on credit risk assessment. During the post war period when European economies concentrated on industrial restructuring, banks came to enjoy a privileged position. In the environment of underdeveloped capital markets and industry relying mainly on "Hausbank" financing banks evolved as universal financial service firms, forming, in the absence of competition, major constellations of substantial financial and political clout. This is one reason why European banking sector in particular remained isolated and unaffected by major competitive pressures until the liberalization and the integration of the European markets. Even in the United States however, until the 70ies banking was mainly a supply-led industry, "the

lowest paying business in town", enjoying high net margins, cheap sources of funds and passive customer base.

The inflation rate and the general instability of the 1970ies introduced increased market uncertainty. Increased volume of businesses put pressure on banks for increased lending capacity. Trade expansion generated growing demand for corporate funds. In the personal sector, rise of net disposable income and reduced savings rate increased personal indebtedness. In both US and Europe the increase of middle class income made this group became increasingly important source of bank deposits. During the 1970ies financial lending increased substantially in volume to all sectors: government, corporate and personal, which formed mass markets for bank services (Wilson 1986, p.80-3; also Molyneux 1994, p.83-0).

2.2.2. Marketization

Deposits from the middle class group became so important for banks because they partly offset the declining deposit base of corporate customers as they began to shift their idle funds from banks to liquid short term securities convertible to cash on demand in the money and capital markets (Wilson, p.80). Seeing their position eroded in the corporate sector, banks shifted their focus on retail customer. However, during the inflation years of the 1970ies businesses and households also began demanding Money Market rate earning financial instruments, while economizing on non-interest bearing deposits. As a result, between 1960 and 1980 banks increased significantly their proportion of funds remunerated in money market terms. They also remunerated a growing proportion of term deposits at a higher rate, which increased the cost of carrying small deposits. Those two developments had the effect of tying the bank's large funding base to the market rate, or the "marketization" of bank funds with the result of significant decline in banks' demand deposits and the increasing dependence of banks on "bought in funds" (**Table 2.1**) (Molyneux 1994, p.64-6). Increased competition introduced innovative, margin-increasing

bank products. In growing chase for loyal customers banks began focusing on sophisticated "market segmentation" and "relationship pricing". More importantly, banks began to manage their liabilities more actively. The increased exposure of liabilities to interest rates greatly increased the importance of banks' security portfolio.

Table 2.1

Fall in Demand deposits for some Large European Banks as % of Total Average assets: 1960-84

	1960	1971	1984
Austria	20.5	13.7	4.6
Germany	15.9	11.1	8.6
France	49.3	39.3	19.2
Italy	40.1	48.9	41.5
Luxembourg		10.3	0.9
Netherlands	33.9	24.0	11.4
Spain	33.7	24.9	12.9
Switzerland	23.1	18.6	17.1
Denmark	33.9	44.6	38.9
Sweden	10.6	9.9	6.4
Finland	12.1	10.3	8.4
Norway	59.7	38.9	19.6
Belgium	43.5	18.4	5.4
UK	45.6	19.0	6.6
US	51.1	34.2	18.3
Canada	27.9	30.0	13.8
Australia	39.3	25.2	16.9

Source: Molyneux 1992 p.66

2.2.3. Expanding the security portfolio

In order to match interest sensitive assets and liabilities, banks began undertaking variable rate lending. They expanded and diversified their security portfolio to match maturities (Hempel 1994, pp.179, 197). Variable rate lending however required shortening the maturities of loan contracts and

other security issues. As a result, the treasury function of the portfolio expanded substantially and came to encompass both short-term and long-term assets and liabilities as well as monitoring the bank's liquidity position and maturity gaps (Hempel 1994, p.197ff). With time banks evolved from net margin business towards complex integrated asset/liability systems.

2.2.4. Securitization and disintermediation

Traditionally banks have acted as direct financiers, bringing together ultimate borrowers and lenders, which exchanged primary securities (debt and equity). Over the years banks began undertaking indirect financing, e.g. purchasing primary securities from the borrowers and selling them (e.g. issuing indirect securities) to the ultimate lenders. The issuers of primary securities was the owner of the real asset, while the holder of the primary security became indirect owner of real assets and a direct owner of a financial asset. When sold (for profit) to the ultimate lenders, the financial asset provided indirect ownership of primary security (Quinn 1975, p.3-4). The issuance of such security instruments backed by financial assets is called "securitization" of assets and it is an outcome of the development of the secondary markets for securities (Appendix 1).

In the later 1970ies many banks began securitizing their mortgages, installment loans and other assets turning them into marketable instruments. As sellers of such instruments, they received the proceeds, writing the sold assets off the balance sheet and thus excluding them from capital adequacy requirements. Banks also began issuing hybrid (debt-backed-by-equity) instruments and derivatives such as bonds with put options, futures, forwards etc. They began specializing in various marketable financial assets such as zero-coupon bonds, bonds adjusted to inflation and exchange rates etc. Banks issued such marketable securities to finance their own needs, or to incorporate them in their asset portfolio. They also offered them to customers as additional option to bank financing (Hempel 1994, p.34). In Europe the securitization of

bank funds effectively made them players in the capital markets replacing institution-based intermediation by market-based intermediation. The net income focus shifted away from margins towards security management, fee income from placing instruments, Off Balance Sheet (OBS) activities (options, futures etc.). Thus bank industry expanded into the securities businesses.

With the new focus on asset management banks took advantage of the proliferation of new capital backed financial instruments: mortgage based securities, bonds adjusted to the rate of inflation, zero coupon securities and put options, interest rate swaps etc. Banks issued them to fund their own needs, or to integrate them in their corporate clients' asset portfolio. They sold financial securities receiving the proceeds (less any commission, credit enhancement fees) writing them off the balance sheet. With the blurring of differences between bank s and other financial services sectors banks were no longer intermediaries, but participants in the capital markets as providers of a wide range of financial products (Appendix 2). By the 1990ies this moving away from "pure" banking margin business towards asset management was clearly visible both on the income statement on the balance sheet which became increasingly securitized and disintermediated (as seen for example by the rise in Off balance Sheet (OBS) activities), (**Table 2.2a**, **Table 2.2b, and Table 2.3)**:

Table 2.2a

Changes in Income Statement as % of Total Average Assets for Large European banks

Income Statement	**1982**	**1986**	**% Change**
Int. Income	**9.96**	**8.42**	**-15.41**
Int. Expense	**6.92**	**5.52**	**-20.17**
Net Int. Income	*3.04*	*2.90*	*-4.53*

Non-int. Income	0.77	0.82	6.99
Gross Income	3.81	3.73	-2.09
Op. Expenses	2.60	2.61	0.19
Net Income	**1.2**	**1.11**	**-7.29**
Provisions Net	0.55	0.49	-11.06
Profit Before Tax	0.65	0.62	-4.51
Income tax	*0.24*	*0.26*	*9.54*
Profit After tax	0.43	0.35	-17.50
Distributed Profit	0.17	0.14	-19.97
Retained Profit	0.41	0.25	-36.82
Other Items			
Staff Costs	1.53	1.42	-7.03
Loan Provisions	0.48	0.42	-12-06
Prov. on Securities	0.17	0.03	-80.00

Source: OECD (1987) and OECD (1988).
(Molyneux, p.77)

Table 2.2b
Changes in Income Statement as % of Total Average Assets

Balance Sheet	**1982**	**1986**	**% change**
Assets			
Cash & Balance with central Bank	3.74	3.28	-12.27
Interbank Deposits	24.34	24.68	1.39
Loans	45.64	43.84	-3.99
Securities	13.83	13.40	-3.10
Other Assets	15.44	14.80	-4.15
Liabilities			
Capital and reserves	4.09	4.86	18.91
Central bank borrowing			
Interbank deposits	27.67	26.77	-3.25
Non-bank deposits	55.8	53.38	-4.33
Bonds	4.97	6.36	27.98
Liabilities	11.17	11.55	3.40

Source Euromoney 1986, p.122
(Molyneux, p.78)

Table 2.3

Large Banks' OBS activities ($US bill)

Bank	OBS if known	Total Assets	Estimated OBS
Citicorp	260.7	162.1	150
BankAmerica	197.4	114.8	150
Chase Manhattan	132.9	87.9	100
J.P. Morgan	121.2	67.6	150
Bankers Trust	114.0	48.1	100
Chemical Bank	112.6	54.3	100
Manufacturers Hanover	95.0	74.4	75
Mitsubishi Bank		132.9	75
Societe generale		97.6	50
Deutsche Bank		95.7	50
Credit Lyonnais		11.4	50

Source Euromoney 1986, p.122
(Molyneux, p.77)

2.2.5. Impact of European integration

The strongest competitive impetus in banking came from the European economic integration during the 80ies with the resulting growth of the European capital markets. Most European securities traded in that period were still domestic with banking and financial companies making about 62% of those issues. In particular, European non-financial corporations, traditional corporate clients, also increased their participation in the capital markets which began to replace banks as a source of funds. A comparative OECD data presented here shows the intensifying capital market activity, approaching that of UK and US on that period (**Tables 2.3a, 2.3b, and 2.3c**).

Table 2.3a

Capital Market financing by all European Companies, 1985-88. $US bill

	Euro & foreign Bonds	*Domestic Bonds*	*Total Bonds*	*Euro & Foreign Equities*	*Domestic Equities*	*Total Equities*	*Euro & Foreign Issues*	*Domestic Issues*	*Total Issues*
1985	*37,066*	*110,432*	*147,498*	3,409	29,233	32,642	40,475	139,665	***180,140***
1986	*54,047*	*142,509*	*196,556*	16,240	57,570	73,810	70,287	200,079	***270,366***
1987	*35,884*	*165,845*	*201,549*	15,301	74,306	89,607	***51,005***	***240,151***	***291,156***

Source: European and Foreign date. Securities Data Corporation (OECD)
(Walter and Smith 1992, p. 113)

Table 2.3b

Volume of capital Market financing by regional corporations in respective regional markets, 1987.

1987	***US***			***Europe***			***Japan***		
	Financial	**Non-Fin**	**Total**	**Financial**	**Non-Fin**	**Total**	**Financial**	**Non-Fin**	**Total**
Equities	34,500	33,900	68,400	163,593	73,986	237,579	4,400	23,600	28,000
Bonds	145,600	167,100	312,700	239,019	37,470	276,489	227,900	103,100	331,000
Total	*180,100*	*201,000*	***381,100***	*402,612*	*111,456*	***514,068***	*232,300*	*126,700*	***359,000***
GNP $USbill		4,700			5,300			2,400	
Financing /GNP	**0.038**	**0.043**	**0.081**	**0.042**	**0.026**	**0.068**	**0.097**	**0.053**	**0.150**

Source: European and Foreign date. Securities Data Corporation (OECD)
(Walter and Smith 1992, p. 112)

Table 2.3c

Capital market financing by European non-financial corporations $US mill, average exchanger rate

	Non-financial debt			***Non-financial equities***			***Total non-financial issues***			
	Euro & Foreign Bonds	**Domestic Bonds**	**Total Bonds**	**Euro& Foreign Equities**	**Domestic Equities**	**Tot. Equities**	**Euro- and Foreign Issues**	**Domestic Issues**	**Tot Issues**	**Non-Fin as % of GNP**
1985	11,779	12,249	24,028	2,660	23,610	26,270	14,440	35,859	50,299	27.92
1986	25,314	19,122	44,436	13,112	45,886	58,998	38,426	65,008	103,434	38.26
1987	13,576	23,894	37,470	9,873	64,113	73,986	23,449	88,007	**111,456**	**38.28**

Source: European and Foreign date. Securities Data Corporation (OECD).
(Walter and Smith 1992, p. 114).

- *Debt/Equity issues volume*: **Table 2.3b** reflects consolidated capital market volume financing including both domestic and Eurobond and Euroequity financing. **Table 2.3a** reflects only domestic European financing. In terms of domestic financing, in 1987 the volume of capital market issues in Europe was about 76% of the US ($ 291/381 bill) and 81% ($291/359 bill) of Japanese issuing activity. For 1985-7 (**Table 2.3a**) European bond financing increased by 36% and equity financing by 174.5%. Domestic Equities issues increased by 154% and foreign issues by 348%.

- *Financial VS Non-Financial*: European non-financial corporations' usage of capital markets increased about 40% by volume. US non-financial corporations tend to use the capital market more than the European. The traditional reliance of corporations on bank financing has prevented the rapid increase in non-financial issuing of securities, although the liberalization and privatization reforms decreased the difference. European non-financial corporations' issues made up 38% of domestic issues, but 48% of foreign issues. This suggests that investors have increased usage of the Euromarkets as opposed to domestic capital markets. US total amount of issues for that year 381 bill of which 53% were issues of non-financial corporations.

- *Debt/Equity*: The total equity: bond ratio for non-financial corporations has increased for European approximately form 1.1 to 1.5 which suggests a tendency away from the traditional alternative of bank debt (Walter and Smith p.111, 115-9).

Towards the end of the 1980ies, the European market still included 3 rather segregated sub-markets: that of Eurosecurities, the domestic securities markets, and that for foreign bonds and securities. The free capital flow resulting from the deregulation initiatives started the converging of domestic

markets into a global super-competitive playing field. Free capital flow led to larger transaction volumes and pressured banks to raise their lending limits. Those limits presented a problem for the middle size banks causing them to loose borrowing businesses to the larger players. Raising capital through public issues was difficult, and sustained equity growth from retained earnings was usually a slow process for banks. For that reason banks improved their capital position by consolidating (Wilson 1986, p.81-2). Thus capital base and market access became traditional motives for "marriages of convenience" in the 1980ies.

2.2.6. Growth of the European M&A market

The securitization of financial institutions resulted in a growing proportion of short-term shareholdings in institutional portfolios. This trend stressed liquidity, structural flexibility and, the ability of institutions to realize the underlying equity value of their holdings. Meanwhile, the banking "playing field" expanded to include many competitors: traditional brokerage firms, insurance companies, investment banks, postal, savings banks, and credit institutions, among others. In the consequent wave of capital restructuring the global financial firms and the global nich players became the two dominant organizational models in the growing market for corporate power.

The European M&A market was internal, favoring gradual commitment and deals negotiated face to face, which Europeans believed were wiser, less financially demanding and reversible. European companies preferred stakes, or equity participation that allowed them to preserve independence, although in many cases, acquisitions of minority stake holding assured actual control of the company. In the US however, mergers often took place for tax and legal purposes and acquirers therefore usually preferred 100% ownership. Tables 2.4a,b,c,d,e compare merger activity regarding domestic vs. cross border mergers in both Europe and the US, as well as the ownership preferences.

Table 2.4a
Volume of Completed international merger and corporate transactions, 1985-91.

			Cross Border									
	Domestic		**US buyer**		**US seller**		**Total**		**Outside US**		**Global Tot.**	
Year	*No.*	*$bill*	*No.*	$bill	*No.*	$bill	*No.*	$bill	No.	*$bill*	*No.*	*$bill*
1985	*804*	192.9	*25*	3.9	*76*	10	***101***	**13.9**	*143*	20.7	***1,048***	**227.4**
1986	*1,178*	203.9	*39*	2.9	*164*	31.1	***203***	**34.1**	*296*	38.7	***1,677***	**276.5**
1987	*1,311*	205.8	*52*	8.5	*187*	36.9	***239***	**45.3**	*586*	86.6	***2,136***	**337.8**
1988	*1,580*	294.4	*81*	6.7	*247*	61.4	***328***	**68.1**	*1,452*	124.2	***3,360***	**486.7**
1989	*1,872*	244.8	*149*	25.3	*405*	52.3	***554***	**77.7**	*1,832*	203.1	***4,528***	**525.5**
1990	*1,564*	106.8	*143*	20.9	*398*	50.4	***541***	**71.3**	*1,986*	204,4	***4,091***	**382.6**
1991	*1,139*	48.1	*133*	8.2	*212*	8.1	***345***	**16.4**	*1,354*	83.2	***2,338***	**147.6**
Total	*9,448*	1,296.7	*622*	76.5	*1,689*	250.5	*2,311*	326.9	*7,649*	761	*19,408*	**2,384.7**

Source Large, Smith, and Walter, Securities data Corporation.
(Smith and Walter 1992, p.123)

- *US vs. non-US transactions*: During 1985-91 approximately 19,000 transaction were completed with volume of $2.4 trillion. US domestic transactions make up about half of them and the volume for slightly more than half of the total volume. About 30-35% were transaction completed outside the US, and the rest include deals between US buyers and sellers (mostly with European buyers and sellers). For the 1985-91 period US has remained the largest M&A market.

Table 2.4b
Merger Activity Domestic and Crossborder Europe 1985-91

			Cross Border					
	Intra-European		**Eur buyer**		**Eur seller**		**Total**	
Year	*No.*	*$bill*	*No.*	$bill	*No.*	$bill	*No.*	$bill
1985	*72*	10.6	*45*	6.2	*29*	2.3	***74***	**8.6**
1986	*195*	18.9	*106*	18.6	*44*	6.1	***150***	**24.7**
1987	*416*	48.9	*132*	28.1	*63*	12.3	***195***	**40.5**
1988	*1,091*	79	*209*	38.3	*133*	13.6	***342***	**51.9**
1989	*1,359*	121.8	*306*	40.1	*212*	25.1	***518***	**65.2**
1990	*1,296*	109.9	*261*	47.6	*297*	50.1	***558***	**97.8**
1991	*788*	47.9	*142*	6.3	*211*	13.9	***353***	**20,2**
Total	*5,217*	437.3	*1,201*	185.6	*989*	123.5	*2,190*	**309.1**

Source Large, Smith, and Walter, Securities data Corporation. (Walter and Smith 1992, p.12)

- *European M&A:* Number of cross-border European M&A make up about 12% of total with volume of 12% of all total. Intra-European transactions exceed for all years cross border deals by wide margin. Despite the large volume of US transactions, European M&A activity both domestic and cross border (1985-91) has grown much faster.

Table 2.4c

Partial Ownership positions as % of the transaction volume of all completed US and European M&A transaction 1985-1991.

		European Seller		***Intra-European Deals***	
Year	**US seller**	**UK**	**Rest of Europe**	**UK**	**Rest of Europe**
1985	5.82	15.49	22.41	5.59	23.02
1986	14.59	9.77	43.23	6.26	36.82
1987	12.65	40.71	4.88	31.80	3.35
1988	9.58	27.27	35.70	13.59	28.54
1989	20.9	26.86	33.12	30.01	28.08
1990	10.00	25.58	4.22	4.91	9.69
1991	15.4	49.45	5.21	5.62	11.91
Avg	**12.71**	**27.88**	**21.56**	**13.97**	**20.20**

Source Large, Smith, and Walter, Securities data Corporation.
(Smith and Walter 1992, p.123)

Table 2.4d

Leveraged Buyouts as a % of all completed US and European M&A transactions, 1985-1991.

		European Seller		***Intra-European Deals***	
Year	US seller	UK	Rest of Europe	UK	Rest of Europe
1985	13.52	5.61	0.00	0.96	0.00
1986	6.43	2.37	1.03	3.69	0.00
1987	17.32	5.36	0.61	6.92	0.64
1988	25.81	6.76	3.62	9.66	3.21
1989	11.10	9.76	2.47	13.96	2.37
1990	6.63	1.32	0.15	2.66	1.67
1991	4.49	4.99	0.049	4.22	6.49
Avg	**13.61**	**5.17**	**1.13**	**6.01**	**2.05**

Securities Data Corporation, (OECD)
(Smith and Walter 1992, p.124)

Table 2.4e
Unsolicited Hostile Offers as % of all completed US and European Transactions 1985-91

				Intra-European Transactions			
		US cross border		***UK cross border***			
	US Domestic	US buyer	US seller	UK Domestic	UK buyer	UK seller	Rest of Europe
1985	9.98	0.00	16.16	71.80	0.00	0.00	4.88
1986	5.82	0.00	15.78	7.61	0.00	*20.78*	0.00
1987	3.51	2.12	9.85	*22.27*	0.00	0.00	0.00
1988	*21.61*	2.02	29.91	17.22	7.65	60.66	*4.31*
1990	0.00	0.00	0.00	14.72	0.00	0.00	0.26
1991	0.00	0.00	0.00	2.67	0.00	0.00	0.00
Avg.	**5.63**	**0.59**	**10.65**	**21.43**	**1.09**	**11.63**	**2.94**

Source Large, Smith, and Walter, Securities data Corporation.
(Smith and Walter 1992, p.127)

Acquisitions vs. Stakeholdings: The data indicate the clear preference of stockholding for European companies as opposed to LBOs. In addition continental banks are last in the list of hostile takeovers.

2.2.7. Towards global strategies

The mid 80ies merger activity was branded by many as opportunistic, predatory, involving "asset stripping" and "corporate raiding". The stock market crash of 1986 revealed the extent of speculative excesses. Many post-crash market firms focused on longer-term vision and core competence activities, in which the firm enjoyed intrinsic competitive advantage. Such strategies became particularly relevant as internationalization of the financial industry required the capacity to manage a global asset base. As the advances of network technology and the introduction of the single Euro currency in the 90ies speeded the integration of the world financial markets, global strategic placement in banking became central focus in management strategy.

3. Global strategic positioning

Following the above review of the main evolution in the banking industry, the paper proceeds to outline the current financial markets environment by considering three key current macro variables: the advances of technology, the introduction of the single European currency and the demographic trendsas they shape and will continue to shape the financial markets for the near future.

3.1. Key macro variables:

3.1.1. Information technology

To the extent that money is "information on the move" the financial service industry, is the most information intensive sector of the global economy. Today information quality, processing capacity, asymmetry form the key resource base for higher value-added products and services, and create a technological leverage which directly affects bank performance, both in terms of cost and profitability.

New opportunities:

- Expansion of product range: Information technology leads to products innovation and diversification, which expands the earning base and lends earnings stability. Products diversification of redefines both firm and market structure by expanding the frontiers of the financial firm's activity.

- Efect on profitability: Capacity of the telecommunications hardware can be used simultaneously to automate any number of services and creating operating economices of scale and scope. Automation capacity also decreases labor input for low value based services.

- Network technology allows the access to and expansion of customer base. Ability to process voluminous customer data is a major tool in marketing.

- Impact on firm and market structure: technology lowers the cost of market entry, however at the same time it shortens the profit time horizon of product innovation.

New Risks

- Market intelligence: Due to market volatility, information value decays at rapid rate, requiring swift changes in direction. The volume and complexity of information in financial service requires constant surveillance, introducing a new cost of market intelligence.

- Market risk: technology creates a new risk exposure, for although it allows firms to create new products, it cannot guarantee that they would sell.

- Costs: investment in IT infrastructure represents a lrge fixed cost for a banks. It has to consider equipment depreciation, security, customer identification, and fraud costs. Technological performance in several markets simultaneously puts high pressure on organization, system compatibility, and choice of investment levels.

- Capital base requirements: Technological investment raises the requirement for funds the bank needs and often confronts the smaller players with the choice to outsource, specialize or go under. The cost of a global system for funds transfer network ranges between $20 mill - $50 mill. A global credit card system requires $50 mill -$100 mill technological investment. An integrated global exchange money market technology cost is about $200. For a large network bank the development

of such fund transfer network capable to serve all customers in real time requires about $1 bill capital outlay, and also involves additional costs of disposing of or converting the existing infrastructure. For a European bank to establish presence in fundamental sectors merchant banking, money market, private banking requires an investment of about $0.5 -$1 bill. A strategic investment in Japan requires similar commitment. Few European banks are capable of investing on such large scale (de Carmoy, 1990, pp.23-27).

- Human constraint: Most importantly, the technology interacts directly with the human constraint, because it induces a fast paced environment, which often meets the resistance of work force and high management.

Implementation

IT transforms banking industry by four stages. This transformation takes place from back office to front office automation, bringing customers to online interaction to an integrated banking system. During the transformation process, people and papers are displaced by machines and software to some extends in every stage (Mark St. J. Carrington, Philip W. Langguth, and Thomas D. Steiner, pp. 6-11).

- *Stage I* back office automation converts paper to electronic book-keeping. Traditionally, the most labour-intensive work of retail banking was involvedthe the manual daily update of the current accounts. Since updating and balancing work usually did not take place during banking hours, consolidation of all the accounts information was limited and delayed. Back office automation technology solved this problem. It enabled the daily automatic update of customer and eliminated the data-input by hand and the manual mistakes.
- *Stage II* automates the front office through a computerized link with the core processing functions in Stage I. In this stage, it is possible to

transmit data between input or output terminals and mainframes effectively. That means that branch staff can access current accounts on-line, and the accounts of customers at other branches. To implement front office automation, banks need access to proprietary data networks, which links their data centers with thousands of terminals in their branches throughout all business geographic area. Front office automation improves service to customers by speeding up information transferring and increasing their controls over their own accounts. However, its economic and competitive effects are yet limited because it still requires looking up stale information in a ledger or computer printout, and staff to do it.

- *Stage III* brings customers on-line where they handle their business electronically. In this stage, customers have direct access to their accounts just by Automatic Teller Machine (ATM) at any time anywhere, instead of queuing up in the line during limited working hours. This stage can reduce bank staff or allow its transferred to value-added functions, such as sales and marketing. Bringing customers on-line system can only capture some of the volume but not all, because some people believe manual processing is more secured than machine, therefore, mostly well-educated, young and affluent customers prefer the electronic option.
- *Stage IV* integrates the preceding stages into an electronic business system linking fragmented software and hardware to provide a complete picture of customers´ relationship with the bank. It is believed that this integrated system will have great economic and competitive consequences.

Present banking has become a technologically driven business. Most products and services, from loans to credit cards, are marketed through computers and telephones, instead of the traditional branch distribution system. Derivative securities, securitization, processing and trading, are even

more technologically intensive functions. Infomration systems will play critical role in the long-term profitability in banking, by lowering operating costs and boosting the cross-selling of additional products and services.

Future investments in automatic delivery systems, will likely include automating branches, phone-based customer service, and home-based delivery. Naturally, customers will likley become more dependent on electronic-, computer- and telephone- based banking with in-person, paper-based interaction is expected droppping considerably. Technology provides a major merger motivation, since it offers the banks an opportunity toleverage its advanced products and technology over a much customer larger base.

3.1.2. Impact of the Euro currency:

The introduction of the Euro currency will have far-reaching consequences for the European financial markets. The elimination of currency risk, the reducing of transaction costs, convergence in interest and inflation rates, will create a relatively low risk, transparent financial environment which will attract large capital inflows into the Euro zone and will lead to the growth of European capital markets, particularly the bond and corporate credit markets.

The Bond, corporate Credit Markets

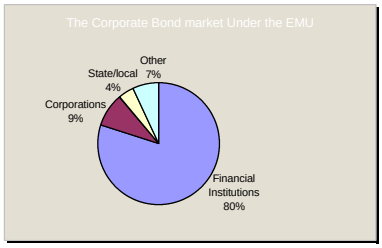
In the single currency environment, national bond markets will become close substitutes for an aggregate Euroland bond portfolio. Investors will not be able to adjust risk preferences by diversifying across countries and will seek higher returns by taking additional duration risk or increasing non-European exposure (Hurst and Wagenvoort, ed., Brookes, p. 20-22).

At the same times returns on bond portfolios are subject to limitations, due to EMU convergence criteria which include interest payment on government securities as part of the government deficit. Managers of asset-

liability systems seeking higher returns on fixed income funds are expected to respond by taking greater credit risk, which is likely to increase demand for corporate bonds. Corporate issuers currently account for less than 35% of the Eurobond market, while domestic European corporations constitute less than 20% of all Eurobond issuance. Banks, supranationals, financial institutions and sovereigns have provided the bulk of the pre-EMU volume (Hurst and Wagenvoort, ed. 1999, Walter, p.150). Corporate credit will reduce dependence on bank borrowing and banks will find themselves under increased pressure to preserve their corporate client base.

Commercial banks, insurance companies and savings institutions, which together hold about 85% of the total financial assets in the system, compared with 40% in the United States and have performed the bulk of financial intermediation within the Euro zone (Figure 3.1) (Hurst and Wagenvoort, ed., 1999, Brooks, p 23-4). The growth of the capital markets will is expected to reduce their influence dramatically.

Figure 3.1

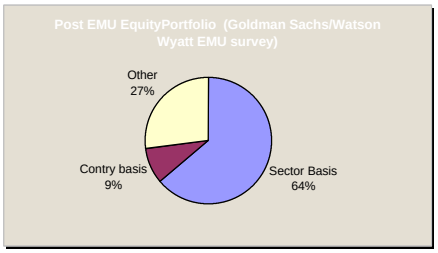


Source: Hurst and Wagenvoort, ed., 1999, p.24

The Pan-European equity market

In this new equity bases financial culture the broadened investor base which will diversify across sector rather than country base and will compare against Pan-European benchmarks (Figure 3.2) (Hurst and Wagenvoort, ed., 1999, Brookes, p. 27). Several pan-European equity indices have already gained wide acceptance. Pre-EMU national and regional players which had felt pretty comfortable as number 3 or 4 will find themselves number 46 or 50 in the post EMU. This will put intense competitive pressure. Global presence will take precedence over regional depthas financial houses compete for the transactions of Europe's largest companies undermining the value of domestic relationships (Keegan, 1999, p.2; Hurst and Wagenvoort, ed.1999, Walter, p. 149).

Figure 3.2



Will your post EMU portfolio be organized on a country or a sector basis?
Source Hurst and Wagenvoort, ed.1999, Brookes, p. 149

Electronic trading and the consolidation of the German and London stock markets will make it less costly for investors and institutions to restructure portfolios and diversify across the Euroland At the same time, restructuring the portfolio on a pan European basis will increase credit,

liquidity and maturity risk. For many banks this would mean higher capital adequacy requirements. On the other hand, this would present them with an opportunity, since pan European investing will increase the demand for inquiries and information and advisory services (Keegan, 1999, p.3)..

Capital markets will further speed the disintermediation of the bank's balance sheets and put the financial focus on asset management systems. From intermediaries, banks will become market players, deriving increasing proportion of their income from fees as security managers, underwriters, creators and distributors of financial products to a pan European customer base.

3.1.3. Demographic trends

Complying with the convergence criteria on deficit spending, European governments are expected to cut back on welfare programs and pension systems (Billoud 1998). The ageing European population and its increased reliance on personal savings plans, pre-funded pension plans and mutual funds will generate new savings flow. This aging group will be primary retail target for banks and insurance companies. The globalization in the retail market However, will be gradual, due to historical cultural differences, which make it impossible to market retail products to a "European consumer". At the same time the increased flow of personal savings will create large performance-driven managed pools of fixed income securities and an opportunity to marketing, mass distribution, and branding of pension products. Financial institutions with strong historical and local presence will look to expand in the retail segment which will also become contested market for mutual funds and insurance companies.

3.2. Determinants of performance

Given the competitive nature of the new financial environment, what will be the main determinants of financial performance in banking? The recent surge in mergers and acquisitions indicates that bank restructuring aims firstly to reduce costs. Of the main perceived benefits of the single currency is the realization for the first time of significant scale and scope economies. Given the complexity of current decision-making the question arises which technical tools that banks can use in efficiency analysis? At the same time bank restructuring strategy focuses increasingly on the incorporation of value adding service, such as asset management, brokerage, and risk management. The view of the bank as a financial production process, rather than as an institution is more relevant today, given the disintermediation of the balance sheet and the increased orientation of banks towards fee based products and services. The next sections considers the relevance of the economies of scale and scope analysis in bank restructuring from the perspective efficiency and fits them in the general analysis of long term performance determinants.

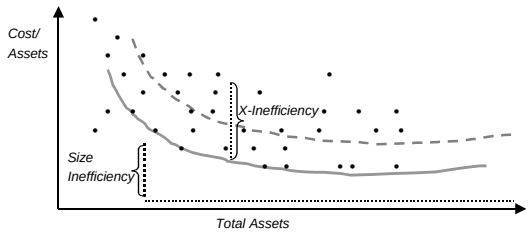
3.2.1. Economies of scale

By themselves, or in combination, economies of scale and scope spread overhead costs and decrease costs per-asset unit. This leads to increased efficiency, higher profit margins, implying lower prices for consumers and corresponding increase in market share. Economies of scale an scope have provided the impetus for many mergers and are a central strategic issue in banking particularly since financial services is one of the highest fixed-cost sectors. Many studies have attempted to provide empirical evidence for operating economies in mergers. The general economic opinion seems to be that greatest scale economies are observed with the increase of size of small banks. The evidence is less conclusive in regard to middle sized banks (assumed $100 million - $5 billion range). The slimmest evidence surrounds the size economies of large banks. Walter (1999) refers to several studies which seem to indicate that scope economies do in fact peter out as

institutions increase in size, and this is valid for both European, US large commercial banks and insurance companies.

In order to illuminate this issue somewhat, this section briefly reviews a recent study Wagenvoort and Shure (1999), which presents a classical example of scale efficiency analysis by using the cost frontier approach. The study considers three main efficiency criteria: scale (the right amount of output), scope (the right combination of outputs)and the so called X-efficiency which is the managerial ability to control costs. (Efficiency is defined as cost per unit of input) The study aims essentially to identify the source which contributes most to inefficiencies in European banking as compared to "the cost frontier", represented by a "best practice" sample. The best practice uses the lowes possible amount of input per given unit of output. (Figure 3.3).

Figure 3.3



The study considers only scale and X-efficiency and attempts to answer the question: would banks improve on most to their efficiency by adjusting for size, or by improvng their managerial skill in cost control? The position of the 2000 European banks relatie to the frontier reveals the relative significance of

scale and X-inefficiency: small deviations from the frontier indicate some scale inefficiency, while larger deviations from the frontier are too much reflect the need for mere adjustments in size. According to the study, such large deviations indicate a deeper organizational-cultural problem, termed X-efficiency, which management can only remedy by changing "the way the firm is run".

The study concludes that there exist large inefficiencies in the European banking sector, in which with only 16% percent, or 321 banks, are located on the frontier for the sample period. Managerially efficient bank incurred range from 10% higher to 14% lower cost than the predicted optimal costs (95% confidence interval). A relative small "thickness" of the frontier and the set of largely dispersed inefficient bank around it correspond to an average X-inefficiency of 77% (with confidence interval between 57% and 97%). The overlapping part of these two confidence intervals corresponds to a set of banks in the gray zone with banks of optimal performance, but not fully cost efficient.

Table 3.1 presents the main conclusion of the study: its essential argument is that banks achieve the greatest scale benefits when they grow from small to medium size. The study concludes that scale efficiency does influence performance of the banking sector as a whole. However, size economies generally exhaust themselves when a bank reaches a balance sheet of EUR 60o, and large banks banks can achieve the greatest cost reductions by improving on their managerial X-efficiency.

An important concluding note in regard to the study is that large banks may *seem* to benefit from economies of scale due to the so called *financial* scale economies: since larger firms have better risk diversification options, they have lower cost of funding relative to the small firms and this would distort up in the measures of scale economies.

Table 3.1

Factor	Full sample	Commercial Banks	Savings Banks	
Number of banks	1974	773	1025	
	X-inefficiency	X-inefficiency	Inefficiency X	Size
1997	16%	13%	9%	5.6%
1996	20%	18%	6%	5.7%
1995	19%	14%	7%	5.4%
1994	19%	14%	7%	5.4%
1993	20%	13%	7%	5.3%
Technology-driven cost improvement 1993-1997	Not Significant	Not significant	9%	

3.2.2. Economies of scope

The evidence regarding economies of scope in banking seems to be also inconclusive. On the supply side banks usually expect scope economies to achieve reduction of the overhead cost by joint production of generically similar services. On the revenue side, scope economies from cross-selling arise when the total cost of a buyer of multiple financial services from a single supplier (including cost of contracting, service, monitoring, and informition)is less than purchasing them from separate suppliers.

However, as banks diversify, scope *dis*-economies may arise from bureaucratization and profit sharing conflicts that increase cost over the long run and degrade the relationship with customery by decreasing banks ability to meet client needs. They can be particularly sever if cultural differences within the firm inhibit the ability to deliver a broad range of products in different markets.. Diversification can involve significant front-end costs, staff and

infrastructure (Walter 1999). In general economies of scope do contribute to larger throughput volume, and broader client coverage. At the same time they are tend to be demand demand-driven, related to the strategic positioning across market segments and also tend to be specific to the types of service providedand the types of customers served.

3.2.3. X- Efficiency

The above analysis makes the point that the "the way banks are run" is more important than their size and their range of business. Financial firms of similar size, similar product range can still have very different cost levels and productivity-efficiency measures due to many internal factors, including, among others .production function efficiency, effective use of labor capital, sourcing and technological leverage, organizational design and culture, incentive payments: all those factors that form the managerial identity of the firm, and determine its X-efficiency.

An interesting observation regarding X-efficiency is that it seems to favor large size firms. This issue is raised by both Walter (1999) and Molyneux (1999) in the context of the relationship between market concentration and firm performance. The traditional supposition in regard to highly concentrated markets is that the higher margins of large firms in concentrated markets are due to monopoly power and non-competitive pricing. Molyneux argues that the actual evidence for this supposition, although positive, is weak, which may reflect the fact that large firms in general are more X-efficient, or better run (Hurst and Wagenvoort, ed., 1999, Molyneux p.129). On the basis of this assumption, size, market share and X-efficiency would seem to be the main determinants of X-efficient performance.

3.2.4. Corporate Culture

X-efficiency relates closely to organizational design and corporate culture. Those are often impossible to define and measure in a meaningful way, but they influence bank performance as much as, if not more than the tangible financial variables. One reason for that is that banks are capital intensive industries, whose major investment is in human resources. The human constraint poses the greatest management challenge.

Culture can exert enormous influence on the firm since they are embedded in the decision making process. In some cases culture influence can be stronger than strategy, organizational structure, management systems, financial analysis and tools. One theoretical approach to the relationship between corporate culture and performance is developed in a study by Kotter and Heskett: (1992). His study argues against the contention that strong cultures result in superior firm performance. The authors argue that strong cultures can become inwardly focused, politicized, bureaucratic and arrogant which can make strategic change difficult to implement.

One interesting feature of this work is that it distinguishes between culture *content* and culture *strength*. Culture content is the fit between culture and environment. And strength is the power of assertion. It has been often argued that "weak cultures", usually result from poorly assimilated acquisitions in which case the firm exerted market power. However acquireing firm often preserves the autonomy of the acquired firm, preserving cultural diversity, which does not necessarily imply weakness. Kotter and Hesket argue that culture fit is more important that culture strength because it allows lighter structures with faster information flow. A basic conclusion of this studyis that consistent superior performance is usually associated with adaptive cultures. Those encourage risk taking, trust, common effort and enthusiasm, as well as strong spirit of commitment associate with. The non-adaptive culture is usually bureaucratic, with slow information flow, emphasis

on control. As a natural conclusion from the second definition is that overly adaptive cultures can be in fact very non-adaptive, when, for example they encourages people to change everything, or the wrong things. To "'work" on consistent basis, culture needs to allow for flexibility and should serve to provide general direction.

Reviewing of the current features of the financial environment and the determinants of market performance indicates the great complexity of the and the need for a long term vision in the decision making process. The Client-Arena-Product model of the industry presented in the next section puts financial decision making in a comprehensive perspective with focus on firm's sources of competitive advantage and strategic market positioning.

3.3. C-A-P model of competitive positioning

3.3.1. Description

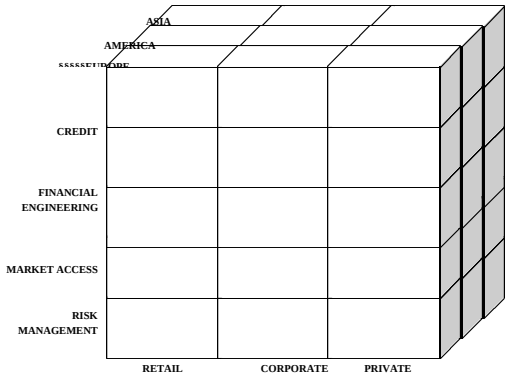
The model proposed here puts the global market for financial services in three-dimensional matrix consisting of the product, arena and client. The model focuses on the bank not as an institution, but as a financial process (manufacturer of financial products?), which chooses between the extensive ranges in each of these three variables. Each product-arena-client combination corresponds to a market segment (cell) with different strategic and competitive profiles, based on economic and public policy considerations.

Each player can evaluate for himself the strategic benefit of positioning in each cell depending on the size ***S*** and durability, ***D*** (adjusted for risk) of the prospective returns (***PR***). The highest likelihood values for size and durability of prospective returns describe the competitive positioning of a player in each cell expressed as the value of the cell potentially available to him.

In absolute terms, the total "embedded value" of each cell depends on the level of demand for each financial service, its price, cost, and the price elasticity (product substitutability).

Figure 3.4

THE GLOBAL PRODUCT-AREA-CLIENT MATRIX



The main variables describing each cell's profile include:

Determinants of size and durability:

Access: Access is subject mainly of technological and regulatory constraints. This variable relates to each of the three dimensions. In terms of geographic arena it is positively related to deregulations and removal of barriers for

foreign investment. In terms of access to clients, it is positively related to a firm's placement capability and distribution network. In terms of product substitutability, it is positively related to technological constraints Technological constraints determine the cost of entry which allow both firms from the same sector as well as outside players to enter the cell. It is important to remember that cell value is potentially accessible to all players and a firm assesses the aforementioned variables as relative to others.

Access is of course inversely related to the natural barriers to entry: requirement for capital adequacy, human resources, and economies of scale. Entry barriers also include contracting costs, which are inversely related to a close long-term relationship between the financial firm and its clients. Natural barriers to entry also to the extent firms perceive their markets as contestable, which induces them to act as if competing with the new entrants. In this case a cell may be characterized by profit margins, product quality and intense competition even if the concentration ratio is in fact relatively high.

Funding Leverage:(Market Power of suppliers) In relationship to the client dimension, this variable is essentially related to the financial firm's cost of funds. Suppliers of funds for the production of financial services including depositors, bondholders and purchasers of securities issued by a financial institution, can absorb part of the cell's rents by demanding returns commensurate with their perceived risk exposure. To the extent that bondholders perceive a financial institution to be less credit worthy relative to others, they would demand higher returns on their funds. This clearly erodes the market power of a financial institution because it increases the cost of liabilities, particularly in segments of high competition for funds of sophisticated customers and removal of regulations on interest rates payable on various types of deposit accounts. In view of the increased demand for skilled software competent labor in this sector, labor suppliers can also capture part of the available rent. In relation to the product dimension, funding

leverage differs according to the type of debt or security. In relation to the arena dimension *FL* differs with the environment in which financial intermediaries operate, regulatory constraints on consolidation etc. Other things being equal, an environment with higher developed capital markets would reduce the reliance on bank lending, increasing the cost of funds relative to environments with less developed capital markets where industries traditionally rely on banks for their funds.

(Market Power of clients)

This client category includes mainly reputable multinational corporations and high net worth clients for whose transactions firms compete intensely. The market power of this client group differs across the C-A-P dimensions, from one product to another, from one client groups to another and relative to areas, but in certain they can exert more monopsony power than client groups with lower credit ratings for whom competition is less intense.

Degree of available product substitutability:

The higher the degree of substitution among products in the market, the higher is the demand elasticity. In this sense the degree of substitution determines the price volume vector (?) available to the financial firm and consequently, the level of returns. Degree of substitution is mainly determined by the technological constraint.

Intensity of Competition

Competitive structure is usually measured in concentration ratios using the number of firms, distribution of market share etc. Competitive structure is the principal determinant of prospective excess returns. If competition takes place in terms of pricing, then customers become the main beneficiaries and absorb a significant part of the rent in each cell. The lower the concentration ratio, the more intense is the competition and faster is the erosion of profit

margins as each financial innovation is copied by competitors. Other things being equal, it is assumed that successful cell penetration by a player from a different strategic group leads to a more intense competition than the incremental presence of a player in the same strategic group. We assume this is the case because of diversification benefits to earnings, staying power and cross subsidy (e.g. when profits of a firm from one cell are used to "buy in" the market in another by merger or acquisition agreement).

Benefits from cell Linkages

In financial services adding to the client base within the same product segment involves economies of scope. In respect to the product it involves economies of scale by adding to the product base within the same client segment. Arena-driven linkage takes place when an institution can benefit from competence in one are to supply products in another area. The effect on of arena diversification on prospective returns is to decreases the overall risk level lowering the risk adjusted discount rate.

As mentioned, the purpose of this model is to identify market cells with maximum potential size and durability of prospective returns (adjusted for risks). In absolute terms, the Prospective Returns are a function of the demand level for a particular financial service, its price and cost and the price elasticity of demand. Actual Returns depends competitive positioning, or how efficiently the firm matches its sources to exploit market opportunities. Durability of actual returns depends on degree of access for competitors and on product substitution.

3.3.2. Application

We assume that a firm faces a given C-P-A configuration and institutional capability, subject to the constraints discussed. The firm may have accessed a cell or set of cells, but some may still be accessible for further development. Players:

1. Identify the sources of their specific competitive advantage (Table 3.2)
2. Identify the cells where they can apply their resources most efficiently
3. Using the competitive structure framework, identify cell links with potential to add value

In effect that management faces an enormous opportunity set, while being familiar with only of small part. Due to the complexity of information it seems natural that management cannot possibly apply a comprehensive decision-making analysis, even given the present capability of support and expert systems. Thus in many cases it follows an ad hoc decision approach identifying options under best available information and assessing results and trying again. However the matrix does provide a general direction for expansion path, which may involve deeper penetration in a cell of entering new cells.

Here a general taxonomy of strategies yields 27 options along 3 Product levels: niche, diversified, supermarket, 3 Arena levels : national, international, global and 3 Customer levels: focuses, segmented, non segmented

Table 3.2

	Competitive Resources								
Financial Services	Type	Capital Adequacy	Human Capital	Information Access	Placing Power	Techno logy	Innovative Capability	Franchise	Res Int.
Funding	C	1					3	1	5
Lending	C	3	3	2					7
Financing	C FE	3	3	2					7
Credit Activities	C	1	2	2		2	2		9
Trading	RM MA	3	3	3		2			11
Brokerige	MA	2	2	3	2		1		10
Advisory services	FE RM		3	3		1	2	3	12

Asset Mngmt.	FE RM		3	3		1	3	1	11
Underwriting	RM MA	3	2	2		2	3	3	15
Distribution	MA			1	3				4
Payment mechan	MA			3		3			6
Insurance servs.	C RM	3	2	2					7
Int. Trade servs.	RM MA		2	2		2	1		7

Legend: C: credit
FE: financial engineering
RM: risk management } products
MA: market access

1. Principle
2. Important
3. Contributing

4. Case Study: SEB and Codan Group

4.1. SEB-Codan Merger Package

Key Agreement Figures:

Table 4.1

1DKK=1.18 SEK

Agreement Items	SEK Mill
Sale of Trygg-Hansa Försäkring AB Includes: Non-Life Company, excluding Run- Off Division.	4,300
Licensing of Trygg-Hansa Trademark	
Tax free dividend May 1999	2,700
Equity divested	2,700
Goodwill, net reduction	500
Capital Gain	500

Acquisition of Codan Bank	885
Acquisition of 49% of Codan Link	30
Acquisition of 15.8% in Amagerbanken	94
Asset management Agreements:	70,000
1) SEB will manage the accounts of Codan Forsikring in Denmark, Codan Bank and its Swedish subsidiary, Holmia in Sweden, plus custody accounts	
2) SEB will continue to manage Trygg-Hansa's portfolio in Sweden	12,000

Market Shares, Non-Life 1998

	Sweden	Denmark
Codan Group	2%	13%
Trygg Hansa	14%	0%

4.1.1. SEB Profile:

- Total Assets 610 billion SEK. 20% foreign funds
- Strong position in the Swedish Corporate Market and the Nordic Area

- Priority markets: Savings and Corporate markets;
- Priority Business Areas: Asset Management,

Aspirations:

Short term becoming the leading asset manager in the Nordic

Long term: network into EU area and the Baltic region

Becoming a portal for Internet customers: 300,000 Internet customers, 20,000 of them corporate clients. 35% private customer payments, 15 mutual fund transactions 20 of equity transactions.

Table 4.2

SEB Some Key Figures

	Jan-Sept 1999	**Jan-Sept 1998**	**Full 1998**
Return on Equity % 1)	13.3	12.7	14.8
Return, incl. Change in surplus value, %	14.5	13.4	16.1
ROE , 12 month moving average, %	15.2	4.8	14.9
Earnings per share, total period SEK	5.26	4.70	7.35
Income per share, after tax, SEK	6.05	5.18	8.27
Income/ cost ratio before loan losses	1.33	1.40	1.35
Income/cost ratio after loan losses	1.36	1.15	1.15
Loan loss level, % 2)	-0.09	0.79	0.65
Provision ratio for doubtful claims, %	56.6	48.4	52.0
Level of doubtful claims, %	0.89	1.14	1.08
Total capital ratio, %	11.84	8.97	10.85
Core Capital ratio, %	9.02	6.97	8.12

1) Ratio for the period calculated as a % of average equity
2) Lending losses as a % of opening lending balance, excluding banks, credit guarantees and assets taken over

Trygg Hansa: 1,300 Employees, 14% Market Share in Sweden, 800,00 clients
Subsiduaries: Aktsam

1999 Position:

Table. 4.3

Products	Area	Customer
Retail distribution	Sweden	
SEB Securities Services	Nordic	
Asset management	Nordic, Baltic	
Merchant Banking	Global	
Enskilda Securities	Nordic	
SEB Trygg Liv (life insurance)	Sweden	

SEB Trygg Hansa (non life)	Sweden Denmark	
SEB Kort	Nordic	
SEB Finans	Nordic	
Corporate bond	EMU	Corporate
Cash pooling contracts	EMU Nordic	MNC: Volvo Alfa Laval etc.
Securities	Stockholm stock exchange	

Assets involved:

- Total funds 1999 608 billion SEK, of them 5 billion SEK from Codan Bank, 64 billion SEK account of Codan Group.
- Portfolio management 220 billion SEK,
- Life Insurance 165 billion SEK, Mutual funds 110 billion SEK, unit linked insurance 44 billion SEK
- 10.2 of the Stockholm stock exchange

Major Events 1999:

- Sale of Trygg-Hansa Sak portfolio completed
- Reduction of exposure to emerging markets
- Euro cash pool contracts (Volvo and Alfa Laval)

Codan Bank Position

135 Employees, 17,000 Clients

Table 4.4

Profile	**Key Figures 1998** (DKK M)	
Main business lines	Total assets	7.110
Asset management	Customer loans	874
Securities trading	Customer deposits	2.732
Private banking	Equity	751
Services (retail and	Net interest income	108
Institutional clients)	Total income	167
Mutual funds	Net profit (pre-tax)	66
	ROE	7%

The Danish market

Openness: The Danish banking market is one of the more open and competitive in European community. It was opened up to foreign bank ten years ago, and all foreign exchange controls were removed in 1988. Commercial banks and saving banks are allowed to offer the same, universal banking service to both personal and corporate customers. etc, and serve a domestic population of 5.2 million people. Previously Besides the usual run of loans and deposits, the banks buy and sell securities, provide custodian services, issue guarantees, carry out currency transactions, including the repatriation of foreign loans for the corporate sector, and arrange the issue of bond loans and equities.

Structure: Most of banks in Denmark are small, town ones, but in recent years, this sector has undergone far-reaching changes. The two largest mergers resulted in two biggest banks, Den Danske Bank and Unibank. Moreover, because the competition within the Dannish banking sector is

getting stiff and the banks have developed sophisticated products to satisfy the needs of both private and corporate customers, some banks have entered into alliances or are planning mergers with mortgage credit associations and insurance companies. The primary purpose of the mergers has been to diminish costs. A secondary purpose is to prepare for the increased competition that will come with the internal market from 1993.

M&A activity: The small local and regional banks tend to cater to the retail banking market, while larger banks specialize in merchant banking and corporate finance. The banks in Denmark are experiencing increasing competition either from outside and from inside. For example, from inside, insurance companies are diversifying into traditional bank areas, such as consumer lending and project finance; from outside, with the foreign exchanges controls removed, it removed the obstacles for foreign banks to enter into Danish banking market.

Another area the larger banks are expanding into is mortgage credit. Before 1989, there were only three credit institutions who had a monopoly over this area, but now banks are allowed to issue mortgage bonds for borrowers as well. The bonds are issued based on the value of the property, rather than on the borrower's creditworthiness. The stock exchange has also been reformed to allow banks to participate in it. Since the banks have long handled most of their deals themselves off the exchange, the trading monopoly previously enjoyed by stockbrokers was abolished. This meant that the banks could return to the exchange and avoid extra brokerage fee. Thus, now both banks and insurance companies set up their own limited liability brokerage companies and trade on the Exchange. In securities market, modernization has taken place. Securities used to be traded under an auction system, after computerization, futures, bonds, equities and options can be traded, cleared and settled on the same on-line system.

In spite of the openness of its markets and the sophistication of its stock exchange trading, Denmark has several drawbacks, which prevent it becoming an international financial center. Because of its high rates of corporation tax (50%, compared to 35% in UK), high labor and other costs, tough capital requirements (a ratio of 8% on liabilities, rather than on the more normal risk-weighted assets), and a lack of large companies, foreign banks find it difficult to afford a successful and profitable operation in Denmark. In addition, most foreign banks are not allowed to set up brokerage companies, only those from the other Nordic countries can do so.

Taxation: Taxation in Denmark subjects to the old National Tax Law of 1922; however, company tax is levied under the law for the Taxation of company 1960. Individuals resident in Denmark are taxed on their worldwide income at a basic progressive rates up to a maximum of 40 percent. Resident corporations are taxed on their worldwide income as well of about 40 percent. In addition, foreign source income is taxable at the full rates, but if a resident company has income from a permanent establishment or from certain other activities abroad the corporation, tax is reduced by half the tax attributable to the income. (Financial Times-business information)

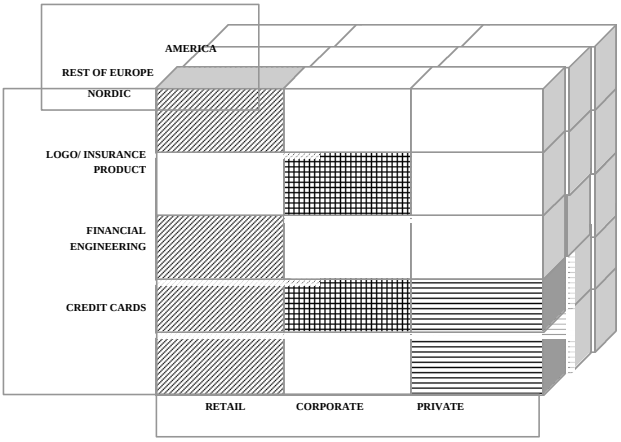
4.1.2. Merge reasons For SEB

- Exchange of equity participation (Trygg-Hansa) allow to create a loose structures that can generate a European network at lower cost.
- The size of the bank firm allows it to make long-term investment, whose returns in some cases take over decade. In such situations banks need access to long-term funds. Nature of its financial flows affords the insurance company funds for long term uses. A banking group with ability to advise and to support and insurance firms in its development and diversification of assets would generate value

- Level of expertise in trading and arbitrage for SEB is much higher than that of Codan. Banks in general employ higher quality traders and have better management support systems than most insurance companies. Banks sell insurance funds to individuals while insurance companies offer savings and pension products. Both are ware that in the medium and short run the individual customers form the most profitable business segment. Banks have sought to increase market penetration to spread their fixed cost, distribution network.

Figure 4.1

SEB Matrix



4.2. Management Perspective:

Agreement package key word: Infrastructure for expanding (SEB presentation 1999)
The management presented the agreement package of the merger as strategically oriented

4.2.1. Codan Bank and SEB on the Danish market:

- Allows SEB to focus on its core lines of business
- Codan can run and develop the non-life business on a larger scale
- Asset management Agreement with Codan group
- Custody Services
- Acquisition of Codan bank
- Similar business concepts
- Acess to Codan's Customer base resulting in: 1) Utilizing Codan's experience in non-life insurance, 2)gain of market share for SEB Tryg-Liv (life insurance)in Denmark

- Combination Products
- Joint Distribution networks
- Market for Internet banking

In regard to the Tryg-Hansa deal:

- Allows SEB to use Trygg-Hansa Logo
- Utilizing its distribution network for non-life insurance products without the
- Management of Tryg Hanss Portfolio in Sweden

- Distribution agreements with Trygg-Hansa/Codan in Denmark and Sweden
- Acquisition of 49% of Codan Link
- Block of Shares Amagerbanken (est. 1903)
- Gaining presence in local Greater Copenhagen market
- Access to Amagerbanken's private and particularly corporate client base
- Expanding the asset management business line

5. Conclusion

The purpose of this paper was to articulate a decision framework for restructuring financial firms in as they seek to expand into new markets in the new pos EMU environment. We showed that the traditional approaches of financial ratios, and synergies from economies of scale and scope do not always offer the best framework because they rarely take into account the complexity of decision making. Thus we adopted a more comprehensive framework which focused on strategic competitive variables and put decision making for financial services into three dimensional space, namely a product, arena, customer matrix. The model offered is a generic approach focusing on the firm activities as strategic positioning. In this the model fits the long terms perspective in bank restructuring and is offered as a management tool. The model was then applied to a case study where it served to illustrate that in cases of comprehensive agreements, involving the transfer of substantial equity positions, nature of management thinking is long term strategically oriented.

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7. Appendices

7.1. Mortgage Securitization

One example of highly securitized market is the mortgage market. Today most mortgages are securitized, meaning that loan origination and financing are decoupled as separate financial concepts, and the principle and the interest payment are decoupled as separate financial instruments. A holder of a mortgage loan need no hold this asset to maturity, and need not have the resources to do so. The originator of the mortage can sell it to other purchasers of security, which view the mortgage as a fixed income investment.

Mortgages have been traditionally “secured” by real estate, although some are secured by airplanes, trains, or other financial assets. This means that the originator of the mortgage can claim the real asset if the borrower fails to make payments in accordance with the loan provisions. Mortgage value can fluctuate: the appreciation of the underlying real assets (e.g. mansions in prestigious neighborhoods) increases value of the mortgage and depreciation in the value of the real asset has a converse effect. Mortgages are bought and sold. For example, financial institutions with deposits exceeding their loan demand would purchase mortgages from retail mortgage lenders redirecting the stream of cash flows. Conversely, issuers of mortgages in need of liquid funds may pool them in a package of several hundreds and sell them to potential investors who receive a prorate share of this mortgage cash pool. The re-channeled cash flows are passed through to the investors on a monthly or quarterly basis. Such cash flows emanating from a pool of mortgages can be further structured as “mortgage backed securities” with various duration and risk profile. The main attraction of this new instrument is the separation of principle and payment, which creates a new financial product by constructing various cash flow patterns to suit individual preference.

Like any fixed income cash flows, such securities are interest rate sensitive and affect the interest rate risk exposure of investors. Today many banks own mortgage institutions and there exists an active secondary market for mortgages. Securitization means also that banks can sell some of their loans as securities and become active players in the capital markets. The option to securitize debt and has allowed banks to preserve relationship with the "less credit worthy" borrowers while limiting credit risk by shedding loans away from the balance sheet and avoiding the tying of capital to cushion potential loan losses. (Santomero: 1997, pp. 295-323).

7.2. Classification of bank products for the typical European Universal Bank

Service/ Product	Product Classification			
	Credit Products	Financial Engineering	Risk Management	Market Access
Deposit taking	L			
Trading and dealing				X
Merchant Banking				
Enskilda Securities				
Money Market				X
Securities				X
Foreign Exchange				X
Swaps, Futures, Options				X
Sale of bank securities	L			
Lending	X			
Sovereign	X	X		
Corporate	X	X		
Correspondent	X	X		
Dom.banks	X	X		
Foreign banks	X	X		
Private high net worth	X	X		
Retail	X	X		
Specialized financing activities				

SEB Finans	**X**	**X**		
SEB Security Services	**X**	**X**		
SEB Foretags Invest	**X**	**X**		
Real estate	**X**	**X**		
M&A	**X**	**X**		
Securities underwriting			**X**	**X**
Sovereign debt			**X**	**X**
State debt, agency bonds			**X**	**X**
Mortgage backed securities			**X**	**X**
Insurance			**X**	**X**
Equities				
Securities distribution				
Domestic				**X**
Foreign				**X**
Advisory Services				
Corp. Cash management	**X**	**X**	**X**	**X**
Corp. financial services	**X**	**X**	**X**	**X**
M&A, domestic & foreign	**X**	**X**		
Risk Management Services	**X**	**X**		
International trade adv. Serv.	**X**	**X**	**X**	**X**
Consumer Services				
SEB Kort	**X**			**X**
Asset Management Services				
SEB Enskilda		**X**	**X**	
Private banking				
Fiduciary services		**X**	**X**	
Safekeeping		**X**	**X**	
ABB Inv. Mngm.		**X**	**X**	
Corp. and correspondent		**X**	**X**	
Pension fund management		**X**	**X**	
Mutual fund management		**X**	**X**	
Codan Bank				
Codan Group				
Insurance				
Portfolio Mnmg				
Brokerage				**X**
Money Market				**X**
Euro and forex				**X**
Gov. and corporate				**X**
Equities				**X**
Futures, options etc.				**X**
Other				**X**

Payment mechanism			**X**
Dom. funds transfer			**X**
Int. funds transfer			**X**
Insurance services			
Life: SEB Tryg Liv		**X**	
Non life: SEB Trygg-Hansa		**X**	
International trade services		**X**	**X**
Market intelligence			**X**

Source Walter (1988, p.23-26)

7.3. Balance Sheet SEB Group (abbreviated)

SEK Mill

	30 September 1999	**30 September 1998**	**31 December 1998**
Loans to credit institutions	81,109	118,518	91,137
Loans to general Public	340,147	352,474	324,442
Interest bearing securities	88,223	122,428	131,182
Financial fixed Assets	3,916	14,979	14,564
Financial current Assets	80,153	91,035	95,779
Investment Assets	4,154	16,414	20,839
Shares and Participations	52,462	40,099	47,334
Investment Assets	1,835	6,291	6,421
For account of policy holders	44,686	31,541	37,454
Other shares & participations	5,941	2,267	3,459
Other assets	99,461	127,533	95,562
Total Assets	**661,402**	**761,052**	**689,657**
Liabil. to credit institutions	111,788	188,378	153824
Deposits and Funding from the general public	202,893	197,715	187,901
Securities Issued, etc.	124,835	141,017	133,052
Technical Provisions	2,854	12,836	12,433
Provisions for account of policy holders	45,934	31,950	37,378

Other liabilities & Provisions	116,601	137,311	110,625
Subordinated Liabilities	25,025	23,209	24,010
Shareholders equity	31,472	29,006	30,434
Tot Liability & Shareholders Equity	**661,402**	**761, 052**	**689,657**