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A study of the motives for restructuring commercial banks

The aim of the article is to analyse the main motives for restructuring commercial banks. It investigates the M&A transactions in the Ukrainian banking sector and changes in its trends and assesses the level of banking market concentration and its dynamics in 2010–2016 by calculating the Herfindahl-Hirschman Index based on the volume of bank assets. The main theories that explain the reasons for restructuring commercial banks with the intention of their integration are discussed. The effectiveness of bank mergers is evaluated with the example of PJSC 'Ukrsotsbank' and PJSC 'UniCreditbank'. The financial restructuring mechanism is presented schematically as a sequential plan of action of a commercial bank. The author concludes that success of M&A transactions usually results from a synergy effect, and lack thereof – from irrational actions of management (agency theory of free cash flow) or overestimating the value of the target company (hubris theory). The research methods used in the paper include economic analysis and a critical review of the literature.

Keywords: restructuring, commercial banks, M&A, concentration, Herfindahl-Hirschman Index

JEL classification: G21, G32, G34

Badanie przyczyn restrukturyzacji banków komercyjnych

Celem artykułu jest zbadanie głównych motywów restrukturyzacji banków komercyjnych. Przeanalizowano w nim transakcje M&A w ukraińskim sektorze bankowym i zmiany w obecnych tam trendach oraz oceniono poziom koncentracji na rynku bankowym i jego dynamikę w latach 2010–2016 poprzez obliczenie wskaźnika Herfindahla-Hirschmana w oparciu o wielkość aktywów banków. Omówiono podstawowe teorie wyjaśniające przyczyny restrukturyzacji banków komercyjnych celem ich integracji. Skuteczność bankowego połączenia oceniono na przykładzie SP „Ukrsotsbank" i SP „Unikreditbank". Finansowy mechanizm restrukturyzacji przedstawiono schematycznie w postaci planu działania banku komercyjnego. Wyciągnięto wniosek, że sukces transakcji M&A wynika z efektu synergii, jego brak zaś z irracjonalnej działalności zarządzania (teoria wolnego przepływu pieniężnego) lub przeceniania przedsiębiorstwa celu (teoria pychy). W artykule dokonano analizy ekonomicznej i krytycznego przeglądu literatury.

Słowa kluczowe: restrukturyzacja, banki komercyjne, M&A, koncentracja, wskaźnik Herfindahla-Hirschmana

Klasyfikacja JEL: G21, G32, G34

Introduction

Under conditions of financial globalisation and increasing minimum regulatory capital requirements for commercial banks, unifying forms of restructuring become of strategic significance for their development and competitiveness. The conducted research have led scientists to believe that the observed trend towards multinational business concentration is a natural phenomenon, which is why national and international policy makers should make an attempt to answer the question of how to make the most of the advantages of the concentration and restructuring processes and mitigate their disadvantages [Ostrolutskyj, 2012].

The aim of the article is to study the main motives for restructuring commercial banks. This was achieved by investigating the M&A transactions in the Ukrainian banking sector, assessing the level of banking market concentration and its dynamics, discussing the theories that explain commercial banks' motives for conducting M&A transactions, and evaluating the effectiveness of restructuring commercial banks with the example of PJSC 'Ukrsotsbank' and PJSC 'UniCreditbank'.

1. Concentration of the Ukrainian banking market

According to the Ukrainian law 'On Banks and Banking', unifying forms of restructuring commercial banks include mergers and acquisitions [Verkhovna Rada Ukrainy, 2001]. International practice uses the abbreviation 'M&A' for transactions in which the control over one business is transferred to the management of another company.

Recent years brought changes in the M&A trends in the Ukrainian banking sector: in 1999–2004, financial-industrial groups were buying banks to service and control their financial flows; in 2005–2011, large Ukrainian and foreign banks were buying other banks to increase their share of the market [Churylo, 2010]; in 2012–2013, an opposite trend began – a significant share of foreign banks left the Ukrainian banking sector, while the rest increased their influence on the banking institutions through consolidation [*Zlyttya…*, 2013; Skorobagach, 2011].

This activity of commercial banks increases the concentration of banking capital, which has both advantages and disadvantages. The former include, in particular:
– at the macro-level: higher stability during crisis; technological modernisation of the economy (by encouraging large enterprises to make real investments); lending capacity of large-scale government projects,

   – at the bank level: higher customer trust; possibility of risk diversification and innovation.

The main disadvantages include: strengthened monopoly of banks, increased share of risky operations, and reduced possibility of inspection [Ostrolutskyj, 2012; Tsyganova, 2003].

The Herfindahl-Hirschman Index (HHI) is widely used to assess the level of market concentration:

$$I = \sum_{i=1}^{k} A_i^2 \qquad\qquad [1]$$

k – total number of banks in the market i,
A_i – share of deposits, liabilities, or assets controlled by the bank in the market i [Gryaznova, 2003; Korets'ka, 2013].

The Herfindahl-Hirschman Index demonstrates the importance of large banks by assigning them a larger share than to smaller banks and is sensitive to the entry of new banks into the market. Its value can range from 0 to 10,000 (100^2). A market is considered competitive if $I<1,000$, moderately concentrated if $1,000<I<1,800$, and highly concentrated (monopolised) if $I>1,800$.

The National Bank of Ukraine (NBU) included HHI of at least 800 to the list of key success indicators for the Comprehensive Program of Ukraine's Financial Sector Development until 2020. Therefore, the NBU is now paying more attention to the level of concentration of the banking market. Vladyslav Rashkovan and Roman Kornyliuk emphasise that it might be necessary to set additional parameters for a maximum concentration level in order to prevent its long-term consequences. They also proved that HHI is an optimal indicator to measure the concentration of the banking system [Rashkovan, Kornyliuk, 2015].

The level of concentration of the banking market of Ukraine is determined by calculating the Herfindahl-Hirschman Index based on the volume of assets of each commercial bank as of January 1, 2017. At this time, ninety-three commercial banks operate in Ukraine. PJSC 'Privatbank' has the largest share of the market (17.70%); top five banks account for 56.33% of the market. Since $I = 899.79$, the banking market of Ukraine can be considered competitive.

As evidenced in Figure 1, in 2010–2016 the banking market of Ukraine was competitive, but the Herfindahl-Hirschman Index shown a two-time increase. This testifies to a strong tendency of the Ukrainian banking market toward concentration, which, in our opinion, results mainly from:

   – the consolidation of commercial banks in 2010–2013 that caused a gradual increase (from 407.33 in 2010 to 517.38 in 2013) in market concentration (sales of PJSC 'Astra bank', PJSC 'Brokbusinessbank', PJSC 'Swedbank', PJSC 'Erste bank', PJSC 'Platinum bank', PJSC 'TMM bank', PJSC 'BM bank'; mergers of

PJSC 'Ukrsotsbank' and PJSC 'UniCredit Bank' as well as PJSC 'Delta Bank' and PJSC 'Kreditprombank') [Zlyttya…, 2013; Churylo, 2010];

– the insolvency and bankruptcy of banking institutions in 2014–2016 followed by a rapid (from 564.53 in 2014 to 899.79 in 2016) increase in market concentration. In the process of cleaning the banking system, eighty-seven banks (30% of total banking assets) were deemed insolvent or liquidated [Natsionalnyj bank Ukrainy].
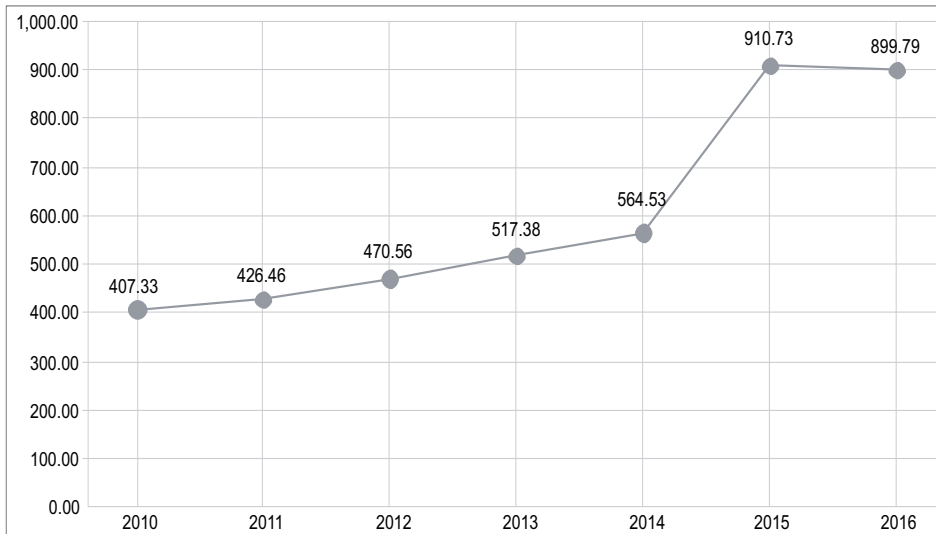

Figure 1. The dynamics of Herfindahl-Hirschman Index for the banking market in Ukraine, 2010–2016

Source: Own elaboration based on: [Natsionalnyj bank Ukrainy].

2. Theories of company and bank consolidation

The increased number of M&A transactions led researchers to undertake studies of motives for implementing restructuring processes in commercial banks. Modern economics offers three main theories that explain the reasons for the consolidation of companies and banks: synergy theory, agency theory of free cash flow, and hubris theory.

The synergy theory was formulated in 1983 by Bradley, Desai, and Kim. Synergy (synergy effect, synergistic effect) is the phenomenon of combining individual elements to produce a total effect larger than the sum of these elements. This is often called the '2 + 2 = 5' rule or the '1 + 1 = 3' rule. The synergy theory assumes that the managers of the target company and the buying company act in the inte-

rest of shareholders, because they themselves will benefit from the merger only if it increases the shareholders' welfare. The management's main objective is therefore to obtain synergy. In the process of bank consolidation, synergy is achieved when the value of the newly created bank exceeds the sum of the values of banks participating in consolidation. The main objectives of consolidation are to: reduce economies of scale, obtain large loans by combining financial resources, increase income through product diversification and universalisation of banking activities, diversify credit risk, improve management's quality and efficiency, and optimise management structure. However, the structural changes entail significant costs and may lead to loss of capital, i.e., to negative synergy (the '2 + 2 = 3' rule) [Rudyk, 2000; Bradley, Desai, Kim, 1983; Tkachuk, 2009].

The agency theory of free cash flow was formulated in 1986 by Michael Jensen. It views managers as agents of shareholders – a relationship that entails a conflict of interests. This conflict stems from payments made to shareholders (in dividends or capital returns) that deplete the company's resource base and thus decrease the financial flexibility of the management, who also seek to maximise their own interests (i.a. by authorising inefficient consolidation strategies and thus increasing the volume of their assets) [Rudyk, 2000; Jensen, 1986].

The hubris theory was introduced in 1986 by Richard Roll. It states that M&A transactions either do not create synergy or, if they do, its value is almost always overrated, which means that the decision to undertake a merger is motivated only by the irrational confidence of the buying company [Rudyk, 2000; Roll, 1986; Gohan, 2004].

The above theories adopt different approaches to explaining corporate mergers. The question therefore arises which of them best describes reality. Scientists conducted numerous empirical studies, testing theories of corporate mergers, analysing data regarding hundreds of tenders. Most studies attest to the superiority of the synergy theory. Berkovich and Narayanan [1993] show that ca. 75% of mergers have positive total returns and are primarily motivated by seeking synergy, while the remaining 25% have negative total returns and can be explained in terms of hubris and irrational behaviour.

In order to gain synergy in the process of restructuring (merger), more than 2,000 different steps should be taken and more than 10,000 non-standard tasks performed [Wallace, 1966].

The consulting group McKinsey & Co. identified three problems that arise from not taking due diligence before a merger and lead to worse than expected results:
– incorrect assessment of the market attractiveness or competitive position of the target company,
– underestimation of the investment required,

– inability of managers to overcome the difficulties caused by the integration of two companies with different production processes as well as accounting and corporate culture.

The financial mechanism of restructuring commercial banks that plan to gain synergy can be presented schematically as a sequential plan of action:

– analyse external environment (market conditions, competing banks and products, corporate relations, government restructuring legislation),
– determine operational objectives (become one of the largest banks in the region; achieve recognition for technological innovativeness, highly-qualified personnel, specialisation, and automation; establish relationships with major international centres and obtain the status of a bank of international standards from the World Bank; use domestic growth potential and limit the 'blurring' of share capital; become one of the leading banks in terms of return on assets) [Tsyganova, 2003; Tabaharniuk, 2012],
– determine restructuring objectives (higher rate of return, securing a favourable starting position, geographical diversification, etc.),
– evaluate investment opportunities (assess the financial need for restructuring based on data on similar mergers, the need for credit resources, and the bank's financial condition after restructuring) and select payment method (self-financing or debt-financing),
– search for alternative ways of development (creating bank associations, restructuring assets and liabilities, participating in investment projects, marketing agreements, improving organisational structure and management performance) [Vasyl'chenko, 2004],
– choose a restructuring strategy (prepare a general integration plan that determines the duration of the process and the bank's final structure) [Bashlai, Miroshnychenko, 2007],
– search for a target bank compatible in terms of financial performance, similarity of product series and market presence, corporate structure, information and management systems,
– closely examine and evaluate the selected companies (gather comprehensive, authenticated information about their profitability, revenues, assets, legal structure, market position, production capacity, compliance with standards, etc.; look for financial, taxation, legal, and technical risks related with the change of ownership that may affect future business activities),
– negotiate (pointing to the risks identified in the previous step that constitute grounds for discount, mainly unresolved property rights, tax claims, accrued debts, shadow turnover),
– integrate the acquired assets and sell all or some units of the acquired company [Tabaharniuk, 2012].

3. Commercial bank restructuring: The merger of PJSC 'Ukrsotsbank' and PJSC 'UniCredit bank'

The synergy resulting from restructuring PJSC 'Ukrsotsbank' and PJSC 'UniCredit Bank' will be evaluated using the discounted cash flow method [Tkachuk, 2010] in the following stages:
  – estimate the market value (MV) of each bank using the discounted cash flow method and the discount rate,
  – determine the market value of the restructured bank without synergy (by adding the market values of both banks before restructuring),
  – estimate the value of synergy based on the expected growth and cash flows and determine the market value of the restructured bank with synergy,
  – estimate the value of synergy as the difference between the market value of the restructured bank with and without synergy.

To assess the market value of each bank using the discounted cash flow method we need to calculate the discount rate, i.e., the weighted average cost of capital (WACC), whose simplified formula (1.14) is shown below.

$$WACC = \sum_{j=1}^{n} z_{jt} \times r_{jt} \qquad [2]$$

z_{jt} – total value of financing j (equity and liabilities) at the time t,
r_{jt} – cost of financing (annual %),
n – number of financing sources at the time t.

For a banking institution, a more detailed formula can be developed.

$$WACC = i_{Eq} \cdot \frac{Eq}{LAE} + \sum (1 - Tax) \cdot i_{Li} \cdot \frac{Li}{LAE} =$$

$$= i_{Eq} \cdot \frac{Eq}{LAE} + 1 - Tax) \cdot \left[i_{SD} \cdot \frac{SD}{LAE} + i_{TDLE} \cdot \frac{TDLE}{LAE} + i_{TDI} \cdot \frac{TDI}{LAE} + i_{LOB} \cdot \frac{LOB}{LAE} \right] \qquad [3]$$

Eq   – equity,
LAE – liabilities and equity,
Tax   – corporate profit tax rate,
Li – liabilities,
SD   – sight deposit,
TDLE – term deposits of legal entities,
TDI   – term deposits of individuals,
LOB   – liabilities to other banks,
$i_{Eq}, i_{Li}, i_{SD}, i_{TDLE}, i_{TDI}, i_{LOB}$ – appropriate interest rates.

The weighted average costs of capital of PJSC 'Ukrsotsbank' and PJSC 'UniCredit bank' in 2012 are calculated in Table 1 below.

Table 1. Weighted average costs of capital of PJSC 'Ukrsotsbank' and PJSC 'UniCredit bank', 2012

Item	PJSC 'Ukrsotsbank'	PJSC 'Uni-Credit bank'
Equity, UAH mn	7,657.09	6,441.28
Liabilities, UAH mn:	31,172.77	5,483.87
incl.: sight deposits	7,513.48	1,223.42
term deposits of legal entities	6,725.63	1,269.64
term deposits of individuals	11,644.83	802.02
liabilities to other banks	11,554.57	2,491.84
Liabilities and equity, UAH mn	38,829.86	11,925.15
Average interest rate on sight deposits, %	0.80	1.00
Average interest rate on term deposits of legal entities, %	15.00	16.00
Average interest rate on term deposits of individuals, %	12.00	14.00
Average interest rate on liabilities to other banks, %	8.00	9.00
Corporate profit tax rate, %	21.00	21.00
Interest rate with minimal risk (based on the average yield on deposits), %	12.00	12.00
Regulatory allowance estimated in relation to specific risks, %:		
inaccurate forecasting of cash flows	2.00	2.00
capital structure	1.50	1.50
high payables turnover ratio	0.50	0.50
bank deterioration	1.00	1.00
risks specific for the banking industry	1.00	1.00
WACC, %	10.46	12.37

Source: Own elaboration based on: [Natsionalnyj bank Ukrainy; Ukrsotsbank].

The 2012 weighted average cost of capital was 10.46% for PJSC 'Ukrsotsbank' and 12.37% for PJSC 'UniCredit bank'.

In order to adequately assess the impact of a merger or an acquisition on the expected cash flows, it is necessary to clearly establish the type of synergy (cost reduction or revenue increase) as well as the time of its impact on the cash flow and the time of receiving profit. Restructuring PJSC 'UniCredit Bank' and PJSC 'Ukrsotsbank' is expected to provide annual synergies by reducing operating expenses.

Table 2 presents the main characteristics of the two banks based on their financial statements and WACC.

Table 2. The main characteristics of PJSC 'Ukrsotsbank' and PJSC 'UniCredit bank', 2012

Item	PJSC 'Ukrsotsbank'	PJSC 'UniCredit bank'
Revenues, UAH mn	2,833.00	432.80
Operating expenses, UAH mn	1,527.00	368.27
EBIT, UAH mn	1,306.00	64.53
Expected growth in EBIT, %	1.50	1.80
WACC, %	10.46	12.37
Corporate profit tax rate, %	21.00	21.00

Source: Own elaboration based on: [Natsionalnyj bank Ukrainy; Ukrsotsbank].

Free cash flows (FCF) of the two banks have been calculated taking into account taxation:
  – for PJSC 'Ukrsotsbank':
  $FCF_{Ukrsots} = EBIT \cdot (1–Tax) = 1,306 \cdot (1–0.21) =$ UAH 1,031.74mn
  – for PJSC 'UniCredit bank':
  $FCF_{Ukrsots} = EBIT \cdot (1–Tax) = 64.53 \cdot (1–0.21) =$ UAH 50.98mn

The Gordon growth model, which is a simplified version of the free cash flow measure useful for minority shareholders, is commonly used to determine a bank's market value. However, in this case we consider it inapplicable, since PJSC 'Ukrsotsbank' has paid only insignificant dividends (0.66% of its 2012 EBIT) and PJSC 'UniCredit Bank' – none.

A bank's market value can be generally calculated using the discounted cash flow method. However, this method finds application only to limited forecast periods. If annual synergies are expected, this formula should be used:

$$P = \frac{A}{i} \qquad [4]$$

P – present value of perpetuity,
A – annuity,
i – discount rate.

In the case of continuous growth of EBIT, P is determined as follows:

$$P = \frac{A}{i-g} \qquad [5]$$

g – growth rate of income (profit).

This formula can be modified to determine the bank's market value:

$$MV = \frac{FCF}{WACC-g} \qquad [6]$$

The market values of the two banks before restructuring and key characteristics of the restructured bank have been calculated below, taking into account synergy, which is expected to reduce operating expenses by UAH 106mn.

Market value of the two banks:
- PJSC 'Ukrsotsbank':

$$MV_{Ukrsosts} = \frac{FCF}{WACC-g} = \frac{1,031.74}{10.46-1.5} = UAH\,11,511.56mn$$

- PJSC 'UniCredit bank':

$$MV_{Ukrsosts} = \frac{FCF}{WACC-g} = \frac{50.98}{12.37-1.8} = UAH\,482.21mn$$

Market value of the restructured bank without synergy:

$$MV_{Ukrsosts+Unicredit} = MV_{Ukrsosts} + MV_{Unicredit} = 11,511.56 + 482.21 = UAH\,11,993.77mn$$

Growth rate of EBIT:

$$\bar{g} = 1,5\% \cdot \frac{11,511.74}{11,993.77} \cdot 1.8\% \cdot \frac{482.21}{11,993.77} = 1.51\%$$

Weighted average cost of capital:

$$\overline{WACC} = 10.46\% \cdot \frac{11,511.74}{11,93.77} \cdot 12.37\% \cdot \frac{482.21}{11,993.77} = 10.54\%$$

Expected free cash flow, taking into account taxation and synergy:

$$FCF_s = EBIT \cdot (1-Tax) = 1,476.53 \cdot (1-0.21) = UAH\,1,166.45mn$$

Market value:

$$MV_s = \frac{FCF}{WACC-g} = \frac{1,166.45}{10.54-1.51} = UAH\,12,921.38mn.$$

Table 3. The main characteristics of the restructured bank with and without synergy gained from reducing EBIT by 3.2%

Item	Without synergy	With synergy
Revenues, UAH mn	3,265.80	3,265.80
Operating expenses, UAH mn	1,895.27	1,789.27
EBIT, UAH mn	1,370.53	1,476.53
Expected growth in EBIT, %	1.51	1.51
WACC, %	10.54	10.54
Market value, UAH mn	11,993.77	12,921.38

Source: Own elaboration based on: [Natsionalnyj bank Ukrainy; Ukrsotsbank].

The value of synergy:

$$S_{MV} = MV_s - MV_{Ukrsots+Unicredit} = 12,921.38 - 11,993.77 = UAH\,927.61mn.$$

Reducing operating expenses of the restructured bank by UAH 106mn led to an increase in its market value by UAH 927.61mn, which is the value of synergy.

The difference between the market value of PJSC 'Ukrsotsbank' after restructuring with and without synergy is presented in Figure 2.
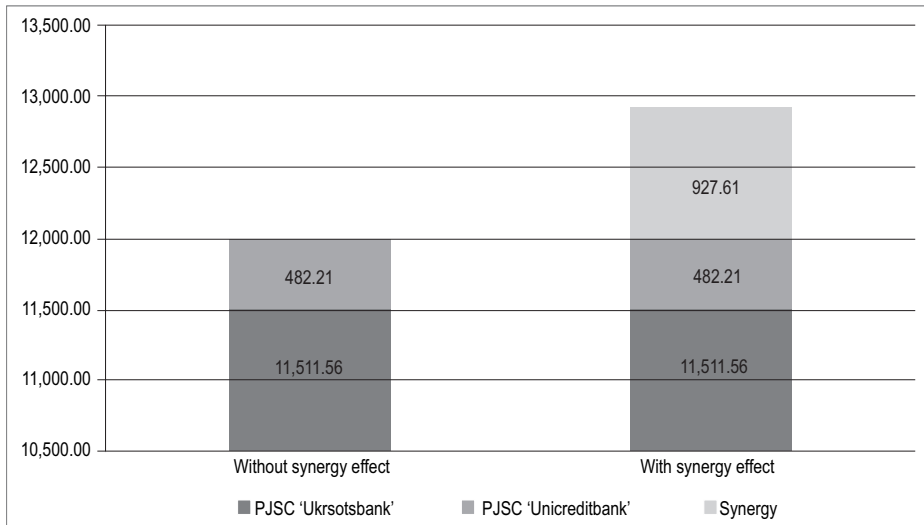

Figure 2. The market value of PJSC 'Ukrsotsbank' after restructuring (UAH mn)

Source: Own elaboration based on: [Natsionalnyj bank Ukrainy; Ukrsotsbank].

The results of calculations confirm that only mergers or acquisitions of banks more profitable in comparison with the sum of market values of particular banks can be highly effective:

$$MV_{A+B} > MV_A + MV_B \qquad [7]$$

Conclusions

In 2010–2016, the banking market of Ukraine was not a 'concentrated market', but a strong tendency towards concentration is indicated by the annual increase in the Herfindahl-Hirschman Index, which was mainly caused by the consolidation of commercial banks in 2010–2013 and the instances of insolvency and bankruptcy of banking institutions in 2014–2016.

There are three main theories that explain the reasons for bank consolidation: synergy theory, agency theory of free cash flow, and hubris theory. Most unsuccessful transactions that bring lower profits to the buying company result from irrational actions of management (agency theory of free cash flow) or overestimating the value of the target company (hubris theory). If the target company and merger effects have been accurately assessed, the buying company can identify

synergies and ensure a successful merger that will improve its financial performance, strengthen its competitive position, and increase its market value, as shown with the example of PJSC 'Ukrsotsbank' (synergy theory).

The financial mechanism of restructuring commercial banks that plan to gain synergy needs to be guided by a strategic development vision and should take into account: external factors, operational objectives, investment opportunities, payment method, alternative development options, restructuring strategy, the target bank, examination and evaluation of selected companies, negotiations, integration of acquired assets, and the reasons for selling all or some units of the acquired company.

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