Ireland: taking the next step

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Introduction

As if recent scandals concerning offshore banking and tax evasion schemes weren't enough to raise serious doubts about the effectiveness of the Irish financial regulation authority, now greater exposure to foreign banking has made the job of financial regulators even more difficult. Since the European Monetary Union (EMU), European banks have become ever more aggressive in extending their presence beyond their national borders, taking advantage of the new rules of the game. Already banks in Ireland are busy keeping pace with the new dynamics and scrambling to become more competitive. Furthermore, talks of bank mergers have flourished. Indeed, given the EMU and its steadfast commitment to creating a single marketplace devoid of any national barriers, greater consolidation in European financial services is most certainly to take place. In light of the Irish banks' modest size and strength relative to their competitors in the European Union (EU), it is possible they could soon become acquired by wealthy foreign buyers. Fear of this prospect and concerns about conceding too much bank capital to the control of foreigners has led to a debate concerning the future of Irish banks.

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Thus far, mergers and acquisitions have been a popular solution. Feeling that bigger means better, Irish banks (along with most European banks) have been quick to execute merger deals. Some have even proposed creating a "National Champion," whereby Ireland's two biggest banks would come together to fend off foreign pressure. As I argue in this essay, however, mergers of financial establishments should be given a more thorough look. For one thing, recent mergers haven't always produced clear and favorable results. Some even seem downright unnecessary. On the other hand, the continual integration of the EMU as well as advancement in technology have rendered financial mergers less important. From the exceptional results that have been recorded by countries which have brought foreign players into their banking systems, it should be clear that what Ireland needs is greater competition in its financial services market. The concerns relevant to foreign control are issues that pertain to government regulation, not ownership. At the conclusion of this essay, it should be clear that mergers are inevitable and will continue; however, not all are necessary. Irish bankers and policy makers should take care not to jump too quickly onto the merger bandwagon, as many bankers have already been led off course by the ongoing bank consolidation movement worldwide.

EMU Impact on Financial Services

The creation of the EMU affects financial services in Europe tremendously because it creates a level playing field by ridding key sources of competitive advantage for all financial institutions operating in Europe. (Dermine) More than just eliminating foreign exchange, the EMU is an uncompromising commitment to breaking down national barriers and to creating a unified capital market.

Partly as a result of the EMU, merger talks (or speculation about them) have been rampant. Economists and financiers argue that the elimination of regulation barriers and foreign exchange risk opens up terrific opportunities to gain economies of scope and scale as well as for diversification and expansion into growth markets. They maintain that these opportunities, along with the emergence of a single European capital market, can lead to only one prospect – cross-border consolidations in the form of mergers and acquisitions (M&A).

Since the Second Banking Directive was instituted in 1989 and the inception of the EMU in 1999[2], only limited cross-border merger activities have taken place so far. Despite significantly more incentives for banks to expand abroad via M&A, financial institutions have been slow, or even reluctant, to make cross-border acquisitions because of cultural and regulatory differences. Quoting Daniel Bouton, chairman of Société Générale, in a recent interview on future bank consolidation in the short to medium horizon, "We do not believe time has come for cross border mergers owing to differences in fiscal laws and regulations on savings mostly [which significantly limit synergies that could be extracted from merger deals]." (European Banking Team, p.2) These differences, however, will eventually diminish. As long as the EMU exists, regulators will continue to cut down barriers and foster the environment necessary for financial market unification.

Europe's Interest and Foreign Banking in Ireland

As financial liberation and integration intensified throughout Europe in the 1990s, the impact of foreign banks on Ireland's banking market became increasingly greater. Few banks have already broken into the Irish market, and potentially many more will take an interest in Ireland in the years ahead. What has suddenly made Ireland such an attractive place for financial institutions to sell services to? And could the influx of foreign players entering Ireland continue to rise? If a more competitive environment is pursued, what can non-Irish investors or acquirers of banks bring to the Irish market? And where do Ireland's interests lie?

[2] The Second Banking Directive and legislation approved by the EC Council of Ministers in 1988 were especially significant to financial services in Europe because they deregulated cross-border banking and liberalized capital flows within the Euro-zone. Specifically, a financial institution headquartered in a European Union country was permitted to offer products and services anywhere in the Euro-zone. (Canals, p.14)

Possessing probably the most vibrant economy in Europe and a general population whose wealth is growing quickly, Ireland offers great opportunities for banks seeking to find earnings growth. In addition to good economic fundamentals, banks in Ireland enjoy fat profit margins and operate in one of the friendliest banking environments in all of EU.

On the macroeconomic front, Ireland seems a gold mine for European banks. To begin with, the country remains the fastest growing country in the EU with annual GDP growth of about eight percent in the seven years from 1994 to 2000. The unemployment rate has consistently fallen over the past two decades, dipping below four percent in the year 2000. Population has been growing continuously at one percent per annum since 1994. ("Life Insurance and Pensions") Additionally, the savings rate in Ireland remains one of the highest by international standards at over eleven percent in 2000, compared to just over two percent in the U.S. and a little over five percent in the U.K. ("Banking Sector: Some Strategic Issues," pp.73-74) In short, favorable economic figures suggest the Irish banking market is likely to remain vibrant and profitable in the years ahead.

From a business perspective, several of the various areas of financial services in Ireland remain very lucrative. Banking by electronic payments still needs improvement in order to catch up to the most technologically advanced banks in Europe. The pension market is growing tremendously thanks to a booming economy and reforms in government regulation such as the Personal Retirement Savings Account (PRSA) aimed to provide widely accessible low-cost pension plans. ("Life Insurance and Pensions," section. 0.1) As Datamonitor has reported, "Half the population [in Ireland] is still without a private pension." Finally, as the population in Ireland ages and become much wealthier (Datamonitor reports the number of people over the age of 65 will rise by approximately seventy percent between the years 1990 to 2040), the number of high net-worth clients will increase, and their demands for financial products will undoubtedly represent profitable business for banks. Clearly these underdeveloped markets in Ireland can be easily exploited with new products and better technology from sophisticated financial stalwarts in Europe.

In addition to possessing markets with good earnings growth potential, the low degree of competition in the present Irish financial services market reveals opportunities for easy money. To demonstrate, a study by Paul McBride shows that Irish banks are the most profitable financial institutions in the EU (see Table 1).

Table 1
Bank Profitability

Year	Return on Assets	Return on Equity	After-Tax Profit as % of Net Income
1990	1.27	26.8	n.a.
1995	1.54	27.3	62.13
1996	1.78	28.7	65.66
1997	1.44	28.4	71.90
1998	1.72	32.6	73.93
EU Average (1998)	0.78	17.4	51.03

Source: McBride, p.106

In short, these findings lead me to believe that competitive players in European banking and finance will in the future find Ireland not only a good place for diversifying their assets but also an important growth area that cannot be neglected.

The recent entry of foreign banks into Ireland has proved a challenge for local banks. Since the arrival of Northern Rock and the Bank of Scotland, Irish commercial banks have been pressured to offer higher interest rates on savings deposits and lower mortgage rates to stay competitive. (Doyle) The effects of foreign banks undercutting domestic prices have been far-reaching; for example, First Active has been forced to restructure to become more cost efficient, closing down 25 of 72 branches and asking over 175 managers and staff to leave. ("First Active

Axes 175 Jobs, 25 Branches") Similar pressure to cut profit margins (Power), close down branches, or reduce staff has been experienced at the Bank of Ireland, Allied Irish, Ulster Bank, and Irish Life and Permanent. (Creaton, "Branch Consolidation…") An Irish Permanent spokesman insightfully explained the situation at hand in this way:

> The reduction [in Irish Permanent market share] was a response to the introduction of the euro. The EMU regime has created a level playing field for banks in the EMU zone that has simply not been reflected in the cost of mortgages to the consumer. All EMU zone banks are charged the same now for funds, but the cost of loans to the customer differs sharply across regions. (O'Mahony)

As for the consumers of financial services on the other hand, increased competition in Ireland has been good news. The greater presence of competitive foreign banks has pushed financial institutions to innovate and be as competitive as can be. Specifically, prices are quickly being driven down, and financial products have been improving at a breakneck speed since the EMU. For example, banks are now more resourceful and creative in their search for greater efficiency and more consumer-conscious products. ("Banking Sector: Some Strategic Issues." p.18) The recent introduction of the "Tracker" by the Bank of Scotland – a device aimed to give consumers a low mortgage rate by pegging interest to the euro base rate for the term of the loan – is a good example. ("Cut-Price…") As remarked by the minister of finance, Charlie McCreevy, "People are getting deals now they never dreamt of before [five or six years ago]". ("BF McCreevy…") This, I believe, summarizes the importance of competition (domestic and foreign) and highlights the need for more of it.

Merger Contagion in Ireland

Ever since market unification in Europe became imminent, financial institutions of EU nations began to nestle up to one another to strategize and plan for the future. Suddenly because of rapid consolidation in financial services, Ireland has followed suit with its own handful of mergers and acquisitions. Recent trends seem to favor the concept of "Bancassurance" – the marrying of banking and insurance. The most well known of these transactions include the merger between Irish Life and Irish Permanent (now known as IL&P), which created the biggest bancassurance and third largest financial institution in Ireland. Other bancassurances that have emerged include Allied Irish Bank-Ark Life and Bank of Ireland-NatWest.

Most recently, two state-owned Irish banks that have for a long time searched for a strategic relationship – ICC and TSB bank – were sold to the Bank of Scotland and Irish Life & Permanent respectively. Both ICC and TSB will significantly increase the Irish asset base of their acquirers. For Irish Life & Permanent, in particular, TSB will give it a loyal and sizable customer base, membership to the clearing system, demonstrated skills in money transmission banking, and open up cross-selling opportunities for life, pension and investment products, and car finance. ("Consolidation Leaps Forward")

The Bank of Ireland (BoI) has focused on market positioning within Ireland and in the U.K., such as through its Bristol and West mortgage subsidiary in the U.K. and its recent acquisition of U.K. financial adviser Chase de Vere Investments ("Falling Out with the Neighbours," p.42). Meanwhile the Allied Irish Bank (AIB) has expanded abroad through acquisitions or forming strategic relationships in Poland, the U.S., and in the Asia Pacifics. (AIB website)

Speculations about either the Bank of Ireland or Allied Irish being acquired by a foreign bank have surfaced of late. Since archrivals Royal Bank and Bank of Scotland (both bigger than BoI and AIB in size) have always followed each other's strategy closely in the past, Bank of Scotland is seen likely to follow Royal Bank's recent move of acquiring Ulster Bank by purchasing one of Ireland's major financial houses. (Creaton, "Sector to Brush off…")

Despite the considerable consolidation activities that have recently taken place in Ireland, the comprehensive results of these mergers will not be known for at least another few years. Some of these merger deals seem likely to produce positive results such as increased earnings growth and greater efficiency. Others however, will certainly go down in history as exorbitantly useless and downright unprofitable. “Bancassurance” and “National Champion” are, for example, two concepts that I believe fall under the category of unnecessary and senseless mergers.

Bancassurance

As previously mentioned, bancassurance is a new idea that has become increasingly popular in European banking. Proponents of bancassurance argue that banking and insurance make good complements and that the combining of the two creates synergies, meaning that the value of the two entities together is greater than their values as separate parts. After all, it is only natural that customers of banks also need insurance products, and that people who buy life or health insurance also need to invest or safeguard their money in financial vehicles. In short, both fall under the category of household finance; and by merging the two, financial institutions generate consumer value with one-stop shopping convenience, increase their distribution channels and consumer reach, and establish for themselves a stronger household brand name. Additionally, by combining the two client databases and gaining a more comprehensive understanding of consumer demands, providers of financial products could better predict and satisfy customer needs. Finally, the complementary characteristics of banking and insurance amount to one more strategic strength – cost reduction. Given similar enough platforms, the two can significantly eliminate staff, retail branches, and headquarters to reduce overhead expenditure.

Although the advantages of bancassurance seem plausible, in reality the difference between banking and insurance is far too great for the two to work well together. A recent article in the *Economist* argues that cutting cost and deriving economies of scope through bancassurance are difficult because of fundamental differences between the two businesses. ("Life Branches?") The particulars of insurance products, for example, are difficult for lower skilled branch staffs to learn and sell, as the *Economist* explains. And as evidence suggests, there has been little integration between the insurance and banking arms of Citibank and Travelers Group since their merger in 1998. ("Life Branches?") With such limited integration, attaining cost savings and creating synergies are therefore difficult. And even though bancassurances in Ireland have proven to be a successful distribution medium – as supported by significant increases in insurance revenue at Irish Life, Ark Life, Progressive Life, and Lifetime Assurance, which are now all owned by commercial banks ("Life Insurance and Pensions," section.0.3) – the *Economist* asks: "Does it [the bank] need to own the company that offers the insurance it sells? And does an insurer need to buy a bank to get its distribution?" Recent financial performances of bancassurances in Europe suggest arm's length alliances between banking and insurance is preferable to full-fledged mergers between the two.

Dangers of Creating a Champion Bank

In a race to expand abroad and secure market share, the effects of a quickly consolidating European financial industry have left banks in Ireland scrambling to become bigger and stronger. The fear that Irish bank capital could one day be entirely controlled by foreign banks has led some to propose creating a "national champion" bank of Ireland (McBride, p.109), by merging two major Irish banks so that the amalgamated entity is significantly larger and offers a wider range of products, effectively shortening the list of eligible acquirers to only a few dozen true financial powerhouses.

Contrary to what one might expect, the creation of a national champion could render itself a more perfect acquisition target than if the banks were two separate entities. As noted recently in a report from the Department of Finance, "A merger of two major domestic banks would almost certainly not act as an obstacle to a takeover of a major Irish bank by a foreign bank because of the small relative size of all the participants in the Irish banking market, even if merged." ("Banking Sector: Some Strategic Issues," p.57) And since it is much less advantageous for a foreign bank to acquire just one (as opposed to two) major Irish bank due to limited scope for cost reduction, (McBride, p.109) merging two such banks would be the equivalent of making Irish banks a more attractive buy. Leaving the banks as separate entities would at least force the foreign acquirer to risk experiencing the bumpy transition period of integrating managements and closing down overlapping branches.

Creating a national champion would also risk running afoul of Ireland's competition laws. Naturally the merged entity would have control over most of Ireland's financial services market, and this entity would dictate the prices and quality of financial products in Ireland. As it now stands, Irish banks already enjoy the highest profit margins in Europe (Keena); taking competitive players out of the market is hardly necessary. Clearly, what Ireland needs is more competition in its financial services industry; that can be achieved by maintaining an open-door policy to foreign competitors.

All in all, even if one were to disagree with the dangers of creating a champion bank, the fear of foreign banking is senseless. Time and time again, countries that have maintained an open policy towards foreign banks have seen their banking systems become stronger and gain greater credibility with the outside world. On the contrary, those economies which support protecting domestic banks from foreign competition are often more susceptible to banking crises. (Goldberg et al., p.13) If the conclusions from studies on the banking systems of other countries can be applied to Ireland, then one can believe with reasonable certainty that a successful venture of bringing well-capitalized foreign banks to Ireland can open access to valuable capital as well as add stability to the banking system through diversification. (Goldberg et al., p.1)

Regulation and Bank Ownership

For all the complexities and apprehension about conceding excessive bank capital to the control of foreign ownership, these worries are actually quite unfounded. People often forget that banking is an industry heavily regulated by laws. In spite of EMU and Ireland's duty to abide by the EU financial regulatory framework, Ireland still possesses ample authoritative power to control the actions of banks operating within its borders. Simply put, the Irish government dictates what foreign banks can or cannot do. Regulation, not ownership, is the key.

The need for more stringent regulation in financial services is clear, however. Recent scandals in the financial sector involving offshore accounts and tax evasion schemes such as the infamous Deposit Interest Retention Tax (DIRT)[3] payments at various Irish banks highlight the complexities that accompany a thriving economy, and demonstrate clearly the need for greater supervision in the financial industry. With closer watch of foreign accounts and offshore activities, which has already been proposed by the newly formed Irish Financial Services Authority ("Regulating the Finance Sector"), encountering the likes of the DIRT findings in the future is not likely.

[3] A series of DIRT scandals were uncovered in the 1990s by investigators, which revealed several decades of tax evasion schemes being sold by Irish banks to foreign investors with offshore accounts.

That said, Ireland would do just fine as long as sufficient supervision and all necessary regulations are there to ensure good banking practices. As outlined by David Carse, deputy chief executive of banking in Hong Kong, some important areas deserving special attention should be enforcement of capital adequacy, prudence in risk-taking, prevention of excessive exposure to particular geographical regions or business sectors, liquidity, transparency (Carse, "Hong Kong Banking…"), and market risks relating to losses in on and off balance sheet positions. (Carse, "Recent Developments…") The fact that the Irish government has recently drafted solid plans for creating a single regulatory authority to closely monitor the actions of financial institutions is an indication that Ireland is on the right track. (McManus)

To highlight the irrelevance of bank ownership, New Zealand is a particularly fitting example. With all but one of nineteen banks in 1998 owned or controlled by foreigners, the dynamics between New Zealand and its foreign owned banks can prove insightful in determining the right policies that Ireland should hold toward foreign investors of banks. In a speech addressed to the Asian Pacific Bankers Club Annual Conference, the Governor of the Reserve Bank of New Zealand, Donald Brash, said:

> We have seen absolutely no disadvantages [from the situation of having foreign-owned banks] and many advantages. We have a financially stable banking sector, with vigorously competing and highly innovative banks, all of them subject to the monetary policy influence of the central bank. (Brash)

He also added he does not doubt that "the banking sector is considerably more stable than would have been the case had all the banks been domestically-owned, whether in the private sector or in the public sector." Considering New Zealand's experience with foreign banking, the appropriate policies that Ireland should take towards bank ownership is clear. That is, the more banks the better (foreign or domestic) so that competition can be promoted.

For New Zealand, it was particularly important that its banks regain the confidence of international investors after coming close to experiencing several major bank failures ten years earlier. (Brash) Inviting foreign banks to New Zealand proved especially effective in earning that credibility, Brash explained. Similarly, I believe that the presence of reputable foreign banks in Ireland can be an effective way to instill even more confidence and add greater credibility to Ireland's banking system, which is especially important for Ireland considering its heavy reliance on foreign direct investments and international trade.

The Impact of EMU and Technology – Barriers Come Apart

From the consumers' point of view, the EMU has created an environment where ultimately financial services will be the same everywhere in the European market, and technology has made possible the access to the best and least expensive financial products available. Financial capital will flow freely throughout the EU, making the ownership of banking capital less important.

The notion of a single passport for financial services, the EU initiative to permit free movement of financial services and capital, presents interesting opportunities for banking institutions in the European Union. The Second Banking Directive, which legalizes the selling of financial products and services across all member nations, makes mergers less necessary. Financial intermediaries will in the future aim to market available capital to the entire European market as opposed to facilitating lending and borrowing primarily within only one country. In the absence of barriers, similar financial services will be offered everywhere, and Irish consumers will have access to the most sophisticated financial products at the lowest price that Europe can offer regardless of bank strategies (e.g. mergers and acquisitions) within Ireland.

To illustrate, the recent emergence of Jumbo Pfandbriefe is a case in point. Pfandbriefe are German investment vehicles that are comprised of pools of collateral-backed securities such as mortgage loans (the equivalent of Fannie Mae or Freddie Mac in the United States) and are sold to investors in the open market. Traditionally, only German loans were pooled together and sold to investors in the form of a Pfandbrief. But since 1995 those loans that make up Pfandbriefe issues have been extended to include public sector loans from numerous EMU countries, Ireland included. These are termed Jumbo Pfandbrief and are sold widely to investors throughout the EMU. ("Jumbo Pfandbrief") Since January 1998, Pfandbrief securities have spilled over to the global arena to include loans from around the world. The sizes of Pfandbriefe issues have increased tremendously, from the traditional minimum size of 150 million euro, to 500 million euro for Jumbo Pfandbriefe, and now up to volumes of 2-4 billion euros for Global Pfandbriefe. Clearly this is a testimony to the trend towards global integration, and especially to integration within the EMU. In Europe, national borders have become and will continue to be less and less important as the common market facilitates financial transactions and makes provisions for investment needs to EU residences all under the same roof.

The Celtic Tiger: Implications for Financial Services

The economic expansion of the 1990s and the new set of consumer demands that have emerged are reasons why Ireland needs more experienced and well-capitalized banks. As households accumulate wealth and business transactions become more complicated and roll into higher volume, higher levels of available capital and more sophisticated financial tools will be needed to fuel continued growth. The capital shortage in the housing market in recent years is especially illustrative of the inadequacy of the current banking system.

"First time buyers have been all but pushed out of the property market…. The difference between home ownership and long-term tenancy is often a funding shortfall", the *Irish Times* has reported. ("First-Time…") Such is the current situation in Ireland. This shortage of funding in the mortgage loan market should be enough to show how Ireland can benefit from greater access to well-capitalized foreign banks and from pursuing an open relationship with European investors such as its attempt to sell mortgage loans through the German Jumbo Pfandbriefe.

Conclusion

In short, it is hardly surprising to find that Irish banking does not necessarily require mergers and acquisitions to survive. Looking at recently merged financial institutions worldwide, their earnings performance and customer service ratings after the merger have generally been discouraging. Even if the theoretical concept behind the merger was sound, the guiding of two companies through a restructuring and then forging those two entities into a single well-oiled institution are both risky and very difficult. In the U.S., for example, bank mergers are not without their woes; very few have produced good results. In April 2001 the *Economist* dubbed the bank mergers in Germany in the past year as "fruitless bank mergers" that continue to produce ambiguous and sometimes even disappointing results. ("The Big One?")

Bancassurances and the creation of an Irish national champion in particular ought to be given a more careful look. The EMU and new technology will provide Irish consumers with the best products and prices even if all domestic banks fail. Countries that have already incorporated foreign banks into their banking systems have seen nothing but outstanding results; the fear of foreigners taking control of Ireland's banking system, therefore, is hardly justified. Instead, policy makers should welcome foreign banks and promote even more intense competition in Ireland.

As the saying goes: “Same old chatter, but the weak can still take from the strong.”[4] Irish banks and consumers will do just fine in the new millennium as long as they are careful in picking their battles. Mergers and acquisitions might be one battle not to pick.

[4] Pete Carrill, former Princeton University Men’s basketball coach.

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Biography

Kenneth Y. Leung graduated with highest honors from Lehigh University in January 2001 with a Bachelor of Science degree in finance and a minor in Asian studies. While at Lehigh, he studied abroad in China and Mexico, served as president of the Asian Cultural Society, and was a manager for the Thompson International Portfolio. He was also an active member of the varsity tennis team for four years and led the team as Co-captain in his senior year. He was a Presidential Scholar and was inducted into Beta Gamma Sigma, the National Society of Collegiate Scholars, and Phi Eta Sigma honor societies. He was also elected to join the Financial Management Association, Beta Alpha Psi Accounting Honor Society, and Phi Beta Delta International Honor Society, while being chosen as Lehigh University's 2001 representative for the *Wall Street Journal Student Achievement Award*. Currently, Kenny is working at Merrill Lynch as a mergers and acquisitions analyst in New York City.

Abstract

Standing at the crossroads of prosperity, global deregulation in financial services, and continual market unification in the European Monetary Union, Irish banking faces a challenge from the current contagion of mergers and acquisitions (M&A). This paper addresses the role of M&A in Irish financial services: specifically, how should policy makers and financial institutions react to the ongoing consolidation movement?