M&As IN THE BANKING SECTOR OF CROATIA

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Summary

The paper represents an argument for examining M&As as case specific practices. We believe that the case of the recent M&As in the Croatian banking sector is a time and context specific case, where favorable circumstances, most of all government willingness to support the process, lead to what can be characterized as good post-acquisition performance. Even though we find that good post-acquisition performances of the acquired banks can be relate to a specific market circumstances, at least part of the good performances can be attributed to efforts to raise operational efficiency. An important feature of the managerial system of West European banks, adding to more efficient internal processes and governance in general definitely lays in the well-developed standards of financial reporting which could be relatively quickly transferred to Croatian banks contributing to more efficient management processes.

Key words: Croatian banking industry, M&As, post-acquisition performance

1. Introduction

Compared to other sectors of the Croatian economy in transition, the banking sector has been among the most exposed to mergers and acquisitions in its most recent economic history. In fact, during the nineties there have been two mergers waves; the first one following the banking crises in the mid nineties (1995-1996), and the second one, at the turn of the century. This second wave led to a cross border privatization of the largest national banks, opening new concerns about the structure and efficiency of the Croatian banking industry in the years to come.

Starting with the assumption that mergers and acquisitions represent alternative modes for pursuing growth, we tried to point out to the specific circumstances that led European banks to seek for acquisition targets in the Croatian banking industry. In this exploratory study we report on post-acquisition performances of two largest Croatian banks privatized at the end of 1999 and in 2001. We compare the changes of their relative performance after the acquisition, and comment on expected future developments.

The paper is structured in four parts. After a general introduction, we outline the general context that led to the privatization of Croatian banks by selling them to foreign banking groups by referring to the developments in world and European banking and commenting on the situation in banking sector in Croatia at the end of the nineties. The third part describes the cases of Privredna banka and Zagrebačka banka, with the fourth part offering a note on supervisory procedures. The final part summarizes the observations, giving a classification of factors expected to influence on post-acquisition costs.

The study was conducted using publicly available data, including annual reports and reports from the Croatian National Bank, The Croatian Chamber of Economy and other government bodies. We also make references to reports and studies conducted dealing with M&As in the European and global financial sector.

2. Forces and motives leading to M&As

The consolidation of the financial sector has been a worldwide phenomenon, imposing new challenges to government authorities, regulators, the banks themselves, including shareholders, managers, employees, and finally affecting consumers.

Forces and motives leading to M&As in the banking sector, as well as efficiency gains, have been explored by Singh and Zollo (2002), Farell & Shapiro (2000), Berger (2000), and assessed by reports from international organizations (IMF, WB, ILO, ECB).

Here we will just briefly outline the framework that guided our review of the effects of M&As in Croatian banking.

Compared to organic growth, M&As represent a faster, lower risk, less capital demanding means for pursuing growth and especially entry strategies. When used as a strategy of horizontal growth, mergers are credited for producing additional economies of scale by allowing for higher levels of specializations, or for process restructuring so improving operational efficiency. The other side to mergers deals with the effects of mergers on market structure. Concerning its influence on the profit potentials of acquired firms, mergers produce or retain monopolistic effects that result from market power, and those, while providing for private economic gains, might be harmful to society.

When entering new markets, cross-border acquisitions might be motivated by the fact that target firms might already possess the relevant physical infrastructure and market knowledge that might not be easily accessible to a new entrant. Also, if entrance occurs by acquisitions instead of adding a new competitor and new capacity, the acquirer stands a better chance of exploiting rents that result from concentrated market structure.

Another common point to be found in the literature is that M&As would come in waves. They happen at times of market instabilities, when competition increases for reasons of overcapacity or because of building pressure to add scale that will absorb the sunk cots of new technological developments.

The drawbacks of M&As for the private party (the acquirer) include ex-ante and ex-post transaction costs, with the ex-post cost being associated with the possibilities of failure for reasons of system incompatibility and other unforeseen problems encountered in the new affiliates and new markets.[1] Here, we simply assume that the ex-post transactions costs are roughly those costs that are reflected by an acquisition's performance bellow the expectations set up before deciding to go for an acquisition.

Considerations of trade-offs between efficiency gains and welfare losses, and antitrust procedures, traditionally belonging to politics and policy makers have been recently often exposed in papers and reports prepared by international organizations and by governments. In the case of the last wave of M&As in Croatian banking, the potential gains and losses for society, and for various stakeholders, were represented by the Croatian State. The common public was less aware of welfare effects of changes that have and will occur in the market structure. Mostly, the main concern manifested in the media was related to having a large portion (over 90%) of the banking industry come under the control of foreign banking groups, and at that, having the largest portion of the banking industry controlled by banks from a single European country.[2]

Still, leaving aside welfare considerations, the immediate initiative for the M&A rests with the private investor(s) who will evaluate (with a satisfactory level of confidence) the availability of all possible gains, and those comprise financial returns that result from both efficiency gains (synergies) and from monopoly rents. Being outsiders to the process, and considering that the deals between the Croatian Agency for the Restructuring of Banks (the seller) and the acquirers were not made public, we cannot comment on the price of the acquisition and eventual risks for both parties. We are also not aware of specific social networks that might have acted in favor of bringing-in specific partners.

2.1. The European perspective

In any case, any M&A endeavor represents a situation specific business case with discrete advantages and drawbacks. The probability of an M&A happening will depend on three sets of conditions:

1. The existence of a immediate competitive pressure, rendering time a highly valued resource
2. The possibility of envisioning of the M&A as a preferable growth strategy that promises to be less time and capital consuming - Some general framework capable of increasing transparency/predictability of the process

[1] An example of ex-ante cost are costs incurred to alleviate resistance from target companies (resentments by present management, employees and owners; and in cross-border acquisition, the opposition that might be government, local authorities and public opinion.

[2] The role of the State, as the seller conducting a privatization process, was very visible, so that the motives for selling came to be questioned by the press accusing the government of giving up economic authority, hurrying for the process before the elections. That was in 1999. In the four years of Račan's (2000-2004) government the privatization process continued undisturbed. However, recently, beginning in 2003, there is some evidence the National Bank might be taking a more active role in monitoring bank activity. Also, this very spring, we were aware of a media "campaign" to reduce the market power of banks towards private citizens in order to pass a law that will disable banks to charge extensively high interest on defaulted loans. So, the effects of the sell-out of Croatian banks to foreigners are likely to be scrutinized more closely by authorities and the public in the years to come.

3. Available acquisition targets promising verifiable results (or at least results that can be anticipated with some level of certainty)

As we see it, all three sets of factors were available in the Croatian banking sector at the turn of the century.

Developments in the world banking industry in the nineties support the first condition. Merger waves and periods of intense merger activity are believed to coincide with times of intense competitive pressure and at the eve of new technological opportunities demanding (risky) investments in technological replacement and upgrading, which fits with the description of European (and world) financial markets during the nineties.

By the end of the nineties, competitiveness and costs of technological upgrading in mature markets (struggle for market share) lead the strongest banks to search for areas for expanding operations. Overcapacity and slow growth, and need to spread investments in technology over a larger scale were a strong motive for Western European banks to look for adequate acquisition targets.

But other factors also contributed. In the transition countries, there was the State as the bank owner, pressed by inefficiencies of its financial system and by budget deficits. On the other side there were the EU banks, being pushed by globalization, liberalization and the need to reposition in the common EU market. According to an ILO report, in the EU, deregulation has intensified competition by allowing cross-border new entry by financial institutions, including traditional banks, but also different types of "financial operators", all in order to secure a more integrated financial market, both in terms of providing customers with services European instead of only national banks, but also by harmonizing system regulation and inducing more transparency to protection of minority shareholders. The number of banks in the EU declined from 14 640 in 1990 to 8 820 in 1997 (ILO, 2002, p.40).[3] It is estimated that in ten years the European financial industry lost 130.000 jobs, increasing that way efficiency but also adding to the work loads of the employees remaining (Weber, 2000, p.7).

At looking for expected paybacks from M&As, three features can be distinguished:

1. Gains from higher market concentration – lowering of competitive pressure and space for higher operating margins,
2. Cost-cuts achievable through business rationalization/reorganization (re-division and re-specialization inside the banks and banking groups. Part of the cost savings from reducing capacity can be seen through cuts in excess personnel and reduction and restructuring of the number of branches,
3. Spread of sunk cost in investments undertaken to develop new products, new process know-how and to build new infrastructure, especially internal information systems and e-banking.

The know-how acquired in predicting developments in global and unified Europe's markets, as well as product and process know-how, were easily transferable to analysis of the market potential of selected target banks in transition economies.

[3] The figures refer to Koskenkyla's paper, Threats and Opportunities for Today's European Banks, 2000.

An additional advantage, considering that interest rates for most products are higher in transitional markets than in the EU, was that as big, reputable companies - the acquirers from the EU, could raise capital in domestic markets at a lower rate and then employ in high yield loans to transition economy customers (through local banks).

Furthermore, there is enough space for broadening traditional loan markets, lending to markets and private citizens, for further developing mortgage loans, and for attracting some deposit/investment potential from households that still keep large shares of their wealth for personal consumption and investment in non-financial products assets.[4]

2.2. The Croatian banking industry – a history of government involvement

The development of the contemporary financial sector in Croatia can be traced back to its socialist period. In general, the socialist era was marked by simple and shallow financial markets, serviced primarily by banks extending credit lines to business and individual citizens. The banks were organized as regional financial services, usually established by most of the largest regional firms. As a regional bank, the purpose of a bank was to serve the local economy, to distribute credit to business and organize *retail banking*. Same as in the real sector, also in the banking sector, top management was appointed in consent with (regional) government. Also, it could hardly be said that banks run an independent business policies, since most business issues were "agreed" (and regulated by industry level documents SAS's and DD's, the so-called "self-governing agreements" and "social pacts"), while local politics intervened in directing credit lines. Up to some point, it can be said that it was the policy towards citizens, that is retail banking, that represented the part of the banking business that most resembled western practices.

With the beginning of transition, the government declared its intent to strengthen and widen financial markets and to liberate the financial sector so that it may eventually replace the role of the State in administering efficient concentration and efficient (adequately informed and economically responsible) distribution of capital. The liberalization intents were demonstrated by a rather liberal policy towards the formation of new banks (see Table 1). It should be noted that the biggest of all reforms, the privatization of the self-governed enterprises at the beginning of the nineties, was planned with the belief that it would contribute towards the development of capital markets as an alternative source for new capital raising. Throughout the nineties a weak banking-financial system was being indicated as one of the reasons behind the decline of the real sector, which, without a possibility of raising investment capital, could not restructure to new market needs.

Two periods, in the recent, transitional, history of the Croatian banking industry, can be seen as turning points in the government policy towards the Croatian banking sector (Jankov, 1999):

1. The1991-1996 crises – low responsibility level (banks over-lending, low capital adequacy, "crony"- capitalism) forced the government to provide "*consolidation*" programs by allowing some banks to go bankrupt and

[4] For example, Nicastro et al. (2002) report that the ratio of net loans over GDP in transition countries, for example Croatia at 49% in 2000, is quite low compared to EU markets at 170%. Also, the banks studied as M&A cases plan their across-border acquisitions in CEE counting on the still available market space representing a one-time opportunity.

refinancing the others, among which were the 4 biggest banks, including Zagrebačka and PBZ.

2. The 1998 crises – With general economic conditions deteriorating, and faced with slow growth, the government saw the economy faced with low-liquidity, and generally not enough free capital to support restructuring and investment in the real sector.

The first crises of the banking sector (by the State) coincided with the liberation war. In fact, part of the inefficiencies of the banking sector can be attributed to problems caused by the break-down of former Yugoslavia and by the following war. During the war, the banking sector and especially larger banks, operated in tight correlation with the government in order to keep the more or less "normal" functioning of the economy and to contribute to the war effort.[5] By the end of the war, the banks needed to be rehabilitated: financially restructured, liberated from "bad debts" and recapitalized in order to be "prepared" to act independently and function on market principles.

Three big banks, Privredna banka being one of them, underwent government restructuring programs. The restructuring program included four basic points: 1. bad loans were transferred from banks to a government agency, 2. *recapitalization*, 3. the government became the major shareholder, immediately announcing its intent to privatize restructured banks (sell them to foreign strategic investors), and 4. new management was established.[6]

But very soon after the financial rehabilitation, in two years, came the second crises, which manifested itself in the falling of capital adequacy of banks. The problem that now became more apparent was the problem of enforcing financial discipline, which partly derived also from the fact that the State could not cover its liabilities in due time, partly because of the costs incurred for restructuring the financial sector.

This situation led to the acceptance of the fact that foreign strategic investors might serve as a remedy for several central government problems. Foreign investors would compensate for budget deficit problems, they would provide a new flow of investment capital[7] to support economic growth, and last, but not least, new owners will bring

[5]Bokros among others stresses the fact that banks were forced into converting under-performing credits into illiquid portfolios of corporate equity (Bokros, A Perspective of Financial Sector Development in SEE, p.13) However, in the case of Croatian banks, part of this portfolio, especially the hotel industry, has the potential of representing a valuable holding nowadays.

[6]Many problems encountered by Croatia are similar to problems, and solution, in other transition countries. S. Fries and A. Taci: Banking reform and Development in Transition Economies, refer to similarities seen as a result of all countries following the advice of the IMF and WB and the so called Washington consensus that called for liberalization and for restructuring and privatization of the banking sector. Edda Zoli (2001, p. 11-13) points to government bailouts performed to lift the burden of non-performing loans inherited from the socialist period, and made worse by the hyperinflation at the beginning of the nineties. She estimates that the fiscal costs of the banking sector reforms in some transition countries, namely Bulgaria (1991-94), Czech Republic (1991-93) and Hungary (1992-93) mounted to 58%, 67% and 40% of GDP, respectively. Because of the weaknesses of this early nineties consolidation programs, Zoli estimates the total costs to be still higher. Estimate for Croatia (Škreb and Šonje, 2001 and Jankov 2000) are around 30%.

[7] According to the data published by the National Bank and in order to get a felling of the importance of these transactions, it must be said that in the year of 1999 when also banks were being sold out to strategic investors, FDI due to purchasing shares increased to 1284 mil. USD which is about twice the amount in 1998, and each of the years since. It must also be said that retained earnings as the other part

technological know-how (and ownership authority) to finally efficiently restructure the banking industry.

As can be seen in table 1, policy and politics influenced significantly the market structure of the banking industry.

Table 1

BANKING INDUSTRY MARKET STRUCTURE

Number of banks, market share and foreign ownership 1993-2003 (end of year)

	Number of banks (foreign ownership in parenthesis)	Two (four) biggest market share in %	Foreign majority ownership% of total industry assets
1993	43 (0)	-	-
1994	50 (1)	-	-
1995	53 (1)	54 (68)	-
1996	57 (5)	46 (60)	1,0
1997	60 (7)	40 (53)	4.0
1998	60 (10)	41 (53)	6.7
1999	53 (13)	44 (58)	39.9
2000	45 (20)	48 (62)	81.4
2001	44 (24)	46 (60)	89.3
2002	46 (23)	44 (59)	90.2
2003*	46 (20)	43 (61)	90.8

*September 2003. Note that in June 2003 Zagrebačka banka group acquired Cassa di Risparmio di Trieste and in May 2004 Varaždinska banka. Also Riadria banka has effectually become part of the PBZ Group on 01.01.2004. There was also one new entry (foreign), so that there should probably be 44 banks in Croatia by the end of 2004.
Source: Croatian National Bank – http:/www.hnb.hr/publikac/hbanking-sector.pdf

The years to follow, from 2000 up to the present, were the ones of market consolidation, marked by the internalization of the Croatian banking industry which included the acquisitions of the two biggest banks PBZ (1999) and ZABA (2001) by two Italian bank groups: Grupo IntesaBCI and UniCredito Italiano. As can be seen from table 1, foreign entry before 1999 was by foreign banks establishing new branches in Croatia. Acquisitions, both across border and on the national market had become dominant factors in forming market structure only since.

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of FDI started growing since, so that in 2003 at a level of 670 mil. USD they surpassed, for the first time, the amount of FDI that went into strategic and portfolio investments (608 mil. USD)

By 2004, over 90% of the Croatian banking industry capital is under control of eight foreign banking groups. In spite of private ownership, the role of governments has remained strong but less direct. At this moment, government presence is felt mostly through the demands on banks imposed by the regulatory-supervisory authority, The Croatian National Bank, and through new legislative, which we believe is likely to be shaped towards directing bank lending policies so as to protect national economic interests.

The general impression is that two common points dominate the transitional history of Croatian banking, and both were especially visible during the mentioned crises periods:

1. Strong governmental involvement in shaping the market structure and the developmental path of the banking industry and the financial sector in general
2. All major actions were related to some macroeconomic goal.

The implications relevant to our analysis of M&As' efficiencies are that ex-ante and ex-post cost will be strongly influenced by ex-post developments and the acquired bargaining positions of the two "strong" partners: the government and the foreign bank owner. Ex-post cost will be at least as dependant on parties bargaining power as were the ex-ante cost. However, the costs of entry were alleviated by the urge of both parties to conduct the transaction in a relatively short time interval. The extended time dimension of the post transaction period might therefore prove to be least transparent factor affect the total transaction cost, yet still, dominant in influence.

We believe that present power relations will evolve mostly depending on political circumstances, especially time passed before joining EU. Accordingly, the broader macroeconomic conditions and policy, including the size and treatment of the growing budget deficits and foreign dept, will have the strongest impact on the future "bargaining" positions of parties. Consequently, ex-post cost are hardly predictable.[8] Acquisitions that might have been once looked upon as relatively low risk purchases (see for illustration the case of Riječka banka), with terms favorable to the buyers, might eventually evolve into partnerships or into hard bargaining positions among Croatian government, Croatian business sector, Croatian citizens on one side and the acquirers, managers and employees on the other.

However, the case studies explored in our paper suggest that the financial performances of the banks acquired by foreign banking groups have so far been financially sound.

3. Case studies

Privredna banka, Zagreb and Zagrebačka banka, Zagreb represent the two biggest Croatian banks. Together they account for over 40% of the banking industry asset value. Even though the joint market share of the two banks actually fell after the M&As, on banking group levels, the market share of the two banks increased again after new acquisitions.

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[8] The risk of similar considerations to the government (national economy and bank clients) is that the new owners might try to recover the investment to soon, or that they may become restless in case of falling performance indicators, and give up on further improvements and investments, that would otherwise prove efficient.

Same as in Europe, nowadays, leading Croatian banks operate in banking or financial groups much according to the organizational-ownership models. Zagrebačka banka is the head bank of the Zagrebačka banka Group and Privredna banka is the head bank of the Privredna banka Group. In Croatia, banking groups have evolved gradually during the nineties as part of the process of market consolidation and development.[9] Today they generally constitute of banks and other financial institutions and services, showing so far mild interest of moving into other business areas.

3.1. Privredna banka Zagreb (PBZ)[10]

Privredna banka is the leading bank of Privredna Banka Group (PBZ Group) which is itself part of the largest Italian banking group (third in Europe), BankaIntesa BCI, from the beginning of 2000. The ownership is divided among The Intesa Group (75%), EBRD (20%).

Privredna banka was founded in 1962. In 1996 it was consolidated (financially restructured) by the Croatian government, which, by recapitalization became the ***controling*** shareholder. PBZ was the first big bank to be privatized by the Croatian government after the consolidation program, so that BankaIntesa BCI acquired a majority stake in PBZ during December 1999 and in early 2000 PBZ Group became a part of the BankaIntesa's Foreign Banks Division.

PBZ has traditionally been a bank more oriented towards corporate clients.[11] The same orientation is also evident with its acquirer Banka Intesa.

Today, the PBZ Group covers a range of financial businesses, involving banking, credit cards services,[12] leasing, real estate, fund management and brokerage. In cooperation with Croatia osiguranje, the largest Croatian insurance company, it also offers pension fund management. Apart from the Croatian market, PBZ is active, through PBZ American Express also in Slovenia (fully owned by PBZ) and FYR Macedonia (95% ownership). PBZ is also considered a technological leader in retail banking in Croatia, offering the service m-pay (payment of bills over a cellular phone) to its clients.

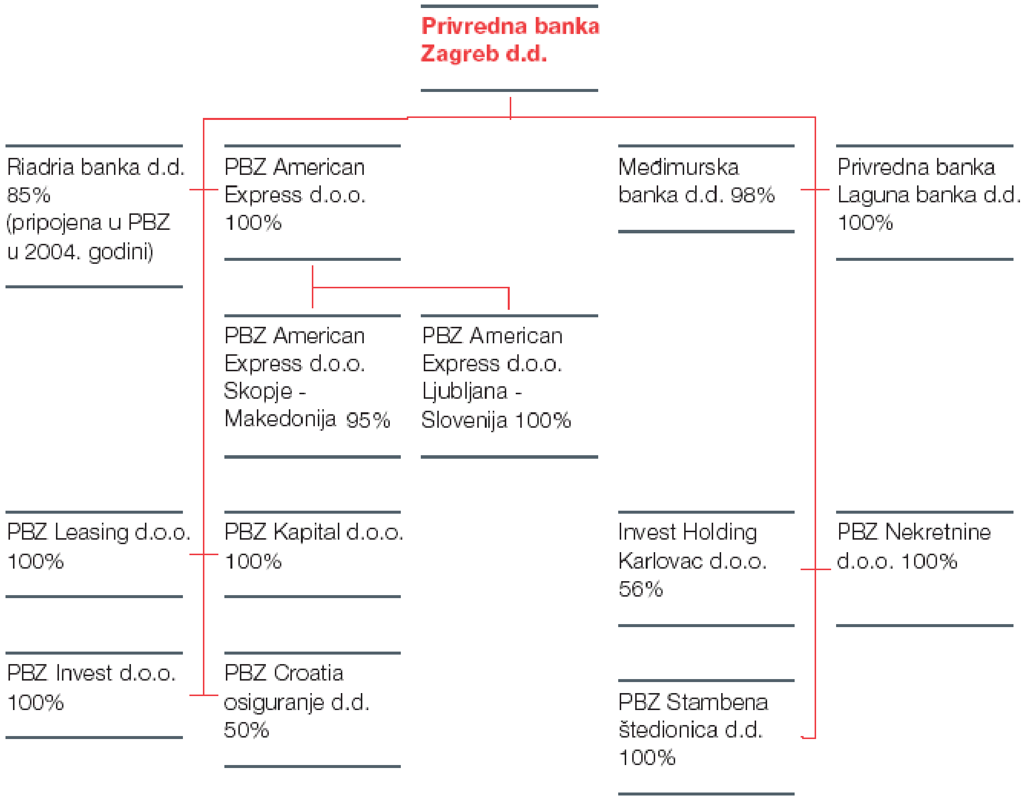
[9] Starting with June 2003, the leading bank or the leading financial institution of the group is responsible for supplying the Croatian National Bank with joint financial statements twice a year. (Still, according to the CNB only four banks did supply the required statements. (BOB, no. 7, p.12) These statements make the banking industry transparent for analysis making our research possible. For other industrial sectors, and other M&As, it would be very hard to extract some relevant figures.

[10] Most information for Privredna banka was extracted from its annual financial reports and Company Profiles available through the web.

[11] Even though Croatian banks are general purpose banks, not specifically specialized to serve certain customer types, or towards certain services, there has been a historical tendency from communist times to establish banks on the regional basis, so that regional banks drew most of the retail banking, for example Riječka banka serviced mostly the region gravitating to Rijeka, Splitska bank served the Dalmatian region and Zagrebačka banka serviced mostly the Zagreb region (even though it has become more national in reach during the nineties). Privredna banka, on the contrary was established as a bank oriented towards business and industry on the national level, being most exposed to the export sectors and government servicing. Today, its main industrial clients are in the food and beverages, processing industry, trade, production of vehicles and public administration.

[12] Privredna banka is the owner of American Express license for Croatia (an acquisition from the mid nineties), which, in Croatia, has the largest number of clients in the banking cards segment of the business.

PBZ Group



The chart suggest that PBZ as a major Croatian bank has followed the general trend in European and world markets during the nineties. Besides showing organic growth by investing in its primary markets, it has autonomously established new businesses (investment funds, leasing, real estate...), acquired others (Međimurska banka, Laguna banka, Riadria banka, American express) and formed partnerships (entered the insurance business through a joint company with Croatia osiguranje).

Once acquired by Intesa,[13] the internal organizational structure generally remained intact. However, some operational improvements, which might otherwise have taken a longer time, were accomplished. Two major organizational upgrading processes include a CRM System for retail banking and the adoption of Group IntesaBci standards for business and corporate governance. These suggest that the technical dimensions and eventual synergies as motives for integration are also an important part of the integration process between parent company and acquired.

Most internal organizational arrangements and labor relations seem to have not been substantially altered by the acquisition. Top management remained in position, including the president of the board. As PBZ showed significant growth, there was no need to dismiss workers, so for the time being there had been no social tension. As PBZ reports, they follow a policy of "staff retention" and of "professional" education.

[13] Gruppo Intesa, itself resulted from a merger process. In 1998 several Italian banks merged and the Intesa Group became one of the largest European banking groups.

On-the-job organizational changes mainly derived from a new line of products and new accounting and supervision standards that will also be shortly presented in this paper.

Consequently, socio-cultural issues of the acquisition have not been a problem so far. Probably because of the continuous growth shown in the post acquisition years, so there were no problems that might have been cause by some drastic restructuring or downsizing. In fact, the number of employees even grew slightly, both for the bank and the Group, which today employs 3,766 (2,866 PBZ Bank). At the present, the relationship with BankaIntesa appears to be successful for both parties.

Employees did receive heavier workloads and had to cope with growing job complexity, having to master the new products and procedures. As can be seen from the table, productivity, expressed as assets to employee ratio, has increased, and so did the number of products and clients. Still employees' loyalty was kept by establishing a system of bonuses to managers and employees that in 2003 was worth 22.7 million kunas.

New products and services that could probably not be developed without the assistance of Banka Intesa include a Liason Desk in Italy for clients doing business in Italy and Croatia, Internet banking for corporate clients, etc. In 2001, Privredna banka group achieved its best financial results in history, at 24.8 % ROE and kept it at the same rate in 2002, falling to still high 19.7 in 2003 as can be seen in Table 2.

Table 2 **PBZ PERFORMANCES (1999-2003) in million kunas**

PBZ Group	**1999**	**2000**	**2001**	**2002**	**2003**
Total revenues	1,997	2,277	2,800	3,321	3,564
Net interests' revenues	556	915	1,096	1,419	1,492
Net operating revenues	1,373	1,575	1,940	2,264	2,424
Net profit	198	406	581	641	695
Total assets	17,188	22,309	31,473	34,917	42,441
Total employees' cost*	-	-	-	505	544
Net wages*	-	-	-	237	257
ROE (in %)	9.74	17.74	24.77	24.76	19.65
ROA (in %)	1.15	2.00	2.16	1.90	1.77
Assets to employee ratio	4.4	6.2	8.5	9.5	11.3
Operating costs to revenues ratio (in %)	62.41	58.52	56.96	58.59	56.93

PBZ Bank	**1999**	**2000**	**2001**	**2002**	**2003**
Total revenues	1,680	1,909	2,230	2,606	2,777
Net interests' revenues	499	687	754	1,012	1,268

Net operating revenues	1,112	1,275	1,480	1,684	1,767
Total employees' costs*	-	-	-	383	406
Net wages*	-	-	-	176	187
Net profit	221	379	517	530	575
Total assets	15,736	20,574	27,600	30,536	37,505
ROE (in %)	10.91	17.53	24.33	21.52	17.85
ROA (in %)	1.40	1.82	1.90	1.80	1.66
Assets to employee ratio	4.8	6.9	9.6	10.8	13.1
Operating costs to revenues ratio (in %)	57.82	52.57	53.38	53.86	53.37

Source: PBZ Company Profile (in Croatian language), 2004, p.10. p.54 for rows marked by an*

As can be seen from the table, of efficiency measures have been showing growth. Also market share has grown, partly due to new acquisitions by the Group. In 2004, due to a new acquisition of RiAdria banka in 2003, its market share in the Croatian banking industry rose to 21%.

PBZ has develop faster than its main competitor on the Croatian markets and it has, so far, met expectations in contributing towards improving the profitability targets of the Intesa Group.[14] But, the good results of PBZ can be partly attributed to a favorable market structure. The other part, and it is hard to establish how big, derives organizational developments, which might be correlated, up to some point with PBZ becoming part of the Intesa Group.[15] There are some similarities between the acquirer and the acquired company, but they may be due to factors existent prior to the acquisition. For one, both have a traditionally strong orientation towards corporate clients, and both companies are and have been technological and market leaders in their national markets. These might mean that similar organizational cultures might have helped ease up the post acquisition adaptation.

Still, we suspect that the absence of ex-post disillusions is primarily due to PBZ meeting the performance targets set by the acquiring company.

Eventual problems might, however appear as the partnership develops in time. Those include primarily potential conflicts among growth strategies between parent and dependant companies. The PBZ Group is a rather small part of the Foreign Banks Division, which, along with the Corporate banking Division, the Italian Banks Division, the Retail Division and the Products Companies,[16] makes up the Intesa Group. Therefore, PBZ is not strategically important for the group in the long run.

According to its Business Plan Draft (2002) the capital allocated in the Foreign Banks Division is planned to diminish in the period 2003-2005 from the 2,031 million euros in 2001 to only 770 million euros in 2005. By 2005 Intesa will totally withdraw from the Latin American market (its Sudamaris Group) in order to increase the capital

[14] In fact, in Italian banking, faced a crises since 2000, 2004 is expected to be the year of recovery.
[15] PBZ has been the second biggest Croatian bank even before the acquisition.
[16] Intesa's Product Companies involve companies for Asset Management, Leasing, Factoring, Corporate Lending, Payments System and Tax Collection.

available for investing in Italian companies and foreign companies operating in Italy.[17]

The remaining Eastern European part of the Foreign Banks Division, consisting of three already controlled banking groups (Croatia, Hungary, Slovakia) and Turkey as a new acquisition, are expected to generate an operating profit of 400 million Euros in 2005, at 770 million of allocated capital. In the same year, the whole Intesa Group is expected to have over almost 12.5 billion euros allocated among the five divisions, plus an additional 870 million for Central Functions. (see Table 48, Results by Divisions, p.113). Extensive centralization might also pose one of the reasons for future disputes, not only on profit distribution among subsidiaries and headquarters, but also on extension of autonomy over investment priorities. For example, Intesa plans to concentrate corporate banking in Italy, forming eventually an autonomous bank for corporate banking, while other divisions are expected to concentrate on retail.[18] Also, future organizational alignments, ICT investment, market and product development issues might be viewed differently in Zagreb and in Italy.

Concerning operational issues, all parts of Intesa Group are expected to further improve efficiency by effective cost management and better operating performance. However, extensive rationalizations, apparently not needed at the moment,[19] might produce organizational conflicts in the future, especially once East European markets are more penetrated, the competition becomes stronger and the profit levels drop. So far, as long as there is space for organic growth on part of the companies acquired in East Europe, relationships between acquirers and acquired are likely to continue peacefully.

[17] To quote a sentence from the Business Plan 2003-2005, p. 23: "The strategy is to increase the percentage of assets (and therefore of capital allocated) invested in Italy. Assets outside Europe will dramatically decrease while assets invested in Eastern Europe and in the Mediterranean area will grow slightly."

[18] The bank's policy to concentrate corporate banking in Italy might be part of its strategy to increase equity holdings in the non-financial sector. As Bianchi, Bianco and Enriques (1997; p. 9-10, 22-24) note that since 1936 to 1993 the Bank of Italy's policy was favored separation of banks from manufacturing firms, with the latter often operating inside pyramidal groups. Following EU harmonization of the Banking law, constrains have for banks holding shares in non-financial firms been lifted. At the time their paper was written, the authors found that banks were slow to take advantages of the new investment possibilities, except in the case of debt-equity swaps. However, the situation might have changed since.

[19] Employment has remained stable at PBZ while the whole group reduced employment in order to cut labor costs. So far, performances in terms of cost per income have been better at PBZ than in the rest of the group. Also, productivity per employee has been growing steadily. In Italy, for BCI, labor issues seem more acute. The ratio of labor costs to total income was 32,2 % in 2001, and expected to be reduced to 28,3% by 2005 (ibid, p. 84) and industrial relations are among the topics explicitly mentioned in Intesa's Business Plan.

3.2. Zagrebačka banka

Zagrebačka banka (Zaba) shows a similar general picture as PBZ. The privatization of Zaba occurred two years after the privatization of PBZ, for similar reasons. In 2001, another Italian banking group, the UniCredito Italiano (UCI)), acquired Zaba by buying 81.91% shares, while another 13.67% are held by the insurance company Allianz AG.[20]

Zaba is still the largest bank in Croatia, but PBZ is catching up on many performance indicators. Same as PBZ Group the Zaba Group also includes other banks in Croatia and Bosnia and Herzegovina (Varaždinska banka, Prva stambena štedionica, Zagrebačka Banka in Mostar, fully or partially owned companies for asset management, real estate, insurance, fund management, companies in the hotel and catering business and a shopping center).

As a Central bank in the Group, Zaba, even though being a general commercial bank, is, by tradition, more oriented to the retail sector than PBZ. In fact, Zaba is the biggest retail banker in Croatia with 1,7 million clients, holding one third of the market, i.e. 31% of deposits and 25% of loans. By developing new credit products, during the year of 2003, Zaba has been able to increase loans to citizens by 30% (short-term and mortgage), and to corporate clients by 15% compared to 2002. Net revenues from interests increased by 25,6% compared to the previous year and today, at 1,926 million kunas, they make up for 58,8% of the total revenues.[21]

Zaba has been the market leader in developing direct distribution channels, and it is presently the bank with biggest number of direct distribution channels. In transactions with citizens, automatic teller machines, POS terminals, telephone and Internet banking account for 60 % of transaction, contributing significantly towards cost reductions. Further rationalization (cost reduction) was achieved by reorganization (new divisional organizational form) and technological improvements that led to a reduction of 32 million kunas in operating costs. Half of the amount was saved by a reduction in personnel.[22] The rest came by reducing the administrative costs and because of reduced losses from currency changes.

In general, same as PBZ, Zaba has improved its performance after the acquisition, without being exposed to any significant social costs.[23] Part of the financial success can be credited to organizational rationalization and the other to deeper market penetration. Secure growth, even though slower than PBZ, secured jobs and allowed for a continuation of the policy of labor retention and rehabilitation. In fact, having a flexible work-force has been one of the explicit goals of the company.

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[20]When acquiring Zagrebačka banka, UniCredito had to sell its stakes in Splitska banka to meet Croatian antitrust authorities' conditions.

[21] On average, Croatian banks collect 70% of their revenues from interests, even though there is a drive among major banks to diversify through investment funds and by offering a larger scale of financial products.

[22] The bank employs 3,800 people and the Group 5.500.

[23] According to the Croatian National Bank, despite the rationalization that pushed up labor efficiency, the number of employees was able to grow slightly for the whole banking sector, so increasing from 17,126 in 2002 to 17,377 in 2003. The rate of growth has been most pronounced with the largest banks, where due to extensive loans placements, the average level of assets to employee reached 11,6 million kunas. (BOB, no.7, p. 31)

Table 3 **ZABA PERFORMANCES (1999-2003) in million kunas**

Zaba Group	**1999**	**2000**	**2001**	**2002**	**2003**
Total revenues	2,089	3,145	2,673	3,099	3.277
Net interests' revenues	942	1253	1509	1533	1926
Net operating revenues	895	1396	848	1115	1295
Net profit	285	977	464	750	832
Total assets	28,748	37,196	47,772	53,695	58,617
Total employees' cost	638	814	875	923	913
Net wages	-	-	-	-	-
ROE (in %)	9,38	28,76	12,52	18,46	17,91
ROA (in %)	1,24	3,28	1,42	1,97	1,86
Assets to employee ratio	4,49	5,64	8,24	9,11	10,66
Operating costs to revenues ratio (in %)	67,20	55,61	68,12	64,00	60,48

Zaba Bank	**1999**	**2000**	**2001**	**2002**	**2003**
Total revenues	1680	2395	1982	2200	2418
Net interests' revenues	929	1167	1281	1533	1926
Net operating revenues	881	1294	683	813	1092
Total employees' costs	502	605	640	691	675
Net wages	-	-	-	-	-
Net profit	304	939	387	592	729
Total assets	27,406	32,453	41,079	46,039	49,403
ROE (in %)	10,01	27,70	10,63	15,24	16,83
ROA (in %)	1,43	3,37	1,40	1,70	1,86
Assets to employee ratio	-	-	9,78	11,23	13,00
Operating costs to revenues ratio (in %)	54,64	45,97	62,81	63,31	54,83

Source: Annual Reports

Part of the expansion of Zaba in the retail business has also been accomplished with the use of syndicated loans. Finding that domestic deposits were not sufficient to fuel the growing demand for mortgage and other personal loans, Zaba has turned for fresh capital to European bankers, thus creating an additional supply of capital that allowed

Zaba to obtain a faster market spread.[24] This too is a form of efficiency that can be credited to the acquisition by UCI. We suppose that a continuing row of favorable financial results in the years to come will also reflect that the sole fact of belonging to a more recognized banking network has lowered input costs for Zaba.

Still, the highest value of synergic effects that will have a fundamental role in increasing the efficiency of Croatian banks are expected to come from know-how transfers and enhanced possibilities to develop at a similar pace as western counterparts. In those terms, if the acquired banks would stand a better chance of adopting contemporary standards of risk management and systems of internal reporting and control mechanisms, after a decade or so, we will be able to comment on what model of entry/growth proved most successful to investors and to other interested parties. These processes, however, (for instance, implementing new reporting standards) take a longer time and require systematic organizational development and process change at the operational level, but also in managerial procedures. Another moment to be taken into consideration is that these processes are less visible from the outside and therefore more complicated to analyse along the way. So, in part four, we just delineate some aspects the entire (extricate) process.

A step forward for Zaba in that matter comes from the perception that, judging by company reports, UniCredito has redefined its organizational structure in order to strengthen group identity and operational efficiency in a more integrated system. The 2002 Changes in the organizational structure of UniCredito,[25] place Zaba inside of the New Europe Division (Bank Pekao in Poland, Zagrebačka banka-Croatia, Bulbank-Bulgaria, Unibanka-Slovakia, UniCredit Romania and new acquisitions planned in The Czech Republic and in Turkey), which, along with other three divisions for Italy: the Retail Division (for Italy), the Corporate Division and the Private Banking and Asset Management Division represents the Business Division.[26] The role of the New Europe Division is defined as promoting and managing the retail and corporate banking operations in CEE markets with the "goal of maximizing UCI Group value, adjusted for risk-related costs and becoming a leading banking group in New Europe." The Division is also expected to support banks in the planning process, implementation of organizational change and information technology development projects, in management controls and in the implementation of new working methods.

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In comparing the two banks as to their position inside their acquiring banking groups, it appear that the level of integration is not too extensive, with perhaps a little more integration efforts being expended in the case of UCI and Zaba. As to PBZ and Intesa, PBZ is showing higher immediate returns than Zaba, but plays a marginal role in the Intesa Group. This opens the question of long-term developments of the relationship between acquirer and acquired. As Capron (1999) points out, target companies are more likely to be burdened by post acquisition asset divestitures. In the case of the

[24] Timing plays an important role and that banks are keen to penetrate the markets as fast as possible in order to reap rents while interest rates are still high and loans, especially in the retail sector, still well secured.
[25] UniCredito Italiano S.p.A. Reports and Accounts, p.225.
[26] Business divisions are opposed to the Head Office Departments serving all four business divisions.

two Croatian banks studied in this paper, this is not likely to occur as long as East European banks are generating profits. But, as soon as profits drop, a struggle will begin to prevent a flight of capital from Croatia to the parent companies, and concerning the strategic importance of the banking sector to the national economy, it is likely that the Croatian government, and not only managers and minority shareholders (here, almost non-existent), will become a source of instability to the parent companies increasing post-acquisition costs.

4. Supervision procedures – the real case for efficiency gains

One of the areas where eventual integration synergies are most likely concerns the processes of knowledge transfer. Up to the extent that the newly acquired banks will be capable of quickly assimilating more efficient business practices and procedures, their profitability will keep stable, even after the effects of market power erode. Unfortunately this area is not so open to observation by outsiders. So, here we just offer a few notes to stress the importance of supervisory procedures in supporting good acquisition performances.

A special role in the process belongs to managerial and supervision procedures. Changes in supervision procedures also represent a single main domain of organizational and process changes that will influence bottom-level organization (job content) and hierarchical structure (staff functions at different organizational levels and capacity for autonomous innovation). Generally, supervisory procedures are classified in two groups, internal and external.

The internal supervision is performed inside the bank, carried out by the bank's employees. Its purpose is to help in decision-making and to advancing the bank's efficiency. Internal controls consists of internal controls and internal audits, where internal controls represent procedures built into the work process and aimed at achieving supervision goals such as: providing timely information, asset protection, preventive action, uncovering fraud... Methods of internal controls are part of an important institutional know-how that, though the process of acquisition by stronger and methodologically more advanced banks is likely to be transferred to Croatian affiliates. Important elements of internal controls include especially methods of risk assessment, and other preventive, detective and corrective activities. Internal audits establish as an independent internal service function further contribute towards achieving managerial control. Their role, as a professionals and analysts, is also to initiate proposals as to the possibilities of improving all business areas.

Audits performed by market specialists on behalf of shareholders/investors have also become a practice, especially in the banking industry during the last decade, so banks audits are one of the most important businesses for subsidiaries of large international auditing and consulting firms. Still, there where some cases were internal controls proved faulty, in spite of foreign ownership, as in the case of a mounting trader's dept that escaped management perception in Riječka banka.[27] An explanation for why this case happened would be that Croatian banks were "forced" to quickly enter business they had little or no experience in and organizational habits and procedures need time to change and that in that specific case, the reorganization has not yet reached performers at lower levels. By becoming parts of more advanced banking systems,

[27] Riječka banka was at that time owned by Bayerische Landesbank from Germany and is now part of Erste Bank Group from Austria.

with more experience and already developed control procedures, such unfortunate events (misjudgments and deliberate fraud) would probably not happen so easily, leading us to conclude that major efficiency gains for Croatian banks, but also to their acquirers should be expected precisely through the willingness of the acquiring banks to transfer their organizational know-how, since the savings so achieved would eventually reflect in their own profits.

Changes in supervision procedures are in fact occurring not only internally, but at two interrelated levels; besides the internal business systems changers are being introduced inside the national regulatory framework.

The Croatian National Bank (CNB) and the State Agency for Deposit Insurance and Bank Rehabilitation are two institutions responsible for the stability of the financial sector. Their role and methods have been developing during the nineties, especially following the already mentioned banking crises, when, as Škreb and Šonje[28] (2001) report, the CNB initiated bankruptcies or revoked licenses for 22 deposit-taking institutions during the period of 1997-2000. The costs of resolving the banking crises only increased because of problems of control and information asymmetries. Škreb and Šonje refer to the various lags in perception and reaction, resulting in problems that are attributed partly to the behavior of banks, that is, "inadequate accounting standards in banks, lags in reporting data from banks to monetary authorities, deliberate fraud that hides real numbers in banks, lax commercial-audits, ill-defined or un-enforced reporting requirements...", and partly to the insufficient capacity of the monetary authorities, lack of human capital, adequate organization and supervisory methodology, mixed incentives to intervene in the crises and start bankruptcy proceedings. The visibility of the control problem at such high instances is already being reflected in more demanding procedures for reporting to monetary authorities and shareholders-financial markets.

The Central Bank is continually revising the accounting standards for banks, since the Croatian Accounting Act prescribes a minimum number of items in the balance sheet and profit and loss statements. Furthermore, disclosures rules require that all information about financial instruments should be visible in the bank's financial position. These include information on terms and conditions relevant to financial instruments, interest rate risk (reprising and maturity dates, fixed and floating interest rates, maturities), credit risk (maximum exposure and significant concentrations), fair values of financial instruments, assets below fair value and hedges of anticipated transactions.

Also, the EU strongly supports efforts to harmonize accounting practices. The growing interdependence of international financial and banking markets need transparent and comparable published financial statements. Principles defined in Second Banking Directive and other EU directives will become valid in Croatia with its' entering into EU. In this way Croatian banking system will become fully open for the banks from other member states and Croatian banks will get the opportunity to provide services in the whole territory of the EU. Those principles that are already entering into Croatia have consequences on banking supervision that is becoming harmonized with Basel's requests.

New Banking Act in Croatia enacted in 2002, four years after previous act, is important step in the implementation of International Accounting Standards. Fair

[28] Marko Škreb was the CNB governor at the time their paper was published.

value measurement issues particularly arise in relation to certain non-marketable assets and liabilities previously held at cost. In the absence of active markets, like in Croatia, there are difficulties in obtaining or calculating reliable fair values.

So, when we look at the role of supervisory procedures and their influence on the performance of M&As, one of their main contributions is through speeding up the efforts for making business activities more transparent. Not only to potential investors and the broader public (and here, once again, we find their interests aligned), but to concrete parties in the deal, the buyer and seller, more transparency means gains valuable in terms of transaction costs saved.

To the acquiring party, the Italian banks in our two cases, sound internal controls are a incentive to implement more precise organizational procedures with expectation that clear rules should eventually contribute towards lowering portfolio risks and towards increasing cost efficiencies. To the seller, that it to the Croatian government interested in the functioning and stability of the financial sector, evolving supervisory procedures and more standards increase the possibilities of early detection of banking crises (and/or macroeconomic risks), so that they may take timely counteraction. Finally, to the point that know-how gets transferred inside the banking system it is likely to spill-off to the banks' clients, especially corporate ones, contributing towards the sounder functioning of the whole economy.

5. Concluding remarks – a TCE perspective of M&As in Croatian banking

The level of organizational integration of the Croatian banks acquired Western European banking groups is not too explicit so far. Even though it is still hard to document for operational synergies, the largest efficiency gains are expected to occur through the process of knowledge and process transfers. For the moment, the good post acquisition performances probably result from temporary market conditions, both on the domestic markets of the acquiring firms and in the Croatian national banking.

As far as strategic synergies go, the acquisitions of Croatian banks by foreign banking groups might be classified as harvesting strategy targeted at reaping one-time profits available at markets not yet fully developed. Further developments in the relationships between parent and dependant companies are likely to evolve depending on the development of the general market conditions, primarily in the domestic market of the acquirer, second, in the "new division" compared to alternative opportunities in world markets.

We do not believe that motives of acquirers have been along the line of evaluating investments against gains from enhancing operational efficiency, but rather more along the line of using the acquisition as a mean of penetrating a profitable market of relatively lower risk, especially at the time when the traditional market was bellow expected performance levels.

This renders the situation interesting to be analyzed from the transaction cost approach, envisaging the longer-term perspective. The parties negotiating the acquisition are believed to have been more interested in the ex-ante side of the transaction cost. Synergies that might be significantly partner specific, thus creating a strong mutual dependence, are still expected to evolve, probably after strategic activities (value adding staff functions) become more centralized, and internal vertical and horizontal coordination channels more visible.

We also see the conditions facilitating cross-border M&A in the pre-acquisition period, and so reducing the impact on ex-ante costs, supporting our view.

In general, it can be said that extremely favorable overall circumstances acted towards reducing ex-ante costs of cross-border M&As in the banking sector. Those can be qualified into several categories: 1) interested (willing) seller with clear ownership stake and adequate motives, 2) relatively transparent market structure (oligopoly) attractive to buyers pressed by their own "domestic" problems and in search for opportunities to raise scale, 3) relatively high profitability and shallow markets adaptive to technology transfers with enough space for new product launching, 4) labor issues not likely to get aggravated considering enough space for market growth extensive, 5) relatively developed organizational culture and acceptance of western style accounting systems

The problem, requiring a more detailed study, is to predict how (and for how long) the relationship will evolve, meaning that ex-post costs are not fully estimable, but will certainly be related to:

1) Performance above or bellow expectations due to integration problems
2) Performance bellow expectations due to outside circumstances

Internal post- acquisition integration problems might arise from different policy in the distribution of wealth and opportunities of growth (intra-group service contracts, dividend policies), where group policy towards related parties, will direct the direction, pace and quality of growth for the acquired banks. Avoiding miss-understandings would require an active integration policy from the acquirer that will demonstrate commitment to the market for the longer period of time.

Concerning the second set of factors, not so controllable by the parent and the acquired company, it constitutes of a set of less predictable market and institutional processes and events. Government and its institutions do not treat the financial industry in the same way as they would treat non-strategic businesses and firms. This has been demonstrated by the strong government involvement in the consolidation program and in the privatization process in the late nineties, and it is visible now through the introduction of new legislation. Also markets will eventually become saturated bringing profits down. Reaching the limits of growth and intensified competition would eventually press for another round of radical cost cuts and restructuring in order to preserve profitability. Also, there are the potential risks of deterioration macroeconomic conditions and palliative government actions to suppress consumer spending and imports of consumer goods. At the tome, Croatian economy is growing more or less soundly. However, in the years to come, depending on how fast and under what conditions Croatia joins the EU, financial markets, and the profits and development of financial companies, will definitely be affected reflecting on ex-post costs of today's acquisitions.

As for cross-border M&As in other industry sectors, it is very likely that similar circumstances would not exist, at least concerning a certain transparency that did exist in the banking industry due to market shares, remaining growth and profit potential of the market, and, not to forget, a relatively well defined position of bargaining parties. Other industries and firms would probably be face with a more confusing situation up-front, but eventually with less visibility (less interventions from the outside) once the acquisition is under-way. A specific moment in M&As in the Croatian banking industry, so far, has definitely been the low social cost. Most layoffs were performed before the acquisitions, and so were the financial consolidations of the acquired banks, leaving the acquirers with a "clean" starting position.

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