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Absorbtion nd Consolidation--- An Emmerging Issue in the Banking Industry

Rajesh Kumar Sain
H.O.D.,
Deptt. of Business Administration,
Ravenshaw University,
Cuttack, Odisha

Sanjay Kumar Satapathy
Associate Professor,
Deptt. of Commerce,
Ravenshaw University,
Cuttack, Odisha

Abstract

India's banking is most striking for its extensive reach. It is no longer confined to metropolises or cities in India. The impact of bank mergers in the banking industry has raised concerns among policymakers as to whether bank borrowers can benefit from the consolidations or not. Since market structures can change as a result of mergers, bank mergers can have a significant impact on changes in bank lending behavior. Many banks find that the best way to get ahead is to expand ownership through mergers and acquisitions. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. A merger can happen when two companies decide to combine into one or when one company buys another. An acquisition always involves the purchase of one company by another. The functions allow for the enhanced cost efficiency of a new entity made from two smaller ones-synergy is the logic behind mergers and acquisitions.

Keywords: Merger, Synergy, Economies of Scale, Cost-Cutting, Acquisitions.

Introduction

Merger is a combination of two or more companies into one company. In India, mergers are called as amalgamations, in legal terms. The acquiring company, (also referred to as the amalgamated company or the merged company) acquires the assets and liabilities of the target company (or amalgamating company). Typically, shareholders of the amalgamating company get shares of the amalgamated company in exchange for their existing shares in the target company. Merger may involve absorption or consolidation.

Merger and Amalgamation

The term merger or amalgamation refers to a combination of two or more corporate entity into a single entity. Forms of merger that can happen:

Absorption

One bank acquires the other.

Consolidation

Two or more banks combine to form a new entity. In India the legal term for merger is amalgamation.

Other ways of classifying merger is upon the basis of what type of corporate combine. It can be of following types-

Vertical Merger

This is the merger of the corporate engaged in various stages of production in an industry. A vertical merger (entities with different product profiles) may help in optimal achievement of profit efficiency. Consolidation through vertical merger would facilitate convergence of commercial banking, insurance and investment banking. E.g.: Mobile producing companies merge with the company which provides those parts of mobile and software.

Horizontal Merger

This is the merger of the corporate engaged in the same kind of business. E.g.: Merger of bank with another bank.

Conglomerate Merger

A conglomerate merger arises when two or more firms in different markets producing unrelated goods join together to form a single firm. An example of a conglomerate merger is that between an athletic shoe company and a soft drink company. The firms are not competitors producing similar products (which would make it a horizontal merger) nor

do they have an input-output relation (which would make it a vertical merger).

Objectives

1. To find out the reasons for merger in banking in banking industry.
2. To find out the impact of merger on the banking industry in India.
3. To find out the impact of merger on the profitability of the banks.
4. To find out the reasons for merger on the growth of the banks.

Review of Literature

Cornett and Tehranian (1992) and Spindit and Tarhan (1992) provided evidence for increase in post-merger operating performance. But the studies of Berger and Humphrey (1992), Piloff (1996) and Berger (1997) do not find any evidence in post-merger operating performance. Berger and Humphrey (1994) reported that most studies that examined pre-merger and post-merger financial ratios found no impact on operating cost and profit ratios. Some studies have also examined the potential benefits and scale economies of mergers. Landerman (2000) explores potential diversification benefits to be had from banks merging with non banking financial service firms. Simulated mergers between US banks and non-bank financial service firms show that diversification of banks into insurance business and securities brokerage are optimal for reducing the probability of bankruptcy for bank holding companies. Wheelock and Wilson (2004) find that expected merger activity in US banking is positively related to management rating, bank size, competitive position and geographical location of banks and negatively related to market concentration. Substantial gains from mergers are expected to come from cost savings owing to economies of scale and scope. In a survey of US studies, Berger and Humphrey (1994) concluded that the consensus view of the recent scale economy literature is that the average cost curve has a relatively flat U-shape with only small banks having the potential for scale efficiency gains and usually the measured economies are relatively small. Studies on scope economies found no evidence of these economies. Berger and Humphrey (1994) conclude that "synergies in joint products in banking are rather small." The second issue identified above is the analysis of merger gains in terms of stock price performance of the bidder and target banks on announcement of merger. A merger is expected to create value if the combined value of the bidder and target banks increases on the announcement of the merger. Pilloff and Santomero (1997) conducted a survey of the empirical evidence and reported that most studies fail to find a positive relationship between merger activity and gains in either performance or stockholder wealth. But studies by Baradwaj, Fraser and Furtado (1990), Cornett and Tehranian (1992), Hannan and Wolkan (1989), Hawawini and Swary (1990), Neely (1987), and Trifts and Scanlon (1987) report a positive reaction in the stock prices of target banks and a negative reaction in the stock prices of bidding banks to merger announcements. A recent study on mergers of Malaysian banks shows that, forced mergers have destroyed wealth of acquired banks (Chong *et. al.,* 2006). Returns to bidder firms" shareholders are significantly greater in bank mergers financed with cash than in mergers financed with stock (Houston and Ryngaert, 1997).

Methodology

The study examines the impact of the banks merged in India from 1999 to 2011. Between 1999 and 2011, around 18 amalgamations took place in Indian banking sector. Out of these 6 banks were selected as samples which constitute 1/3 of the population. The samples were selected on a random sampling basis through lottery method. Among the six acquirer banks selected, three of them are public sector banks and the remaining are private sector banks.

Data Analysis and Interpretations

The aim of any organization is to earn profit and to survive in the long run. An understanding of what happens to different ratios of profitability is useful not only to the firms, but to the government as well, to decide whether they should go for merger strategy or not. Before examining various ratios of profitability, it is necessary to have a clear understanding of the changes in growth of total assets and net profits of selected banks.

Table 1
Changes in Growth of Total Assets
(In Rs. Crore)

Name of the Bank	Pre-merger Average	Post-merger Average	Growth Rate
Punjab National Bank	79568.5	114286.5	43.63
Bank of Baroda	80767	104028.5	28.80
Oriental Bank of Commerce	37503	56503	50.66
Federal Bank	18732	28798	53.74
ICICI Bank	298358.5	389548	30.56
HDFC Bank	112206.5	203175	81.07

Source: Computed from RBI Statistical Tables Relating to Banks in India and Annual Reports of Banks

As per the table, the average total assets of merged banks taken for this study during post-merger period was higher than the total assets during pre-merger Period. It was also evident from the table that HDFC Bank achieved 81.07 highest growth rates in respect of total assets among sample banks followed by Federal Bank, Oriental Bank of Commerce and Punjab National Bank. The lowest growth rates are recorded in Bank of Baroda and ICICI Bank

Table 2
Changes in Growth of Net Profit
(In Rs. Crore)

Name of the bank	Pre-merger Average	Post-merger Average	Growth Rate
Punjab National Bank	702	1259.5	79.42
Bank of Baroda	870	752	-13.56
Oriental Bank of Commerce	571.5	659	15.31
Federal Bank	157.5	330.5	109.84
ICICI Bank	2825	3958	40.11
HDFC Bank	1365.5	2597	90.19

Source: Computed from RBI Statistical Tables Relating to Banks in India and Annual Reports of Banks

As per the table, the average net profits earned by merged banks increased in the post-merger period except for Bank of Baroda. Clearly, Federal Bank and HDFC Bank achieved the growth rate of more than 80 per cent. Oriental Bank of Commerce and Bank of Baroda lags behind any other bank in respect of net profits.

Return on Asset

Return on Asset (ROA) the ratio of net profit to total assets is widely used among financial institutions to measure how profitably the bank carries out its operations. The higher the ratio, the higher will be the managerial efficiency and vice-versa.

Table 3
Return on Assets

Name of the bank	Pre-merger Average	Post-merger Average
Punjab National Bank	0.88	1.10
Bank of Baroda	1.13	0.77
Oriental Bank of Commerce	1.50	1.40
Federal Bank	0.91	1.36
ICICI Bank	1.20	1.05
HDFC Bank	1.33	1.41

Source: Computed from RBI, Statistical Tables Relating to Banks in India and A Profile of Banks, Various Issues.

Table 3 shows that Punjab National Bank is the only public sector bank that achieved higher return on assets when the merger and acquisition programme came to an end. The mean return on asset of two private banks slightly improved. On an average, the private banks outperform that of public sector banks in the field of return on assets.

Return on Equity

Return on Equity (ROE) which shows the return to the shareholders can be computed as a ratio of net profit to the total sum of capital, reserves and surplus.Higher value of the ratio is indicative of higher profitability.

Table 4
Return on Equity

Name of the bank	Pre-merger Average	Post-merger Average
Punjab National Bank	19.18	19.71
Bank of Baroda	18.24	11.29
Oriental Bank of Commerce	23.65	16.82
Federal Bank	15.22	14.44
ICICI Bank	11.94	8.24
HDFC Bank	15.79	14.51

Source: Computed from RBI, Statistical Tables Relating to Banks in India and A Profile of Banks, Various Issues.

All but Punjab National Bank showed a decrease in average return on equity. Table 4 illustrates this trend. The average return on equity of both public sector and private banks came down in the post-merger period.

Net Interest Margin

Net Interest Margin (NIM) is the ratio of spread to total assets. Spread can be calculated as the difference between interest earned and interest expended. For net interest margin, Bank of Baroda and HDFC Bank are the successful banks in terms of profitability.

Table 5
Net Interest Margin

Name of the bank	Pre-merger Average	Post-merger Average
Punjab National Bank	3.39	3.34
Bank of Baroda	2.89	2.98
Oriental Bank of Commerce	3.56	2.77
Federal Bank	2.95	2.76
ICICI Bank	1.76	2.02
HDFC Bank	3.87	3.91

Source: Computed from RBI, Statistical Tables Relating to Banks in India and A Profile of Banks, Various Issues.

The average net interest margin of public sector banks showed a declining trend, but the trend is a good sign so far as the profitability criterion is concerned. On the contrary, an increasing trend is discernible in case of private banks. This might be due to a decrease in competition when the public sector banks adhered to the profit-making goal along with social banking.

Table 6
T-Statistical Analysis for the Selected Banks

Sl. No.	Ratios	Pre-Merger Mean	Post-Merger Mean	SD	T
1	Return on Assets	1.158	1.182	0.288	-0.20 (0.851)
2	Return on Equity	17.34	14.17	3.19	2.43 (0.059)
3	Net Interest Margin	3.070	2.963	0.367	0.71 (0.508)

Source: Author's Calculations

Note: Figures in parenthesis show the p-values

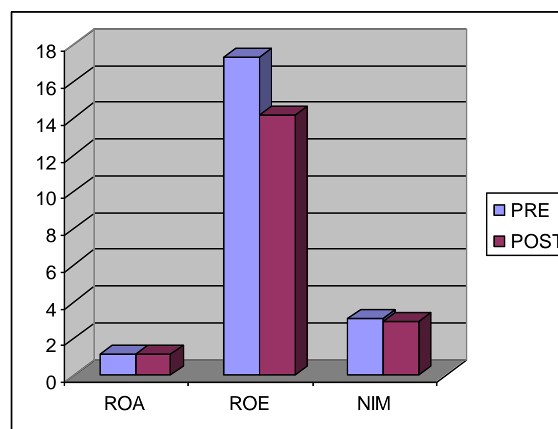

Table 6 shows the paired t-test for the combined banks during pre-and post-merger periods. The average return on assets showed an improvement though it was not statistically significant.

Reasons for Merger

Merger of weak banks- Practice of merger of weak banks with strong banks was going on in order to provide stability to weak banks but Narsimhan committee opposed this practice. Mergers can diversify risk management. Increase in market competition- Innovation of new financial products and consolidation of regional financial system are the reasons for merger. Markets developed and became more competitive and because of this market share of all individual firm reduced so mergers and acquisition

started. Capability of generating economies of scale when firms are merged. Transfer of skill takes place between two organization takes place which helps them to improve and become more competitive. Globalization of economy impacted bank mergers.New services and products- Introduction of e-banking and some financial instruments/ derivatives.Technology- Removal of entry barrier opened the gate for new banks with high technology and old banks can't compete with them so they decide to merge. Positive synergies- When two firms merge their sole motive are to create a positive effect which is higher than the combined effect of two individual firms working alone. Two aspects of it are cost synergy and revenue synergy. Cost Synergy is the savings in operating costs expected after two companies that complement each other's strengths join. Revenue Synergy is refers to the opportunity of a combined corporate entity to generate more revenue than its two predecessors stand-alone companies would be able to generate.

Impacts of Merger

Diversification

When two firms merge their risk in investing assets diversify accordingly. When a firm is operating alone then they don't have many options to diversify their portfolio investment that they can get after merger. Mergers and Acquisition allows firms to obtain efficiency gains through cost reductions (cost synergies), revenue increases (revenue synergies). Broader array of products- When two firms merge they have diversified variety of products and after the merger each consumer in both the firms will be benefited with the range of products or services to choose from. Mergers and Acquisition helps firms to widen its consumer portfolio but it also leads to a more diversified range of services and offer scope economies by optimizing the synergies between the merged activities. Domestic mergers cut costs for both the partners whereas for the majority of cases including domestic and cross border mergers and acquisition, the impact on profitability is insignificant but a clear trend to diversify the sources of revenue was apparent. In terms of cost efficiency and revenue efficiency it has been noticed that in domestic merger organization get the benefit of cost efficiency(reduction in operating cost) and in cross border merger organization get the benefit of revenue efficiency (increase in revenue) because of the benefit of geographical expansion and diversification. Improvement in the activities of organization, however, offer benefits from product Complementarities which helps to enhance revenues. Efficiency may be improved after merger and acquisition, if the acquiring company is more efficient already and brings the efficiency of the target up to its own level by providing its managerial expertise, policies and other operations.

Conclusion

An attempt has been made to analyze the financial performance of banks in the wake of consolidation exercise. The results emerged from the profitability ratios, on an average, showed a significant difference between the profitability of banks in post-merger scenario. The increase in profitability of banks under study is due to an increase in employee turnover and the subsequent reduction in operating expenses. Also return on total assets, return on equity and Interest margin shows the positive trend. Merger and acquisition program in Indian banks cannot be regarded as a false step if the benefits of it accrue to all stakeholders.

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