

Need of Mergers and Acquisitions in Banking Industry of India

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ABSTRACT

This paper analyzes some critical issues of consolidation in Indian banking with particular emphasis on the views of two important stake-holders viz. shareholders and managers. First we review the trends in consolidation in global and Indian banking. Then to ascertain the shareholders' views, we conduct an event study analysis of bank stock returns which reveals that in the case of forced mergers, neither the bidder nor the target banks "shareholders have benefited. But in the case of voluntary mergers, the bidder banks "shareholders have gained more than those of the target banks. In spite of absence of any gains to shareholders of bidder banks, a survey of bank managers strongly favors mergers and identifies the critical issues in a successful merger as the valuation of loan portfolio, integration of IT platforms, and issues of human resource management. Finally we support the view of the need for large banks by arguing that imminent challenges to banks such as those posed by full convertibility, Basel-II environment, financial inclusion, and need for large investment banks are the primary factors for driving further consolidation in the banking sector in India and other Asian economies.

Keywords - Bank Mergers, Market Valuation of Mergers.

I. INTRODUCTION

DEFINITION OF MERGERS AND ACQUISITIONS

The terms mergers, acquisitions and consolidation may often be confused, look similar and mostly used interchangeably. However, the three have different meanings. Mergers may be of various types and so can acquisitions and consolidation be. A merger refers to the combination of two or more organizations into one larger organization. Such actions are commonly voluntary and often result in a new organizational name (often combining the names of the original organizations). An acquisition, on the other hand, is the purchase of one organization by another. Such actions can be hostile or friendly and the acquirer maintains control over the acquired firm. Mergers and acquisitions differ from a consolidation, which is a business combination where two or more companies join to form an entirely new company. All of the combining companies are dissolved and only the new entity continues to operate also defines merger as 'a combination of two or more corporations in which only one corporation survives' while Section 590 of the Nigerian Companies and Allied Matters Act 1990 defines merger as "any amalgamation of the undertakings or any part of the undertakings or part of

the undertakings of one or more companies and one or more bodies corporate".

TYPES OF MERGERS AND ACQUISITIONS

Vertical merger

VM is a merger in which one firm supplies its products to the other. A vertical merger results in the consolidation of firms that have actual or potential buyer-seller relationships.

Horizontal merger

HM is the merger of two or more companies operating in the same field and in the same stages of process of attaining the same commodity or service. In other words, a horizontal merger is the combination of firms that are direct rivals selling substitutable products within overlapping geographical markets

Conglomerate merger

CM occurs when unrelated enterprises combine or firms which compete in different product markets, and which are situated at different production stages of the same or similar products combine, to enter into different activity fields in the shortest possible time span and reduce financial risks by portfolio diversification.

Concentric merger

This involve firms which have different business operation patterns, though divergent, but may be highly related in production and distribution technologies. The acquired company represents an extension of the product lines, market participation, or technologies of the acquiring firm under concentric M&A

Stages of Merger and Acquisition

A five-stage model that will result in successful pursuit of synergistic gains from M&A:

- a. Corporate strategy development;
- b. Organizing for acquisitions;
- c. Deal structuring and negotiation;
- d. Post-acquisition integration; and
- e. Post-acquisition audit and organizational learning.

Corporate strategy development

Corporate strategy development is concerned 'with ways of optimizing the portfolios of businesses that a firm currently owns, and how this port folio can be changed to serve the interests of the corporation's stakeholders'

Organizing for acquisition

The firm lays down the criteria for potential acquisitions consistent with the strategic objectives and value creation logic of the firm's corporate strategy and business model.

Deal structuring and negotiation

This involves following stage of M&As:

- a. valuing target companies, taking into account how the acquirer plans to leverage its own assets with those of the target; choice of advisers to the deal;
- b. obtaining and evaluating as much intelligence as possible about the target from the target as well as other sources through due diligence;
- c. determining the range of negotiation parameters including the walk-away price negotiating warranties and indemnities; negotiating the positions of senior management of both firms in the post merger dispensation; and
- d. developing the appropriate bid and defense strategies and tactics within the parameters set by the relevant regulatory regimes.

Post-acquisition integration

This stage involves the combination of the distinct organizations into one, resulting in changes in both the target and the acquirer, to deliver the strategic and value expectations that informed the merger

II. OVERVIEW OF INDIAN BANKING INDUSTRY

The history of Indian Banking shows that seeds of banking in India were sown back in the 18th century when efforts were made to establish the General Bank of India and Bank of Hindustan in 1786 and 1790 respectively. Later some more banks like Bank of Bengal,

Bank of Bombay and the Bank of Madras were established under the charter of British East India Company. These three banks were merged in 1921 and it formed the Imperial Bank of India, which later became the State Bank of India. The period between 1906 and 1911 witnessed the establishment of banks such as Bank of India, Bank of Baroda, Canara Bank, Corporation Bank, Indian Bank and Central Bank of India; these banks have survived to the present. The banking sector in India can be divided into two era i.e. preliberalization era and post liberalization era since 1991. In the pre-liberalization era, the Government of India nationalized the 14 largest commercial banks in 1969. A second dose of nationalization of six more commercial banks followed in 1980. The stated reason for the nationalization was to give the government more control of credit delivery. Later, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was only the merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19.

The banking sector has seen a tremendous amount of change in the post liberalization era i.e. in the early 1991; the then Narasimha Rao government embarked the policy of liberalization. Licenses were given to small number of private banks like Global Trust Bank, which later amalgamated with Oriental Bank of Commerce, Axis Bank (earlier UTI Bank), ICICI Bank and HDFC Bank. This move had augmented the growth in Indian Banking. Along with the rapid growth in the economy of India, followed by the growth with strong contribution from all the three sectors of banks, viz. government banks, private banks and foreign banks.

The impact of globalization on Indian Banking has caused many changes in terms of regulations and structural. With the changing environment, many different strategies have been adopted by this sector to remain efficient and to surge at the forefront in the global arena. One such strategy is in the course of consolidation is merger and acquisition.

III. CONCEPTUAL FRAMEWORK

In the wake of economic reforms, Indian industries have started restructuring their operations around their core business activities through merger, acquisition, and takeovers because of their increasing exposure to competition both domestically and internationally.

According to Accounting Standard (AS) 14, 'Accounting for Amalgamations', issued by the Council of the Institute of Chartered Accountants of India, amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not only of the assets and of liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. Such amalgamations are in the nature of 'merger' and the accounting treatment of such amalgamations should ensure that the resultant figures of assets, liabilities, capital and reserves more or less represent the sum of the relevant figures of the amalgamating companies. In the second category, those amalgamations which are in effect a mode by which one company acquires another company and, as a consequence, the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company, or the business of the company which is acquired is not intended to be continued. Such amalgamations are amalgamations in the nature of 'purchase'.

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It is observed in literature that most of the work done on mergers and acquisition is based on financial & accounting aspect like performance of banking institutions based on. Devos, Kadapakkam & Krishnamurthy (2008) studied M&A as value creation, efficiency improvements as explanations for synergies and produced evidence that suggests mergers generate gains by improving resource allocation rather than by reducing tax payments of increasing the market power of the combined firm. has used accounting ratios to compare the post-merger profitability of two banks i.e. RBS and ABN AMRO. DeLong (2003) studied sample of 54 bank mergers announced between 1991 and 1995, tests several facets of focus and diversification. The study found that upon announcement, the market rewards the merger of partners that focus their geography and activities and earning stream. Only of these facets, focusing earning streams enhances long-term performance. Shanmugam & Nair (2004) identified factors in their study on mergers and acquisitions of banks in Malaysia like globalization, liberalization and information technology developments have contributed

to the need for a more competitive, resilient and robust financial systems.

There are few efforts have been made to measure the impact of bank's M&A on their employees and staff. However, apart from this some efforts have been made to study the state of customers in the course of M&A. Acquisitions often have a negative impact on employee behavior resulting in counterproductive practices, absenteeism, low morale, and job dissatisfaction. It appears that an important factor affecting the successful outcome of acquisitions is top management's ability to gain employee trust. Panwar (2011) studied ongoing merger trends in Indian banking from the viewpoint of two important stakeholders of a banking firm stockholders and managers. The findings shows that the trend of consolidation in Indian banking industry has so far been limited mainly to restructuring of weak banks and harmonization of banks and financial institutions. Voluntary mergers demonstrating market dynamics are very few. She concluded that Indian financial system requires very large banks to absorb various risks emanating from operating in domestic and global environments.

IV. MERGERS OF INDIAN BANKS

The Indian Banking Sector

The history of Indian banking can be divided into three main phases 1:

- Phase I (1786-1969)-Initial phase of banking in India when many small banks were set up
- Phase II (1969-1991)- Nationalization, regularization and growth
- Phase III (1991 onwards)-Liberalization and its aftermath

With the reforms in Phase III the Indian banking sector, as it stands today, is mature in supply, product range and reach, with banks having clean, strong and transparent balance sheets. The major growth drivers are increase in retail credit demand, proliferation of ATMs and debit-cards, decreasing NPAs due to Securitisation, improved macroeconomic conditions, diversification, interest rate spreads, and regulatory and policy changes (e.g. amendments to the Banking Regulation Act).

Certain trends like growing competition, product innovation and branding, focus on strengthening risk management systems, emphasis on technology have emerged in the recent past. In addition, the impact of the Basel II norms is going to be expensive for Indian banks, with the need for additional capital requirement and costly database creation and maintenance processes.

Larger banks would have a relative advantage with the incorporation of the norms.

Key M&A Deals 2000 onwards: Some Case Studies

The cases chosen for the purpose of this study were selected based on their prominence and agency (all post-2000) to ensure that the motives driving the deals will remain relevant in the current context.

HDFC Bank Acquires Centurion Bank of Punjab (May '08)

Intent: For HDFC Bank, this merger provided an opportunity to add scale, geography (northern and southern states) and management bandwidth. In addition, there was a potential of business synergy and cultural fit between the two organizations.

For CBoP, HDFC bank would exploit its underutilized branch network that had the requisite expertise in retail liabilities, transaction banking and third party distribution. The combined entity would improve productivity levels of CBoP branches by leveraging HDFC Bank's brand name.

Benefits: The deal created an entity with an asset size of Rs 1,09,718 crore (7th largest in India), providing massive scale economies and improved distribution with 1,148 branches and 2,358 ATMs (the largest in terms of branches in the private sector). CBoP's strong SME relationships complemented HDFC Bank's bias towards high-rated corporate entities.

There were significant cross-selling opportunities in the short-term. CBoP management had relevant experience with larger banks (as evident in the Centurion Bank and BoP integration earlier) managing business of the size commensurate with HDFC Bank.

Drawbacks: The merged entity will not lend home loans given the conflict of interest with parent HDFC and may even sell down CBoP's home-loan book to it. The retail portfolio of the merged entity will have more by way of unsecured and two-wheeler loans, which have come under pressure recently.

Standard chartered acquires ANZ grind lays bank (November '00)

Intent: Standard Chartered wanted to capitalize on the high growth forecast for the Indian economy. It aimed at becoming the world's leading emerging markets bank and it thought that acquiring Grind lays would give it a well-established foothold in India and add strength to its management resources. For ANZ, the deal provided immediate returns to its shareholders and allowed it to focus on the Australian market. Grind lays had been a poor performer and the Securities Scam involvement had made ANZ willing to wind up.

Benefits: Standard Chartered became the largest foreign bank in India with over 56 branches and more than 36% share in the credit card market. It also leveraged the infrastructure of ANZ Grind lays to service its overseas clients. 2

For ANZ, the deal, at a premium of US \$700 million over book value, funded its share buy-back in Australia (a defense against possible hostile takeover). The merger also greatly reduced the risk profile of ANZ by reducing its exposure to default prone markets. 3

Drawbacks: The post merger organizational restructuring evoked widespread criticism due to unfair treatment of former Grind lays employees. 4 There were also rumors of the resulting organization becoming too large an entity to manage efficiently, especially in the fast changing financial sector.

Bank of Baroda acquires South Gujarat local area bank ltd (June '04)

Intent: According to the RBI, South Gujarat Local Area Bank had suffered net losses in consecutive years and witnessed a significant decline in its capital and reserves⁵. To tackle this, RBI first passed a moratorium under Section 45 of the Banking Regulation Act 1949 and then, after extending the moratorium for the maximum permissible limit of six months⁶, decided that all seven branches of SGLAB function as branches of Bank of Baroda. The final decision about the merger was of the Government of India in consultation with the RBI. Bank of Baroda was against the merger, and protested against the forced deal⁷.

Benefits: The clients of SGLAB were effectively transferred to Bank of Baroda, deriving the advantage of dealing with a more secure and bigger bank. SGLAB did not benefit much, except that it was able to merge with a bigger bank and able to retain its branches and customers, albeit under a different name. Since BoB was a large entity (total assets of Rs. 793.2 billion at the time of merger), addition of a small liability did not affect it much. Albeit minor, it obtained seven more branches and the existing customers of SGLAB. This further strengthened its position in rural Gujarat.

Drawbacks: There was no widespread criticism or any apparent drawback of the merger since the financials involved were not very high.

ICICI Bank Ltd. Acquires Bank of Madura (March '01)

Intent: ICICI Bank Ltd wanted to spread its network, without acquiring RBI's permission for branch expansion. BoM was a plausible target since its cash management business was among the top five in terms of volumes. In addition, there was a possibility of

reorienting its asset profile to enable better spreads and create a more robust micro-credit system post merger.⁸

BoM wanted a (financially and technologically) strong private sector bank to add shareholder value, enhance career opportunities for its employees and provide first rate, technology based, modern banking services to its customers.

Benefits: The branch network of the merged entity increased from 97 to 378, including 97 branches in the rural sector.⁹ The Net Interest Margin increased from 2.46% to 3.55 %. The Core fee income of ICICI almost doubled from Rs 87 crores to Rs 171 crores. IBL gained an additional 1.2 million customer accounts, besides making an entry into the small and medium segment. It possessed the largest customer base in the country, thus enabling the ICICI group to cross-sell different products and services.

Drawbacks: Since BoM had comparatively more NPAs than IBL, the Capital Adequacy Ratio of the merged entity was lower (from 19% to about 17%). The two banks also had a cultural misfit with BoM having a trade-union system and IBL workers being young and upwardly mobile, unlike those for BoM. There were technological issues as well as IBL used Banks 2000 software, which was very different from BoM's ISBS software. With the manual interpretations and procedures and the lack of awareness of the technology utilisation in BoM, there were hindrances in the merged entity.

Oriental bank of commerce acquires global trust bank ltd (August '04)

Intent: For Oriental Bank of Commerce there was an apparent synergy post merger as the weakness of Global Trust Bank had been bad assets and the strength of OBC lay in recovery.¹⁰ In addition, GTB being a south-based bank would give OBC the much-needed edge in the region apart from tax relief because of the merger. GTB had no choice as the merger was forced on it, by an RBI ruling, following its bankruptcy.

Benefits: OBC gained from the 104 branches and 276 ATMs of GTB, a workforce of 1400 employees and one million customers. Both banks also had a common IT platform. The merger also filled up OBC's lacunae-computerisation and high end technology. OBC's presence in southern states increased along with the modern infrastructure of GTB.

Drawbacks: The merger resulted in a low CAR for OBC, which was detrimental to solvency. The bank also had a lower business growth (5% vis-a-vis 15% of peers). A capital adequacy ratio of less than 11 per cent could also constrain dividend declaration, given the applicable RBI regulations.

Motives Behind Consolidation

Based on the cases, we can narrow down the motives behind M&As to the following:

- Growth-Organic growth takes time and dynamic firms prefer acquisitions to grow quickly in size and geographical reach.
- Synergy-The merged entity, in most cases, has better ability in terms of both revenue enhancement and cost reduction.
- Managerial efficiency-Acquirer can better manage the resources of the target whose value, in turn, rises after the acquisition.
- Strategic motives-Two banks with complementary business interests can strengthen their positions in the market through merger.
- Market entry-Cash rich firms use the acquisition route to buyout an established player in a new market and then build upon the existing platform.
- Tax shields and financial safeguards-Tax concessions act as a catalyst for a strong bank to acquire distressed banks that have accumulated losses and unclaimed depreciation benefits in their books.
- Regulatory intervention-To protect depositors, and prevent the de-stabilisation of the financial services sector, the RBI steps in to force the merger of a distressed bank.

Future of M&A in Indian Banking

In 2009, further opening up of the Indian banking sector is forecast to occur due to the changing regulatory environment (proposal for upto 74% ownership by Foreign banks in Indian banks). This will be an opportunity for foreign banks to enter the Indian market as with their huge capital reserves, cutting-edge technology, best international practices and skilled personnel they have a clear competitive advantage over Indian banks. Likely targets of takeover bids will be Yes Bank, Bank of Rajasthan, and IndusInd Bank. However, excessive valuations may act as a deterrent, especially in the post-sub-prime era.

Persistent growth in Indian corporate sector and other segments provide further motives for M&As. Banks need to keep pace with the growing industrial and agricultural sectors to serve them effectively. A bigger player can afford to invest in required technology. Consolidation with global players can give the benefit of global opportunities in funds' mobilization, credit disbursal, investments and rendering of financial services. Consolidation can also lower intermediation cost and increase reach to underserved segments.

The Narasimhan Committee (II) recommendations are also an important indicator of the future shape of the sector. There would be a movement towards a 3-tier structure in the Indian banking industry: 2-3 large international banks; 8-10 national banks; and a few large local area banks. In addition, M&As in the future are likely to be more market-driven, instead of government driven.

The following table also clears the picture of mergers in Indian Banking Industry.

BENEFITS OF MERGER TO INDIAN BANKS

After clearly understanding the motives and rationale for merger, we studied the mergers of 17 banks in India. In this analysis, we can identify following benefits of mergers to the all participants.

- Sick banks survived after merger.
- Enhanced branch network geographically.
- Larger customer base (rural reach).
- Increased market share.
- Attainment of infrastructure.

V. CONCLUSION

Based on the trends in the banking sector and the insights from the cases highlighted in this study, one can list some steps for the future which banks should consider, both in terms of consolidation and general business. Firstly, banks can work towards a synergy-based merger plan that could take shape latest by 2009 end with minimisation of technology-related expenditure as a goal. There is also a need to note that merger or large size is just a facilitator, but no guarantee for improved profitability on a sustained basis. Hence, the thrust should be on improving risk management capabilities, corporate governance and strategic business planning. In the short run, attempt options like outsourcing, strategic alliances, etc. can be considered. Banks need to take advantage of this fast changing environment, where product life cycles are short, time to market is critical and first mover advantage could be a decisive factor in deciding who wins in future. Post-M&A, the resulting larger size should not affect agility. The aim should be to create a nimble giant, rather than a clumsy dinosaur. At the same time, lack of size should not be taken to imply irrelevance as specialised players can still seek to provide niche and boutique services.

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