Mergers And Acquisitions: Impact On Competition And Efficiency In India

Dr. Vikash*

Abstract

This paper examines the impact of mergers and acquisitions on performance of selected commercial banks in India. The impact of mergers and acquisitions on performance of the banks has been evaluated. Bank in general terminology is referred to as a financial institute or a corporation which is authorized by the state or central government to deal with money by accepting deposits, giving out loan and investing in securities. The main role of banks is the growth of economy by providing funds for investment. In recent times banking sector has been undergoing a lot of changes in terms of regulations and effects of globalization. These Changes have affected this sector both structurally and strategically. With the changing Environment, many different strategies have been adopted by this sector in order to remain efficient and to surge ahead in the global arena. One such profitable strategy is the process of consolidation of the banks. There are several ways to consolidate the banking industry; the most common adopted by banks is merger. Merger of two weaker banks or merger of one healthy bank with one weak bank can be treated as the faster and less costly way to improve profitability then spurring internal growth (Franz H Khan 2007). The main motive behind the merger and acquisition in the banking industry is to achieve economies of scale and scope.

Keywords: Mergers, Acquisitions, Indian Banking Sector, Performance

Introduction:

The impact of consolidation through M&As on competition operates through a number of channels, and among others, depends on the market structure, the nature of competition and the regulatory and supervisory framework. The competition effect would depend on the degree of concentration, the degree of entry barriers, the heterogeneity of products and price differentiation allowed. Depending on the level of

***Department of Economics, +2 Marwari High School, Darbhanga**

competition of the banking industry, consolidation influences the provision of credit to different customer groups. Cross-country analysis does not provide support for the view that bank concentration is closely associated with banking sector efficiency, financial development, industrial competition, general institutional development, or the stability of the banking system. In fact, the impact of M&As on competition in the banking sector has not been uniform.

M&As, especially market driven, are aimed at stepping up size (market powers) and maximising value (revenue) by exploiting economies of scale and scope, risk diversification and strengthening capital. Most recent studies have found unexploited scale economies even for larger banks in the US (Berger and Mester, 1997; Berger and Humphrey, 1997)[i] and in Europe (Allen and Rai, 1996 and Vander Vennet, 2001)[ii]. In the presence of excess capacity, some banks are bound to operate below efficient scale and may also have an inefficient product mix and, therefore, may be inside the efficiency frontier. In such a situation, M&As may help solve these problems more efficiently rather than outright bankruptcies because they preserve the franchise values of the merging banks (Huizinga et al, 2001)[iii] .

The Indian banking system has witnessed certain visible structural changes in the post-reform period. Apart from mergers/amalgamations and entry of new private and foreign banks, the Government equity has also been diluted in public sector banks. Of the 28 public sector banks, 22 banks have raised capital from the market. In three banks, the Government equity holding has come down close to 51 per cent. The changes in the ownership structure along with consolidation and entry of private and foreign banks are expected to have an impact on the overall competition in the banking sector.

Some of the studies in the Indian context found that during the post-reform period, the bank mergers led to considerable enhancement of efficiencies for the merging banks. The mergers themselves exhibited considerable potential efficiency gains. The greater part of these gains stemmed from the synchronisation of varied but related product mixes. Gourlay et al (2006)[iv] found that mergers between distressed and strong banks in India tended to exhibit persistence in efficiency across time. In other words, economic policy reforms have succeeded in weeding out the weaker and inefficient banks by merging them with healthier banks. However, incumbent strong banks did not appear to adopt the M&As route to raise their efficiencies.

One of the motives of M&As is to enhance efficiency by reducing cost or increasing revenues or combination of both, as alluded to earlier. Efficiency gains stemming from M&As may be analysed by comparing the performance ratios in terms of return on assets and operating cost between the pre-merger and post-merger periods. The profit efficiency effect of M&As is the most inclusive. It embodies the scale, scope, product mix and X-efficiency (effectiveness with which a given set of inputs are used to produce outputs) effects for both costs and revenues and also includes at least some of the diversification effects. For the bank mergers in India, efficiency gains both in terms of increase in return on assets and reduction in cost were found only in the case of public sector banks. Similar gains were not observed in respect of merger of private sector entities.

As a result of banking sector reforms, there has been a general improvement in the performance of the overall banking sector in India during the post-reform period. Hence, it is possible that the differences in the efficiency between pre and post-merger of the select transferee banks as referred to above were the result of overall improvement in the banking sector and not because of mergers. In order to check for efficiency gain/loss from mergers, the return on asset ratios of the select transferee banks in the post-merger period were compared with the return on assets of their respective bank groups. It was observed that in the case of most public sector banks with which other banks were merged, the return on assets ratios were above their group average both during the pre and post-merger periods. It may thus be interpreted that gains in efficiency were more due to the general improvement in the industry than through mergers.

a) Efficiency Gains from M&As: A Case Study of Select Banks

During the post-reform period, there have been 21 mergers and amalgamations in the Indian banking sector. Of these, seven merger cases involving relatively larger banks were selected. In order to test the change in the profitability/ efficiency indicators in sample banks during the post-merger period, Wald test was used. The Wald test is a statistical test, typically used to determine whether an effect exists or not. Under this test, the maximum likelihood estimate ? of the parameter(s) of interest q is compared with the proposed value ?0 (zero in the present context), with the assumption that the difference between ? and ?0 will be approximately normal. Typically the square of the difference is compared

to a chi-squared distribution. Two variables are chosen, viz., return on assets and operating cost to assets ratio. Given the fact, mergers/amalgamations are envisaged to lead to synergy effects; return on assets is expected to increase while operating cost to assets ratio is expected to decrease during the post-merger period. Statistical significance of increase/decrease in the parameter can be inferred from the corresponding p-value of X2 statistic.

As per a priori expectations, it was found that change in the average return on assets during the post-merger period over pre-merger period was positive and statistically significant in the case of public sector banks, while positive but insignificant in the case of two private sector banks. In the case of one private sector bank, the mean return on assets declined after the merger.

Efficiency gains in terms of decline in operating expenditure measured by mean of operating cost-assets ratio during post-merger period were also found to be significant in the case of three out of fours select public sector banks. On the other hand, for the sample of private sector banks, it was found that the mean of operating cost-assets ratio was higher during post-merger, though not statistically significant, reflecting that these banks could not realize efficiency gains in terms of operating expenditure emanating from merger and acquisitions (Table 1). Thus, public sector banks have been able to derive greater efficiency gains during the post-merger period than the private sector banks.

Table 1: Testing of Efficiency Indicators in Merged Banks in India

Panel A: Change in Return on Assets (RoA) during Pre and Post Merger: Wald Test.

Bank	Δ RoA	X^2 Statistics	S/NS
Punjab National Bank	0.57	25.34	S
Union Bank of India	0.49	15.68	S
Oriental Bank of Commerce	0.7	13.62	S
Bank of Baroda	0.53	12.5	S
HDFC Bank	-0.4	1.33	NS
ICICI Bank	0.04	0.02	NS
Centurion Bank of Punjab	0.52	0.26	NS

Panel B: Change in Operational Cost-Assets Ratio (OP) during Pre and Post Merger: Wald Test.

Bank	Δ RoA	X^2 Statistics	S/NS
Punjab National Bank	0.46	15.69	S
Union Bank of India	-0.84	54.61	S
Oriental Bank of Commerce	-0.83	12.97	S
Bank of Baroda	-0.21	6.71	S
HDFC Bank	0.34	1.0	NS
ICICI Bank	0.21	0.45	NS
Centurion Bank of Punjab	1.44	2.7	NS

Note: S/NS: Significant/ Not Significant.

Source: RBI, Report on Currency and Finance, 2014.

To sum up, M&A activity accelerated in the post-reform period, especially after 1999. However, alongside mergers/amalgamation, new private and foreign banks also came into existence. On the whole, the number of banks increased up to 1998-99 but declined thereafter every year. Since mergers/ amalgamations were mostly among smaller banks or financially weak banks were taken over by stronger banks, the level of competition in the Indian banking system improved even as the total number of banks declined after 1998-99. This improvement was indicated in various measures of concentration ratios and competition indicators. Concentration in the Indian banking sector was found to be significantly lower than many EMEs. Like several other advanced countries and EMEs, the Indian banking industry operated under monopolistic competitive conditions. However, the impact of mergers on efficiency varied. Efficiency measured both by return on assets and operating cost to assets of public sector banks, with which private entities were merged, improved. Similar efficiency gains, however, were not observed in respect of private sector entities.

b) Consolidation and Its implications for Financial Stability

Consolidation, among others, has implications for financial stability and monetary policy. With the increase in the size of banks and concentration of banking activities in a few megabanks, various types of risks such as operational risk, contagion risk and systemic risk could increase. Consolidation impacts market power which can have adverse effects on the yield curve by impeding interest rate arbitrage, lending to borrowers and the value of collateral, in turn, affecting the channels of monetary policy transmission.

Banking consolidation, irrespective of the motives and types, gives rise to several challenges, of which the implications on financial stability and monetary policy are important ones. It is emphasised that even though there are several potentials for reducing the financial risk through geographical and product diversification at the individual firm level, consolidation leading to creation of megabanks could heighten various types of financial risks at the macroeconomic level. In fact, understanding the financial stability implications of evolving state ownership of banks after consolidation and also increasing presence of foreign banks is a high priority in policy makers agenda in various countries. Operational risk could increase with the size of operations, as the distance between management and operational personnel is greater in large companies and the administrative systems are more complex. The transparency of the operations could also deteriorate with increase in size, particularly with regard to cross-border mergers, rendering detection of potential crises in time by the authorities difficult. The contagion risk, i.e., problems arising in an individual bank spreading to others also increases with size as banks' exposures against one another rise along with the size of operations. Evidence suggests that the inter-dependencies, which are positively correlated with consolidation, have increased among large and complex financial institutions. Further, the consolidating institutions are found to shift their portfolios towards higher risk-return investment. Consequently, the concerns about systemic risk are heightened, as concentration of banking activities in few megabanks would mean that given their wholesale activities, any shock could have repercussions to the financial system and the real economy. For a small host nation, cross-border financial integration would mean increase in possibility of even a medium-sized foreign bank becoming a source of instability, and also increased probability of losing domestic ownership of its major banks.

The increased potential for systemic risk further intensifies the concerns for these banks being considered 'too-big-to-fail', which gives rise to the problem of moral hazard. Because of the increased potential systemic instability from impairment of such large banks, whatever be the ex ante declaration, the perception of the general public would be that the Government would not allow these banks to fail, and therefore, ex post provide bailout. Because of this perceived implicit or explicit guarantee by the Government, the risk taking behavior of these banks could increase, thereby further enhancing the systemic risk. It is, however, not possible to formulate a specific criteria on when a bank becomes 'too big to fail', though it may be concluded that there is a certain critical level with regard to the bank's importance in the economy and the financial system.

Consolidation leads to greater concentration of payment and settlement flows among few parties within the financial sector. Such concentration implies that if a major payment processor were to fail or were not able to process payment orders, systemic risks could arise. The emergence of multinational institutions and specialised service providers indulging in payment and settlement systems in different countries coupled with increasing inter-dependence of liquidity among them accentuate the potential role of payment and settlement systems in the transmission of contagion effects.

SUMMING UP

An important aspect of liberalisation of the banking sector in the early 1990s was the entry of new private sector and increased presence of foreign banks to enhance the competition. The number of new private sector and foreign banks increased during the larger part of the 1990s, resulting in an overall increase in the number of banks. However, the process of consolidation through mergers and amalgamations gained momentum during the latter part of the 1990s, which led to a decline in the number of banks. Mergers and amalgamations were market driven with the Reserve Bank acting only as the facilitator. Despite the accelerated pace of consolidation, competition in Indian banking sector increased as was reflected in the various measures of concentration, which declined in recent years. It was mainly because banks involved in mergers and amalgamations were small. Concentration in the Indian banking sector was lower than that in many other emerging market economies and even some advanced countries. As is the case with several other advanced and emerging market economies, the Indian banking sector was operating under monopolistic competitive conditions and the degree of competition improved somewhat in recent years.

M&A activity accelerated in the post-reform period, especially after 1999. However, alongside mergers/amalgamation, new private and foreign banks also came into existence. On the whole, the number of banks increased up to 1998-99 but declined thereafter every year. Since mergers/ amalgamations were mostly among smaller banks or finan-

cially weak banks were taken over by stronger banks, the level of competition in the Indian banking system improved even as the total number of banks declined after 1998-99. This improvement was indicated in various measures of concentration ratios and competition indicators. Concentration in the Indian banking sector was found to be significantly lower than many EMEs. Like several other advanced countries and EMEs, the Indian banking industry operated under monopolistic competitive conditions. However, the impact of mergers on efficiency varied. Efficiency measured both by return on assets and operating cost to assets of public sector banks, with which private entities were merged, improved. Similar efficiency gains, however, were not observed in respect of private sector entities.

End Notes:

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