ABSTRACT

The government, Reserve Bank of India (RBI) and bank managers are in favour of bank consolidation for various reasons. While the government intends to create a few big banks that could compete with the international banks, RBI compels the stronger banks, at times, to acquire structurally weaker banks. Bank managers, on the other hand, appear to prefer mergers to achieve quick growth and to gain from economies of scale and scope. Such mergers driven by commercial considerations have happened more frequently in the post-reform period. However, international studies and Indian studies on bank mergers indicate that the evidence in favour of bank mergers is mixed. Hence, this study was conceived to analyse the effect of bank mergers on stockholders and bank efficiencies in India during the post reform period, 1999 – 2010.

Modern finance theory advocates that ‘shareholder wealth maximisation’ should be the objective of corporate firms and in this ‘wealth’ stock value is an important component. Potentially harmful corporate actions would lead to stock price declination, in an efficient market. However, market efficiency assumptions are not true always and sometimes the market tends to react irrationally. Hence, it is essential to analyse both stock prices and financial performance of firms to fully understand the impact of corporate
actions. Therefore, stock price and financial performance of banks involved in mergers were studied using event study model and data envelopment analysis.

Event study analysis was done using the ‘market model’ with BSE-500 stock index as the reference index. Each merger announcement was considered as an event and daily stock returns in a 30-day time window before and after the event was computed. This was compared with expected returns and the difference between expected returns and actual returns i.e. abnormal returns was computed. Overall, if the abnormal returns are positive it could be implied that the merger announcement had a positive impact on the stock prices and vice versa.

Data Envelopment Analysis is a non-parametric technique used to calculate the relative efficiency of ‘decision making units’. Here, bank is considered to be a decision making unit, with three inputs namely, ‘shareholders capital, interest expenses and operating expenses’, and two outputs. The outputs used for ‘cost efficiency’ computation are ‘annual increase in assets and total income’. The outputs considered for ‘profit efficiency’ computation are ‘annual increase in assets and profit after tax’. Though there is no consensus on choice of input and output variables, this intermediation model has been widely used in bank merger analysis.

Event study analysis indicates that stock returns of acquiring banks and acquired banks had generally declined in the time period around merger
announcement. Further, in case of acquiring banks adverse reaction was observed in nine out of the sixteen bank-to-bank mergers that were analysed. Among the sixteen acquired banks nine were listed banks and adverse reaction was noted in five cases. Overall, merger announcements appear to have had an undesirable effect on stock returns of acquiring and acquired banks.

Post-merger financial performance of merged banks i.e. acquiring banks is also not encouraging. Results of data envelopment analysis indicate that the mean profit efficiency of acquiring banks had declined after merger. However, there was no significant difference in the mean cost efficiency of acquired banks before and after merger. Profit efficiency of fourteen banks and cost efficiency of six banks appear to have declined after merger. Profit efficiency gains were observed in two mergers and cost efficiency gains were observed in one merger. In general, mergers do not appear to have a favourable impact on the efficiency levels of acquiring banks.

In many mergers stockholders appear to have rightly identified the potential negative impact of the merger deal on their banks. The profit efficiency of acquiring banks had declined mainly due to higher operating expenses (non-interest expenses) incurred as advertising expenses and rapid expansion expenses.

Irrespective of whether mergers were carried out due to regulatory compulsion or commercial consideration the results are not encouraging.
Though the government, RBI and bank managers favour bank consolidation most of the bank mergers appear to have resulted in lower stock returns and lower efficiency levels. In future, merger option for banks must be considered only if other alternatives are not available and such decisions must be carried out with adequate precaution.