CHAPTER 1

INTRODUCTION

Major changes carried out to the operations, financial ownership, legal structure or other structures of a firm for the purpose of making it more profitable or better organised are typically categorised as corporate restructuring exercises. The most common forms of corporate restructuring are mergers, amalgamations, acquisitions, takeovers, financial restructuring, divestitures, de-mergers and buyouts. Mergers and acquisitions involve buying, selling, combining and dividing of different companies or similar entities to facilitate rapid growth (Schweiger & Very 2003). Though a “merger” is different from an “acquisition”, both the terms are used interchangeably, at times, to denote corporate consolidation. Across the world, such mergers are commonly observed in industries such as airline, automobile, pharmaceutical, information technology, banking, financial services and insurance. In the recent past, India has also witnessed an increase in the number of mergers in the realm of cement, power, steel, drugs, telecommunications, media & entertainment and banking (Prasad 2011).

Though corporate mergers are more common in developed economies such as US, UK and Germany, this phenomenon is gaining popularity in India and other developing economies like Malaysia, Indonesia, Philippines and Brazil. Most often, these mergers are driven by managerial expectations such as synergy benefits, cost reduction, economies of scale and economies of scope (Murthy 2007 and Sharma 2002). However, failure or poor performance of merged firms is common, in spite of perceived benefits and diligent implementation process. Numerous studies have examined the impact of bank mergers on bank efficiency and profitability, and the results
generally indicate that mergers have not resulted in increased efficiency or profitability (John & Graham 1990). Inherent risks like incompatible business model or technology, conflict of interest among different stakeholders and resource management challenges have been cited as reasons for such failures (Mallikarjunappa & Nayak 2007, and Jayadev & Sensarma 2007). So, there is always a need to carefully evaluate the gains and losses made in corporate mergers across various time horizons. These results would serve as reference points to various stakeholders of firms contemplating inorganic growth through mergers.

1.1 Merger scenario in India

In India, corporate expansion through mergers and acquisitions was not a common phenomenon and financial sector, particularly the banking sector was averse to such expansion due to a strict regulatory environment. However, there has been considerable increase in the number of ‘Merger and Acquisition’ deals in India after the economic liberalisation in the year 1991. Indian companies have been more open to both domestic and cross-border mergers in the recent years.

The Associated Chambers of Commerce and Industry in India (ASSOCHAM 2012) studied the ‘Merger and Acquisition’ phenomenon in India from 2008 to 2012 and reported that Indian companies had spent billions of US dollars on acquiring foreign companies. The compilation revealed that the Indian companies had mainly acquired US based companies, followed by companies based out of Sri Lanka. These merger deals were primarily driven by the desire for growth (Accenture 2008). Foreign multinational companies attracted by positive factors such as, robust legal framework, relatively resilient economic conditions, weak rupee and lower stock market valuations have also used the merger route to enter the Indian market. They tend to use the merger route as a precaution against green field risk.
The Grant Thornton & ASSOCHAM (2012) report additionally contemplated that India’s merger and acquisition environment would continue to grow stronger and bigger in the years that were to come. However, corporate consolidation is not happening in all the sectors and a few sectors such as the financial sector appear to lead the way. ASSOCHAM (2012) noted that financial sector had continuously been one among the top three preferred sectors for ‘Merger and Acquisition’ deals from 2008 to the first quarter of 2012. This was followed by other sectors such as energy and power, manufacturing, healthcare, high technology and real estate. Within the financial sector, ‘Mergers and Acquisitions’ in the banking sector assumed importance since the government was in favour of consolidation among banks (Bose 2007). An understanding of the banking structure in India would provide a better insight into the bank merger scenario in India.

1.2 Commercial banking in India

The commercial banking structure in India consists of Scheduled Commercial Banks and Non-scheduled Banks. Scheduled Commercial Banks constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI includes only those banks which satisfy the criteria laid down vide section 42 (6) (a) of the Act in this schedule. RBI’s annual publication about the profile of banks shows that India had 89 Scheduled Commercial Banks with 92,114 branches, as of March 2013 (Table 1.1). With so many banks India appears to be overbanked with a large number of small banks. The size of these banks, except State Bank of India, is small in comparison to the international banks (Nitsure 2008).

The government expects that lesser number of banks must be able to offer comprehensive service more efficiently by sharing the resources. In its opinion, this would also help in reduction of fixed costs incurred by banks. Due to economic reforms, the existing public sector banks face stiff
competition from the technology savvy private sector banks. The government also expects large flow of foreign capital into the Indian banking sector and anticipates tough competition from bigger global players.

Table 1.1 Scheduled Commercial Banks in India

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Category</th>
<th>No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>SBI and Associates</td>
<td>5</td>
</tr>
<tr>
<td>2</td>
<td>Nationalised Banks</td>
<td>20</td>
</tr>
<tr>
<td>3</td>
<td>Other Public Sector Banks</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>Private Sector Banks - Indian Banks</td>
<td>20</td>
</tr>
<tr>
<td>5</td>
<td>Private Sector Banks - Foreign Banks</td>
<td>43</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>89</strong></td>
</tr>
</tbody>
</table>


1.3 Bank merger scenario in India

Banking sector has always remained under the close surveillance of RBI and the government, owing to the importance of this sector for the country’s financial stability. It could be stated that banking in India has come a full cycle from complete dominance of the private sector banks in the past, to absolute government control and partial deregulation at present. The banking consolidation started in the year 1969 when fourteen banks were nationalised and with the subsequent nationalisation of 6 more banks in the 80’s major segment of the banking sector came under government control.

Nationalisation led to expansion of branch networks in rural and semi urban areas, which resulted in huge deposit mobilisation and increase in overall savings rate of the economy. But, banks had to increase their loan exposure to priority sectors like agriculture, as identified by the government at
government prescribed interest rates. Such governmental intervention in operational and strategic issues led to reduction in profitability, weakening of their capital base and inefficiencies. Over a period of time the nationalised banks turned complacent, since they were protected by the government and there was no compulsion or incentive to perform. Whenever the commercial viability of any nationalised bank became a problem it was merged with another nationalised bank. These mergers were facilitated by the government to protect the interest of various stakeholders such as employees, customers and the general public. Generally, mergers which took place during this era were based on regulatory compulsions and not on commercial considerations (Bose 2007 & Kamesam 2007).

However, the merger scenario changed after the onset of economic reforms in the year 1991. Due to various compulsions the government promoted the ideas of liberalisation, privatisation and globalisation and many sectors benefitted from these reforms. In case of banking, the focus was to create strong and competitive system, increase operational efficiency, strengthen supervision, create competitive environment and develop technological and institutional infrastructure. Overall, these measures were aimed at improving the financial health, soundness and efficiency of the banking sector.

Another development was the entry of more number of agile private sector banks, which did not have to operate in a bureaucratic setup. They had access to the best possible resources and their operations were frugal, which enabled them to be more profitable. Hence, private sector banks were able focus on growth and development through strategic initiatives such as mergers. Though it is not appropriate to compare the motive and operation of public sector banks and private sector banks owing to the differences in
structure and requirements, both had to consider ‘Merger and Acquisition’ for almost similar reasons.

By design the public sector banks had social obligations to perform and were docile in approach. In contrast, the private sector banks were able to take aggressive stance since they were not bound by stringent regulatory or social welfare compulsions of the government. Hence, they were able to expand their business rapidly and posed a severe threat to the public sector banks. Consequently, there was considerable pressure on public sector banks to survive, perform and grow, as well. So, both private sector banks and public sector banks were keen on achieving growth through organic and inorganic means.

Overall, the scenario changed from that of regulatory compulsion to commercial consideration and market-driven mergers gained momentum. This is evident from the fact that before 1999 the mergers were triggered by weak financials of the bank being merged, and after 1999 mergers among healthy banks which were driven by business and commercial considerations had also happened. Such mergers were termed as market-driven mergers by the Second Narasimham Committee Report (1998). The first such market-driven merger in India was between HDFC Bank and Times Bank in the year 1999.

On the other hand, the notion of banking consolidation was actively promoted by the government and Reserve Bank of India (RBI) for strategic reasons. RBI had asserted that it would play a supportive role in the task of banking consolidation based on commercial considerations. The intention was to create a small number of bigger banks which could compete with the international banks which had a large capital base and wide reach. Further, four trends were changing the banking industry world over, viz. consolidation of banks through mergers and acquisitions, globalisation of operations, development of new technology and universalization of banking (Gupta 2003).
Based on its own assessment of the situation and in line with above mentioned trends the Government supports consolidation among the Indian banks. Capital being a basic requirement for expansion, the government intended to create banks with bigger capital through the merger exercise. Besides, the government did not have enough resources to fund organic growth of nationalised banks and so the alternate route of building scale by mergers was encouraged. The government also intended to overcome the in-built inefficiencies of smaller banks by merging them (Bose 2007 and Vasudevan 2007). However, it does not actively intervene in the consolidation process and allows the mergers to happen on the basis of specific requirements (Dasgupta 2007).

1.4 Need for bank mergers

The Indian banking sector has undergone significant changes in the post-liberalisation era. Since significant time had elapsed after the reforms were initiated in India researchers like Shirai (2002) and Bhattacharya & Menon (2007) proposed that the Indian banks could consider consolidation in view of the benefits experienced through mergers globally (Murthy 2007 and Sharma 2002). Studies on bank mergers by Hughes et al (2002), Toyne & Tripp (1998) and Neely (1987), in US provide important evidence about its effect on shareholder wealth. In general, they observed that bank mergers had resulted in gains to shareholders of either the acquiring bank or the acquired bank.

While growth cannot be achieved without taking calculated risks such as mergers, not all mergers have resulted in favourable outcome to all the stakeholders. Pilloff & Santomero (1997) too raised doubts about the alleged positive effect of consolidation on shareholder value since they had not observed increase in shareholder wealth. Likewise, DeLong (2003) reported that on average bank mergers did not create value for shareholders in
US. Staff et al (1986) showed that although the increase in merger activity in US resulted in larger and more powerful holding companies, it apparently did not increase the wealth of the shareholders of those holding companies. They felt that the frenzy in bank acquisitions could have happened due to a perceived need to grow, to create economies of scale, to prepare for eventual changes in interstate banking laws or to grow larger and to avoid becoming an acquisition target. Such adversities could affect the overall post-merger profitability in the long-run and lead to stock price volatility in the short-run.

Srinivasan et al (2009) had also observed that merger or large size was just a facilitator and not a guarantee for improved profitability on sustained basis. They ruled that larger size should not be allowed to affect agility and at the same time lack of size should not make the banks irrelevant. So, it is important to study the effect of bank mergers both in the long-run and short-run.

Vast literature exists on pre and post-merger performance of banks and the evidence appears to be mixed. Koetter (2005) and DeLong (2003) have studied the long term effects through ratio analysis or DEA using accounting data. In general, studies on American bank mergers have indicated of gains from mergers. Whereas, cross-country study by Bank for International Settlements (2001) showed that, post-merger, return on assets had declined in 12 out of 16 countries and net interest margin had declined in 14 countries. The study indicated that acquirers tend to overpay for targets in mergers.

The results are clearly different from that of studies based in US. The reason for the difference could be because merger wave of the 90’s in the US was driven by relaxation of restrictions on interstate (as also intrastate) banking and their entry into securities activities. Singh (2009) also observed that US bank mergers had created value by eliminating built-in inefficiencies which explains why the US evidence was favourable.
These studies may not be entirely useful to understand the state of affairs in an emerging economy like India, where such market-driven mergers are relatively new phenomena. Moreover, differences in nature of the economy and institutional conditions make it difficult to generalise these implications. As a result there is an increasing interest in examining the benefits of such mergers in an emerging country like India. Since liberalisation, more than twenty mergers have happened in the banking industry and the current merger scenario offers a vital research opportunity to assess the efficiency gains and shareholder benefits.

Though a few researchers have worked on Indian bank mergers, those papers appear to be theoretical in nature and seek to answer whether there should be consolidation of banks or not (Singh & Gupta 2013). For example, Bagchi & Banerjee (2005), Lakshminarayanan (2005) and Mohan (2005) have done their research on this basis. A few like, Anand & Singh (2008) and Jayadev & Sensarma (2007) have evaluated the impact of bank mergers on the wealth creation of acquirer and acquiring banks’ shareholders. Other researchers like Mann & Kohli (2009) and Selvam et al (2006) have each analysed only one merger announcement.

Likewise, a few studies about merger efficiency gains using Data Envelopment Analysis have been done by Kaur & Kaur (2010) and Kumar (2007). The available reviews either in case of US, where numerous mergers have happened, or in India, where the number of mergers are less, offer at best mixed evidence. In the absence of conclusive proof, it became imperative to analyse the effect of bank merger implications on stock returns and efficiencies. Hence, this study analyses the short-run and long-run effect of all post-reform mergers in the Indian banking industry. Similar analysis has been done by DeLong (2003) in US, based on the argument that more the
difference in efficiency ratios, higher should be the abnormal returns of the merging banks.

1.5 **Objectives**

The objective of this study is to understand the gains from post-reform banking sector mergers in India.

The specific objectives of the study are:

1. To analyse the impact of merger announcements on stock returns of acquiring and acquired banks
2. To study the effect of merger on the efficiencies of merged banks

1.6 **Null Hypotheses**

The above objectives necessitate testing of the following null hypothesis:

- $H_{01}$: There is no significant difference in the stock returns of acquiring banks before and after merger announcement
- $H_{02}$: There is no significant difference in the stock returns of acquired banks before and after merger announcement
- $H_{03}$: There is no significant difference in the performance of merged banks before and after merger

1.7 **Time period of the study**

This study pertains to post-reform bank mergers in India that had happened during 1999 – 2010.
1.8 Scope of the study

The first market-driven bank merger in the post-reform period was announced in the year 1999. Hence, 1999 is considered as the beginning year for this study. The upper limit was chosen as 2010, since a time window of three years is required for efficiency analysis. During this time period many banks acquired other banks and at times they have also acquired some non-banking financial companies. Grouping of such non-banking firms and banking firms together for analysis of stock returns and efficiencies would be inappropriate. Hence, mergers involving non-banking firms have not been considered for this study. Overall, this study analyses all the post-reform bank-to-bank mergers in India that had happened from 1999 to 2010.

1.9 Significance of the study

Mergers are generally conceived on the expectation of potential benefits to various stakeholders. However, numerous mergers have failed both in India and abroad owing to different strategic and operational issues. The results of this study would help the general investors and stockholders of banks to take informed decisions about selling, buying or holding the stocks of banks involved in mergers. Further, this analysis would serve as reference point for bank managers who might contemplate the idea of consolidation, in future. The results would indicate the gains or losses made by acquiring banks in the long-run and prompt the policymakers either to continue or to have a relook at the banking consolidation notion. Researchers could gain by comparing this study with other studies or their own analyses and appreciate the similarities / dissimilarities in the approach and results.
1.10 Limitations

Apart from the variables that have been analysed in this study, other variables such as business environment, macro-economic factors, technology integration challenges and human resource issues would affect the operations of banks and that could affect the outcome of a merger exercise. Outcome of mergers during periods of economic decline and economic growth could be different. Gains or losses in stock returns and efficiencies could have been caused by such extraneous factors and that could cause noise in the analysis and results. Also, if a bank acquires two or more banks within a short time period the effect of previous mergers would be still present on the acquiring bank. The analysis techniques used in this study do not have the ability to filter out the effect of such random factors on the results. Moreover, these findings relate to bank mergers within India in a given time period and hence the results cannot be generalised across time periods or geographies.

1.11 Organisation of thesis

The thesis is organised into five chapters as follows:

Chapter I Introduction

The bank merger scenario in India, banking structure, problem focus, objectives, hypotheses, scope and limitations are presented in this chapter.

Chapter II Literature Review

Past studies on bank mergers in India, US and Europe pertaining to shareholder implications and long-term performance implications are presented in the order of relevance.
Chapter III  Research Methodology

Sources of data, method of data collection and tools of data analysis are presented in this chapter.

Chapter IV  Analysis and Interpretation

Effect of merger announcements on stock returns is analysed using event study methodology and the impact of merger on bank efficiencies is analysed by applying Data Envelopment Analysis.

Chapter V  Findings and Conclusions

Results of analysis, inferences and suggestions to stakeholders are presented in this chapter.