MERGERS AND ACQUISITIONS IN THE INDIAN BANKING SECTOR

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ABSTRACT

The aim of this paper is to probe into the various motivations for mergers and acquisitions in the Indian Banking sector. India is slowly but surely moving from a regime of large number of small banks' to 'small number of large banks'. Like all business entities, banks want to safeguard against risks, as well as exploit available opportunities indicated by existing and expected trends. Mergers &Acquisitions in the banking sector have been on the rise in the recent past, both globally and in India. The fast growing domestic economy, a climate conducive to investment and easy financing have caused an increase in the mergers and acquisitions. This paper seeks to explain the motives behind some Mergers &Acquisitions that have occurred in India post- 2000, analyze the benefits and costs to both parties involved and the consequences for the merged entity.

This paper also seeks to explain the motives behind some Mergers &Acquisitions that have occurred in India, analyze the benefits and costs to both parties involved and the consequences for the merged entity. A look at the future of the Indian banking sector, and some key recommendations for banks, follow from this analysis.

KEYWORDS - *Strategy, Banking, Financial Services, India, Mergers, Acquisitions*

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INTRODUCTION

Mergers and Acquisitions aim towards Business Restructuring and increasing competitiveness via increased efficiency. In recent years India Inc. has seen a surge in M&As. The fast growing domestic economy, a climate conducive to investment and easy financing have caused an increase in the mergers and acquisitions. During the period January-May 2007 there have been 287 deals with a value of US$ 47.37 billion. Of these, the total outbound cross border deals were 102 with a value of US$ 28.19 billion, accounting for 59.5 per cent of the total M&A activity in India.

The International banking scenario has shown major turmoil in the past few years in terms of mergers and acquisitions. Deregulation has been the main driver, through three major routes - dismantling of interest rate controls, removal of barriers between banks and other financial intermediaries, and lowering of entry barriers. It has lead to disintermediation, investors demanding higher returns, price competition, reduced margins, falling spreads and competition across geographies forcing banks to look for new ways to boost revenues. Consolidation has been a significant strategic tool for this and has become a worldwide phenomenon, driven by apparent advantages of scale-economies, geographical diversification, and lower costs through branch and staff rationalization, cross-border expansion and market share concentration. The new Basel II norms have also led banks to consider M&As.

This paper looks at some M&As that have happened post-2000 in India to understand the intent (of the targets and the acquirers), resulting synergies (both operational and financial), modalities of the deal, congruence of the process with the vision and goals of the involved banks, and the long term implications of the merger. The paper also analyses emerging future trends and recommends steps that banks should consider, given the forecasted scenario.

The Indian financial system would be open to intense international competition with complete implementation of the provisions of WTO agreement on services (GATS) during the year 2005-06 when banks will be required to compete across the globe with multinational banks having greater financial strengths. The banks will also be required to strengthen their capital position to meet stringent prudential capital adequacy norms under Basel-II (beginning 2006-07). In the backdrop of growing openness of Indian financial system, there is growing interest in mergers and acquisition with focus on size of the banking organization. It is inevitable that banks in India, particularly the

public sector banks, could no longer afford to operate as a monolith and the Central government has already indicated that the banks have to consolidate, not just to create behemoths, but to create synergies.

Mergers and Acquisitions

The term 'merger' is not defined under the Companies Act, 1956 (the 'Companies Act'), the Income Tax Act, 1961 (the 'ITA') or any other Indian law. Simply put, a merger is a combination of two or more distinct entities into one; the desired effect being not just the accumulation of assets and liabilities of the distinct entities, but to achieve several other benefits such as, economies of scale, acquisition of cutting edge technologies, obtaining access into sectors / markets with established players etc. Generally, in a merger, the merging entities would cease to be in existence and would merge into a single surviving entity.

Mergers and acquisitions are methods by which distinct businesses may combine. Joint ventures are another way for two businesses to work together to achieve growth as partners in progress, though a joint venture is more of a contractual arrangement between two or more businesses.

An acquisition or takeover is the purchase by one company of controlling interest in the share capital, or all or substantially all of the assets and/or liabilities, of another company. A takeover may be friendly or hostile, depending on the offer or company's approach, and may be effected through agreements between the offer and the majority shareholders, purchase of shares from the open market, or by making an offer for acquisition of the offeree's shares to the entire body of shareholders.

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FOCUS OF MERGERS:

The growing tendency towards mergers in banks world-wide, has been driven by intensifying competition, need to reduce costs, need for global size, take benefit of economies of scale, investment in technology for technology gains, desire to expand business into new areas and need for improvement in shareholder value. The underlying strategy for mergers, as it is presently being

thought to be, is, 'larger the bank, higher its competitiveness and better prospects of survival'. Due to smaller size, the Indian banks may find it very difficult to compete with international banks in various facets of banking and financial services. Hence, one of the strategies to face the intense competition could be, to consolidate through the process of mergers.

Recent Scenario of Mergers In India:

In India, the mergers in 60s had taken place under the direction of RBI and as a result from 566 banks during 1951, the no. came down to 85 (14 non- scheduled) by 1969. During 90s, the merger of NBI with PNB created personnel integration problems and as a result, PSB mergers were not contemplated, subsequently. However private bank mergers continued with merger of Bank of Madura with ICICI, that of Times Bank with HDFC, Benares State Bank with BoB in 2002, Nedungadi Bank with PNB in 2003 and more recently that of the Global Trust Bank with OBC in 2004. Reverse merger of ICICI Ltd also took place with ICICI Bank, during the year 2001. These mergers did help in strengthening financially, helped to avoid the complex processes of restructuring the weaker of the units and foster financial stability and opened the possibility of actively promoting universal banking. It is encouraging that these mergers were facilitated to a large extent by banking sector reforms. However, there is little published empirical literature on the impact of mergers in banking in India.

Case For Mergers:

The mergers and acquisitions can be thought of in India on merit, due to following factors also:

- Top 5-6 Indian banks have solid management and they can improve the functioning of some of the smaller banks, through changes in their management.
- Indian banks are scattered regionally and can consolidate to improve their client and industry positions. There is an opportunity for smaller banks to become large and larger banks to consolidate and become even larger.
- There are other cost cutting opportunities in IT implementation, branch rationalization and staff rationalization.
- M & A provides a fast and easy method for many banks to enter areas where they lack a presence.

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) - Nationalisation, regularisation and growth
- Phase III (1991 onwards) - Liberalisation 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 Securitization, 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.

Global Banking Developments

- The year 2010-11 was a difficult period for the global banking system, with challenges arising from the global financial system as well as the emerging fiscal and economic growth scenarios across countries
- Global banks exhibited some improvements in capital adequacy but were beleaguered by weak credit growth, high leverage and poor asset quality. In contrast, in major emerging economies, credit growth remained at relatively high levels, which was regarded as a cause of concern given the increasing inflationary pressures and capital inflows in these economies
- In the advanced economies, credit availability remained particularly constrained for small and medium enterprises and the usage of banking services also stood at a low, signaling financial exclusion of the population in the post-crisis period
- On the positive side, both advanced and emerging economies, individually, and multi-laterally, moved forward towards effective systemic risk management involving initiatives for improving the macro-prudential regulatory framework and reforms related to systemically important financial institutions

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 recency (all post-2000) to ensure that the motives driving the deals will remain relevant in the current context.

Standard Chartered Acquires ANZ Grindlays Bank (November '00)

Standard Chartered wanted to capitalise 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 Grindlays 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. Grindlays 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 Grindlays 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 defence against possible hostile takeover). The merger also greatly reduced the risk profile of ANZ by reducing its exposure to default prone markets.

DRAWBACKS

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

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

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.

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. 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 utilization in BoM, there were hindrances in the merged entity.

Bank of Baroda Acquires South Gujarat Local Area Bank Ltd (June '04)

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.

Oriental Bank of Commerce Acquires Global Trust Bank Ltd (August '04)

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 - computerization 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.

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

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.

Motives behind Consolidation

Based on the cases, we can narrow down the motives behind M&A's 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-stabilization 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 20012, 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' mobilisation, 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&A's in the future are likely to be more market-driven, instead of government-driven.

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 2013 end with minimization 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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