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MERGERS AND ACQUISITION OF INDIAN OVERSEAS BANK IN POST-REFORM INDIA

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ABSTRACT

Mergers and acquisition have emerged as one of the common methods of consolidation, restructuring and strengthening of banks. A major perspective of the Reserve Bank of India's banking policy is to encourage competition, consolidate and restructure the system for financial stability. There are several theoretical justifications to analyze the M&A activities, like change in management, change in control, substantial acquisition, consolidation of the firms, merger of buyout of subsidiaries for size and efficiency, etc. The objective here is to examine the performance of banks after mergers. Mergers add value to the performance of the banks and firms, others show that mergers retard growth, reduce profitability, and affect the credit risk position of the merger banks. The current study is an attempt to analyze the mergers of banks in India from the early 1990's, when the financial sector reforms began, till 2010.

Key Words: Mergers, Financial Stability, Acquisition, Profitability, Restructuring

Introduction

Mergers and acquisition have been one of the measures of consolidation, restructuring and strengthening of banks. In banking sector mergers and acquisition seeks to enlarge the size of banks to tap economies of scale or present bank failure. Profitable growth constitutes one of the prime objectives of most of the business firms. It can be achieved internally either through the process of introducing new products or by expanding the capacity of existing products. Motives of bank mergers and amalgamation vary from change of ownership to enhancing size for efficiency gains.

Mergers can be classified into three categories; horizontal mergers, vertical mergers and conglomerate mergers. A horizontal merger is between merger is a combination of two or distribution of merger. A conglomerate merger is a combination of firms engaged in unrelated lines of business activity. The type of M&A also dictates the acquisition logic, the framework for the evaluation of targets, the acquisition target profile and the post-acquisition integration. The objectives of the firms that opt for mergers may be attributed to: (i) change in management, (ii) change in control, (iii) substantial acquisition, (iv) merger of buyout of subsidiaries for size and efficiency, (v) consolidation of the firms.

Though there was urgent need to strengthen amalgamation was very poor and discouraging. Amalgamation of banks took place on voluntary basis under section 44A of the BRA as there was no other provision for the purpose till 1960. In view of this, RBI acquired statutory powers through an amendment in the BRA in 1960 for reconstruction or compulsory amalgamation of banks. Since then, amalgamations were on voluntary basis with RBI approval (Section 44A of BRA) whenever possible, and compulsion whenever necessary.

RBI's policy is to encourage amalgamation to protect the interest of depositors in particular and strengthen the banking structure in the area in general. RBI also encourages banking integration through the transfer of assets and liabilities of small and unsound, weak and small units into fewer and strong banking units. 14 big banks were nationalized in 1969 to strengthen public sector undertaking (PSU) dominance. It is assumed that all these processes contribute towards an efficient and optimal banking structure. Thus, the restructuring and consolidation through strategy of M&A is continuous process to improve the working of Indian banking and steer it towards optimal structure in terms of size distribution, ownership and organizational diversity.

The present study analyses the performance of banks that went in for mergers during and after the financial sector reforms. The main emphasis is to see whether the M&A in bank sector have contributed to overall growth and economies of scale and efficiency of the bank.

Mergers and Acquisition Trends in India

Economic reforms and de regulation of the Indian economy has brought in more domestic as well as international players in Indian industries. This has caused increased competitive pressure leading to structural changes of Indian industries. From 1960 to June 1982, 20 voluntary amalgamation, 49 compulsory mergers, 18 mergers with State Bank of India (SBI) and its associates, and 130 transfers of assets and liabilities were completed. Prior to 1969, the Indian banking system was very weak and dominated by small unviable banks owned by business houses, So, in 1960, RBI was empowered to bring compulsory mergers and integrations. In the post-1960 period, there were large numbers of compulsory mergers (particularly 30 in 1961) and integration (transfer of assets/liabilities; 62in 1964). The elimination of weak banks helped boost economic efficiency and financial integrity, leading to an improved banking structure.

Table I

Banks Amalgamated since Nationalization of Banks in India 1969 - 1990

S.No	Date of Merger	Merging Bank	Merged with	Motive of Merger	Type of Merger
1.	08/11/1969	Bank of Bihar	State Bank of India	Restructuring of Weak Bank	Compulsory
2.	20/02/1970	National Bank of Lahore	State Bank of India	Restructuring of Weak Bank	Compulsory
3.	29/07/1985	Miraj State Bank	Union Bank of India	Restructuring of Weak Bank	Compulsory
4.	24/08/1985	Lakshmi Commercial Bank	Canara Bank	Restructuring of Weak Bank	Compulsory
5.	26/08/1985	Bank of Cochin	State Bank of India	Restructuring of Weak Bank	Compulsory
6.	19/12/1986	Hindustan Commercial Bank	Punjab National Bank	Restructuring of Weak Bank	Compulsory
7.	13/05/1988	Traders Bank	Bank of Baroda	Restructuring of Weak Bank	Compulsory
8.	31/10/1989	United industrial Bank	Allahabad Bank	Restructuring of Weak Bank	Compulsory
9.	20/02/1990	Bank of Tamil Nadu	Indian Overseas Bank	Restructuring of Weak Bank	Compulsory
10.	20/02/1990	Bank of Thanjavur	Indian Bank	Restructuring of Weak Bank	Compulsory
11.	20/02/1990	Parur Central Bank	Bank of India	Restructuring of Weak Bank	Compulsory
12.	29/08/1990	Purbanchal Bank	Central Bank of India	Restructuring of Weak Bank	Compulsory

Source: Report on Trend and Progress of Banking in India, RBI Various Issues.

Table 1 shows the merging of Bank of Baroda after the bank nationalization in 1969, till the financial sector reforms in the early 1990s. Twelve cases of mergers were found during the period. From the table it can be observed that consolidation of banks was carried out by RBI before the reforms period to amalgamate unviable units. All the merging banks are public sector banks. The main motive is to strengthen the banking sector through compulsory amalgamation in order to weed out unviable banks by liquidation, or by the taking of assets of the non-functioning banks by other banks.

Table 2

Mergers, Amalgamations of Indian Overseas Bank from 1991 to 2010

S.No	Date of Merger	Merging Bank	Merged with	Motive of Merger	Type of Merger
1.	31/03/2007	Bharat Overseas Bank	Indian Overseas Bank	For economies of Scale & Scope	Voluntary

Source: Report on Trend and Progress of Banking in India, RBI Various Issues.

Hypotheses

The main objective is to examine whether the performance of banks has increased after mergers. Accordingly, the following hypotheses are formulated for the current study:

H_o : there is no significant change in the performance of banks after mergers.

H_1 : there are significant changes in the performance of banks after mergers.

Methodology

The performance of the banks is analyzed in terms of financial ratios such as profitability ratios, solvency ratios, efficiency and earning capacity of banks, and growth rate of total assets.

These factors as well as the specific measures used to represent them are defined in the following Table. These indicators are used to identify whether mergers have any improvement or bearing on the performance of the banks.

Table 3

Definitions of Performance Ratios used in Analysis of Merged Banks

Ratio	Definition
Profitability indicators (i) Return on assets (ROA)	Measure overall performance Ratio of profit after tax to total assets
(ii) Return on equity (ROE)	Ratio of net profit to average shareholder's equity
Solvency indicator (i) Capital Adequacy Ratio (CAR)	Measure the bank's ability to meet its obligations relative to its exposure to risk Ratio of tier I & tier II capital to capital weighted assets
Efficiency indicators (i) Spread	Measure the bank's ability to generate income, pay expenses and measure the productivity of employees Net interest income as a percentage of total assets
(ii) Operating cost/total assets (OC/TA)	Total operating expenses as a percentage of total assets
(iii) Profit per employee	Ratio of net profit to the number of employees
Growth indicator (i) Asset growth rate	Measure the bank's changes in assets Change in book value of total asset as a percentage of book value of total assets in the previous year

Analysis

A comparison of the post-merger and pre-merger performance allows measuring of the impact of the mergers. The financial data of the bank was collected for six years, three years before the merger and three years after the merger. The financial data for the year in which the merger occurred is omitted under the study. The financial indicators used are profitability, solvency, and efficiency. The average values of the selected financial parameters for the periods T-3, T-2 and T-1 are compared with its average values at T+1, T+2 and T+3 for each bank. In the next step, a paired Student's t-test is performed to check the statistical significance of the two means of pre-and post-merger periods.

Three mergers took place in Indian Overseas Bank

The formula of the paired sample t-test is given by:

$$t= \frac{\dfrac{\sum_{i=1}^{N}(X_0 - X_1)}{N}}{6\sqrt{N}} \qquad \ldots\ldots (1)$$

Where

X_0 = pre-merger performance of the bank(s)

X_1 = post-merger performance of the bank(s)

N = number of parameters used in the sample

б = the standard deviation (SD) of the distribution of the change in performance of the merging banks

By using Formula (1), pre-merger and post-merger performance of the individual merging bank is measured for each of the performance indicators.

Performance of the Bank

The results of the descriptive t-test for the merging bank in shown below

Table 4

Descriptive statistics of Paired t-Test for Indian Overseas Bank

Financial Ratios	Period	Mean	Standard Deviation	t-value	Probability	Remark
Merger case-1 Bharat Overseas Bank with Indian Overseas Bank in 2007						
ROA	Pre-merger	1.32	0.04	2.492	0.130	Not significant
	Post-merger	0.80	0.330			
ROE	Pre-merger	27.78	0.486	3.616	0.069	Not significant
	Post-merger	14.81	6.476			
CAR	Pre-merger	13.50	0.614	-0.795	0.510	Not significant
	Post-merger	14.18	0.854			
Spread	Pre-merger	3.72	0.085	10.275	0.009	significant
	Post-merger	2.60	0.108			
OC/TA	Pre-merger	2.03	0.307	2.744	0.111	Not significant
	Post-merger	1.64	0.223			
Profit per employee	Pre-merger	3.31	0.694	-0.720	0.546	Not significant
	Post-merger	----	----			
Growth rate of assets	Pre-merger	27.70	15.39	1.693	0.340	Not significant
	Post-merger	22.33	19.87			

*Significant at the 5% level

Performance of Indian Overseas Bank

The Sole voluntary merger with Oriental Bank of Commerce occurred when Bharat Overseas Bank merged with it (Table 4). Even though it was a voluntary merger, most performance indicators show the merger had poor results. The sample paired t-test indicated that, except spread, none of the performance indicators were statistically significant.

Reasons for statistically insignificant Ratios

Profitability Ratios:

From the table of the merged bank, it can be observed that the profitability measures, ROA and ROE, did improve after some of the mergers. However, mean values of these ratios did not improve. The squeeze on profitability has been driven from the expenditure side, like the increase in interest costs of deposit, growing functional diversification of banks, rapid growth in the wages and salary of staff, and accelerated promotions, etc.

Solvency Ratios:

The merged bank fulfilled the regulatory CAR (Capital Adequacy Ratio) requirement of the 9% level. This signified that the merged bank successfully managed to meet the increased remerged bank successfully managed to meet the increased requirement under the new regulatory framework. In other words, bank could absorb the unexpected losses easily and manage their reduced cost of funding, which ultimately improved their profitability. However, the average CAR declined in the post-merger period and needed recapitalization with fresh funds in order to cope with the new environment of mergers.

Other Ratios:

Non-performing assets (NPA) have been the major track in varying importance for bank's performance. Besides, slow adoption of technology across banking functions and branches has delayed the approval of bigger benefits. Business restructuring and manpower restructuring imposed the additional cost.

Table 5: Summary of Descriptive Statistics – Statistically Significant Ratio only

Acquiring Bank	ROA	ROE	CAR	Spread	OC/TA	Profit per Employee	Asset Growth
Indian Overseas Bank	X	X	X	Significant	X	X	X

Summary

Table 5 provides bank-wise statistically significant ratio of each performance indicator, pre and post-merger from 1991-2010. Statistical significance was observed for Indian Overseas Bank. ROE and ROA was not formed to be statistically significant. Spread shows statistical significance, other indicators have a limited significance. Generally the strategies focus on long-term gains and not short term objectives; hence the null hypothesis (H_o) that there is no significant improvement after mergers is accepted.

Conclusion

Further when results are classified for compulsory merger cases and voluntary merger cases separately, there is no difference as more or less equal number of significant ration are seen for both categories, this indicates that in the Indian banking sector merging banks seem to be of very small size relative to the size of the bank merged with so as to make the impact insignificant, irrespective of the type of merger, compulsory or voluntary. Even when we look at performance of a bank in the control period (normal years without M&A transactions), results of this study remain unchanged. The strategy of M&A to consolidate the banks citing efficiency as the reason is doubtful. Future banking policy must take note of this empirical reality and the long drawn experience of the years since the financial reforms.

To be most successful, Reserve Bank of India and the Government must streamline the procedures and law relating to mergers. The liberalized policies and procedures will definitely bring good results in the near future. In the area of acquisition in the last few years certain interesting changes have taken place in banking sector. Thus on the whole, acquisition will become the most favorite method for achieving growth.

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