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## BANKING SECTOR REFORMS AND BANK CONSOLIDATION: CONCEPTUAL FRAMEWORK

By  
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### I. Introduction

**R**eforms are predicated upon the need for reorientation and repositioning of an existing status quo in order to attain an effective and efficient state. There could be fundamental bottlenecks that may inhibit the functioning of institutions for growth and the achievement of core objectives in the drive towards enhancing and sustaining the economic and social imperatives of human endeavour. Carried out through either government institutions or private enterprises, reforms become inevitable in the light of the global dynamic exigencies and emerging landscape. Consequently, the banking sector, as an important sector in the financial landscape needs to be reformed in order to

enhance its competitiveness and capacity to play a fundamental role of financing investments. Anecdotal literature indicates that banking sector reforms are propelled by the need to deepen the financial sector and reposition it for growth; to become integrated into the global financial architecture; and evolve a banking sector that is consistent with regional integration requirements and international best practices.

Consolidation is viewed as the reduction in the number of banks and other deposit-taking institutions with a simultaneous increase in size and concentration of the consolidated entities in the sector (BIS, 2001). It is mostly motivated by technological innovations, deregulation of financial services, enhancing intermediation and increased emphasis on shareholder value, privatization and international competition (Berger et al., 1999; De

Nicolo et al., 2003; IMF, 2001).

The nexus between consolidation and financial sector stability and growth is explained by two polar views. Proponents of consolidation opine that increased size could potentially increase bank returns, through revenue and cost efficiency gains. It may also, reduce industry risks through the elimination of weak banks and create better diversification opportunities (see Berger, 2000). On the other hand, the opponents argue that consolidation could increase banks' propensity toward risk taking through increases in leverage and off-balance sheet operations. In addition, scale economies are not unlimited as larger entities are usually more complex and costly to manage (De Nicoló et al., 2003).

The objective of this paper is, therefore, to present

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the conceptual framework for banking sector reforms, particularly, consolidation. To do this, the paper is divided into five sections. Following the introduction, section II conceptualizes the facets of reforms and conceptual issues on consolidation in the banking sector, while section III discusses the critical success issues in banking sector consolidation. Section IV presents concepts associated with country elements of banking reforms, while section five concludes the paper.

## **II. Facets of Reforms and Conceptual Issues on Consolidation in the Banking Sector**

A combination of many weak elements of financial institutions could jeopardize the health of the system. This results primarily from extraction of rents which are made possible through weak regulatory and supervisory framework, weak safety nets arrangements, poor crisis resolution techniques, poor corporate governance and the structure of the banking system.

In view of the above, the facets of banking reforms aimed at ensuring a healthy ambience

encompasses reforming the regulatory and supervisory framework, the safety net arrangements, crisis resolution mechanisms, shareholding structure, and structure of the banking industry and entronement of good corporate governance.

Reform of the regulatory and supervisory framework is aimed at aligning the institutional framework governing the regulation and supervision of financial institutions to the needs of a growing and complex financial system. It involves issues of regulatory independence, risk-focused and rule-based supervision, while safety arrangement in reforms embrace the traditional lender of last resort role, deposit insurance arrangements which cater for both 'normal' and 'financial crisis' situations, and prudential regulation and supervision. Reforms relating to corporate governance evolve in order to provide a well established governance structure and oversight process. This is essential in order to engender proper evaluation, understanding, and mitigation of risk as well as permit banks to strengthen the stability of

their operations and instill accountability. In this regard, risks throughout the institution will be properly managed and improvements will be reflected in a stronger balance sheet.

While reforms in the banking industry are aimed at addressing issues such as governance, risk management and operational inefficiencies, the vortex of the reforms is around firming up capitalization. Capitalization is an important component of reforms in the banking industry, owing to the fact that a bank with a strong capital base has the ability to absolve losses arising from non-performing liabilities (NPL). Attaining capitalization requirements is achieved through consolidation, convergence as well as the capital market. Thus, banking reforms are primarily driven by the need to achieve the objectives of consolidation, competition and convergence (Deccan Herald, 2004) in the financial architecture.

Consolidation and convergence are achieved through mergers and acquisition. A merger is

the combination of two or more separate firms into a single firm. The firm that results from the process could take any of the following identities: acquirer, target or new identity. Acquisition on the other hand, takes place where a company takes over the controlling shareholding interest of another company. Usually, at the end of the process, there exist two separate entities or companies. The target company becomes either a division or subsidiary of the acquiring company.

While consolidation involves mergers and acquisitions between/among banks, convergence involves the consolidation of banking and other types of financial services like securities and insurance (FRBSF Economic Letter, 1998). Anecdotal evidence indicates that the commonest form of mergers and acquisitions found in the financial services industry involves domestic firms competing in the same segment (for instance, bank-to-bank). The second most common type of merger and acquisition transactions involved domestic firms in different segments (e.g. bank-insurance firms). Cross-border mergers and acquisitions are less

frequent, particularly those involving firms in different industry segments (Roger Ferguson Jr., 2002).

An early view of consolidation in the banking sector conceived it in terms of the relative cost efficiency where larger banks could eliminate excess capacity in the areas of data processing, marketing, or overlapping branch networks. Cost efficiency could also improve if more efficient banks acquired less efficient ones. Though studies on efficiency in banking raised doubts about the extent of overcapacity, they did point to the considerable potential for improvement in cost efficiency through mergers (FRBSF Economic Letter, 1998).

A 'newer' concept of consolidation view bank mergers as not just about adjusting inputs to affect costs; but, also involves adjusting output (product) mixes to enhance revenues. The studies of Akhavein, et al. (1997) and Berger (1998) in support of this view found that bank mergers do tend to be associated with improvements in overall performance, partly because banks achieved higher valued output mixes through a shift

toward higher yielding loans away from securities. These studies revealed that merged banks also tend to experience a lowering of their cost of borrowed funds without needing to increase capital ratios. The lower cost of funds is consistent with a decline in the overall risk of the combined bank, compared with that of the merger partners taken separately. This apparently occurs even though a shift to loans by itself might be expected to increase risk. This may imply that a merger can result in a reduction in some dimensions of risk. This then affords the post-merger bank more latitude to shift to a higher return, though perhaps higher risk output mix. The sources of diversification could be differences in the range of services, the portfolio mixes, or the regions served by the merging banks (FRBSF Economic Letter, 1998).

Aside consolidation, the other route of achieving capitalization requirements – the capital market – requires some succinct discussion. The capital market provides a conduit for investment funds and devolution of the ownership structure. Through offer for

subscription by either private placements or public offer, banks expand their capital base consistent with new business initiatives, technological innovations and regulatory guidelines. This channel for raising bank's capitalization do not directly encourage consolidation of any kind, but allow large and complex banking institutions to evolve under a set of banking reforms, and indirectly increase the value of shareholders for possible merger discussions. In the later sense, the capital market assist in sustaining consolidation as it helps in reducing valuation problems associated with consolidation.

### **III. Drivers and Critical Success Issues in Banking Sector Consolidation**

Consolidation is, in some instances driven by regulation, the generic factors influencing a potential acquirer or buyer encompasses economies of scale, growth in market share, need to enter a new and more growth-oriented market, and desire to invest excess capital. On the side of the potential sellers, the influencing factors may include lack of management succession, inability to

keep pace with change, particularly, technology, regulatory pressures and perceived opportunity to cash out at a high price. Thus, reforms through consolidation are motivated by four key economic factors namely, economies of scale and scope, potentials for risk diversification as well as bank managements' personal incentives.

First, is economies of scale – the relationship between the average production cost per unit of output and production volume. A firm that produces a higher volume of output can see its unit cost of production declining because the costs of some of the inputs are fixed, such as administrative and overhead expenses. However, diseconomies of scale are also possible. The average production cost may start to rise when output exceeds a certain volume because it may be more costly to manage a very large firm. These costs may stem from corporate governance issues, difficulties in coordination and execution, and diminished flexibility in responding quickly to changing markets. While researchers generally agree that economies of scale do exist in the banking industry at low

levels of output, there is less agreement about whether dis-economies of scale prevails at high levels of output.

The second economic force is economies of scope – a situation where the joint costs of producing two complementary outputs are less than the combined costs of producing the two outputs separately. This may arise when the production processes of both outputs share some common inputs, including both capital (such as the actual building the bank occupies) and labour (such as bank management).

The third economic factor is the potential for risk diversification. Evidence has shown that geographic expansion would provide diversification benefits to a banking organization not only by reducing its port-folio risk on the asset side, but also by lowering its funding risk on the liability side, as it spreads funding activities over a larger geographic area (Hughes, Lang, Mester, and Moon 1999). Further evidence suggests that product expansion could yield diversification benefits, most notably between banking and

securities activities, while less so between banking and insurance. Thus, a bigger bank is expected to be less vulnerable to economic shocks, and that alone could reduce its cost of capital, further confirming the benefits of scale and scope economies that come only from the production process.

The fourth economic force involves the bank managements' personal incentives. These may include the desire to run a larger firm and the desire to maximize their own personal welfare. Managerial compensation and perquisite consumption tend to rise with firm size. (Kwan and Eisenbeis 1999).

In order to achieve a less costly consolidation exercise, due diligence and negotiation are essential ingredients. Due diligence involves the judgment, care and prudence that an entity should reasonably undertake in order to evaluate any business proposition. In mergers and acquisitions, due diligence is a critical element. It seeks to confirm the material facts and figures provided by the seller. The acquirer therefore has the opportunity to identify

subtle but important background details that will impact on the eventual value placed on the business. Due diligence is therefore intended to provide an accurate assessment of the target by highlighting key issues; uncover hidden competitive threats; ensuring disclosure of adequate information to enable the potential acquirer take informed decisions; and determine a fair value that is satisfactory to the parties involved.

Negotiation demands complete attention to details, mental dexterity and coordination of skills. Closing on the negotiation implies consummation of the transaction through the execution and delivery of the appropriate documentation, and if applicable, the transfer of funds. The creation of the new company imposes the challenge of integration for the purpose of achieving synergies which are intended to justify the premium that has probably been paid for the acquisition. Post merger integration is a tortuous and complex process which involves the integration of organizations, operations, customers, and products and service offerings (Deloitte, 2005). This requires an effective post-

acquisition integration plan that incorporates the processes involved in the integration. The integration process involves careful staff selection process that is fair, transparent, efficient and profitable; interfacing information technology applied by the companies; and synchronization of operational procedures and service offerings. Successful integration requires that a rapid choice is made between the different processes used in the companies involved (pre-merger) and harmonization carried out as rapidly as possible.

While there can be many measures for success, most mergers fail to generate 'above-market' returns to the shareholders, often due to poor execution and alignment with goals (Deloitte, 2005). The Deloitte's paper on consolidation drawing on the Asian Pacific experience observed that the common reasons for merger failures include: unexpected issues relating to technology, credit, customer and capacity; unclear, intangible merger objectives; poor management of different corporate cultures; unrealistic expectations of possible synergies;

overpayment for the acquired organization; and under-estimating the information technology integration effort.

The critical success factors include the ability to manage risks, ensure control and exploit growth areas in the blended organization. The paper also notes that in addition to establishing a well-defined strategy framework that covers strategic priorities, business models and the overall governance process, a successful merger integration effort requires the following:

- Proper program management - defining an integration roadmap and process to manage issues that may arise.

- The ability to realize value - being able to capture synergies, and meet strategy targets and establish the appropriate culture.

- Integrating infrastructures - establishing common back office operations, procedures and processes, and rationalizing and migrating information systems to a common platform.

- Organization preparedness - such as leadership and staffing, execution plans and change management support.

It is proper to observe that each transaction, company and integration is unique and banks will need to maintain an obsessive focus on customer management to ensure minimal disruptions and revenue loss. Well targeted market strategies are crucial to retaining and attracting new customers.

#### **IV. Country Elements of Banking Reforms**

Banking reforms involve several elements that are unique to each country based on historical, economic and institutional imperatives. For example, in Hungary as documented by Gyargy Szapáry (2001), the reforms in the banking sector proceeded against the backdrop of banking crisis due to highly undercapitalization of state owned banks; weakness in the regulatory and supervisory framework; weak management practices; and the tolerance of deficiencies in the corporate governance behaviour of banks.

The consolidation and restructuring of the Hungarian banking system proceeded in stages as the problems arose and the true magnitude of the problems became evident. The stages included

portfolio cleaning, enterprise-oriented portfolio cleaning, and recapitalization. Portfolio cleaning is a process where banks and savings cooperatives which had a capital adequacy ratio (CAR) of less than a specified per cent (in the case of Hungary - 7%) were given government bonds in exchange for their non-performing loans. While part of the bad loans was sold by the government at a discount to the Hungarian Development Bank which was charged with the work-out, some were left with the banks to be worked out. It generally took between 1 to 2 years for the problem loans to be worked out. The term "work-out" covers the different techniques to deal with non-performing debt. It might include rescheduling of the debt, exchanging the debt for shares in the debtor company, forgiving part of the debt, or writing off the debt altogether. The cost of the exercise in the case of Hungary amounted to an equivalent of about 3.7 per cent GDP.

Enterprise-oriented portfolio cleaning targets debtors. This is usually intended to avoid the closure of certain state-owned enterprises which are considered essential but yet unable to service

their debt. Usually, the government cleans out their debts from the banks' portfolio in exchange for government bonds, most of which eventually get written off. The cost of this enterprise-oriented portfolio cleaning attained the equivalent of about 1.6 per cent of GDP. Recapitalization, on the other hand, proceeded in three stages. The first stage involved setting the CARs of eight participating banks to about zero per cent, and then in the second stage to four per cent, while in the third stage the CARs of four large state-owned banks was raised to the prescribed Basle rule of 8 per cent. The recapitalization in the first and second stages took mainly the form of government purchasing newly issued shares by the recapitalized banks. The government paid for these shares through bonds issued with the same conditions as the earlier consolidation bonds. This action heightens temporarily state ownership in the banking industry, while the third stage involved the extension by the government of subordinated loans to the banks with little effect on increasing government ownership in the banks. All the consolidation processes

involved a total gross cost of approximately 13 per cent of GDP over the eight-year period (1992-2000).

In the Yugoslav economy, banking industry restructuring was motivated by the need to establish a healthy banking sector that will carry out its financial intermediation role at a minimal cost; effectively provide services consistent with world standards and which will involve foreign financial institutions; and banks privatization as the ultimate goal. The central focus was to shore up the capital base of banks consolidated through mergers and takeovers of local banks and selection of strategic investors for additional capitalization. Specifically, foreign banks permeated the industry exclusively by providing additional capitalization through investment in the existing infrastructure, particularly new banking products and operating technologies and buying shares of the existing banks.

The banking sector reforms in Japan involved the reform of the regulatory and supervisory framework, the safety net arrangements, as well as mechanisms to speed up

attempts at resolution of banks' non-performing loans. In an attempt to revitalize the Japanese banking system, a package of proposals were used comprising, among others, the following: the government would work with the Bank of Japan (BoJ) to try to halve the bad loan ratios of the big banks; the government would consider the possibility of establishing a new system for the prompt infusion of state capital into under-capitalized banks – the so-called “pre-emptive” capital injections; the government would act to ensure a tightening of the assessment of bank asset quality, possibly involving the use of Discounted Cash Flow (DCF) techniques in the assessment of the adequacy of provisions; adoption of stricter criteria concerning the banks' use of deferred tax assets within regulatory capital, with no limits or timetables for implementation; government conversion of bank preference shares that it already owns, because of previous bailouts, into common stock in order to trigger nationalization for institutions whose operations had been seriously impaired; and the establishment of a

new body to operate *pari-passu* with the Resolution and Collection Corporation (RCC) to rehabilitate troubled companies whose future prospects appeared bright.

Pre-emptive capital injections as a framework for injecting public funds, involved the establishment of a new account for strengthening financial functions at the Deposit Insurance Corporation (DIC) with a government guarantee to revitalize the regional economy and maintain the orderly supply of credit by weak but solvent banks. It also allows for the public injection of capital through the purchase of preferred stocks from banks, or preferred equity securities/subordinated loans from co-operatives whilst avoiding the stigma of market uncertainty (Maximilian Hall, 2004).

One important lesson of experience that could be gained from other countries is the use of portfolio cleaning to work-out the non-performing loans of banks with CAR below a specified minimum. The work-out process could be achieved through various channels including exchanging of the debt for shares in the

debtor company. However outright write off of the debt may not be encouraged as this was susceptible to moral hazard.

## V. Conclusion

The paper observed that the fundamental objective of reforms is the repositioning of an existing status to attain an effective and efficient state consistent with best practices. Consequently, for banking industry reforms, intended to achieve the objectives of consolidation, competition and convergence, the nucleus remain that of firming up capitalization. Country elements reveal that various conceptualization of the reform processes are unique and proceed as the problems become evident. Consolidation was identified as a key means of achieving capital adequacy in line with regulatory stipulations as well as raising the competitive advantage and strategic positioning. Also, the path towards integration was evidently tortuous involving complex integration process relating to organizations, operations, customers, and products and service offerings. This raises the potential for a break-down if there exists an inadequate ability to

manage risks, ensure control and exploit growth areas in the blended organization. A well defined strategy that covers strategic priorities, business models and overall governance process are among the successful post-consolidation efforts. Finally, there should be in place a proper management program that: defines the integration roadmap and processes to manage issues that may arise; captures synergies; integrates infrastructure; and guarantees the organization's readiness to provide the requisite leadership and staffing as well as execution plans and change management support.



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