THE ROLE OF MERGERS ON MARKET STRUCTURE IN THE BANKING INDUSTRY OF PAKISTAN

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ABSTRACT

The aim of this investigation is to find out the impact of mergers on the market structure in banking industry of Pakistan. Furthermore, this research examines the impact of merger on profitability, operational costs, and customer base and market share of the commercial banks. This study employs case method to extract relevant data. Sample size of this research comprises of Faysal Bank and Royal Bank of Scotland (RBS) 2011, Summit Bank, and My Bank and Atlas Bank 2011. The official website of State Bank of Pakistan (SBP) was used to get the secondary data which includes the annual reports of the mergers Pre-merger and post-merger financial statements of the year 2010 and 2011 of merged banks were analyzed. In addition, a comparative financial ratio analysis was used for testing and interpreting the data. Hence, this study presents the four major findings which include; first, merger shows positive relationship with profitability. Second, the pre-merger and post-merger deposits of banks show that merger increases customer base. Third, merger also increases operational costs. Fourth, mergers show positivity with the market share of the banks. The authors of this study suggest more qualitative and quantitative empirical research on the mergers so that a better scientific understanding can be developed.

Keywords: *Merger, Profitability, Operational cost, Market share, Customer base, Banking industry of Pakistan.*

INTRODUCTION

Banking sector plays fundamental role in economic development (Hasan, Wachtel & Zhou, 2009). It is noticed that banking sector of Pakistan is experiencing multiple challenges in competitive environment. According to Abbas (2014) most of the banks in Pakistan have become privatized and process strategically to merger and acquisitions in order to sustain negative trends and stabilize financial status. This change in ownership and market structure influences the overall performance of banks in Pakistan. The banking sector of Pakistan is turned in to competitive financial sector and has immense share in economic growth of the country (Mahesar, Zehri, Zafar & Chaudhry, 2015). Many empirical studies also supported the phenomenon that financial development is correlated with economic growth of the country. Some have asserted that merger is supposed to happen when two or more business entities deliberately are merged together, mutually in order to form a completely new and diverse legal entity. These authors have further added that the merger

occurs in between the competitive firms leading towards horizontal combination, whereas if the firms that were either supplier or customer and merged then the merger is known as vertical integration.

Merger helps in attaining different objectives of the business and at the same time, it also provides benefits like value generation, increased market share, and acquiring cost efficiency. In order to meet the global competition of banking sector, State bank of Pakistan has developed strong regulatory mechanism to increase efficiency and profitability. Authors further explain that banks therefore choose either to merge with other banks or ultimately prefer to close down the business. The overall market structure is deeply affected by these strategic actions of banks. According to Harford and Jarred (2012), merger may occur in result of regulatory and technological advancement and in addition they concluded that merger leads to efficiency gains. This research mainly focused to analyse the role of mergers on market structure in banking industry. Furthermore, this study conceded to find out whether the bank mergers increase market share and cost efficiency, profitability and also increases customer base or not. In addition, this research also analyses the changes in the market structure that occur because of the mergers.

LITERATURE REVIEW

The literature review part of the paper portrays the concepts of mergers and acquisitions.

Merger

Extensive literature review has suggested that a merger occurs when more than two organizations join to form a new entity and positive changes in market structure benefits banks. According to Pearce and Robinson (2005), the market power raises when more than two banks combine their resources and strategies to attain the specific objectives. Further suggested that merger also helps to achieve the objective of cost reduction as it reduces the duplication cost. Altunbas and Marqués (2008) have revealed that every organization's main objective is to reduce the cost. Rezitis (2008) emphasized that merger and acquisition sometimes could be the cause of reduction of efficiency gains, technical efficiency, and production. Chong, liu and Tan (2006) demonstrate that the banks which are merged forcefully would result in the demolition of economic value. These authors explain that the forceful mergers are negatively related to economic growth. Gaughan (2002) authenticated the reasons behind a merger. According to Gaughan, mergers represent rapid growth and also increase economies of scale or scope of organizations. The firms want to grow in size and also maintain capital adequacy ratio to expect more profits from merger.

Profitability

Some investigated the impacts of merger on performance of banks in market structure. They concluded that merger increases efficiency in the merged bank and its operational

cost remains the same. They found that performance of banks is enhanced after merger but particularly in case of cross-border mergers. Numerous discussed about profits reduction and general rise in share price after merger deal. They explained that mergers often reduce profits on one hand and raise the share prices on the other hand. They further revealed that, if being an 'insider' is good than being an 'outsider', firms may merge to prevent partners merging with competitors. Others conducted study on the Egypt banking sector merger in which their results revealed that merger strengthen the banks and increase in return on equity. These authors added that mergers show the capital gains and improves the overall efficiency. The above literature entails that mergers bring positive results for the firms in terms of achieving both financial and organizational objectives. Hence, the authors of this paper based on the literature develop the following hypothesis:
Hypotheses 1: Merger increases profitability of the merged banks.

Operational cost

Numerous researchers determine the cost efficiencies of pre and post-merger banks of 348 mergers. They identified that mergers of banks bring improvement in the efficiency but equally affects the profit margin of the banks. Further, these authors add that cost efficiency could be improved merely if both the partners who are ready to combine were cost ineffective. The operational performance of post mergers in United States of America in the period (1980-2002) in which the return on cash flow was not improved significantly. They also proposed that, operating performance was slightly improved due to increased size of the firm. According to Mester (1987), merged banks are advantageous of economies of scale. Because of their efficiency banks become cost effective by reducing the unit cost of production. Sirower (1997) defined that synergy increases the capacity for competition and surplus of cash flows when firms aim to attain through a merger. Based on survey of 45 banks explained that merger benefits to both public and private banks in terms of improved services, cost reduction, and open selection of loan schemes. The above literature shows that mergers are not always good in terms of improving the operation coast and gaining required amount of profits. Hence, we develop the following hypothesis:
Hypothesis 2: Merger in banking industry reduces operational cost.

Customer base

According to Paulter (2003), every organization whether it is small and large, merged to attain savings in cost, gain in market share, and become economically stronger. He also recognized that, a merged business also save costs to consumers through lower prices. Mergers produce qualitative products and services which are beneficial for consumers and the product quality improvements decreases costs due to the merged entity may be able to eliminate assured expenditures, such as, rental bills and other administrative support. Different observed from their study that merger increases profits of the banks. These

authors added that due to merger, banks utilized SHRM strategies in order to produce and utilize effective and empowered employees. Highly expertise and trained employees used their skills to attract more customers through services and packages. As a result customers' deposits increase in numbers as well as amount. Literature review gives impression that mergers help in gaining customer confidence. Hence, the third hypothesis stands as:
H3: Mergers in banks increase customer base.

Market share

Different researchers focused on the outcomes of the Indian banking merger tendency and its consequences upon managers and investor. Their study has revealed that banks after merger witnessed negative trends. Paulter (2003) during analysis of event study illustrated that merger and acquisition had a beneficial impact on the share value of the merging firm whereas acquiring firm's shareholder did not have beneficial results. Sinha, Kaushik and Chaudhary (2010) studied the case study of Indian merger &acquisitions and found that there is positive link of financial performance and the merger and acquisition transaction. These authors have added that value generation of the merged firm raises and it becomes better than that of the parents companies. Cetorelli (1999) defined that merger might be cause of gain in taxation to an organization which effects in increase of revenue. He further explored that the combine working of more organizations together may lead to generate more value. From above mentioned literature it can be learnt that mergers and acquisitions help companies to gain advantage of obtaining in increase of market share. Hence, the authors of this paper have developed the fourth hypothesis:
Hypothesis 4: Mergers increases market share of the merged banks.

RESEARCH METHODOLOGY

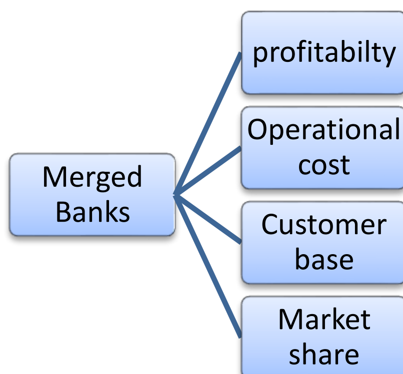
The objective of the study was to answer a central questions; "Do mergers affect the market structure in banking industry of Pakistan? The central idea of developing the research question was to describe the impact of merger over profitability, operational cost, customer base and market share. For this reason, two merger cases were chosen as a sample banks which are merger of Faysal bank with Royal bank of Scotland and other case is merger of Summit bank with My bank and Atlas Bank. Financial ratios analysis was used as most important tool and for hypotheses testing the ratios results of banks pre-merger and post-merger have been compared. Companies use analysis of financial statements to measure performance and also for important decision making for to achieve goal or for betterment of the organization.

Sample

The sample of the study includes financial annual reports of two mergers i.e. Faysal bank with Royal bank of Scotland and Summit bank with My bank and Atlas bank. The reports are of the pre-merger and post-merger years (2010 and 2011).

Theoretical Model

The theoretical model below describes that that merger increases profitability, customer base, market share of the banks, and sometimes it decreases as well as increases operational cost.



FINDINGS AND DISCUSSIONS

In this study two cases of mergers have been analysed i.e. merger of Faysal Bank limited with RBS limited. Other merger is of Summit bank ltd with My bank ltd and Atlas bank ltd. For hypotheses testing pre-merger and post-merger data have been tested by comparative ratio analysis in order to know whether merger is profitable, increases customer base, decreases operational cost and increases market share of banks. Detailed analysis is given below:

Case one: Merger (Faysal bank limited with Royal bank of Scotland limited)

Sometimes merger is considered as unprofitable strategy. Though, mergers increase revenues and decrease costs provision, it impact indirectly on the profitability by decreasing the loss ratio on the balance sheet. In case of merger of Faysal bank ltd with RBS its investment and advancement profit increases by 58 % to Rs 13.7 billion in a year. The net advances increases by 7% about Rs 142 million (Faysal bank annual report, 2011). Faysal bank maintained its Non-performing loans (NPLs) level up toRs 24.5 Billion, Obviously mergers with RBS is costly for Faysal Bank due to increase in operational expenses. As there is increase in staff, so the cost increase doubles up to Rs 5.6 Billion. As given in (Faysal bank annual report, 2011). Further analysis is given below:

H1: Merger increases Profitability of merged banks

In order to test hypothesis one e.g. merger increases profitability of merged banks, the post-merger profit after tax (PAT) of Faysal bank is Rs 1.28 Billion which is 8% higher than the last year's pre-merger (PAT) was Rs 1.190 Billion as shown in table 1.

Table 1 Faysal bank pre and post-merger profit after tax PAT

PAT	Rs in Billion
Pre-Merger 2010	1.19
Post-Merger 2011	1.28

Source Data: (Faysal bank Profit and loss Statement, annual report, 2010 and2011)

Further with the help of ratio analysis it is observed that, after merger EPS ratio increased by 0.1 but price per earnings ratio (P/E) decreases by 5.5.This negative impact might be due to the RBS ltd.

Table 2 Faysal bank ltd. Price Earnings Ratio (P/E Ratio), EPS & Share Price

	EPS	P/E	Share Price
Pre-merger-2010	1.45	10.75	15.59
Post-Merger-2011	1.55	5.25	8.1375

Source data: (Faysal Bank Annual report 2011 and 2010, *p* 67)

P/E ratio represents confidence of investor in order to generate required return. It seems that P/E ratio before merger was good i.e. 10.75 but after merger it reduced to 5.25, which is around 51% decline in investor's confidence, further it is observed that EPS ratio has increased as compared to pre-merger EPS..

H2: Mergers in industry reduce operational cost

To analyse the H2 in case one of merger, it is observed that there is increase in operating expenses by 63%, pre-merger administrative expenses were Rs 6.644 Mn which is substantially bigger to Rs. 10,814 Mn in year 2011. The fragment of the Administrative expenses is listed below:

Table 3 Administrative expense

	Administrative Expenses
Pre-Merger-2010	Rs6.644 Million
Post-Merger-2011	Rs. 10,814 million

H3: Mergers in banks increase customer base

In order to test third hypothesis it is observed that there is increase in deposits of Faysal bank ltd after merger, which shows that its customer base also increases.

Table 4 Faysal bank pre and post-merger deposits

Total Deposits	Rs. In Bn
Pre-merger- 2010	195 Bn
Post-merger- 2011	215Bn

Source Data: (Faisal bank annual report 2011 and 2010, *p*109) (Deposits and Other Accounts, Note 17) (Deposits by Segments, *p* 138 & 139)

H4: Mergers increases market share of the merged banks

As shown in table 5 that there were 147 branches in pre-merger year 2010 and also there were 7107 Domestic Private Branches of Faysal Bank with the market share of 2.06% in the same year. In post-merger period it was observed that there were 257 branches and 7450 Domestic Private Branches of Faysal bank in 2011. The market share of Faysal bank in 2011 became 3.45%. The facts showed that there was increase in the market share of Faysal bank after merger.

Table 5 Market share (pre and post-merger)

	Branches	Branches (Domestic Private Banks)	Market share
Pre-merger- 2010	147	7107	2.06%
Post-merger- 2011	257	7450	3.45%.

Source Data: (Faisal bank ltd annual report, 2010 and 2011)

Case two: Merger (Summit bank with Mybank & Atlas bank Ltd)

Case two is based on merger of Summit bank ltd with two other banks i.e. Mybank Ltd. Atlas bank Ltd. Bank has produced the coverage ratio for NPL up to 55% in pre-merger year 2010 although the interest rates have begun to decrease. Summit bank limited has revised the price from 9.7% to 9.49%. Due to low price customers are highly attracted towards the services. Merger of summit bank also shows increase in administrative expense/operational expense, further analysis is given below.

H1: Merger increase profitability of merged banks

Merger of summit bank shows indirect positive impact on profitability by decreasing the Loss after tax (LAT) after merger it is substantially reduced from Rs. 3,018 Mn to Rs. 1,537 Mn. As This decrease during merger, there is also reduction in Loss per Share (LPS) from 5.58 to 1.53 Mn. Further to that, the P/l ratio for both the years is given in table number 6. From the financial ratios it is observed that the profitability of the bank such that P/l before tax Ratio has reduced to -31.39% from 54.8% and on the other hand income to

expense ratio has increased to 0.77 after merger which clearly indicates that said merger is profitable.

Table 6 Summit bank ltd before income tax ratios and income tax expense

	P/L Before Tax	Income to expense
Pre-Merger	-54.80%	0.66
Post-Merger	-31.48%	0.77

Source data: (Summit Bank ltd. Profit /Loss statement, Annual report, 2010-2011)

H2: Merger in banking industry reduces operational cost

It is found that the administrative expenses of the summit bank after merger have increased to great extent i.e. Rs. 3,782 Mn as compared to last year's (Rs. 2,736 Mn) as shown in table 7.

Table 7 Administrative expense (pre and post-merger)

	Administrative Expenses
Pre-Merger-2010	Rs. 2,736 Mn
Post-Merger-2011	Rs. 3,782 Mn

Source data: (Summit bank ltd. Admin Expenses Note, 29 Annual report, 2010 and 2011, *p,* 69)

H3: Mergers in banks increase customer base

The deposits of the summit bank after merger increased around 46% and have attained toRs. 90 billion after merger in year 2011; in the previous year deposits were Rs. 62 billion.

Increase in deposit is sensed as increases in customers as shown in table 8 below.

Deposits	Rs. In Bn
Pre Merger- 2010	62
Post Merger- 2011	90

Source data: (Summit bank deposits. According to annual report 2011, p 144, 164 &165)

H4: Mergers increases market share of the merged banks

It was found during the analysis that summit bank had 36 branches and 7107 branches (Domestic Private Branches with market share of 0.51% in 2010. But in post-merger in the year 2011, Summit bank had 156 branches and 7450 Domestic Private Branches with the market share of 2.09%. The results have shown that there is an increase in the market share of the said bank after merger.

Table 9 Market share of summit bank (pre-post-merger)

	Branches	Branches (Domestic Private Banks)	Market share
Pre-merger- 2010	36	7107	0.51%.
Post-merger- 2011	156	7450	2.09%

Hypotheses

To attain the objective of this study, following hypothesis has been framed from the analysis of pre and post-merger of two cases such as Faysal bank and Summit bank ltd. three hypotheses were accepted and one hypothesis which is merger in banking industry reduces operational cost is declared as null hypothesis. Alternate hypothesis is merger in banking industry increases operational cost. Outcome for all the hypotheses are given below:

H1: Mergers in the banking industry of Pakistan usually increase Profitability of merged banks. (Accepted)

H0: Mergers in the said sector usually reduces operational cost. (Rejected)

H2: Merger in many circumstances increases operational cost (Alternate hypothesis)

H3: Mergers in the sector also increase customer base. (Accepted)

H4: Mergers in the proposed sector also increase market share of merged banks. (Accepted)

CONCLUSION

Current study concludes that mergers are being increasingly implemented in different sectors over the entire world. Mergers take place to increase competitiveness and to beat the competitor globally. Due to merger process the market share raises which decreases the chances of business risk for to entering new market, economies of scale etc.Banks which were going to be merged in Pakistan should have to follow the same policies and plans provided by central bank which could be useful for profitability enhancement. Banks might decrease the ratio of cost of capital so that returns can be boost up. The aim behind mergers could be to increase the economies of scale, market share, taxation, synergy, revenues generated, geographical and different diversifications.The authors of this study have concluded that mergers have a significant impact over the market structure in banking industry of Pakistan. After the mergers considerable alteration has come into the behaviour of the market. Besides this, the study concludes that mergers have positive impact over the profitability of banks. The merged banks are either generating more profits or sustaining lower losses when their pre and post-merger scenarios are evaluate with each other.

The research showed that there is correlation between the merger and operational cost. Furthermore, it has been found out that the operational cost of banks have increased after

mergers. In spite of the increase in the operational cost of the merged banks they are maintaining effective and efficient performance. Due to merger there is increase in market share of the banks, as branches are increased after the mergers. It is also found out through data that after merger significant increase have been made into the number of banks in the market. Proposed hypotheses of this research have indicated that merger increase the profitability of the merged banks is not rejected because mergers directly as well as indirectly impact on efficiency of the banks. The finding from secondary data of the research work rejects the hypothesis which suggests that mergers reduce operational cost in banking industry.

In some banks there is redeployment of employees and due to this there is increase in administrative cost. Other proposed hypothesis which assumes that merger in banks has increased customer base is completely backed by the secondary data and hence it is not rejected. The last hypothesis of the research study which proposed that merger increases market share of the merged banks is also supported by the secondary data; therefore, it is not rejected. Finally, this study concludes that mergers in the banking industry put a significant impact over the market structure. Mergers also bring significant changes in overall performance of the market. Merger is also beneficial for overall economy. The authors of this study encourage that more empirical research is needed in the mergers and acquisitions of the banks so that a better understanding, challenges, and opportunities can be learnt.

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