

The Significance of Mergers in the Restructuring of the Banking and Financial Sector

Banks, as well as other economic institutions, have long resorted to mergers to realize strategic growth and expansion objectives. Mergers help them acclimatize themselves to changing internal and external developments. The last ten years have witnessed an intensive increase in mergers internationally. For example, the United States of America alone witnessed over four thousand mergers among domestic banking institutions during the 1980's.

Mergers during that period were not limited only to domestic institutions in each country but included, on many occasions, cross-border merger estimated to reach during the last five years 600 mergers, with a total value of approximately US\$ 34 billion.

The increase in mergers among banking and financial institutions during recent years can be attributed to several factors:

First: Intensified international competition and an urgent need to rationalize expenditures towards viability and continuity. This is due to the changes witnessed by the world economy since beginning of the 1980's because of the continued decreases in the rates of economic growth, particularly in the major industrial countries, and the state of affairs resulting from deregulation of economic activities and trends toward globalization of banking and financial markets due to technological advances and innovations in monetary and financial instruments.

Second: The emergence of large-scale institutions as a consequence of the appearance of large economic blocs in Europe, America and Asia. This has increased the difficulties smaller economic units experience in conducting activities and realizing profits.

Third: The occurrence of international economic crises such as Third World debts and an increase in defaulting cases in world banks, prompting some of them towards mergers to improve their financial positions.

Fourth: New supervisory techniques and instruments introduced to cope with continued developments in international banking activities and financial and monetary markets, particularly in capital adequacy and credit concentrations. The purpose has been to enhance the capital base of banking and financial institutions, strengthen equality in competition internationally, and to distribute credit risks over a larger number of customers.

Mergers in the United States of America are an example of the above factors that can expedite integration. Economic crises suffered by US banking and financial institutions include the decline in real estate values, the collapse of saving and loan associations, the slowdown in rates of economic growth, and consequences of Third World Debt problems; these have driven American banking institutions towards mergers as a means of restructuring their activities, services and geographic distribution to enhance their financial positions, augment their profits, and enable them to withstand growing competition from foreign banks.

Official statistics in the U.S.A. indicate an increase in banking merger cases. In 1980, there were 188 merger cases; this

number increased to 550 during 1990. In consequence, the number of banking institutions operating in the United States fell 24% during the 1980's, from 12679 in 1980 to 9688 in 1990. In Europe, most of the banks at the end of 1980's and the beginning of the 1990's began to move towards integration into blocs, in preparation for the emergence of a Unified European Market. Consequently, the number of banks dropped in European countries, such as France, England, Italy, Spain and the Netherlands. Available statistics indicate that the number of banks in England fell 24% from 334 to 253 during the period from 1987-1993. The most important reason was banking and financial mergers.

Merger activities have not been limited to small-scale banking and financial institutions, but have also included large bank mergers. In the U. S. A., merger activities have been concluded between Chemical Bank and Manufacturers Hanover Bank and between Bank of America and Security Pacific. In the United Kingdom, Midland Bank and Hong Kong and Shanghai Banking Corporation have been merged. In the Netherlands, Algeme Bank Netherland and Amsterdam - Rotterdam Bank have merged.

The increasing tendency toward mergers among banking and financial institutions has gained international attention especially during the last ten years, as the number of banking units has declined worldwide.

Mergers among banking and financial units in Kuwait have been one of the serious directions of the Central Bank of Kuwait since 1989, to rearrange the positions of this sector. Mergers could create banking and financial units large and strong enough to overcome the difficulties facing Kuwaiti banking and financial institutions as a result of the Securities' Market crisis, and the Iraq-Iran war, repercussions of which

have reflected on the local banking and financial sector. During 1990, there were serious efforts to implement mergers. Nevertheless, the Iraqi occupation of the State of Kuwait on August 2 impeded those efforts. It disrupted the economic cycle in general and negatively affected the banking and financial sector in particular.

Following the liberation of Kuwait from the occupation, the Central Bank of Kuwait became more convinced of the significance of mergers as an effective mechanism through which to develop and restructure the banking and financial sector. The Bank, as a supervisory authority, believes that successful mergers shall realize the following major objectives:

First: Formation of large-scale banking units with a strong capital base:

In this regard, we would like to recall that the State was given the responsibility of protecting depositors' rights at the local banks. The State thus purchased difficult debts from the banking and financial units, relieving them of an adverse effect on their solvency and activities and enabling them to satisfy international requirements for capital adequacy standard. The average of this standard at national banks reached 22.3 per cent at the end of the second quarter of 1993. This happened as a result of replacing government debt bonds of no risks instead of debts purchased.

Nevertheless, the Central Bank believes that the banking and financial units still need to increase their capital bases in the face of the State's decision to lift its guarantee of shareholders' rights in Kuwaiti banks. These banks must rely on their capital base, as they assume sole responsibility for the results of their

transactions. Further, the State shall not guarantee depositors' rights at these banks forever. Thus, the banks' ability to attract deposits will depend on depositors' confidence in their financial positions. This can be secured through creation of a capital base which represents the minimum limit of protection for customer deposits.

Second: Consistency between the number of banking and financial units and Kuwait's situation:

The Central Bank of Kuwait is of the opinion that the number of the local banking and financial units should be reduced in line with the size of population and the current nature of economic activities. One of the indicators of "over-banking" is that this sector comprises six national commercial banks in addition to a branch of a foreign commercial bank, two national specialized banks, 23 national investment companies, 21 national exchange companies, and the Kuwait Finance House. This large number does not correspond to the size of population, which has fallen from around 2.2 million before the Iraqi occupation to approximately 1.5 million at present. The demographic structure has changed, and with it the need for the banking and financial services in the post-liberation period. The ratio of domestic banks to population in the State of Kuwait is double that of the Gulf Cooperation Council Arab states. In Kuwait, each bank serves about 156 thousand persons on the average, while each bank in the GCC countries serves 315 thousand, on the average.

Another indicator of over-banking in the state of Kuwait is the decline in the volume of domestic economic activities and investment opportunities. The

non-oil GDP, excluding manufacturing industries, fell from KD 3328.3 million in 1989 to KD 2716.4 million in 1992 at a rate of 18 per cent. This rate will largely decline if we put aside the effects of some activities which are not, in our belief, marked by recurrence and which led to an increase in GDP during 1992.

This over-banking will be increased by qualitative improvements currently underway, specifically the introduction of the unified automated system which connects between all ATMs of the domestic banks, and the introduction of purchase cards (KNET) to facilitate payment for local purchases by the immediate debit of customer accounts at points of sale, (POS) scheduled for implementation at the beginning of 1994.

Third: Stability for the banking and financial sector through the establishment of units that have strong financial positions, enjoying benefits and advantages realized through mergers. Successful mergers realize large-scale benefits, which can be divided into three types:

- Internal benefits, derived from revenues generated through selling unused real estate, usage maximization of existing assets and rationalization of expenses through restructuring.
- Administrative benefits, resulting from reorganization of administrative structure and selectivity in the management of the new firm, coupled with upgrading the efficiency of employees and increasing the effectiveness of internal supervision.
- External benefits, represented in earnings that can be realized through credit lines or agreements with other

banks at favourable terms, which are themselves a result of improvements in the credit position of the new firm, and increases in its operations after merger.

Furthermore, a merger helps a new institution to enhance its position and increases its share and competitive capacity in the banking and financial market, locally and internationally. This is realized through the activities and services undertaken. Some activities may be discontinued or expanded or other new activities and services can be introduced. Such reconstruction will improve the services extended to customers. Besides, the merger will also provide greater opportunity for the new firm to strengthen its deposit base, stabilize, and diversify fund resources, in addition to increasing possible geographic expansion.

If the Central Bank of Kuwait considers mergers among units of the banking and financial sector necessary to achieve the objectives of mergers, surely from the perspective of the banking and financial sector, mergers must be deemed an urgent necessity. In fact, mergers help realize the ultimate goal of any unit working on commercial basis, namely, profit maximization. Benefits generated from mergers increase opportunities for making profits. Besides, expansion of the capital base, stemming from a merger, will increase the new firm's ability to extend credit to its customers under the rules of credit concentration, which set a maximum limit on the amount of credit which a bank may grant to an individual client as a percentage of the bank's comprehensive capital; and this will ultimately increase the firm's ability to generate revenues. Furthermore, a merger will enable the new firm to increase its customer deposit base and expand the volume of its transactions with the Central Bank and local and international banking and financial institutions at a lower cost. This will

reflect positively on performance and on the share price of the new firm in the markets, bringing benefits to the shareholders.

If it is apparent that mergers are a necessity, as above indicated, merger implementation is nevertheless not an easy issue. It will entail making decisions that may be painful in quest of the objectives in mind. The success of a merger is not guaranteed. If most of mergers have succeeded, some have failed. However, fear of failure should not prevent the serious consideration of mergers. Units intending to merge should undertake thorough studies. At the outset, they have to define the **objectives** to be realized. Then, the **method** of the merger should be specified, whether through horizontal expansion to merge with institutions of similar activities or vertical expansion to merge with institutions different in activities. Thus, clearly-defined methods of merger should be decided upon through answers to the following questions:

- Will the bank be merged with another bank?
- Will the bank be merged with a financial institution such as an investment company?
- What will be the identity of the new firm emerging from the merger? What will be its objectives?

After determining the objectives and method of the merger, the **technique** to be used will be specified: takeover, acquisition or merger. A thorough study on the suggested merger, or the so-called merger plan, should be undertaken. The assistance of specialized organizations with professional experience in this field is necessary at the preparation stage.

Here, it is worth pointing out to the importance of clear objectives of mergers, the precise evaluation of their potential

benefits, resultant costs and difficulties and the importance of taking objective and prudent decisions concerning details and requirements of practical implementation of mergers.

Some difficulties and precautions, which might impede a successful merger, include local regulations which do not support mergers. In pursuance of local legal provisions, trading the shares of the new company established through a merger shall not be allowed before three years from the date of final incorporation have elapsed.

Since such provisions place obstacles before companies interested in merging, the Central Bank of Kuwait has suggested to the concerned authorities the amendment of existing statutes to encourage and expedite merger processes.

Furthermore, the merger process requires that the leading officials at the banking and financial sector units shall intensify efforts exerted toward merger and take tough decisions to give precedence to the public interest of their institution.

A question to be raised in this regard is: What is the role of the Central Bank of Kuwait in the merger processes?

The Central Bank of Kuwait does not seek to impose mergers on the banking and financial sector. Rather, merger decisions should stem from those units desiring to merge, with the approval of their general assemblies.

The Central Bank does not encourage mergers as an end in themselves, but as a means to realize the public interest through amending the course of banking and financial activities.

In its capacity as the supervisory authority, the Central Bank is responsible for evaluating the preliminary studies prepared by the units willing to merge, which deal with objectives, methods and techniques, and take into consideration the effect of the new institution on competition in the local market. After the Central Bank expresses tentative approval of a merger, it will at a later stage undertake the task of evaluating the merger plan to verify authenticity and to check compliance with international accounting standards. In addition, the Bank will evaluate the impact of the merger on the solvency of the new firm and the extent of its liquidity and ability to generate profits.

The Central Bank of Kuwait recognizes that the merger process requires time for research and study. However, the Central Bank is confident that Kuwaiti banking and financial units which regard mergers as advantageous will proceed. Our national organizations do not differ from their counterparts in other countries in terms of the possible realization of success in merger processes.

In conclusion, the Central Bank of Kuwait will extend all possible assistance and advice to make mergers a success, as they are the best means to rearrange the Kuwaiti banking and financial sector, and enhance and develop its performance. The Bank will spare no effort to help those banking and financial units willing to merger, including the expediting of an appropriate legislative environment for merger procedures.
