MERGERS AND ACQUISITIONS IN THE NIGERIAN BANKING SYSTEM: ISSUES AND CHALLENGES

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1.0 INTRODUCTION

The Nigerian banking system and in deed, the entire nation's financial system has its share of the global financial crisis. In addition to the effects of the global financial crisis on the Nigerian financial system, the challenges posed by the banking consolidation programme that was concluded in 2005 and other developments within the economy, made the nation to experience another round of financial crisis in 2008/2009, as revealed by the CBN/NDIC joint Special Examination carried out in 2009. The Examination results revealed among others, that 10 of the 24 deposit money banks were in grave financial condition. The findings from the examination led to the removal of eight (8) CEOs of the distressed banks and members of their executive management teams and their replacement with new executive managements appointed by the CBN. The CBN also injected N620 billion in the affected banks as tier 2 capital.

Out of the 10 banks, owners of Wema Bank and Unity Bank Plc were able to adequately re-capitalize their banks. The efforts of the Regulatory Authorities to ensure that the remaining eight banks were recapitalized were stalled by various court injunctions obtained by the shareholders of the banks. In order to address that challenge, the CBN gave the banks a deadline of 30th September, 2011 to recapitalize or have their licences revoked. In response, five of the banks, namely: Intercontinental Bank Plc, Oceanic Bank Plc, Union Bank of Nigeria Plc, Finbank Plc and Equitorial Trust Bank Plc got the court injunctions vacated and entered into negotiations with prospective core investors.

Prior to the deadline, five (5) banks had executed Transaction Implementation Agreements (TIAs) and held court-ordered Extra Ordinary General Meetings where the shareholders approved the recapitalization/merger transactions. The banks and their preferred investors were: Intercontinental Bank Plc (Access Bank Plc); Oceanic Bank Plc (Ecobank Plc); Union Bank Plc (Shareholders and African Capital Alliance Group); Finbank Plc (First City Monument Bank Plc); and Equitorial Trust Bank Plc (Sterling Bank).

However, the three (3) banks that could not find a preferred investor/merger partner had 3 bridge banks established for them by NDIC to assume their assets and liabilities on a going concern basis. The bridge banks were Mainstreet, Keystone and Enterprise Banks for former Afribank Plc, BankPHB Plc and Springbank Plc respectively. The Bridge banks were immediately sold to AMCON through share subscription, while the banking licences of Afribank Plc, BankPHB Plc and Springbank Plc were revoked by the CBN.

The purpose of this presentation is to highlight issues and challenges in mergers and acquisition. For ease of comprehension, the rest of the paper is organised into 4 sections. In Section 2, we examine the meaning of mergers and acquisition and enumerate reasons for the accelerating pace of mergers and acquisition in financial services industry world-wide. Section 3 examines some pertinent issues and challenges in mergers and acquisition while Section 4 concludes the paper.

2.0 MEANING OF MERGERS AND ACQUISITIONS AND REASONS FOR ITS ACCELERATING PACE

2.1 Meaning of Mergers and Acquisitions

There are two broad alternative methods for firms combining with each other. These are:

a) Mergers and Acquisitions (M & A); and

b) Joint Ventures and Strategic Alliance

Of the two alternatives, the most common methods often employed are M & A. While a merger can be defined as a transaction where one entity is combined with another so that one initial entity loses its distinct identity, an acquisition is classified as a transaction where one firm purchases a controlling stake (and/or the whole) of another firm. The terms mergers and acquisition shall be used interchangeably to refer to transactions involving the combination of at least two independent firms to form one.

2.2 Reasons for Accelerating Pace of M & A

Mergers and acquisitions among financial institutions are occurring at a rapid pace in the US, Europe, Japan and emerging economies of the former Eastern Europe and Far East Asian countries. For instance, Berger et al (1998) found that between 80s and 90s, there were about 3,600 mergers in the US. In 1996, the Bank for International Settlements (BIS) reported a similar trend in Japan and across Europe, especially during the 1990s.

Many reasons have been adduced for increasing pace of M & A. In their general form however, they are classified into motives and environmental factors. These two broad classifications of reasons for the observed accelerating pace of consolidation in the financial services industry are discussed briefly below.

2.2.1 Motives for M & A

The primary motives for M & A are cost savings and revenue enhancement.

a. Cost Savings

Mergers and acquisitions can lead to reductions in costs for a variety of reasons as the emerging large banks are expected to enjoy both scale and scope economies on the one hand, and avoid cost duplication, on the other hand.

b. Revenue Enhancement

M & A can lead to increased revenues through its effects on firm size, firm scope (through either product or geographic diversification), or market power. Research suggests that mergers may provide some opportunities for revenue enhancement either from efficiency gains or from increased market power.

2.2.2 Environment Factors Encouraging M & A

The main environmental factors propelling M & A among financial service providers include the following, among others.

a. Improvement in Information and Telecommunication Technology (ICT)

New technological developments have encouraged M & A because of their high fixed costs and the need to spread these costs across a large customer base. At the same time, dramatic improvements in the speed and quality of communications and information processing have made it possible for financial service providers to offer a broader array of products and services to larger numbers of clients over wider geographic areas than had been feasible in the past.

b. Deregulation

Over the past 25 years, many governments have removed important legal and regulatory barriers to financial industry development. The removal of these barriers has opened the way for increased M&As, both within and across national boundaries and both within and across financial industry segments.

c. **Shareholders' Pressure**

Increased competition has helped to squeeze profit margins, resulting in shareholders' pressure to improve performance. M & A has in many cases, seemed an attractive way to accomplish this objective.

d. **Common Currency**

The adoption of common currency by an economic block, such as euro in the European Union, has induced changes in financial markets in the region and this has provided new opportunities for realizing economies of scale and revenue enhancement through M & A.

3.0 ISSUES AND CHALLENGES IN M & A

The first experience of M & A in Nigeria took place during the banking consolidation programme of 2004/2005. The recent M & A transactions for 4 of the intervened banks were largely driven by the need to address their deficient capital positions. The transactions were largely assisted by the Regulatory Authorities through the provision of technical support in the form of advice. While the development is expected to resolve the problems of the intervened banks, there are obvious issues and challenges that should be addressed both by the Regulatory Authorities and operators in order to derive maximum benefits from the outcome of the transactions. Some of these issues and challenges are highlighted below.

3.1 Payments System Efficiency

As M & A has the direct effect of positively affecting the payments system by improving scale efficiencies in bank office payments operations as larger processing sites may yield scale efficiencies in processing payments information/instruments. In addition, many of the remaining inter-bank payments may be cleared more quickly and efficiently because there are fewer end points to which to send payment information or payment instruments. Thus, even if individual institutions are not more proficient in handling cheques, credit card, debt cards, automated clearing system, wire payments, etc, the payments system efficiency increases as the number of institutions declines.

The issue that arises in this regard is how quickly the merging entities are able to integrate into a formidable entity that can produce scope and scale economies in the payments system. It is however, worthy of note to indicate that since all the affected banks are products of M & A of the recent consolidation programme, they will bring their experience to bear in this regard. The Regulatory Authorities should, however, pay close attention to the integration process with a view to quickly detecting problems when they occur and proffering remedies to address such problems.

3.2 Distress Resolution

M & A transactions are usually encouraged as they serve as an efficient way of resolving problems of financial distress. Institutions that are troubled because of their own inefficiency or under performing investments are often taken over as an efficient alternative to bankruptcy or other means of exit. In that type of situation, the ideal merger would be for the ailing financial institution to be merged with a conservatively leveraged one that has a complementary mix of financial products, services and target markets. In the United States, the Federal Home Loan Bank System had arranged the mergers of a number of large "problem" savings and loan associations into sound institutions, and the Federal Reserve System had done same for banks.

While that may be desirable, the possibility that the depth of distress of the weaker bank may adversely affect the soundness of the healthier one remains an issue of concern to the Regulatory Authorities. The comfort in this regard is that the exact depth of distress in all the affected weak banks was unearthed by the Management teams of the respective banking institutions that were appointed by the Regulatory Authorities and the financial advisers.

3.3 Range of Product Lines Available to Consumers

Successful M & A transactions should potentially be in the public interest**,** particularly in the area of service delivery as the outcome is expected to add some depth to the local banking sector and make a worthwhile contribution to banking services and the banking industry in a particular country.

A frequent factor in motivating mergers is the possibility of scope efficiencies. The pursuit of these efficiencies often results in the product lines of the two entities being rationalized, with consequent cost benefits, since a single delivery system is used to sell a "better" (bigger) range of products. This often increases the options that consumers have and enhances the utility of these options.

Furthermore, economies of scale are fairly likely to improve after a successful M & A. Larger transaction volumes and larger asset positions, through a rationalized delivery system, mean that unit costs can be reduced. When such cost reductions are passed on to the consumers, this may be regarded as a public interest benefit.

The challenge here is that the development may compound the oligopolistic structure of the market where only a few banking institutions dominate and dictate quality and prices of products and services offered to consumers. It is instructive to note that when banks merge, the number of players will reduce and hence, the intensity of competition. This might have implications for the prices, products and quality of services in the banking sector. In addition, the reduction in the level of competition, which is a direct result of M

& A, implies that there may be less need for innovation, with possible less research and development spending and, which might adversely affect potentials for future growth and development at desirable rates.

Furthermore, M & A can easily result in a substantial increase in the market power of a bank. Despite the fact that a merger, for instance, is often being motivated on grounds of economies of scale and cost containment, shareholders interests also drive mergers, and the cost savings may not always be passed onto customers. In addition, the possibility exists that the increased market power might be abused by the emerging entity, raising costs to customers to unacceptable levels.

In that regard, rather than deriving benefits arising from scope and scale economies of the emerging large entities, consumers may be getting less quality products/services at higher prices. Regulatory Authorities should therefore put in place stricter regulation for banking products and service delivery to minimize possible abuses and they should equally strengthen supervision to ensure compliance.

3.4 Confidence in the Banking System

Banks, although stringently regulated, are prone to runs. This is because they are known to be highly geared. Confidence is therefore crucial for banks to attract and retain deposits. Big banks have been observed to be less vulnerable to external shocks. It could therefore, be said that big banks enhance the confidence of the public. Since M & A is expected to lead to the creation of large and strong banks, confidence in the nation's banking system is likely to be enhanced and this in turn may lead to improvement in banking habits of the populace thereby enhancing the efficacy of monetary policy.

The challenge is that the development my lead to the creation of significantly important financial institutions (SIFIs) which may take the features of too-big-to-fail institutions. The concerns of regulatory and supervisory agencies have been that the impact of a large bank failing will challenge the issues of moral hazards, systemic risk and impede the achievement of their mandate. There is the need therefore, to put in place additional measures to cope with the too-big-to-fail problem. The objectives of regulatory/supervisory agencies in this regard are basically three, namely:

i. To reduce the possibility of failure of large banks (also called Global Systematically Important Banks (G-SIBs);
ii. To reduce the extent or impact of the failure of such banks in the unlikely event of its occurrence; and
iii. Provide a level playing field by reducing the competitive advantage in funding markets that these institutions have.

In line with practices in other jurisdictions, particularly in Europe, America, Japan and emerging economies in the Eastern block, the following measures could be considered for adoption by the

Regulatory Authorities in order to achieve the above-listed objectives of addressing the too-big-to-fail problem.

a. Reducing the Probability of Failure

The cornerstone of regulatory/supervisory response to the problem was the raising of the amount of capital requirement for this category of banks through the application of capital surcharge, which has the possibility of lowering the risk of failure by enhancing their resilience to shocks. Jurisdictions that have started taking such measures by requiring even higher minimum capital for this category of banks, have categorized banks in their jurisdictions using size, interconnectedness, global activity, substitutability and complexity.

b. Reducing the Impact of Failure

One way of reducing the impact of failure of big banks is to reduce their systemic importance directly by regulatory/supervisory measures. Such measures may include placing limitations on the size or business activities by separating core banking services from other speculative investment activities and proprietary trading operations.

c. Leveling the Playing Field

The distortion to the level-playing-field created by funding advantages by banks perceived to be too-big-to-fail has remained an issue of concern to regulators and other key stakeholders. Several attempts have been made to quantify such funding advantages and the general conclusion has been that the advantage is huge. Measures such as capital surcharge, restrictions on certain business activities and imposition of special recovery and resolutions regimes, such as creation of living will and direct policy intervention, are often put in place for the big banks to help reduce the undue advantage by making transactions in the market fairer for small banks which could ensure the creation of a level playing field.

3.5 Access to Financial Services by Small Firms

Typically, small banks lend a larger proportion of their assets to small businesses than do large banks. The large institutions created through M & A transactions may shift away from providing retail-oriented services for small depositors and borrowers because of new opportunities to provide wholesale services for large capital market participants. This is because it may be scope inefficient for the emerging large banking entity produce outputs/services that are suitable for small businesses because diseconomies may most likely arise in providing services to informationally opaque small businesses.

In the main, M & A may inadvertently eliminate small banks, thereby raising the concern that small firms may find it difficult to access banking services. In view of the strategic importance of small businesses in the development process of any nation, the need to strengthen the non-bank financial institutions, particularly microfinance banks that are capable of rendering services to this group of economic agents has become imperative.

3.6 Staff Rationalization

In a service industry such as banking, motivation of staff is a key factor in ensuring that efficiency is maintained. When banks merge, there is the tendency that jobs might be lost as part of the repositioning strategies the new management may want to undertake. Apart from the adverse impact on employment level, the development could also impact negatively on the morale of the remaining workforce. This development should be envisaged, at least in the short-run, hence appropriate strategies must be put in place by the new managements of the emerging banks to boost the morale of staff. In addition, adequate attention should be given to trade unions in the industry in order to minimize disruptions from their activities which rationalization of staff might inadvertently prompt.

The adverse effects on employment is, however, expected to wane with time as a stronger banking sector would inevitably recruit more staff when the respective banks grow and open new branches. In addition, the induced employment generation from the real sector of the economy might more than compensate for job loss, net of attrition, after a successful M & A.

3.7 Effectiveness of IT Architecture

The effectiveness of IT system might be impaired, at least in the short-run. IT systems should be able to provide management information that is accurate, timely and relevant to managing a bank's risks. IT is most probably the biggest risk if not properly planned and managed. For example, there could be a lack of management information, an increased possibility of fraud and incorrect measurement of risk, since manual intervention is required until proper IT systems are in place.

In the long run however, successful M & A transactions are expected to lead to the deployment of highly sophisticated IT systems that would be of immense advantage to the industry in particular and the economy in general.

3.8 Executive Capacity

Management of banks should be fit and proper, competent, adequately skilled and prudent. The ability of executive management to build and mould a management team that is able to lead the emerging banking entity after M & A through the painful process of merging IT systems, business lines and products, cultures and people is of critical importance. In that regard, the management of the emerging entity needs to have the ability to identify the integration risks at an early stage and manage them effectively in the shortest possible time.

In addition to the above, the management of the emerging banking entity must at all times place the interests of the bank and its depositors before their own interests and should at all times act in the best interests of depositors and other stakeholders, regardless of the demands of shareholders.

The foregoing implies a change of orientation, attitudes, value system and above all, capacity building by the operators at all levels in general and at the management level, in particular.

3.9 Financial Safety Net

Given the importance of banks to the economy, their inherent fragility and the devastating and painful consequences of bank failure, most governments put in place safety nets. Financial safety nets are a set of rules and institutions that will ensure a safe, sound and stable banking system. They are usually made up of effective supervision, lender-of-last-resort role of central banks and deposit insurance. The current trend in M & A in the Nigerian banking industry will raise the following issues in the three components of the safety net.

a. Regulation and Supervision

The on-going M & A in the banking industry, will undoubtedly, lead to the emergence of large banking entities. The development will necessarily entail strengthening of the subsisting regulatory/supervisory framework. In particular, strong prudential regulation that will introduce additional capital surcharge for large banks and periodic review of fit-and-proper test results has become more imperative than hitherto. Similarly, there is the need to develop guidelines for the development of special resolution regime framework for systemically important banks so as to reduce the problem of moral hazard as well as minimize utilization of public funds to bail out banks. In addition, fine-tuning of the framework for risk-based and consolidated supervision, ensuring compliance with the recently issued guidelines on accounting and disclosure regimes and effective self-regulation may be unavoidable so as to promote market discipline. It is instructive to note that the recent banking reform has addressed these imperatives but efforts should be made to sustain the momentum. In the case of risk- based and consolidated supervision, the current efforts of the CBN/NDIC in up-grading the electronic Financial Analysis Surveillance System (e-FASS) and the activities of the Financial Services Regulation Coordinating Committee (FSRCC) would go a long way to assist in this regard.

Furthermore, in view of the fact that M & A would create large and sometimes complex banks, statutory regulation should be complemented by self-regulation. Effective self-regulation requires probity, transparency and accountability. The regulatory/supervisory authorities should take necessary steps to encourage these virtues and operators must be made to appreciate the need for compliance with rules and regulations to promote healthy competition since self-regulation does not amount to a total elimination of regulatory controls and supervision.

In addition, consideration should always be given to the possibility that corporate governance, in particular internal control systems, will be less effective during a merger, since the individuals responsible for governance and control will be focusing on strategic issues relating to the merger. Regulatory/supervisory authorities must therefore, continue to encourage the enthronement of responsive corporate governance structure for effective risk management both during and after M & A by banks.

b. Deposit Insurance

As a deposit protection agency, NDIC is concerned with putting in place appropriate strategies to ensure adequate depositor protection in the banking industry both during and after M & A transactions. In order to adequately protect depositors, contribute to the stability of the banking system and reduce the problem of moral hazard often associated with deposit insurance, some specific deposit insurance design features as being applied by the NDIC may have to be reviewed to enhance the effectiveness of the Corporation. These features, some of which are already in place, include the following:

- Placing limits on the amounts insured as currently being done but the limits should be periodically reviewed to ensure their adequacy in engendering confidence;

- Excluding certain categories of depositors from coverage: this is also the practice in Nigeria;
- Fine-tuning the subsisting differential premium assessment system to make it more effective in promoting sound risk management in banks;

- Minimizing the risk of loss by adopting prompt corrective action and employing least costly failure resolution option as demonstrated recently when bridge bank option was adopted. That has implication for capacity building in the relevant areas; and

- Demonstrating a willingness to take legal action, where warranted, against directors and others for improper acts.

c. Lender-of-Last-Resort Facility

With the emergence of bigger banks arising from the on-going M & A in the industry, the CBN should stand ready to provide temporary liquidity to deserving banking institutions so as to avoid devastating damage to the entire banking system. However, a lot of care should be exercised by the CBN so as to avoid making itself lender-of-first-resort with a view to promoting sound and prudent bank management.

4.0 SUMMARY AND CONCLUSION

In the paper, we have attempted to highlight some issues and challenges in the on-going M & A in the banking industry. In the main, the paper has provoked the managements of the emerging bigger banking institutions to brace up to the challenges and run their banks in a safe and sound manner. In that regard, they should enhance their risk management capacity, enthrone responsive corporate governance, embrace the right culture that would promote market discipline and should complement statutory regulation with self-regulation and self-discipline. The Regulatory/Supervisory Authorities should be more proactive in the discharge of their role which implications for capacity building in all relevant areas.