Bank Merger – some considerations

X and Y Bank

Merger

- The decision to merge two banks or consolidate a banking sector should be beneficial to ;
  - the banking sector
  - the national economy
  - the Shareholders

Merger

- A merger can have a lasting effect on the structure and performance of the banking industry , the Central Bank has an important role to play in the Oversight process.
- The preservation and enhancement of competitiveness in the banking system should remain an important objective.

Merger

- A poorly conceived or badly executed merger can present to the participating banks, to the banking system and other economic sectors in general
- Evaluate the quality of each business plan, assess its ability to merge with earnings accretion and cost savings.

Merger

- The main benefits of a merger between two banks can be:
  - Higher efficiency and profitability (earnings accretion) due to favourable synergies and economies of scale
  - Increased safety and soundness due to broader diversification of business lines, improvements in information technology and enhanced branch network.

Merger

- Listed Concerns can be:
  - The merger may enhance systemic risk in the local banking markets
  - Customers of two banks may not embrace the concept of one stop shop – Here there could be customers who prefer to spread their purchases of financial services among several providers
  - Public may fear loss of competition resulting from mergers, worry about the potential closure of nearby branches and employees may have the apprehension at the possible losses of employment due to cost cutting measures.

Merger

- Listed Concerns contd:
  - There could be a potential loss of key staff members due to merger and potential for erosion of the banks customer base because of the business uncertainties as the merger process proceeds
  - The proposed new bank consequent to the merger must meet the capital and other regulatory requirements and the licensing criteria stipulated by the Central bank.

Merger

- Recommendations to assist regulators in a merger process (by IMF);
  - There should be an independent review of the proposal to transfer ownership in the participating banks
  - Review the merger proposal and ensure that the newly formed bank after merger meets with the licensing criteria and other requirements including capital.

Merger

- Review the merger in terms of their investments so that the bank is not exposed to undue risk
- Assure that the merger process is transparent. The supervisor is accountable in connection with action taken on bank mergers
- Be able to assess the newly formed bank in terms of ownership structure, directors and senior management, its operating plan and internal controls and its projected financial condition, including its capital base.

Merger

- Assess how the merging banks predicate their financial projections on anticipated cost savings and claimed efficiencies. The supervisor has an important role to play in ensuring that the projections are not unduly optimistic, as achieving the required capital adequacy ratios will likely depend on them.

Merger

- Ensure that the provisions of any outsourcing contracts (to carry out mainly their back office transaction) to be affected by the merger are closely reviewed and that any costs related thereto are properly reflected in the projected financial statements

Merger

- Review any proposed job cuts in the new bank and the adverse effect on employee morale. This may erode the business of the resulting bank by weakening ties to customers. We may have to ensure that the new bank devotes appropriate attention to the human resource requirements related to the merger.

Merger

- Ensure that the interests of the customers of the participating banks are not jeopardized due to establishment of uniform product and prices by the newly formed bank and its proposed charges for services that may be deemed as monopolistic

Merger

- Review the accounting treatment to be accorded to the merger proposal that may arise significant issues such as creation of goodwill in the amalgamated balance sheet, valuation of tangible and intangible securities etc..

Merger

- Major information to be obtained from banks participating in merger activity;
  - Copies of all agreements entered into or to be entered into, in connection with the merger proposal.
  - A description of the effect of the transaction on competition.
  - Complete description of the financial effects of the merger proposal

Merger

- The information may include;
  - Any plans to raise additional equity or to incur debts
  - Copies of any offering circulars to be distributed to existing or prospective shareholders
  - Financial information, including a description of assumptions used to prepare projected statements
  - And a list of material changes since the date of the financial statements

Merger

- Additional financial information may include;
  - Pro forma balance sheet, as of the most recent quarter and for the first three quarters. Balance sheet of the previous 3 years. Projected balance sheet of the merged entities for the next three years.
  - Applicants should indicate separately for each institution each principal group of assets, liabilities and capital accounts; debit and credit adjustments explained in the footnotes reflecting the proposed acquisition
  - The resulting pro-forma combined balance sheet.
  - Goodwill and all other intangible assets should be listed separately on the balance sheet.
  - Projected combined statement of income for the first three years of operation following consummation/ merger..

Merger

- Pro forma and projected regulatory capital schedule, as of the end of the most recent quarter and for the first three years of operation, indicating
    - Each component item for Tier 1 (Core) and Tier 2 supplementary capital, subtotal for Tier 1 and Tier 2 capital (less any investment in unconsolidated or non includable subsidiaries, Total capital (including Tier 3, if applicable)
    - Total risk weighted assets including off balance sheet items
    - Capital ratios; (1) Tier 1 capital to total risk weighted assets, (2) Total capital to total risk weighted assets, and (3) Tier 1 capital to average total consolidated assets (leverage ratio)

Merger

- Directors and senior officers of the resulting institution should be identified and financial and biographical information on each such person provided.
- All branches sought to be operated by the resulting institution should be identified
- All consents and approvals requested by applicants (in this and any other jurisdiction) in connection with the merger proposal should be listed.

Merger

- The integration strategy to be followed to combine the operations of the constituent institutions should be described.
- Corporate Governance matters relating to the resulting entity should be discussed, including Board and management committees that will come into existence, their composition, responsibilities, and reporting obligations; internal controls, any operating companies, and their respective corporate governance, should be discussed.

Merger

- In case of a merger of an islamic institution, the concurrence and approval of the Sharia Advisory Board should be obtained.
- Clear definition of the accounting and reporting treatment of assets and liabilities in the merged bank should be provided.

Merger- Synergies

Synergies relate to performance benefits accruing to the combined organization directly as a result of the combination and relative to their performance prior to the combination.

Merger should bring about significant synergies in the form of:

Earnings Accretion – Revenue related

Cost Savings – Expense related

Merger - Synergies

- Revenue Related would include;

  Product cross sell

  Enhanced market share

  Enhanced leverage off the larger balance sheet

Merger - Synergies

- Cost related synergies could result from;
  - Savings from duplication of branches
  - Reduction in ATM
  - Savings in IT system overlaps
  - Savings from other operational platforms
  - Head office functions
  - Head count reduction
  - Advertising and marketing cost reduction

Merger - synergies

- One off synergies can also be attributed to;
- Avoiding development costs associated with the setting up of a new business (e.g. islamic banking) or a mortgage business etc..
- Integration costs related to the entities in question.

Source of Merger Synergies

- The data and information related to potential or projected synergies is derived from ;
- Preliminary assessment by managements of both entities to be merged etc..
- Quantified but validated data from financial records, management estimates, and publicly available industry benchmarks of prior years. E.g. past three year bench marks.

Merger – Market Report

- Reporting back to the market on synergies realized over a segmented interim period is of particular interest to the investor community.
- Hence a focused response on synergies to the investors can have a direct impact on the price of shares and impact Earnings per share?
- The synergies can impact projected operating performance, dividend disbursements, level of capitalization and market perceptions.

Merger – Synergy Statement

- The synergy statement and the achievement of synergies is the sole responsibility of the Board of Directors.
- Aside from assessing performance impact, the benefits of the synergy statement are multifold;
    - Delivering on a promise – s statement would be a progress report against a promise made to the shareholders at the time of the merger
    - Enhanced shareholder value; demonstrate that the Board and Management have shareholder value enhancement at the core of the agenda
    - Enhanced management credibility; demonstrate the effectiveness of management decisions

Merger – Ownership of Synergies

- The ownership to identify, deliver and evidence business synergies can be vested with the business unit and supported by business finance units and integration teams;

Merger – Framework for Synergies

Stages	Objectives
Identification and Planning	>Capture potential actions that could lead to synergies early during the integration discussions >Identified teams could then be tracked >Ensures completion of evaluation, since items not identified would not be tracked
Realization/ Crystallization	➢Ac action or decision leading to the generation of a synergy ➢Most of the time realization and crystallization happens simultaneously
Documenting and Evidencing	>The process of articulating the drivers and assumptions leading to a synergy with documentary evidence is required to be maintained
International Standard on Assurance Engagement	➢The external accountants should review and discuss the merger benefits with management. They should check the supporting evidence and the computation calculations as well as the assumptions made. ➢An independent regulatory review should be performed of the measurement techniques and the underlying assumptions

Summary

- Bank Merger
  - Impact on banking sector, Economy and Systemic Risk
  - Impact on Customers/ General public
  - Supervisory oversight and Integration
  - Measurement and Framework of Synergies