An approach to the consideration of bank merger issues by regulators: a South African case

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1. Introduction

An aspect of banking policy that recently received a great deal of attention in South Africa is the issue of bank mergers, and the regulator's approach to considering whether to allow a merger to proceed.

This paper describes the approach taken by the Registrar of Banks in considering a recent application by a "big four" bank to make a hostile acquisition of another "big four" bank. From the outset, many complex issues were at stake. Therefore, a fairly formal decision-making process, and a normative framework of factors to be considered, was developed. It is intended that this approach will be used, adapted where appropriate, for such cases in future.

2. Background

2.1 Overview of banking supervision in South Africa

Until 1986, the Department of Finance supervised banks in South Africa. This duty was then transferred to the South African Reserve Bank (SARB). In 1990, the approach of the SARB's Bank Supervision Department was revised, and the Banks Act rewritten, to support a modern risk-based approach to the supervision of banks. This approach, as continually refined, has served the banking system well. An independent assessment of the SARB's compliance with the Core Principles for Effective Banking Supervision in 1998, as well as a subsequent IMF Article 4 consultation, confirmed that the approach was appropriate to the country's circumstances. A recent Financial Sector Assessment Programme investigation resulted in further refinements to the supervisory process and supporting legislation. These refinements made the SARB fully compliant with the minimum standards set out in the Core Principles.

2.2 The South African banking sector

The South African banking sector, and for that matter the whole corporate sector, is still highly concentrated as a result of the years of economic isolation during the 1980s. Approximately 60 banks are registered in South Africa, but the largest four have approximately 70% of the assets, and own the bulk of the retail banking system. The others are mainly small niche banks, focusing on specific activities, regions or communities.

The "big four" South African banks have always invested heavily in information technology (IT), and their systems are as sophisticated as those in much more developed countries. This has increased the availability of information in the markets and has led to a substantial expansion in cross-border transactions. Technological developments have also facilitated the design of complex new financial instruments, which have provided innovative ways of hedging against risks. But most importantly, IT is seen as a major strategic competitive factor, since it forms the basis for South African banks' drive to improve cost efficiencies.

A related development has been the liberalisation and modernisation of financial markets. South Africa has adopted a clearly defined policy of actively participating in globalisation, and has implemented a number of economic policies to facilitate this process. Deregulating the exchanges, phasing out exchange controls, restructuring the capital market to provide for more specialised trading in equities, bonds and derivatives, upgrading the national payment, clearing and settlement system, and more active participation in multinational economic cooperation have all helped integrate South Africa into the global financial markets. Foreign banks are largely free of restrictions. Some 10 foreign banks operate in South Africa, and a further 60 have representative offices. The large banks also have significant operations and interests in several major foreign markets.

However, a large proportion of the population is not served by the "formal" banking system. In pursuing cost efficiencies, the main banks have left a vacuum of access to basic banking services in mostly rural areas and primarily among the poorest of the population. So far, formal government institutions, such as the Post Bank or Land Bank, have been unable to fill the gap. An informal, but largely unregulated and fairly exploitive, microfinance industry has developed. Recent moves to regulate this industry are, however, showing some promise. Nevertheless, pressure is mounting for the banking system to play a bigger role in resolving the problem of access to finance by, specifically, small, medium-sized and micro enterprises and potential sub-economic homeowners. Legislation may be promulgated soon, in order somehow to "compel" banks to undertake more developmental investment.

2.3 Overview of legal requirements relating to bank mergers and acquisitions

The Banks Act, 1990, requires the consent of the Minister of Finance, after consultation with the Competition Commission, in approving a merger between two banks. Before permission is granted, the act requires that the Registrar of Banks or the Minister, as the case may be, is satisfied that the proposed acquisition of shares will not be contrary to the interests of the general public, the bank concerned, its depositors or the controlling company concerned.

The Supreme Court of Appeal recently ruled that the Registrar of Banks and the Minister of Finance are responsible for regulating and judging bank takeovers and mergers. Subsequent proposed amendments to the Competition Act after the merger application, however, give the Registrar of Banks and the Competition Commission concurrent jurisdiction with regard to share acquisitions in banks and banking mergers or takeovers.

3. Description of the proposed merger case

3.1 The application and rationale

Bank A, through its associates, already held 26% of the issued shares in Bank B, and wished ultimately to acquire all of the issued shares. Bank A announced it would make an offer to the shareholders of Bank B once the permission of the Minister of Finance had been obtained.

The overriding reason put forward by Bank A for the merger was to create a fundamentally better banking group, for the benefit of South Africa and all stakeholders. The merged bank would have a stronger capital structure and a reduced risk profile. By eliminating duplicated costs, it would have a stronger free cashflow, allowing it to accelerate the development of state of the art IT.

Furthermore, they argued the merger would create a regional bank with sufficient scale and efficiency to compete with international banks. This would enhance trade across South Africa, whilst also contributing to the enhancement of African banking and the development of the Southern African Development Community.

Bank A argued that the merger was unlikely to reduce competition substantially, since the banks operated in the financial services industry generally, rather than just the retail banking market. It also asserted that globalisation, facilitated by IT developments, meant that South African banks effectively competed with other financial service providers worldwide.

Bank A also argued that the proposed merger had substantial public interest benefits, in that the merged entity's lower cost base would enable it to extend banking services to the underbanked and provide black economic empowerment opportunities.

3.2 The defence presented

Bank B responded by citing recent research showing that the majority of bank mergers had not delivered the promised benefits. A Deloitte & Touche report had concluded that “most mergers simply have not delivered the benefits that were promised” and in particular struck problems integrating IT systems. BNP/Paribas had underperformed its peers by 26% since its merger announcement. A review of the five largest US bank mergers in 1997 and 1998 had indicated that estimated earnings for two years after completion were substantially below initial expectations. Another South African bank had experienced a falling market share, reduced revenues and higher cost to income ratios after merger. Furthermore, empirical research had demonstrated that bigger was not better; in the United States between 1988 and 1997 the 10 largest banks had a lower than average return on assets. Furthermore, implementation risks were high as there was no experience of such large-scale integration, especially of IT systems, which could take up to six years.

They argued South African domestic banking was already concentrated, since the four large banks dominated the retail, small business and large corporate markets. Comparable mergers would not be allowed in Australia and Canada. They argued the merger would vastly increase systemic risk and concentration.

They rejected the argument that the merged bank would have an increased global profile as emotive and illogical, pointing out it would be only number 144 in the world in terms of assets, and argued European-style regional expansion was not relevant to South African banks.

Bank B also rejected the public interest argument. Its existing mass market strategy would be jeopardised by a competitor with no appetite or experience in this regard. There would be a permanent loss of 10,000 to 15,000 jobs, primarily at the clerical and the branch level, probably within 12 months, mostly from previously disadvantaged communities, which could not be handled by attrition.

4. The process of forming a recommendation

The process followed in analysing the issues and making a recommendation to the Minister involved:

- review of international bank merger practice;
- research of merger and acquisition considerations as they apply to banks;
- fact-finding discussions with the banks concerned;
- consultation with other domestic and international regulators;
- workshops to refine policy and other considerations;
- consultation with the Competition Commission;
- consultation with the Governor and Deputy Governors of the SARB;
- preparation of documentation.

Owing to the importance of the decision, and the apparent balance of the considerations for and against, an attempt was made to quantify the many complex and abstract issues. A list of 47 considerations, structured under six main headings, was considered by a panel of the management of the SARB’s Bank Supervision Department, including the analysts of the banks concerned. The SARB’s Internal Audit Department organised workshops and prepared background material for the panel. Each consideration was discussed, evaluated and scored in terms of the impact of the proposed merger.

As the questions were somewhat abstract, there was an element of judgement and subjectivity involved in answering. However, to limit this, independent, anonymous “voting” was conducted on each detailed question. The range of possible answers to each question was limited to:

– 2 – significant adverse impact;

– 1 – some adverse impact;

0 – no impact;

+ 1 – some positive impact;

+ 2 – significant positive impact.

The voting process used the commercially available “Option Finder System”, a combination of software and interactive wireless keypads used to improve group communications in face to face meetings. During the course of the meeting, facilitators posed questions or statements relating to each consideration to the participants, which were projected onto a large screen. The participants voted by pressing the keypad number of the response that matched their opinion. The software processed the keypad responses and, instantly, produced a graph of the results. The graph was projected for all to see, and outliers were discussed and resolved by revoting if necessary. The system provided a full audit trail of responses and ensured voting integrity at all times. This process made it possible to quantify the multitude of issues into a value for each category and, after account had been taken of relative weightings, into a single value, indicating a bias for or against allowing the merger. These averages were then used to guide the Registrar in assessing whether the proposed acquisition would be contrary to the various interests stated in the Banks Act.

The advantages of this approach were:

- *Anonymity* - the keypads allowed participating experts to respond anonymously, thereby encouraging more honest and accurate responses, and greater focus on content and outcomes.
- *Productivity* - more was accomplished, in a shorter time, because of the structured nature of the workshops and the comprehensive framework of considerations.
- *Democracy of input* - every participating expert was given a keypad and could register his or her opinion; not just the participants who spoke more or who had the most “power”. The graph of this input provided the basis for further discussion and decision-making.

It is stressed that the process followed did not change a judgmental decision into an objective one, but helped to structure the considerations and to break down the decision into manageable parts. Particularly the weightings of strategic issues could easily affect the outcome of the model. Ultimately, after due consideration of the objective factors and analysis, the decision remained a judgment call, informed by the process, but not solely determined thereby.

5. Normative overview of merger issues

5.1 Objectives of regulation

Regulatory authorities worldwide have three main objectives, that is to ensure that:

- banks are safe and sound;
- banks’ customers have faith and confidence in their banks; and
- banks operate efficiently and effectively.

Every country has its own instruments, contained in legislation and regulations, to achieve this. The international community of bank regulators has developed a wealth of knowledge, culminating in guidelines known as the Core Principles for Effective Banking Supervision. These comprise 25 basic principles that need to be in place for a supervisory system to be effective, and they relate to:

- preconditions for effective banking supervision - Principle 1;
- licensing and structure - Principles 2 to 5;
- prudential regulations and requirements - Principles 6 to 15;
- methods of ongoing banking supervision - Principles 16 to 20;
- information requirements - Principle 21;
- formal powers of supervisors - Principle 22;

- cross-border banking - Principles 23 to 25.

The environment in which banks operate underwent globalisation long before other industries. Banks, in performing their pivotal role in the economy, influence the repo rate, participate in the payment system and influence the international banking scene through the international payment system. It is therefore a further regulatory objective to cherish the national financial system jealously, in order to retain its systemic strength. A balance must be struck between, on the one hand, serving the national market and, on the other hand, the interest in competing internationally.

The international role of the South African financial system is to:

- be a reliable member of the international financial community, engendering confidence in investors;
- form a liaison with international financial systems;
- play a leading role in Africa; and
- lead by example in the East and Southern Africa Banking Supervisors' Group.

Not only must the robustness of the South African financial system be safeguarded, it must be enhanced and be an export product. Against this background, and being conscious of the principles applicable to competition, the regulator must adjudicate an application without falling into the trap of taking a commercial decision on behalf of the parties concerned. Although competition considerations are certainly in the interest of depositors, that interest may have to yield, under appropriate circumstances, to the regulatory objectives set out above.

Furthermore, in considering a merger application, a number of regulatory principles have to be taken into account. With regard to the shareholding structure, a bank must pay appropriate regard to the interest of its depositors. Therefore, no single shareholder (or group) should be in a position to exercise undue influence over the policies and operations of a bank. The shareholding structure should not be a source of weakness and should minimise the risk of contagion from non-bank activities conducted by shareholders in other entities within the conglomerate. Banking groups vary widely in terms of structure, range of activities and complexity. This could complicate the effective supervision of banks within such groups. Furthermore, users of banking services must be able to make a proper assessment of the banking group's activities and risk profile. The principle that the regulator does not create wealth, but is intent on protecting wealth, must prevail.

5.2 Review of international best practice

The experience in nine countries was reviewed. The number of bank mergers has increased significantly during the past two decades and creates the impression that "big is beautiful". Although there are some hostile takeover bids, most mergers are by agreement.

Some key observations were:

- Although bank regulators play an important role in the process of approving a merger, competition considerations would appear to be regarded as more important.
- European mergers and acquisitions surged during 1999 as European monetary union heightened competition and forced banks to seek ways to cut costs and to increase market share. Governments in many European countries welcomed the process of consolidation in their banking sectors and, in some cases, even urged their banks to merge as a way of creating formidable national champions and improving the international competitiveness of their banking sectors.
- Consolidation of the Japanese banking system was due mainly to an effort to restructure a struggling industry.
- Regulators and competition bodies in countries such as Australia and Canada maintain a tough stance on mergers. The Australian authorities maintain the "four pillar" policy in order to prevent a merger of any two or more of the big four banks. In Canada, two proposed mergers were recently refused, mainly because of an unacceptable concentration of economic power. The United States, with much less concentration, is reconsidering existing policy standards.

- Hostile bids are generally not well received by governments, regulators and competition agencies. Although the French government was in favour of a recently proposed three-way merger, it stated that the merger could take place only by agreement and in an ordered way. In Italy, the central bank has a strong aversion to hostile bids.
- The UBS/SBC merger in Switzerland had to be approved by two thirds of the shareholders, the Swiss regulators, the European Commission and the US Federal Reserve Board.
- In some cases, approval is granted for a merger to go ahead subject to certain conditions, for example in Australia, Switzerland and the United States.
- The international movement towards the consolidation of banking systems has held promise for more efficient, better diversified banks, with more intense competition in local markets. In many cases, especially when acquirers paid a reasonable price and managed the resulting post-merger organisational problems effectively, this promise has certainly come true. There is, however, accumulating evidence in surveys and empirical research that the promise has not always been fulfilled for retail customers in local banking markets. In many cases, neither greater efficiency nor substantial improvements in diversification appear to have been realised, and bank profitability has fallen in 12 countries, despite the recent wave of consolidation. There is also some evidence of less, instead of more, competition resulting from the process of consolidation.

Drawing on this international experience, the following principles emerged:

- There should always be sound and rational reasons for mergers. Reasons for seeking to increase size should always relate to the generally accepted standards for performance, such as revenue growth, lower costs, return on equity and assets, customer loyalty and dividend yield. The potential for rapid improvement in one or more of these measures must always be present, and a merger should be carried through to the point at which the benefits are realised.
- The potentially negative effects or disadvantages should be considered and managed carefully if it is decided to go ahead with a merger.
- A merger between two or more banks should not only be to the advantage of the institutions involved, but should also promote the soundness and stability of the banking sector (or, at least, not harm it) and should develop along the lines of national economic interests.
- Stability considerations relating to safeguarding the economy from potential shocks caused by systemic problems in the banking system are important. Since sound banks ensure a sound banking system, there is a close relationship between stability and safety considerations. The stability considerations focus more on the robustness of the system and its ability to deal with a bank failure without instability spreading to other banks and damaging the economy. Stability can either be enhanced or harmed by a merger.
- An efficient structure in the banking system would promote free competition and, therefore, efficient resource allocation. Again, a merger can either improve the efficiency of the structure, or harm it.
- The purpose of regulation is to address externalities and market imperfections, and, in a sense, regulation is a “public good”. More specifically, public interest considerations, such as changes in cost structures, can be affected by a merger.
- The interests of the bank or bank controlling company concerned should be considered. The Banks Act requires that a merger not be contrary to the interests of the bank concerned or of its controlling company. A merger can affect, for instance, a bank’s market niche and, thereby, the sustainability of its profits.
- A further set of considerations is of a more abstract nature, such as considerations relating to an industry’s present positioning in the international context. It is conceivable that permission for a merger might be based on one such strategic issue alone, following the judgement of the regulator, rather than on hard facts.

6. Framework of the relevant considerations

6.1 Introduction

A combination of the normal objectives of the regulation of banks, international best practice and the requirements of the Banks Act leads to the emergence of a framework of six categories of consideration that would be pertinent to any bank mergers. The framework can be said to be as follows:

6.2 Safety considerations

Safety considerations relate to the soundness of banks and the protection of depositors.

Ability to create a top-class management team

Management of banks should be fit and proper, competent, properly skilled and prudent. It is within this context that the management of a merged entity should be viewed. In particular, the ability of executive management to build and mould a management team that is able to lead the merged organisation through the painful process of merging IT systems, business lines and products, cultures and people is of critical importance. In this regard, the management of the merged entity needs to have the ability not only to identify the integration risks at an early stage, but to “bed down” the merger in the shortest possible time.

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

Probability of a bank failure

The regulatory authority needs to consider whether the chance of failure in the merged entity is greater or less than the possibility of failure in either one or both of the stand alone entities. While research has generally indicated that the chance of failure of a large merged entity is less than the chance of failure of two smaller entities, when a large bank runs into financial difficulties, the impact is usually much greater.

Ability of authorities to assist with problems

In most banking systems, the authorities are faced with the “too big to be allowed to fail” problem. Should one or more big banks have problems, the authorities may be “compelled” to provide assistance to such banks, to avoid devastating damage to the entire banking system.

Moral pressure on authorities for forbearance

If the result of a banking merger is the creation of a very large bank, added pressure for forbearance (being “soft”, instead of making more painful, but possibly more correct, decisions) may be placed on the relevant authorities. In many banking systems worldwide, such “regulatory capture” is a key concern of regulators.

Effectiveness of moral suasion by authorities

In a highly concentrated banking sector, the effectiveness of moral suasion (pressure on banks to agree to do something that they are not compelled to do by legislation) by the central bank and/or the regulatory authorities can be reduced. The sheer size and power of a very large bank would make it more difficult for the authorities to exercise moral suasion over it.

Capital adequacy and the ability to raise capital in the future

An important requirement for any bank is that it should have adequate capital to meet both its regulatory requirements and its own internal requirements, taking into account its risk profile. The capital that a bank holds should be permanent, of high quality and readily available to absorb losses. Furthermore, it is important for a bank to have in place adequate plans to ensure that it can raise sufficient capital to meet future growth.

When considering the merger of two or more banks, the regulator needs to be comfortable that the capital base of the merged entity will be sufficient to meet the objectives stated above.

Shareholding structure and the role of major shareholders in the merged entity

A regulatory authority ideally wishes to see a shareholding structure that not only has a diversified spread of shareholders, but which also has one or two key shareholders that would be available to support the bank in times of need. Of importance, however, is that, preferably, no shareholder should have the ability to exert an overwhelming influence over a bank.

In addition, the shareholding structure should be transparent and allow the regulatory authority to supervise the banking group effectively, on both a solo and a consolidated basis.

Overall risk profile of the merged entity

The authorities need to consider whether the overall risk profile of a merged bank would over time stay within acceptable boundaries and be capable of being managed properly. Common reasons for the risk profile of the merged entity possibly being higher, especially initially, include failure of control systems, lack of management focus and poor understanding of "adopted" risks. If it is clear that the risk profile of the merged entity would increase to unacceptable levels and that the management of the merged entity would not have the ability to manage the process, the regulatory authority should stop the merger.

Level of risk during the integration process

During a merger process, the overall risk profile of the merged entity will usually increase, because of the integration risk and the complexity of the rationalisation process. These risks increase in relation to the size of the merging entities and the circumstances surrounding the merger, in particular whether the merger is friendly or hostile. Furthermore, management would in all likelihood become more inwardly focused as it meets the challenges of integration.

It is also possible that the bank proposing the merger or takeover could seriously underestimate the risks associated with the integration process, further increasing the inherent risk.

Appropriateness and effectiveness of the existing regulatory and supervisory process

At any given time, the regulatory authority needs to ensure that the existing regulatory and supervisory processes and practices are adequate to cater for the complexities of the individual banks operating in the banking system and of the banking system as a whole. In addition, the banking regulator needs to ensure that the risks flowing from a complex group are well understood by the regulatory authority itself and that the risk management processes adopted by the complex group are adequate. When a merger results in a large complex banking group, the regulatory authority needs to give close consideration to its current practices, to ensure that the banking system will not be placed at risk and that the regulatory authority can effectively supervise the new merged entity.

Effectiveness of corporate governance

Effective corporate governance is always an aspect that is closely monitored by the regulatory authority. Consideration should always be given to the possibility that corporate governance, in particular internal control systems, will be less effective during a protracted merger, since the persons responsible for governance and control will be focusing on strategic issues relating to the merger. Another consideration is the possibility that a new owner would be inclined to use its influence to override sound corporate governance processes to "get things done", especially in a hostile situation.

Finally, if the merged entity is large, it is more difficult in practice to manage and control corporate governance throughout the organisation.

Ability to retain key staff at critical times

The success or failure of any merger depends upon the ability of management and staff in key positions to implement the necessary changes in order to ensure a smooth transition to a new organisation.

6.3 Stability considerations

Stability considerations have to do with the protection of the economy from potential shocks caused by systemic problems in the banking system. (As sound banks make for a sound system, there is a close relationship between this category and the previous one.) Stability considerations focus on the robustness of the system and its ability to deal with a bank failure without such a failure spreading to other banks and damaging the economy. Stability can be either enhanced or reduced by a merger.

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. This holds more for small banks than for larger banks, which are less exposed to this vulnerability. It could therefore be said that larger banks enhance the confidence of the public.

On the other hand, the responsibility of the management of a large bank is more onerous, particularly to ensure effectiveness, containment of costs and adequate control systems. The demands of modern times bring pressure to bear on banks to take on risks in order to be more competitive, particularly in the international arena. In the local arena, the same applies, albeit on a lesser scale. Since a single management error in a large bank can affect the entire banking system, it is also possible that a bank that is considered to be too big by the public could reduce confidence in the banking system, especially among foreign observers.

Concentration of systemic risk

All banks, however well their risks are managed, have the same inherent flaw in their balance sheets - their liabilities are certain and short-term whereas their assets are uncertain in value and long-term. This “sameness” of banks results in a high tendency for known problems in one bank to spread rapidly to other banks and to the whole banking system if the problems are not checked. Such “systemic risk” is the worst fear of any bank regulator, and any factor that can impact thereon should be considered carefully. Although a larger bank does not imply more systemic risk, there is a possibility that a small number of very large banks would impact on the ability of regulators to “check” a systemic problem.

Level of moral hazard among management

Because of the importance of banks to the economy, their inherent fragility, and hence the need for confidence in the system to be maintained, central banks would usually consider extending assistance to banks with short-term liquidity problems. Governments have also been known to assist failing banks (those with more than just liquidity problems) or their depositors, in order to avoid even more costly damage to the system. This “implied guarantee” tends to make bank management risk-prone, rather than risk-averse, because of the presumption that there is likely to be “lender of last resort” assistance.

Central banks and governments always have the prerogative of letting a bank fail without assistance. The bigger the bank, however, the fewer alternatives the authorities have but to assist it, owing to the possibility of widespread hardship and irreparable damage.

Extent of adverse selection by consumers

A consumer of banking products would normally avoid risk by dealing only with banks that (in the consumer’s opinion) have appropriate risk profiles. The lack of reliable information about a bank's risk profile, however, combined with the fact that consumers also rely on the “implied guarantee” described above, means that there is every chance of consumers deliberately selecting the riskiest banks (in pursuit of higher returns). Such “adverse selection” undermines the effectiveness of market discipline and the importance of the “buyer beware” principle as part of the regulatory system.

Ability of authorities to stem a systemic crisis

The authorities have only limited instruments and resources to assist a bank, or worse many banks simultaneously, in order to prevent a systemic crisis. The bigger the bank, the more difficult it would be to implement rapidly an effective measure, owing to the increase in the scope of the problem.

Social cost of failure

It is an economic tenet that the social cost of a bank failure exceeds the private costs. It is one reason for the existence of regulation. The statement has three aspects. First, the “indirect” cost to the taxpayer of a failed bank, plus the losses of deposits not reimbursed, can easily exceed the losses of shareholders, who are the real risk takers; this is not equitable. Second, and more importantly, the damage caused in the form of a loss of confidence in the banking system may never be fully recovered. Third, if the problem becomes systemic, the cost to the fiscus of resolving the ensuing crisis could easily exceed 10% of GDP. The latter two aspects can cripple the entire economy of a country.

Ability to return to the status quo if necessary

Mergers are for all practical purposes irreversible, and can usually not be undone without damage if they do not turn out in the way that the parties had intended. Hostile mergers have a higher risk of failing in this regard, which is why jurisdictions usually do not allow hostile bank mergers. A factor to consider in very large mergers is that the change affects the entire structure of the banking system. Such irreversible change to the banking system, even if driven by market forces, may be just too risky to allow, simply because all the implications cannot be foreseen. The risks are often too high, because they may impact on the stability of the system.

Capacity to conduct orderly consolidation among smaller banks

In a merger between large banks, there are clearly many operational risks that have to be managed during the integration process. In addition to the management and staff of the two banks involved, there will be a focus on other resources of the banking system, notably the regulator, analysts, rating agencies and the auditing profession, during the merger. It should be borne in mind that any other structural changes being contemplated, such as a change in the supervisory approach or a regulator-induced restructure of the banking sector, would also be at risk. (Note: The new capital framework is an example, as are the many banking sector restructures that have recently taken place in emerging economies).

Possibility of mass management walkout if hostility is not resolved

An important potential source of operational and continuity problems is a loss of key staff. The risk is exacerbated if the merger is not friendly.

6.4 Efficiency considerations

An efficient structure in the banking system would promote free competition and, therefore, more efficient resource allocation. Again, a merger can either improve or harm the efficiency of the structure.

Level of competition between banks

When two large banks (both having a large market share) merge, one of the key considerations will be the impact on the level of competition between the banks. In such a merger, one should consider how the merged entity can influence the prices, products and quality of service in the banking sector. One must also consider the impact that the merger will have on the financial sector.

The H-index ranges from 1 (for a monopoly) to 1/n, when there are many banks in an industry. In a competitive system, 1/n tends towards 0. For South Africa, which currently has some 60 banks, the adjusted index had improved to 0.15, from a level of 0.16 in 1996. A comparison of H-indices for different countries shows that South Africa belongs to a group of countries with a relatively high level of concentration, including Finland (0.33), New Zealand (0.18), Israel (0.22), Ireland (0.17), Denmark (0.20), Sweden (0.18) and the Netherlands (0.19). If the proposed merger had succeeded, the index would have increased, leaving South Africa with a highly concentrated banking sector in terms of world standards.

As indicated in an appendix to the original report on the proposed merger under discussion and in a submission of the Competition Commission, several international thresholds were crossed. When the Australian and Canadian thresholds were applied to the proposed merger, the Australian thresholds were crossed on four out of a possible 10 occasions, whereas the stricter Canadian thresholds were crossed on eight out of a possible 10 occasions.

Level of innovation

It is a well known risk that the practical implementation of merger strategies tends to lead management to focus inwardly on the implementation process, thus facing the risk of losing the innovative touch.

In addition, the loss of a competitor, which is a direct result of a merger, means that there may be less need to innovate, with possibly less research and development spending and, consequently, less long-term sustainability.

Availability of sound banking skills in the marketplace

The possibility of a merger resulting in a better management team, the risks during integration, and potential losses of key staff have all been discussed above. A related consideration is the impact that the merger may have on the market for competent banking and management skills. In a mature market, the impact may be negligible. In a market with little depth, however, the marketplace could be flooded with skills, causing widespread mobility and disruption.

Ability to control input costs

Sound and rational reasons for mergers should always exist. Reasons for seeking to increase size should always relate to the generally accepted standards for performance, such as revenue growth, lower costs, return on equity and on assets, customer loyalty and dividend yield. The potential for rapid improvement in one or more of these measures must always be present, and a merger should be carried through to the point at which the benefits are realised.

A merger should not be contrary to the interests of the banks concerned, for instance their ability to control costs. One of the objectives of regulation is efficient and effective operation of banks. Therefore, returns of scale, scope and efficiency are all factors to be considered.

According to one school of thought, the most important factor to be considered is the cost efficiency versus margin ratio of the banks before and after a merger.

According to this thinking, cost efficiency will be such an important competitive aspect in the globalised banking system that a proven ability to enhance cost efficiency substantially through a merger must be the most compelling argument. More correctly, if the merged bank will reduce both margins and the cost to income ratio, there should be a strong bias towards letting the merger proceed.

Effectiveness of IT architecture

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.

A bank’s systems should also be able to serve the needs of its customers adequately and contribute to a sound internal control environment.

Ability to compete with foreign banks

A proposed merger between banks should not be considered only in a domestic context. The spate of mergers in Europe provides ample evidence that regional and international competitiveness is also considered to be a powerful motivator for bank mergers.

Ability to maintain morale, motivation and commitment of staff

In a service industry such as banking, motivation of staff is a key factor in ensuring that efficiency is maintained. In a hostile merger, the regulator must assess the impact that the hostility factor will have on the morale, motivation and commitment of staff. In addition, in any merger, the issue of different corporate cultures arises.

Ability to maintain credit/deposit lines in the sum of the parts

In any merger, it is important to consider the impact that the possible decrease in credit/deposit lines will have on the merged entity.

6.5 Public interest considerations

The purpose of regulation is to address externalities and market imperfections, and, in this sense, regulation is a public good. More specifically, public interest considerations can be affected by a merger.

Range of product lines available to consumers

A merger of banks should potentially be in the public interest, for instance as regards service considerations. The proposed merger should therefore ultimately 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 rationalised, 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.

In some cases, however, rationalising product lines may work against the public interest. This would be the case if a product line that is less profitable, but which serves a public need, were to be discontinued by the new management.

Ease of access to basic banking services by the public

Economies of scale are fairly likely to improve after a merger. Larger transaction volumes and larger asset positions, through a rationalised delivery system, mean that unit costs can be reduced. Provided such cost reductions are passed on to the consumer, this may be regarded as a public interest benefit.

Ability to address black empowerment and the underbanked

In particular cases, a merger could be the catalyst for a fundamental shift in social uplift and redistribution of ownership and wealth.

Ability to maintain service levels during integration

The possibility of operational problems during the integration process has been considered above. A possible result of a merger integration process, even if there are no significant operational problems, is the tendency for a deterioration in service quality levels to customers. The complexity of unifying cultures, working methods and systems, combined with possible motivational problems, may result in frequent errors causing customer inconvenience. The existence of an “excuse” that can be used to absolve responsibility can further exacerbate the problem.

Spread of ownership in the banking industry

A widespread ownership of banks has the potential benefit of reducing the possibility of abuse by owners of banks, for instance, the owners using the bank to fund other activities. On the other hand, the absence of a large shareholder means that the regulator will find it more difficult to identify a party with sufficient interest to stand by the bank in times of difficulty. A merger can often be the vehicle for a major shift in the ownership spread, and regulators need to consider the possible impact in the context of each merger.

Ability of the merged entity to abuse market power

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

Ability to ensure fair treatment of all stakeholders

In any merger, there is a possibility of passive resistance from the staff of the banks concerned. People are averse to change, especially if they feel they cannot really be part of the change process. When staff organise and offer overt resistance, for instance by organising and participating in demonstrations to protest against the merger, such polarisation can be unhealthy. It is possible that staff may feel, or indeed be, victimised afterwards. In general, the process of unification and rationalisation will affect staff, and there may be many pitfalls, including cases of inequitable treatment of staff. In addition, rationalisation of suppliers can result in unfair treatment.

6.6 Interest of the bank or controlling company concerned

The Banks Act requires that a merger not be contrary to the interests of the bank concerned or of its controlling company. A merger, for instance, can affect a bank's market niche and, thereby, its sustainability.

Ability to maintain market share and profitability

A major consideration in examining a merger of two major players in the banking sector is the ability of the merged entity to maintain market share and profitability.

One should also consider whether, given the characteristics of the two banks in question, the merged entity will result in a better bank.

Possibility of subtle sabotage owing to hostility

A major consideration when a hostile takeover is under consideration is the increased risk of sabotage or lack of cooperation (active or passive) related specifically to the hostile nature of such transactions. When banks are involved, regulatory authorities should carefully consider the potential impact thereof on the banking sector, the stability of the financial system and the economy of the country at large.

Relationship of the merged entity with unions

An important consideration relating to proposed takeover transactions, especially as regards two key players in the banking sector, is relations with relevant trade unions, since these unions play an important role in the labour market and the economy as a whole.

6.7 Strategic issues

This last set of considerations is of a more abstract nature, for instance relating to an industry's present positioning in the international context. It is conceivable that a merger might be permissible based on any one such strategic issue alone, and based on the intuition of the regulator, rather than on hard facts.

Harmony with the Competition Commission and public opinion

Worldwide, the objectives of bank regulators and competition authorities coincide in two respects - both have the efficiency of the system and fairness to consumers at heart. Whether or not the bank regulator has final jurisdiction, there should obviously be very good reasons for the bank regulator's decision to differ from that of the competition authority.

In addition, bank mergers often become fairly emotive subjects among the general public, who often have stronger than usual views on whether or not a transaction would be good for the economy. Although it is not implied that the regulator should be influenced unduly by public opinion, it should be remembered that sound, understandable reasons will have to exist and be explained if the decision goes against prevailing public opinion.

Use of opportunity for a pre-emptive strike

Several recent mergers, especially in Europe, have had an element of urgency, even desperation, in that the parties involved seem to believe that the opportunities for achieving the benefits of a merger are diminishing rapidly. The bank regulator should never precipitate a trend by allowing a merger that, although it may be in the interest of the system, is not market-driven. Nor should the regulator be an artificial stumbling block if the time for a merger is ripe, but there is uncertainty about whether or not the merger is good for the system.

Consistency with international trends

The reasons for mergers internationally have been discussed, as have the problems often associated therewith. Although no two countries are exactly alike, the dangers of being the "odd one out" should be kept in mind. If the international trend is clearly one of mergers, then care should be taken to understand fully the reasons for a merger not being permitted.

On the other hand, the international trend may be only fleeting, since the pendulum has a tendency to swing through in such matters. "Big is beautiful" can easily make way for another strategy as the underlying nature of banking changes.

Presumption that market forces should prevail

A key consideration at this strategic level is how important is the presumption that market forces should prevail unless intervention is unavoidable. A tenet of bank regulation is that it should be unobtrusive and low-cost, and that it should be limited to addressing market imperfections. The trend in international thinking about regulation is towards increasing adherence to this principle.

Clarity of policy for future mergers

The banking system, in order to work effectively, requires from the regulator, first, certainty. Whatever the decision on a proposed merger, the regulator should always seek to provide some insight into policy, which would bring a measure of certainty to the market.

Ability to manage fallout if the merger is halted

In any merger situation, the mere announcement of an intention creates expectations, which, if the merger does not go ahead, may result in unforeseen implications. Consideration should at least be given to what these implications may be, and how to mitigate their impact.

Level of reliance on a single dominant shareholder to act in the interests of the banking system

Banking regulation, unless it is so intensive that it may constrain free enterprise, usually relies in part on trust between the regulator and the owners and management of banks. In a merger situation, the trust relationship can often change. Consideration should therefore be given to whether it would be possible to rely on the owners and management of the new entity to the same extent as before.

7. Conclusion

It is clear from the discussion in this document that the decision either to allow or to disallow a merger is not easy. The arguments for and against this particular proposed merger both had validity. The process followed assisted the decision by adopting a generally acceptable structure of normative considerations and quantifying the views of a panel of experienced bank supervisors on each issue.

As is usual, however, with such abstract issues, a final judgement had to be made. In terms of the Banks Act, the Registrar of Banks had to apply his mind, and make a recommendation to the Minister of Finance. Because the Registrar is accountable to the Governor of the SARB, his recommendation was made in consultation with the SARB.

The Registrar was very conscious that the international trend towards globalisation and the resultant need for more efficient banks constituted strong arguments for regulators not to impede the ability of the market to decide on the ownership of a bank, provided that the owners met the criteria set out in the legislation.

The Registrar was also aware that, if the shareholders were not allowed to consolidate their investment in banks, this would beg the question where natural growth in the banking system would arise. The perception in the market might be that a “four pillar” approach was being applied. If this was not carefully managed, it could imply that efficiencies in the banking system were not regarded as the prime consideration in takeovers. Such a perception could lead to price fixing amongst the players and, thereby, to an inefficient market.

Notwithstanding the above, there needed to be very compelling reasons of an imminent stability nature for the regulator of banks to permit a merger that the competition authorities believed should be prohibited.

The eventual outcome of the above-mentioned process was a recommendation to the Minister of Finance by the Registrar, in agreement with the Competition Commission, not to allow the hostile takeover. Subsequently, both of the banking institutions have repositioned themselves in the market and their share prices have recovered to previous levels after being seriously affected by the intended hostile takeover.

Finally, it has to be emphasised that the considerations in Section 6 were developed and applied in a South African context. Therefore, they might not be applicable to all possible mergers. The Bank Supervision Department of the SARB, however, believes that these considerations cover the most important areas for review when a merger is assessed.