EFFECTS OF MERGERS ON FINANCIAL PERFORMANCE OF NON LISTED BANKS IN KENYA

BY

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TO

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A MANAGEMENT RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENT FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION (MBA), SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI.

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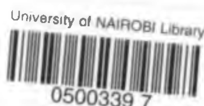

DECLARATION

This management research project is my own original work and has not been presented for award of a degree in any other University.

Signed.................................Date...29/11/07.......

Kithinji Matangu

This management research project has been submitted for examination with my approval as the University Supervisor

Signed.................................Date...30/11/07

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DEDICATION

This paper is dedicated to my parents Mr & Mrs Bernard Marangu, my siblings, my wife Karen and my daughter Mellisa who have been a source of inspiration and support both financially and morally in the course of my studies.

ACKNOWLEDGEMENT

The MBA programme has been a long, taxing and challenging journey and the successful completion has been as a result of support received from many people. I am indebted not only to people who gave me the inspiration, support and encouragement to pursue the MBA programme but also to everybody who gave me the guidance and assistance on what has been reported in this paper.
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May God bless you all abundantly, I would not have managed through my own efforts were it not for you. Our God Almighty made all these possible. May his name be praised!

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LIST OF ABBREVIATIONS

ABSA	Amalgamated banks of South Africa
CBA	Commercial Bank of Africa
CBK	Central bank of Kenya
CRA	The Community Reinvestment Act
FABK	First American bank of Kenya
GDP	Gross domestic product
IAS	International Accounting Standards
ICPAK	Institute of Certified Public accountants of Kenya
KCB	Kenya Commercial bank
KCFC	Kenya Commercial finance Company Ltd
KBA	Kenya Bankers Association
M&As	Mergers and acquisitions
N	Nigerian Naira (currency)
NBFI	Non-bank financial institutions
NPV	Net present value
OECD	Organisation for Economic Co-operation and development
UNCTAD	United Nations conference for trade and development

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ABSTRACT

The research was to determine the effects of mergers on financial performance of non listed banks in Kenya. Theoretically it is assumed that consolidation improves company performance due to increased market power, enhanced profitability and diversification of risks. The research focused on the profitability of non listed banks which merged from 1994 to 2001.

Comparative analysis of the banks` performance for the pre and post merger periods was conducted to establish whether mergers lead to improved financial performance before or after merging. Secondary data was collected for 5 years before merger and five years after merger and analyzed with the aid of statistical tools. As a control, financial performance for banks that didn't merge was also analysed during the same period. The results of the data analysis showed that three measures of performance: Profit, return on Assets and Shareholders equity/Total assets had values above the significance level of 0.05 with exception of Total liabilities/Total assets.

The research concludes that there was significance improvement in performance for the non listed banks which merged compared to the non listed banks that did not merge within the same period. This confirms the theoretical assertion that firms derive more synergies by merging than by operating as individual outfit is.

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

In the 2006 banking survey carried out by Marketing Intelligence, Ochieng (2006) notes that "Kenya has too many banks on one hand and too many Kenyans do not have access to banking or access to affordable banking and financial services" The Kenyan banks remain too small to carry out their vital role because it is total assets in relation to GDP is only 48% compared to South Africa whose banking sector assets exceed 100% of GDP.

Our banking sector loans and advances amount to just 25.1% of GDP which is below benchmark levels in leading emerging markets like South Africa which has bank loans to GDP ratio of 73%. A small banking sector is considered inhibiting to economic growth on account of being too small to carry out the core function of financial intermediation. In an attempt to rein on the mushrooming of small week banks, Hon Amos Kimunya in his June 2007/08 budget speech made the following policy announcement;-

*"**Mr. Speaker**, our banking sector is currently characterised by many small unviable institutions incapable of investing in modern technology and critical mass of competency required to provide modern and efficient banking services to Kenyans. This has led to dominance of local banking sector by foreign owned institutions. In order to encourage **the merging of small local banks** so as to enable them to expand and compete with foreign owned banks, in terms of resources, technology and services, **I propose to raise the minimum capital for bank from the current KShs.250 million to KShs.1 billion over a period of three years.** This will prepare our banking industry players to consolidate their services and ensure efficiency in order to take advantage of the emerging regional opportunities"*

Source: Kenya Finance bill 2007(Budget Speech) 14-06-07

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1.1.1 The merger concept

A merger or amalgamation occurs when two or more companies combine into one company. One or two companies may merge with an existing company or they may merge to form a new company. In this case the assets and liabilities of the amalgamating company (Pandey 1998). A merger or amalgamation may either be through absorption or through consolidation. Absorption is a combination of two or more companies into an existing company. All companies except one lose their separate identities in a merger through absorption. The acquirer survives and the acquired company ceases to exist. The acquired company transfers it is assets, liabilities and shares to the acquiring company. According to Brealey and Myers(1991), the existing capabilities of a firm influence the kinds of acquisition activity that will make business and economic sense. The central strategy for most firms seeking Mergers and Acquisitions (M&A) is to seek to become the leading player in the product-market area of the strategic business unit. The changing environments and the new forms of competition have created new opportunities and threats for business firms. The change imperatives are strong, and firms must adjust to new forces of competition from all directions and this has forced many of them to adopt many forms of restructuring activity.

Weston et al (2003) found that business firms have used a wide range of activities in seeking to exploit potential opportunities. The major objective of mergers, tender offers, and joint ventures is to achieve expansion and growth. Merger is any transaction that forms one economic unit from two or more previous separate business unit is. Tender offer is a method of making a takeover via a direct offer to target firm shareholders to buy their shares, while joint venture is a combination of subsets of assets contributed by two (or more) business entities for a specific business purpose and a limited duration. Each of the venture partners continues to exist as a separate firm, and the joint venture represents a new business enterprise. Sell-offs is a general term for divestiture of part or all of a firm

by any one of a number of means, e.g., sale, liquidation, spin-off, and so on. Spin-offs is a transaction in which a company distributes on a pro rata basis all of the shares it owns in a subsidiary to it is own shareholders. This creates a new public company with (initially) the same proportional equity ownership as the parent company

1.1.2 The Effects of bank mergers

Houston and Ryngaert (1994), argue that mergers and acquisitions facilitate synergies between merged organizations, generate efficiency improvements and increase competitiveness. Indeed, they hold that mergers, by increasing economies of scale and spreading costs over a larger customer base, enable financial operators to provide services at lower prices.

The effect of bank mergers was recently witnessed in Nigeria when Mr Charles Solodo became the Governor of the Nigerian Central bank, he raised the minimum capital requirements by 12.5 times from N2billion to N25billion. This forced the many small and weak banks which could not meet the revised regulatory requirements to merge, close or be taken over. This reduced the banking industry in Nigeria by over -300% from 89 to 25 banks. In January 2006, The Banker Magazine (2006) voted him, "Central Banker of the year 2005" because of transforming the Nigerian banking sector in less than 18months. The immediate benefit is from the banking sector reforms were many, for example it was rated BB- by both Standard and poor and Fitch rating. The Paris club of creditors agreed to a comprehensive re-structuring of USD 30 billion and gave them a generous debt write off. As a result, the country was able to repay their multilateral debt in full becoming the first country in Sub-Saharan Africa to repay it is official multi lateral debt. At the industry level, the reforms in the banking sector increased competition, the bigger and stronger banks could offer more products and services to customers and because they are better capitalized they can finance bigger projects in the private sector.

1.1.3 An over view of the banking industry in Kenya

There are forty-six bank and non-bank financial institutions, fifteen micro finance institutions and fifty two foreign exchange bureaus. Thirty-five of the banks, most of which are small to medium sized, are locally-owned. The industry is dominated by a few large banks most of which are foreign-owned, though some are partially locally-owned. Six of the major banks are listed on the Nairobi Stock Exchange. Kenya features a commercial banking system dominated by numerous commercial banks and a small number of non bank financial institutions which concentrate mainly on mortgage finance, insurance and other related financial services. Over the years the sector has grown into a more complex scene of banking institutions of different types and ownership.

Of all the banks, 35 are locally owned. The commercial banks and the non-banking financial institutions offer corporate and retail banking service but a small number, offer other services which include investment banking. In addition there are 10 specialized organizations set up by the government to assist the specific sectors of the economy; these include:

1. The Agriculture Finance Corporation,
2. Agriculture Development Corporation,
3. Industrial and Commercial Development Corporation,
4. Kenya Industrial Estates, and;
5. Industrial Development Bank

According to the CBK the number of banking institutions declined to 51 from 54 in November 2002 due to mergers and liquidations. The number of foreign exchange bureaus increased to 52 in November 2003 from 48 in November 2002 following the licensing of 26 new foreign exchange bureaus, 4 of which are already operational

Of all the 44 commercial banks, 9 control 74% of the total assets in the sector. As a part of cost and business rationalization measures, a number of banks closed some branches resulting to the branch network of commercial banks declining to 488 by the end of June 2003 from 497 in

June 2002. Currently the branch network has grown to 530. Assets of the banking sector were mainly made up of loans and advances (47%), investment in government securities (25%) and balances with Central bank (6%), foreign assets (6%) and cash and other assets (16%).

The sector experienced high non-performing loans. The Bank reports that while the proportion of non-performing to total loans declined to 28.8% in June 2005 from 29.2% in June 2004, the absolute amounts of non-performing loans increased to Ksh. 73.2 billion from Ksh. 71.5 billion. However, the CBK reports that the threat of these loans was mitigated by provisions already made amounting to Ksh. 32.3 billion and securities held by banks estimated at Ksh. 33.8 billion. The increasingly advanced levels of information technology embraced by banks have had a positive impact in the sector.

The new and dynamic information systems adapted by most banks have enabled them to process data faster and efficiently. This has enabled them to downsize their branch operations, thereby cutting on cost and improving service delivery to their customers.

After the liberalization of the banking sector and exchange controls lifted in 1995, the non-bank financial institutions have exhibited an ability to compete with commercial banks, particularly because of the less restrictive regulatory framework within which they operate. On paper, NBFIs operate as merchant or investment banks. In practice, they operate as commercial banks, taking deposit is and making short-term loans. In June 1994, the Central Bank instructed NBFIs to convert and operate as commercial banks. So far 18 NBFIS have become banks and 7 merged with parent commercial banks.

1.1.4 Merged banks in Kenya

In the recent years, according to Central Bank, a number of mergers and acquisitions have taken place in the banking sector in Kenya. The first wave of bank mergers in Kenya occurred in 1993 while the second in 1998 and continues to the present day (CBK 2000) Some mergers have been

occasioned by the need to meet the increasing minimum core capital requirements and to enhance the institution's market share in the local banking environment.

Table 1.1: Merged banks in Kenya

Year	Institutions merging	New Entities(Merged unit is)
1994	6 banks	3 banks
1995	2 banks	1 banks
1996	8 banks	4 banks
1997	2 banks	1 banks
1998	4 banks	2 banks
1999	12 banks	6 banks
2000	2 banks	1 banks
2001	4 banks	2 banks
Total	**40 Fragmented banks**	**20 Merged banks**

Source: Central Bank of Kenya

In the same period, Citibank took over the business of ABN Amro (which was pulling out of the country) but for this study we will not consider it a merger per se.

1.2 Definition of terms

1.2.1 Bank

A bank is a financial institution that accepts money from depositors and makes loans there from. By so doing Banks serve three main functions; That is pooling savings and converting the savings into financing and investments, managing risks inherent in searching, selection and monitoring of borrowers and provision of effective and efficient banking systems (Crowther 1989).

1.2.2 Non listed banks

The Advanced Learners Oxford Dictionary defines the term list as the "inclusion a catalog, or directory" A listed company is a company whose shares are placed on a list of securities that may be traded on an exchange.

Conversely, a non-listed company is a company whose shares are not traded in the stock market. By extension, a non-listed bank in Kenya is a bank whose shares have not been publicly sold in the Nairobi Stock Exchange.

1.2.3 Mergers

According to Pandey 1998, a merger or amalgamation occurs when two or more companies combine into one company. A merger or amalgamation may either be through absorption or through consolidation. An absorption is a combination of two or more companies into an existing company. All companies except one lose their separate identities in a merger through absorption. The acquirer survives and the acquired company ceases to exist. The acquired company transfers it is assets, liabilities and shares to the acquiring company. For the purpose of this study, mergers between related banks have been ignored.

1.2.4 Consolidation

Brealey and Myers (1991) define consolidation as a combination of two or more companies into a new company. In this form of merger all companies are legally dissolved and a new entity is created. In a consolidation, the acquired company transfers all it is assets, liabilities and shares to the acquiring company for cash or exchange of shares.

1.2.5 Acquisition

Van Horne(1985) defines an acquisition as an act of acquiring effective control by one company over assets or management of another company without any combination of companies. Thus in an acquisition, two or more companies may remain independent, separate legal entities, but there may be change in control of companies. It is a fundamental characteristic of merger (either through absorption or consolidation) is that the acquiring company (existing or new) takes over the ownership of other companies and combine the operations with it is own operations.

1.2.6 Take over

Berger(1999) defines a takeover as obtaining of control of management of a company. An acquisition or takeover does not necessarily entail full legal control. A company can have effective control of another company by holding minority ownership. Under the monopolies and restrictive trade practices Act, a takeover means acquisition of not less than 25% of the voting power in a company. Some times the term 'take over' is understood to connote hostility. When an acquisition is a ' forced' or 'unwilling' then it is called a take over.

1.2.7 Holding company

Piloff (1996) defines a holding company as a company that holds more than half of the nominal value of the equity capital of another company, called a subsidiary company, or controls the composition of it is board of directors. Both holding and subsidiary companies retain their separate legal entities and maintain their separate books of accounts. A company can obtain the status of a holding by acquiring shares of other companies.

1.2.8 Forms of mergers

According to Pandey(1998) there are 3 major types of mergers

1. Horizontal merger-This is a combination of two or more firms in similar type of production/ distribution / area of business. Examples would be combination of two book publishers or two banks to gain dominant market share.
2. Vertical merger-This is a combination of two or more firms involved in different stages of production or distribution eg joining of a TV manufacturing (assembling) company with a TV marketing company
3. Conglomerate merger-It is a combination of firms engaged in unrelated lines of business activity eg manufacturing of cement and book publishing companies.

1.3 Statement of the problem

Following the announcement by the Minister for finance Hon Kimunya in his 2007/08 budget speech that all banks must raise their share capital from the current Sh250 million to Sh1 billion in the next 3 years, Wachira Kang'aru and Muna Wahome (2007) writing on the daily Nation (15/06/2007) predicted that the stage has been set for *mergers and acquisitions in the banking sector following the increase in minimum capital requirement by up to four times.* They predicted that the new rule will see the banks' population reduce from the current number of 44 banks. The minister envisaged that "*This will prepare the banking industry players to consolidate their services and ensure efficiency in order to take advantage of the emerging regional opportunities," This, he noted, would encourage the merger of small banks to enable them expand and compete with foreign-owned banks and service bigger clients*

In the banking industry survey 2006, Ochieng (2006) argues that the Kenyan banking sector is too fragmented because more banks are being licenced and yet only 20 banks have a market share of more than 1% (by total assets). "*If the banking sector is left to continue it is current trend of increasing fragmentation, the top banks will continue winning less of the assets and deposit is pie, while changes in market shares at the lower end of the market will remain miniscule*". In order to benefit from economies of scale, Kenya needs to have 12-13 big banks, which can effectively compete, in the market and expand regionally.

Ochieng (2006) notes that just like Mr Charles Solodo transformed Nigeria`s banking sector from 89 to 25 banks, "*about 30 Kenyan banks need to be merged and acquired under market forces or prodding from regulatory changes*". This can only be achieved by raising the minimum capital requirements to force the many small and weak banks which do not meet

the revised regulatory requirements to either merge, close or be taken over.

Rhoades (1998) argues that global corporations today expect their bankers to have the expertise, products and presence to serve them anywhere. Many bankers believe that a greater resource base and presence across a wide range of markets is necessary to satisfy their corporate customers and argue that restrictions on merger & acquisitions, including among major domestic financial institutions, should be relaxed to enable the development of institutions with the size and resources to compete globally. Consolidation for size and increased efficiency is for many the chosen strategy to stay alive and remain competitive. In his paper, Santomero (1996) observes that the general findings of the merger literature raise the question of "why bank consolidation has been and continues to be so prevalent when gains are not observable on average". Moreover, equity returns indicate that they have been difficult, if not impossible, to accurately forecast.

It is in light of the policy announcement by the Kenya Minister for Finance in the June 2007/08 budget, the lessons learnt from the Nigerian experience (The Banker 2006) and the inconclusive findings from past studies, (Santamero -1996) that this study seeks to examine whether indeed small banks in Kenya will benefit from merging as envisaged by the policy announcement on the increase of core capital requirement from Kshs 250million to Kshs 1billion in the 2007/08 budget.

1.4 Objective of the study

The objective of this study is to find out the effect of mergers, on the financial performance of non listed banks in Kenya.

1.5 Justification of the study

Firstly, the recent policy announcement by the minister for Finance in the June 2007 budget that *"All banks and financial institutions will in the next three years have to raise their share capital from the current Sh250 million to Sh1 billion"* envisages that the small players in the industry will;- *"consolidate their services and increase efficiency in order to take advantage of the emerging regional opportunities,"* This can be achieved through mergers to enable them expand and compete with foreign-owned banks and service bigger clients

Secondly, past studies in this area -Chesang (2002) in her paper noted that one of the limitations to her study is because she used data from both banks (Listed and non listed) and non financial institutions and therefore she concluded that it was difficult to out rightly conclude that merger per se had an impact on bank performance. It is on this basis that I want to study one category of banks (non listed/ small) to find out how they faired before and after the merger.

Thirdly, Chesang (2002) conducted tests on profitability measures of bank performance like, Asset utilization, return on equity and return on assets and in all the three tests, she concluded that 25-40% of the mergers showed improvement, 45-60% showed decline and for 15% of the mergers it was too early to conclude on the merger results. This study will be a follow up of these earlier findings to find out if the same results will be reported. In particular the 15% of the mergers which she concluded were too early to report conclusively.

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Fourthly, Chesang (2002) conducted her research by looking at only 3 years pre-and post merger data. In my study I will use the 5 years as recommended by Lev and mandelker (1972) and Kelly (1967)

Fifth, Korir (2006) conducted a research of effects of mergers with a particular focus on the companies listed in the Nairobi Stock exchange and he suggested further research in this area especially focusing on non listed companies in Kenya. Sixth, In his study on mergers, Korir (2006) used data which was limited to 2-3 years. He suggested further research using data drawn from a longer time frame. In my case I want to use data for 5 years (pre and post merger).

Seventh, I am conducting this study because I will use harmonized ,published accounting data from the Central bank of Kenya (CBK) which is easily comparable to determine whether consolidation leads to changes in reported costs, revenue or profit figures.

Eighth, the data from financial accounting performance can be directly measured and the data can be easily obtained and well understood. Data from both pre-merger and post-merger will be used in the analysis and evaluated for evidence of a change in the performance around the merger activity.

Nineth, In Kenya, the process of consolidation in the banking industry has attracted substantial attention from many stakeholders (borrowers, politicians bank managers, investors, depositors and policy-makers) because of the pivotal role played by the banking sector in the economy. One of the concerns for policy-makers is the possible impact of consolidation on the transmission mechanisms of monetary policy. The impact of bank consolidation on the transmission of monetary policy is a multidimensional issue. According to most empirical studies, an increase in banking concentration tends to drive loan rates up in many local markets thereby probably hampering, to some extent, the pass-through from market to bank lending rates.

1.6 Importance of the study

James Makau a columnist with the Business daily (12/07/2007) argues that *the strong returns posted by the Nigerian stock market is partly because of the consolidation of banks in 2004 that saw the number of banks reduce from 89 to 25. He reckons that similar consolidation is in the offing in Kenya (which with 44 banks is considered over banked) especially after the recent proposals in the June 2007/08 budget to increase bank capitalization by 4 times from Kshs 250million to Kshs 1billion in three years.*

In 2004, the Governor of the Nigerian Central bank started to tame the banking industry in that country by 'culling' the weak and small banks by increasing the core capital requirements by 12.5 times from N2billion to N25billion (USD190m). This saw the merger acquisition and closure of the weak banks hence reducing them from 89 to 25 in 18months. The immediate benefit is from the banking sector reforms were many, for example it was rated BB- by both Standard and poor and Fitch rating. The Paris club of creditors agreed to a comprehensive re-structuring of USD 30 billion and gave them a generous debt write off. As a result, the country was able to repay their multilateral debt in full becoming the first country in Sub-Saharan Africa to repay it is official multi lateral debt.

This is a desirable outcome which should inspire our policy makers in the Treasury and central bank to emulate the Nigerian model. "*Bank mergers in Kenya will need to deliver benefit is. They are likely to promote greater soundness and stability in the banking sector while developing national economic interests like increasing savings and extending credit efficiently to productive sectors of the economy* "(Ochieng 2006)

From the fore going, it is evident that the minister's announcement in his budget speech about the increase of bank capitalization was a small but 'timid' step towards reining in the small and weak banks in the industry. It is expected that bank executives and shareholders will start realigning

themselves for possible mergers and acquisitions to shore up their capital requirements in the next 3 years. This study is expected to be of value to:

1. **The Central Bank of Kenya-** As the country's banking sector regulator and supervisor, the central bank will be challenged to critically assess methods used to re structure banks with an aim of improving solvency, profitability and re building confidence. The paper will serve as a guide to consolidate the small banks in the industry.
2. **Government policy makers/ Treasury** The monetary authorities and the Treasury will benefit from the study when designing policies which would facilitate strengthening of the small and weak banks whose assets are less than 1% of the industry total.
3. **Academic researchers**-The study will stimulate further interest in this area of bank mergers, contribute to existing literature and provide a basis for further research in the mergers and acquisitions of small banks
4. **Shareholders and managers / executives-** of non listed banks who might want to merge following the ministers directive to increase their capital base to Kshs 1billion
5. **Potential investors and banks in competitive industry**-This will add knowledge on the understanding of the effects of mergers in financial performance and therefore they can be able to forecast their returns more prudently.
6. **Management practitioners and consultants-** They will find this case stimulating because they can use it as a reference point when advising bank managers and boards of directors on the pros and cons of mergers of non listed banks.

CHAPTER TWO: LITERATURE REVIEW

2.1 An overview of bank failures in Kenya

In the immediate post-independence Kenya, the banking and financial industry was highly controlled. However, after 1982, the government relaxed the hitherto stringent rules in the issuance of licenses, especially licenses to operate non-bank financial institutions (NBFI). The low capital requirement of only Ksh. 5 million for a non-bank financial institution brought about the mushrooming of these institutions in the country. The relaxed regulatory and supervisory systems with which the banking and financial institutions operated at this time brought with it poor governance and management culture in the industry.

The eighties thus witnessed the collapse of a number of banking institutions. The first casualty was the Rural Urban Credit Finance Company Limited which was placed in interim liquidation in 1984. The institution was eventually liquidated. After the first failure, the government made extensive changes in both the Banking Act and the Central Bank of Kenya Act so as to stem further instability in the industry. The changes saw the capital adequacy requirement increased to Ksh. 15 million for banks and Ksh. 7.5 million for non-bank financial institutions. Another major change was the creation of Deposit Protection Fund - and insurance scheme paid for by the contributions by member banks to meet liabilities of small depositors.

The capital was further tied to deposit is with a maximum gearing ratio of 7.5 percent. To further protect the core capital from erosion by bad and doubtful advances, statutory reserve fund was established to be funded by banks' declared profit is. Of such profit is, 12.5 percent were to be

transferred to reserves to guard against future loses. Such reserves were to be invested in government securities.

It worth noting however, that despite the government's effort to streamline the banking sector by introducing statutory regulatory measures of containment more banks, 32 to be precise, have been liquidated or put under receivership in the period that followed the introduction of these control mechanisms. During this period, more banks collapsed due to the weak internal controls and bad governance and management practices. Seven banks which had collapsed were merged in to the Consolidated Bank of Kenya limited in 1989, thirteen banks collapsed in 1993 and five banks collapsed between 1996 and 1999. In 1999 Trust Bank, the sixth largest bank in Kenya - in terms of deposit is - collapsed due mainly to insider lending to directors and share holders. The most recent bank failure was witnessed when Charter house bank was put under statutory management by the Central Bank.

The Central Bank and the Capital Markets Authority are the main regulator of banks in Kenya. The Banks are regulated under the Banking Act CAP 488 and the Central Bank Act CAP 491. The CBK is tasked with the role of regulating and supervising monetary policy operations in Kenya. The aim is to achieve and maintain stability in the general level of prices, and foster the liquidity, solvency and proper functioning of a stable market-based financial system. In addition, the CBK licences and supervises authorised dealers in the money market. The Bank also promotes a sound and stable banking system in Kenya by enforcing the requirements of the Banking Act and prudential regulations of banking institutions, ensuring efficiency in banking operations and encouraging high standards of customer service.

The statutory provisions are closely enforced by the Central Bank of Kenya, which monitors the Banks almost on a daily basis. The changes in the banking Act saw the capital adequacy requirement increased substantially for banks and non-bank financial institutions.. In 2005 CBK

issued new prudential guidelines that are aimed at ensuring stability in the banking sector. The Bank also works closely with the Institute of Certified Public accountants of Kenya (ICPAK) to ensure that the banking sector leads the other sectors in the implementation of International Accounting Standards (IAS). The Kenya Bankers Association (KBA) is an umbrella association for banks in Kenya whose membership allows a bank to participate in the clearing house after meeting certain conditions.

2.2 Global trends on mergers & acquisitions

Humprey and Vale (2004) argue that mergers and acquisitions (M&A`s) are a global phenomenon, with an estimated 4,000 deals taking place every year. Four periods of high merger activity, also known as merger waves, occurred in the United States (1897-1904, 1916-29, 1965-69 and 1984-89) before the current one that began in the early 1990s. This latter wave has attained exceptional levels in terms of sheer value and volume of transactions. In the United States, Mergers and acquisitions have been instrumental in the decline in the number of banking organizations – between 1980 and 1997 they decreased from 12,333 to 7,122. Europe has also experienced similar mergers and acquisitions. Between 1980 and 1995 the number of banking establishments in Europe fell, particularly in Denmark (-57 per cent) and France (-43 per cent).

Vander Vennet, R. (2002), argue that institutions need size to spread growing information technology and processing costs over larger revenue bases. Another key factor is the need for greater market capitalization, with governments and financial sector regulators accepting financial operators' arguments that greater size is crucial to cost-cutting and strong national institutions. Smaller countries are also encouraging consolidation to counter growing competition from larger institutions in neighbouring countries. According to UNCTAD (2000), the value of worldwide mergers and acquisitions has grown dramatically during the past two decades (1980-99), at the rate of 42 per cent a year. In

1999, their completed value was about $2.3 trillion, representing 24,000 deals. Developed countries are the most important sellers and buyers in cross-border mergers and acquisitions, accounting for close to 90 per cent and 95 per cent of sales/purchases in 1998-99, respectively. Of the 5-10 per cent of sales/purchases involving developing countries, the bulk (70 per cent) originates in Latin America and the Caribbean. The value of cross-border M&A sales by developing countries increased from $12 billion in 1991-95 to $61 billion in 1996-99. Mergers and acquisitions purchases by firms from developing countries rose from an average of $8 billion in 1991-95 to $30 billion in 1996-99.

Acquisitions are considerably more important than mergers in developing and transition countries. In developing countries, cross-border mergers & acquisitions sales fell in 1999, largely caused by reduced privatization activity in Latin America, where the value of cross-border mergers and acquisitions fell from $64 billion in 1998 to $37 billion. In developing Asia, they continued to grow, including in the countries most affected by the 1997 financial crisis. The value of cross-border mergers and acquisitions sales in Central and Eastern Europe doubled between 1998 and 1999 from $5 billion to $10 billion UNCTAD (2000),.

2.3 Forces driving bank mergers

Karina robinson (2002) argues that crashing markets and a stalled economic recovery are starting to hit banks, causing problems which will make them vulnerable to acquisition especially in Europe are a result of crisis situations caused by plummeting markets and a deteriorating economic scenario. Academics and other observers advance value-maximization, managerial ego, mimicry, the need to reduce uncertainty and defensive considerations (acquire to avoid being acquired; ensure that growth keeps up with that of competitors, etc.) and high levels of corporate reserves and share valuations among the motives behind consolidation in financial services.

Houston and Ryngaert (1994), argue that mergers and acquisitions facilitate synergies between merged organizations, generate efficiency improvements and increase competitiveness. Indeed, they hold that mergers, by increasing economies of scale and spreading costs over a larger customer base, enable financial operators to provide services at lower prices. Demonstrating that mergers and acquisitions improve efficiency is thus central to making the case for the consumer benefit is of mergers and in assessing their potential impact on consumers. If mergers improve efficiency, then larger, combined firms may be expected to pass some savings on to consumers through lower prices or improved service.

Marks(1991) notes that If mergers are primarily cost-cutting exercises, involving job cuts and branch closures, the impact on consumers will most likely be a lowering in the quantity and quality of services; individuals are affected by branch closures in rural regions and low-income urban neighbourhoods and have to bear the brunt of a generalized decline in quality resulting from reduced effort in certain product lines or service modes (e.g. teller service, cheque-cashing, transaction and other basic services). Those opposing financial sector mergers and acquisitions strongly contest their consumer gains and maintain that they only result in employment losses and diminishing access to services.

Cornett and Tehranian (1992) observes that many financial executives agree that preventing consolidation and the efficiency gains mergers and acquisitions make possible would be tantamount to forcing enterprises to engage in "social policy" through retaining unnecessary levels of employment and preserving distribution outlets that would be redundant in the event of a merger. They therefore believe that mergers and acquisitions are part of necessary restructuring to improve efficient use of resources – which can only be beneficial for long-term employment.

Cerasi and Daltung (2000) stress the fact that financial sector operators lack transparency and accountability with respect to the social and economic impact of sectoral consolidation. They argue that privately owned financial institutions perform essential public functions and so government regulation is the corollary of the rather privileged and profitable positions these companies enjoy. In most countries, the scope of regulation relative to mergers and acquisitions is narrowly focused on financial probity and competition issues; however, in some countries - such as the United States - a degree of socio-economic accountability exists . The Community Reinvestment Act (CRA) provides benchmarks under which bank performance on loans, investment and consumer service is measured whenever banks apply to expand their operations. This is crucial to ensure consideration of the employment effects of organizational changes and to enhance transparency and accountability. Similarly, systematic tracking of banks' transactions with the small business community may now be timely.

2.4 Motives and benefit is of mergers

Pandey (1998) argues that mergers and acquisations are strategic decisions leading to the maximisation of a company's growth by enhancing it is production and marketing operations. They have become popular in the recent times because of the enhanced competition, breaking trade barriers, free flow of capital across countries and globalisation of business. Brealey and Myers(1991) notes that there are several benefit is that accrue to a firm because of engaging in merger activity such as maintaining or accelerating a company's growth, enhancing profitability through cost reduction resulting from economies of scale operating efficiency and synergy, diversifying the risk of the company, reducing tax liability because of the provision of setting off accumulated losses and unabsorbed depreciation of one company against the profit is of another and limiting the severity of competition by increasing the company's market power.

2.5 Source of synergies from mergers &acquisitions

The possible sources of synergies from mergers and acquisitions fall into four basic categories; revenue enhancement, cost reduction, lower taxes, and lower cost of capital (Ross et al 1990).

Revenue Enhancement -The combined firm may generate greater revenues than two separate firms. Increased revenues may come from marketing gains, strategic benefit is and market power

Cost reduction-One of the most basic reasons to merge is that a combined firm may operate more efficiently than two separate firms. Many merging firms for example airlines and banks the site cost reduction as a primary reason for merging in order to obtain operating efficiency in several different ways through a merger or acquisition

Tax gains-These may be a powerful incentive to merge in that the acquiring firm can gain by using tax losses from net operating losses of the acquired firm(the merged firm can pay less taxes by taking advantage of the accumulated tax losses), use unused debt capacity and use of surplus funds.

Cost of capital-The cost of capital can often be reduced when two firms merge because the costs of issuing securities are subject to economies of scale. The costs of issuing both debt and equity are much lower for larger issues than for smaller issues.

2.5.1 Determining the synergy from an acquisition

Suppose a firm A is contemplating acquiring firm B. The value of firm A is V_A and the value of firm B is V_B. The synergy of the merged entity is the difference between the value of the combined firm (V_{AB}) and the sum of the values of the firms as separate/ independent entities as shown below - (Ross et al 1990).

$$\text{Synergy} = V_{AB} - (V_A + V_B)$$

The acquiring firm must generally pay a premium for the acquired firm. For example, if the stock of the target is selling at $50, the acquirer might need to pay $ 60 a share implying a premium / 'good will' of $10 or 20%. Firm A will want to determine the synergy before entering into negotiations with firm B on the premium (Ross et al 1990).

NB: Goodwill is the excess of purchase price over the sum of the fair market values of the firms individual assets.

According to Ross et al (1990), the synergy of an acquisition can be determined from the discounted cash flow model as shown below.

$$\text{Synergy} = \sum_{t=1}^{T} \frac{\Delta CF_t}{(1+r)^t}$$

ΔCF_t is the difference between the cash flows at date t of the combined firm and the sum of the cash flows of the two separate firms. Ideally ΔCF_t is the incremental cash flow at date t from the merger. The term r is the risk adjusted discount rate appropriate for the incremental cash flows. This is generally considered to be the required rate of return on the equity of the target. Incremental cash flow can be separated as shown below;

$$\Delta CF_t = \Delta Rev_t - \Delta Costs_t - \Delta Taxes_t - \Delta \text{capital requirements}_t$$

Where ΔRev_t is the incremental revenue of the acquisition $\Delta Costs_t$ is the incremental costs of the acquisition. $\Delta Taxes_t$ is the incremental acquisition taxes and $\Delta \text{capital requirements}_t$ is the incremental new investments required in working capital and fixed assets.

2.5.2 NPV of a merger

An acquisition of one firm by another is an investment made under un certainty. In principle a firm is acquired if it generates a positive net present value (NPV) for the shareholders of the acquiring firm. The computation of NPV when using the market price of the shares is distorted by the price swings following the merger announcement- (Ross et al (1990). NPV of a merger to acquirer = Synergy – premium

2.6 Empirical evidence

Since the mid-to-late 1980s, many bankers and bank analysts have argued that bank mergers result in efficiency gains (Krabill, 1985; Meehan, 1989; McNamee, 1992). On the other side, some analysts (Houston and Ryngaert, 1994; Piloff, 1996; Kwan and Eisenbeis, 1999) have expressed skepticism. The bulk of empirical research shows no evidence of efficiency gains from bank mergers or from increased bank size per se (that is, due to scale efficiencies) beyond a small size(Kwan and Eisenbeis, 1999).

Empirical studies in the United States devoted to the issue of banking consolidation, evaluates the effects of bank mergers comparing pre- and post- merger performance by measuring performance using either accounting or productive efficiency indicators. The bulk of these studies measuring bank efficiency show that scale economies seem to exist in the banking sector in the United States and Europe . This finding tentatively suggests that improvements in efficiency could be expected from banking mergers (Humphrey and Vale, 2004). Surprisingly, the majority of studies comparing pre- and post-merger performance finds that these potential efficiency gains derived from size rarely materialize (Piloff, 1996). A possible rationale for this puzzle could be that some efficiency gains might take a long time to accrue (Focarelli and Panetta, 2003). More specifically, while some efficiencies (such as those derived from risk diversification or the benefit is of brand name) can be accrued in the short run, others such as the benefit is derived from cost reductions or the majority of scope economies might take longer to materialise. This is probably due to the difficulties of integrating broadly dissimilar institutions (Vander Vennet, 2002).

As surveyed by Berger et al. (1999), a substantial literature investigates the causes and consequences of bank mergers. Bank mergers and acquisitions may be geared to exploit economies of scale or scope, improve the X-

efficiency of the consolidating banks, may enable the merged banks to exercise increased market power, or may simply be motivated by the management's desire for increased size. Consequently, bank mergers may entail diverging effects on cost and profit efficiency, as well as on loan and deposit pricing.

All other things being equal, a combination of firms with different culture and strategic characteristics is expected to be followed by difficulties associated, among other things, with clashes between corporate cultures that could hinder performance. Even those few studies that have analyzed the efficiency effects of horizontal mergers, the type of merger thought to be the most likely to yield efficiency gains, have found that such mergers do not, on average, yield efficiency gains (Azarchs, 1995; Srinivasan and Wall, 1992; Berger and Humphrey, 1992; Rhoades, 1998); nor have ``event'' studies of bank mergers.

De Nicolò (2000) provides empirical evidence on the cross-sectional relationships
between bank size and market measures of charter value and insolvency risk with reference to a sample of publicly traded banks in 21 industrialized countries for the 1988-98 period. Insolvency risk, proxied by a Z-score, turns out to increase with size, meaning that size-related diversification benefit is and /or economies of scale in bank ntermediation are either absent or, if they exist, are more than offset by banks' policies or increased complexities. As a consequence, bank consolidation is likely to have detrimental effects on the safety of individual institutions.
Rhoades (1998) conducted 9 studies because of the continuing disagreement between most systematic empirical studies and the views of some bankers, and because of the relevance of the issue for individual bank strategy, industry performance, and public policy. He used a case study methodology rather than the cross-section statistical methodology used in earlier studies (Piloff and Santomero, 1996). The nine mergers

studied were not randomly selected. Indeed, the mergers selected were generally large horizontal mergers that are thought to be the kind of merger most likely to yield efficiency gains. These deals occurred since the mid-to-late 1980s, most during the early 1990s, during which time there had been considerable emphasis in the industry on cutting costs in his analysis

Rhoades (1998) found out that it was important to distinguish between cost reductions and efficiency improvements; because they are not synonymous. Reductions in operating expenses may result from cutting employees, closing branches, consolidating headquarters offices, closing computer and back-office operations, and so forth. Such reductions in expenses, however, do not automatically translate into improvements in efficiency as measured by an expense ratio, such as expenses to assets or revenues.

Reductions in expenses may be accompanied by corresponding reductions in assets and revenues, which simply represent shrinkage of the firm rather than efficiency improvements. Improvement in efficiency requires that costs be reduced by more than any decline in assets (revenues). Failure to distinguish between cost reductions and efficiency gains may at least partly explain the difference in views between bankers, who often emphasize the cost reductions to be achieved from mergers, and researchers, who generally study the efficiency effects of mergers.

Hughes, Mester, and Moon (1999), argue that larger banks are more exposed to *moral hazard*, as a result of being *too-big-to-fail*. As a consequence larger banks could misuse the diversification gains to engage into risky strategies without the market requiring additional capital or higher interest rates on uninsured debt. On the basis of such arguments, some proposals have been made in order to reduce the deposit insurance protection to large banks, or to introduce some constructive ambiguity

into the safety net, or to make bank supervision more stringent on systemically relevant institutions

Rhoades (1998) analyzed 9 merger cases that he noted that earlier research on the efficiency effects of mergers used a cross-section analysis which typically includes a relatively larger number of mergers and the use of a statistical model. The great appeal of the cross-section approach is that it permit is statistical tests that control for various other influences on merger performance and, as a result, statistically valid generalizations may be made. Despite the virtues of the cross-section methodology, criticisms of this methodology for not adequately capturing industry-specific or firm-specific idiosyncrasies have resulted in the re-emergence of the analysis of particular industries or firms in industrial organization. Because of the limited number of observations (often only one industry or firm) case studies do not permit statistically valid generalizations. However, the case study methodology may provide insights into firm (industry) behavior and performance that cannot be captured in a cross-section study because a case study may use a wide range of data and institutional detail from sources that may be unique to a firm, or industry.

Such information may allow explanations for observed behavior and performance and help to identify situations to which the cross-section generalizations do not apply. From the interviews that were conducted, There was a substantial degree of consistency in the views of the interviewees. Particularly notable observations were as follows.

1. Roughly one-half of savings from mergers will occur during the first year, and all savings will be achieved within three years
2. Most significant cost savings could be accomplished without merger
3. Any cost saving or efficiency gain should be observable in public financial data such as the Call Reports (Rhoades (1998)

Acharya, Hasan, and Saunders (2002) provide some empirical evidence regarding Italian banks that asset diversification, as measured by the Herfindahl index of six industrial sector exposures, turns out to help a bank's return only slightly when loans have moderate downside risk; when loans have a sufficiently high downside risk, diversification may actually reduce returns. Moreover they find evidence that when banks enter as lenders into "newer" industries, there is a contemporaneous deterioration in their loan quality, proxied by the ratio between doubtful and non-performing loans and total assets, the standard deviation of this ratio and the ratio of loan-loss provisions to assets. On the basis of these results the authors argue that there may exist diseconomies of diversification due to poor monitoring incentives or to an adverse selection problem in new sectors of activity.

Rhoades (1998) analyzed, at a minimum, a common set of financial ratios, three econometric cost measures, and the effect of the merger announcement on the stock price of the acquiring and acquired firms. In total at least 16 financial ratios, including seven expense ratios, two profitability ratios, and five balance sheet ratios. The expense and profitability ratios were used to analyze efficiency and profitability during the pre- and post-merger periods.

The balance sheet ratios provided information on other changes that may have occurred, aside from or as a result of the merger that might have affected efficiency or profitability. All ratios were analyzed for three years preceding the year of the merger and three years after the merger. For the post-merger period, the focus of the analysis was on the combined firm relative to a control group. Post-merger data were compared with the pre merger data to determine what changes occurred in efficiency, performance, and some balance sheet ratios from the pre- to post-merger period. The control group was particularly valuable at this stage because it permit is an assessment of whether any observed changes in the combined

firm simply reflect changes in the economic environment or instead were unique to the combined firm. The balance sheet ratios were also valuable at this point because they were indicative of whether there had been basic balance sheet changes from the pre- to post-merger period that might be associated with and therefore help explain any observed performance change, rather than the changes being the result of the merger per se.

Rhoades (1998) used 16 financial ratios to examine the efficiency, profitability, and balance sheet structure of the mergers studied which were all based on the Consolidated Financial Statements for Bank Holding Companies. The standard ratios are based on foreign and domestic data for the consolidated holding company. He noted that even though these nine mergers that were selected for study possessed attributes believed likely to yield efficiency improvements, there was considerable variation in the performance results. Results ranged from no improvement in efficiency to substantial improvement.

The key findings are:

(1) All of the studies found that significant cost cutting objectives were achieved or surpassed fairly quickly;

(2) Four of the nine mergers showed clear efficiency gains relative to peers.

(3) Seven of the nine mergers exhibited an improvement in return on assets relative to peers. In addition, the net wealth effect, based on the stock price reaction to the merger announcement, was positive for five of the seven mergers for which data were available.

4) All of the studies found that the combined firm achieved it is cost cutting objectives in a timely fashion. Generally, the largest volume of cost reductions

was associated with staff reductions and data processing systems and operations. The reduction in staff costs often accounted for over 50% of the total cost reduction, and in at least one case, reduction in staff costs accounted for nearly two-thirds of the total.

5) In all cases, the savings achieved were of the order of 30±40% of the non interest expenses of the target. All of the merged firms indicated that the actual savings met or exceeded their expectations. Most of the firms projected that the cost savings would be fully achieved within three years after the merger, with the majority of savings being achieved after two years.

Rhoades (1998) further observed that even though all of the mergers achieved cost cutting goals, only four of the mergers yielded unambiguous efficiency gains relative to their respective peer groups. This conclusion holds even when focusing only upon the two total expense ratios ± total expenses/ total assets and total expenses/total revenue. According to the total expenses to- assets ratio, five of the nine mergers resulted in an improvement in efficiency relative to peers. Of the four mergers that did not show improvement based on the assets ratio, three decreased in efficiency relative to peers, and one (G) essentially exhibited no change relative to peers as shown over leaf.

Table 2.1Summary of merger case studies: Change in performance

Pre to post merger change in performance relative to peers[a]							Stock price change[b]		
Merger	Acquiring firm more efficient than target	Return on assets	Total Expenses/ Total assets	Total Expenses/ Total Revenue	Non interest exps / Total assets	Non interest exps / Adj. oper. Rev	Acquiring	Acquired	Net wealt effec
Merger									
A	Not Clear	Imp	Imp	Imp	Imp	Imp	Wk	Imp	Imp
B	Yes	Imp	Wk	Imp	Imp	Imp	Wk	Imp	Wk
C	Yes	Imp	Wk	Imp	Wk	Imp	Imp	N/A	N/A
D	Yes	Imp	Imp	Imp	Wk	Imp	Imp	N/A	N/A
E	Yes	Imp	Imp	NC	Imp	Imp	Wk	Imp	Wk
F	Not Clear	Imp	Imp	Imp	Imp	Imp	Imp	Imp	Imp
G	Not Clear	WK	NC	NC	Imp	Imp	Imp	Imp	Imp
H	Yes	Imp	Wk	Imp	Wk	Imp	Wk	Imp	Imp
I	Yes	Wk	Imp	Wk	Imp	Wk	Imp	Imp	Imp
Imp Improved; Wk-Weakened; NC No Change; N/A Not available									

[a] Based on averages of the three years before and after merger

[b] Based on cumulative abnormal return

Source: Rhoades(1998) Journal of Banking and Finance 22 Pg 284

Of these, however, the B, C, and H mergers all showed gains in efficiency relative to peers, based on the total expenses-to-revenue measure, while the G merger again showed essentially no change relative to peers. The I merger was the only one to exhibit a decrease in efficiency relative to peers based on the total expenses- to-revenue ratio, although it showed some gain based on the assets ratio. Most of the mergers were associated with an improvement in return on assets relative to the respective peer groups. Such improvement may have been particularly feasible, because all of the merged firms except G, on average, had a lower return on assets than peers prior to merging. The two mergers that recorded declines in return on assets relative to peers were I and G, although the declines in returns were rather small. It is interesting and perhaps not just coincidental that these were two of the five mergers that resulted in an efficiency loss (or at least no gain) relative to peers based on one of the total expense ratios.

Finally, the stock market tended to have a positive view of the merger announcements Specifically, the stock price of the acquiring firm increased
around the announcement date, relative to the market(Rhoades 1998).

These results contrast with many studies that have found that the stock market generally has a negative reaction to the acquiring firm's stock upon announcement of a merger, including in-market mergers. This relatively good stock price performance may reflect the fact that the mergers selected for study were, by design, the type believed most likely to yield efficiency gains. Thus, for at least that reason, they should have been attractive to the market. The work of Linder and Crane (1992) is also noteworthy. They analyze the operating performance of 47 bank-level intrastate mergers that took place in New England between 1982 and 1987. Of the 47 mergers in the sample, 25 were consolidations of bank subsidiaries owned by the same holding company. The authors aggregate acquirer and target data one year before the merger and compare it to performance one and two years after consolidation. The performance of

merged banks is adjusted by the performance of all non-merging banks in the same state as the merging entities. The results indicate that mergers did not result in improved operating income, as measured by net interest income plus net non-interest income to assets.

2.7 Review of Kenyan Literature

Studies in this area in Kenya are in their nascent stages and the findings are inconclusive. Little has been done to clearly assess the success of bank restructuring tools used in Kenya. Kenya has experienced three (3) financial crises since the 1980`s; 1989,1993 and 1998 which led to tightening of the regulatory framework by introducing changes in the Banking Act aimed at enhancing efficient operations of the industry in conformity with the primary objectives of the International Basel Committee on bank supervision (CBK 1998)

Korir (2006) conducted a research on the merger effects of companies listed in the Nairobi Stock Exchange and concluded that mergers improves performance of companies listed at the NSE.

In the 2006 banking survey published by the Market intelligence, Ochieng (2006) notes that when Commercial bank of Africa (CBA) acquired First American bank of Kenya (FABK), CBA`s 2005 results indicated sharply reduced earnings and lower regulatory ratios compared to the stand alone CBA pre -acquisition. Chesang (2002) concluded that though some banks showed a decline in performance in the post merger period, merger restructuring could still be considered as a recommended option to improve the overall financial performance of weak and ailing small medium sized banks with a narrow business. She noted that merger restructuring is likely to positively affect financial performance due to renewed attention to new business growth strategies, improved management, accounting and reporting systems, legal regulatory systems, better credit assessments, and reduced staffing levels. All these operational efficiencies are likely to realize higher rates of return for the

merged firms. In an article titled *"CFC Bank, Stanbic Bank Merger Nears Completion"* published in the East African Business Week, Kabilu (2007) reports that the merger between CFC bank and Stanbic bank is expected to be sealed in September this year if regulating agencies (Kenya's Ministry of Finance, the Central Bank and the Capital Markets Authority) approve it.

The merger will see Stanbic Bank(SBK) become a wholly- owned subsidiary of CFC bank with a new capital of Ksh 4.8 billion and assets value at Ksh60 billion. In the new entity CFC bank will change it is name to CFC Stanbic Holdings Limited while Stanbic Bank will change to CFC Stanbic Bank Limited. According to the agreement, Stanbic bank will be listed in the Nairobi stock exchange through CFC bank which will be the listed entity.

2.8 Measures of Financial performance

Performance is the ability to sustain income, stability and growth. It is is a measurement of relative investment and can be relative to one of the following factors; assets, capital adequacy, liabilities, number of employees and other size matters. Ross et al (1998) lists the following as the common measures of performance.

Profitability Analysis

This is the most common measure of financial performance. The measures are used to assess how well management is investing the firms total capital and raising funds. Profit is depend on 3 primary structural aspects of financial institutions; Financial leverage, Net interest margin and non-portfolio income sources. Return on equity (ROE) and return on assets (ROA) are the most applied profitability ratios used to assess financial performance.

Return of equity (ROE) is the ratio of Net income to Total equity capital (%) and it measures overall profitability of financial institutions per dollar of equity. Return on Assets is the ratio of Net income to Total assets (%) and it measures profit generated relative to the financial institutions

assets. Equity Multiplier is the ratio of Total assets to Total equity capital and it measures the extent to which assets of financial institutions are funded with equity relative to debt. Net Profit Margin is the ratio of Net income to Total operating income (%) while the Profit margin measures the ability to pay expenses and generate net income from interest and non interest income.

Asset utilization is the ratio of Total operating income to Total assets and measures the amount of interest and non-interest income generated per dollar of total assets. Capital adequacy ratios relate to the firms overall use of financial leverage. Generally firms with high financial leverage will experience more volatile earning behavior. It indicates the extent to which an institutions capital base covers the risks inherent in it is operations such as shareholders equity to total assets

Long term Solvency refers to the ability of an enterprise to survive over a long period of time. Total liabilities to Total assets measures the proportion of assets financed by creditors. The higher the percentage of debt financing the riskier the business. Shareholders equity to Total assets indicates proportion of total assets financed by owners funds whereas Shareholders equity to total loans indicates the proportion of loans covered by the owner's funds

Asset credit ratios measures asset quality and refers to credit risk embodied in the institutions asset portfolio e.g. performance loans, investments in treasury bills and other securities. Interest rate risk position measures Interest rate risk exposure. It is the most sophisticated analysis within the well run financial firms. Interest rate risk is the risk that change in interest rates will cause the market value of a firms asset to move closer to the market value of the firms liabilities and thereby reduce firms equity.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research design

The research was carried on 14 non listed banks which merged and the results compared with those of non listed banks which never merged. The performance of these banks was analyzed before and after merger. The question was to determine whether the act of merging had an impact on performance of the non listed banks that merged. i.e. *Was the financial performance of the non listed banks better of before or after merging?* The time frame for analysis was from 1994-2001

3.2 Population

The population used in this study was all the 34 non listed local banks in Kenya. 20 of them have not merged. (appendix 1)

3.3 Sample

The sample of study was the 14 non-listed banks which merged and 20 non listed banks which have not merged between 1994-2001. The reasons for choosing the non listed banks in Kenya for my research is because they are the ones which have not been studied. Earlier studies on mergers by Chesang (2002) and Korir (2006) were cross sectional and looked at companies listed in the Nairobi Stock Exchange. This is in line with the approach used by Rhoades (1998) when he conducted 9 studies where he used a case study methodology rather than the cross-section statistical methodology used in earlier studies (Piloff and Santomero, 1996).

Secondly the study of the non listed banks is particularly important because they are the focus of the policy announcement by the Kenya Minister for Finance in his June 2007 budget instructing the small banks to raise their share capital from the current Sh250 million to Sh1 billion in 3 years. This move is similar to what Mr Charles Solodo the Governor of the Nigerian Central Bank did when he transformed Nigeria`s banking sector in less than 18 months by reducing the industry from 89 to 25 banks.

He raised the minimum capital requirements by 12.5 times from N2billion to N25billion. This forced the many small and weak banks which could not meet the revised regulatory requirements to either merge, close or be taken over. The Banker magazine (2006). The performance of these on listed banks will be analyzed 5 years before and 5 years after merger in order to determine whether the mergers had a positive or negative impact on financial performance the merged banks.(appendix 2)

3.4 Data Collection

The study mainly used secondary data from Central Bank of Kenya , published facts and figures from 1994-2001. Also reports from the Market Intelligence Banking survey publication 2004-2006 were used. The data collected was on the financial performance of the banks 5 years before and 5 years after merger. Profit and loss account, balance sheets and cash flow statements were used. The data was analyzed on the basis of the mean, mode, median, standard deviation, and variance. The Paired t- test was computed to determine the level of significance.

3.5 Data Analysis

The study focused on the financial performance of the merged firms.(Appendix 3) The comparative analysis for the pre and post merger periods was conducted to establish whether mergers lead to improved financial performance.

Comparative analysis was done by aggregating the acquirer and target data five years before the merger and comparing it to performance 5 years after consolidation/ merging. This approach has been borrowed from Linder and Crane (1992) who compared aggregate data both pre and post merger. Merger and acquisition activity results in overall benefit is to shareholders when the consolidated post-merger firm is more valuable than the simple sum of the two separate pre-merger firms. The primary cause of this gain in value is supposed to be the performance improvement following the merger. The t-test which is a special case of

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ANOVA is used to test whether there are significant differences between two means derived from two samples or groups at a specified probability level (Mugenda 1999). According to Mugenda (1999), there are two types of t-tests;-

a. The T-test for independent samples
b. The T-test for non independent variable

The method that was applied in the research is the paired *t*-test for non independent samples because the banks tested in the pre merger period are related to the ones tested in the post merger period. Ideally, there was need to compare several variables in the two groups (pre merger and post merger) and essentially each comparison required a separate t-test to determine whether the t value was significant. The 5% significant level was used.

Descriptive statistics describe data on variables with single numbers while analysis of variance, (ANOVA) tests for any significance difference between two or more groups and often with more than one variable (mugenda 1999). Arithmetic mean and the standard deviation are some of the main descriptive statistics that was applied in data analysis. The arithmetic mean, the average of values in an observation, was used to represent the entire data by a single value. The standard deviation is a measure of variation and was used to determine how the mean was a representative of the observations.

CHAPTER FOUR: RESEARCH FINDINGS AND INTERPRETATIONS.

4.1 Introduction

The main objective of this study was to determine the effects of merger on performance for non listed Banks before and after merger. In order to achieve this objective, financial data of profit, return on assets, shareholders equity/total assets and Total liabilities/total assets, for five years before merger was compared with average data for the same measures of performance for five years after merger with a view of testing the following hypothesis.

Ho: There was an improvement in financial performance after merger.

H1: Bank Mergers had no effect on financial performance.

4.2 Measures of central tendency

Basic analysis begun with the determination of mean and standard deviation before and after the merger. Standard deviation was used as measure of dispersion (variation). Calculations were carried out for correlation, significance and paired t- test. Since the paired samples t- test compares the means for the two variables it was useful to know what the mean values are.

Table 4.2: Descriptive statistics for measures of performance

	Before Merger		After Merger	
	Mean	Standard deviation	Mean	Std. Deviation
Profit	39.4069	66.11027	143.8381	164.57088
ROA	0.0033	0.04034	0.0172	0.00754
Share holders/Total assets	0.1568	0.04591	0.1439	0.3453
Total liabilities/Total Assets	0.8432	0.04591	0.8560	0.3446

Source: Research data

The paired t test is generally used to compare means on related subject over time or in differing circumstances. The table above displays the mean values and standard deviation values for the measures of performance before and after merger. The mean values of the measures of performance before and after merger were ;- The mean profit before merger was 39.4069 ROA was 0.0033,shareholders equity/total assets was 0.1568 and Total liabilities/total assets was 0.8432. The standard deviation before merger was as follows;-profit 66.11027, ROA was 0.04034, shareholders/total assets was 0.04591 and total liabilities/total assets was 0.04591..

The same analysis was carried out for the four measures of performance after merger. The mean profit was 143.8381 while standard deviation was 164.57088, the mean ROA was 0.0172 while the standard deviation was 0.00754. shareholders equity to total assets had a mean of 0.1439 and a standard deviation of 0.3453 while for total liabilities to total assets had a mean of 0.8560 and standard deviation of 0.3446.

Table 4.3: Paired t-test for merged banks

		Paired t - test
Profit		-2.152
Return on Assets		-1.018
Shareholders Equity/Total Assets		0.641
Total Liabilities/Total Assets		-0.638

Source: Research data

The mean values for the measures of performance before and after merger are displayed in the Paired Samples Statistics table above. The Paired-Samples T Test procedure compares the means of two variables for a single group. It computes the differences between values of the two variables for each case and tests whether the average differs from 0. A low significance value for the t-test (typically less than 0.05) indicates that there is a significant difference between the measures of performance before and after merger.

The t-test for Profit was -2.152, for Return on Assets was -1.018, 0.641 for Shareholders equity/Total assets and -0.638 for Total liabilities/Total assets. All the measures of performance except share holders equity/ total assets exhibited a low value of less than 0.05 significance level implying that they are linearly related.

Table 4.4: Paired t-test for non-merged banks

		Paired t - test
Profit		1.225
Return on Assets		0.6
Shareholders Equity/Total Assets		1.343
Total Liabilities/Total Assets		-0.927

Source: Research data

Data for 5 randomly selected non-merged banks was analysed for a period of 10 years and paired t-test showed the following;- profit was found to be 1.225, Return on assets 0.6, Shareholders equity/Total assets was 1.343 and Total liabilities/Total assets was -0.927. All the measures of performance except total liabilities/total assets exhibited values higher than 0.05 significance level.

CHAPTER FIVE: SUMMARY AND CONCLUSIONS

5.1 Introduction

This chapter summarizes the various findings in line with the main objective of finding out the effect of mergers on the performance of non-listed banks. It summarizes the findings for various measures of performance used, profit, return on assets, share holders equity to total assets and the total liabilities to total assets before and after merger

5.2 Summary of findings

The mean before merger for the various measures of performance were; Profit was 39.4069, ROA was 0.0033, Shareholders equity/total assets was 0.1568 and Total liabilities/total assets was 0.8432. The standard deviations before merger for Profit was 66.11027, ROA was 0.04034, Shareholders equity/total assets was 0.04591 and for Total liabilities/total assets 0.04591.

The means for the various measures of performance after merger, were;-profit was 143.8381, ROA was 0.0172, Shareholders equity to total assets it was 0.1439 and total liabilities to total assets was 0.8560. The standard deviation for the various measures of performance after merger were;-profit143.8381, ROA was 0.00754, Shareholders equity to total assets was 0.3453 and total liabilities to total assets was 0.3446. The data shows generally shows evidence of improvement after merger. For instance, the mean profit figures improved from Kshs 39million before merger to Kshs 143million after merger.

The mean values for the measures of performance before and after merger are displayed in the Paired Samples Statistics table 4.3. A low significance value for the t-test (typically less than 0.05) indicates that there is a

significant difference between the measures of performance before and after merger. The t-test for Profit was -2.152, for Return on Assets was -1.018, 0.641 for Shareholders equity/Total assets and -0.638 for Total liabilities/Total assets. . If the significance level is very small (less than 0.05) then the correlation is significant and the two variables are linearly related.

Analysis of the data of the banks that did not merge at 0.05 significance level showed fairly high values of the paired t-test. The profit was found to be 1.225, Return on assets 0.6, Shareholders equity/Total assets was 1.343 and Total liabilities/Total assets was -0.927. . If the significance level is relatively large (for example, 0.50) then the correlation is not significant and the two variables are not linearly related.

5.3 Conclusion

The main objective of this research was to find out the effects of mergers on financial performance of non listed banks in Kenya. In line with the objectives data from banks that merged was compared with data from banks that did not merge. Four measures of performance were used in arriving at the conclusion; they were profit, return on assets, shareholders equity/total assets and total liabilities/total assets. The average data for five years before merger and five years after merger for the merged banks was computed and ten years period for the non merged banks was also analyzed, where the ten years was split into two and the average figures computed. The non merged non listed banks were selected randomly but within the same period that the merged banks were considered. The paired t-test was performed on the average figures for all the measures of performance.

The results for three of the measures of performance out of four showed a significance difference in paired t-test. Profit, return on assets and total

liabilities/total assets had the paired t-test of below 0.05 significance level, while shareholders equity/total assets had the paired t-test of over 0.05. Significance level of below 0.05 showed that there was change in performance after merger.

The paired t-test was also performed on the average data for the non merged banks within the same period. Three measures of performance: Profit, return on Assets and Shareholders equity/Total assets had values above the significance level of 0.05 with exception of Total liabilities/Total assets.

From the above results, the research concludes that there was significance improvement in performance for the banks after merger. With significance value of 0.05 for paired t-test used, three of the four measures of performance showed improvement after merger while three of the measures of performance used showed no improvement for the non merged banks within the same period. The study accepts the Ho and rejects the H1.

5.4 Limitations of the study.

Considering that it is difficult to have a perfect research situation, it is then expected that this research will have some limitations. There is need to highlight some of these limitations so that the conclusions can be understood in view of the weaknesses of the research study.

Some of the limitations of this research study are:

1. The available data was for late 90's onwards while most banks merged in early and mid 90's, this made the research to sample only a few banks.

2. It was difficult to access the data on Banks given they are found in central bank and because of the security threat, accessibility was only allowed on limited time.

5.5 Suggestions for further research.

Further research on mergers and performance could focus on the following areas:

1. Given that the research was only carried on Banks that merged in mid 90s onwards, a further study could be carried out to cover a longer period say 20 years and cover the first banks that merged in the 1980`s.
2. For the measures of performance used in this research there is strong correlations before and after merger, the researcher suggests a further research using alternative measures of performance than the ones used.

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Appendix 1: Non listed banks in Kenya

Non Listed Banks in Kenya

1	African Banking Corporation Ltd.
2	Bank of Africa Kenya Ltd
3	Bank of Baroda (K) Ltd
4	Bank of India
5	Charterhouse Bank Ltd
6	Chase Bank (K) Ltd
7	Citibank N.A Kenya
8	Co-operative Bank Of Kenya Ltd
9	Commercial Bank Of Africa Ltd
10	Consolidated Bank of Kenya Ltd
11	Credit Bank Ltd
12	Development Bank of Kenya Ltd
13	Dubai Bank Kenya ltd
14	East African Building Society
15	Equatorial Commercial Bank Ltd
16	Family Finance Building Society
17	Fidelity Commercial Bank Ltd
18	Fina Bank Ltd
19	Giro Commercial Bank Ltd
20	Guardian Bank Ltd
21	Habib Bank A.G Zurich
22	Habib Bank Ltd
23	Imperial Bank Ltd
24	Investment & Mortgages Bank Ltd
25	K-Rep Bank Ltd
26	Middle East Bank (K) Ltd
27	Oriental Commercial Bank Ltd
28	Paramount Universal Bank Ltd
29	Prime Bank Ltd
30	Prime Capital and Credit Ltd
31	Southern Credit Banking Corp. Ltd
32	Stanbic Bank Kenya Ltd
33	Trans-National Bank Ltd
34	Victoria Commercial Bank Ltd

Source: Central Bank of Kenya

Appendix 2: Banking Institutions that have merged in Kenya

Institution	Merged with	Current Name	Date approved
Indosuez Merchant Finance	Banque Indosuez	Credit Agricole Indosuez	10.11.1994
TransnationalFinance Ltd.	Transnational Bank Ltd.	Transnational Bank Ltd.	28.11.1994
Ken Baroda Finance Ltd.	Bank of Baroda (K) Ltd.	Bank of Baroda (K) Ltd.	02.12.1994
First American Finance Ltd.	First American Bank Ltd.	First American Bank (K) Ltd.	05.09.1995
Stanbic Bank (K) Ltd.	Stanbic Finance (K) Ltd.	Stanbic Bank Kenya Ltd.	05.01.1996
Mercantile Finance Ltd.	Ambank Ltd.	African Mercantile Banking Corp. Ltd.	15.01.1996
Delphis Finance Ltd.	Delphis Bank Ltd.	Delphis Bank Ltd.	17.01.1996
CBA Financial Services Ltd.	Commercial Bank of Africa Ltd.	Commercial Bank of Africa Ltd.	26.01.1996
National Industrial Credit Bank Ltd.	African Mercantile Banking Corp.	NIC Bank Ltd.	14.06.1997
Giro Bank Ltd.	Commerce Bank Ltd.	Giro Commercial Bank Ltd.	24.11.1998
Guardian Bank Ltd.	First National Finance Bank Ltd.	Guardian Bank Ltd.	24.11.1998
Diamond Trust Bank (K) Ltd.	Premier Savings & Finance Ltd.	Diamond Trust Bank (K) Ltd.	12.02.1999
National Bank of Kenya Ltd.	Kenya National Capital Corp.	National Bank of Kenya Ltd.	24.05.1999
Standard Chartered Bank (K) Ltd.	Standard Chartered Financial Services	Standard Chartered Bank (K) Ltd.	17.11.1999
Barclays Bank of Kenya Ltd.	Barclays Merchant Finance Ltd.	Barclays Bank of Kenya Ltd.	22.11.1999
Habib A.G. Zurich	Habib Africa Bank Ltd.	Habib Bank A.G. Zurich	30.11.1999
Guilders Inter. Bank Ltd.	Guardian Bank Ltd.	Guardian Bank Ltd.	03.12.1999
Universal Bank Ltd.	Paramount Bank Ltd.	Paramount Universal Bank	11.01.2000
Kenya Commercial Bank	Kenya Commercial Finance Co.	Kenya Commercial Bank Ltd.	21.03.2001
Bullion Bank Ltd.	Southern Credit Banking Corp. Ltd.	Southern Credit Banking Corp. Ltd.	07.12.2001

Appendix 3: Non Listed Banks that have merged in Kenya

	Institution	Merged with	Current Name	Date approved
1	Indosuez Merchant Finance	Banque Indosuez	Credit Agricole Indosuez	10.11.1994
2	Transnational Finance Ltd.	Transnational Bank Ltd.	Transnational Bank Ltd.	28.11.1994
3	Ken Baroda Finance Ltd.	Bank of Baroda (K) Ltd.	Bank of Baroda (K) Ltd.	02.12.1994
4	First American Finance Ltd.	First American Bank Ltd.	First American Bank (K) Ltd.	05.09.1995
5	Stanbic Bank (K) Ltd.	Stanbic Finance (K) Ltd.	Stanbic Bank Kenya Ltd.	05.01.1996
6	Mercantile Finance Ltd.	Ambank Ltd.	African Mecantile Banking Corp. Ltd.	15.01.1996
7	Delphis Finance Ltd.	Delphis Bank Ltd.	Delphis Bank Ltd.	17.01.1996
8	CBA Financial Services Ltd.	Commercial Bank of Africa Ltd.	Commercial Bank of Africa Ltd.	26.01.1996
9	Giro Bank Ltd.	Commerce Bank Ltd.	Giro Commercial Bank Ltd.	24.11.1998
10	Guardian Bank Ltd.	First National Finance Bank Ltd.	Guardian Bank Ltd.	24.11.1998
11	Habib A.G. Zurich	Habib Africa Bank Ltd.	Habib Bank A.G. Zurich	30.11.1999
12	Guilders Inter. Bank Ltd.	Guardian Bank Ltd.	Guardian Bank Ltd.	03.12.1999
13	Universal Bank Ltd.	Paramount Bank Ltd.	Paramount Universal Bank	11.01.2000
14	Bullion Bank Ltd.	Southern Credit Banking Corp. Ltd.	Southern Credit Banking Corp. Ltd.	07.12.2001

Appendix 3 : Financial Ratios

Profitability Ratios
1) Gross Profit Margin= Gross profit/ Turnover (%)
2) Net Profit Margin = Net profit/ Turnover (%)

3) Return of equity (ROE) =Net income/ Total equity capital (%)
4) Return on Assets =Net income/ Total assets (%)-
5) EPS= Net income/ Shares outstanding
Capital adequacy ratios

6) Asset Utilization = Total operating income / Total assets
7) Shareholders equity to total assets=Shareholders funds/ Total assets
8) Shareholders equity to total loans=Shareholders funds/ Total loans

9) Shareholders equity to total customer deposit is (gearing ratio)=Shareholders funds/ Customer deposit is

Solvency

10) Current Ratio=Current Assets/ Current liabilities

11) Total debts ratio = Total assets-Total equity/Total assets

12) Long-term debt ratio=Longterm debt/ (Longterm debt +Total equity)

13) Cash ratio=Cash / Current liabilities

14) Net working capital to total assets=Net working capital/ Total assets

15) Equity Multiplier =Total assets/ Total equity capital
16) Times interest earned ratio=EBIT/Interest

NB: Source: Ross/Westerfield/Jordan(1998) *Fundamentals of Corporate Finance* 4th Edtn Irwin Mcgraw Hill Pg 55-67

Appendix 4: Banks in Kenya

		Branches
1	African Banking Corporation Ltd.	7
2	Bank of Africa Kenya Ltd	3
3	Bank of Baroda (K) Ltd	6
4	Bank of India	4
5	Barclays Bank Of Kenya Ltd	43
6	CFC Bank Ltd	5
7	Charterhouse Bank Ltd	10
8	Chase Bank (K) Ltd	2
9	Citibank N.A Kenya	2
10	City Finance Bank Ltd	1
11	Co-operative Bank Of Kenya Ltd	37
12	Commercial Bank Of Africa Ltd	12
13	Consolidated Bank of Kenya Ltd	11
14	Credit Bank Ltd	4
15	Development Bank of Kenya Ltd	1
16	Diamond Trust Bank (K) Ltd	5
17	Dubai Bank Kenya ltd	3
18	East African Building Society	9
19	Equatorial Commercial Bank Ltd	2
20	Equity Bank Ltd	36
21	Family Finance Building Society	28
22	Fidelity Commercial Bank Ltd	3
23	Fina Bank Ltd	5
24	Giro Commercial Bank Ltd	6
25	Guardian Bank Ltd	5
26	Habib Bank A.G Zurich	4
27	Habib Bank Ltd	4
28	Housing Finance Ltd	10
29	Imperial Bank Ltd	5
30	Investment & Mortgages Bank Ltd	9
31	K-Rep Bank Ltd	28
32	Kenya Commercial Bank Ltd	119
33	Middle East Bank (K) Ltd	2
34	National Bank of Kenya Ltd	23
35	National Industrial Credit Bank Ltd	5
36	Oriental Commercial Bank Ltd	4
37	Paramount Universal Bank Ltd	3
38	Prime Bank Ltd	9
39	Prime Capital and Credit Ltd	1
40	Southern Credit Banking Corp. Ltd	10
41	Stanbic Bank Kenya Ltd	8
42	Standard Chartered Bank (K) Ltd	28
43	Trans-National Bank Ltd	7
44	Victoria Commercial Bank Ltd	1
		530

Source: *Central bank of Kenya*

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