International Journal of Management and Commerce Innovations ISSN 2348-7585 (Online)
Vol. 9, Issue 2, pp: (45-49), Month: October 2021 - March 2022, Available at: www.researchpublish.com

MERGERS AND ACQUISITIONS ON FINANCIAL STABILITY OF COMMERCIAL BANKS IN KENYA: A THEORETICAL PERSPECTIVE

[1]Odhiambo Frank Amolo, [2] Dr. Ambrose Jagongo

[1]Accounting and Finance Department, School of Business, Kenyatta University

[1]amolloodhiambo35@gmail.com

[2]Senior Lecturer, Accounting and Finance Department, School of Business, Kenyatta University

Abstract: **Kenya's recent economic reforms have tremendously improved its macroeconomic indices and financial sector. As a result of these reforms aimed at privatizing and strengthening the banking sector, banks have seen substantial merger and acquisition taking place. This study purposed to investigate the theoretical perspective of mergers and acquisitions and its effect on financial stability of Commercial Banks in Kenya. Monopoly -Market Power Theory, Value-Increasing Theories, Hubris Hypothesis and Corporate control theory informed the study. These theories added to our understanding of how mergers and acquisitions influence financial stability. Mergers and acquisition, according to the study, have a positive effect on financial stability of commercial Banks. Therefore bank stability is strongly reliant on the success of mergers and acquisitions.**

Keywords: **Mergers and Acquisition, Financial Stability, Monopoly -Market Power Theory, Value-Increasing Theories, Hubris Hypothesis and Corporate control theory.**

1. INTRODUCTION

Following the Global Financial Crisis (GFC) of 2007-2009, policymakers have prioritized bank stability as a top priority on the international agenda (Musau, 2017). The Financial Stability Board and the Basel Accords have played an important role in improving the financial stability of Kenya's Commercial Banks. Central Bank of Kenya (CBK), through regulations, is tasked with the responsibility of promoting financial stability. By embracing the Basel II Accord and guaranteeing compliance with financial institution laws, the CBK has assured stability (CBK, 2016).

Governments, central banks, and other policymakers around the world are increasingly tasked with safeguarding the financial stability of financial institutions, the financial sector, and, by extension, country economic stability (Ciha'ki, Mare, & Malecky, 2016). As a result, major financial institutions, such as banks, have stepped up to ensure stability through mergers and acquisitions (Delloite, 2017).

The financial sector is growing and consolidating at an exponentially increasing rate worldwide. Many continental trade agreements have been formed in the recent decade, and international trade volumes and transactions have increased globally (Beck et al., 2010). This integration has strengthened financial markets and enabled the combining of a variety of financial operations to provide investors with even more investment options. According to Focarelli, Panetta and Salleo (2002), United States and Europe Banks were the first countries to adopt mergers and acquisitions (M&A) though the wave is recently extending to other nations around the world.

Hubbard (2001) in his study stated that many researchers in the area of M&A have concentrated on United States since it was the first country to experience this shift in the late 1800s. Following the consolidation of the European economies, recent studies have looked on bank mergers and acquisitions in Europe (Yener et al., 2004; Lindblom et al., 2002). However, because such expansion efforts were non-existent until recently, it has been difficult to obtain research on bank M&A in the emerging countries of the Middle East and Central Africa region. This lag in expansion activities can be attributed in part to protective laws in these areas, which have stifled the banking sector's growth, as well as extensive public sector intervention. Nonetheless, an increasing number of banks are expanding through M&A as a result of greater openness in various countries in the region. As a result, it is critical to examine bank M&A in the region and evaluate how liberalization has impacted the banking sector's stability.

2. LITERATURE REVIEW

A study conducted by Muchoki and Njuguna (2020), on the effect of M&A on financial performance revealed that organizations used strategic alliances to gain more value. This means that, to obtain the necessary cushion against financial turmoil that affect the survival of small firms, it is important for organizations to gain more capital to run their day to day activities.

Küçükkocaoğlu and Bozkurt (2018) analyzed the effects of M&A on the performance of Turkish financial institutions. Research findings from the study indicate an increase in foreign capital investments owed to M&A which led to the strengthening of operations in the market. From this, organizations gained the necessary financial muscle to outshine their competitors.

According to Njambi and Kariuki (2018), in the banking industry M&A has been considered a strategy that can be used to overcome competition in the Kenyan market. Equally, Muchoki and Njuguna (2020) discovered that to overcome competition players in the Kenyan banking industry consider M&A as a tool since it accords firms’ competitive edge in the market.

Warter & Warter (2015) in their paper, mention that due to challenges intrinsic in all bank M&A stages, turning a merger or acquisition into a success may be difficult. In order to deal with differences in regulatory and accounting systems and, cultural differences among banks with operations in different countries, a high-level of management skills and significant resources is required.

Kim & Finkelstein (2008) show that when banks merge, the combined bank can use the resources more proficiently by directing capital from the lower capital cost market to the market with greater return prospects**.**

3. THEORETICAL FRAMEWORK

Monopoly -Market Power Theory, Value-Increasing Theories, Hubris Hypothesis and Corporate control theory, are adopted to provide more insight on mergers and acquisition and its effect on financial stability.

3.1 Monopoly -Market Power Theory

Monopoly-market power Theory was initiated by Trautwein in 1990. According to the monopoly theory, mergers are formulated in order to achieve a monopoly through increased market power. It is a description of horizontal and conglomerate mergers. Market power can be achieved through the decrease of supply, cross-subsidizing products and preventing potential market participants (Trautwein, 1990; Rodermann, 2004). These benefits are also called collusive synergy (Chatterjee, 2007) and player interrelationships (Porter, 1985).

This theory states that Mergers were affected to achieve market power. The effect of this type of merger is that firms use it to cross subsidize products, to edge competition in more than one market simultaneously, and to deter the potential entrance of competitors into its market. These three advantages of the monopoly theory supported the idea of a collusive synergy (Trautwein, 2006) or competitor Interrelationships (Barros, 1998). Choi and Weiss (2005) argue that M&A can also create value if they intensify organization market power, allowing the post-merger entity to earn higher economic rents.

However, in some businesses, such as personal lines insurance in the United States, this justification for market-value advancement is dubious. The structure-conduct-performance hypothesis that concentration and higher business size lead to market power and anti-competitive conditions is refuted by Choi and Weiss (2005). The theory is useful for the proposed research because it explains how mergers are accomplished in order to gain monopoly status through greater market power.

3.2 The Value-Increasing Theories

The value-Increasing theories were developed by Malatesta (1983) and Lubatkin (1987) who are regarded as the pioneers. (Malatesta, 1983; Lubatkin, 1987) mergers happen extensively, on grounds that they produce cooperative energies for the acquirer and objective which consequently builds the worth of the firm as stated by value increasing school. The efficiency theory recommends indeed, both teams will benefit only when consolidations will possibly happen and they are relied upon to create enough feasible cooperative energies which in return is symmetric assumptions for gains which brings about a 'amicable' consolidation being proposed and acknowledged. It is recommended, on the off chance that if the value to the objective was not positive, the objective company's proprietors would not sell or submit to the procurement, and if the additions were negative to the bidders' proprietors, the bidder would not finish the arrangement. Thus, in the event that we notice a consolidation bargain, effectiveness hypothesis predicts value creation with positive returns of both the acquirer and the objective.

The value-Increasing theories are used to review how income diversification is acquired by firms following merging via generating 'synergies' for both the target and acquirer, which in return builds the worth of the firm and consequently stability is realized. Essentially this theory gives experiences of how firms develop, settle and expands their qualities altogether because of merging with increased profitability.

3.3 Hubris Hypothesis

The theory of Hubris Hypothesis was proposed by Roll (1986). As indicated by managerial hubris theory, there might be overvaluation of value of what they buy because of hubris, regardless of whether managers attempt to optimize the firm's worth (Roll, 1986). When managers indiscriminately follow the business sectors and change their convictions on combination against strategic focus or when various bidders seek a similar objective, this is especially obvious in waves of consolidation. Managers likewise could underrate the expense of post-consolidation combination or overrate their capacity to control a bigger foundation. Consequently, an exchange that is accepted to help the acquirer could basically be a poor key choice where advantages are overvalued or costs are thought little of. The outcome is that investors of the obtaining firm lose from the arrangement on the grounds that the market responds to the misstep of the procuring association's managers.

This theory will be of great significance in this review for it features how the acquirer of the organizations ought to be extremely determined due to overrated acquiring fee in procuring firms. This increases the value of the review for it distinguishes how firms might likely make misfortune if the gained firm was overrated because of intense competition.

3.4 Corporate Control Theory

Corporate control hypothesis (Jensen, 1988 and Shleifer and Vishny, 1988) contends that for incompetent managers of target organizations takeover is a productive means to supplant them. If the managers seek after their own advantages to the detriment of owners' inclinations or they lack information and abilities to maximize the firm value, then the target firm might fail to meet its expectations. The efficiency of target can be worked on in a case whereby managers of acquiring firms are more proficient than those of acquired. This theory predicts that ineffectively performing firms are bound to be gained and that the presentation of targets will upgrade after the takeover. Securing firms are additionally expected to acquire from the takeover action in the event that they can carry working collaboration to the post takeover substance.

4. CONCEPTUAL FRAMEWORK

The conceptual framework of the study highlights the relationship between the independent and dependent variables which are mergers and acquisitions and financial stability respectively.

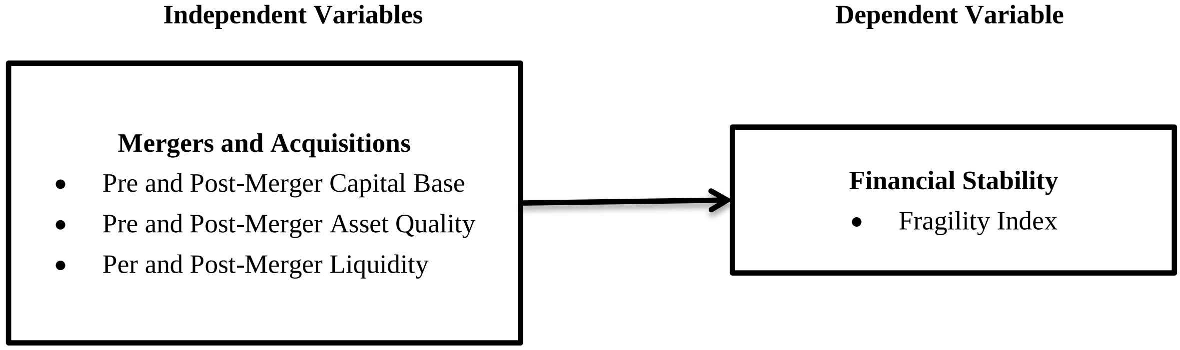

Fig 1: Conceptual Model

Source: Researcher, 2021

4.1 Discussions

The capital base upon merger has a significant effect on financial stability of Banks in Kenya. Capital base increase in terms of assets, cash and securities, competitive advantage and increased market share. Similarly, financial stability can be affected by asset quality upon merger. The asset quality of Banks increases as a result of merger or acquisition. Liquidity upon merger also affects the financial stability of Banks. When companies come together there is increased pool of liquidity as different employees with great experiences, skills and competencies come together and share ideas.

According to the findings of Njambi and Kariuki (2018) organizations' capital base, income diversification, asset quality and liquidity improve significantly after M&A, strengthening their financial stability. A strong positive relationship is witnessed between the liquidity of firms and their financial stability as well as between the capital base, income diversification and asset quality and financial stability. Mergers and Acquisitions are used to pursue organization's objectives of the stability, liquidity, profitability and solvency.

5. CONCLUSION

Due to the shifting regulatory landscape and severe economic conditions around the world, banks are under increasing pressure to enhance their operating efficiency. Banks are likely to be more conservative in their M&A expansion strategy, allowing them to reap the full benefits of a successful merger or acquisition. Various studies such as Francis and Peter (2018); Muchoki and Njuguna (2020); Njambi and Kariuki (2018); and Njangiru and Ondieki (2015) demonstrate that effective mergers and acquisitions must be prioritized at the suitable time to achieve financial stability.

Merger and acquisition is an effective instrument for the prediction of Banks financial stability. It is due to low emphasis by the government and private sector investors and lack of effective merger and acquisition knowledge in the country that a number of Banks and Insurance companies are collapsing in the economy. The study recommends that financial institutions especially Banks and Insurance firms with weak and unstable capital base should consolidate their establishments through mergers and acquisitions so as to expand their market share and revenue base thus increase their stability.

Similarly it is important for firms which have weak liquidity to consider mergers and acquisitions so as to improve their liquidity since it plays a significant role in improving the financial stability of a company. Therefore firms will be able to meet short term financial obligations when they fall due and there is no time that the firm is declared bankrupt. The government should also that regulatory measures are favorable in order to allow for mergers and acquisitions thus stable financial institutions in the country.

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