

Revocation of a Banking License as an Instrument for Regulating Merger and Acquisition Transactions



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Abstract: The article analyzes the dynamics of the indicators of the merger and acquisition market in the banking sector, as well as the indicator of revocation of banking licenses. The analysis has shown the outperformance of bank decrease in relation to bank acquisition over the same period, which indicates a significant impact of license revocation on the merger and acquisition market. The article assesses the impact of the merger and acquisition market on the structure of proportional regulation in favor of banks with universal licenses. An increase in the concentration of capital is observed, especially in banks with state participation. The article investigates the methods of calculating the cost of mergers and acquisitions. The authors propose to add two more factors to the already known factors of change in earnings per share due to mergers and acquisitions: the type of license revoked by the regulator as a result of the rehabilitation and goodwill, which should be considered in the merger cost using additional coefficients. This will allow the merger cost to be more accurately determined and provide the investor with additional information for decision-making.

Keywords: license revocation, banks, regulation, rehabilitation, license type, merger cost, financial market.

I. INTRODUCTION

In Russia, the merger and acquisition market is not currently growing (like many other markets [1-4]). According to the A&M news agency, the Russian merger and acquisition market had shown the worst result since 2010 in terms of the amount, number, and average cost of transactions: the amount of transactions in 2018 reached 42,258 billion US dollars, the number of transactions involving Russian companies – 335, and the average cost of a transaction – only 126.1 million, excluding the largest transactions, which amounted to 65.7 million US dollars [5]. Compared to 2017, the number of merger and acquisition

transactions decreased by 26.9%. The number of transactions is decreasing while the number of mega transactions, i.e. transactions with amount of over 1 billion US dollars, is increasing. In 2018, there were eight such transactions as compared to seven in 2017 [5]. One of these mega transactions in 2018 was the rehabilitation of the credit organization "Promsvyazbank" by the Central Bank, which amounted to 4.25 billion US dollars.

The situation of proportional regulation of banks [6] during the period of their rehabilitation by the regulator is largely reflected in mergers and acquisitions associated with two directions: first, on the merger and acquisition cost and, second, on the decision of investors involved in such transactions. All these coefficients are subject to volatility; thus, the situation when these parameters do not change at all is unlikely.

The analysis of factors that had a significant impact on the state of the Russian merger and acquisition market showed a significant number of bankruptcies of organizations and bank rehabilitations, including the top ten banks. Even though the number of bankruptcies of Russian companies in 2018 decreased by 3.1%, the total number of bankruptcies remains significantly high [7].

The situation is aggravated by the overheating of the credit market and the continuing trend of revocation of banking licenses: only from 2008 to 2016, the number of banks decreased from 1,136 to 635 – by 501 credit organizations (44.1%) [8].

The dynamics of the indicators of the merger and acquisition market in the banking sector and the indicator of revocation of banking licenses are presented in Table 1.

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Table 1: Dynamics of indicators of the merger and acquisition market in the banking sector and the indicator of revocation of banking licenses

Article	Year										
	2013	2014	2014/2013, %	2015	2015/2014, %	2016	2016/2015, %	2017	2017/2016, %	2018	2018/2017, %
Number of banks	897	859	-4.3	783	-8.8	683	-12.7	623	-8.7	561	-9.9
Number of mergers	2	2	-	2	-	2	-	2	-	2	-
Number of acquisitions	458	469	2.4	476	1.5	504	5.8	523	3.7	544	4.0
Number of revoked licenses	32	86	168.7	87	1.2	93	6.8	47	-50.5	57	21.3
Share of revoked licenses per acquisition, %	6.9	18.3	by a factor of 2.6	18.3	-	18.4	0.8	8.9	-51.6	10.4	17.7

Compiled by the authors based on [8]

It can be seen from Table 1 that the number of banks is decreasing faster than the number of bank acquisitions. The largest reduction in the number of banks occurred in 2016 and amounted to 12.7% while the number of bank acquisitions over the same period was only 5.8%. Bank mergers have almost no noticeable impact on the merger and acquisition market as the number of mergers is small (only two in the market) and has not changed in the last five years. The largest number of revoked licenses was observed in 2014 (86 licenses). The number of revoked licenses in 2014 compared with 2013 increased by 54, which was 168.7% in relation to 2013 (86-32 = 54; 32 x 100%). The largest specific indicator of revoked licenses per one bank takeover in 2014 is 18.3 (86: 469 x 100%), which is 2.6 times higher than the same indicator in 2013 (18.3: 6.9 x 100% = 265.2% or 2.6 times).

The merger and acquisition market in the banking sector significantly changes the structure of proportional regulation against the background of the regulator’s policy aimed at the banking sector rehabilitation. In 2018, there were 230 banks with a basic license and 286 banks with a universal license; as of January 1, 2019, there are 149 banks with a basic license and 291 banks with a universal license. In the conditions of bank rehabilitation, the tendency for growth is observed in banks with a universal license, which indicates imbalances in banking regulation. Considering the fact that banks with a basic license include the majority of regional banks, the decrease in the number of banks with a basic license indicates the closure of, first of all, regional banks, which negatively affects the economic development of the regions.

Another notable trend in changes in the banking sector amid rehabilitation by the regulator is an increase in the concentration of capital, especially in banks with state participation. According to the Banki.ru rating, in 2018, the total assets of banks increased by 10.7%, or 8.9 trillion rubles, and amounted to 92.1 trillion rubles as of January 1, 2019 [9].

II. LITERATURE REVIEW

A. General description

We share the opinion of researchers in relation to assessing the cost of a banking business after a merger and acquisition

using the income approach, including the method of discounted future cash flow [10]. The effect of a merger and acquisition transaction significantly depends on the amount of net income. In the short term, such transactions reduce the cost of the earnings per share due to the payment of the merger premium to the shareholders of the acquired bank; thus, the earnings per share are diluted (EPS dilution effect). The cost of the merger (acquisition) is determined as follows [10]:

$$P_{bv} = \left[\frac{MP_t}{BV_t} \right]_{avg} \bullet BV_t \tag{1}$$

where MP_t is the market price per share of the bank-buyer;

BV_t is the book value of the target bank's (acquired or new) share.

The market price per share of the bank-buyer consists of the nominal price per share (S) and market value resulting from market supply and demand. As investors seek to carry out a merger (acquisition) transaction, the market value will be positive, i.e. an increase in value, actual income (D):

$$MP_t = S + D \tag{2}$$

B. Algorithm

The factors named by N.V. Gorelova as reasons for changes in earnings per share include the following [10]:

- 1) amount of the merger premium paid to the shareholders of the target bank;
- 2) relative income of bank-participants to the merger;
- 3) relative growth rates of bank-participants to the transaction;
- 4) presence or absence of synergy.

We believe that it is necessary to add two more factors that have a significant impact on the amount of earnings per share:

- 5) type of license revoked by the regulator as a result of rehabilitation;
- 6) reputational component (goodwill).



The Central Bank divided credit organizations in the course of proportional regulation into organizations with universal and basic licenses. Basic license holders are prohibited from working with certain types of customers, securities, and operations. Therefore, these banks have fewer opportunities to earn earnings per share and the merger and acquisition market responds to this process. In addition, the amount of earnings per share is affected by the reputational component of the bank (goodwill) due to lower confidence of potential customers in banks with a basic license.

Therefore, it is advisable to consider the fact that the rate of revocation of a particular type of license and the confidence factor influence the earnings per share, which can be reflected in the calculation formula using additional factors β_1 and β_2 :

$$\beta_1 = \frac{r_i}{r_m} \quad (3) \quad \text{and} \quad \beta_2 = \frac{r_j}{r_n} \quad (4)$$

where r_i is the average income per transaction of the acquired bank;

r_m – the average income per transaction in the banking market;

r_j – experimental assessment of the reputational component of the acquired bank;

r – assessment by the employees of the acquired bank of the reputational component.

Then formula (2) has the following form:

$$MP_t = S + (D \cdot \beta_1 \cdot \beta_2) \quad (5)$$

Given (3), (4), and (5), the merger (acquisition) cost formula (1) is as follows:

$$P_{bv} = \left[\frac{S + (D \cdot \frac{r_i}{r_m}) + (D \cdot \frac{r_j}{r_n})}{BV_t} \right] + BV_t \quad (6)$$

III. RESULT ANALYSIS

The merger and acquisition costs of banks, in our example with a basic license, considering additional coefficients that take into account the type of license revoked from the acquired bank and the reputational component, will be lower than the merger costs without these indicators since additional coefficients, in this case, are less than one. In fact, these ratios lower the merger and acquisition costs, which can significantly affect the decision of the investor on the implementation of the merger and acquisition transaction. As soon as the transaction is completed and the acquired bank is purchased, investors, as a rule, try to lower its capital in order to increase the return on their investments. Additional ratios have already reduced capital, so investors can speed up their decisions. If the acquired bank had a universal license and a higher reputational component (goodwill), the additional coefficients will be greater than one and the merger cost with

additional coefficients will be higher than without these indicators, which, in turn, may slow down the decision of investors to implement the merger and acquisition transaction.

The obtained results do not contradict the basic provisions of the theory of valuation of banking business used by theorists and practitioners. However, there is a condition to which special attention should be paid. We assumed that if the acquired bank has a basic license and low goodwill, the coefficient value is less than one and if the bank has a universal license and high goodwill, the coefficient value is greater than one. However, there may be transactions, even theoretically, entailing the simultaneous acquisition of banks with different types of licenses and levels of goodwill. In this case, it is advisable to approach each acquired bank individually and use the values of the coefficients that we described earlier.

IV. CONCLUSION

Thus, based on the calculations, it is possible to conclude the following:

- in the process of determining the cost of mergers and acquisitions of banks in the market, it is necessary to consider the policy of rehabilitation of banks conducted by the regulator over a period of time, license type of the acquired bank, as well as the reputational component (goodwill) associated with a certain level of confidence of potential customers in the credit organization;

- it is also necessary to consider the value of input values of additional coefficients that increase or decrease the cost of a merger or acquisition of the bank in view of the above factors: the type of license (basic or universal), which is largely reflected in the multiplier of earnings per share, and the modified income received due to the reputational component of the bank;

- interpretation of all received changes of parameters from the point of view of economic expediency provides for a more exact and detailed calculation of the cost of mergers and acquisitions of banks in the financial market.

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