

## **Exit Strategy In Banking Sector: A Review Of The Literature Associated With Conventional And Islamic Banking**

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### **Abstract**

*This paper provides a review of exit strategy literature that have examined the theories, the impact of exit strategy towards banking performance, both conventional and Islamic, as well as the factors associated with exit strategy activity. The authors have been able to review more than thirty investigations over a twenty-year period, from 1993 to 2017. The study is theoretical and analytical in nature and secondary method has applied. Through a literature review, this study provide an account of the theories and main findings of the literature as well as examines the extent to which exit strategy give impact to the banking performance and highlights some factors contribute to the successfulness of exit strategy activity. Overall, the evidence reviewed suggests that exit strategy affect the conventional and Islamic banks in several different ways. This could be explained by different approaches in handling exit strategy (i.e., domestic or cross border) and various factors contributing to the decision of conducting the exit strategy activity. As far as the development and increase interest in Islamic finance are concerned, it is perhaps surprising that very little empirical research on exit strategy in Islamic banking sector. The paper concludes with several recommendations for future research, the most important of which is the need for a systematic effort on conceptual analysis as well as empirical study on exit strategy in Islamic banking and finance.*

Keyword: Exit strategy, theory, bank performance, Islamic banking

### **Introduction**

Exit strategy has been in the mainstream news in the recent past (massoudi & fontanella-khan, 2016). Global trend shows a record breaking of \$5 trillion worth of deals worldwide in 2015 which was more than a one-third increase over 2014 and it was \$4.4 trillion in 2007(liner, 2016). Globalization and financial deregulation of banking sector went through a period of considerable consolidation during 1990s. The financial world has experienced the down side of financial innovation and deregulation in the recent global financial crisis which leads to massive bank failures in the developed economies. Moreover, this affect has been spread in the developing countries as well.

At the age of the competitive business arena, financial enlargement, technological innovation, structural modification of the financial system and demands for the financial products, all financial institutions have to face numerous problems and need to change their business approach accordingly. With a view to keeping face with this changing trend all financial institutions need to espouse strategy to survive in the competitive business world. Exit strategy is one of the most renowned strategies to make adoption with those changing businesses. According to the efficiency theory, the bottom line and special alchemy of the exit strategy is for the purpose of synergy. Even though the main bottom line of exit strategy is to have synergy, element of necessity is equally important for the target banks to be considered. In several cases for example infant bank, bank that is incapable to compete, facing financial distress and unable to maintain requirement of common equity of risk weighted asset, exit strategy could become necessity in the first place rather than to acquire synergy. Hence, it becomes necessary for the

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banks to be merged or acquired by other matured and stable financial institutions before reach the target of having synergy in the deal.

As far as the exit strategy is concerned, today's business is not bound within the domestic arena; it has crossed the national boarder. Efficient and well-built financial institutions tend to broaden their market or man oeuvre beyond national boarder throu ghout foreign direct investment (fdi) in the form of cross border exit strategy. This strategy creates direct or indirect external or spillover effect on the performance of the banks as well.

The latest literatures show that bank exit strategy activities has been growing rapidly on the backdrop of global financial crisis, financial deregulation, and market competition in the developed and developing world. However, a recent comprehensive review on this vital issue is still not well documented especially for Islamic banks.

The rest of the chapter is structured as follows. The next section presents a brief review of exit strategy underlying theories. Further discussion on the impact of exit strategy towards the performance of banking sector for conventional and its counterpart is presented in section 3. Sections 4 extends the review on the factors associated with exit strategy deals. Finally, section 5 concludes the paper.

## **Overview of underlying theories of exit strategy**

A number of theories have been applied in the previous studies to explain exit strategy such as, efficiency theory of merger [daniya et al. (2016); weitzel, u., & McCarthy, k. J. (2011)], neoclassical theory [mitchell, m. And mulherin, h. (1996) and (polemis&paleologos (2014), Petmezas (2009)] behavioral theory [shleifer&vishny(2003), polemis&paleologos (2014)] and resource dependency theory [kandil&chowdhury (2014), das &rao (2011), morris (2004), kiel&nicholson (2003)].

Specifically, within the sphere of banking sector, many studies have used efficiency theory and resource dependency theory (rdt). According to efficiency theory, it suggests that mergers are planned and it will only occur when they are expected to generate enough realizable synergies to make the deal beneficial to the parties, bidder and target. Similarly, several studies [i.e., daniya et al. (2016) wadhwa&syamala (2015) and weitzel&mccarthy (2011)] mention that the main motive of exit strategy is to gain synergy (operating and financial synergy). These synergies could be in the form of reduction in cost or increase in revenue. It is the symmetric expectations of gains which results in a 'friendly' merger being proposed and accepted. If the gain in value to the target is not positive, it is suggested that the target firm's owners would not sell or submit to the acquisition. Similarly, if the gains were negative to the bidders' owners, the bidder would not complete the deal.

Whereas, rdt is defined as an explanation of how the external resources like, skilled worker, money, technology and raw materials etc. Of an organization affect the behaviour of said organization. Nair, trendowski& judge (2008) claims that resources of a firm is consist of tangible assets, human and other intangible assets which are put to produce productive services planned by the firm. In addition, rao-nicholson (2003) notes that board members contribute to the important external resources and can maximize firm's performance.

Similarly, morris, t. (2004) states that rdt is could explain the impact of social action and organisational changes towards an organization.rdt offers an externally focused perspective of why an organization might acquire or merge with another organization.

## **Impact of exit strategy towards the banking performance.**

While the importance of exit strategy is becoming crucial in addressing financial instability, there is relatively lacking, inconclusive and mixed evidence on the influence of exit strategy on banking performance.

Using data from the banking sector, abbas, q., hunjra, a. I., azam, r. I., ijaz, m. S., & Zahid, m. (2014). Finds a direct positive performance in banking productivity, profitability as well as shareholders' value. Similarly, daniya et al. (2016) find that there is an improved and robust financial performance owing to merger and acquisition, leading to a more financial efficiency in the nigerian banks. In addition, okpanachi (2011) implies that between pre and post exit strategy, post mergers and acquisitions period is more financially efficient than the pre period. Similarly, using data from malaysian banks, sufian&habibullah (2014) find that the acquiring banks have been relatively more productive as compare to the target banks.

Whereas, several studies reveal that exit strategy deal has less important impact on the bank performance. Kandil&chowdhury (2014) and gattoufi et al. (2014) show that exit strategy activity has no significant impact on operational performance of the banks involved. In the similar vein, piloff&santomero (1998) and goyal&joshi (2011) argue that acquisitions often have a negative impact on employees' behaviour resulting in counterproductive practices, absenteeism, low morale, and job dissatisfaction. It appears that an important factor affecting the successful outcome of acquisitions is the top management's ability to gain employee trusts (amihud, et al., 2002). Shed light on that, sufian et al. (2012) have explored and investigate an interesting result in their analysis. It shows that banks' revenue efficiency has not significantly improved during the post-merger compared to the pre-merger period.

In addition, mix result is also found in several studies. Using information from public listed companies from asean countries, rao-nicholson et al. (2016) finds negative effect of exit strategy deal on the performance of the banks. With respect to domestic consolidation, however, they argue that friendly deals help to smoothen integration between the two companies and managers can work proactively to derive synergistic gains from the exit strategy activity. In the case of domestic deals, it can be quite costly to integrate institutions which are dissimilar in terms of their loan, earnings, and cost, deposit and size strategies. As for cross-border mergers, differences between merging partners in their loan and credit risk strategies are conducive for higher performance, whereas diversity in their capital and cost structure has a negative impact from a performance standpoint (altunbaş&marqués, 2008; antoniadis, alexandridis&sariannidis, 2014).

With regards to the announcement time of the size-adjusted combined performance of both the bidder and the target, cybo-ottone&murgia (2000) find that this factor is important in exit strategy deal and it is economically relevant. They argue that only the combined value of domestic deals creates shareholder value, whilst cross-border deals do not capture positive expectations from the market.

Moreover, antoniadis et al. (2014) review the literature for exit strategy in the European banking sector and state that there are positive abnormal returns for target banks due to investors' expectations for better utilization of their assets. While, shareholders of acquiring banks suffer minor losses of value that leads to negative abnormal returns. This is due to investors' disbelief on the motives and successfulness of the proposal.

Furthermore, empirical investigation and analysis of al-sharkas, a. A., hassan, m. K., & Lawrence, s. (2008) highlights that there is an improvement at cost and profit efficiency after merger and acquisition in us banking sector. They have argued that, merged banks show more cost efficient than non-merged banks due to application of efficient technology available.

### **Cross border exit strategy and its impact on banks performance**

Nowadays, business is not only bound within the domestic arena but also it crosses the national boarder. Efficient and strong financial institutions tend to broaden their market or man oeuvre beyond national boarder. This could be accomplished through foreign direct investment (fdi) which comes with two approaches namely green filed investment and new operation procurement. The second approach might involve cross boarder exit strategy. However, to a certain extent, fdi through cross boarder exit strategy contributes to an external or spillover effect on the performance of the banks.

Amihud et al. (2002) asserts that there is risk of insolvency in cross border exit strategy. If the acquisition of the foreign target fails and the domestic bank's (acquirer's) solvency is threatened, the acquiring bank may be bailed out either by its own domestic regulator or by the host regulator (the regulator of the target bank). Hence, cross-border mergers may has less advantage for either one or both of the parties involved, i.e, the domestic (acquirer) and host bank regulators (target). This conventional wisdom is based on the traditional notion that it is better for a bank to not put all its "eggs in one basket" and thus geographic diversification is a naturally risk that need to properly consider.

In addition, gattoufi et al., (2014) argues that regional factor impede cross border exit strategy. Each region has different set of rules and regulations imposed by the regulators. By the same token, zou&simpson (2008) claims that studies related to exit strategy in developing economies are relatively much lacking Exit strategy activity can be seen as a means of managing resource dependencies through absorption and integration at a low-cost base and acquiring or consolidating market power position.

Furthermore, nagano (2013) reports that both inward cross-border exit strategy and greenfield fdi attract the host country (target) through opportunities such as to increase population size and per capita income as well as decrease in corporate tax rates. However, a home-country (bidder) firm tends to choose cross-border exit strategy rather than greenfield fdi when the host country enforces intellectual property rights laws. Besides, neto, et al., (2010) states that depending on the potential economic growth of the host country, exit strategy has a great potential to boost internal competition which could lead to high growth.

The size of the bank is also equally important to have decision to invest abroad. This notion is supported by focarelli&pozzello (2001) which found that the size of the banks is the key determinant of the decision to expand business abroad.

## **Benefit of exit strategy in banking sector**

Due to several differences in terms of the concept, operations and methodology between Islamic and conventional banking system, it is almost impossible for the two banks to be merged, askari, h., iqbal, z., & mirakhor, a. (2011). However, there is room for Islamic subsidiary of the conventional banks to merge with Islamic banks. Following are the argument for exit strategy in the Islamic banking sector.

Datuk serizukrisamat, former chief executive officer (ceo) of bimb holdings bhd. expressed his opinion in the press conference on 28 & 29 of May 2017 by stating that creation of mega Islamic banks through exit strategy could be rival not only for the other Islamic banks but also the “big boys” or “giants” from the conventional side. It would help to survive in the competitive market, boost industry growth, huge potentiality to cross the border and able to be a global hub for Islamic banking sector. Similarly, dr alexander von pock, principal of financial institutions group mentions that exit strategy offers a way to build more powerful players with better chances to compete. Likewise, finance minister of Bangladesh, abulmaalabdulmuhith states that there is provision under the act to facilitate exit strategy deals for those banks like basic bank and national bank Bangladesh limited which facing financial problems due to the huge amount of non-performance loans (npls).

However, empirical studies are still much lacking. Ibrahim & rizvi (2017) state that size of the Islamic bank is smaller as compared to conventional banks. So, it becomes concern of ‘too small to have the economics of scale and scope’. Islamic banks are expected to achieve both economies of scale and scope if exit strategy activities could be implemented.

According to iqbal (2008), incentives are necessarily to increase size through consolidation in order to lower the cost of funding and increase the value of shares. It is important to distinguish how exit strategy activities work in Islamic finance industry. Iqbal (2008) also claim that there are two matters that should be considered in exit strategy within Islamic financial institutions. Firstly, there should be benefits arising out of economies of scope and scale.

Secondly, it is expected that risk management and risk sharing strategy are enhanced diversification. A well-diversified bank has better expected return-risk trade-offs resulting in lower variability of profits and higher security for depositors. These are supported by study of Ibrahim & rizvi (2017) who find that larger Islamic banks are more stable, at least when they surpass a certain threshold size.

Kandil & chowdhury (2014) argue that many acquisitions are not failure from an ex post perspective and suggest that an acquirer may sell a business it has improved or a business that it once had synergies with but no longer does. Exit strategy in Islamic banking sector could achieve efficiency which arise through economies of scale or scope. This could happen when there is changes in the market structure which in turn affects the Islamic banks’ profits.

## **Factors associated with exit strategy activity**

The decision to embark in exit strategy depends on several reasons. There are some influential factors that could either directly or indirectly effect the exit strategy deal. Factors that are associated with the exit strategy activity reviewed as follows.

Roberts et al. (2003) mentions that the reasons of why one financial institution merged with another institution are due to the rationale and the drivers. Rationale indicates strategic implementation whereas, drivers indicates control of the capacity from the economy.

Besides, Barros & Caporale (2012) argue that size also creates further pressure on managers owing to the difficulty of managing large institutions. It is said that mergers are not always beneficial as they might make firms more aggressive when they compete in quantities. This is supported by Pinter (2011) who mentions that this is due to the fact that many of the cost of operation do not increase proportionally with the size of the company.

According to Wadhwa & Syamala (2015), the main motivation behind exit strategy is to have synergy but inconsistency result has found by the previous studies. As far as motivational factors as concern, many attempts have been made by previous studies to explain the motives of an institution to involve in exit strategy. An institution involves in exit strategy with several intentions; to expand into new markets of both national and international, to exploit strategic opportunities (challenges) through synergies and convergence of industries, to reduce the number of competitors, to enhance and obtain new integrated knowledge, to combine superior technology, to gain access to better and greater resources, to achieve greater efficiency through economies of scale and scope as well as to increase market power (Smirnova, 2014; Cigola & Modesti, 2008; Pasiouras & Zopounidis, 2008; Guo & Yang, 2013; Antoniadis et al., 2014).

Besides, Sufian (2011) mentions that exit strategy occurs to achieve economies of scope rather than economies of scale. Furthermore, Linder & Crane (1993) assess the impact of mergers which focusing primarily on operating income and its three components<sup>3</sup>. They find that bank can easily gain the economies of scope and economic of scale by holding cash (i.e., cash & other deposit to other bank) and security (i.e., security held for liquidity). This supports the view that merger programme was driven by economic reasons (Sufian & Habibullah, 2009).

In addition, Pinter (2011) highlight that there are two ways in which the acquirer may take over the target banks i.e. Either through statutory merger or purchase of assets. They argue that this action could lead to improvement of the shareholder value, efficiency enhancement and the boost of operating synergies and managerial motives. They categorised the factors into three broad types; shareholders wealth maximization goals, managerial self-interest and other factors which contribute to the conducive environment for exit strategy. The study supported by Focarelli & Pozzolo (2001) which states that acquisitions are made for the purpose of 3 i.e., operating income = (net interest income + noninterest income) – (noninterest expense). 17 improving the quality of portfolio of acquired banks by having larger bank size.

## Conclusion

This paper is a humble attempt to review the literature on mergers and acquisitions, especially in banking sector. The inner objective of the authors is to provide a better picture on the impact of exit strategy towards both conventional and Islamic banking performance as well as the factors associated with this activity. The observation of the previous studies concluded that exit strategy effect the conventional and Islamic banks in several different ways. This could be explained by different approaches in handling exit strategy (i.e., domestic or cross border) and various factors contributing to the decision of conducting the exit strategy activity. In addition, this study endeavors research on exit strategy in Islamic banking sector as there is little theoretical research on this timely topic. In the next step, a systematic effort on conceptual analysis as well as data

collections on exit strategy in Islamic banking needs to be in place in order to efficiently analyse the its performance, factors and issues.

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