IC-05
Political Uncertainty and COVID-19 Disruption as a Catalyst for Bank Consolidation: Experiences from Kenya

Authors: Charles Mwitari [1], and Sharan Kumar Shetty [2]
[1] PhD Candidate, Manipal GlobalNxt University, Malaysia.
[2] Associate Professor, Manel Srinivas Nayak Institute of Management, India.

Abstract

The World Health Organization declared COVID-19 a global pandemic on the 11th of March 2020, but the world is still reeling from its aftermath. Originating from China, cases quickly spread across the globe, prompting the implementation of stringent measures by world governments in efforts to isolate cases and limit the transmission rate of the virus. These measures have however shattered the core sustaining pillars of the modern world economies as global trade and cooperation succumbed to nationalist focus and competition for scarce supplies. Against this backdrop, this paper presents a critical review of the impact of the pandemic on mergers and acquisitions and proffers perspectives on how it can be leveraged to steer towards a better, more resilient economy. In this study, we seek to decipher the impact of COVID-19 and political uncertainties associated with presidential elections has in the banking industry in Kenya.

Keywords: Merger, Acquisition, Banking, Covid-19

Introduction

The Covid-19 pandemic has triggered a severe economic downturn that threatens to trigger another financial crisis. Nonetheless, banks have been a source of resilience during the recent financial turbulence. COVID-19 shut down most business operations and kept the vast majority of the world's population indoors for their own safety. Organization-environment fit/misfits have resulted from a lack of precedent and preparedness for such exogenous events by organizations of all sizes. Trying to meet increased sanitation standards while also complying with government limits and supply and demand constraints has revealed how well businesses are prepared for a health crisis-induced change in business environment. Corporate restructuring, mergers and acquisitions have become essential considerations for organizations searching for ways to realign their strategic goals in order to compete and even survive in this new climate (Kooli & Lock Son, 2021).

As a result of the worldwide recession brought on by COVID-19, the fundamental dynamics of mergers and acquisitions (M&As) have shifted. Covid-19 has transformed the M&A market from a seller's market to a buyer's market by making cheap assets and distressed companies available (Bauer, Friesl, & Dao, 2021). The acquisition reasons and strategies of the previous M&A waves were different from one another (Roy, 2021). It is our belief that, like during prior economic crises, corporations' strategy may have changed due to current market shifts for corporate control. This also necessitates a shift in acquisition tactics.

The literature on the economic impact of COVID-19 is limited particularly in the context of an emerging economy like Kenya. Limited studies have attempted to analyze the relationship between the pandemic and bank performance. We add to the limited literature by studying the impact of COVID-19 on mergers and acquisition. Specifically, we contribute to the literature in that this article studies, for the first time, the impact of COVID-19 on on bank performance in reference to mergers and acquisitions in Kenya (Ozili, 2020).

Liquidity provision and credit allocation are two ways in which a well-functioning banking system contributes to economic growth. As a result, regulators are particularly concerned in whether banks adjust their lending behavior in response to increased uncertainty and risk. During the epidemic, banks' lending decisions are affected by enormous uncertainty, and this research provides new evidence on this topic. Non-financial corporations' solvency and liquidity were a worry during the epidemic, prompting central banks to implement monetary stimulus programs. Others aimed to alleviate short-term pressure on financial markets, such as government-sponsored credit lines or liability guarantees, while others sought to ease banks' restrictions on using capital buffers in order to support the flow of credit to businesses (e.g., easing banks' constraints on the use of capital buffers). Loan guarantees and other types of credit support for firms have also been introduced in record numbers by a number of countries (Bennedsen et al., 2020). Key policy mechanisms for injecting cash into impacted companies include loan guarantees, which are occasionally complemented by government purchases of corporate bonds (Alstadsaeter et al., 2020).

The first case of COVID-19 to be reported in Kenya was on March 14th, 2020. Restrictions on gatherings in non-essential public locations were increased; telework was encouraged; isolation facilities were established, and a night curfew and restrictions on public transportation passenger capacity were put in place. Since then, some of the confinement measures have been loosened. In response to the pandemic, Kenya's government, through the Central Bank, lowered its policy rate by 100 basis points to 7.25 percent; lowered banks' cash reserve ratio by 100 basis points to 4.25 percent; increased the maximum tenor of repurchase agreements from 28 to 91 days; and announced flexibility to banks regarding loan classification and provisioning for loans that were performing on March 2, 2020, but were restructured because of the pandemic (Mbae, 2020).

As a result of the pandemic, the central bank has also urged banks to give borrowers more leeway in terms of their loan conditions and to waive or reduce charges on mobile money transactions in order to discourage the use of cash. Non-performing loans became uncollectible after April 1,2020 therefore the central bank decided to delay reporting negative credit information for six months. When the central bank decreased its policy rate to 7.0 percent on April 29, it did so by 25 basis points. There were a few policies that were overturned on January 1st of 2021, including no longer publishing negative credit information for debtors and waiving or decreasing mobile money transaction fees. On March 2, 2021, the measures on debt restructuring and categorization flexibility ended (Muthiora, Awanis, Clifford, Chadha, & Kipkemboi, 2020).

The Central Bank of Kenya (CBK), the country's banking regulator, predicted that Kenya's economy would grow by 6.2 percent in 2020, up from 5.8 percent growth in 2019. In the wake of the COVID-19 outbreak, CBK has lowered this down to 3.4%, citing the impact on the economy. According to McKinsey, a management consultancy firm, GDP growth would

slow to 1.9% in 2019. Due to the current state of the financial markets and the potential influence of COVID-19 on the majority of firms' operations and revenues, M&A activity is projected to decrease, as companies prioritize the safety of their employees and their own survival. Demand and supply in the global market have been significantly affected because of the COVID-19 pandemic. Some businesses have been forced to merge or be taken over by other companies because of the epidemic, which has left them in financial difficulties (Makiya, 2020).

Distressed businesses are attractive acquisition targets. If they are struggling financially, they may be compelled to sell assets, businesses, or securities fast in order to raise funds or pay off debt. Assets, businesses, and securities can all be sold under these circumstances. As a result, potential buyers may be able to get a good deal on valuable assets, businesses, or securities.. The number of mergers and acquisitions (M&A) deals will almost certainly rise as a result of this. Many banks in Kenya's banking sector have been forced to look for methods to save money in the last three years after the government regulated interest rates, which has resulted in a flurry of deals. Continued M&A activity is encouraged by the CBK to establish larger and more resilient institutions capable of coping with financial market volatility as well as financing massive infrastructure projects while maintaining low-interest rates for customers (Murimi, 2020).

As much as $2.8 trillion in capital is redirected each year as a result of mergers and acquisitions (M&As) globally. M&As are essential to academics, practitioners, and policymakers because of their sheer size and ability to develop synergies. Prior studies have spent a lot of work trying to figure out why M&A activity fluctuates so much over time. Uncertainty about taxes, government expenditure, and monetary and regulatory policy—or policy uncertainty—is a key source of variation in M&A activity, which we demonstrate in this ongoing discussion. One strand of literature shows that firms postpone M&A in response to economy-wide political uncertainty (Bonaime, Gulen, & Ion, 2018); however, this finding cannot be generalized to firm-level political uncertainty because types of political uncertainty differ in nature (Laker & Roulet, 2019). As such, this study extends and complements the existing literature by providing evidence from Kenya.

Politics' effect on investment has garnered a lot of focus. It is vital to note that M&As might be affected by political instability because of the possibility of a change in national leadership. Political unrest and other violent events have the potential to reduce overall investment on a macroeconomic scale (Chahine, Dbouk, & El-Helaly, 2021). Amore and Corina (2021) found that enterprises cut back on capital expenditures when faced with political uncertainty at the micro level. This correlation is stronger in nations with fewer checks and balances, presidential systems, and lower levels of shareholder protection, which are more likely to encounter political instability due to an upcoming national election. If an incumbent leader is expected to win re-election, this correlation is less than if an incumbent is expected to lose. According to these findings, companies time acquisitions and diversification to coincide with political uncertainty at home before elections.

Companies' financial restrictions can be exacerbated and the cost of external funding can rise as a result of political instability. A merger or acquisition is often a substantial financial commitment that is difficult to undo. They are also a sign of managers' discretionary risk taking, which tends to raise the default risk of the acquirers (Chen, Cihan, Jens, & Page, 2018). M&A acquisitions are more difficult and expensive to fund because of political instability in the dairy business, for example. The unpredictability of future cash flows is also increased by political uncertainty, which raises the risk of the enterprise. Acquiring companies are expected to be cautious with their liquidity in the face of policy uncertainty and its negative repercussions and are likely to employ stock as M&A payment. Additionally, political unpredictability increases operational risk for businesses, magnifies significant investment risks such as mergers and acquisitions (M&A), and raises capital expenditures, potentially resulting in lower value for the acquirer's shareholders. As a result, major and riskier investments are postponed in high-uncertainty periods by more cautious companies.

Within Kenya, upcoming general elections could pressure budget execution and reform implementation and potentially lead to socio-political tensions." Both ODM leader Raila Odinga and Deputy President William Ruto are gearing up for what seems to be an intense contest for State House in the next general elections. In the run-up to the 2017 elections, Kenya was classified as the world's second-worst business environment by the IMF in a survey conducted in September 2019 (Onyango, 2020)

Only South Africa ranked lower than Kenya in the World uncertainty Index (WUI) between July and October of this year. Investors were more comfortable investing in Kenya after the so-called handshake between President Uhuru Kenyatta and Opposition leader Raila Odinga in the third quarter of 2016. Since Kenya's elections tend to reduce growth, investors prefer to take a wait-and-see approach to the country's economy in the fourth quarter of 2002, according to a new study (Ahir, Bloom, & Furceri, 2018).

Firm-level political instability may have an impact on mergers and acquisitions in the following ways. Firms may postpone mergers and acquisitions due to political instability at the firm level. Companies should postpone M&A as the real options value grows with uncertainty according to real options theory (Ahammad, Leone, Tarba, Glaister, & Arslan, 2017). This suggests that political instability could have an impact on companies' propensity to engage in mergers and acquisitions. For example, the financing costs argument suggests that increased financing costs associated with uncertainty in general and political uncertainty in particular deter M&A activities because of these costs (Nguyen, Zaied, & Pham, 2019). As a result of political instability, companies are likely to increase their acquisition activity in order to mitigate their idiosyncratic risks. According to Garfinkel and Hankins (2011), organizations use vertical M&A to reduce the volatility of their cash flow. Furthermore, the theory of agency anticipates a link between political uncertainty at the company level and corporate acquisitiveness since. For this reason, the relationship between political uncertainty and business acquisitiveness remains an open empirical subject.

Conclusions

Kenya has long been considered East Africa's investment hub, attracting some high-value M&A deals in the last few years. However, the country's post-pandemic economy will take some time to recover. There is bountiful evidence that political uncertainty stemming from presidential elections or doubt about the direction of future policy make financial markets significantly volatile, especially in proximity to close elections or elections that may prompt radical policy changes

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