VIII COMPETITION AND CONSOLIDATION

8.1 The financial services industry, particularly the banking industry, has undergone significant transformation all over the world since the early 1980s under the impact of technological advances, deregulation and globalisation. An important aspect of this process has been consolidation as a large number of banks have been merged, amalgamated or restructured. Although the process of consolidation began in the 1980s, it accelerated in the 1990s when macroeconomic pressures and banking crises forced the banking industry to alter its business strategies and the regulators to deregulate the banking sector at the national level and open up financial markets to foreign competition. This led to the blurring of distinctions between banks and non-bank financial institutions, various products and the geographical locations of financial institutions. The resulting competitive pressures on banks in the emerging economies led to deep changes in the structure of the banking industry, including, among others, privatisation of state-owned banks, mergers and acquisitions (M&As) and increased presence of foreign banks. The financial value involved in the M&As multiplied over the years. As a result of these M&As, the number of banks has declined substantially both in advanced and emerging market economies (EMEs).

8.2 The motives of consolidation have depended on firm characteristics such as size or organisational structure across segments, or even across lines of business within a segment (BIS, 2001). In developed countries, market forces have been the prime driving force behind M&As. Globalisation and deregulation led to decline in bank spreads, and consequently, profitability. In order to offset the decline in profitability, there were mergers between banks and between banks and non-banks to reap the benefit of economies of scale and scope. On the other hand, in many EMEs, mergers and amalgamations have often been driven by governments in order to restructure the banking systems in the aftermath of crisis.

8.3 Financial consolidation has implications not only for competition but also for financial stability, monetary policy, efficiency of financial institutions, credit flows and payment and settlement systems. Given the diverse nature of financial institutions, different levels of financial development, legal framework and other enabling environment, the causes and impact of financial consolidation have also tended to vary across the countries. For instance, financial consolidation led to higher concentration in countries such as US and Japan, though they continue to have much more competitive banking systems as compared with other countries. However, in several other countries, the process of consolidation led to decline in banking concentration, reflecting increase in competition. This was mainly because banks involved in M&As were of relatively small in size.

8.4 The Indian banking sector has not remained insulated from the global forces driving M&As across the countries. M&A activity in the Indian banking sector is not something new as it took place even before the independence. However, economic reforms introduced in the early 1990s brought out a comprehensive change in the business strategy of banks, whereby they resorted to mergers and amalgamations to enhance size and efficiency to gain competitive strength.

8.5 Against the above backdrop, this chapter, drawing on the theoretical perspective and country experiences on consolidation and competition, assesses various aspects of consolidation and competition in the Indian banking sector. The focus of the chapter is to examine the extent and nature of the process of consolidation and its impact on competition in the banking sector and efficiency of the merged entities. Some important issues that have arisen in the process of ongoing consolidation process have also been discussed. The chapter is organised into eight sections. Section II briefly sets out the theoretical underpinnings of the banking consolidation process. It also spells out the motives and factors driving M&As and the various methods of consolidation. Trends in M&A activity in various countries and the progress in banking consolidation in India are detailed in Section III and Section IV, respectively. The impact of the consolidation process on competition in the Indian banking sector and efficiency of the merged entities is analysed in section V. Section VI addresses the issues arising out of the ongoing process of competition and consolidation such as (a) future course of the process of consolidation that is underway; (b) role of public sector banks in the changed economic environment; (c) further

opening the banking sector to foreign competition; and (d) combining of banking and commerce. Section VII makes some suggestions as a way forward, while Section VIII sums up the main points of discussion.

II. CONSOLIDATION – THEORETICAL UNDERPINNINGS

8.6 There are several alternative methods of consolidation with each method having its own strengths and weaknesses, depending on the given situation. However, the most commonly adopted method of consolidation by firms has been through M&As. Though both mergers and acquisitions lead to two formerly independent firms becoming a commonly controlled entity, there are subtle differences between the two. While acquisition refers to acquiring control of one corporation by another, merger is a particular type of acquisition that results in a combination of both the assets and liabilities of acquired and acquiring firms (Halperin and Bell, 1992; and Ross *et al.,*1995). In a merger, only one organisation survives and the other goes out of existence. There are also ways to acquire a firm other than a merger such as stock acquisition or asset acquisition.

8.7 Mergers generally take place in three major forms, *viz.*, horizontal merger, vertical merger and conglomerate merger. Horizontal merger is a combination of two or more firms in the same area of business. Vertical merger is a combination of two or more firms involved in different stages of production or distribution of the same product, and can be either forward or backward merger. When a company combines with the supplier of material, it is called backward merger, and when it combines with the customer, it is known as forward merger. Conglomerate merger is a combination of firms engaged in unrelated lines of business activity.

8.8 M&As in the financial sector, in particular the banking sector, are undertaken mainly either to maximise the value of firms or for personal interest of managers. As is the case with any firm, the value of a financial institution is determined by the present discounted value of expected future profits. Mergers can increase expected future profits either by reducing expected costs or by increasing expected revenues or a combination of both. Cost reduction through M&As could arise for several reasons including economies of scale, economies of scope, infusing efficient management, reduction and diversification of risk due to geographic or product diversification, access to capital markets or a higher credit rating because of increased size, and entry into new geographical or product markets at a lower cost than that associated with *de novo* entry. M&As could also enable banks to make the provision of additional services making them capable of facing competition from larger banks. By this way, mergers can also lead to increase in revenue by allowing larger size firms to better serve large customers, offering "one-stop shopping" for a variety of different products, increased product or geographical diversification, leading to expanded pool of potential customers and enhancing the risk-taking abilities. M&As could also be used as a deterrent against unwanted possible acquisitions, particularly hostile takeovers, by other larger banks in the future.

8.9 Managers' actions and decisions, however, are not always consistent with the maximisation of a firms' value. In particular, when the identities of owners and managers differ and capital markets are less than perfect, managers may take actions that further their own personal goals and are not in the interests of the firm's owners. In some cases, managers may get engaged in consolidation simply to enhance their firms' size relative to competitors.

8.10 Deregulation, improvements in information technology, globalisation, shareholders' pressures and accumulation of excess capacity or financial distress have been some of the important factors that have encouraged consolidation of financial institutions. While new technologies embody high fixed costs, they enable provision of a broad array of products and services to a large number of clients over wider geographical areas at faster pace and quality of communications and information processing. In other words, it confers economies of scale by spreading the high fixed costs across a larger customer base and motivates mergers of firms operating at uneconomical scales. Further, new tools of financial engineering such as derivative contracts, off-balance sheet guarantees and risk management may be more efficiently produced by large institutions. Some new delivery methods for depositors' services such as phone centers, ATMs and on-line banking networks may also exhibit greater economies of scale than traditional branching networks (Radecki *et al.*, 1997).

8.11 Deregulation influences the restructuring process in banking through effects on market competition and entry conditions, approval/ disapproval decisions for individual merger transactions, limits on the range of permissible activities for service providers, through public ownership of institutions and efforts to minimise the social costs of failures. Over the past two decades, as a response to technological advances and financial

crises, governments, after reconsidering the legal and regulatory framework in which financial institutions operate, have relaxed many official barriers to consolidation. This has resulted in accelerated pace of M&As in the financial sector. At the same time, ceilings on interest and deposit rates have been removed leading to narrowing of interest rate spreads of banks. M&As wave has also been a response to increased competition that threatened profits. To offset the impact of decline in bank spreads on profitability, banks responded by expanding volume (economies of scale) and diversifying their activities (economies of scope). The removal of restriction on geographical areas for banking operations and on diversification of activities provided the opportunities for banks to consolidate among themselves and non-bank financial firms.

8.12 Globalisation, which is a by-product of technology and deregulation in many respects, has its bearing on economies of scale and consequently, influences consolidation strongly among the firms engaged in the provision of wholesale financial services. M&As have also been a frequent option for banks seeking to build a global retail system. It is felt that by acquiring an existing institution in the target market, the acquirer gains a more rapid foothold than would be possible with an organic growth strategy.

8.13 Increased access to the capital markets, both domestic and international, has increased the importance of shareholders relative to other stakeholders. On the other hand, increased competition has led to squeeze in the profit margins of financial firms, resulting in shareholders' pressure to improve performance. Financial firms have been adopting a simpler strategy of M&As to improve performance instead of achieving the same through business gains, productivity enhancement or more effective balance sheet management.

8.14 When there exist excess capacity in an industry or local market, firms, for several reasons, are rendered inefficient as they operate below the optimum level or below the efficient frontier of production. Consolidation through M&As can solve these inefficiency problems more effectively than bankruptcy or other means of exit by preserving the pre-existing franchise value of the merging firms. Similarly, consolidation is employed as an efficient way of resolving problems of financial distress, with weak or inefficient firms being taken over by stronger ones. In short, mergers of banks may help reduce the gestation period for launching/promoting new businesses, strengthen the product portfolios, minimise duplication, and gain competitive advantage, among others. They are also recognised as a good strategy for enhancing efficiency. Ideally, mergers should be aimed at exploiting synergies, reducing overlap in operations, right-sizing and redeploying surplus staff either by retraining, labour restructuring or voluntary retirement.

8.15 Consolidation in the banking industry, on the other hand, can be impeded by regulations, differences in corporate culture and governance regime and inadequate information flows. The legal and regulatory environment represents a substantial potential impediment for consolidation in the banking industry, as it directly affects the range of permissible activities undertaken by financial firms. In some countries, antitrust laws constitute an important impediment, mainly for domestic consolidation within sectors. Prudential regulation may hinder cross-border consolidation through differences in capital requirements. Regulatory impediments to consolidation include protection of national champions, government ownership of financial institutions, competition policies and rules on confidentiality.

8.16 The differences in corporate governance, which encompasses the organisational structure and the system of checks and balances of an institution, could also be deterrents to M&As. There are significant differences in the legislative and regulatory frameworks across the countries with regard to functions of the boards of directors ("supervisory") and senior management. These differences affect the inter-relation of the two decision-making bodies within an institution and relations with the firm's owners and other stakeholders, including employees, customers, the community, rating agencies and governments. There are also cultural differences and the related information asymmetries. These differences act as strong impediments to cross-border and cross-product levels of consolidation and in the hostile takeovers of financial institutions.

8.17 Information asymmetry faced by stakeholders may hinder M&As as the inadequate information flows increase the uncertainty about the outcome of a merger. Such information asymmetry would arise due to incomplete disclosure or large differences in accounting standards across countries and sectors, lack of comparability of accounting report, difficulties in asset appraisal and lack of transparency.

8.18 Consolidation, among others, has implications for financial stability and monetary policy. With the increase in the size of banks and concentration of

banking activities in a few megabanks, various types of risks such as operational risk, contagion risk and systemic risk could increase. Consolidation impacts market power which can have adverse effects on the yield curve by impeding interest rate arbitrage, lending to borrowers and the value of collateral, in turn, affecting the channels of monetary policy transmission (Box VIII.1).

III. RECENT TRENDS IN MERGERS AND ACQUISITIONS IN THE BANKING INDUSTRY

8.19 The number of M&As increased in the advanced countries in recent years. Insofar as EMEs are concerned, while in some countries M&As activity accelerated in recent years, in some other countries, it slowed down. However, the value of M&As increased

Box VIII.1
Consolidation and Its implications for Financial Stability and Monetary Policy

Banking consolidation, irrespective of the motives and types, gives rise to several challenges, of which the implications on financial stability and monetary policy are important ones. It is emphasised that even though there are several potentials for reducing the financial risk through geographical and product diversification at the individual firm level, consolidation leading to creation of megabanks could heighten various types of financial risks at the macroeconomic level. In fact, understanding the financial stability implications of evolving state ownership of banks after consolidation and also increasing presence of foreign banks is a high priority in policy makers' agenda in various countries. Operational risk could increase with the size of operations, as the distance between management and operational personnel is greater in large companies and the administrative systems are more complex. The transparency of the operations could also deteriorate with increase in size, particularly with regard to cross-border mergers, rendering detection of potential crises in time by the authorities difficult. The contagion risk, *i.e.*, problems arising in an individual bank spreading to others, also increases with size, as banks' exposures against one another rise along with the size of operations. Evidence suggests that the inter-dependencies, which are positively correlated with consolidation, have increased among large and complex financial institutions. Further, the consolidating institutions are found to shift their portfolios towards higher risk-return investment. Consequently, the concerns about systemic risk are heightened, as concentration of banking activities in few megabanks would mean that given their wholesale activities, any shock could have repercussions to the financial system and the real economy. For a small host nation, cross-border financial integration would mean increase in possibility of even a medium-sized foreign bank becoming a source of instability, and also increased probability of losing domestic ownership of its major banks.

The increased potential for systemic risk further intensifies the concerns for these banks being considered 'too-big-to-fail', which gives rise to the problem of moral hazard. Because of the increased potential systemic instability from impairment of such large banks, whatever be the *ex ante* declaration, the perception of the general public would be that the Government would not allow these banks to fail, and therefore, *ex post* provide bailout. Because of this perceived implicit or explicit guarantee by the Government, the risk taking behavior of these banks could increase, thereby further enhancing the systemic risk. It is, however, not possible to formulate a specific criteria on when a bank becomes 'too big to fail', though it may be concluded that there is a certain critical level with regard to the bank's importance in the economy and the financial system.

Consolidation leads to greater concentration of payment and settlement flows among few parties within the financial sector. Such concentration implies that if a major payment processor were to fail or were not able to process payment orders, systemic risks could arise. The emergence of multinational institutions and specialised service providers indulging in payment and settlement systems in different countries coupled with increasing inter-dependence of liquidity among them accentuate the potential role of payment and settlement systems in the transmission of contagion effects.

Monetary policy decisions are influenced by the behavior of financial firms and markets. The consolidation process by altering them has also a number of implications in the conduct of monetary policy. Consolidation can reduce competition in the markets, increase the cost of liquidity for some and impede the arbitrage of interest between markets. The performance of the markets could also be affected if the resulting large banks behave differently from their small predecessors. The impeding of arbitrage along the yield curve due to reduced competition would affect the monetary policy channel of transmission effected through interest rates across financial markets. The exercise of market power by the banks resulting from consolidation could also alter the monetary transmission operating through bank lending to borrowers without direct access to financial markets. Consolidation could also affect the way monetary policy affects the value of collateral, and, thus, on the availability of credit to those requiring collateral to obtain funds.

manifold in several countries, including those where M&As activities slowed down (Table 8.1).

8.20 Much of the consolidation activity in France took place during the 1990s among small banks leading to a large reduction in the total number of banking institutions. Similarly, in Germany consolidation took place among smaller savings and co-operative banks and the number of banks declined by about a third during the 1990s. Following consolidation, the number of banks in Italy also declined by more than a third during the same period. A combination of dismantling of restrictions on inter-state and intra-state banking, removal of interest rate ceilings on small time and savings deposits and permission on diversification of activities paved the way for mergers between banks and non-bank financial companies in the US during the 1990s. The consolidation that followed resulted in substantial growth, in both absolute and relative terms, by the largest institutions. In the UK, the regulatory reforms during the 1980s and the 1990s removed restrictions on financial institutions to compete across traditional business lines. This enabled the development of universal banking and led to growth of international banking and conversion of building societies into banks. Consequently, the number of banks in UK increased substantially before declining by almost 20 per cent following subsequent consolidation.

Table 8.1: Cross-Country Bank Mergers and Acquisitions

	Number		Value (US $ million)	
Country	1995-1999	2000-04	1995-1999	2000-04
1	2	3	4	5
UK*	7	52	1,137	20,376
Germany*	22	84	13,100	34,023
Italy*	36	121	12,953	153,346
Japan*	18	58	8,892	41,069
Hong Kong	0	14	0	–
Singapore	8	8	2,900	11,400
Korea	11	7	14,360	27,410
Indonesia	1	0	–	0
Malaysia	2	16	20	3,020
Philippines	2	13	6,900	17,740
Thailand	5	2	57,700	28,000
Chile	5	6	870	1,220
Colombia	9	11	40	33
Mexico	8	5	81,900	170,600
Czech Republic	9	3	–	–
Hungary	11	9	8,620	17,990
Poland	23	30	–	–

* : Based on Bloomberg database for the sub-periods 1997-2000 and 2001-2007. Value may not necessarily represent the amount of all deals.

– : Not Available

Source : BIS (2006) and Bloomberg.

8.21 In Canada, domestic banks traditionally controlled a large share of the banking sector. Owing to the dominance of the banking industry by a few banks, consolidation is regulated through a guideline established in 2000 to ensure that it does not lead to unacceptable level of concentration and drastic reduction in competition and reduced policy flexibility in addressing future prudential issues. Thus, not much consolidation took place during the 1990s and the number of banks did not decline much from the substantial increase observed during the 1980s due to entry of foreign banks. In Japan also, little consolidation took place during the 1990s and there was only a modest reduction in the number of banks at the end of the 1990s following some bank failures.

8.22 The banking industry in Sweden during the 1990s experienced the merger of co-operative banks into one commercial bank and transformation of the largest savings banks into one banking group. Further, there was consolidation among all the major banking groups. While all the above mergers reduced the number of banks, the total number of banks increased somewhat due to entry of foreign banks and the establishment of several 'niche banks' around the same time.

8.23 The banking consolidation since the 1990s resulted in a substantial decline in the number of banks in many emerging market and advanced economies. In US, about 25-30 per cent of banks have closed or merged due to consolidation in last two to three decades (Nitsure, 2008). In fact, the banking systems in EMEs have generally continued to evolve towards more private and foreign-owned structures, with fewer commercial banks and often smaller number of bank branches. In some countries, these trends have been the result of post-crisis weeding-out of weak financial institutions, and mergers encouraged by the authorities (for instance, Indonesia, Malaysia and Thailand). Elsewhere, these developments have been mostly market-driven (for instance, central Europe and Mexico) (Table 8.2).

IV. CONSOLIDATION AND COMPETITION IN INDIA

8.24 The banking sector reforms undertaken in India from 1992 onwards were aimed at ensuring the safety and soundness of financial institutions and at the same time making them efficient, functionally diverse and competitive. Financial sector reforms

Table 8.2: Number of Commercial Banks

Country	2001	2005	Percentage Variation
1	2	3	4
Advanced Economies			
Denmark	190	161	-15.3
France	444	294	-33.8
Germany	304	251	-17.4
Greece	44	21	-52.3
Italy	830	784	-5.5
Japan	234	215	-8.1
Korea	20	13	-35.0
Singapore	128	110	-14.1
Spain	285	272	-4.6
UK	398	333	-16.3
US	8,075	7,515	-6.9
Emerging Economies			
Peru	15	12	-20.0
Philippines	42	41	-2.4
Poland	69	54	-21.7
Argentina	86	71	-17.4
Brazil	180	161	-10.6
Chile	27	26	-3.7
Mexico	32	29	-9.4
Egypt	53	43	-18.9
India	100	88	-12.0
Israel	26	15	-42.3
South Africa	59	34	-42.4

Source: World Bank Database on Regulation and Supervision.

provided banks with operational flexibility and functional autonomy. Reforms also brought about structural changes in the financial sector by recapitalising them, allowing profit making banks to access the capital market and enhancing the competitive element in the market through the entry of new banks. Apart from achieving greater efficiency by introducing competition through the new private sector banks and increased operational autonomy to public sector banks, reforms in the banking system were also aimed at enhancing financial inclusion, funding of economic growth and better customer service to the public.

8.25 The Government and the Reserve Bank provided the enabling environment through an appropriate fiscal, regulatory and supervisory framework for the consolidation of financial institutions and at the same time ensured that a few large institutions did not create an oligopolistic structure in the market (Talwar, 2001). Competitive conditions in the Indian banking sector were strengthened by relaxing entry and exit norms and the increased presence of foreign banks. In February 2005, with a view to further enhancing the efficiency and stability of the banking system, a two-track and gradualist approach was adopted by the Reserve Bank. One track was consolidation of the domestic banking system in both the public and private sectors. The second track was gradual enhancement of the presence of foreign banks in a synchronised manner (Annex VIII.1). The regulatory framework, however, varies for different segments of the banking sector in India.

Mergers and Amalgamations: Regulatory Framework

8.26 The regulatory framework for M&As in the banking sector is laid down in the Banking Regulation (BR) Act, 1949. In the post-Independence era, the legal framework for amalgamations of banks in India was provided in the Act. The Act provides for two types of amalgamations, *viz.,* (i) voluntary and (ii) compulsory. For voluntary amalgamation, Section 44A of the BR Act provides that the scheme of amalgamation of a banking company with another banking company is required to be approved individually by the board of directors of both the banking companies and subsequently by the two-thirds shareholders (in value) of both the banking companies. Further, Section 44A of the BR Act requires that after the scheme of amalgamation is approved by the requisite majority in number representing two-third in value of shareholders of each banking company, the case can be submitted to the Reserve Bank for sanction. However, the Reserve Bank has the discretionary powers to approve the voluntary amalgamation of two banking companies under section 44A of the BR Act.

8.27 The experience of the Reserve Bank has been, by and large, satisfactory in approving the schemes of amalgamation of private sector banks in the recent past and there has been no occasion to reject any scheme of amalgamation submitted to it for approval. There have been six voluntary amalgamations between the private sector banks so far, while one amalgamation between two private sector banks (Ganesh Bank of Kurundwad and the Federal Bank) was induced by the Reserve Bank in the interest of the depositors of one of the banks. Most of these voluntary mergers was between healthy banks, somewhat on the lines suggested by the first Narasimham Committee. The Committee was of the view that the move towards the restructured organisation of the banking system should be market-driven and based on profitability considerations and brought about through a process of M&As (Leeladhar, 2008)

8.28 Insofar as compulsory amalgamations are concerned, these are induced or forced by the Reserve Bank under Section 45 of the BR Act, in public interest, or in the interest of the depositors of a distressed bank, or to secure proper management of a banking company, or in the interest of the banking system. In the case of a banking company in financial distress, the Reserve Bank under Section 45(2) of the BR Act may apply to the Central Government for an order of moratorium in respect of a banking company and during the period of such moratorium, may prepare a scheme of amalgamation of the banking company with any other banking institution (banking company, nationalised bank, SBI or its subsidiary). Such a scheme framed by the Reserve Bank is required to be sent to the banking companies concerned for their suggestions or objections, including those from the depositors, shareholders and others. After considering the same, the Reserve Bank sends the final scheme of amalgamation to the Central Government for sanction and notification in the official gazette. The notification issued for compulsory amalgamation under Section 45 of the BR Act is also required to be placed before the two Houses of Parliament. The amalgamation becomes effective on the date indicated in the notification issued by the Government in this regard.

8.29 In the case of voluntary merger or acquisition of any financial business by any banking institution, there was no provision under the BR Act for obtaining approval of the Reserve Bank. In order to revisit the regulatory, legal, accounting and human relations related issues, which may arise in the process of consolidation in Indian banking system, the Working Group (Chairman: Shri V. Leeladhar) was constituted by the Indian Banks' Association. The Group in its Report titled "Consolidation in Indian Banking System" submitted in 2004 highlighted the need for making an omnibus provision in the BR Act requiring any banking institution to obtain prior approval of the Reserve Bank before acquiring any other business or any merger or amalgamation of any other business of banking institution or non-banking financial institution, with absolute right to the Reserve Bank to finalise the swap ratio which should be made binding on all concerned.

8.30 The Reserve Bank, on the recommendations of the Joint Parliamentary Committee (2002), had constituted a Working Group to evolve guidelines for voluntary mergers involving banking companies. Based on the recommendations of the Group, the Reserve Bank announced guidelines in May 2005 laying down the process of merger proposal, determination of swap ratios, disclosures, the stages at which boards will get involved in the merger process and norms of buying/selling of shares by the promoters before and during the process of merger. Voluntary amalgamation of a non-banking company with a banking company is governed by sections 391 to 394 of the Companies Act, 1956 and the scheme of amalgamation has to be approved by the High Court. However, to ensure the continued strenght of merged entity, it has been provided in the guidelines that in such cases, the banking company should obtain the approval of the Reserve Bank of India after the scheme of amalgamation approved by its Board but before it is submitted to the High Court for approval.

8.31 In both situations, whether a non-banking company amalgamates with a banking company or amalgamation is among banking companies, the Reserve Bank ensures that amalgamations are normally decided on business considerations. For this, the Reserve Bank also laid down guidelines, to which boards of directors should give consideration during the merger process. These guidelines mainly relate to (i) values of assets and liabilities and the reserves of amalgamated entity proposed to be incorporated into the book of amalgamating banking company; (ii) swap ratio to be determined by competent independent valuers; (iii) shareholding pattern; (iv) impact on profitability and, capital adequacy of the amalgamating company; and (v) conformity of the proposed changes in the composition of board of directors with the Reserve Bank guidelines in that context (Box VIII. 2).

8.32 The statutory framework for the amalgamation of public sector banks, *viz*., nationalised banks, State Bank of India and its subsidiary banks, is, however, quite different since the foregoing provisions of the BR Act do not apply to them. As regards the nationalised banks, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980, or the Bank Nationalisation Acts authorise the Central Government under Section 9(1)(c) to prepare or make, after consultation with the Reserve Bank, a scheme, *inter alia*, for the transfer of undertaking of a 'corresponding new bank' (*i.e*., a nationalised bank) to another 'corresponding new bank' or for the transfer of whole or part of any banking institution to a corresponding new bank. Unlike the sanction of the schemes by the Reserve Bank under Section 44A of the BR Act, the scheme framed by the Central Government is required, under Section

Box VIII.2
Guidelines on Mergers and Amalgamations of Banks

The guidelines on merger and amalgamation announced by the Reserve Bank in May 2005, *inter alia,* stipulated the following:

- The draft scheme of amalgamation be approved individually by two-thirds of the total strength of the total members of board of directors of each of the two banking companies.
- The members of the boards of directors who approve the draft scheme of amalgamation are required to be signatories of the Deed of Covenants as recommended by the Ganguly Working Group on Corporate Governance.
- The draft scheme of amalgamation be approved by shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of shareholders, present in person or by proxy at a meeting called for the purpose.
- The swap ratio be determined by independent valuers having required competence and experience; the board should indicate whether such swap ratio is fair and proper.
- The value to be paid by the respective banking company to the dissenting shareholders in respect of the shares held by them is to be determined by the Reserve Bank.
- The shareholding pattern and composition of the board of the amalgamating banking company after the amalgamation are to be in conformity with the Reserve Bank's guidelines.
- Where an NBFC is proposed to be amalgamated into a banking company in terms of Sections 391 to 394 of the Companies Act, 1956, the banking company is required to obtain the approval of the Reserve Bank before the scheme of amalgamation is submitted to the High Court for approval.

9(6) of the Bank Nationalisation Acts, to be placed before the both Houses of Parliament. Under this procedure, the only merger that has taken place so far relates to the amalgamation of the erstwhile New Bank of India with Punjab National Bank, on account of the weak financials of the former. As regards the State Bank of India (SBI), the SBI Act, 1955, empowers the State Bank to acquire, with the consent of the management of any banking institution (which would also include a banking company), the business, including the assets and liabilities of any bank. Under this provision,the consent of the bank sought to be acquired, the approval of the Reserve Bank, and the sanction of such acquisition by the Central Government are required. Several private sector banks were acquired by State Bank of India following this route. However, so far, no acquisition of a public sector bank has taken place under this procedure. Similar provisions also exist in respect of the subsidiary banks of the SBI. Thus, there are sufficient enabling statutory provisions in the extant statutes governing the public sector banks to encourage and promote consolidation even among public sector banks through the merger and amalgamation route, and the procedure to be followed for the purpose has also been statutorily prescribed.

8.33 In short, the primary objective of the Reserve Bank/Government in the process of consolidation is to ensure that mergers are not detrimental to the public interest, bank concerned, their depositors and shareholders, and also that they do not impinge on financial stability. Thus, the Reserve Bank ensures that after a merger, acquisition, reconstruction or takeover, the bank or banking group has adequate financial strength and the management has sufficient expertise and integrity.

Trends in Mergers and Amalgamations

8.34 Consolidation of banks through M&As is not a new phenomenon for the Indian banking system, which has been going on for several years. Since the beginning of modern banking in India through the setting up of English Agency House in the 18th century, the most significant merger in the pre-Independence era was that of the three Presidency banks founded in the 19th century in 1935 to form the Imperial Bank of India (renamed as State Bank of India in 1955).

8.35 In 1959, State Bank of India acquired the state-owned banks of eight former princely States. In order to strengthen the banking system, Travancore Cochin Banking Enquiry Commission (1956) recommended for closure/amalgamation of weak banks. Consequently, through closure/ amalgamations that followed, the number of reporting commercial banks declined from 561 in 1951 to 89 in June 1969. Merger of banks took place under the direction of the Reserve Bank during the 1960s. During 1961 to 1969, 36 weak banks, both in the public and private sectors, were merged with other stronger banks.

8.36 There have been several bank amalgamations in India in the post-reform period. In all, there have been 33 M&As since the nationalisation of 14 major

banks in 1969. Of these mergers, 25 involved mergers of private sector banks with public sector banks, while in the remaining eight cases, mergers involved private sector banks. Out of 33, 21 M&As took place during the post-reform period with as many as 17 mergers/ amalgamations taking place during 1999 and after (Table 8.3)[1]. Prior to 1999, the amalgamations of banks were primarily triggered by the weak financials of the bank being merged, whereas in the post-1999 period, there have also been mergers between healthy banks, driven by the business and commercial considerations (Leeladhar, 2008).

Table 8.3: Banks Amalgamated since Nationalisation of Banks in India

Sr. No.	Name of Transferor Bank/Institution	Name of Transferee Bank/Institution	Date of Amalgamation
1	2	3	4
1.	Bank of Bihar Ltd.	State Bank of India	November 8, 1969
2.	National Bank of Lahore Ltd.	State Bank of India	February 20, 1970
3.	Miraj State Bank Ltd.	Union Bank of India	July 29, 1985
4.	Lakshmi Commercial Bank Ltd.	Canara Bank	August 24, 1985
5.	Bank of Cochin Ltd.	State Bank of India	August 26, 1985
6.	Hindustan Commercial Bank Ltd.	Punjab National Bank	December 19, 1986
7.	Traders Bank Ltd.	Bank of Baroda	May 13, 1988
8.	United Industrial Bank Ltd.	Allahabad Bank	October 31, 1989
9.	Bank of Tamilnadu Ltd.	Indian Overseas Bank	February 20, 1990
10.	Bank of Thanjavur Ltd.	Indian Bank	February 20, 1990
11.	Parur Central Bank Ltd.	Bank of India	February 20, 1990
12.	Purbanchal Bank Ltd.	Central Bank of India	August 29, 1990
13.	New Bank of India	Punjab National Bank	September 4, 1993
14.	Kashi Nath Seth Bank Ltd.	State Bank of India	January 1, 1996
15.	Bari Doab Bank Ltd.	Oriental Bank of Commerce	April 8, 1997
16.	Punjab Co-operative Bank Ltd.	Oriental Bank of Commerce	April 8, 1997
17.	Bareilly Corporation Bank Ltd.	Bank of Baroda	June 3, 1999
18.	Sikkim Bank Ltd.	Union Bank of India	December 22, 1999
19.	Times Bank Ltd.	HDFC Bank Ltd.	February 26, 2000
20.	Bank of Madura Ltd.	ICICI Bank Ltd.	March 10, 2001
21.	ICICI Ltd.	ICICI Bank Ltd.	May 3, 2002
22.	Benares State Bank Ltd.	Bank of Baroda	June 20, 2002
23.	Nedungadi Bank Ltd.	Punjab National Bank	February 1, 2003
24.	South Gujarat Local Area Bank Ltd.	Bank of Baroda	June 25, 2004
25.	Global Trust Bank Ltd.	Oriental Bank of Commerce	August 14, 2004
26.	IDBI Bank Ltd.	IDBI Ltd	April 2, 2005
27.	Bank of Punjab Ltd.	Centurion Bank Ltd.	October 1, 2005
28.	Ganesh Bank of Kurundwad Ltd.	Federal Bank Ltd.	September 2, 2006
29.	United Western Bank Ltd.	IDBI Ltd.	October 3, 2006
30.	Bharat Overseas Bank Ltd.	Indian Overseas Bank	March 31, 2007
31.	Sangli Bank Ltd.	ICICI Bank Ltd.	April 19, 2007
32.	Lord Krishna Bank Ltd.	Centurion Bank of Punjab Ltd.	August 29, 2007
33.	Centurion Bank of Punjab Ltd.	HDFC Bank Ltd.	May 23, 2008

Source: Report on Trend and Progress, RBI, Various Issues.

[1] On February 25, 2008, the respective boards of the HDFC Bank and Centurion Bank of Punjab approved the merger of the latter bank with the former.

8.37 More recently the process of M&As in the Indian banking sector has been generally market driven. Given the policy objective of mergers, most of the mergers between banks in India have taken place voluntarily for strategic purposes. Given the difficulty of small banks to compete with large banks, which enjoy enormous economies of scale and scope, the Reserve Bank has been encouraging the consolidation process, wherever possible. Most of the amalgamations of private sector banks in the post-nationalisation period were induced by the Reserve Bank in the larger public interest, under Section 45 of the Act. In all these cases, the weak or financially distressed banks were amalgamated with the healthy banks. The over-riding principles governing the consideration of the amalgamation proposals were: (a) protection of the depositors' interest; (b) expeditious resolution; and (c) avoidance of regulatory forbearance. The amalgamations of the erstwhile Global Trust Bank and United Western Bank with public sector banks are recent examples of such mergers. Even in such cases, commercial interests of the transferee bank and the impact of the amalgamation on its profitability were duly considered. The mergers of many weak private sector banks with the healthy ones have brought the Indian banking sector to a credible position, as the CRAR of all private sector banks in the country was more than the minimum regulatory requirement of nine per cent as at end-March 2007.

8.38 M&As in India have also been used as a tool for strengthening the financial system. Through a conscious approach, the weak and small banks have been allowed to merge with stronger banks to protect the interests of depositors, avoid possible financial contagion that could result from individual bank failures and also to reap the benefits of synergy. Thus, the Indian approach has been different from that of many other EMEs, wherein the Governments were actively involved in the consolidation process. For instance, in East-Asia, after the banking crisis in 1997, the Government led the process of bank mergers in order to strengthen capital adequacy and the financial viability of many smaller and often family-owned banks. In these crisis ridden countries, the involvement of the Government was inevitable, as viable but distressed institutions were hardly in a position to attract potential buyers without moving some non-performing loans to an asset management company and/or receiving temporary capital support. Such intervention also proved more cost-effective than taking the bank into public ownership. However, with the intensification in competition through deregulation, privatisation and entry of foreign banks in the emerging markets, consolidation is becoming more market-driven (Box VIII. 3).

8.39 The consolidation process in the banking sector in India in recent years was confined to mergers in the private sector and some consolidation in the state-owned sector. After nationalisation of banks in 1969, India did not allow entry of private sector banks untill January 1993, when barriers to entry for private sector banks were removed. India also liberalised the entry of foreign banks in the post-reform period. These liberalised measures resulted in entry of many new banks (private and foreign). Accordingly, the number of banks increased during the initial phase of financial sector reforms. However, the pace of consolidation process gathered momentum from 1999-2000, leading to a marked decline in the number of private and foreign banks (Table 8.4). In February 2005, providing a comprehensive framework of policy relating to ownership and governance in private sector banks, the Reserve Bank prescribed that the capital requirement of existing private sector banks should be on par with the entry capital requirement for new private sector banks prescribed on January 3, 2001, according to which, banks are required to have capital initially of Rs. 200 crore, with a commitment to increase to Rs.300 crore within three years from commencement of business. In order to meet this requirement, all banks in the private sector should have a net worth of Rs. 300 crore at all times. Thus, post-2005 period, amalgamations/mergers have resulted partly from these guidelines. The number of scheduled commercial banks (SCBs) declined to 82 at end-March 2007 from 100 at end-March 2000 due to merger of some old private sector banks. In recent years, in the case of some troubled banks, the only option available with the Reserve Bank was to compulsorily merge them with stronger banks under section 45 of the Banking Regulation Act, 1949. These included amalgamation of Global Trust Bank with Oriental Bank of Commerce in August 2004, Ganesh Bank of Kurundwad Ltd. with Federal Bank Ltd. in September 2006 and the United Western Bank with IDBI Ltd. in October 2006.

8.40 Mergers and amalgamations involved relatively smaller banks. The largest number of mergers took place with ICICI Bank, Bank of Baroda and Oriental Bank of Commerce (each one of them was involved in three mergers). ICICI Bank replaced many entities to occupy the second position in the Indian banking sector after State Bank of India. In the Banker's list of the top 1000 banks of the world

Box VIII.3
Market driven versus Government-led Bank Consolidation: Cross-Country Experience

While the rationale and the driving factors behind the consolidation process might have undergone change inter-temporally and varied across countries, two distinct dimensions broadly emerge from the history of bank consolidations, *viz.,* market driven *vis-à-vis* government led consolidation.

A large number of banking consolidations since the early twentieth century followed from the Government policy to consolidate either on account of efforts to restructure inefficient banking systems or from intervention following the crisis. In Japan, the Bank Law of 1927 set the minimum capital criterion for banks, which came as a powerful measure for the Government to promote bank consolidation. Likewise, during the 1920s in the US, agriculture distress produced a wave of small bank failures, necessitating the repeal of many State laws prohibiting branch banking. In the emerging markets of South-East Asia and Latin America, much of the banking consolidation since the 1990s has been government-driven following the need to redress the distress within the financial system. During the financial crisis in 1997, the Korean Government accorded the top priority to financial sector restructuring through the earliest possible resolution of unsound financial institutions. The Government acted swiftly and decisively to close down financial institutions deemed non-viable after an exhaustive review of their financial situations. Somewhat similar phenomenon was observed in Malaysia, Indonesia and the Philippines. The Taiwanese Government also promoted consolidation in the financial sector in recent years. Similarly in Latin America, following numerous episodes of financial sector crises, the number of banks in the region declined significantly mainly through government efforts to restructure and consolidate the banking system. In Japan, realising the emergence of NPLs and lack of prudent risk management, Government steered some of the mergers in the overcrowded Japanese banking system during the 1990s.

On the other hand, the bank consolidation process since 1984 in the US, though facilitated by some legislative changes, was also an outcome of market-led forces. During the 1980s, many banks in the US experienced large loan losses and profits associated with depressed economy and excessive risk taking (Shull and Hanweck, 2001). Bank failures rose to high levels resulting in substantial number of mergers and acquisitions by better capitalized and profitable banks. These developments led to substantial improvements in profitability and capitalisation of banks in 1990s. With the onset of improved performance of banks, the number of mergers attributable to bank failures decreased but the number of mergers continued to increase on account of policy permissiveness in the US. The strict regulatory environment that existed before the 1980s largely precluded any dramatic consolidation within the US banking industry. Consolidation of the banking industry began in the earnest only after the regulatory constraints were relaxed in the early 1980s through a decade-long process of deregulating the banking and thrift industries so that they could be more responsive to marketplace realities (Jones and Critchfield, 2005). The removal of geographical restrictions on bank branching and holding company acquisitions by the individual states by the Reagle-Neal Interstate Banking and Branch Efficiency Act of 1994 greatly facilitated bank consolidation. Most of the bank acquisitions were carried out with the aim of securing consistent earnings growth in the future. The saturated markets offered limited organic growth potential, while the banks' balance sheets were strong. Thus, there was the need to grow *via* mergers and acquisitions for ensuring long-term earnings. This trend sometimes also led to increased market pressure for banks and financial institutions in other mature economies to keep pace and consolidate in their home markets. In the case of EU commercial banks, the banks responded to the new operating environment by adapting their strategies, seeking new distribution channels and changing their organisational structures. Thus, increased competition has been considered the main driving force behind the acceleration in the consolidation process in the EU economies (Casu and Girardone, 2007).

In Central and Eastern Europe and Mexico, the bank consolidation process that started in the late 1990s, has also been more market-driven with the foreign banks playing an important role. Political action, however, has influenced the process of consolidation in some but not all European markets. For instance, the very good performance of big Italian banks was enabled by the privatisation of the savings banks. Similarly, domestic consolidation in France was encouraged through the formation of "national champions". It is being observed that multiple forces have been at play to motivate consolidation deals, both within European countries and cross-border. These forces resulting in market driven consolidation process included the fragmented market, foreign competition, deregulation, technological innovation and the introduction of a single currency. For instance, 'Bank Consolidation Program' in Poland involved pooling of state-owned banks in order to increase their market share and efficiency.

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Table 8.4: New Private Sector and Public Sector Banks and Bank Mergers in India

Year	Number of Bank Mergers	New Banks Set Up			No. of Banks (at the end of March)
		Private	Foreign	Public Sector Banks	
1	2	3	4	5	6
1989-90	4	0	0	0	75
1990-91	1	0	2	0	74
1991-92	0	1	0	0	77
1992-93	0	0	0	0	77
1993-94	1	0	0	0	74
1994-95	0	8	4	0	86
1995-96	1	2	4	0	92
1996-97	0	1	8	0	101
1997-98	2	0	4	0	103
1998-99	0	0	8	0	105
1999-2000	3	0	1	0	100
2000-01	1	0	0	0	99
2001-02	0	1	4	0	98
2002-03	3	0	1	0	92
2003-04	0	1	1	0	90
2004-05	2	1	0	1*	88
2005-06	2	1	0	0	84
2006-07	3	0	1	0	82

– : Not available.
* : After merger of IDBI Bank Ltd. with IDBI, IDBI Ltd. is classified as other public sector bank. Apart from mergers and setting up of new banks, change in number of banks over the years is also on account of closure of some banks.

Table 8.5: Ranking of Indian Banks Among World's Top 1000 Banks

(As on March 31, 2006)

Sr. No.	Name of Bank	Overall Ranking	Assets (US$ Million)
1	2	3	4
1	State Bank of India *	70	186,988
2	ICICI Bank	147	56,258
3	Punjab National Bank	255	32,509
4	Bank of Baroda *	259	33,690
5	Canara Bank *	281	38,069
6	IDBI	329	20,209
7	HDFC Bank*	335	20,945
8	Oriental Bank of Commerce	378	13,190
9	Bank of India	411	25,126
10	Indian Overseas Bank *	414	18,868
11	Union Bank of India	495	19,945
12	Corporation Bank	507	9,079
13	Andhra Bank *	533	10,905
14	Allahabad Bank	548	12,374
15	Central Bank of India	561	16,713
16	UTI Bank	580	11,129
17	Syndicate Bank	601	13,668
18	Indian Bank	623	10,660
19	UCO Bank	699	13,839
20	United Bank of India *	708	9,700
21	Jammu & Kashmir Bank	744	5,919
22	Vijaya Bank	722	7,057
23	Bank of Maharashtra	805	6,989
24	Federal Bank	904	4,620
25	Punjab & Sind Bank	916	4,262
26	Karnatak Bank	962	3,346
27	Dena Bank	988	5,941

* : Data pertain to March 2007.
Note : Ranking of the banks is by the size of Tier I capital.
Source : The Banker, July 2007.

(July 2007), there were 27 Indian banks (as compared with 20 in July 2004). Of these, 11 banks were in the top 500 banks (as compared with 6 in July 2004) (Table 8.5). Even within Asia, India's largest banks, *viz*., SBI and ICICI Bank held 11th and 25th place, respectively.

8.41 The combined assets of the five largest Indian banks, *viz*., State Bank of India, ICICI Bank, Punjab National Bank, Canara Bank and Bank of Baroda, on March 31, 2006 were about 51.0 per cent of the assets of the largest Chinese bank, Bank of China, which was roughly 3.6 times larger than State Bank of India. Even in the Asian context, only one Indian bank – State Bank of India – figures in the top 25 banks based on Tier I capital, even though Indian banks offer the highest average return on capital among Asian peers. The total assets of State Bank of India were less than 10.0 per cent of the top three banks in the world. However, the size of State Bank of India was larger than the largest bank operating in some emerging markets such as Korea and Brazil. In a way, this suggests that the size of bank and the banking sector depends on the size of the economy (Table 8.6).

8.42 The mergers of regional rural banks (RRBs) have taken place on a large scale in India since September 2005. Mergers of RRBs were largely policy driven in pursuance of the recommendations of the Committee on the "Flow of Credit to Agriculture and Related Activities" (Chairman: Prof. V.S. Vyas). The Committee in its Report submitted in June 2004 had recommended restructuring of RRBs in order to improve the operational viability of RRBs and take advantage of the economies of scale. In order to reposition RRBs as an effective instrument of credit delivery in the Indian financial system, the Government of India, after consultation with NABARD, the concerned State Governments and the sponsor banks, initiated State-level sponsor bank-wise amalgamation of RRBs to overcome the deficiencies prevailing in RRBs and making them viable and

Table 8.6: The Relative Size of the Largest Bank of India vis-à-vis the Largest Banks in Select Countries

Sr. No.	Bank	Country	Assets (US million)	Relative size of SBI *vis-à-vis* Largest Banks in other Countries (per cent)
1	2	3	4	5
1.	UBS	Switzerland	1,963,870	9.5
2.	Barclays Bank	UK	1,956,786	9.6
3.	Citigroup	US	1,882,556	9.9
4.	Mitsubishi UFJ Financial Group	Japan	1,579,390	11.8
5.	Deutsche Bank	Germany	1,483,248	12.7
6.	ABN Amro Bank	The Netherlands	1,299,966	14.4
7.	ICBC	China	961,576	19.4
8.	National Australia Bank	Australia	331,408	56.4
9.	Kookmin Bank	Korea	180,805	103.4
10.	Banco Itau Holding Financeira	Brazil	98,124	190.6
11.	State Bank of India	India	186,988	—

Source: The Banker, July 2007.

profitable units. Consequent upon the amalgamation of 154 RRBs into 45 new RRBs, sponsored by 20 banks in 17 States, effected by the Government of India, the total number of RRBs declined from 196 to 88 as on May 1, 2008 (which includes a new RRB set up in the Union Territory of Puducherry). The structural consolidation of RRBs has resulted in the formation of new RRBs, which are financially stronger and bigger in size in terms of business volume and outreach and would enable them to take advantage of the economies of scale and reduce their operational costs.

8.43 Consolidation has also been seen as one of the exit routes for non-viable urban co-operative banks in India. The process of merger of weak entities with stronger ones was set in motion by providing transparent and objective guidelines for granting no-objection to merger proposals. The Reserve Bank, while considering proposals for merger/ amalgamation, confines its approval to the financial aspects of the merger taking into consideration the interests of depositors and financial stability. Almost invariably it is a voluntary decision of the banks that approach the Reserve Bank for obtaining no objection for their merger proposal. The guidelines on mergers are intended to facilitate the process by delineating the pre-requisites and steps to be taken for merger between banks. As on October 30, 2007, a total of 33 mergers had been effected upon the issue of statutory orders by the Central Registrar of Co-operative Societies/Registrar of Co-operative Societies (CRCS/ RCS) concerned (RBI, 2007).

V. MERGERS AND ACQUISITIONS: IMPACT ON COMPETITION AND EFFICIENCY IN INDIA

8.44 A good deal of debate on competition effects of bank consolidation has been phrased in terms of two competing hypotheses. The structure-conduct-performance paradigm argues that concentration will intensify market power and thereby stymie competition and efficiency. In contrast, the efficiency paradigm argues that economies of scale drive bank mergers and acquisitions, so that increased concentration goes hand-in-hand with efficiency improvements.

8.45 The impact of consolidation through M&As on competition operates through a number of channels, and among others, depends on the market structure, the nature of competition and the regulatory and supervisory framework. The competition effect would depend on the degree of concentration, the degree of entry barriers, the heterogeneity of products and price differentiation allowed. Depending on the level of competition of the banking industry, consolidation influences the provision of credit to different customer groups. Cross-country analysis does not provide support for the view that bank concentration is closely associated with banking sector efficiency, financial development, industrial competition, general institutional development, or the stability of the banking system. In fact, the impact of M&As on competition in the banking sector has not been uniform (Box VIII. 4).

8.46 M&As, especially market driven, are aimed at stepping up size (market powers) and maximising value (revenue) by exploiting economies of scale and scope, risk diversification and strengthening capital. Most recent studies have found unexploited scale economies even for larger banks in the US (Berger and Mester, 1997; Berger and Humphrey, 1997) and in Europe (Allen and Rai, 1996 and Vander Vennet, 2001). In the presence of excess capacity, some banks are bound to operate below efficient scale and may also have an inefficient product mix and, therefore, may be inside the efficiency frontier. In such a situation, M&As may help solve these problems more efficiently rather than outright bankruptcies because they preserve the franchise values of the merging banks (Huizinga *et al,* 2001).

Box VIII.4
Impact of Consolidation on Competition: Cross-country Evidence

Consolidation process may be a response to tackle the increased competition but it also affects potential competition. The primary factor that affects potential competition is the relative position of both merging entities in the banking system. For instance, merger of banks operating at the lower end of the banking system may have little implications for potential competition. Consolidation may affect competition through increase in the market concentration. Generally, in the case of financial industry, full contestability does not hold due to entry barriers directly imposed by regulatory authorities, inherent features in firms' cost structures and relatively inelastic customer demand.

The effect of concentration on competition also depends on whether firms compete on quantities or prices. In the first case, it is straightforward to show that the smaller the number of firms, the closer is the market outcome to monopoly. In the second case, the effect depends on the heterogeneity of products; the more heterogeneous the products are, the greater is the market power of firms. Firms tend to adopt niche strategies in order to differentiate products beyond their essential characteristics.

The effects of consolidation on competition is evaluated either directly by studying markets that have experienced consolidation or indirectly in cross-sectional studies comparing markets with different degrees of concentration at a point of time. Most of these studies find that M&As may have influenced market prices. In the US, a reduction in the interest rate on deposits is detected in markets that have been affected by consolidation (Prager and Hannan, 1998). Estimates of the impact of mergers on prices for the Swiss retail banking market indicate that concentration may have a negative effect on prices (Egli and Rime, 2000). In the M&As in Italy, loan rates increase when the market share of the acquired bank is large (Sapienza, 1998). The indirect approach using European data generally finds that higher concentration leads to less favourable conditions for bank customers (De Bonis and Ferrando, 1997). Market power in connection with prices for small business loans and retail deposits is found to exist in both US and Europe (Berger and Hannan, 1989 and Hannan 1991). However, it was indicated that the connection between concentration and retail deposit rates has dissipated somewhat in the 1990s relative to the previous decade (Hannan, 1997). Though the US banking industry has become stronger through the geographic diversification of risks, most researchers, especially those focusing on the 1980s and the early 1990s, did not find any broad-based improvements in cost efficiency emanating from economies of scale or scope. For the Latin American banking system, it was found that (i) concentration in banking markets did not necessarily lead to a lower level of competition and higher bank performance; and (ii) bank returns were negatively linked to the degree of competition and, to a lower extent, to foreign bank participation (Yildirim and Philippatos, 2007). Furthermore, in the context of the Latin American banking system, Yeyati and Micco (2007) suggested that it was not at all clear whether competition and concentration should go in opposite directions. In a cross-country study using structural model covering 50 major advanced and emerging market economies, Claessens and Laeven (2003) found that lower activity restrictions in the banking sector and greater foreign bank presence make banking systems more competitive. Emerging economies in the study included Argentina, Brazil, Chile, India, Indonesia, Malaysia, the Philippines, Russian Federation and Turkey, among others. However, they found no evidence that banking system concentration was negatively associated with competition.

In the emerging market banking systems, consolidation, to a large extent, has not yet translated into decline in competitive pressures. To some degree, this has been attributed to the process still being in its infancy, particularly in Central Europe and Turkey. Taking into account the internationalisation of banking sector in Turkey, Abbasoglu, Aysan and Gunes (2007) found no evidence of the existence of relationship between consolidation and competition. However, even for countries where the consolidation process is more advanced, namely Argentina and Mexico, no obvious impact of consolidations on competition intensity has been found (Gelos and Roldos, 2002). Bank consolidation in most emerging economies has not yet been associated with any marked rise in concentration, as most mergers appeared to have involved smaller banks. One reason for this pattern could have been reluctance on the part of the authorities to sanction mergers between the largest banks, which could raise both competition and moral hazard concerns. An important point that the recent literature on concentration-competition suggests is that the number of banks and the degree of concentration are not, in themselves, sufficient indicators of contestability. Other factors play a strong role, including regulatory policies that promote competition, a well-developed financial system, the effects of branch networks, and the effect and uptake of technological advancements (Northcott, 2004).

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8.47 The Indian banking system has witnessed certain visible structural changes in the post-reform period. Apart from mergers/amalgamations and entry of new private and foreign banks, the Government equity has also been diluted in public sector banks. Of the 28 public sector banks, 22 banks have raised capital from the market. In three banks, the Government equity holding has come down close to 51 per cent. The changes in the ownership structure along with consolidation and entry of private and foreign banks are expected to have an impact on the overall competition in the banking sector.

8.48 To evaluate the impact of various changes specifically on competition in the banking system, a number of concentration indicators have been analysed. The process of consolidation may affect competition by enhancing concentration. To assess the implications, it is important to measure concentration, which could reflect the size distribution of banks. These include K-concentration ratio, Herfindahl-Hirschman Index (HHI) and Theil's Entropy measure of major banking sector variables such as assets and deposits (Box VIII. 5).

8.49 A number of widely used indicators suggest that despite a number of bank mergers and acquisitions, the Indian banking system has become less concentrated during the post-reform period. On the basis of asset size, there was little change in the

Box VIII.5
Measures of Concentration Indices

Various methods have been devised to measure degree of concentration based on various theoretical foundations (Bikker, 2004). Concentration measures can be classified according to their weighting schemes and structures. The weighting scheme of an index determines its sensitivity towards changes in the tail end of the bank size distribution. The structure of concentration index can be discrete or cumulative. Discrete measures of concentration correspond to the height of concentration curve at an arbitrary point. The K-bank concentration ratio, for instance, is discrete measure which is simple and can be calculated even when the entire data set is not available. However, this measure ignores the structural changes taking place in those parts of banking sector which are not covered in the concentration ratio. Cumulative measure of concentration, on the other hand, explains the entire size distribution of banking sector and covering the structural changes in all parts of the distribution. Herfindahl-Hirschman Index (HHI) and Theil's entropy index display such features.

Simplicity and limited data requirements make K-bank concentration ratio as the most commonly used measure of concentration which sums up the market shares of K largest banks. It gives equal weight to K leading banks, but neglects smaller banks. It varies between 0 and one (if market shares are measured in fractional form instead of percentage form).

$$CR_k = \sum_{i=1}^{K} S_i$$

The Herfindahl-Hirschman Index is second most popular summary measure of market concentration. It is defined as the sum of the squares of the market shares of each bank in the market. This is also often called full information index as it captures features of the entire distribution of bank sizes. It takes the form:

$$HHI= \Sigma^{K}_{i=1} (S_i)^2$$

The index ranges from 10,000 in the case of monopoly (or 1.0 when market share is in fractional form) to close to zero when there are large numbers of firms with no one firm having substantial market share. It will vary not only with the proportion of deposits/assets held by an arbitrary number of large K banks in the market, but also with the relative distribution of deposits among all banks in the market. In the US, the HHI plays a significant role in the enforcement process of anti-trust laws in banking. HHI is used for scrutinising proposed merger of banks (Shull and Hanweck, 2001). Since 1982, the US Department of Justice has based its merger guidelines on the HHI.

In contrast to HHI, the entropy index assigns greater weight to smaller banks and vice-versa. Under this method, each market share is weighed by taking log of the inverse of market share of each bank. The major advantage of using the HHI and the entropy measures is that each bank is separately included in order to avoid arbitrary cut-offs and insensitivity to the share distribution.

The entropy index assigns weights to the shares of a bank's activity by a log term of the inverse of the respective shares. This index gives less weight to larger activities than the HHI. These two measures are inverse of each other. Apart from these, there are several other alternative measures of concentration examining the evenness or unevenness of the size distribution of entities in a particular sector. These include Kwoka index, Horvarth Index and Rosenbluth Index, among others.

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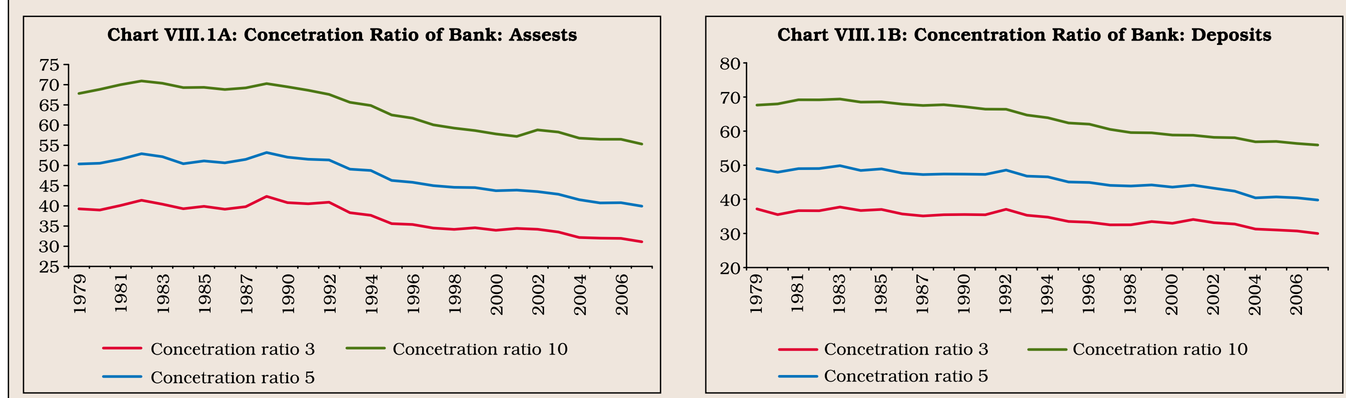
Chart VIII.1: Concentration Ratio of Commercial Banks in India



five-bank concentration ratio during 1978-79 and 1990-91, while it declined substantially from 51.4 per cent in 1991-92 to 44.5 per cent in 1998-99 and further to 39.9 per cent in 2006-07. A similar trend was discernible in the concentration of bank deposits (Chart VIII.1).

8.50 This was perhaps for the reason that bank mergers took place mostly among the small banks having little impact on market structure indicators. Besides, several new private and foreign banks were also set up. However, it is significant to note that the concentration declined even after 1999-2000 when the number of operating banks declined.

8.51 A cross-country analysis in terms of concentration ratios suggests that in several countries, concentration declined between 1991 and 2006, while in some advanced countries (US, Japan, Germany, Spain and France), it increased somewhat. The market structure of the Indian banking sector is less skewed when compared with most of the advanced and other emerging market economies (Table 8.7). The degree of concentration in the Indian banking sector was far lower than that in China, France, Spain, the UK, Singapore and South Africa. In fact, the degree of concentration in the Indian banking system, based on concentration ratio in 2006, was one among the lowest (after Russian Federation and the US).

8.52 The evidence of growing competitive pressures was also well supported by the declining trend of HHI. The HHI for total assets declined from 1008.2 per cent in 1991-92 to 540.7 per cent during 2006-07. The entropy index of concentration also corroborated the finding based on HHI (Chart VIII.2). Similar trend was discernable from the market structure indicators based on the size of bank deposits, in which concentration was relatively lower than that of assets.

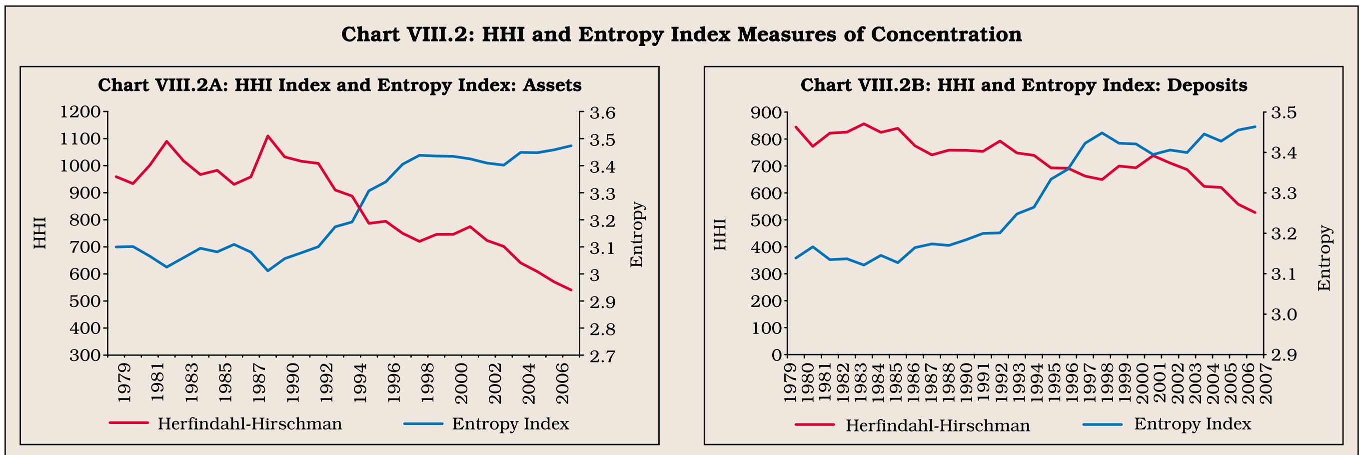
Table 8.7: Trend in Banking Concentration Ratio Across Countries*

Country	1991	1998	2006
1	2	3	4
Advanced Economies			
Singapore	0.86	0.81	0.99
Germany	0.55	0.63	0.72
Spain	0.71	0.74	0.75
France	0.60	0.48	0.68
Australia	0.89	0.62	0.64
Canada	0.71	0.55	0.60
United Kingdom	0.56	0.70	0.57
Netherlands	0.55	0.77	0.54
Korea, Rep.	0.58	0.38	0.51
Japan	0.32	0.33	0.41
Italy	0.69	0.48	0.40
United States	0.20	0.22	0.33
Emerging Market Economies			
South Africa	0.99	0.94	0.99
Israel	0.85	0.74	0.81
China	0.91	0.83	0.70
Turkey	0.83	0.53	0.70
Indonesia	0.72	0.40	0.63
Philippines	0.83	0.65	0.60
Brazil	0.94	0.40	0.59
Malaysia	0.42	0.40	0.53
Thailand	0.56	0.51	0.51
Argentina	0.76	0.32	0.37
India	0.46	0.35	0.35
Russian Federation	0.99	0.75	0.20

* : Based on assets of three largest banks.

Source : T. Beck, A. Demirguc-Kunt and R.E.Levine, Financial Research, WPS2146, Financial Structure dataset updated in November 2007, World Bank.

Chart VIII.2: HHI and Entropy Index Measures of Concentration



8.53 A comparison with other countries shows that the concentration ratio measured in terms of HHI declined in India between 1998 and 2004, while it increased in all the select advanced and emerging market economies studied. In 2004, concentration was lowest in the US, followed by Germany and the UK. The concentration ratio in India, based on HHI measure was also lower than the select sample of emerging market economies, reflecting a greater degree of banking competition in India. The findings based on HHI are largely consistent with the concentration ratio as set out in Table 8.7 Although the concentration ratio and the HHI are most commonly used measure of concentration, the findings based on them can be somewhat different as concentration merely covers top K number of banks while the HHI, being more informative, covers the whole size distribution of the banking sector. Concentration in the Indian banking sector based on HHI was higher than that in the US, Germany and the UK (the least concentrated countries) perhaps on account of a large number of banking institutions operating in these countries, but HHI was lower than all other countries in the sample (Table 8.8).

8.54 While the various measures of concentration ratios provide the market structure and influences the way the banks operate, they do not fully indicate the actual conduct, and, therefore, the performance of the market. In other words, a highly concentrated banking sector does not necessarily imply lack of competition though it creates the potential for collusion among large banks. Similarly, a less concentrated market does not necessarily imply a greater degree of competition though its potential for the same is higher. Efficiency is also not necessarily enhanced by competition, as it can so happen that collusive behavior of large banks in a highly concentrated market results in superior market performance (Bikker and Haaf, 2002). In the literature, one common measure for the conduct (competition) of the banking industry is the H-statistic formulated by Panzar and Rosse (1987) to distinguish between oligopolistic, competitive and monopolistic markets. Based on H-Statistic, the Indian banking industry could be characterised as a monopolistically competitive market as is the case with most other advanced and EMEs. The level of competition appeared to have declined somewhat in the initial years of reforms, but improved thereafter. It was also found that the level of competition in the Indian banking industry was influenced by the concentration of assets with the largest three to five banks. In other words, greater is the degree of concentration of banking assets in a few large banks, the lower is the degree of competition (Box VIII. 6).

Table 8.8: Herfindahl-Hirschman Index*

Country	1998	2004
1	2	3
Advanced Economies		
US	117	157
Germany	245	283
UK	339	493
Italy	489	542
France	399	682
Spain	854	1188
Emerging Market Economies		
India	**720**	**541#**
Malaysia	1317	1334
Chile	974	1462$
Mexico	1542+	1529&
South Africa	1310++	1840#
Brazil	2164+	3352

+ : For 2000; ++ For 2001; $ For 2002; & For 2005 and # For 2006
* : Based on asset size of banks.
Source: IMF and other Country-specific Papers (Except India).

Box VIII.6
Panzar-Rosse Statistics: The Indian Case

An empirical test was developed by John C. Panzar and James N. Rosse (1987) to discriminate between oligopolistic, monopolistically competitive and perfectly competitive markets. Their procedure, which is based on the comparative static properties of reduced-form revenue equations, accomplishes a concise indicator which is called H-statistic. Under certain restrictive assumptions, it can be interpreted as a continuous and increasing measure of the overall level of competition prevailing in a particular market. The methodology suggested by Panzar and Rosse stems from a general equilibrium market model. It is based on the premise that firms employ different pricing strategies in response to changes in factor input prices depending on the competitive behavior of market participants. In other words, competition is measured by the extent to which changes in input prices are reflected in firms' equilibrium. The H-statistic provides a single number reflecting the overall level of competition prevailing in the market under consideration. The H-statistic can be used to identify the three major market structures, namely, monopoly/perfect collusion, monopolistic competition and perfect competition/ contestable market. Conclusions about the type of market structure are made based on the size and sign of the H-statistic.

Panzar and Rosse argued that market power can be measured by the extent to which changes in factor prices are reflected in revenues. With perfect competition, an increase in factor prices (say, deposit interest rates) induces no change in output but a proportional change in output prices (*i.e.*, under a perfectly elastic demand assumption). Instead, with monopolistic competition, or with potential entry leading to contestable markets, revenues would increase less than proportionally, as the demand for banking products facing individual banks is less than perfectly elastic. A number of studies in recent years have extended the P-R methodology to banking sector. Based on a reduced-form equation of revenue at the individual bank level, market power is inferred from the H-statistic, which measures the extent to which changes in factor prices are reflected in banks' revenue. If the market is perfectly competitive, an increase in factor prices would raise revenues equi-proportionally and the H-statistic should assume a value equal to 1. On the other hand, in the "intermediate" case of monopolistic competition, the H-statistic assumes a value between 0 and 1, with an increase in input prices leading to a less than proportional increase in revenues, as the demand for bank products facing individual banks is inelastic. A negative H arises when the market structure is a monopoly or a perfect colluding oligopoly (Rozas, 2007). Contestable markets would also generate an Ira H-statistic equal to unity.

Since P-R is a static approach, a critical feature of the empirical implementation is that the test must be undertaken on observations that are in long-run equilibrium. In previous studies, testing for long-run equilibrium involved the computation of the H-statistic in a reduced-form equation of profitability, using a measure such as return on equity/assets (ROE or ROA) in place of revenues as dependent variable. The resulting H was supposed to be significantly equal to zero in equilibrium, and significantly negative in case of disequilibrium. Overall, the P-R model is regarded as a valuable tool for assessing market conditions.

Most of the previous empirical estimations of P-R model were done for developed countries and recently, several studies employed this methodology to quantitatively assess the degree of competition and market structure of banking industry in developing and transition countries. In general, all of these studies find that banking market is best described as monopolistic competition. Using annual data on scheduled commercial banks for the period 1996-2004, Prasad and Ghosh (2005) found that the Indian banking system operates under competitive conditions and earns revenues as if under monopolistic competition.

In an attempt to compute H-Statistic in the context of Indian banking system, the following reduced form of equation for bank revenue function was estimated:

$$Ln(TREV) = \alpha 0 + \alpha 1\ Ln\ PL + \alpha 2\ LnPK + \alpha 3\ Ln\ PF + \alpha 4\ Ln\ EQ + \alpha 5\ Ln\ Size + \alpha 6\ Ln\ LO$$

Where:

TREV is the ratio of total revenue to total assets, PL is ratio of personnel expenses to employees as percentage of total assets, PKs ratio of other expenses to total assets used as proxy for unit price of capital, PFs ratio of annual interest expenses to total assets. A number of bank-specific factors were also included as control variables to account for size, risk, and capacity differences. These were size measured in terms of total assets, capital to assets ratio (EQ) to control for difference in capital structure, and loan to total assets ratio (LO) as a proxy for degree of intermediation. Under the P-R framework, the H-statistic is equal to the sum of the elasticities of the revenue with respect to the three input prices, *i.e.*, $H = \alpha 1 + \alpha 2 + \alpha 3$. The testable hypothesis for monopolistic competition is $0 < H < 1$, while $H \leq 0$ is monopoly. In a symmetric monopolistic competitive market, $0<H<1$. It is worth emphasizing that not only is the sign of H important, but its magnitude is equally important (Panzar and Rosse, 1987).

The H-statistics was estimated for the period 1990 to 2007 using 5-years rolling regressions. The unit cost of funds (PF) had a positive sign and was statistically significant at the 1 per cent level. Also, PL turned out to be significant at the conventional levels of significance. Confirming the findings of Prasad and Ghosh (2005), the results indicated

that the price of funds provided the highest contribution to the explanation of interest revenues (and therefore to the H statistic), followed by the price of labor. The H-statistic ranged between 0.8 to 0.45 with the value showing an initial decline and a rise thereafter (Chart). Bank competition seems to have strengthened particularly during post-2000 period. Since H statistics are found to be significantly different from both 0 and 1, the monopoly and perfect competition hypotheses are rejected and thus support the view that Indian banks earn their revenues under monopolistic competition which is also the case in most of the developed countries and other emerging market economies. A survey of literature, however, shows that banking sectors in China, Hong Kong, Kuwait, UAE and Saudi Arabia operate under near perfect competition conditions (Table A). In the case of China, Yuan (2006) argues that the small banks in China are newer, and are in the stage of studying the managerial experience of international banks, and in addition they are not protected by the State. As a result, the competition among small banks is so high that it is near perfect competition. Similarly, the large Chinese banks operate businesses on an international scale and compete with others in the international market and also operate under much more competitive conditions.

Further, as the conduct of the market is expected to be influenced by the market structure, the relationship between H-statistics and various measures of concentration was estimated for India. As expected from *a priori* theoretical arguments, it was found that all the measures of concentration ratios and index had a negative relationship with H-statistics, indicating that the greater the degree of concentration of banking assets, the lesser is the degree of competition. However, the relationship was statistically significant at the conventional level only with the concentration ratio of the three largest banks. On augmenting the relationships with the share of private sector in total assets, it was found that the negative relationships were statistically significant for all the measures of concentration ratios, except 'CR10' (Table B). In sum, the level of competition in the Indian banking industry was influenced by the concentration of assets with the largest three to five banks.

Chart: H-Statistics Obtained from 5-Years Rolling Regressions: Indian Context

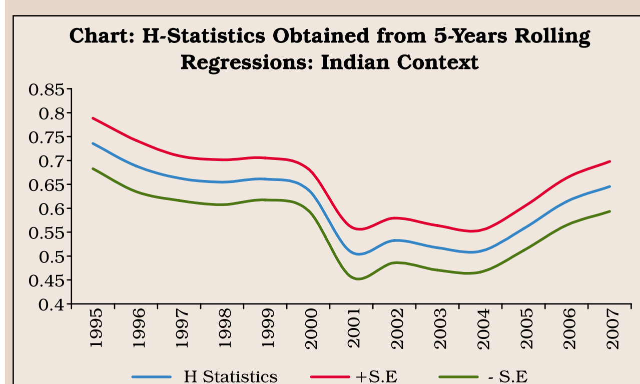


Table A: Cross-country H Statistics

Country	Period	H Statistics	Study
Argentina	1997-99	0.87	Yildrim and Philippatos, 2005
Bahrain	1993-2002	0.70	Muharrami, Matthews and Khabari, 2006
Brazil	1997-99	0.71	Yildrim and Philippatos, 2006
Chile	1997-99	0.62	Yildrim and Philippatos, 2007
China	2000	0.95	Yuan, 2006
Germany	1993-2002	0.43	Gischer and Stiele, 2004
Hong Kong	1992-2002	0.98	Jiang, Wong, Tang and Sze, 2004
India	1996-2004	0.37	Prasad and Ghosh, 2005
Korea	2005	0.47	Lee and Lee, 2005
Kuwait	1993-2002	1.02	Muharrami, Matthews and Khabari, 2006
Malaysia	2002-05	0.73	Majid and Sufian, 2006
Mexico	1993-2005	0.50	Maudos and Solís, 2007
Qatar	1993-2002	1.02	Muharrami, Matthews and Khabari, 2006
Saudi Arabia	1993-2002	0.63	Muharrami, Matthews and Khabari, 2006
Spain	1986-2005	0.57	Rozas, 2007
UAE	1993-2002	1.00	Muharrami, Matthews and Khabari, 2006
UK	1992-2004	0.46	Matthews, Murinde and Zhao, 2007
US	1976-2005	0.61	Yildrim and Mohanty, 2007
US	1996-2005	0.44	Yildrim and Mohanty, 2007

Table B: Relationship Between Competition and Concentration Ratios in Indian Banking Sector
(Dependent Variable H Statistic)

	HHI	CR3	CR5	CR10
Constant	1.08	1.96	1.85	1.90
	(3.0)*	(2.7)*	(2.2)*	(2.1)*
Concentration Index	-7.95	-4.2	-3.0	-2.34
	(-17.4)*	(-2.0)*	(-1.6)	(-1.6)
$\bar{R}^2$	0.16	0.20	0.14	0.14

Figures in parentheses are t-statistics. *: Significant at conventional levels.

References:

Gutiérrez de Rozas, Luis. 2007. "Testing for Competition in the Spanish Banking Industry: The Panzar-Rosse Approach Revisited." *Banco de España Research Paper* No. WP-0726, August.

Panzar, J. and Rosse. J. 1987. "Testing for monopoly equilibrium." *Journal of Industrial Economics*, Vol.35, pp. 443–56.

Prasad, A. and Ghosh. 2005. "Competition in Indian Banking, *IMF Working Paper* No. WP/05/141.

8.55 Some of the studies in the Indian context found that during the post-reform period, the bank mergers led to considerable enhancement of efficiencies for the merging banks. The mergers themselves exhibited considerable potential efficiency gains. The greater part of these gains stemmed from the synchronisation of varied but related product mixes. Gourlay *et al* (2006) found that mergers between distressed and strong banks in India tended to exhibit persistence in efficiency across time. In other words, economic policy reforms have succeeded in weeding out the weaker and inefficient banks by merging them with healthier banks. However, incumbent strong banks did not appear to adopt the M&As route to raise their efficiencies.

8.56 One of the motives of M&As is to enhance efficiency by reducing cost or increasing revenues or combination of both, as alluded to earlier. Efficiency gains stemming from M&As may be analysed by comparing the performance ratios in terms of return on assets and operating cost between the pre-merger and post-merger periods. The profit efficiency effect of M&As is the most inclusive. It embodies the scale, scope, product mix and X-efficiency (effectiveness with which a given set of inputs are used to produce outputs) effects for both costs and revenues and also includes at least some of the diversification effects. For the bank mergers in India, efficiency gains both in terms of increase in return on assets and reduction in cost were found only in the case of public sector banks. Similar gains were not observed in respect of merger of private sector entities (Box VIII.7).

8.57 As a result of banking sector reforms, there has been a general improvement in the performance

Box VIII.7
Efficiency Gains from M&As: A Case Study of Select Banks

During the post-reform period, there have been 21 mergers and amalgamations in the Indian banking sector. Of these, seven merger cases involving relatively larger banks were selected. In order to test the change in the profitability/ efficiency indicators in sample banks during the post-merger period, Wald test was used. The Wald test is a statistical test, typically used to determine whether an effect exists or not. Under this test, the maximum likelihood estimate θ of the parameter(s) of interest θ is compared with the proposed value θ_0 (zero in the present context), with the assumption that the difference between θ and θ_0 will be approximately normal. Typically the square of the difference is compared to a chi-squared distribution. Two variables are chosen, *viz.*, return on assets and operating cost to assets ratio. Given the fact, mergers/amalgamations are envisaged to lead to synergy effects, return on assets is expected to increase while operating cost to assets ratio is expected to decrease during the post-merger period. Statistical significance of increase/decrease in the parameter can be inferred from the corresponding p-value of X^2 statistic.

As per *a priori* expectations, it was found that change in the average return on assets during the post-merger period over pre-merger period was positive and statistically significant in the case of public sector banks, while positive but insignificant in the case of two private sector banks. In the case of one private sector bank, the mean return on assets declined after the merger.

Efficiency gains in terms of decline in operating expenditure measured by mean of operating cost-assets ratio during post-merger period were also found to be significant in the case of three out of fours select public sector banks. On the other hand, for the sample of private sector banks, it was found that the mean of operating cost-assets ratio was higher during post-merger, though not statistically significant, reflecting that these banks could not realize efficiency gains in terms of operating expenditure emanating from merger and acquisitions (Table). Thus, public sector banks have been able to derive greater efficiency gains during the post-merger period than the private sector banks.

Table: Testing of Efficiency Indicators in Merged Banks in India

Panel A: Change in Return on Assets (RoA) during Pre and Post Merger: Wald Test*

Bank	Δ RoA	X^2 Statistics	S/NS
Punjab National Bank	0.57	25.34	S
Union Bank of India	0.49	15.68	S
Oriental Bank of Commerce	0.7	13.62	S
Bank of Baroda	0.53	12.5	S
HDFC Bank	-0.4	1.33	NS
ICICI Bank	0.04	0.02	NS
Centurion Bank of Punjab	0.52	0.26	NS

Panel B: Change in Operational Cost-Assets Ratio (OP) during Pre and Post Merger: Wald Test

Bank	Δ RoA	X^2 Statistics	S/NS
Punjab National Bank	0.46	15.69	S
Union Bank of India	-0.84	54.61	S
Oriental Bank of Commerce	-0.83	12.97	S
Bank of Baroda	-0.21	6.71	S
HDFC Bank	0.34	1.0	NS
ICICI Bank	0.21	0.45	NS
Centurion Bank of Punjab	1.44	2.7	NS

Note : S/NS: Significant/ Not Significant.

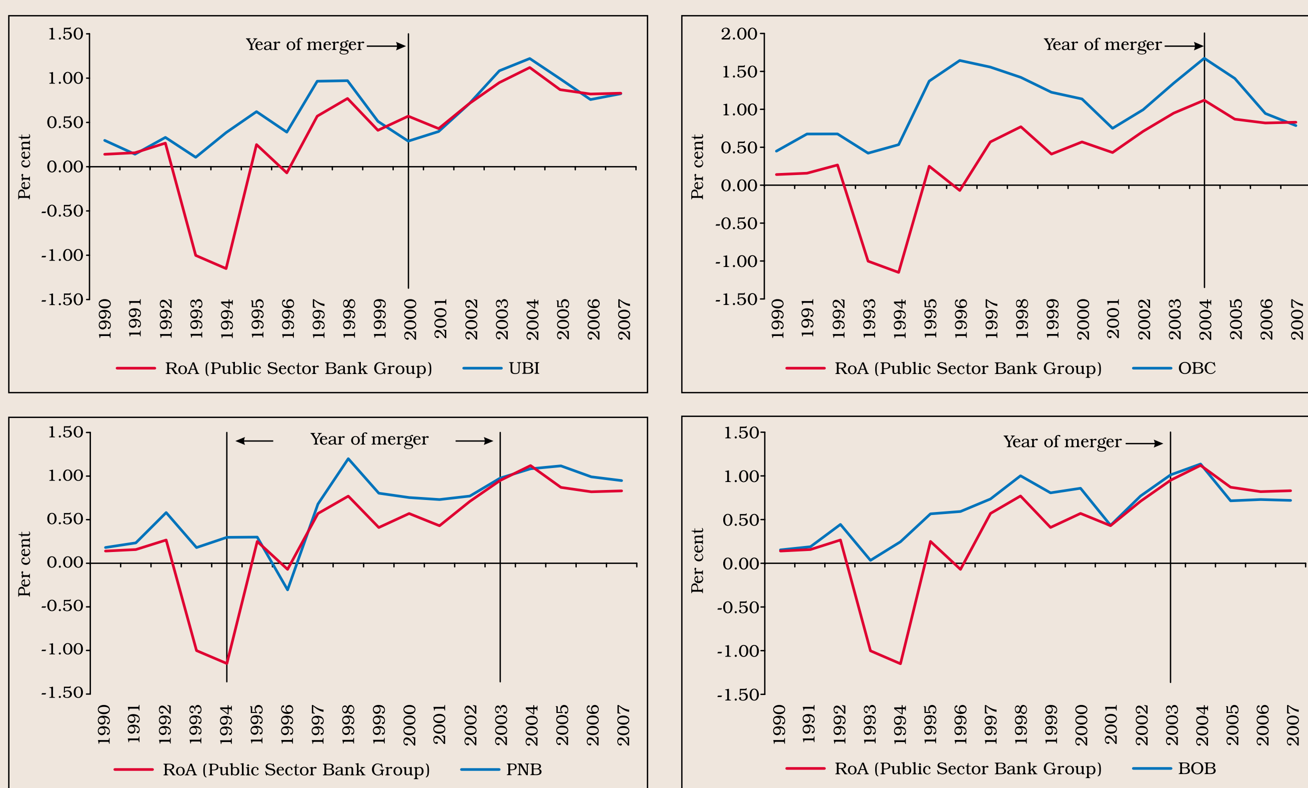
of the overall banking sector in India during the post-reform period. Hence, it is possible that the differences in the efficiency between pre and post-merger of the select transferee banks as referred to above were the result of overall improvement in the banking sector and not because of mergers. In order to check for efficiency gain/loss from mergers, the return on asset ratios of the select transferee banks in the post-merger period were compared with the return on assets of their respective bank groups. It was observed that in the case of most public sector banks with which other banks were merged, the return on assets ratios were above their group average both during the pre and post-merger periods (Chart VIII.3). It may thus be interpreted that gains in efficiency were more due to the general improvement in the industry than through mergers.

8.58 To sum up, M&A activity accelerated in the post-reform period, especially after 1999. However, alongside mergers/amalgamation, new private and foreign banks also came into existence. On the whole, the number of banks increased up to 1998-99 but declined thereafter every year. Since mergers/ amalgamations were mostly among smaller banks or financially weak banks were taken over by stronger banks, the level of competition in the Indian banking system improved even as the total number of banks declined after 1998-99. This improvement was indicated in various measures of concentration ratios and competition indicators. Concentration in the Indian banking sector was found to be significantly lower than many EMEs. Like several other advanced countries and EMEs, the Indian banking industry operated under monopolistic competitive conditions. However, the impact of mergers on efficiency varied. Efficiency measured both by return on assets and operating cost to assets of public sector banks, with which private entities were merged, improved. Similar efficiency gains, however, were not observed in respect of private sector entities.

VI. ISSUES IN CONSOLIDATION AND COMPETITION IN INDIA

8.59 The Indian banking sector is passing through a critical phase. Various measures initiated to make the banking sector competitive have yielded the desired results. However, at this juncture, the Indian banking sector is also faced with several challenges

Chart VIII.3: RoA of Select Merged Banks *vis-à-vis* Respective Bank Group



and issues. These, *inter alia*, relate to (i) what should be the future course of the consolidation process that is underway? (ii) whether public sector banks need to be privatised in the changed economic environment? (iii) is the banking sector ready to embrace greater competition from foreign banks? and (iv) should industrial houses be allowed to enter the banking sector? These issues are of substantive nature with serious ramifications for the future of the banking sector. These are examined in detail in this section, while in the next section, specific suggestions as a way forward, have been made to ensure the future growth of the banking sector along sound lines.

Consolidation and Competition

8.60 The issue as to what should be the nature and extent of consolidation in the Indian context has been widely debated. The need for consolidation in the Indian banking system was highlighted by the Committee on Financial System – CFS (Chairman: Shri M. Narasimham) in 1991. The CFS argued that in view of the emerging trends in the global financial sector, mergers between banks and between banks and non-banks would make economic and commercial sense and the whole should be greater than the sum of parts and have a “force multiplier effect”. The CFS recommended a possible structure towards which the banking system could evolve over time. Under the recommended structure, three to four large banks (including the State Bank of India) could have an international presence, while eight to ten national banks with a network of branches throughout the country could engage in general or universal banking. It also recommended for local banks whose operations would be confined to specific regions; and rural banks (including RRBs) whose operations would be confined to rural areas and whose business would predominantly be financing of agriculture and allied activities.

8.61 The Committee on Banking Sector Reforms – CBSR (Chairman: Shri M. Narasimham) in 1998 reiterated the recommendations of the CFS on the creation of few mega banks for an effective instrument of domestic and international competition. Taking cognisance of the global trends in banking, which was marked by twin phenomenon of consolidation and convergence, the CBSR stressed the importance of mergers and questioned the need for 27 public sector banks. It underlined the need for banks to be of a size which could offer greater competitive thrust to banking operations. The Committee, however, stressed that consolidation process in public sector banks needed to be based on synergies, and locational and business specific complementarities, which would help them in adapting to the emerging situations. An important factor highlighted by the CBSR was that the merger process in Indian public sector banks should emanate from the management of banks with the Government as a common shareholder playing a supportive role. The Working Group on Restructuring of Weak Public Sector Banks (Chairman: Shri M. S. Verma) in its report released in 1999 also emphasised the need for a comprehensive restructuring of the Indian banking system requiring careful considerations of merger or closures and privatisation of Indian banks.

8.62 Highlighting the inadequacy of size of Indian banks to face global competition, the need for consolidation in the Indian banking sector was also emphasised by the Union Finance Minister in his Budget speech for 2005-06. It is also argued that the prevalence and success of consolidation in the banking sector across the world and compulsions imposed by globalisation would make consolidation more visible in the Indian financial system in the near future. In a Report on “Banking Industry: Vision 2010” of the Indian Banks’ Association released in 2003, it was visualised that mergers between public sector banks, or public sector banks and private sector banks, could be the next logical thing to happen as market players tend to consolidate their position to remain in the competitive race. However, the Report also pointed that merger or large size is just a facilitator but no guarantee for improved profitability on a sustained basis. The thrust should be on improving risk management capabilities, corporate governance and strategic business planning. In the short run, options like outsourcing and strategic alliances could be attempted in a meaningful manner.

8.63 In the context of banking consolidation process, the Report of the Committee on Fuller Capital Account Convertibility (FCAC) observed that some of the smaller banks, which specialise in certain areas of business or regions may have a comparative advantage over larger banks by virtue of their core competence. As such, emphasis on consolidation to mean larger banks, merely by mergers, may not lead to strengthening of the banking system. In other words, there is no immutable relationship between size and operational efficiency. Another issue that was emphasised by the Committee on FCAC was with regard to the legislative framework. About three-fourth of the banking system is covered by the public sector. This, by itself, should not be a constraint but the

legislative framework is a major handicap and there are embedded disabilities for consolidation and governance. First, within the public sector, the legislative framework for the State Bank group is different from the nationalised banks. The major constraint is majority ownership by the Government in public sector banks. The capital requirements of banks will go up in the context of Basel II, since they have to maintain capital for certain risks which do not attract a capital requirement under Basel I. Since banks would be exposed to greater level of risks than at present, the capital requirement would go up even further. The Government, according to the Committee, was unable or unwilling to provide large additional capital injection into public sector banks; at the same time, the Government did not agree to a reduction in the Government majority holding in public sector banks.

8.64 Going forward, the Indian banking system will be exposed to greater competition. The Committee, therefore, cautioned that regulatory forbearance in the case of public sector banks would greatly weaken the system and as such should be avoided. In this context, the issue of majority Government ownership of public sector banks would come to the fore. All public sector banks should not be on a 'one-size-fits-all' approach. The Committee recommended that the Reserve Bank should formulate its prudential policies in a manner which favour consolidation in the banking sector. The Committee also recommended that the Reserve Bank should facilitate emergence of strong and professionally managed banks and not only large banks. Different statutes for different segments of the banking sector in India have embedded provisions which hinder good governance and consolidation. Thus, the Committee emphasised that all commercial banks should be subject to a single banking legislation and separate legislative frameworks for groups of public sector banks should be abrogated so as to promote easier market driven consolidation within the banking sector.

8.65 Furthermore, it has been argued that as global integration of the Indian financial system and the task of banking system expands, the demand of the corporate sector for banking services is expected to change not only in size but also in composition and quality (Rangarajan, 2007). This would require a focus on the organisational effectiveness of banks.

8.66 The logic for consolidation in India is based on two explicit or implicit assumptions. One, there are too many banks in India. Two, if the banking sector has to be assessed in the international context, size is the most important factor. It is argued that the size of a bank enhances its risk-bearing capacity, for which consolidation through orderly M&As may be necessary. With more competition, as net interest margins get thinner, the need for more sophisticated products and low-cost technology may arise. Banks with sub-optimal size, it is argued, may not be able to invest in technology and serve their customers.

8.67 The number of deposit-taking institutions (DTIs) per million persons in India is significantly higher than in many other countries, though the size of the banking sector in relation to the size of the economy was comparable to these countries. For instance, there were 110 DTIs per million population in India as against 79 in the US, 65 in Malaysia, 9 in Brazil, 2 in Chile and more than one in South Africa, although the size of the banking sector in relation to the size of the economy in all these countries was broadly comparable with that of India (Table 8.9).

8.68 As regards size, it is difficult to say as to what is the optimal size of a bank, which is country-specific and depends on several factors such as the composition of liabilities, the credit-deposit (CD) ratio, the quality of assets, and the ratio of fee to interest income. Small banks also have a place in the system

Table 8.9: Size of the Banking System in Relation to the Size of Economy

Country	Number of DTIs per million People 1999	Bank Assets to GDP Ratio (2006)
1	2	3
India*	**110**	**0.58**
Indonesia	48	0.33
Korea	80	1.02
Malaysia	65	1.17
Thailand	80	0.99
Argentina	3	0.26
Brazil	9	0.72
Chile	2	0.63
Mexico	0.4	0.30
South Africa	1.4	0.77
Japan	5	1.55
UK	9	1.64
US	79	0.63

* : For India, DTIs include only scheduled commercial banks, regional rural banks, urban co-operative banks, rural co-operative institutions and deposit taking non-bank financial companies.

DTIs : Deposit-taking institutions include commercial, savings and various types of mutual and cooperative banks, and similar intermediaries such as building societies, thrifts, savings and loan associations, credit unions, post-banks and finance companies, but excluding insurance companies, pension funds, unit trusts and mutual funds.

Source : BIS (2001) and World Bank (2008).

as they cater to the requirements of some specific sectors. It may be noted that small and medium sized banks have been able to survive even in advanced countries along with large banks. Having said that, it is felt that India has many commercial banks that are very small. That is, of the 53 domestic banks (both public and private), the size of the 16 banks at end-March 2007 individually was less than 0.5 per cent of the size of the banking sector. Even in the public sector (nationalised banks and SBI group), the size of the five banks individually was less than one per cent of the size of the banking sector and of eleven other banks was between one and two per cent. Analysis in the subsequent chapter also suggests that, in general, large institutions are more efficient than the smaller ones. It is, therefore, felt that the system could be served better, if small and not so efficient banks consolidate with larger and more efficient banks. Thus far, the Indian banking sector has undergone a consolidation process involving relatively smaller banks. However, M&As to weed out the less efficient small banks or to remove excess capacity in the system has to be driven by the market, depending upon their synergies. Any meaningful consolidation among public sector banks must be driven by commercial motivation by individual banks with the Government and the regulator at best facilitating the process. Second, the process of consolidation does not mean that small or medium sized banks will have no future. Small but efficient banks should be able to survive. In fact, small banks in the Indian context should play a more active role as natural lenders to small businesses. It is small and inefficient banks that may find it difficult to cope in the changed environment.

8.69 There are three aspects to consolidation, *viz*., clear cut legal and regulatory regime governing consolidation, enabling policy framework, especially where several banks are owned by Government, and market conditions that facilitate such consolidation, recognising that all M&As may not necessarily be in the interests of either the parties concerned or the system as a whole (Reddy, 2004). Also for mergers to be successful, it is necessary that there is integration of manpower and culture of the two merged entities. It is only when integration in these aspects is achieved successfully that the merged entities would be able to capitalise on the synergies. Hence, while the consolidation moves would be triggered by market forces, it will be necessary to ensure that mergers are successful in all respects, including manpower and cultural aspects, which are unique in the Indian context (Udeshi, 2004).

Issues Relating to State-owned Banks

8.70 Banking is one of the key sectors that come under the purview of the Government. The ownership issue of banks becomes pertinent as commercial banking is arguably the most basic industry in modern economy having central role in the allocation of capital and monitoring corporate borrowers. Policymakers in many countries during the post-World War II period were generally much more inclined toward state ownership as a response to the market failures and political pressures. This resulted in directed credit to favoured groups, guaranteeing loans by private banks, and providing many financial services themselves through state-owned banks and development finance institutions (DFIs). To protect domestic banks, the Governments also restricted competition from foreign banks and other financial institutions. Even with a large number of privatisations in many countries, state-owned banks still play a major role in their financial systems. The state ownership and other interventions in the financial sector were often cited as ways of ensuring that small and rural borrowers had access to funding. However, the overall record of these government interventions was discouraging (World Bank, 2005).

8.71 Contrasting views exist about the impact of Government ownership of banks. One view holds that Governments help overcome capital market failures, exploit externalities, and invest in strategically important projects (Gerschenkron, 1962). According to this view, Governments have adequate information and incentives to promote socially desirable investments. In contrast, it has been argued that government ownership politicises resource allocation, softens budget constraints, and hinders economic efficiency. Thus, Government ownership facilitates the financing of politically attractive projects, not economically efficient ones. Empirical evidence suggests that countries with higher initial levels of Government ownership tend to have subsequently less financial development and slower economic growth (La Porta *et al*, 2002). Greater Government ownership is generally associated with less efficient and less well-developed financial systems (Barth *et al*, 2001a).

8.72 In recent years, some deficiencies of public ownership have become more explicitly visible. A vast amount of literature on benefits and costs associated with privatisation and foreign ownership of banks in EMEs suggests that inefficient state-owned banks may provide opportunities for inefficient private sector banks to thrive in less than competitive markets, or

alternatively permit efficient banks to earn extraordinary profits. Summarising the cross-country experience of the role of state-owned banks in the financial sector, Andrews (2005) argues that state-owned banks generally have a cost of funds advantage over privately owned banks due to an implicit or explicit Government guarantee. Furthermore, he asserts that these funds have generally been used to finance inefficient state-owned enterprises leading to crowding out of private intermediation. In general, the evidence suggests that productive, allocative and dynamic efficiencies tend to be lower in the banking systems dominated by state-owned banks, while privatisation and an increased role of foreign banks helps in improving some aspects of efficiency at least (Mihaljek, 2006). Analysis of the banking sectors, particularly those in Western Europe, confirms that the privatisation of state-run banks has resulted in positive effect on banks' profitability and efficiency. Since all the European banking systems have witnessed an increased market concentration in recent years, Lahusen (2004) argued that this should generally improve banks' performance since high concentration, as a rule, allows large banks to operate with efficiently sized units and generate economies of scale more easily. He also highlighted that by giving the greatest possible freedom in the selection of suitable partners for cooperation, systematic privatisation has been key to efficient consolidation.

8.73 The increased number of bank privatisations around the world since the mid-1970s provides evidence that state ownership of banks has become less popular with many policymakers. This arose for several reasons: (i) to promote economic efficiency and reduce government interference in the economy; (ii) to promote wider share ownership; (iii) to introduce competition; (iv) to introduce market discipline among the state-owned enterprises; and (v) to raise revenues for the state. In some countries, banks were privatised after a systemic crisis. Given the fiscal cost involved in recapitalisation of state-owned banks and output loss associated with banking crisis, Governments in many post-crisis countries tended to avoid these adverse implications by resorting to privatisation. Furthermore, the decreasing role of state-owned banks also partly reflects the declining role of non-financial public enterprises in most countries to which the wherewithal was largely provided by state-owned banks (Box VIII. 8).

8.74 In developing countries, the premise for Government ownership of the financial sector was to control the "commanding heights" of the economy for ensuring that (i) business enterprises balance social and economic objectives rather than focusing merely on profit maximisation; (ii) market failures do not impede the growth process; and (iii) informational asymmetries between principal and agent are addressed. Given these issues, the state-ownership was perceived as an economically efficient way of addressing them. Literature in the context of countries with a long history of state ownership of commercial banks, however, suggests that concerns regarding safety, efficiency and transparency are often found to be infinitely more complex and intractable than in more *laissez-faire* systems.

8.75 In the Indian case, though the banking system made considerable progress both functionally and in terms of geographical coverage during the post-Independence decades of the 1950s and the 1960s, there were still many unbanked rural and semi-urban areas. Moreover, large industries and big and established business houses tended to enjoy a major portion of the credit facilities, to the detriment of the priority sectors such as agriculture, small-scale industries and exports as detailed in Chapter III. These concerns led to the nationalisation of banks in 1969. The objective of bank nationalisation of 14 banks was to serve better the needs of development of the economy in conformity with national priorities and objectives. Bank nationalisation served to intensify the social objective of ensuring that financial intermediaries fully met the credit demands for productive purposes. Two significant aspects of nationalisation were (i) rapid branch expansion; and (ii) channelling of credit according to Plan priorities (Mohan, 2004a). In a somewhat repeat of the same experience, eleven years after nationalisation, the Government announced the nationalisation of six more scheduled commercial banks above the cut-off size. The second round of nationalisation gave an impression that if a private sector bank grew to the cut-off size, it would be under the threat of nationalisation (Reddy, 2002). Thus, public sector banks in India came into existence by way of nationalisation of private sector banks over the years, the trend which was then prevalent in other countries also.

8.76 With the onset of economic reforms since 1991, the debate on privatisation of public sector banks (PSBs) in India also gained prominence. This issue, however, did not merit much consideration in the CFS. In the view of the CFS, integrity and autonomy in the functioning of financial institutions was a more relevant issue than ownership, and the

Box VIII.8
Privatisation of Commercial Banks: Cross-Country Experiences

Although the wave of privatisation of state-owned banks began during the 1970s, the changes in the ownership structure of banks have been more significant in the recent years. In Chile, as part of a broad reform program initiated in 1973, 19 of 20 state-owned banks were sold to private investors in 1975. The bulk of these banks were acquired by financial conglomerates. In Mexico, government sold controlling stakes in 18 banks during June 1991 to July 1992. In 1997, Hungary was the first transition economy to practically complete the process of privatising state banks. In general, a notable decline has been observed in the share of state-owned banks in total bank credit across the countries. The other major privatisations have taken place in Indonesia, Korea, Thailand and the Central Europe. In Central Europe and Latin America, state-owned banks now account for merely 10 per cent and 11 per cent of total bank credit, respectively (45 per cent and 15 per cent, respectively in 1994), while there has been a sharp increase in the share of foreign owned banks. In Korea, privatisation was done in four banks which were nationalised during 1997-98 crisis. In Thailand, the authorities have reduced their shareholding in three out of five major domestic banks taken over by the Financial Institutions Development Fund during the 1997 crisis. Likewise, in Indonesia, during 2000-2004, 15 banks accounting for 70 per cent of total banking assets were sold in initial public offerings by the bank restructuring agency. Although the share of private domestic banks in total bank credit has increased in emerging market economies including China, India, Russia and Indonesia, state-owned banks still account for a substantial share in total bank credit. In sum, banking systems in emerging market economies have generally continued to evolve towards more private and foreign-owned structures.

As far as privatisation methods during the 1990s are concerned, in most of the East Asian economies they were carried out by way of disposing of the impaired assets of crises-ridden nationalised banks through asset management companies. In contrast, in Central Europe and Latin American economies, banks were privatised by selling the stakes to strategic foreign investors. In more recent years, privatisation of banks has been attempted through initial and subsequent public offers, sale of shares through tender or auction and in a few cases through private placements to strategic investors (Mihaljek, 2006). However, the Brazilian experience of bank privatisation is somewhat different, as some state-owned banks were straight privatised by their controllers whereas some others had their control first transferred from the States to the federal Government before they were privatised. The change in methods of privatisation of banks in recent years, in fact, reflects the systemic transformation of economies towards a market based principles in the late 1990s.

Despite the fact that privatisation has been increasingly undertaken in most of the emerging market economies, it has been observed that change in ownership alone may not suffice to address many of the factors contributing to poor performance by state-owned banks. According to Andrews (2005), institutional factors conducive to sound banking such as sustainable macroeconomic policies, legal infrastructure, particularly with respect to contract law and measures for pledging collateral and enforcing security agreements, and appropriate and widely-used accounting standards are the essential pre-requisites for a successful outcome of privatised banks. Based on the privatisation experience in Croatia, the Czech Republic, Mozambique and Uganda, an appropriate prudential review prior to privatisation of banks was also generally emphasised upon, as it had important implications for the post-privatisation performance of banks. Furthermore, evidence from a number of case studies suggests that better financial performance is achieved when privatisation involves a strong financial institution as a significant shareholder. Apart from these, privatisation of banks is also perceived to be a political process, as it has implications for regional as well sectoral allocation of resources/services and also preserving employment. Andrew (2005) noted that even when privatisation of banks is viewed as a good policy option, its implementation may be problematic. In developing countries as compared to developed ones, political factors significantly affect state-owned banks' privatisation process (Boehmer *et al,* 2005). Key issues which need to be managed include the cost associated with continued state-owned banking system, sequencing of other reforms, and achieving political consensus.

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issues of efficiency and profitability were neutral to ownership. Holding a similar view, Reddy (1992) opined that "the privatisation trend in the financial sector has to be viewed basically as a part of macroeconomic reforms, and ensuring appropriate regulatory framework to enhance competition and

making ownership a secondary issue". Further, given the fragile nature of the financial market as compared to other manufacturing industries, it was emphasised that the focus for the banking sector should be more on regulation than ownership. In an efficient market, competition leads to exit of inefficient firms. However, because of fragile nature of banking segment of the financial sector, exit of banks, it was felt, needed to be considered with a lot more caution. The stability in the financial system depends on confidence of the service takers. Owing to 'herd behavior' leading to information asymmetries, this confidence could be easily lost resulting in bank runs, which can even be on healthy units and spread to the entire financial system. In this regard, Reddy (1992) noted that "the cost of exit of a firm in financial sector could have serious repercussion on the viability of the financial sector as a whole, compared to the cost of exit of a firm in the manufacturing sector. This, perhaps, is the main reason why ownership is not as focused and regulation more readily accepted in respect of financial sector". While recognising the importance and potential benefits of competition, World Development Report 2001 highlighted that excessive competition may create an unstable banking environment, while insufficient competition may breed inefficiency or reduced credit access for borrowers (World Bank, 2001).

8.77 Along with the progress in economic reforms, Government ownership of banks, however, began to be questioned. Joshi and Little (1996) found a strong empirical case for privatisation of banks, as public ownership was mainly responsible for management inefficiency due to political and administrative interference in the allocation of credit. They, therefore, recommended that "rather than go through a futile process of attempting to secure autonomy within the framework of Government ownership, the Government should prepare a plan to privatise several public sector banks".

8.78 The CBSR, however, approached the issue from a pragmatic assessment of the situation, and instead of privatisation, recommended PSBs accessing capital market to meet the likely gap in capital requirements, and also to bring down the statutory minimum shareholding by the Government/ the Reserve Bank to 33 per cent from 51 per cent. The Working Group on Restructuring of Weak Public Sector Banks (Chairman: Shri M.S. Verma) in the context of three weak banks had noted that privatisation of these three weak public sector banks was an acceptable course as the process alone could reduce the Government's responsibility of capitalising further and enable the Government, in the long run, to recoup the investment made in these Banks. However, the Working group did not recommend privatisation at that point of time considering (i) the prohibitively high cost of restructuring; (ii) lack of the required resources; (iii) inability to access capital markets by these banks; and (iv) the given staffing pattern and levels of skills and technology.

8.79 It has been argued that most of the problems of PSBs were inextricably associated with Government ownership and control, for which they should be privatised as was done in other sectors of the economy (Acharya, 2001). However, Ram Mohan (2002) in the context of privatisation in general, concluded that "contrary to popular supposition, neither the theory nor the empirical evidence on privatisation provides unqualified support for the belief that privatisation leads to outcomes superior to those under public ownership. The theoretical literature, while pointing to the potential benefits of private ownership, also underlines the many conditions required for such benefits to materialise".

8.80 Many studies in the Indian context have not found any significant difference between the performance indicators of PSBs *vis-à-vis* private sector banks in the post-reform period. While studying the impact of nature of ownership on bank efficiency, Ram Mohan and Ray (2004) and Mahesh and Rajeev (2006) found that it was difficult to support the proposition that efficiency and productivity were lower in public sector banks relative to their peers in the private sector. Comparing the PSBs and private banks, Sarkar *et al* (1998) also found that there was only a weak ownership effect on the performance. This could be attributable to the fact that there has been a change in the orientation of PSBs from social objectives towards an accent on profitability, particularly, given that some of these banks have been listed on the stock exchange and, thus, a stake of private investors is involved. Another factor that seems to have played a role is that PSBs enjoy a huge first-mover advantage in terms of scale of operations over private sector banks and these advantages perhaps offset any inefficiency that could be ascribed to the Government ownership (Ram Mohan, 2005).

8.81 Privatisation of public sector banks in India has generally been argued along the following lines: (a) recapitalisation of banks is a huge cost to the fisc; (b) State ownership of banks leads to loss of competition and breeds inefficiency; (c) State ownership does not necessarily lower the probability

of banking crisis; and (d) private and foreign ownership of banks stimulates efficiency, innovation and economic growth.

8.82 The general recapitalisation was continuously effected till 1998-99. Since then it took place only during 2001-02, 2002-03 and 2005-06. The cost of recapitalisation as per cent of GDP was, however, much lower than many other countries. While this is so, international experience suggests that private ownership does not necessarily lead to decline in the recapitalisation cost. This is because even under private ownership, Governments would not allow banks failure, and consequently, the fiscal cost for recapitalisation could be significant. In the banking crisis-ridden countries, irrespective of state ownership of banks, the impact on budgets has been as high as 40-55 per cent of GDP (Hononhan and Klingebiel, 2000). The health of the banking system is critical for both macroeconomic and fiscal stability. If the banking system, public or private is unhealthy and weak, the hit is on the fisc since the bailout has to be publicly funded. The contention that merely shifting of the ownership from the public sector to the private sector will immunise the possible impact on the fisc is not correct (Reddy, 2001).

8.83 As far as the efficiency of PSBs in India is concerned, well-designed policy reforms have gradually exposed them to increased competitive environment. These policy reforms by releasing the forces of competition forced the PSBs to optimise the use of resources to attain efficiency. Consequently, there has been significant improvement in the performance of PSBs. As brought out in the following chapter, some public sector banks are as efficient as private sector banks and foreign banks. In fact, the 29 least efficient banks in the Indian banking sector relate to private and foreign bank segments. In terms of soundness and asset quality parameters also, the performance of public sector banks has converged with private sector and foreign banks.

8.84 Thus, public sector banks have responded to the new challenges of competition, as reflected in the increase in the share of these banks in the overall profit of the banking sector. From a position of net loss in the mid-1990s, in recent years, the share of public sector banks in the profit of the commercial banking system has become broadly commensurate with their share in assets, indicating a broad convergence of profitability across various bank groups. This suggests that with operational flexibility, public sector banks have been able to compete effectively with private sector and foreign banks. The 'market discipline' imposed by the listing of most public sector banks has also probably contributed to this improved performance. Public sector bank managements are now probably more attuned to the market consequences of their activities (Mohan, 2006).

8.85 On the banking system stability with public sector ownership, the underlying argument has been that because of the inherent inefficiency due to lower competition associated with public ownership, the risk of crisis is heightened. International experience, however, does not reveal any unambiguous relationship between state ownership and banking crisis. In a sample of 34 countries that faced banking crisis, Barth, *et al* (2000) found that in half of the countries, state owned banks controlled more than 20 per cent of the total banking assets, while in six countries, the share was less than 20 per cent. In as many as nine countries that faced crises, the state-owned banks did not exist (Table 8.10). There are instances where privatisation preceded banking crisis such as in Cameroon, Croatia, Mexico, Korea and Ukraine (Andrews, 2005). Thus, the risk of banking crisis was not associated with the degree of Government ownership of banks. The fact that India has not faced any systemic banking crisis may be attributed to the dominance of the banking sector by public sector banks.

8.86 Apart from the fact that the performance of public sector banks has improved significantly, there have been several other advantages of public sector banks over private sector and foreign banks. In comparison with private and foreign banks, public sector banks through their huge branch network have played a far greater role in extending credit to agriculture and the SME sector as envisaged under the priority sector norms for them. Public sector banks have also been more actively engaged in promoting financial inclusion, which, of late, has emerged as a major policy objective. It has been argued that in the Indian context, particularly in view of the need to give adequate attention to agriculture and the rural sector, public sector character of existing PSBs should not be given up (Jalan, 2002). Furthermore, a well diversified banking system, operating under competitive conditions, bodes well in the perspective of financial stability.

8.87 To sum up, privatisation of public sector banks is an issue which gained prominence after the initiation of financial sector reforms. The most commonly cited reason for privatisation of PSBs has been their inherent inefficiency. However, in the Indian

Table 8.10: Degree of State-Owned Bank Assets and Banking Crisis

Country	State Ownership Up to 20 Per cent	Type of Crisis		Country	State Ownership Up to 20 Per cent	Type of Crisis	
		Systemic	Major			Systemic	Major
1	2	3	4	5	6	7	8
Bolivia	0	Yes	Yes	Argentina	30.5	Yes	Yes
Canada	0	Yes	Yes	Brazil	51.0	Yes	Yes
Colombia	19.0	Yes	Yes	Chile	23.8	Yes	Yes
Denmark	0	No	Yes	Egypt	66.6	Yes	Yes
Ecuador	NA	Yes	Yes	Finland	41.1	Yes	Yes
El-Salvador	6.9	Yes	Yes	Ghana	38.8	Yes	Yes
Hong Kong	0	No	Yes	India	80.0	No	Yes
Japan	0	Yes	Yes	Indonesia	41.5	Yes	Yes
Korea	0	Yes	Yes	Italy	25.0	No	Yes
Malaysia	9.6	Yes	Yes	Madagascar	22.0	Yes	Yes
Nigeria	13.0	Yes	Yes	Mexico	41.5	Yes	Yes
Peru	0	Yes	Yes	Norway	37.6	Yes	Yes
Philippines	19.8	Yes	Yes	Sri Lanka	58.0	Yes	Yes
Sweden	0	Yes	Yes	Tanzania	50.1	Yes	Yes
US	0	No	Yes	Thailand	29.0	Yes	Yes
Venezuela	7.2	Yes	Yes	Turkey	36.5	Yes	Yes
				Uruguay	45.5	Yes	Yes
				Zimbabwe	24.6	Yes	Yes

Source: Barth, Caprio and Levine (2000).

context, it is observed that there have been significant improvements in the performance of PSBs derived from the operational flexibility and functional autonomy. In fact, the performance of private sector and foreign banks was not necessarily superior to many of these banks, despite PSBs being subject to a greater social responsibility. However, there are several other issues such as changed operating environment and sustaining the operations of PSBs due to constraints faced by the Government in providing capital to banks, which need to be carefully assessed. These are discussed in the subsequent section.

Issues Relating to Operations of Foreign Banks

8.88 The process of consolidation of the banking sector has led to extensive entry of foreign banks, especially in EMEs. Moreover, internationalisation of trade in goods and services has also forced foreign banks to expand their operations cross-borders, reflecting the desire of large international and regional banks to enter profitable markets. Foreign banks are now playing an increasingly important role in the evolving global financial system. Historically, with economic integration, the main motivation for foreign banks was to establish representative offices to handle trade credit operations to assist their home country customers in international transactions and possibly arrange international private debt and equity placements between borrowers in the host country and lenders in the source country. At a later stage, with greater understanding of the foreign market and a developed network of relationship with local financial institutions, foreign banks open branches dealing with wholesale deposit and money markets. Eventually, subsidiaries are set up to enter retail banking. However, the reasons for foreign entry, as well as the competitive and regulatory conditions, differ significantly between developed and developing countries.

8.89 In general, foreign banks enter into business activities outside their parent economies either through cross-border lending or by physical presence. In the case of cross-border lending, as a cost effective strategy, foreign banks do not have any outposts in the territory of host country. Physical presence of foreign banks can be either in the form of opening a *de novo* bank through greenfield investment or from purchase of a majority stake of a domestic bank. Through greenfield investment, foreign banks either open a branch or subsidiary in the host country, depending upon the bank's strategic requirement and regulatory regime prevalent in the host country. In

recent years, profit opportunities have become a key factor in determining the pattern of foreign bank shareholdings and have taken varied forms: acquisition, targeted purchases of specific activities, joint ventures or alliances and outsourcing of administrative and financial services (Box VIII.9).

Box VIII.9
Branches *versus* Subsidiaries of Foreign Banks

Since the second half of the 1990s, banking sectors in some of the emerging economies in Latin America and Eastern Europe have witnessed increasing control and dominance of foreign banks. In fact, most of these emerging economies were inflicted by banking crises and subsequently, as a part of strengthening, the banking sector in these economies was opened for entry of foreign banks. Policy makers while deciding liberalisation of the foreign banks entry not only weigh the costs and benefits on domestic banks and on the corporate sector but also often analyse pros and cons of the mode of entry before deciding. Foreign bank can be allowed to enter through two modes: First, foreign bank can open a *de novo* bank through greenfield investment and second, foreign bank can enter through acquisition of the existing domestic banking entity.

Again, in the case of greenfield investment, policy makers as well as foreign banks have two options, *i.e.,* to establish a branch or a subsidiary. A branch is licensed by the host country with powers defined in the parents' company charter but with obligation and limitation stated by the authorities in the host country. A subsidiary is a fully independent legal entity, with powers and responsibilities set by its own charter in the host country. Normally, foreign banks decide the mode of entry in the case of greenfield investment depending upon the purpose of investment by the parent bank. In case a foreign bank wants to explore profitable opportunities through host of banking activities, *i.e.*, deposits, credits and other financial services in the host country, then the obvious choice would be a subsidiary. On the other hand, the choice will most likely dwell on a branch if entry of foreign bank stems with an objective of promoting the coordinated operations of the parent bank. As recently illustrated by the decisions of some foreign banks not to capitalise their subsidiaries in Argentina, the branches' access to the parent bank capital is more often direct than is the case for subsidiaries (Clarke *et al.*, 2002). Foreign bank branches are typically involved in wholesale banking, while subsidiaries are involved in retail banking in most of the countries.

Another issue related to foreign bank entry in the form of branch or subsidiary emanates from their likely behaviour during the crisis periods. Although, there is a general belief that foreign banks may be a stabilising influence before or during local crisis, their response may depend upon their entry through branches or subsidiaries. A branch is a part of a parent bank and can draw upon the capital of the parent in the case of a difficulty. In case the subsidiary face any difficulty, the parent company may simply wind up the subsidiary. In other words, parent banks face full responsibility of the liabilities of branches, while their liability is limited to the loss of the equity invested in the case of subsidiaries. However, concerns about loss of reputation have at times led banks to support their subsidiaries, although they were not legally bound to do so.

Eisenbeis and Kaufman (2005) highlighted that despite the benefits that might accrue to foreign ownership, either in the form of branch offices or subsidiary banks, cross-border banking raises a number of important policy concerns. These relate to the provision of deposit insurance, the effectiveness of prudential regulation, the strength of market discipline, the timing of declaring an insolvent institution officially insolvent and placing it in receivership or conservatorship, and the procedures for resolving bank insolvencies. It is also often found that the main benefits associated with foreign branches are in terms of their increased lending capacity (basing loan size limits on the parent bank's capital), and reduced corporate governance requirements, unlike foreign bank subsidiaries.

The Committee on Global Financial System (2004) highlighted the issues regarding the sharing of information by foreign entities with host regulatory and supervisory authorities. Concern is especially acute for foreign branches which do not have meaningful balance sheets or income statements. This makes monitoring difficult for the host country regulator. In the case of subsidiaries, since they are separate legal entities, they would have balance sheets and income statements that would be available to the regulator in the country in which they are chartered.

From the host country's perspective, foreign banks entry in the form of branches and subsidiaries would largely depend on the competency and preparedness of the regulatory and supervisory authorities of that country. However, with increasing size of foreign outposts of foreign banks, the division of supervisory responsibilities between host and home country based on the distinction between branch and subsidiary is getting increasingly blurred.

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8.90 In many of the emerging market economies, foreign bank entry has been the result of initiatives taken by the local authorities to improve the efficiency and stability of their financial systems, and also to reduce the recapitalisation of weak domestic banks, following the banking crisis. With improvements in risk measurement and management in emerging economies, foreign banks have gained experience in quantifying and managing market and credit risks using standard frameworks. The revamped macroeconomic policy frameworks and a greater reliance on market forces have also aligned the character of EME-related risks more closely with those in mature economies. These developments have facilitated the expansion of foreign banks in these countries. Various studies have found the increased influence of foreign banks in terms of their control and participation in the banking sectors of emerging economies, especially during the second half of 1990s onwards (Eichengreen and Mussa, 1998). The liberalisation of the Latin American economies with free trade and capital flows spearheaded the demand for new financial products and services that was accommodated by the reformed and restructured banking systems (Aguirre and Norton, 2000).

8.91 EMEs provided the foreign banks the opportunities for entry, as in these countries, interest margins as well as operating costs were invariably very high. Further, EMEs, with a greater openness to foreign trade and investment in the aftermath of financial crises, wanted to transform the banking sectors by infusing competition and efficiency and bring about financial stability by looking upon to international banks (Box VIII.10).

8.92 There are several potential costs and benefits associated with the entry of foreign banks. The entry of foreign banks can stengthen the financial systems of the host nations. The benefits from entry of banks arise for several reasons. The increase in the number of banks directly increase the competition. Efficiency also improves from the infusion of technology and skilled management leading to overall improvement in the quality of services. Allocation of credit improves due to application of formal credit standards. Incentives and expertise to develop certain segments of the market also help in the development of local markets. The introduction of superior risk management practices also enhances the soundness of the domestic financial system. Stronger capital base and less sensitiveness to host country business cycle of foreign banks lend a stabilising influence at the time of financial distress. A lower cost structure of foreign banks also helps in lowering the cost structure of the entire banking system.

8.93 On the other hand, depending upon the mode of entry of foreign banks, there can be loss of competition due to concentration. Consequently, the benefits to customers in terms of lower cost of intermediation would depend upon the form of entry and the consequent pricing strategy followed. For the domestic banks, competing with larger foreign banks could mean incurring additional costs. There is also a general concern that entry of foreign banks would lead to neglect of small customers and diversion of domestic funds to large corporate through inter-bank market. Further, there are also supervisory and regulatory challenges that crop up with entry of foreign banks (Box VIII. 11).

8.94 Cross-country evidence reveals that the benefits and costs of foreign banks are not unambiguous, and have been contextual, depending upon the sequencing of financial sector reforms and the level of development of the concerned country. In some countries such as Thailand, the Philippines and countries in the Central and Eastern Europe, foreign banks entry led to improved competition and efficiency. On the other hand, in many of the Latin American countries, the level of competition declined due to increased concentration of banking assets with foreign banks. In general, foreign banks exert more competitive pressure in developing countries than in the developed countries, where domestic banks are already competitive. The empirical evidence on the impact of foreign banks entry on financial stability and the lending pattern of banks has not been conclusive (Box VIII.12).

8.95 The cross-country evidence on the relative efficiency between foreign and domestic banks has also been mixed. For the developing countries, as a group, net interest margins of foreign banks were lower than those of domestic banks. However, the overhead to asset ratio and the cost to income ratio of domestic banks were lower. Significant variations were observed across the regions. In South Asia, however, mainly reflecting their performance in India net interest margins of foreign banks were higher than those of domestic banks. However, the overhead to asset ratio and the cost to income ratio were lower than those of domestic banks (Table 8.11).

Box VIII.10
Growing Significance of Foreign Banks in EMEs

With increasing financial liberalisation, one of the most striking changes in many emerging markets' financial system has been the growing presence of foreign-owned financial institutions, particularly in the banking sector. Following banking crises in many EMEs during the 1990s, authorities opened up their economies to foreign banks as a part of a strategic consolidation of the banking sector. Yet, the rise in foreign ownership of banks in emerging markets is one facet of the ongoing consolidation of banking systems in both mature and emerging markets (Mathieson and Roldos, 2001).

The extent of foreign banks control and participation in EMEs have increased significantly during the second half of the 1990s and onwards. However, studies have found divergent trends across different regions, with Central Europe and Latin America witnessing larger increase in the presence of foreign banks than Asia. Foreign banks' participation in Central Europe, which increased considerably in the second half of the 1990s, reached over 50 per cent by the end of the decade. In Latin America, although foreign banks presence dates back for many decades, there has been a quantum jump in the extent of participation in the second half of the 1990s with the acquisition program initiated by the leading Spanish financial institutions. For example, foreign banks had a relatively large presence in Argentina and Chile by end-1994, and the share of assets under foreign control increased to 50 per cent, following a series of mergers and acquisitions in 1996-97 (Mathieson and Roldos, 2001). In Mexico, foreign banks accounted for over 75 per cent of total banking sector assets.

A comparison of the performance of foreign and domestic banks in select Latin American countries revealed that while foreign banks differed little from their domestic counterparts in overall financial condition, they showed more robust loan growth, a more aggressive response to asset quality deterioration, and a greater ability to absorb losses characteristics that could help to strengthen the financial systems of their host countries (Goldberg, Crystal and Dages, 2002). Foreign banks in Asia have played a smaller role than in Central Europe and Latin America, partly due to the official policies stance on limited entry, especially the local retail banking markets.

The past decade has also seen a transformation of the role of foreign banks in EMEs. First, while the large foreign banks expanded there operations in select markets, some mid-size foreign banks also entered EMEs since the mid-1990s. Accordingly, international claims of BIS reporting banks increased substantially in all emerging markets in Asia, Latin America and Central & Eastern Europe (Table A). Second, while initially foreign banks provided services to their traditional clients, later they also started targeting aggressively local customers in EMEs. One reflection of this development is that direct cross-border lending by the head offices of foreign banks has been progressively overshadowed by the local lending of their foreign affiliates. The rising focus of foreign banks on local retail activities has resulted into substantial rise in local claims of BIS reporting banks in emerging market economies across the world (Table A). Increased participation of foreign banks in

Table A: International and Local Claims of BIS Reporting Banks in Emerging Market Economies

Item	Year	Asia	Latin America	Central & Eastern Europe	Others
International Claims* (US $ billions)	1995	745	188	76	61
	2000	471	257	87	91
	2005	590	196	190	105
	2007	961	251	353	186
Local Claims** (US $ billions)	1995	159	28	3	1
	2000	286	165	35	7
	2005	529	331	175	17
	2007	730	505	276	114
Local Claims/ International Claims (%)	1995	21	15	4	2
	2000	61	64	40	8
	2005	90	169	92	17
	2007	76	202	78	61

* : BIS reporting banks' cross-border claims in all currencies and their foreign affiliates' local claims in foreign currencies.
** : BIS reporting banks' local claims in local currencies.
Source: BIS (Consolidated Banking Statistics).

emerging market economies is visible in rising cross-border international claims and local claims of BIS reporting banks in these countries.

Another manifestation of increasing influence of foreign banks across the world including EMEs is in their rising share in total assets across the regions (Table B). The share of foreign banks in total assets in Eastern Europe and Latin America more than doubled during 1995-2005. In some of the Central and Eastern European countries, foreign banks accounted for about 90 per cent of total assets of banking system. However, foreign banks' share in total assets in Asia was very low and stagnated at the same level during this period.

Table B: Foreign Banks' Assets across the Regions (Per cent)

Region	1995	2005
All Countries	15	23
North America	10	21
Western Europe (19)	23	29
Eastern Europe (8)	24	58
Latin America (14)	18	38
Africa (25)	8	8
Middle East (25)	14	17
Central Asia (4)	2	2
East Asia & Oceania (13)	5	6

Note : Figures in brackets indicate number of banks.
Source : IMF, Global Financial Stability Report, April 2007.

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Goldberg, L. S., Crystal, J and Dages, B. G. 2002. "Has Foreign Bank Entry led to Sounder Banks in latin America?" *Current Issues in Economics and Finance*, Vol.8, No. 1.

Mathieson, Donald J. and Roldos, J. 2001. "The Role of Foreign Banks in Emerging Markets." Prepared for 3rd Annual Financial Markets and Development Conference, The World Bank, International Monetary Fund, and Brookings Institution.

Box VIII.11
Cost and Benefits of Foreign Banks Entry

The following are the commonly highlighted benefits of foreign bank entry. First, it heightens competition and promotes efficiency leading to decline in costs or increase in productivity. When a foreign bank enters through greenfield investment and sets up a *de novo* institution, the increase in the number of banks in the host country directly enhances competition. Entry through merger and acquisition, which infuses more skilled management and upgrade governance through introducing more advanced systems and risk management, may force other banks in the host country to improve their efficiency in order to protect their market shares.

Second, entry of foreign banks improves credit allocation, as in making credit decisions, they apply formal credit standards and risk-adjusted pricing and are not influenced by other considerations.

Third, foreign banks help in the development of local financial markets since they have both the incentives and the expertise to develop certain segments of local market, such as funding, derivatives and securities markets. Foreign banks that lack a branch network to guarantee deposit financing of their activities are more likely to turn to the inter-bank market. Foreign banks can also contribute by bringing professional expertise to the local foreign currency markets. They often try to create markets or gain market share through product innovation, especially by offering a variety of new financial services to corporate clients, including structured products.

Fourth, the overall soundness of domestic financial system is enhanced by introducing the risk management practices of the foreign parent banks. Based on tighter credit review policies and practices, they adopt more aggressive measures to address asset quality deterioration and limit the build-up of non-performing assets in the financial system.

Fifth, foreign banks may exert a stabilising influence in times of financial distress, as stronger capitalisation and the possibility of an injection of additional funds by the parent, if needed, reduces the probability of failure. For the same, foreign banks are less sensitive to both home and host country business cycles, and consequently, lending to local residents in the local market is likely to be more stable in times of stress than either cross-border lending or the lending of indigenous banks in the markets. Further, when the foreign banks continue to operate in a crisis, the probability of the system as a whole remaining functional increases.

Sixth, there could be long-term benefits from lower cost structures in the banking system. Foreign banks, in general, are found to operate with lower administrative costs as has been found in Latin America and most of other developing countries (Cull and Peria, 2004). However, in some countries such as India, operating cost of foreign banks was found to be higher than that of domestic banks.

Seventh, foreign ownership usually involves the transfer of human capital at both the managerial and the operational level. Complementary to this is the transfer of "soft" infrastructure such as back office routines or credit control systems. Such transfers have gained importance to reap economies of scale through standardisation of processes.

There could also be several costs associated with the entry of foreign banks.

First, entry of foreign banks could also lead to concentration and loss of competition. In many countries, foreign banks entered the system mainly by acquiring existing domestic banks, while in some countries domestic banks consolidation and concentration occurred in response to foreign competition.

Second, though foreign banks entry may lower interest margins and potentially foster the process of financial intermediation, the impact would depend on the form it takes and may not benefit all borrowers. The benefits would depend on whether the lower spread is the result of a more aggressive pricing strategy across the board or the banks choosing to lend only to the most transparent segments where there is more competition or at least greater market contestability.

Third, the growing presence of foreign banks can increase the complexity of the tasks facing supervisory authorities and thus lead to regulatory conflicts. This could be a particular concern in countries where foreign commercial banks expand their operations rapidly in the area of non-bank financial services such as insurance, portfolio management, and investment banking. Given the complex structure of many internationally active banks, Integral issues within foreign banks are increasingly being shown to be of potential systemic significance (Song, 2004).

Fourth, foreign banks expose the country to some downside risks/ challenges attached with their entry. More strikingly, domestic banks in emerging markets generally incur costs since they have to compete with large international banks with better reputation, particularly in developing world.

Fifth, there is a general concern that as foreign banks have historically followed home-country customers or specialised in servicing corporate customers, their entry would lead to neglect of rural customers and small and medium sized firms. Another concern is that with foreign banks using the inter-bank market for much of their funding, local banks could divert their funds from domestic loans to the inter-bank market, thereby channelling fund to large corporate at the expense of small companies.

Sixth, it is also argued that the presence of foreign banks may not necessarily yield a more stable source of credit to domestic borrowers because foreign banks can, at times, shift funds abruptly from one market to another for risk management purposes. Literature also suggests that foreign banks will be more likely to shift their funds to more attractive markets during a crisis if their parent banks are weak.

References:

Cull, R. and Peria, M.S.M 2007. "Foreign Bank Participation and Crises in Developing Countries." *World Bank Policy Research Working Paper* No. 4128.

Song, Inwon. 2004. "Foreign Bank Supervision and Challenges to Emerging Market Supervisors." *IMF Working Paper* No.WP/04/82.

Box VIII.12
Benefits and Costs of Foreign Banks Entry: Cross-Country Evidence

The empirical evidence on the benefits and costs of foreign banks entry has been mixed. With regard to impact of foreign banks on competition, in the context of Thailand, Chantapong and Menkhoff (2005) reveal that to a large extent domestic banks were able to catch up to the best-practice standards throughout 1995-2003, significantly after the 1997 financial crisis, partly due to greater foreign participation through acquisitions, which increased the competitive pressure in the banking industry, and also to financial restructuring of domestic banks. In the context of the Philippines banking sector, Unite and Sullivan (2002) also found that foreign bank entry was associated with a reduction in interest rate spreads and bank profits, but only for those domestic banks that were affiliated to a family business group. Foreign entry, in general, led to improvements in operating efficiencies, but a deterioration of loan portfolios. Analysing the performance of 219 banks, between 1995-2001, from a sample of ten countries in Central and Eastern Europe, Uiboupin (2004) offered evidence consistent with the notion that foreign bank entry increased competition.

On the other hand, examining the increased consolidation and foreign bank penetration in 11 Latin American countries, Yildirim and Philippatos (2007) found that there was a decline in competition for Brazil, Chile, and Venezuela in the late 1990s, which may be attributable to increased consolidation. However, they observed that deregulation and opening up of the financial markets for foreign participation served as an important catalyst to increase the competitiveness of banking markets. In the case of Mexico, foreign bank participation did not lead to increase in competition and efficiency, and instead, led to a retrenchment in lending (Haber and Musacchio, 2005). In the case of China, Huang *et al.* (2007) argued that it was difficult to be conclusive on whether the foreign banks entry had enhanced the competitiveness of Chinese domestic banks.

The benefits from entry of foreign banks were found to depend upon the sequencing of financial sector reforms and the level of economic development. Using data on 30 developing and developed countries, Bayraktar and Wang (2004) found that foreign banks entry had significantly improved domestic banks competitiveness in countries which liberalised their stock market first. In these countries, both profit and cost indicators were negatively related to the share of foreign banks. Countries which liberalised their capital account first seemed to have benefited less from foreign banks entry as compared to the other two sets of countries.

Literature also suggests that impact of foreign banks entry on domestic banks is not uniform across the developed and developing countries. For instance, based on a sample of 7900 banks from 80 countries, Claessens *et al.* (2001) found that although entry of foreign banks led to reduction in profitability and margins for domestic banks, foreign banks had higher profits than domestic banks in developing countries, while the opposite was true in developed countries. This may be due to home ground advantage of domestic banks such as organizational problem, better knowledge of local customers and difference of language and culture. Consequently, foreign banks in developed countries are unable to exert any influence on interest margins, operating expenditure and profitability etc., of domestic banks.

The evidence on the impact of foreign banks entry on the economy and the stability of the financial sector has also been ambiguous. In some emerging markets, foreign banks entry are found to exert a stabilising influence before and during the crisis periods, as they appear not to retrench their lending significantly during the crisis periods when compared to domestic banks. Credit granted by foreign banks in Argentina and Mexico was more stable than credit granted by locally-owned banks (Goldberg *et al.*, 2000). Foreign banks did not abandon the local markets during 1997-98 crisis in Malaysia and received less Government support than domestic institutions (Detragiache and Gupta, 2004). On the other hand, in the cross country context, it was found that foreign ownership neither showed unambiguous impact on the economy nor on the stability of the financial sector.

With regard to divergence in the business focus of foreign and domestic banks, the empirical evidence has been mixed. In Central Europe, foreign banks were found to increasingly focus on lending to small and medium-sized enterprises and households due to strong competition and significant penetration. However, in most emerging markets, foreign banks were cautious of lending to smaller firms due to limited knowledge of local industry. Thus, there is no decisive cross-country empirical evidence that foreign banks entry adversely affects lending to SMEs.

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Claessens, S., Demirguc-Kunt, A. and Huizinga, H. 2001. “How Does Foreign Entry Affect Domestic Banking Markets?” *Journal of Banking and Finance*, Vol. 25, No.5.

Uiboupin, J. 2004. “Implications of Foreign Bank Entry on Central and East European Banking Market.” *Kroon & Economy*, No.1. pp.25-35.

Yildirim, H. S. and G. C. Philippatos, 2007. Restructuring, Consolidation and Competition in Latin American Banking Markets, *Journal of Banking and Finance*, Vol.31 No. 3.

Table 8.11: Foreign and Domestic Bank Performance Indicators in Developing Regions – 1998-2005 (Average)

Category	Net interest margin (%)	Overhead to assets ratio (%)	Taxes to assets ratio	Loan loss reserves to assets ratio	Loan loss reserves to gross loans	Pre-tax profits to assets ratio	Cost to income ratio
Developing countries							
Domestic	7.27	**5.72**	**0.53**	4.51	**8.32**	**1.69**	**69.60**
Foreign	6.86	**6.30**	**0.63**	3.63	**7.27**	**1.29**	**76.52**
East Asia and Pacific							
Domestic	3.84	2.68	**0.35**	**3.26**	**6.01**	**0.66**	63.98
Foreign	3.83	3.03	**0.57**	**10.35**	**11.85**	**2.04**	62.10
Europe and Central Asia							
Domestic	**7.71**	**6.55**	**0.67**	**5.24**	**8.13**	**2.08**	**67.86**
Foreign	**6.02**	**5.59**	**0.41**	**2.92**	**5.70**	**1.43**	**73.73**
Latin America and the Caribbean							
Domestic	**9.79**	7.55	**0.44**	3.06	7.23	**1.84**	76.74
Foreign	**7.83**	8.05	**0.83**	2.74	7.52	**0.63**	81.30
Middle East and North Africa							
Domestic	3.57	**2.16**	0.25	5.84	12.66	1.08	**59.78**
Foreign	3.71	**2.69**	0.27	8.25	16.07	0.90	**76.09**
South Asia							
Domestic	2.85	2.52	**0.44**	2.47	6.35	**0.92**	64.75
Foreign	3.75	2.38	**1.02**	1.62	7.06	**2.46**	51.07
Sub-Saharan Africa							
Domestic	10.08	7.76	0.79	**8.52**	**12.56**	2.55	74.08
Foreign	9.07	7.24	0.81	**3.31**	**5.54**	1.89	81.40
Developed countries							
Domestic	2.63	2.20	0.27	**1.92**	3.19	1.01	**59.78**
Foreign	1.80	1.74	0.23	**1.40**	2.69	1.26	**55.86**

Note : Pairs in bold indicate difference in means of corresponding indicators for foreign and domestic banks and are statistically significant at 10 per cent level. Net interest margin is net interest income as percentage of earning assets.

Source : Global Development Finance 2008, World Bank.

8.96 In India, the presence of foreign banks dates back to the pre-independence period. After independence greater emphasis, however, was laid on strengthening the domestic banking sector with the increased participation of public sector banks. After the initiation of financial sector reforms, entry of foreign banks in India was opened up further. The CFS in 1991 and the CBSR in 1998 recommended further opening up of the Indian banking sector to foreign banks to augment competition and efficiency. The CFS put forth that entry of more foreign banks would enhance competitive efficiency of the Indian banking sector and encourage domestic banks to induct banking technology and professional governance practices. Furthermore, a window for expansion of foreign banks was opened in India under the General Agreement on Trade in Services (GATS) of World Trade Organisation (WTO). Initially, under GATS India committed to issue five additional branch licenses to both new and existing foreign banks. Subsequently, in a supplementary agreement signed in July 1995, this limit of five branches was increased to eight branches and further to twelve branches in February 1998. Along with allowing more branches of foreign banks, giving them more flexibility in their operations. India has gone beyond the WTO commitment of 12 branches. In fact, number of branches allowed each year has already been higher than WTO commitments.

8.97 Initially foreign banks in India were allowed to enter and expand by *de novo* branches only and were not permitted to own controlling stakes in domestic banks. Subsequently, the aggregate foreign investment from all sources was allowed up to a maximum of 74 per cent of the paid-up capital of a private bank.

8.98 The road map for the presence of foreign banks in India, divided into two phases, was unveiled in February 2005. In the first phase (April 2005-March 2009), foreign banks are permitted to establish presence by way of WOS or conversion of the existing branches into a WOS following the one mode presence criterion. The WOS are treated on par with the existing branches of foreign banks for branch expansion in India. So far, however, no bank has applied for a WOS presence. Second phase will begin from April 2009 and further measures related to foreign banks presence would be decided after reviewing the experience in phase I.

8.99 The existing procedures indicate that regulatory regime followed by the Reserve Bank in respect of foreign banks is non-discriminatory, and is, in fact, very liberal by global standards. This is evident from (i) India issues a single class of banking licence to foreign banks and does not require them to graduate from a lower to a higher category of banking licence over a number of years; (ii) the single class of licence places them virtually on the same footing as an Indian bank and does not place any restrictions on the scope of their operations; (iii) no restrictions exist on establishment of non-banking financial subsidiary in India for the specified 18 activities under automatic route by the foreign banks and their group companies; (iv) deposit insurance cover is uniformly available to all foreign banks at a non-discriminatory rate of premium; (v) the prudential norms applicable to the foreign banks for capital adequacy, income recognition and asset classification, *etc.*, are, by and large, the same as for the Indian banks. Thus, the Indian regulatory regime is essentially non-discriminatory as between branches of foreign banks and domestic banks, in regard to their authorisation or the scope of their operations. In fact, some hold that there is some positive discrimination in favour of foreign banks by way of lower priority sector lending requirement at 32 per cent of the adjusted net bank credit as against a level of 40 per cent required for Indian banks. Thus, Indian regulatory regime is in fact much more equitable and provides a far more level playing field to the foreign banks, than in many other jurisdictions, both developed and emerging economies (Leeladhar, 2007).

8.100 The number of foreign banks in India increased from 24 in 1990 to 41 during 2000; although their number consequently declined to 29 in 2005 on account of merger between the Indian branches of foreign banks, merger of banks at a global level and closure of some foreign banks. However, the share of foreign banks in total scheduled commercial banks operating in India increased from 13.9 per cent in 2000 to 16.5 per cent during 2007 due to decline in total number of domestic banks. Yet, the number of branches of foreign banks augmented significantly from 138 in 1990 to 186 in 2000 and further to 272 during 2007. The share of foreign banks' in total assets of SCBs improved from 5.6 per cent in 1990 to 7.5 per cent in 2000 and further to 8.0 per cent during 2007 (Table 8.12). Thus, the policy changes on entry of foreign banks in India implemented during 1995 and 2004 have had positive impact on their presence in the Indian banking industry.

Table 8.12: Foreign Banks in India

Year	Foreign Banks (No.)	Foreign Branches (No.)	Share in Total Number of Commercial Banks Operating in India (Per cent)	Share in Total Assets of Commercial Banks (Per cent)
1980	14	129	9.5	3.9
1990	24	138	8.8	5.6
1995	29	156	10.2	7.3
2000	41	186	13.9	7.5
2003	36	207	12.9	6.9
2005	29	251	13.6	6.5
2006	29	262	16.5	7.2
2007	29	272	16.5	8.0

Source : Report on Trend and Progress of Banking in India (RBI), Various Issues.

Banking and Commerce

8.101 The guidelines for licensing of new banks in the private sector were issued by the Reserve Bank on January 22, 1993. While reviewing the guidelines for entry of new private sector banks in January 2001, the Reserve Bank had specifically barred the large industrial houses from directly promoting a bank. However, individual companies connected with large industrial houses were allowed to take up equity of new private sector banks up to maximum 10 per cent, but without controlling stake. The 10 per cent limit is applied to all inter-connected companies of large industrial houses and the final decision about which company belongs to an industrial house or was connected with it rests with the Reserve Bank (RBI, 2001).[2] Any higher level of acquisition is to be with the prior approval of the Reserve Bank and in accordance with the guidelines of February 3, 2004. Similarly, it was laid down that the proposed bank shall maintain an arm's length relationship with business entities in the promoter group and the individual company/ies investing up to 10 per cent of the equity as stipulated above. Banks can not extend any credit facilities to the promoters and company/ies investing up to 10 per cent of the equity.

8.102 Given the need for consolidation of Indian banking industry in the context of greater capital account convertibility, the Committee on FCAC (Chairman: Shri S.S. Tarapore) recommended for allowing greater participation of industrial houses in commercial banking. The Committee observed that the commercial banks in India, depending on the banking groups, are governed by six different statutes [*viz*., Banking Companies (Acquisition & Transfer of

[2] RBI Notification on 'Guidelines on entry of new banks in the private sector', RBI, 2001.

Undertaking) Act, 1970; Banking Companies (Acquisition & Transfer of Undertaking) Act, 1980; State Bank of India Act 1955; State of Bank of India (Subsidiary Banks) Act, 1959; Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003; and the Companies Act, 1956)], which are in addition to the Banking Regulation Act, 1949. These statutes having embedded provisions hinder good governance and consolidation. The Committee, therefore, recommended that to promote easier market driven consolidation, necessary legislative amendments be made to the above statutes so that all commercial banks are registered under a single Companies Act and regulated under the Banking Regulation Act. The Committee further recommended that until the amendments of the relevant statutes to promote consolidation in the banking system, the Reserve Bank should evolve policies to allow, on a case by case basis, industrial houses to have a stake in Indian banks or promote new banks.

8.103 Greater participation of industrial houses in commercial banking has also been argued for the post-2009 period when entry of foreign banks would be reviewed. It has been argued that already there is majority foreign shareholding in the two largest private sector banks in India.

8.104 Arguments for combining banking and commerce mainly dwell upon the potential gains stemming from operating and information efficiencies. Operating cost would fall if there are economies of scale and scope as average cost of production would fall with the increase in the scale of production and product diversification. Evidence provides that banking and commercial affiliations arise out of confluence of a particular need for a service in a particular market and the ability of a particular bank to provide that service. Similarly, commercial firms would have the incentive to affiliate with banks if there are scope economies to be realised. With regard to informational efficiency, it is maintained that when banks hold equity of non-financial firms, the financial constraints of the latter are eased since the banks by having specific information can accommodate funding requirements of the firm. An insider bank can also make more accurate assessments of the risks facing the firm than an arm's length bank can and enable providing additional services.

8.105 While the policy makers should have no objections if combining banking and commerce leads to lower operating costs and improves flow of information between firms and investors, there are several risks involved. The three most serious regulatory concerns stem from the conflict of interest between banking and commerce, reduced level of competition and the threat to safety net. The most frequently cited example on conflict of interest is the potential for banks to help firms issue bonds and use the funds to pay off their bank loans. Banks could also use their insider knowledge of a firm to trade profitably in the firm's securities. Historically, one of the chief reasons for separating banking and commerce was the desire to curtail concentration of economic powers in the hands of banks. When banks hold a large equity share of firms, they may deny finance to the competitors of the firm to earn a greater return on its equity investment. However, such situations are likely where the competition is already imperfect and the discriminated firms have no alternative sources of finance.

8.106 The greatest source of risk from combining banking and commerce arises from the threat to the safety net provided under the deposit insurance and 'too-big-to-fail' institutions whose depositors are provided total insurance and the mis-channeling of resources through the subsidised central bank lending to banks. Because of the safety net provided, the firms affiliated with banks could take more risk with depositors' money, which could be all the more for large institutions on which there is an implicit guarantee from the authorities. Bank can also channel cheaper funds from the central bank to the commercial firm. On the other hand, bad assets from the commercial affiliate could be shifted to the bank either by buying assets of the firms at inflated price or lending money at below-market rates in order to effect capital infusion. Though the regulators temper the risk taking incentives of banks by monitoring and through formal examinations, this supervisory task is rendered more difficult when banking and commerce are combined.

8.107 Empirically, in the cross-country context, the cost and benefit of combining bank and commerce is an unsettled issue. It is argued that in the German universal banking system "hausbank", the ownership and control on companies by the universal banks led to provision of better corporate control on companies. A similar view is held in the case of Japan, where by combining bank and commerce, main banks are able to rescue financially distressed companies by extending credits in an environment with weak contract enforcement. For the less developed economies where contracts are ineffective and price signals from the market are relatively uninformative, relationship-lending by combining commerce and banking may work better than arm's length credit relationship (Rajan and Zingales, 1998).

8.108 In the US, the policy of separating banking and commerce has been generally followed since 1787 and has gained strength over time. Banks have frequently tried to engage in commercial activities, and commercial firms have often attempted to gain control of banks. However, federal and state legislators have repeatedly passed laws to separate banking and commerce, whenever it appeared that either (i) the involvement of banks in commercial activities threatened their safety and soundness; or (ii) commercial firms were acquiring a large numbers of banks (Wilmarth, Jr, 2007). In this context, concerns relate to loans to commercial affiliates with favourable terms and relaxed underwriting standards and distortions in the allocation of credit, resulting from preferential bank lending to suppliers and customers of commercial affiliates. A new law 'the Gramm-Leach-Bliley Act' was enacted in 1999 which allows commercial and investment banks to consolidate but continues to separate the banking and commercial activities. Besides the US, several other countries including Canada, Israel, Hong Kong, Italy, Malaysia, Mexico, the Philippines and Thailand do not permit non-financial firms to own banks.

8.109 Empirical evidence provided by Edwards and Fischer (1994) on German universal banking and Kang and Stulz (2000) on Japanese firms, however, have refuted the advantages of combining banking and commerce. It may be noted that in Germany and Japan, banks exercise their right to hold equity in commercial firms, but it is unusual for commercial firms to own banks. Further, combining banking and commerce has been singled out as an important factor for the financial crisis in the emerging market economies. Notable examples have been the Chilean banking crisis of 1982, where unending rollovers of loans evading regulatory controls were allowed due to liaison between banks and corporate and financial crisis in Thailand in 1997 where there were high level of related party transactions between banks and their affiliates. Barth, Caprio and Levine (2000), however, found that the likelihood of a banking crisis was greater if tighter restrictions were placed on bank ownership of non-financial firms.[3]

8.110 Recognising the inherent problems in mixing banking and commerce, some of the emerging markets have taken steps to separate the two activities. In Singapore, banks have been asked to divest their non-financial assets and cross-holdings are allowed in only one direction. The sharing of directors, managers or brand names is also prohibited. Similarly, in Brazil, the major banks have been asked to divest from their non-financial companies, while in Republic of Korea, individual ownership of a bank holding company is limited to 4 per cent of total equity to prevent industrial capital from controlling financial capital.

VII. THE WAY FORWARD

8.111 In the previous section, some of the issues relating to the process of consolidation, role of public sector banks, operations of foreign banks in India and combining the banking and commerce were discussed. In this section, some specific suggestions relating to each of the four above referred aspects are made with a view to further consolidating the gains in the banking sector.

Consolidation

8.112 There have been some mergers and amalgamations in the Indian banking industry in recent years. Despite this, however, competition in the banking sector has increased as mergers involved smaller banks. At present, of the 15 largest banks, 13 are in the public sector in which the holding of the Central Government can not be less than 51 per cent. This also ensures that there is no threat to competition. However, going forward, the scenario could change. The Government may have to allow PSBs to raise capital from the market as discussed subsequently in this section. Also, the roadmap for foreign banks is due for review in 2009. These developments, as and when they occur, would need to be monitored and guided carefully so that competitive pressures in the banking system are maintained in the interest of overall banking efficiency. Cross-country experiences suggest that where entry of foreign banks was allowed in the form of acquiring existing domestic banks, domestic banks consolidated in response to foreign competition, leading to concentration of assets and liabilities in the banking system and loss of competition. The cross-country experiences also suggest that FDI in banking activities of EMEs increased substantially beginning the mid-1990s. The value of FDI, as measured by cross-border M&As targeting banks in EMEs, rose from about US$ 2.5 billion during 1991-95 to US$ 51.5 billion in the following five years and US$ 67.5 billion from 2001 to October 2005. The share of cross-border M&A deals involving financial institutions from EMEs as the target increased from 13 per cent of the global amount in 1991-95 to 28 per cent in 1996-2000 and further to 35 per cent from 2001 to October 2005. Between 1991

[3] The study, however, did not distinguish in clear terms whether the tighter norms on bank ownership followed after the crisis or existed before.

and 2005, transactions targeting banks in the Latin America region accounted for US$ 58 billion or 48 per cent of total cross-border M&As targeting banks in EMEs. Latin America was followed by emerging Asia with US$ 43 billion (36 per cent of total M&As) and central and eastern Europe with US$ 20 billion (17 per cent of total M&As) (Domanski, 2005). The implementation of Basel II could also accelerate the process of consolidation as smaller banks would face several difficulties such as cost implications and higher management information system (MIS) requirements. The implementation of Basel II itself would also immediately raise capital requirements. In view of the above referred developments, there would be need to ensure that consolidation does not undermine competition.

8.113 Consolidation among large banks, in particular, would raise both competition and moral hazard concerns, *i.e.,* “too big to fail”. It has also been argued in some quarters that in terms of size, banks in India do not compare well with banks in other countries. As alluded to earlier, the size of the banking sector needs to be seen in relation to the size of the economy. And if size is the issue, some banks in the world are larger than the size of the scheduled commercial banking sector in India.

8.114 In order to preserve competition, some countries such as Canada have denied mergers of banks. In Australia, there is a policy of ‘four pillars’, whereby the merger of any two or more of the big four banks is not allowed. Some countries have also imposed higher CRAR for banks with large market share, *i.e.,* 20 per cent or more. It would, therefore, be necessary to have appropriate policy in place, whereby the competition is not undermined any time in future. While mergers among large banks can undermine competition, competition can be enhanced if mergers take place among the smaller and weaker banks in order to compete with the larger banks. Empirical analysis shows that scale economies exist significantly at the lower size segment of the banking sector.[4] However, these economies of scale get exhausted with increase in size and turn into diseconomies only for the banks in the largest class size. This suggests that in India there is scope for several small banks to expand further through mergers and acquisitions and still operate in the economies of scale zone. While a large and well capitalised bank can readily absorb isolated small banks and improve the performance of the merged entities, it is unlikely that merging two weak banks can quickly create a single strong bank. However, any move to merge even the smaller banks, as in the past, needs to be driven by the synergies. It would also need to be ensured that the larger entities do not neglect small customers.

Public Sector Banks

8.115 After nationalisation of 14 banks in 1969 and six banks in 1980, a major segment of the banking system came under the ownership of the Government. Although with the entry of new private sector banks, the share of public sector banks has declined, they still remain the mainstay of the Indian banking sector, accounting for nearly 70 per cent of assets and income.

8.116 As alluded to in the previous section, in several emerging market economies state-owned banks have been privatised. However, this was done to restructure the banking systems after the crises. In contrast, the Indian banking sector is in robust state. Public sector banks have been able to improve their performance. Public sector banks have been able to achieve, to a large extent, the objectives for which they were nationalised. There has been sharp overall increase in credit to the preferred sectors, especially agriculture. Adequate safeguards are in place to avoid the pitfalls which forced the Government to nationalise banks. Priority sector targets are in place to ensure that credit flows to the desired sectors. Such targets can continue to exist so long as the need is felt for directing credit to certain preferred sectors.

8.117 Although ownership is not an issue insofar as efficiency of public sector banks and providing credit to the desired sectors is concerned, there are several other issues that need to be carefully weighed. The operating environment for banks has changed quite significantly in the last few years. The Indian economy is getting increasingly integrated with the global economy. India is also progressively moving towards fuller capital account convertibility. Competition in the banking sector has intensified. In a competitive environment, banks need flexibility to respond to the changing conditions. Also, in order to sustain operations, banks need to raise capital from the market on an ongoing basis. At present, all public sector banks have CRAR of more than 10 per cent.

[4] Essentially, the ray scale economies measure the response of cost to change in output (scale) for different sizes of bank groups. A value of greater than 1 shows that a unit increase in scale leads to more than unit increase in cost, i.e., there is diseconomies of scale. A value of less than 1 implies cost increasing by less than 1 for unit increase in output, *i.e.*, economies of scale. A value of 1 shows constant return scale (Annex VIII.2).

Although with the Basel II norms, capital requirements are expected to go up by 100 to 150 basis points, all PSBs should be able to meet Basel II norms. Thus, in the near term, public sector banks would not have difficulty in funding the capital requirements as detailed in Chapter V. However, in the medium to long-run, banks may be required to raise capital (other than the innovative instruments) from the market. In terms of the present provisions of the law, Government equity in public sector banks cannot be less than 51 per cent. This can become an issue hampering the growth of public sector banks if the Government is not able to provide adequate capital for expansion of public sector banks. Thus, there would be need to find a durable solution to the problem, whereby either the Government contributes to the capital of banks or allows banks to raise capital from the market. Therefore, the issue of state ownership needs to be weighed against the changed operating environment and whether public sector banks can continue to expand without being constrained by capital.

Foreign Banks

8.118 Although India has committed 12 branches of foreign banks in a year, it has been more liberal than the commitments. During the period 2003 to October 2007, India gave approval for 75 new foreign bank branches. In the roadmap for presence of foreign banks, it was envisaged that the issues concerning according full national treatment to the foreign banks, dilution of stake in WOS and mergers/acquisitions of any private sector bank in India will be taken up for a review in April 2009. At the time of review, several issues would need to be carefully weighed.

8.119 One of the arguments in favour of increased foreign bank presence is to enhance efficiency of the domestic banking sector. It is often argued that foreign banks entry renders the domestic banking system more competitive and thereby puts pressure on domestic banks to improve their efficiency and productivity. For instance, following banking sector crises and macroeconomic pressures in many EMEs during the 1990s, banking sectors in EMEs were opened up for foreign banks entry to generate competition, efficiency and stability. In emerging market economies, historically, the banking was a highly protected industry with very little operational flexibility to banks and no presence of foreign banks. The case of the Indian banking, however, is different. India has already a well developed banking sector. The Indian banking sector has widespread coverage as well as expertise in providing banking services. Extensive banking expertise in India stems from the diversified banking entities, *i.e.*, public sector, private sector, and foreign banks existing historically and catering to the needs of the different sections of the economy. This co-existence of different groups of banks along with the deregulation of various banking activities led to efficiency gains across the banking groups in India. Foreign banks in India in the past have played an important role. They have also brought with them latest skills and technologies and their presence had an important positive spillover effect on domestic banks. Going forward, although efficiency gains from the increased presence of foreign banks would need continued consideration, there would be need to consider the other kinds of impact that the operations of foreign banks may have. The increased presence of foreign banks, by intensifying competition, could accelerate the consolidation process that is underway. While this may be the positive outcome, it may, at the same time, also raise the risk of concentration. The prospect of liberalisation of foreign banks' entry also could lead to consolidation within the domestic banking sector. There is not much empirical evidence on the impact of cross-border consolidation on the scale, scope and product mix efficiencies. It, however, is likely to be different from the scale, scope and mixed effects within the country. If mergers involve large banks, it may lead to concentration as was observed in several Latin American countries. Here, it is significant to note that it is number of entrants, rather than their market share, which matters more for enhancing the efficiency of the domestic banking system.

8.120 Another issue which concerns the effect of foreign banks' expansion is on the supply of credit to domestic entities, especially small ones that rely heavily on bank credit for external finance. There are studies which suggest that large foreign bank presence can lead to reduction in lending to small businesses substantially. This issue is of special relevance in the present context because lending to the SME sector even in the present structure has not received adequate attention. The larger presence of foreign banks also raises several home-host issues as detailed in Chapter X. These issues, therefore, would need to be carefully weighed while reviewing the roadmap for the presence of foreign banks.

8.121 In regard to the operationalisation of the envisaged road map for the presence of foreign banks in India, in the days ahead, there are multiple dimensions of the issues involved, which need to be kept in view. As mentioned earlier, one of the important considerations relating to removal of the

statutory restriction on the exercise of voting rights and empowering the Reserve Bank of India to strengthen the governance standards in the banks and to secure this diversified ownership, envisaged under Phase I of the road map, has yet to take place. In the public sector banks segment, which continues to account for a major share of the assets of the Indian banking system, no significant progress has taken place so far in regard to the consolidation and governance practices. Public sector banks are yet to be fully compliant with the process for ensuring the observance of 'fit and proper' criteria in respect of the selection of independent directors nominated to the boards of these banks.

8.122 The foreign banks present in India had a share of 10.1 per cent in the aggregate assets and 63.8 per cent in the aggregate off-balance sheet business of the Indian banking system as on June 30, 2008 and receive a favourable regulatory treatment in certain aspects vis-à-vis their Indian counterparts. The experience of the Indian banks in other jurisdictions, however, indicates that the principle of reciprocity is not fully observed in certain jurisdictions. Certain large global banks are in the midst of considerable turmoil and financial distress in the aftermath of the credit market turbulence and its fall out. This raises question about the audit of the risk management capability of these global banks, the efficacy of their corporate governance and transparency in their financial affairs. The approach to the road map may have to take account of these developments whose implications and ramifications are not yet clear.

8.123 In terms of our WTO commitment, licences for new foreign banks may be denied when the share of foreign banks' assets in India, including both on- as well as off-balance-sheet items, in the total assets (including both on- and off-balance sheet items) of the banking system exceeds 15 per cent. The actual share of foreign banks in the total assets of the Indian banking system, including both on- and off-balance sheet items (on a notional principal basis), has been far above the limit. This share of foreign banks was at 49 per cent at end-January 2007, as mentioned in the India's Trade Policy Review, 2007. However, India has autonomously not invoked this limitation so far to deny licences to the new foreign banks.

8.124 There is also need to weigh the various issues of cross-border operations of Indian banks. As the Indian economy expands further, the number of corporates accessing the international capital markets would also increase. This would also require larger presence of Indian banks overseas, and reciprocity issues would also need to be considered in the expanded entry of foreign banks in India.

Combining Banking and Commerce

8.125 The issue of combining banking and commerce in the banking sector needs to be viewed in the historical perspective as also in the light of cross-country experiences. India's experience with banks before nationalisation of banks in 1969 as well as the experiences of several other countries suggest that several risk arise in combining banking and commerce. In fact, one of the main reasons for nationalisation of banks in 1969 and 1980 was that banks controlled by industrial houses led to diversion of public deposits as loans to their own companies and not to the public, leading to concentration of wealth in the hands of the promoters. Many other countries also had similar experiences with the banks operated by industrial houses. Several countries, therefore, continue to place restrictions on combining banking and commerce.

8.126 The issue of allowing commercial interests to undertake banking business involves several issues. One, banks by nature are highly leveraged institutions, whereby with small equity, they have command over a large amount of resources. It is in this context that the issue of diversified ownership in banks is emphasised. In contrast, industrial houses are either highly concentrated or are not so well-diversified. Also, in some cases, business houses are owned by families. The concentrated ownership of commercial interests makes it extremely difficult to achieve diversified ownership of banks. Given the fact that owners or shareholders of the banks have only a minor stake and considering the leveraging capacity of banks (more than ten to one), they command a very large volume of public funds of which their own stake is miniscule. Thus, concentrated shareholding in banks controlling huge public funds does pose issues relating to the risk of concentration of ownership because of the moral hazard problem and linkages of owners with businesses. Apart from this, greater control of individual companies also poses the issue of inter-connected lending that once was widely prevalent before the nationalisation of banks in India. Thus, diversification of ownership is desirable as also ensuring 'fit and proper' status of such owners and directors (Mohan, 2004b). The policy relating to ownership of banks by commercial interests may, therefore, have to take full account of international practices, given the issues relating to potential conflict of interests, increased potential of contagion effects and increased concentration.

VIII. SUMMING UP

8.127 An important aspect of liberalisation of the banking sector in the early 1990s was the entry of new private sector and increased presence of foreign banks to enhance the competition. The number of new private sector and foreign banks increased during the larger part of the 1990s, resulting in an overall increase in the number of banks. However, the process of consolidation through mergers and amalgamations gained momentum during the latter part of the 1990s, which led to a decline in the number of banks. Mergers and amalgamations were market driven with the Reserve Bank acting only as the facilitator. Despite the accelerated pace of consolidation, competition in Indian banking sector increased as was reflected in the various measures of concentration, which declined in recent years. It was mainly because banks involved in mergers and amalgamations were small. Concentration in the Indian banking sector was lower than that in many other emerging market economies and even some advanced countries. As is the case with several other advanced and emerging market economies, the Indian banking sector was operating under monopolistic competitive conditions and the degree of competition improved somewhat in recent years.

8.128 The Indian banking sector is at a critical juncture and is faced with several challenges/issues. These relate to nature and extent of further consolidation, the changed environment for public sector banks and the capital constraints faced by them due to Government ownership and further opening of the banking sector to foreign competition. However, some banks in India are of very small size. Although small banks have a role to play to cater to some sector specific needs, small and not so efficient banks may find it difficult to sustain their operations in a highly competitive environment. There is, therefore, a scope for consolidation. The empirical analysis also suggests that the scope for achieving economies of scale exists for banks operating at the lower end. However, the process of consolidation even of small banks should be driven by the market.

8.129 Public sector banks in India have played a very useful role in promoting the growth of the Indian economy. In the post-reform period, their performance, both in terms of efficiency/productivity and soundness parameters, has converged with that of private and foreign banks. Thus, while ownership from the efficiency viewpoint is not an issue, banks now operate in a competitive environment and, therefore, need sufficient flexibility. Another issue relates to the funding of capital requirements. Although such funding is not an issue in the near future, in the medium to long-term, the issue of funding of capital of PSBs is expected to surface. Provision will have to be made for the adequate expansion of capital of public sector banks as necessary and also of governance norms and practices that enable them to be competitive in the presence of increased competitive pressures. It is, in this context, that the issue of Government ownership needs to be weighed and the consolidation of public sector banks needs to be considered.

8.130 The road map for the presence of foreign banks in India envisages a review, in 2009, of the experience gained during the implementation of Phase I of the road map. At that stage, several dimensions of the presence of foreign banks in a country would need to be carefully examined. There is a general perception that the foreign banks bring many benefits to the host countries in the emerging markets, such as modern technology, accelerated consolidation, increased competition and the resultant gains in efficiency. While in the Indian context, the considerations of efficiency gains would need to be continually kept in view, the evidence of how the expanded presence of foreign banks, through organic or inorganic route, affects different sectors of the host economy in a variety of countries is not clear. It has been a public policy concern that the foreign banks enter a country but do not deliver the benefits to the wider community on account of their largely urban-centric presence and also since they tend to ignore the local factors due to a decision making structure, particularly in the area of credit, centralised at the overseas head office. It is also argued that the foreign banks tend to focus on the larger corporates while avoiding bank credit to the small and medium-sized enterprises. There are several studies that suggest that the expanded foreign bank presence in a country could lead to reduced availability of credit to the small firms and small borrowers. This would be an area of particular concern in the Indian context. Thus, all these considerations would need to be carefully evaluated while evolving a policy framework in regard to the enhanced presence of foreign banks in India.

8.131 India's experience before nationalisation of banks in 1969 as well as the experiences of several other countries suggest that several serious risks arise from combining banking with commerce such as conflicts of interest, misallocation of resources and emergence of the monopoly power of industrial houses. Realising these concerns, many countries have continued to place restrictions on combining banking and commerce.

Annex VIII.1: Roadmap for Presence of Foreign Banks in India

The Reserve Bank of India (RBI) released the roadmap for presence of foreign banks in India and guidelines on ownership and governance in private sector banks. Shri P Chidambaram, Minister of Finance, Government of India, in his speech announcing the Union Budget for 2005-2006, stated that the 'RBI has prepared a roadmap for banking sector reforms and will unveil the same.'

Accordingly, the following three documents were released:

a. Roadmap for presence of foreign banks in India,
b. Annex for setting up of wholly owned banking subsidiaries, and
c. Guidelines on ownership and governance in private sector banks.

Roadmap for Presence of Foreign Banks in India

It may be recalled that the Ministry of Commerce and Industry, Government of India had, on March 5, 2004 revised the existing guidelines on foreign direct investment (FDI) in the banking sector. These guidelines also included investment by non-resident Indians (NRIs) and FIIs in the banking sector.

As per the guidelines the aggregate foreign investment from all sources was allowed up to a maximum of 74 per cent of the paid up capital of the bank while the resident Indian holding of the capital was to be at least 26 per cent. It was also provided that foreign banks may operate in India through only one of the three channels, namely (i) branch/es (ii) a Wholly owned Subsidiary or (iii) a subsidiary with an aggregate foreign investment up to a maximum of 74 per cent in a private bank. In consultation with the Government of India, RBI has released the road map for presence of foreign banks in India to operationalise the guidelines.

The roadmap is divided into two phases. During the first phase, between March 2005 and March 2009, foreign banks will be permitted to establish presence by way of setting up a wholly owned banking subsidiary (WOS) or conversion of the existing branches into a WOS.

To facilitate this, RBI has also issued detailed guidelines. The guidelines cover, inter alia, the eligibility criteria of the applicant foreign banks such as ownership pattern, financial soundness, supervisory rating and the international ranking. The WOS will have a minimum capital requirement of Rs. 300 crore, i.e., Rs 3 billion and would need to ensure sound corporate governance. The WOS will be treated on par with the existing branches of foreign banks for branch expansion with flexibility to go beyond the existing WTO commitments of 12 branches in a year and preference for branch expansion in under-banked areas. The Reserve Bank may also prescribe market access and national treatment limitation consistent with WTO as also other appropriate limitations to the operations of WOS, consistent with international practices and the country's requirements.

During this phase, permission for acquisition of share holding in Indian private sector banks by eligible foreign banks will be limited to banks identified by RBI for restructuring. RBI may if it is satisfied that such investment by the foreign bank concerned will be in the long term interest of all the stakeholders in the investee bank, permit such acquisition. Where such acquisition is by a foreign bank having presence in India, a maximum period of six months will be given for conforming to the 'one form of presence' concept.

The second phase will commence in April 2009 after a review of the experience gained and after due consultation with all the stakeholders in the banking sector. The review would examine issues concerning extension of national treatment to WOS, dilution of stake and permitting mergers/ acquisitions of any private sector banks in India by a foreign bank in the second phase.

Guidelines on Ownership and Governance

For Private Banks

It may be recalled that the Reserve Bank had released a draft policy framework for ownership and governance in private sector banks on July 2, 2004 for discussion and feed back. These guidelines emphasised desirability of diversified ownership in banks, 'fit and proper' status of important shareholders, directors and the CEO and the need for a minimum capital / net worth criteria. Suitable transition arrangements had been provided while keeping the policy and the processes transparent and fair. The guidelines have remained in the public domain for a sufficient length of time and have been widely debated. There is a general consensus on the need for good governance and management in the banking system and desirability of diversified ownership to the extent possible while keeping the overriding objective of ensuring fit and proper status of owners and directors. Certain issues were also raised on the application of the framework to existing banks and the need for enabling shareholding higher than 10 per cent to facilitate restructuring in the banking system and consolidation.

Based on the feedback received and in consultation with the Government of India, the Reserve bank has now finalized the guidelines on ownership and governance. The guidelines provide for higher levels of shareholding, inter alia, for ensuring restructuring and consolidation simultaneous with compliance of fit and proper criteria. The present policy of acknowledgement for acquisition / transfer of shares by FIIs will continue based upon the guidelines on acknowledgement of acquisition / transfer of shares issued on February 3, 2004 and RBI may seek certification from the concerned FII of all beneficial interest.

While implementing the above policies it will be ensured by RBI that the approach is consultative, processes are transparent and fair, and a non-disruptive path is followed.

Annex VIII.2: Ray Scale Economies

	1999-2000	2006-07
Size Class / No. of Banks	99	79
I	0.908	0.867
II	0.880	0.888
III	0.909	0.889
IV	0.943	0.921
V	0.950	0.921
VI	0.960	0.936
VII	0.973	0.941
VIII	0.987	0.944
IX	0.984	0.948
X	0.992	0.953
XI	0.990	0.956
XII	0.992	0.926
XIII	0.992	0.964
XIV	0.990	0.969
XV	0.997	0.971
XVI	1.004	0.998
XVII		1.008

Note: A particular class does not necessarily represent the same size for both periods of analysis.