Consolidation among Public Sector Banks[1]

At present banking system in India is evolving with a mixture of bank types serving different segments of the economy. In the last few years, the system has seen entry of new banks and emergence of new bank types targeted to serve niche segments of the society. However, banking system continues to be dominated by Public Sector Banks (PSBs) which still have more than 70 per cent market share of the banking system assets. At present there are 27 PSBs with varying sizes. State Bank of India, the largest bank, has balance sheet size which is roughly 17 times the size of smallest public sector bank. Most PSBs follow roughly similar business models and many of them are also competing with each other in most market segments they are active in. Further, PSBs have broadly similar organisational structure and human resource policies. It has been argued that India has too many PSBs with similar characteristics and a consolidation among PSBs can result in reaping rich benefits of economies of scale and scope.

2. The suggestion of consolidation among PSBs has quite old history. Narasimham Committee Report in 1991 (NC-I), recommended a three tier banking structure in India through establishment of three large banks with international presence, eight to ten national banks and a large number of regional and local banks. Narasimham Committee Report in 1998 (NC-II) also reiterated the recommendations on NC-I. Recently, in the budget speech for 2016-17, Finance Minister mentioned that a roadmap for consolidation of PSBs would be spelt out. The desirability of

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[1] *Speech delivered by Shri R. Gandhi, Deputy Governor at the MINT South Banking Enclave, Bangalore on April 22, 2016.* *Assistance provided by Shri Santosh Pandey is gratefully acknowledged.*

consolidation in Indian banking sector is widely felt across the spectrum.

Current Imperatives

3. There are at present times several congruent factors that indicate that consolidation in Indian banking scene has its right time. They are as follows:

4. The need for consolidation is specially felt now, due to the fact that although India is seventh largest economy in the world in terms of nominal GDP, there is no Indian bank in the list of 70 large banks in terms of asset size. We can easily see that large banks reap certain advantages in terms of efficiency, risk diversification and capacity to finance large projects. The efficiency gains resulting from lower cost of services and higher quality of services is too attractive to ignore.

5. It is also felt that a larger bank may be less risky than a smaller bank as the larger bank will have a more diversified portfolio resulting in less volatility in its earnings. Consequently, a large bank may command higher credit rating than a smaller bank. In a March 2016 report, Fitch rating agency mentioned following: "*More stable banking systems tend to be structured around a number of large 'pillar' banking groups. These large banks in a consolidated banking system enjoy scale benefits leading to better diversification of risks and stronger overall profitability contributing to higher credit ratings.*"

6. Large banks do benefit from economies of scale in terms of risk diversification, although this benefit disappears when banks become excessively large beyond a certain threshold size. This threshold size has been subject of much debate in the discipline of finance. However, there is no clear research which may point towards an optimum size for a bank in a particular country. Perhaps in future, research will throw light on the optimum size of banks. However, in the context of India, it is felt that there is ample room for consolidation in the banking sector, especially among PSBs without creating issues of moral hazard or too big to fail concerns. It does appear that the banking system in India is too fragmented at present. There is evidence, as measured by Herfindahl-Hirschmann Index (HHI) for Indian banking sector using square of on-balance sheet market share of all banks in the system which works out to be 518.53. This indicates that our banking system is highly fragmented and diffused. In fact there is evidence which shows that this index has been falling over the years in India.

7. There are 48 domestic banks (excluding RRBs and LABs) out of which there are 27 PSBs having a market share of around 70% in terms of asset size. A comparison of performance of larger PSBs with smaller PSBs does indicate that larger PSBs perform better. For example, among all PSBs, larger PSBs like SBI and Bank of Baroda are trading at higher Price to Book Value ratio in comparison to other smaller PSBs. SBI has been able to maintain relatively strong capital ratios and appears to be in a better position to withstand shocks to asset-quality. This indicates that under Indian conditions, there is lot of scope for banks to grow in size to become efficient and diversify their risks.

8. The other important aspect which needs to be considered is credit demand of a growing economy. As Indian companies increase their business and become global in nature, their demand for large scale credit will become higher. Banks also have to grow in size to meet the higher demand of credit. The banking system will be required to enhance its capacity to lend to larger companies and to larger projects. With increase in credit penetration and as credit to GDP ratio increases from present levels of 50 percent, PSBs with a market share of over 70 per cent need to contribute significantly in the process. Without strong PSBs which are efficient, competitive and well-capitalised, meeting higher demands of bank credit would be quite challenging in future.

9. Recent proposals on Large Exposure norms which limit banks' exposure to a group by 25% of their common equity will further limit their capacity to fund large credit demands. It is therefore imperative that some consolidation among PSBs do happen to support the growth potential of the economy.

10. After the crisis, internationally there has been a significant tightening of regulatory norms. As mentioned earlier, G-SIBs are required to maintain higher amount of common equity capital than other banks. Further, Financial Stability Board has agreed on Total Loss-Absorbing Capacity (TLAC) standard for G-SIBs. G-SIBs will be required to meet the TLAC requirement alongside the minimum regulatory requirements set out in the Basel III framework. Specifically, they will be required to meet a Minimum TLAC of at least 16% of the resolution group's risk-weighted assets (TLAC RWA Minimum) from 1 January 2019 and at least 18% from 1

January 2022. These regulatory requirements have compelled many of these internationally active banks to reframe their business strategies into downsizing, quitting some businesses and some jurisdictions. This provides an opportunity for EME banks who have global ambitions, a ready business and market space. If we have good large banks, such banks can tap these opportunities and can become global banks.

11. Thus we can see that right now the time is ripe for consolidation in the public sector bank space.

Consolidation in Indian banking system in the past

12. There have been two types of bank consolidation in India. One and most obvious has been voluntary merger of banks driven by the need for synergy, growth and operational efficiency in operations. Recent merger of ING Vysya Bank with Kotak Mahindra Bank is an example of this kind of consolidation. ING Vysya Bank had a stronger presence in South India while Kotak had an extended franchise in the West and North India. The merger created a large financial institution with a pan-India presence. This kind of voluntary merger driven by synergy and clear economic logic has been rather common in the private banks segment. Other examples of this kind of merger may be acquisition of Bank of Madura in 2001 and Sangli Bank in 2007 by ICICI Bank, acquisition of Centurion Bank of Punjab by HDFC Bank in 2008, etc. The Reserve Bank has been given powers under Section 44A of Banking Regulation Act 1949 to approve such voluntary mergers. The Reserve Bank has been quite supportive of voluntary mergers of banks which have the prospect of creating value for those banks. However, such examples are not many in

public sector banks sphere. Recent merger of State Bank of Saurashtra and State Bank of Indore into State Bank of India may be seen as basically merger among group companies. The only example of merger of two PSBs is merger of New Bank of India with Punjab National Bank in 1993. However, this was not a voluntary merger.

13. The other type of merger of banks has been from the perspective of resolution of a weak bank. Section 45 of Banking Regulation Act 1949 empowers the Reserve Bank to make a scheme of amalgamation of a bank with another bank if it is in the depositors' interest or in the interest of overall banking system. The operation of the weak bank may be kept under moratorium for a certain period of time to ensure smooth implementation of the scheme. Many private sector banks have been merged with other private sector banks or the PSBs under this mechanism. The merger of Global Trust Bank with Oriental Bank of Commerce in 2004 was an example of this kind of merger. Earlier way back in 1960s, post Palai Central Bank's failure, there were several such mergers guided by the Reserve Bank.

14. Since the onset of reforms, there have been about 32 mergers / amalgamations in the banking sector. Prior to 1999, most of the mergers were driven by resolution of weak banks under Section 45 of Banking Regulation Act 1949. However, after 1999, there has been increasing trend of voluntary mergers under Section 44A of Banking Regulation Act 1949. As noted above, most of these Section 44A mergers were among private sector banks. PSBs have bypassed this trend despite the fact that there

might have been ample opportunities of creating value through strategic mergers and acquisitions among two PSBs.

Some caveats

15. Having said that Consolidation in PSBs is worth considering, I would hasten to add certain caveats.

16. It is not that a large size is always beneficial for the banking system and overall economy. The benefit of size is observed up to a threshold level of size. A size beyond this threshold size may have negative consequences for the economy. Existence of excessively large banks may also create significant moral hazard costs for the entire system. A failure of a very large bank may have systemic implications and therefore, there is a perception that large banks may be bailed out during stress periods. This expectation of government support create the perception of too big to fail, and this may improve their creditworthiness resulting in significant funding advantages. This implicit government subsidy enjoyed by these banks incentivises them to grow even bigger and makes them use higher leverage and engage in risky market-based activities. During the recent financial crisis, it was learnt that problems created by large banks (seen as too big to fail) can only be addressed by specific regulations targeted to these banks only. One of the important aspects of the post crisis regulatory reforms has been formulation of specific regulatory requirements targeted at larger banks.

17. PSBs as a group have not been performing well during the last few years. There has been a large increase in Non-Performing Assets (NPAs). As a part of managing large NPAs, some

suggestions have been made that perhaps a consolidation of PSBs can render them more capable of managing such challenges relatively better. The basic argument is that a large bank will have been well capitalised, will have deeper expertise to handle large credits and large NPAs and hence can ride off troughs with relative ease.

18. It has to be ensured that mergers among two banks should not be seen as a fix to short term problems as being faced by certain PSBs. Merger may be useful only if it has strategic vision driven by synergy and creating value for both the banks. Merger of a weak bank with a strong bank may make combined entity weak if the merger process is not handled properly. The problems of capital shortages and higher NPAs may get transmitted to stronger bank due to unduly haste or a mechanical merger process. Consolidation should not be seen from the sole perspective of creating larger sized banks. While it is agreed that under present banking structure in India, creating a few large size banks is desirable, it has to be a well calibrated and cautious process.

Suggested Consolidation Process

19. Ideally, the process has to be initiated by the boards of individual banks themselves. NC-I had also mentioned that any move towards restructuring and reducing the number of banks through mergers and acquisitions should evolve on the basis of market driven and profitability considerations and with understanding and support from bank officers and staff. The committee had emphasized on the voluntary character of the exercise to avoid the type of problems associated with a top down approach.

20. However, as discussed above the examples of two PSBs coming together voluntarily and planning for merger have not been seen, although such examples have been quite numerous in private banking sector. So the question is how to ensure consolidation among PSBs when PSBs themselves are not coming forward voluntarily. One way forward may be a nudge from large shareholder of PSBs i.e. Government of India. As the Honourable Finance Minister, in his Budget speech of 2016-17 has mentioned, that a road map in this regard will be announced soon. An approach in this direction may be constitution of an expert committee which may thoroughly examine the business of each PSB, their forward looking business plans and try to find out opportunities of consolidation based on sound business strategy and synergy in the operations of concerned banks. The areas of synergies are to be properly identified encompassing, inter alia, compatibility of businesses, culture, treasury and IT and locational advantage. The committee may interact with the boards of banks on the tentative plans it might be having with respect to individual banks and try to understand their reactions. Further, interests of all stakeholders like depositors, borrowers, supervisor, employees, etc. also need to be balanced. Perhaps, the recently constituted Banks Board Bureau (BBB) can perform such an advisory role.

21. It also needs to be emphasised that PSBs are listed and their shares are held by diversified private institutions and individuals and interests of these minority shareholders need to be protected. Any plan for merger or acquisition has to be a Board led process in which all stakeholders have to be involved from beginning.

22. Further, mergers among PSBs may reduce competition in certain segments or geographies substantially and may alter competition between banks and non-banks. As discussed above HHI of the Indian banking system is about 518 which is very low and therefore there is room for consolidation. However, as the HHI scores approach a level of 1800, the competition authorities are usually alarmed about competition issues. Hence, the aspects related to competition and consumer protection need to be evaluated diligently in the context of consolidation.

23. There may also be significant implementation challenges in the merger of two entities even if it is based on sound business logic and synergy. Integration of two different organisation cultures and technological platforms may not be a simple process. The treatment of legacy issues, closure of redundant branches, redeployment of human resources and efficient allocation of capital post-merger are not straight forward decisions. The considerations related to implementation challenges also need to be adequately factored in.

Consolidation beyond Mergers

24. Very often, we understand consolidation means mergers and acquisitions. It need not be so. There is another type of consolidation viz. consolidation of businesses. This is distinctly different from consolidation of entities. Under this type of consolidation, a bank consciously decides to be in particular types of businesses and sheds or quits certain types of businesses. Why a bank would decide so? One set of circumstances, as I have alluded earlier, relates to reaction and readjustment to the new regulatory structure. The TLAC requirements, the Dodd-Frank Act

compliance, the Vickers Commission reforms, the Likanen Group reforms, etc. have forced banks in USA, UK and EU to rethink and rearrange their businesses. I believe this is also a type of consolidation.

25. Our PSBs can take a leaf out of this type and can examine whether every one of them need necessarily be a universal bank or can each of them choose to be a differentiated bank in its own area or business of strength. For example, there are a few PSBs whose major presence, strength and expertise is in agriculture and rural segment. There are a couple of PSBs whose assets and reach are predominantly in the SME segment. These PSBs can choose to be Small Finance Banks. This way they can conserve capital, do not dissipate their energy in the highly complex and specialised corporate and project financing business.

26. Similarly, there are a few other PSBs who are effectively Payments Banks, as they primarily undertake deposit acceptance business and their loan book has been built only to comply with the Priority Sector Lending requirements. They even give an impression that such loan book was built reluctantly. These banks may better be Payments Banks and undertake that activity in full vigour and generate value for its stakeholders.

27. Likewise, there may be opportunities for some other PSBs to be wholesale / infrastructure banks, about which the Reserve Bank in the recent Monetary Policy Statement expressed its intention to usher in such differentiated banks in the coming times.

28. The advantage of being a differentiated bank is that its capital can be conserved and put to its best use. It can leverage its core strength, in a focussed manner.

Conclusion

29. Let me conclude by saying that there is tremendous scope for consolidation among PSBs. Consolidation will bring efficiency and synergy of operations and will ensure that Indian banking sector is capable of meeting credit demand of our growing economy. However, the consolidation needs to be a well-calibrated process based on sound economic logic. A hasty top-down approach which does not adequately consider synergies in the business models and compatibility in the business cultures and technology platforms of the merging banks may not be sustainable in the long run. And, finally, consolidation does not mean only merger of banks; consolidation also means focussing on chosen businesses only.

30. Thank you very much for your patient attention.

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