Consolidation in the Indian Financial Sector *

Shri V. Leeladhar

It is my pleasure to be here with you this morning on the occasion of International Banking & Finance Conference 2008 of the Indian Merchants' Chamber. I am grateful to the organisers for having afforded me this valuable opportunity to address this august audience and share some of my thoughts on the subject of consolidation in the Indian financial sector. The Chamber has indeed come a long way since its establishment in the pre-independence days in September 1907 under the presidentship of late Sir Manmohandas Ramji. In that era, it performed the role of the nation's watchdog on the economic front under the alien rule. The Chamber also has the unique distinction of having had the patronage of the Father of the Nation, Mahatma Gandhi as its honorary member since 1931. The Chamber, during its functioning of hundred years, has done yeoman service to the country and society at large in promoting the cause of business community through strengthening the government-business partnership and representing the business point of view before the public policy authorities and I hope that it will continue to perform its productive role in the national policy formulation, in the days to come as well.

In my address today, I would like to briefly touch upon the experience in and the emerging contours of consolidation in the Indian financial sector, that have taken shape over the past few decades, in the Reserve Bank-regulated entities, as a result of a calibrated policy response designed for the purpose.

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Consolidation in the Financial Sector

Consolidation of business entities, through mergers and acquisitions, is a world-wide phenomenon. The numerous mergers and acquisitions all over the world, including in India, in the real as well as in the financial services sector, appear to be driven by the objective of leveraging the synergies arising from the process of merger and acquisition. However, such structural changes, particularly in the financial system, can also potentially have public policy implications. With this brief backdrop, I would like to present an overview of consolidation in the Indian financial sector, particularly amongst the banks, development financial institutions and the non-banking financial companies.

The Indian Scenario

The Diversity of Statutory Frameworks

In the context of consolidation in the financial sector in India, let me say a few words about the unique features of the Indian credit institutions and their operating environment. While talking about consolidation in the Indian milieu, it is important to bear in mind that there is diversity of the governing statutes applicable to different entities in the Indian credit system. Further, they are governed by divergent statutory provisions, depending upon the nature of their operations and the form of their organisation or ownership.

Thus, while the private sector banks are subject to the provisions of the Banking Regulation Act, 1949, the public sector banks are governed by their respective founding statutes and by those provisions of the B R Act which have been made specifically applicable to them. The urban co-operative banks, on the other hand, are governed by the provisions of the Cooperative Societies Act of the respective State or by the Multi-State Cooperative Societies Act, as also by the provisions of the B R Act which are specifically applicable to them.

The development financial institutions (DFIs), which were founded by a statute, attract the provisions of those statutes while the DFIs structured as limited companies, were subject to the provisions of the Companies Act, 1956, but both the types of the DFIs are regulated and supervised by the Reserve Bank under the provisions of the RBI Act, 1934.

The Regional Rural Banks (RRBs) were created under the RRBs Act, 1976 and are regulated by the Reserve Bank but supervised by the NABARD, while the non-banking financial companies are subject to the provisions of the Companies Act, 1956 and are regulated and supervised by the Reserve Bank under the provisions of the RBI Act.

The housing finance companies, which are a sub-set of the NBFC category, are currently regulated and supervised by the National Housing Bank while the rural co-operative credit structure falls within the regulatory and supervisory domain of the NABARD.

History of Consolidation in the Indian Banking Sector

In the context of consolidation in the Indian banking sector, it may be recalled

that the Report of the Committee on Banking Sector Reforms (the Second Narasimham Committee - 1998) had suggested, *inter alia*, mergers among strong banks, both in the public and private sectors and even with financial institutions and NBFCs. Indian banking sector is no stranger to the phenomenon of mergers and acquisition across the banks. Since 1961 till date, under the provisions of the Banking Regulation Act, 1949, there have been as many as 77 bank amalgamations in the Indian banking system, of which 46 amalgamations took place before nationalisation of banks in 1969 while remaining 31 occurred in the post-nationalisation era. Of the 31 mergers, in 25 cases, the private sector banks were merged with a public sector bank while in the remaining six cases both the banks were private sector banks.

Since the onset of reforms in 1990, there have been 22 bank amalgamations; brief particulars of these are furnished in the Annex - I. It would be observed that 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.

Consolidation in the Commercial Banking Segment: Recent Developments

The consolidation efforts in the Indian banking sector can be broadly placed, as per the nature of the entities involved and of the mergers, into several categories *viz.*, (a) voluntary amalgamation between private sector banks; (b) compulsory amalgamation of a private sector bank; (c) merger between public sector banks; (d) merger of a non-banking financial company (NBFC) with a private sector bank; and (e) merger of a housing finance subsidiary with the parent public sector bank. Let me present a brief overview of the policy and processes involved in each type of merger.

(a) Voluntary Amalgamation Between Private Sector Banks

As regards the statutory provisions, the procedure for voluntary amalgamation of two banking companies is laid down under Section 44-A of the Banking Regulation Act, 1949 (the Act), which is easy to follow and cost effective. After the two banking companies have passed the necessary resolution proposing the amalgamation of one bank with another bank, in their general meetings, by a majority in number representing two-thirds in value of the shareholding of each of the two banking companies, such resolution containing the scheme of amalgamation is submitted to the Reserve Bank for its sanction. If the scheme is sanctioned by the Reserve Bank, by an order in writing, it becomes binding not only on the banking companies concerned, but also on all their shareholders.

Pursuant to the recommendations of the Joint Parliamentary Committee, the Reserve Bank had constituted a Working Group to evolve the guidelines for voluntary merger between banking companies. Based on the recommendations of the Group, the Reserve Bank had issued guidelines in

May 2005 laying down various requirements for the process of such mergers including determination of the swap ratio, disclosures, the stages at which Boards will get involved in the merger process, *etc.* While amalgamations are normally decided on business considerations (such as the need for increasing the market share, synergies in the operations of businesses, acquisition of a business unit or segment, *etc.*), the policy objective of the Reserve Bank is to ensure that considerations like sound rationale for the amalgamation, the systemic benefits and the advantage accruing to the residual entity are evaluated in detail. While sanctioning the scheme of amalgamation, the Reserve Bank takes into account the financial health of the two banking companies to ensure, *inter alia,* that after the amalgamation, the new entity will emerge as a much stronger bank.

The experience of the Reserve Bank has been, by and large, satisfactory in approving the schemes of amalgamation of the private sector banks in the recent past and it had no occasion to reject any scheme of amalgamation submitted to it for approval. There have been five 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 the former. A majority 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 mergers and acquisitions.

(b) Compulsory Amalgamation of a Private Sector Bank

Compulsory amalgamations are induced or forced by the Reserve Bank, under Section 45 of the B R 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, which has been placed under the order of moratorium, under Section 45(2) of the Act, on an application made by the Reserve Bank to the Central Government, the Reserve Bank can, for the foregoing reasons, frame a scheme of amalgamation for transferring the assets and liabilities of such distressed bank to a much better and stronger bank. 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 consideration 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 Act is also required to be placed before the two Houses of Parliament.

Most of the amalgamations of the private sector banks in the post-

nationalisation era 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 public sector 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 the erstwhile United Western Bank with public sector banks are recent examples. 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 us to a creditable stage today when not a single private sector bank in the country has the capital adequacy ratio of less than the minimum regulatory requirement of nine per cent. This now paves the way for effective implementation of the Prompt Corrective Action (PCA) Framework by the Reserve Bank, which could not be invoked earlier when the banking system was populated by many weak banks, without creating confidentiality issues.

(c) Merger of Public Sector Banks

The statutory framework for the amalgamation of the public sector banks, *viz.,* the nationalised banks, State Bank of India and its subsidiary banks, is, however, quite different since the foregoing provisions of the B R 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 transfer of undertaking of a 'corresponding new bank' (*i.e.,* a nationalised bank) to another 'corresponding new bank' or for 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 44-A of the B R Act, the scheme framed by the Central Government is required, under Section 9(6) of the Bank Nationalisation Acts, to be placed before both Houses of Parliament. Under this procedure, the lone merger that has happened so far was the amalgamation of the erstwhile New Bank of India with the Punjab National Bank, occasioned by the weak financials of the former. However, the post-merger experience was considered to be not altogether satisfactory on account of the problems in effective integration of the two entities.

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, what is required is 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.

Several private sector banks were acquired by the State Bank of India following this route. However, so far, no acquisition of a public sector bank has materialised under this procedure. Similar provisions also exist in respect of the subsidiary banks of the SBI.

It would thus be seen that there are sufficient enabling statutory provisions in the existing statutes governing the public sector banks to encourage and promote consolidation even within the public sector banks through the merger and amalgamation route, and the procedure to be followed for the purpose has also been statutorily prescribed.

Consolidation and its Impact on the Branch Network

It may be mentioned here that one of the likely effects of consolidation in the banking sector may be the rationalisation of the branch network of the banks concerned, resulting in the likely closure of certain branches of the merging banks, where there might be an overlap in their catchment area. Generally, as part of consolidation process, the emerging bank would be more inclined to shift its branches and focus of operations from the rural to the urban and semi-urban areas, which are usually more remunerative. However, the current regulatory regime for branch authorisation does not generally permit closure of the rural branches of the banks. Such a requirement is in tune with the philosophy of financial inclusion which emphasises increasing penetration of the banking services in the unbanked and under-banked areas of the country. For instance, under the new Branch Authorisation Policy of the Reserve Bank announced in September 2005, during the year 2007-08 (April-March), of the 4117 branch authorisations issued 1979 were for the under-banked centres. In aggregate, 627 authorisations were issued during the year for opening of rural branches and 1471 branches in the semi-urban areas. I would like to emphasise that the new branch authorisation policy does not preclude the possibility of any urgent proposals for opening bank branches being considered by the Reserve Bank even outside the annual plan, specially in the rural / under-banked areas, anytime during the year.

In brief, the Reserve Bank has been discharging the mandate given to it for branch licensing as required by law, public policy and regulatory comforts. Let me add that under the new policy, all the branch-authorisation requests of the banks were granted by Reserve Bank, subject to the banks fulfilling the criteria laid down for opening of branches in under-banked areas, except in the case of a few banks where there were serious regulatory discomfort on account of their indiscretions and contravention of the regulatory norms. It is interesting to note in this context that in the USA, for instance, for lesser regulatory violations, the banks are subjected to "cease and desist" order from the regulator, severely restricting their activities during the currency of the order.

(d) Merger Between a Private Sector Bank and an NBFC

As I mentioned earlier, the Reserve Bank is vested with the discretionary

powers to approve the voluntary amalgamation of two banking companies under the provisions of Section 44-A of the Banking Regulation Act, 1949. However, these powers do not extend to the voluntary amalgamation of a non-banking company with a banking company where amalgamations were governed by sections 391 to 394 of the Companies Act, 1956 in terms of which, the scheme of amalgamation has to be approved by the High Court. Hence, the banks were advised in June 2004 that where an NBFC is proposed to be amalgamated with a banking company, the banking company should obtain the approval of the Reserve Bank after the scheme of amalgamation is approved by its Board but before it is submitted to the High Court for approval.

Subsequently, in pursuance of the recommendations of the Joint Parliamentary Committee (JPC), a Working Group was constituted by the Reserve Bank to evolve guidelines for voluntary merger of banking companies. Based on the recommendations of the Group and in consultation with the Government, it was proposed in the Annual Policy Statement of April 2005 to issue guidelines on merger and amalgamation between private sector banks and with NBFCs. The guidelines were to cover: process of merger proposal, determination of swap ratios, disclosures, norms for buying / selling of shares by promoters before and during the process of merger and the Board's involvement in the merger process. The principles underlying these guidelines were also to be applicable, as appropriate, to public sector banks, subject to relevant legislation. Accordingly, the guidelines were issued in May 2005.

There have been a few instances of mergers of the NBFCs with the private sector banks. The first such merger occurred in May 1999 when the Reserve Bank approved the merger of Twentieth Century Finance Corporation Ltd., an NBFC, with Centurion Bank Ltd. Subsequently, in 2003, the merger of IndusInd Enterprises & Finance Ltd. (IEFL), one of the promoters of the IndusInd Bank Ltd., with the bank was also approved. Further, the Kotak Mahindra Finance Ltd., an NBFC, was converted into Kotak Mahindra Bank Limited, by amending its Memorandum and Articles of Association, and was granted a banking licence by the Reserve Bank in February 2003. In June 2004, the merger of Ashok Leyland Finance Ltd., an NBFC, with the IndusInd Bank Ltd. was approved by the Reserve Bank. Besides, certain banks also have significant stakes in some of the NBFCs. For instance, the Development Bank of Singapore (DBS) has a major stake in Cholamandalam Investment & Finance Ltd. while the Barclays Bank has a major holding in Rank Investments Ltd.

In view of the recent global developments, the current policy of merger of NBFCs with banks will require a comprehensive review.

(e) Merger of a Housing Finance Subsidiary with the Parent Public Sector Bank

There have also been a few instances where the housing finance subsidiaries

of the public sector banks were merged with the parent bank. During April 2002 and March 2007, the merger of the housing finance subsidiaries of Andhra Bank, Vijaya Bank, Corporation Bank and Bank of Baroda with the respective parent banks was approved by the Reserve Bank. The mergers were triggered primarily by the rising cost of funds of the housing finance entities, which adversely impacted the viability of their business models. The approvals for mergers from the Reserve Bank became necessary as there was a change in the structure of the banks' subsidiaries, which had been established under Section 19(1) of the B R Act, 1949 with the regulatory approval of the Reserve Bank.

(f) Attempted Mergers that did not Materialise

Let me also take this opportunity to point out that all the attempts made for merger of banks do not necessarily result in a successful outcome. There has been an instance where despite the process of merger having progressed quite a bit, it did not eventually fructify. The case of the attempted merger of the then UTI Bank and the erstwhile Global Trust Bank can be cited in this regard. While the scheme of voluntary amalgamation of the two banks had been submitted to the Reserve Bank for approval, the approval was kept on hold pending the completion of the SEBI investigations. It may be recalled that, in the run up to the proposed merger, the SEBI had initiated certain investigations into the share-price manipulation of the GTB shares. While the approval from the Reserve Bank was yet to be granted, the proposed merger was called off by the parties concerned. Thus, the merger did not materialise.

Consolidation of the Development Financial Institutions (DFIs)

It may be recalled that the DFIs were set up in the country in the post-independence era for providing long-term finance to the industrial projects to facilitate industrial development, in the absence of alternative sources of long-term funds. Hence, to enable the DFIs to play this role, they were also provided access to certain concessional sources of funds by way of allocation of SLR Bonds and lending from the Long Term Operation Funds of the Reserve Bank. However, with the onset of financial sector reforms, and pursuant to the recommendations of the First Narasimham Committee, the access by the DFIs to the traditional concessional sources of funds was gradually phased out. Consequently, the raising of resources at market-related rates, increased their cost of funds, thereby, affecting the very viability of their business model, coupled with increasing competition from the banks. The DFIs came within the regulatory purview of the Reserve Bank in 1991 for the first time, and the regulatory domain of the Reserve Bank, till recently, extended to the seven Term-Lending Institutions (TLIs - EXIM Bank, ICICI Limited, IDBI, IDFC Limited, IFCI Limited, IIBI Limited, and TFCI Limited) and three Re-Financing Institutions (RFIs - NABARD, NHB and SIDBI).

The Committee on Banking Sector Reforms (Second Narasimham Committee) had recommended in 1998 that the DFIs over a period of time should convert themselves into banks and there should be only two forms of intermediaries - banking companies and non-banking finance companies, and if a DFI does not intend to become a bank with a banking licence, it should be categorised as an NBFC. The Working Group for Harmonising the Role and Operations of DFIs and Banks (Khan Working Group - KWG), was also of the view that a full banking licence be eventually granted to the DFIs. Based on these recommendations, the Reserve Bank had released a 'Discussion Paper' (DP) in January 1999 soliciting wider public debate on the issue. The DP had, *inter alia,* envisaged a transition path for the DFIs for becoming either a full-fledged NBFC or a bank. Based on the feedback received on the DP, the Monetary and Credit Policy for the year 2000-2001, outlined the broad approach proposed to be adopted for considering the proposals in the area of Universal Banking. The Policy stated that the principle of 'Universal Banking' was a desirable goal and any DFI, which wished to transform into a bank, should have the option to do so, provided it was able to fully satisfy the prudential norm applicable to the banks. For the purpose, such a DFI was expected to prepare a transition path for consideration of the Reserve Bank. Thus, in due course, the recommendation of the Narasimham Committee to have only banks and the restructured NBFCs in the system, could be operationalised. Accordingly, in April 2001, the FIs were advised several operational and regulatory issues relevant in evolving their transition path to a universal bank and for formulating a road map for the purpose.

In the light of the Reserve Bank guidance, two leading term lending institutions *viz.,* the erstwhile IDBI and ICICI Limited got converted into a commercial bank, each. The four term-lending institutions (IDFC Ltd., IFCI Ltd., IIBI Ltd. - since wound up, TFCI Limited) which were in the category of NBFCs, are now regulated as per the norms applicable to the NBFCs. However, the EXIM Bank and the three RFIs (NABARD, NHB and SIDBI) continue to be under the regulatory domain of the Reserve Bank and are regulated as per the norms applicable to the financial institutions.

Consolidation of the Regional Rural Banks (RRBs)

The RRBs were established under the RRBs Act, 1976 with a view to create an institutional mechanism for delivery of rural credit through an entity which would have the local feel but the expertise of the commercial banks for catering to the rural credit needs. The RRBs are owned jointly by Government of India, sponsor banks and State governments of 50, 35 and 15 per cent, respectively, and were expected to have region-specific limited area of operation. Over the years, their number had increased to 196, operating in 26 States of the country, being sponsored by 27 scheduled commercial banks and one State Co-

operative Bank. However, with their limited size, scope and area of operations, competition from the rural branches of the commercial banks and the rising cost of operations due to upgraded wage structure on par with the commercial banks, their profitability and viability was adversely affected. This triggered the move towards their consolidation. The consolidation of the RRBs was first suggested by the Working Group to Suggest Amendments to the RRBs Act, 1976 (Chalapathy Rao Committee) in 2001. It had suggested that while retaining the regional character of these institutions, the number of sponsor banks may be reduced. Subsequently, the Advisory Committee on Flow of Credit to Agriculture and related Activities (Vyas Committee) had suggested in 2004 that in the first stage, all RRBs of a sponsor bank in a State should be amalgamated into a single unit in that State and at the second stage, there should be a State-level consolidation of RRBs. Subsequently, the Internal Working Group on RRBs, constituted by the Reserve Bank (Sardesai Committee) in June 2005, also suggested two options for strengthening RRBs, namely, merger between RRBs of the same sponsor bank in the same State or the merger of RRBs sponsored by different banks in the same State.

The main triggers for these recommendations were the small size of the RRBs which had made their operations unviable leading to significant amount of accumulated losses - which was not considered desirable. In order to improve the operational viability of RRBs and to take advantage of the economies of scale by reducing transaction cost, Government of India initiated, in September 2005, a process of amalgamation of RRBs sponsor bank-wise. The first set of amalgamations took place on September 12, 2005 when 28 RRBs were amalgamated to form 9 new RRBs. The amalgamations were carried out under Section 23-A of the RRBs Act, 1976, which provides that the Central Government, after consultation with the National Bank, the concerned State Government and the Sponsor Bank may amalgamate two or more RRBs. The process of amalgamation is still continuing.

As a result of such amalgamations, the number of RRBs has come down to 91 as on March 31, 2008 as against 133 and 196 RRBs as on March 31, 2006 and 2005, respectively. It needs to be noted here that this consolidation has occurred only amongst the RRBs, and not with the sponsor banks, and has been achieved without amendment to the governing statute of the RRBs. The structural consolidation of the RRBs has resulted in formation of new RRBs, which are financially stronger and bigger in size in terms of business volume and outreach. Thus, the emerging RRBs will be able to take advantages of the economies of scale and reduce their operational costs. With the advantages of local feel and familiarity acquired by the RRBs, they would now be better placed to achieve the objectives of rural development and financial inclusion.

Urban Co-operative Banks (UCBs)

The UCBs probably pose the most complex issues for a regulator since their governance is subject to the provisions

of the Cooperative Societies Act, which is administered by the State governments while their banking operations are governed by the B R Act, administered by the Reserve Bank, leading to a duality of control. Hence, any move towards consolidation in this sector, required a very special and collaborative approach involving all the stakeholders. The constitution of the Taskforce for Cooperative Urban Banks (TAFCUB), for each State, at the initiative of the Reserve Bank, with representation from all the stakeholders was, therefore, a step in this direction and has proved effective in resolving the intractable issues of the UCBs.

The spectacular growth of UCBs in the late nineties and up to 2003, which had resulted in increasing their penetration, ironically, also led to certain weaknesses in the sector that adversely affected public perception and thereby, their competitiveness. A major reason for the decline in public confidence was the crisis faced in 2001 by a large multi-state co-operative bank in the State of Gujarat, when the bank witnessed a sudden 'run' on its branches, following rumours of its large exposure to a leading stock broker who had suffered huge losses in the share market. The large-scale withdrawal of deposits within a short time resulted in severe liquidity problems for the bank. The bank was also holding about rupees 800 crore of inter-bank deposits from a large number of UCBs within and outside the State, which posed a systemic risk. In order to protect the interests of the general public and also that of the other co-operative banks, Reserve Bank issued directions to the bank restricting certain operations (acceptance of fresh deposits, restricting payments to any single depositor to Rs.1000 and ban on fresh lending) and requisitioned the Central Registrar of Co-operative Societies, New Delhi to supersede the Board of Directors and appoint an Administrator. An order of moratorium was also enforced on the bank by the Central Government for a short period. The bank was subsequently placed under a scheme of reconstruction with the approval of Reserve Bank of India.

The Gujarat episode was followed by another major crisis in the State of Andhra Pradesh in 2002, when one of the largest co-operative banks in the State faced a run, following a newspaper report regarding an inquiry instituted into the affairs of the bank by the State Registrar of Cooperative Societies. The bank was in a weak position, and ultimately, after attempts for its revival failed, its licence was cancelled by the Reserve Bank in 2004.

The decline in public confidence in the UCB sector, deepened in the aftermath of the crisis in Gujarat and Andhra Pradesh and concomitantly, the position of UCBs generally deteriorated. As on June 30, 2004, 732 out of 1919 UCBs were categorised In Grade III or IV signifying weakness and sickness. With a view to facilitating consolidation and emergence of strong entities and providing an avenue for non-disruptive exit of weak/unviable entities in the co-operative banking sector, Reserve Bank had also issued guidelines in February 2005 to the UCBs to encourage merger/ amalgamation in the UCB sector.

Although the Banking Regulation Act, 1949 (As Applicable to the Cooperative Societies) does not empower the Reserve Bank to formulate a scheme with regard to merger and amalgamation of co-operative banks, the State Governments have incorporated in their respective Co-operative Societies Acts a provision for obtaining prior sanction in writing, of the Reserve Bank for an order, *inter alia,* for sanctioning a scheme of amalgamation or reconstruction. The Reserve Bank's role in the merger of the cooperative banks is, thus, confined to the examination of only the financial aspects of the scheme of merger and to protect the interests of depositors of the banks concerned as well as ensuring the stability of the financial system while considering such proposals. Subsequently, recognising that the UCBs are an important part of the financial system in India, it was also considered necessary for them to emerge as a sound and healthy network of jointly owned, democratically controlled, and ethically managed banking institutions providing need-based quality banking services, essentially to the middle and lower middle classes and marginalised sections of the society. Recognising the systemic risks and keeping in view the needs of its clientele, the Reserve Bank reviewed the entire gamut of legislative, regulatory and supervisory framework for these banks, and in March 2005, brought out a draft 'Vision Document' for the UCBs, setting out the broad approach and strategies needed to be adopted to actualise this vision.

The Urban Cooperative Banking sector witnessed a decline in the total number of banks from 1926 in March 2004 to 1793 in August 2007. Despite this decline in numbers, public confidence in the sector continued to rise as reflected by the increase in deposits by 6.1 per cent during 2006-07 on the top of 8.6 per cent in the previous year, thereby reversing the declining trend of 2004-05 when the deposits of the UCBs had declined by 4.7 per cent. Further, the decrease in the number of weak and sick banks indicated an improved risk profile of the sector. Thus, the number of UCBs in Grade III and IV (the banks with considerable supervisory concerns) constituted 31 per cent of the total number of banks in March 2007 as against the corresponding figure of 37 per cent in March 2006. The decline in number of banks was brought about by liquidation/ merger of banks and rejection of licence applications of banks and the continuance of the policy of not entertaining applications for licence to set up new UCBs.

Unlike in the past, the perception of the sector and of the State governments towards this contraction in the urban cooperative banking sector has undergone a change. As envisaged in the Vision Document for UCBs, drawn up by the Reserve Bank in consultation with the UCBs, State governments, *etc.,* adoption of a consultative approach to regulation and supervision, which is participatory and transparent, has resulted in appreciation of the regulatory actions of the Reserve Bank by all stakeholders. Earlier, the requisition for liquidation of a bank was protested by the bank and the sector, and often resulted in non-implementation or delay in implementation of the requisition by the

State governments. The process has now become smooth and quicker, as the decisions are based on the recommendations of the Taskforce for Cooperative Urban Banks (TAFCUB), constituted in States that have signed Memorandum of Understanding (MOU) with the Reserve Bank. The TAFCUB has representatives from State Government, UCB sector and the Reserve Bank. Till April 16, 2008, MOUs had been signed with 16 State Governments and Central Government, which encompass 1586 UCBs constituting 87.1 per cent of the total number of banks, which account for 93.8 per cent of the total deposits of the UCB sector.

I may mention that a medium-term framework for urban co-operative banks up to the year 2010 has been drawn up in order to facilitate the development of this sector into a strong and vibrant system comprising entities conforming to all prudential requirements. The Standing Advisory Committee for Urban Co-operative Banks is increasingly being used for continuous dialogue with the various stakeholders of the sector.

The deposits with the Grade I and Grade II UCBs (the banks with no / low supervisory concerns) as a proportion of total deposits of the UCBs , excluding the two banks in Gujarat and Andhra Pradesh, which faced the crisis, amounted to 77.5 per cent. This indicates that, at the moment, there is considerable improvement in the regulatory comfort as far as UCBs are concerned. The process of improved cooperation and collaboration with all stakeholders under the MoU is likely to strengthen the position further.

Impact of UCBs on the Amount of Claims Settled by the DICGC

In the context of the UCBs, it is appropriate to mention the impact of their operations on the pay out by the DICGC to the depositors affected by the weak UCBs. It is instructive to note that since the inception of DICGC in 1962 till the year 2000-01, claims paid to co-operative banks by the Corporation amounted to Rs.71.9 crore, which constituted 27.43 per cent of the total claims paid by the Corporation during the period. However, since the year 2001, the quantum of claims paid in respect of co-operative banks multiplied manifold, on account of failure of large UCBs since then.

Thus, during the period between 2000-01 and 2006-07, the claims paid in respect of co-operative banks aggregated Rs.2226.60 crore. Further, out of total claims of Rs.2594.30 crore paid in respect of all the banks up to 2006-07, over 88 per cent of the amount paid was in respect of 176 UCBs alone. However, with the added improvements in the regulatory comforts in the new environment of co-operation and collaboration the position of UCBs is poised to improve.

Local Area Banks (LABs)

The LAB Scheme was introduced in August 1996 pursuant to an announcement made by the then Finance Minister in his budget speech and the Guidelines for setting up the

LABs were thereafter issued by the Reserve Bank. The objective of setting up the LABs was to bridge the gaps in credit availability and enhance the institutional credit framework in the rural and semi-urban areas and to provide efficient and competitive financial intermediation services in their areas of operation. The LAB Scheme envisaged a minimum capital of Rs. 5 crore and an area of operation comprising three contiguous districts. Out of the 227 applications received by the Reserve Bank for setting up LABs, only six banks were actually licensed. Of the six LABs originally licensed, two have since ceased to exit as the licences granted to one of them was cancelled in January 2002 on account of grave irregularities observed in their operations while another one, whose financial position was unsatisfactory, was amalgamated in August 2004 with the Bank of Baroda under section 45 of the Banking Regulation Act, 1949. Thus, there are only four LABs functioning at present, all of which are non-scheduled banks. The LABs were subject to the provisions of the B. R. Act, RBI Act and prudential norms on income recognition and asset classification, *etc.,* since their inception.

In July 2002, a Review Group headed by Shri G. Ramachandran, former Finance Secretary, was appointed to study the working of the LAB Scheme and make recommendations. Based on the recommendations of the Group and with the concurrence of the Government of India, it was decided by the Reserve Bank that no new LABs would be licensed till the existing LABs were placed on a sound footing. The existing LABs were also advised by the Reserve Bank in November 2003 to attain a capital of Rs. 25 crore and a CRAR of 15 per cent over a period of 5 to 7 years. In the absence of any feasible restructuring options, it has been decided to maintain status quo in regard to the LABs, under the existing framework.

Non-Banking Financial Companies (NBFCs)

NBFCs are an important component of the service sector which was a significant contributor to the growth of the economy. It is important for the NBFCs to efficiently intermediate and enhance credit delivery to the dispersed, under-banked and under-serviced sections of the economy. However, it is also the Reserve Bank's responsibility to protect the depositors' interest. While ensuring that the public deposit-taking companies and systemically important non-deposit taking companies are well regulated, the Reserve Bank is looking to further strengthening of the NBFC sector so as to help the sector grow in terms of its asset base. The Reserve Bank had given an option to the NBFCs to voluntarily move out of public deposits acceptance activity if they found the regulatory costs outweighed their benefits. In case an NBFC voluntarily chose to get out of public deposits, the Reserve Bank would, in fact, help the NBFC in its efforts, including imparting training and technology support.

The NBFCs falling within the regulatory domain of the Reserve Bank can be broadly classified as the deposit-taking NBFCs (other than the Residuary Non-Banking Companies), Non-Deposit

taking NBFCs and the Residuary Non-Banking Companies (RNBCs). NBFCs are broadly engaged in four types of activities *viz.,* equipment leasing, hire purchase, loans and investments. Regulatory/ supervisory norms, governing their operations differ reflecting the concerns specific to the segment.

As a part of consolidation in the NBFC sector, the number of deposit-taking NBFCs (NBFCs-D) has come down steeply from 710 as at the end of June 2003 to 376 as at the end of March 2008. The amount of public deposits held by them is also showing a declining trend and has come down from Rs 5035 crore (March 2003) to Rs 2043 crore (March 2007). The bank borrowings of NBFCs-D at Rs 14,923 crores are not significant in relation to the credit extended by them at Rs 37,990 crores as at end of March 2007. Further, the deposits held by NBFCs including RNBCs (Rs 24,665 crore as at end March 2007) is not significant (0.95 per cent) when compared to deposits held by commercial banks (Rs 26,08,309 crore) as on March 31, 2007. Considering that the amount of deposits held and bank borrowings of the deposit-taking NBFCs is not significant in relation to the aggregate bank deposit and credit, the systemic risk may not be considered significant. Furthermore, the number of non-deposit taking NBFCs (NBFCs-ND) declined from 13139 as on June 2003 to 12458 as at end of March 2008.

The number of RNBCs registered with the Bank has decreased from five as on March 31, 2003 to three as at the end of December 2006. Of these, two companies accounted for virtually the entire deposits as the deposits of the third company, at less than rupees one crore, were insignificant. However, in contrast to the trend of deposits of the NBFCs, the Aggregate Deposit Liability (ALD) of the RNBCs has been showing a rapid growth. The deposit liability of RNBCs increased from Rs.15,065 crore as on March 31, 2003 to Rs.22,622 crore as on March 31, 2007, showing an increase of 33.9 per cent. While the ALD of one company recorded a declining trend, the other large RNBC recorded a steady growth. However, it may be pointed out here that in view of the changes in the operating environment of the RNBCs, their business model has now become non-viable and there is a need for them to explore a new business model.

The total deposits of NBFCs as on March 31, 2007 were Rs 24,665 crore of which the deposits with deposit-taking NBFCs, other than the RNBCs, were Rs 2,043 crore forming only 8.3 percent of the total public deposits of the NBFCs. The deposits with the RNBCs as on March 31, 2007 amounted to Rs 22,622 crore which has been growing steadily. As already mentioned, the business model of RNBCs has become non-viable.

Taking into account the declining number of deposit-taking NBFCs, declining trend of public deposits held by NBFCs, strengthening of regulatory prescription in case of NBFCs-ND-SI and RNBCs, low level of NPAs and relatively low level of bank borrowings by the sector, the potential systemic risk from this segment is low at this point of time, even as the process of consolidation is gaining momentum. In these circumstances at the appropriate stage,

the proposal of restricting public deposit taking activities only to banks may have to be taken up for consideration.

Conclusion

Over the years, there has been considerable progress in consolidation in India in the private sector banks and the mergers have happened not only between the weak and the healthy banks but also, of late, between healthy and well-functioning banks as well. The Reserve Bank has been supportive of the initiatives for consolidation and there have been no cases so far where the approval for merger of banks was denied by the Reserve Bank, since the proposals conformed to the requirements and guidelines of the Reserve Bank.

In the case of the urban cooperative banks, notable degree of consolidation has taken place over the years with a good number of weak UCBs getting weeded out from the system, through mergers and amalgamations.

In the case of the RRBs, their number has reduced to less than half of their original number and the existing RRBs are in much better financial health.

What is noteworthy is that the consolidation in the UCB and the RRB sector has been achieved through innovative ways devised, within the existing statutory framework and without waiting for any legislative amendments to come about.

The DFIs have been largely phased out in an orderly manner with only a few refinancing institutions left now.

The NBFCs sector too has witnessed a fair degree of consolidation with a sharp reduction in the number of deposit-taking NBFCs, with their aggregate deposits amounting to not a significant proportion of the total deposits of the banking system, and hence, not a source of systemic risk. However, RNBCs will have to quickly gear up to a change in their business model.

Though consolidation in the public sector banking segment, which accounts for about 75 per cent of the assets of the banking system, is still a work in progress, there are enabling legal provisions for the purpose in the respective statutes of the public sector banks. The Reserve Bank, as the regulator and supervisor of the banking system, would continue to play a supportive role in the task of banking consolidation based on commercial considerations, with a view to further strengthening the Indian financial sector and support growth while securing the stability of the system.

Annex- I

List of Indian commercial banks merged since January 1990 under the provisions of the Banking Regulation Act 1949

Sr. No.	Name of the Transferor Bank	Name of the Transferee Bank	Date of amalgammation
1.	Bank of Tamilnad Ltd.	Indian Overseas Bank	20.02.1990
2.	Bank of Thanjavur Ltd.	Indian Bank	20.02.1990
3.	Parur Central Bank Ltd.	Bank of India	20.02.1990
4.	Purbanchal Bank Ltd.	Central Bank of India	29.08.1990
5.	Kashi Nath Seth Bank Ltd.	State Bank of India	01.01.1996
6.	Bari Doab Bank Ltd.	Oriental Bank of Commerce	08.04.1997
7.	Punjab co-operative Bank Ltd.	Oriental Bank of Commerce	08.04.1997
8.	Bareilly Corporation Bank Ltd.	Bank of Baroda	03.06.1999
9.	Sikkim Bank Ltd.	Union Bank of India	22.12.1999
10.	Times Bank Ltd.	HDFC Bank Ltd.	26.02.2000
11.	Bank of Madura Ltd.	ICICI Bank Ltd.	10.03.2001
12.	Benaras State Bank Ltd.	Bank of Baroda	20.06.2002
13.	Nedungadi Bank Ltd.	PNB	01.02.2003
14.	South Gujarat Local Area Bank Ltd.	Bank Of Baroda	25.06.2004
15.	Global Trust Bank Ltd.	Oriental Bank Of Commerce	14.08.2004
16.	Bank of Punjab Ltd	Centurian Bank	01.10.2005
17.	IDBI Bank Ltd.	IDBI Ltd.	02.04.2005
18.	The Ganesh Bank of Kurundwad Ltd.	The Federal Bank Ltd.	02.09.2006
19.	United Western Bank Ltd.	IDBI Ltd.	03.10.2006
20.	Bharat Overseas Bank	Indian overseas Bank	31.03.2007
21.	The Sangli Bank Ltd	ICICI Bank Ltd. (Voluntary)	19.04.2007
22.	Lord Krishna Bank Ltd.	Centurion Bank of Punjab Ltd. (voluntary)	29.08.2007