

Bank Consolidation: Necessary but Inadequate

Dipinder S Randhawa

Summary

The consolidation of public sector banks is a much-needed step. However, the problems facing banking in India – ineffective governance, pervasive intervention by politicians in lending decisions, and an inability to resolve the mounting volume of non-performing loans – are much more severe and cannot be tackled through bank mergers alone. Public sector banks in India need deeper structural reforms to help revitalise growth in the economy.

On 30 August 2019, India's Finance Minister Nirmala Sitharaman announced that the government would consolidate 10 existing state-owned commercial banks (SOCBs) into four entities to reinvigorate the flow of credit in the economy in the hope of arresting the rapid slowdown in the economy. The announcement is a continuation of the bank consolidation process initiated in 2016. With the announcement, the 27 SOCBs that existed in 2017 will now be reduced to 12.

State banks hold about 70 per cent of bank deposits. They have been hamstrung in recent years by bad loans and governance concerns, including political interference, and a reluctance to lend as they repair balance sheets. The slowdown in lending prompted calls for the government to intervene by consolidating or privatising them to deal with mounting non-performing assets (NPAs) and bolster damaged balance sheets with capital injections. The challenges confronting India's banking system are considered a significant cause of the economic slowdown as repeated financial scandals have further dented confidence.

Table 1: Mergers of State-owned Banks

Anchor Bank	Merged into Anchor Bank
Canara Bank	Syndicate Bank
Union Bank of India	Andhra Bank, Corporate Bank
Punjab National Bank	Oriental Bank of Commerce; United Bank of India
Indian Bank	Allahabad Bank

Source: Based on Ministry of Finance Announcement

Market Reaction

Amid concerns about struggles with bad debts, the impact on asset quality, and the speed at which the merged banks could integrate and resume normal operations, the share prices of all the anchor banks fell following the merger announcement. Mergers of banks in a weakened state with even weaker banks do not augur well. However, the prognosis for the medium term was better, as Moody's affirmed a stable outlook for the Canara Bank, Oriental Bank of Commerce, Syndicate Bank and Union Bank of India. The outlook on Punjab National Bank was raised from stable to positive, reflecting the belief that the injection of capital would enable the bank to deal with write-offs in the aftermath of the merger. Over

the long-run, with complementary reforms in governance, the move should be beneficial for the banking sector and the economy, enhancing capabilities of the SOCBs to repair balance sheets and withstand competition from the private sector.

Rationale and Strategy

Despite economic growth and financial development, India's banking system remains fragmented and inefficient. The volume of non-performing loans (NPLs) has grown steadily, belying expectations that growth would bring the problem down to manageable proportions. Repeated episodes of scandals further undermined confidence in the banking system's ability to find sustainable solutions. Although efficiency among listed SOCBs has risen marginally in recent years, these banks are far from a state where they can compete in international markets or with the better performing private sector banks. On average, they have higher NPLs, higher costs of deposits, and lower spreads than their private sector counterparts.

While size by itself may not be an indicator of competitiveness, as investment in capital-intensive technology becomes imperative, the benefits of size do become compelling. Size engenders economies of scale. The high costs of technological upgrading and increasing competitive pressures dictate that size is essential if the bank wants to grow into national and global markets. The merger should enable the technologically challenged smaller banks to develop their information technology systems and customer interface and find cost savings from reduced demand for personnel and operating costs. The merged bank may well have surplus capital as capital adequacy requirements for smaller banks are higher than those for the larger banks. The larger size of merged banks will allow for the introduction of new technologies, and compliance with Basel III guidelines, eventually enhancing competitiveness in globalising markets.

The Mergers

The Ministry of Finance decided the partners for the mergers. The criteria for mergers differ from those that prevail in the private sector, as the government ruled out any layoffs. The merged banks have the same or similar technical platforms, geographical coverage, and a measure of cultural affinity that would help integrate banks operating in different parts of the country. Besides expecting banks to enter national markets, the government hopes that the merged banks' appetite for generating new loans and taking risks will increase. Also, the government announced capital infusion totalling over ₹55,000 crores (\$10.7 billion).

Expectations and Potential Hazards

Enhanced access to capital is expected to help weaker banks to continue lending while offering them the better governance of bigger banks. Each of the four banking groups is led by an anchor bank, with other banks providing complementary strengths and broadening geographic coverage. The implicit logic underlying consolidation is that the sum of the merged banks will be greater than the sum of the individual banks, with synergies arising from lower capital requirements expected of large, 'anchor' banks, from efficiencies and

elimination of duplication in costs, and access to a broader market. Some SOCBs have been slow in expanding their digital footprint or in adopting new technologies.

The government has also announced some reforms in the governance of banks, allowing markets a role in determining the compensation and governance of public sector banks. The SOCB boards will now be allowed to appoint chief risk officers from the market and pay market-linked compensation. Banks will be allowed to appoint up to four executive directors with specialisation in technology.

The sharp downturn in economic activity, coupled with bad debts of US\$150 billion (\$207 billion), has intensified the debate on how to tackle the crisis. Many economists believe that India's banking system requires a comprehensive clean-up plan, perhaps in the shape of a "bad bank" created to take over the NPAs. The NPAs now account for around 9.3 per cent of total system assets – and 12.6 per cent of state banks' loan portfolios. However, this does not seem to be on the policy radar as policymakers have adopted a gradualist approach to dealing with the persistent problem of poor loan quality.

The bank mergers will not impact short-term growth as the benefits of the merger will take months, if not longer, to manifest. From a medium-term perspective, it is a much-needed reform. In tandem with improvements in governance, strengthening weaker banks should eventually stimulate lending, with bank capital released by the mergers ideally used to repair balance sheets, before releasing funds to the government. The acquired banks are generally smaller, less profitable, less efficient, and in a weaker state than their peers. However, the merged banks could again find themselves in trouble as politicians interfere in lending decisions and banks evergreen outstanding loans.

Inadequate Reforms

These reforms are incremental and do not offer SOCBs the autonomy that private sector banks enjoy. Powerful unions, and the Finance Ministry's promise that there would be no labour redundancies, limit prospects for restructuring and rationalisation and thus possibilities for cost synergies.

The reforms thus far allow for a little more flexibility in appointment and performance evaluation of senior management but do not address the fundamental problems of a lack of transparency and accountability. Ideally, banks should be able to appoint all senior managers at market-linked compensation. The government still has not distanced itself from the governance of SOCBs, while its role should be limited to that of a shareholder. Short tenures dampen senior management's incentives for embarking on long-term initiatives, including restructuring. The biggest Indian bank, the State Bank of India (SBI), barely makes it to the list of the world's largest banks. The bankruptcy legislation was a much-needed initiative; however, the National Law Company Tribunal, mandated with resolving bad loans, works slowly, and is already overburdened with cases to make a systemic impact.

Another challenge faced by SOCBs is fractured and overlapping regulation. The RBI should be extended powers to oversee the regulation of PSBs to ensure governance reforms. The government regulates SOCBs under the Reserve Bank of India Act, Banking Regulation Act,

the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970; the Bank Nationalisation Act, 1980; and other specific legislation overseeing specific areas of operation. The multiplicity of regulatory authorities reduces clarity and raises the costs of compliance. An omnibus and clear demarcation of regulatory responsibilities vested in the Reserve Bank of India will enable regulatory oversight to conform to the needs of banking today.

To launch meaningful reforms, the government should reduce its stake in the SOCBs. As strong trade unions preclude outright privatisation, banks should gradually offload equity into markets to broaden the investor base and enhance market discipline. The demand for bank equity grows swiftly in a growing economy.

Challenges

Despite the seeming homogeneity, organisation cultures in banks differ across regions, between metropolitan areas and small towns and rural areas. Banks, indeed any corporate entity, are also shaped by their own distinct corporate culture. Integration of human resource policies, including compensation and performance appraisal, are often among the most challenging obstacles in the way of effective mergers. The challenges encountered during Punjab National Bank's merger with the New Bank of India, and during IDBI's transition from a development bank to a commercial bank, are well-documented. A clearly enunciated strategy and direct communications with employees can help ease the transition.

Perhaps the most formidable operational challenge banks face is to keep up with the fast pace of technological development in the delivery of financial services. The high costs associated with the introduction of digital platforms create a rationale for bank consolidation.

The adoption and updating of IT systems across SOCBs vary widely. The State Bank of India and its associate banks are at the cutting edge, with compatible IT architecture. Most of the other banks have IT systems often adopted on an ad hoc basis, lacking coherence and lacking uniform standards. While banks should have autonomy in this decision as the sector is continually changing and evolving, cooperation in identifying challenges and the sharing of experiences is useful and could ease future mergers.

The rapid growth of FinTech and Digital banking/alternative platforms pose existential challenges to traditional banking. How banks respond to these challenges may well determine their future, and indeed their survival. The proliferation of applications and possibilities offered by FinTech should keep bankers deeply engaged. While it was hitherto perceived as a disruptive innovation that would supplant traditional banking, today it is seen as an innovation offering potential for generating strong synergies with 'traditional' banking. The major banks have co-opted strategies towards FinTech – encompassing payments, credit to SMEs, insurance, funds management, and real estate loans into their strategic plans. However, it may also lead to structural changes in banking activities and a shift in how banks traditionally operate.

Changes in the landscape for banking and other financial services have reduced the need for expanding geographical coverage. The emergence of alternative platforms, including digital and market-based services, can bring services directly to the consumer's phone through FinTech. The recently sanctioned class of banks deliver microfinance through distribution channels that directly reach the customer. Banks should be paying close attention to this market segment.

Conclusion

The primary objective of bank nationalisation in 1969 and then again in 1980 was to extend the reach of financial services to areas and demographic groups that were neglected or underserved. State banks have done admirably well in reaching remote corners of the country. However, despite physical access, a small percentage of the population had functional bank accounts. A rigorous analysis of the effectiveness of the Prime Minister's *Jan Dhan Yojana* (People's Wealth Programme or PMJDY), which has extended financial inclusion to large segments of the hitherto excluded, would be useful. From the efficiency and effectiveness perspective, it is helpful to draw upon research that considers demand-side issues in the quest for financial inclusion. As research has shown, micro-credit is just one of the services the poor need; the ease of payments, and offering micro-insurance to farmers, maybe just as important.

The break-up of the omnibus State Bank of India into regional banks served a useful purpose by providing a local focus to bank operations. A large number of banks marked by duplication of services and geographical coverage resulted in a banking sector with fragile balance sheets, rigid and intrusive governance, and an inability to keep pace with technological advances. These banks were also losing business to the rapidly expanding private sector banks. Sustained interference from politicians, the compulsions of lending to SOEs that were often non-viable, and the persistence of directed credit programs constrained profitability, and growth.

Over time, the advantage of physical proximity has become less compelling. Mere physical access has not translated into financial access for the underserved and the neglected. However, today, the technological and institutional means for financial inclusion carries more promise than ever before. Directed credit programs and interference in lending decisions severely impaired the bank's ability to make market-based decisions. Banks are also constrained for talent as the low salaries in public sector banks preclude the hiring of much-needed talent in an increasingly competitive and globalised banking system. Reforms in both governance and regulation are imperative if Indian banking is to turn financially viable and go on to compete in international markets.

Technological developments in the form of mobile phones, the expanding reach of FinTech, and a clearer understanding of the financial services needed by those on the economic margin, have yielded sharper insights into which financial services are the most needed. We have a limited, albeit growing understanding of the channels through which these services may be delivered. FinTech may hold a great deal of promise, but until methods are tried and tested on the ground, the operational challenges may not become evident. The simplest of innovations, M-Pesa, was remarkably effective in Kenya but has proven to be far less

successful in other countries, including neighbouring Tanzania, let alone other countries. However, despite physical access, the spread of banks has brought a small percentage of the population under the rubric of financial inclusion. Policymakers need to explore other channels.

The implicit hope was that economic growth could pull the banking system out of the NPL problem. Fiscal constraints preclude committing the needed volume of funds to strengthen bank balance sheets. However, an unfavourable external environment and sinking confidence in the domestic economy is further exacerbating problems in banking. The looming challenges in India's shadow banking system, the prospect of opening up the domestic economy to competition by finally joining the Regional Comprehensive Economic Partnership (RCEP), and the decades-old proclivity for politicians to interfere in banking decisions, all reinforce the urgent need to find solutions to banks' problems.

The biggest Indian bank, the SBI, barely makes it to the list of the world's largest banks. Consolidation is a step in the right direction, but its effects will take far too long to address the immediate and severe challenges facing the Indian economy.

.....

Dr Dipinder S Randhawa is a Senior Research Fellow at the Institute of South Asian Studies (ISAS) at the National University of Singapore (NUS). He can be reached at isasdsr@nus.edu.sg. The author is responsible for the facts cited and opinions expressed in this paper.