Economy Insight:

Bank Consolidation: Way Forward!

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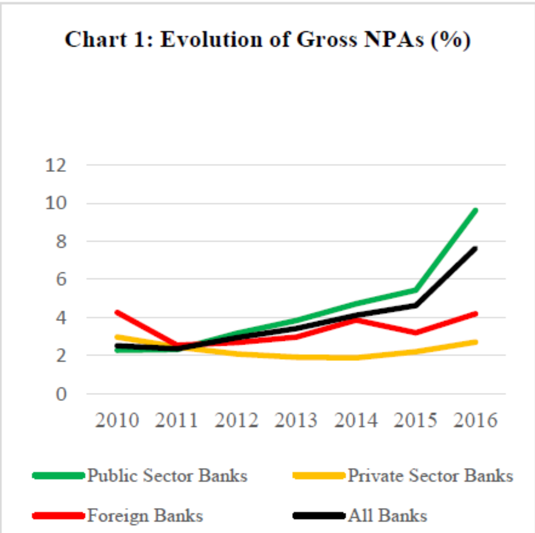
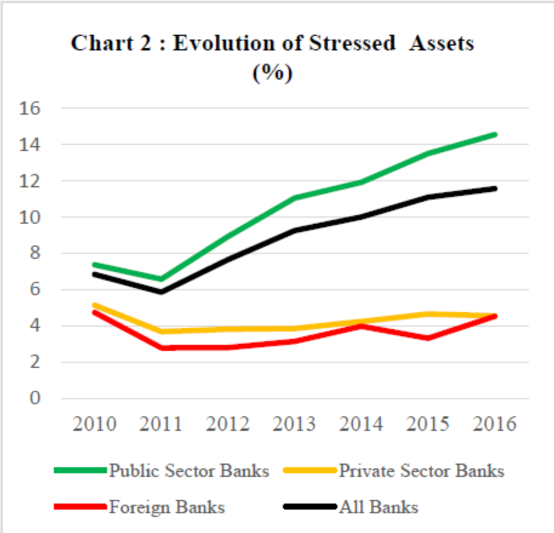
Introduction

Post the financial sector reforms in India, banking sector has played a key role in advancing and sustaining economic growth. However, since the Global Financial Crisis in 2008, the Indian economy has faced multiple challenges including the issues confronting the Indian banking sector. Stressed assets (nonperforming loans plus restructured assets) have been rising since 2010, hampering bank's capital requirements, especially in wake of the Basel III requirements. Besides the problem of stressed assets, there are number of other issues which banks in India are encountering viz. balance sheet management, risk management, technological advancements, human resource issues, etc. All this has affected the asset quality, capital adequacy and profitability of Indian public sector banks (PSBs) for a relatively long period of time.

Over the past three years since 2012-13, the performance of Indian banking sector, especially of Public Sector Banks has deteriorated, as reflected in the below charts.

Snapshot of Scheduled Commercial Banks





Source: Reserve Bank of India

The net interest margin has been on a steady decline for most of the public sector banks in India. The average net margin of PSBs declined from 9 - 10% between FY07 and FY11 to 5 - 8% thereafter until FY14, and dropped to 3.5% in FY15, and was reported negative for most of the public sector banks in FY16. Likewise, the average return on assets for the PSBs has dropped from 0.7 - 1% until FY13 to mere 0.1% in FY16.

The key reason behind the lackluster performance has been the rising NPAs in the system; the ratio of total stressed assets to total advances in the Indian commercial banks have risen to 11.5% with the Public Sector Banks reporting the highest level at 14.5% as at end-March 2016.

Measures being initiated by the government and RBI to deal with the Banking issues:

Various measures have been taken by the government and the RBI to address the issue of NPA and restore the health of banking sector. The Government, as a part of the 'Indradhanush' scheme has committed capital allocation worth Rs 70,000 crores out of budgetary allocations till 2018-19. However, this amount is way below the requirements and it is estimated that PSBs need to raise an additional Rs 1,10,000 crore from the market. The RBI has also introduced measures to help the banks by way of putting out a framework for revitalizing of distressed assets, announcing strategic debt restructuring scheme, introducing 5/25 scheme for infrastructure sector, introducing provisions for revaluing their real estate assets, and recently introduced a Scheme for Sustainable Structuring of Stressed Assets (S4A scheme).

Another step which is being deliberated is bank consolidation of Public Sector Banks. This appears to be a pragmatic step given the current circumstances. The suggestion of consolidation among PSBs was initially suggested in the Narasimham Committee Report I (1991) and reiterated again in the Narasimham Committee Report II (1998). The report had recommended a three-tier banking structure through the establishment of three large banks with international presence, eight to ten national banks and a large number of regional and local banks. The Raghuram Rajan Committee report on Financial Sector Reforms (2008) too discussed bank consolidation and suggested takeover of small, regional and unprofitable banks by well-managed financial institutions seeking complementary assets.

Case for Consolidation of Indian Public Sector Banks

Banking sector in India is too fragmented

Indian banking sector is highly fragmented, especially in comparison with other key economies. The five-bank asset concentration in India is way lower than in several other countries (refer table below). Even the Herfindahl-Hirschmann Index (HHI)[1] for Indian banking sector stands at 545.2, reflecting low levels of concentration in the sector.

Country	5-Bank asset concentration in 2014 (%)
South Africa	99.80
Germany	99.38
Malaysia	95.86
Australia	94.49
Singapore (2013)	94.38
Brazil	91.19
United Kingdom	90.06
China	81.70
France	79.56
Thailand	75.72
Mexico	71.18
Japan	60.46
United States	47.86
Russian Federation	44.03
India	**40.21**

Source: Global Financial Database, June 2016

[1] HHI is an indicator of industry concentration and is calculated as a sum of squared market shares of all firms in the industry. An HHI below 1000 indicates fragmentation, between 1000 and 1800 implies medium level concentration and above 1800 indicates high concentration.

Additionally, most of the PSBs in India are competing within themselves; most of them have same business models and compete in the same segments as well as same geographies. Thus, there is a huge scope of consolidation in this sector. In-fact, even if all the 27 PSBs are reduced to mere 5 large sized PSBs post-merger/ consolidation, FICCI Research shows that the HHI for the Indian banking sector will still not be highly concentrated with HHI estimated at 1142.

Need to build capacity to meet credit demand

India needs to have large banks (global sized banks) that can support the investment needs of economy and sustain economic growth. To meet the growing credit demand of the economy, the Public Sector Banks need to be well capitalized and need to enhance their capacity to lend to larger companies and larger projects. Consolidation of Public Sector Banks into 4 or 5 banks would create larger banks with capacity to fund larger size projects of economic importance.

Need for larger capital base to manage NPAs

Public Sector Banks (PSBs) which form approximately 72% of the Indian banking system are among the most affected by the high non-performing asset (NPA) problem at present. This has further resulted into a slowdown of credit growth in our economy, thereby reducing private investment and our potential economic growth.

Credit Growth - Industrial sector (%)

2012-13	2013-14	2014-15	2015-16
15.1	13.1	5.6	2.7

Source: Reserve Bank of India

There are suggestions that a consolidation of PSBs can help them manage the challenge of NPAs more effectively. In effect, it is argued that a large bank will be better capitalized, will have deeper expertise to handle large credits and large NPAs.

Lessons from Past Mergers and Consolidation

In India, many banks in the past were merged with other banks. For example, New Bank of India and Punjab National Bank, both PSBs, were merged in 1993. Likewise, State Bank of Saurashtra and State Bank of Indore had merged with the SBI in 2008 and 2010, respectively. There have been voluntary mergers of banks as well. Theoretically, key reasons for merger are economies of scale and scope, efficiency gains, cost savings, diversification of customers and assets, and also that large banks help in international recognition. The merger of ING Vysya Bank with Kotak Mahindra Bank helped in creating a large bank with national presence, as ING Vysya had a stronger presence in South India while Kotak Mahindra Bank had good presence in the West and North India.

However, mergers or consolidation can also be a challenge and have to be treaded carefully. It is extremely important to consider the strengths and weaknesses of each PSB before their merger. The process can be smooth if a merger happens between similar institutions with similar culture, but not always as it may lead to job cuts, branch closures, reducing the quality and quantity of services offered to customers. For Example, consider the merger of Global Trust Bank (GTB) with Oriental Bank of Commerce

(OBC) in 2004. The decision was taken by the Reserve Bank of India (RBI) and post the merger, it resulted into OBC's capital adequacy ratio declining and gross NPA rising as GTB's gross NPA was a close to 26 per cent. It took OBC some years after the merger to restore its financial health. Thus, the government and the RBI need to carefully craft the consolidation process.

SBI Merger: An Assessment

Recently, SBI has taken a decision to consolidate five of its subsidiaries (the State Banks of Bikaner and Jaipur, Hyderabad, Mysore, Patiala and Travancore) as well as the Bharatiya Mahila Bank into itself, which in itself presents a stronger case for consolidation among public sector banks going forward.

FICCI Research shows that post the merger of SBI with its associates and Bharatiya Mahila Bank, the merged entity will have an asset size of about Rs 28.7 lakh crore (~US$ 431 billion), which will place it at 65th rank in the list of top global banks (refer Table below). Currently, SBI is ranked at 77th position in this list.

Global Banks

Rank	Bank	Country	Total Assets, US $Billion
1.	Industrial and Commercial Bank of China	China	3549
2.	China Construction Bank Corporation	China	2981
3.	Mitsubishi UFJ Financial Group	Japan	2901
4.	Agricultural Bank of China	China	2818
5.	Bank of China	China	2656
65.	**State Bank of India (Post Merger)**	**India**	**431**
66.	The Export-Import Bank of China	China	427
80.	DBS Group Holdings	Singapore	334
90.	Swedbank	Sweden	292
100.	United Overseas Bank	Singapore	238

Source: http://www.relbanks.com/worlds-top-banks/assets(as of June 2016), FICCI Research

In-fact, if the remaining 20 PSBs are merged into 4 larger PSBs, the average size of assets of each of these newly merged entities would be around Rs 15.5 lakh crore (~ US$ 233 billion). While this will be large from the Indian context, these new entities may still not feature amongst the top 100 global banks.

From above table, we can see 'The Industrial and Commercial Bank of China' is the largest bank in the world with an asset size of US$ 3.5 trillion. It is followed by China Construction Bank Corporation (China) and Mitsubishi UFJ Financial Group (Japan). Four of the top five largest banks are Chinese led. Among the top 100 banks, 19 are from China, 10 from USA, 9 from Japan, 6 from UK and only one from India (State Bank of India).

The merged bank will benefit in terms of synergies in business operations, branch rationalisation and access to tap into cheaper funds. An analysis of profitability and operational indicators of the SBI, its associate banks and the Merged Entity, it is revealed that in terms of operational efficiency, Capital Adequacy Ratio (CAR) of the banks is expected to improve along with a decline in gross and net NPA levels. The Provision Coverage Ratio (PCR) is expected to dip slightly without much impact on the merged entity balance sheet.

SBI: Operational and Profitability Indicators Post-Merger

Indicators	SBI	All Associate Banks	Merged Entity
	FY 16	FY 16	FY 16
Net Profit (Rs crore)	9,951	1,639	11,589
CAR %	13.12	11.59	12.66
Gross NPA (Rs crore)	98,173	23,796	1,21,969
Gross NPA %	6.50	5.98	6.40
Net NPA (Rs crore)	55,807	13,087	68,894
Net NPA %	3.81	3.39	3.73
Restructured Advances (Rs crore)	66,117	35,396	94,569
PCR %	60.69	60.03	60.56

Source: State Bank of India

In terms of profitability indicators, the net profit is expected to increase mainly on account of an increase in asset base for the merged entity. However, there would be a simultaneous increase in the NPA figures along with restructured advances for the merged entity going forward.

Steering Consolidation of other PSBs: Key Criteria

As seen in the past, all mergers and consolidation may not be successful. It is extremely important to weigh all the pros and cons before taking the decision for consolidation. There is no doubt a case for consolidation of India's 27 PSBs into 4 or 5 large banks. The question is whether weak banks should be merged with the strong bank, or banks in same geographies be merged, or banks from different geographies be merged. Highlighted below are some of the key criteria which should be kept in mind while carrying forward the process of consolidation among PSBs in India.

Capital Adequacy

Clearly, the core idea behind exploring merger of banks is to enable creation of large sized banks of adequate capital base to enable disbursement of greater credit, especially for large developmental projects as well as for effective management of NPAs. Hence, the likely capital size of the merged entity needs to be considered while evaluating the decision for consolidation. As discussed earlier, with SBI merging with its 5 associates and Bharatiya Mahila Bank, the remaining 20 banks if consolidated into 4 large banks, the average size of assets of the merged entity would be around Rs 15.5 lakh crore.

Cost rationalisation

The success of merger is gauged from the improvement in key business indicators of the merged entity over a period of time (say 2-3 years). Merger of two or more banks should thus ideally result into value maximisation and efficiency gains. The benefits may entail through rationalization of branches, productivity gains through proper deployment of skilled resources, common treasury pooling, enhanced scale of operations and rationalization of common costs. Additionally, the volume of inter-bank transactions will also come down, resulting in saving of time in clearing and reconciliation of accounts. However, these cost benefits need to be carefully weighed against other parameters such as the likely increase in non-performing assets, and loss of business with closure of some branches.

Different Geographies

Geographical synergy will play a key role in driving the consolidation process forward. A pertinent point deliberated has been that banks from different geographies should be chosen for merger going ahead. For example, a south based bank could be merged with a north based bank as this would enhance business through additional customers. The recent acquisition by Kotak Mahindra Bank of ING Vysya Bank, was primarily driven by geographical synergies. The number of branches of Kotak Mahindra across India has increased to 1333 in FY16 as against 605 in FY14 and 684 in FY15. Even the business per employee for Kotak has increased by 6.5% to Rs 75.1 million in FY16 from Rs 70.5 million in FY15.

On the other hand, without a well thought process, a merger might also result into clash of different organizational cultures. It could further lead to conflicts in the area of systems, processes, organisational culture etc. Hence an alternate view is that merging banks within the same region can be effectively managed and will also strengthen operational synergies and efficiency within the same region. Hence, the likely synergies need to be carefully evaluated while taking a decision for merging banks in same geography or different geographies.

Risks and Challenges

Human Resources

One of the most challenging problems which could hinder the consolidation process would be in terms of human resource integration and management as many employees would fear job loss and disparities in the form of regional allegiances, benefits, reduced promotional avenues, new culture, etc. To ensure that the integration of entities is a smooth process, the most important task would be to embark on a human resource strategy that can help address the core concerns of employees, mitigate their anxieties, and create an environment of trust.

Harmonization of Technology

Another big challenge for integration post banks' merger relates to integration of technology as various banks are currently operating on different technology platforms. Systems integration plays an important role as it involves integration of infrastructure components such as data centers, operating platforms and enterprise applications, and alignment of IT and business strategies of the merging entities. Hence, IT integration strategy should be aligned with the business strategy right from the beginning to ensure a successful merger.

Monitoring, Regulation and Control

From regulatory perspective, monitoring and control of less number of banks will be easier after mergers. Also, for meeting the norms under BASEL III, for ensuring capital adequacy ratio, the larger banks will be at ease. However, it has also been argued that a failure of a very large bank may have macro implications on the economy and may have to be bailed out during stress periods. Existence of excessively large banks may also create significant moral hazard costs for the entire system as witnessed during the Lehman collapse in 2008. RBS from United Kingdom is a leading example of how a big global bank which was too big to fail collapsed post the global financial crises and had to sell its assets globally.

Regulatory Framework for Global Systemically Financial Institutions (G-SIFIs)

The concept of systemic important banks (SIBs) had gained momentum especially after the collapse of Lehman Brothers, which triggered a global financial meltdown worldwide. Since, then G20/FSB along with Bank of International Settlements has undertaken the work related to protecting the global financial system from the failure of a large financial player that is considered to be 'too big to fail'. These are those entities whose failure can threaten the survival of other institutions which in turn can possibly lead to a global financial crisis. The FSB asked the Basel Committee on Banking Supervision (BCBS) to develop a methodology comprising both quantitative and qualitative indicators to assess the systemic importance of Global SIFIs. On 3 November 2015, the FSB published the updated the list of G-SIBs using end-2014 data (30 at present). The broad parameters for evaluating SIBs included the following indicators:

- Size
- Interconnectedness
- Lack of readily available substitutes or financial institution infrastructure
- Complexity

Broadly, G-SIFIs need to hold additional capital buffers to enhance their resilience and should also hold certain amount of subordinated liabilities to absorb losses in resolution cases (Total Loss Absorbing Capacity or TLAC). In addition, in order to limit contagion in case of financial distress, the interconnectedness of G-SIBs is also actively supervised.

USA: The Fed currently does not identify any additional D-SIBs beyond those already designated as G-SIBs. In addition to a higher loss absorbency requirement, these banks are also subject to additional heightened regulatory and supervisory requirements, including stress testing, capital buffer and liquidity requirements, and strengthened expectations for risk management. There are currently eight G-SIBs based in the US. These banks comprise almost 50% of the total exposures of the US banking system.

European Union (EU): The EU equivalent of a D-SIB in the Basel framework is an "other systemically important institution" (O-SII). The O-SII framework was implemented by Article 131 (1) of the CRD, which was issued in June 2013 and took effect from 1 January 2016. The higher loss absorbency requirements set by the relevant authorities and resulting from this identification process are also included and with the obligation for these institutions to maintain a CET1 capital buffer of up to 2% of the total risk exposure amount, as laid down in Article 131 (5) of Directive 2013/36/EU.

India: The Reserve Bank has already issued the Framework for dealing with Domestic Systemically Important Banks (D-SIBs) on July 22, 2014. The Framework requires that D-SIBs should be placed in four buckets depending upon their Systemic Importance Scores (SISs). Based on the bucket in which a D-SIB is placed, an additional common equity requirement is also applied to the financial institution. Banks with assets that exceed 2% of GDP are considered to be part of this class of lenders.

Conclusion

From a global perspective, the consolidation process among banks has been driven primarily by synergies, efficiency, cost saving, and economies of scale. It is essential to evaluate the proposed merger of banks by assessing the likely benefits such as cost rationalization, additional business, etc. against the likely future costs that may arise on account of harmonization of various procedures, technology and integrating human resources. It is also essential that banks work to mitigate exposures in areas related to interconnectivity, the market, regulatory compliance, credit quality, etc.

These risks can be mitigated through advance planning and due diligence to ensure a smooth transition. The consolidation process in India should aim at strengthening the banks' bargaining power, help save costs; improve supervision and corporate governance across the banking system. Besides, the government along with RBI should also start streamlining the PSBs especially in terms of their chosen areas of business so as to help them to focus on their core capacity and strengths in the times ahead.