Consolidation in banking

The Union Cabinet has given in-principle approval for Public Sector Banks (PSBs) to amalgamate through an Alternative Mechanism (AM). In 1991, it was suggested that India should have fewer but stronger PSBs. However, it was only in May 2016 that effective action to consolidate PSBs began to be taken by announcing amalgamation of 6 banks into State Bank of India (SBI). Bharatiya Mahila Bank and 5 subsidiaries of SBI were absorbed into SBI. The merger was completed in record time, unlike earlier mergers of State Bank of Indore and Saurashtra. SBI is now a single bank with about 24,000 branches, over 59,000 ATMs, 6 lakh POS machines and over 50,000 BCs.

There are now 20 PSBs other than SBI. The banking scenario has changed since 1970-80 when banks were nationalized, with an increased banking presence from private sector banks, non-banking finance companies (NBFCs), RRBs, payment banks and SFBs.

Historically, most bank mergers have been offshoots of the central bank's efforts to protect the financial system and depositors' money and very few of them have been driven by the need for consolidation and growth, right from 1969, when Bank of Behar was merged with SBI, to 2015, when Kotak Mahindra Bank took over ING Vysya Bank. The only instance of a state-owned bank being merged with another was in 1993, when New Bank of India was merged with Punjab National Bank, which was not a voluntary merger.

The Cabinet decision is expected to facilitate consolidation among the nationalized banks to create strong and competitive banks in public sector space to meet the credit needs of a growing economy, absorb shocks and have the capacity to raise resources without depending unduly on the state exchequer. Hence, it would be interesting to see how the mergers are done and whether they would help in the consolidation of PSBs.

Based on the description provided in the approval framework, the process of PSB consolidation could be envisaged in four phases and PSBs could follow the below approach for consolidation. The first phase in the process is shortlisting a possible partner suiting the requirements. Based on detailed diligence, cost-benefit analysis, cultural fit, synergies and various other parameters, the process can move forward. The required communication and agreement between parties can then be achieved with mutual consent. The second phase involves preparation of a merger scheme. Once the partner is selected, the merger scheme needs to be prepared and presented to the Cabinet. Upon its approval, the third phase of implementation of merger scheme shall start. After preparation and approval, the merger scheme needs to be implemented. The banks may choose to appoint independent advisors or consultants to complete the transaction. Once the transaction is completed, the final step of post-merger implementation has to be effectively managed to see that all the synergies identified, in terms of technology, products and services, branches, culture, etc. are realized.

There are different views regarding the impact that consolidation will have on the PSBs. One view is that consolidation would be beneficial as it would help in reducing costs and achieving greater efficiency. It would make the PSBs healthier and help them stand up to competition from global banks. The banks may be able to avert a loss of market share to private banks and NBFCs to some extent.

However, there is another view that there would also be some challenges associated with it. Firstly, it may be difficult to arrive at the swap ratio as the rights of minority shareholders need to be protected.

Another critical point to ponder upon is whether the relatively large banks have the ability to absorb weaker peers. Punjab National Bank, which is the largest among them, with assets worth INR 7.21 trillion, has gross NPAs of 12.53%, which is 92% of its capital and reserves, or net worth, as of March 2017. Similarly, Bank of Baroda has gross NPAs of 10.46%, Bank of India has 13.22%, Canara Bank has 10.56% and Union Bank has 11.17% gross NPAs.

Even though the merger of SBI with its associates catapulted it in the league of top 50 global banks in terms of assets, it has not been able to escape the pain associated with it. Following the merger, its gross NPAs jumped from INR 1.08 trillion to INR 1.79 trillion, which was a rise from 7.23% of advances to 9.04%. While its own net profit was INR 2815 crore in the March quarter, the merged entity reported a loss of INR 3300 crore. If this could happen to India's largest lender following the merger of its own entities run by the same management, the other banks could face a worse situation.

While PSBs are evaluating their options, private sector banks are also examining innovative methods of value creation by way of acquisition of NBFCs, be it MFIs or consumer lending NBFCs.

The mergers in the past, between ICICI Bank and ITC Classic Finance, or between HDFC Bank and Times Bank, have provided the banks good value.

In the last couple of years, IDFC Bank acquired a 9.99% stake in ASA International India Microfinance and also acquired Grama Vidiyal Microfinance.

Recently, IDFC and the Shriram Group have agreed to finalise a merger of their financial services businesses. All operating businesses of the two groups will come together under IDFC Ltd. The retail consumer centric business of Shriram Capital – Shriram City Union Finance (SCUF) – will be merged into IDFC Bank. The transport finance business will remain a standalone NBFC that would become a subsidiary of IDFC Ltd. The proposed merger would create a financial giant that will have businesses like mutual funds and insurance as well.

In another transaction, IndusInd Bank and Bharat Financial Inclusion Ltd. have entered into an exclusivity agreement to evaluate the possibility of a strategic merger between them. The deal is expected to help IndusInd Bank to scale up its microfinance book and gain deeper penetration in rural areas.

While bank consolidation is the flavor of the season, we must not forget that there is also a need for more banks to reach the last mile. As per the Narasimham committee, a large number of regional and local banks are needed at the lowest tier of banking structure. Additionally, the Indian banking sector is currently facing a bad loan crisis. Consolidation is likely to help private banks, if the regulatory approvals are in place. However, whether PSBs will truly strengthen from the government's consolidation plans remains to be seen. The focus should be on cleaning up the balance sheets of the banks before going ahead with consolidation.