Indian banking: Let's prepare for consolidation

November 8, 2016: Consolidation in the Indian Banking sector is being considered as one of the reforms awaiting to be taken by the government and the industry. Here is an attempt to evaluate the impact of banking consolidation on the long-term growth path. One could think that M&A's are likely to strengthen the soundness and the financial stability of the sector for three reasons.

Firstly, a tendency of migration towards efficiency calls for consolidation through the rationalization of the banking supply structure thereby strengthening the profitability and competitiveness and therefore the soundness of the banking sector. Analyzing the performance of banking sector in the past, we can observe that the banking activity has slowed down over the past 3-5 years and the growth potential is now questioned. Pace of deposit gathering and credit growth has slowed down and the banks are today focusing more on cleaning up of the balance sheets and working on NPAs rather than expanding the book. The immediate need for capital is adding to the woes of the banking system which is struggling with the bad loans. This is building the pressure in the system and inefficient banks may have to be coerced to merge with more efficient banks to better face the completion and maintain profitability. Theneed for migration towards efficiency will ultimately drive the need for consolidation.

Secondly, the heavy dependence on banking system for financial intermediation is adding to the pressure of performance. The large size of projects that India is talking of needs larger size banks to finance it. The need for two or three world sized banks in an economy that is poised to become one among the five largest in the world is rather obvious and clearly the only way Indian banks can expand rapidly and reach global size is through consolidation. There can be no two opinions about the fact that no Indian bank is of a global size. State Bank of India (SBI), the country's largest lender, is nowhere close to the world's largest lenders. Bank of America is almost six times its size. Another problem of the Indian banking system is that after SBI there is a huge drop in size. ICICI Bank, the second-largest lender, is one-third the size of SBI in terms of total assets.

Also, in a highly competitive environment, where there is a constant battle to maintain the margins and profitability levels to make up for the inefficiencies, market driven consolidation could constitute a response to counter the fragility of thesystem resulting from competitive pressures. Further, mergers were needed not just for achieving economies of scale but also for survival of small banks, which would find it increasingly difficult to operate with the entry of new private sector banks, who being nimble footed have a clear advantage over public sector banks in growing their business inorganically. Among the public sector banks, State Bank of India has been merging smaller banks into itself. But there is still enough room for public sector players to consolidate themselves.

The recent merger of Kotak Mahindra Bank and ING Vysya Bank has brought back the focus on consolidation in the Indian Banking Sector. The new private sector banks could also examine old private sector banks struggling to sustain the competition and market pressure as possible targets. While consolidation in the private sector are mainly driven by market forces and decisions taken independently by the board of each bank, the need for consolidation in public sector should be envisaged by the government, regulators or the bank boards.

Given the shareholding pattern of the public sector banks and the recent performance of these banks, forced mergers by the government cannot be ruled out. Currently the lower M&A activity could be attributed to the valuations being on the lower side owing to the non-performing assets of banks. While little transactional activity is seen in the first three quarters of this year, we can expect some activity towards end of this year and the coming quarters of 2016. Three to five years down the line, the performance of the new entrants, i.e, the small finance banks and payments banks could play a role in adding pressure leading to some more consolidation.

While consolidation is expected to bring in efficiencies and improve performance on various parameters including ROCE, CAR and EPS, due care has to be given to cultural fit, geographical alignment and business synergies, technology integration and many other aspects.