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CONSOLIDATION OF INDIAN BANKS

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1. JOURNEY OF THE INDIAN BANKING SECTOR

In its journey in the past three decades, India's banking system has earned several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to metropolises or cities in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main aspects of India's banking growth story. The first banks were Bank of Hindustan (1770-1829) and The General Bank of India, established 1786 and since defunct. The largest bank, and the oldest still in existence, is the State Bank of India, which originated in the Bank of Calcutta in June 1806, which almost immediately became the Bank of Bengal. This was one of the three presidency banks, the other two being the Bank of Bombay and the Bank of Madras, all three of which were established under charters from the British East India Company. The three banks merged in 1921 to form the Imperial Bank of India, which, upon India's independence, became the State Bank of India in 1955.

The Government of India issued an ordinance and nationalised the 14 largest commercial banks in 1969. These banks have 85 per cent of bank deposits in the country. A second round of nationalization of 6 more commercial banks took place in 1980. Nationalisation took place so that government gets more control of credit delivery. With the second round of nationalisation, 91% of banking business was held by the Government of India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalised banks and resulted in the reduction of the number of nationalised banks from 20 to 19.

Advancement in technology, deregulation, globalization and rapid growth of international trade have led to greater integration of world economies. The financial service industry, particularly, the banking industry has witnessed the greatest changes which has transformed the whole country. Globalization of financial markets has led to intense competition and has encouraged growth of massive financial institutions. The financial sector reforms set in motion in 1991 have greatly changed the face of Indian banking. While the banking system in India has done fairly well in adjusting to the new market dynamics, survived the global sub-prime financial crisis

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and is fairly sound and stable due to strong regulatory framework, it would not be clichéd to say again that greater challenges lie ahead. The financial sector would be open to international competition once the tone for the rules of the game is set under the WTO. Banks will have to gear up to meet stringent prudential capital adequacy norms under Basel-II and Basel III as they compete with banks with greater financial strength. In the past, mergers were initiated by regulators to protect the interest of depositors of weak banks. But, it is now expected that market led mergers may gain momentum in the coming years.

This project examines the consolidation of Indian banking sector by dividing the project into the following chapters. Chapter I introduces the project by clearly stating the objectives of the project. It discusses the motives, prerequisites and need for consolidation of banks, especially for India. Chapter II portrays the historical background of mergers and acquisition of banks both abroad (US & UK) and in India including recent changes. Chapter III discusses the structure and functions of the Indian Banking Sector and points out the possibilities and attractiveness of the banking sector for domestic and foreign mergers. Chapter IV states in detail the whereabouts of merger and acquisitions in general and the need for the same in the Indian Banking sector. Chapter V studies the effect of merger of three famous mergers that has taken place in Indian banking sector by comparing its pre and post merger financial ratios statistically. Chapter VI concludes the project. Appendix A jots down the main features of some important committee reports on Indian Banking Sector.

2. MOTIVES FOR CONSOLIDATION IN INDIAN BANKING

The reasons for consolidation in India are the following: As suggested by Narasimhan Committee Report II, “M & A” Government & RBI have to monitor the process carefully. The Narasimhan Committee has recommended a three-tier banking structure with 2 or 3 large banks of international character, 8 or 10 national banks and a few large local area banks. The committee recommended that Mergers should ideally be among the listed entities, so that they can offer scope to indicate post-merger market parameters like “market capitalization” after merger, etc. The report on “Indian Banks association (IBA) Banking Industry: Vision 2010” stressed that “Mergers and acquisitions will gather momentum as management will strive to achieve the expectation of shareholders. This could see the emergence of 4-5 world class Indian banks. As banks seek niche areas, we could see emergence of some national banks of global scale and number of regional players”. The problem however is not only the small size of Indian banks but also the lack of depth in investment and other financial services and human resource capabilities. Let us take a look at the progress of Indian Banking sector in the next paragraph.

2.1 Basel Norms

Basel III requires banks to meet tougher and higher capital adequacy norms such as capital allocation towards operational risk, in addition to credit and market risks. Firstly, many Indian banks, especially public sector banks, cooperative banks and regional rural banks are unprepared for this implementation due to capital inadequacy. According to the Reserve Bank of India report on " Currency and Finance" released on September 4, 2008, the banking sector would require an additional capital of Rs 5,68,744 cr in the next five years. This is based on the assumption that banks would maintain Capital –to Risk –weighted Assets ratio (CRAR) at 12. 5%. Over the next five years, PSBs would require Rs 3,69,115 cr (64.9% of total requirements , old private sector banks Rs 23,319 cr (4.1%). New private sector banks Rs 113,180 cr (19.9%), and foreign banks Rs 63,131 cr(11.1%). To maintain the 51 per cent minimum government share, PSBs cannot collect additional capital directly from the public and with this view it promotes bank mergers. Table1 depicts that out of 21 nationalized banks 9 banks have Government shareholding in equity capital close to 51 %.In many banks; the government holds a stake just above this limit, restricting its scope to dilute the stake further and reinforce their capital base. Table 1 also reveals that Dena bank and Oriental Bank of Commerce have government shareholding of 51.19 only, hence in future they cannot raise capital from the market as it will reduce the government shareholding to below 51 %. The pace at which the Indian economy is growing and transforming itself, consolidation is inevitable as beyond a point banks can grow only inorganically. Consolidation may be a route for smaller banks to infuse funds to strengthen their capital base.

Table 1

Sl.No.	Name of the Bank	Total paid-up equity capital	Government shareholding
1	Vijaya Bank	433.52	53.87
2	IDBI Ltd.	724.78	52.67
3	Allahabad Bank	446.70	55.23
4	Andhra Bank	485.00	51.55
5	Bank of Baroda	364.27	53.81
6	**Dena Bank**	286.82	51.19
7	**Oriental Bank of Commerce**	250.54	51.09
8	Union Bank of India	505.12	55.43
9	Corporation Bank	143.44	57.17

2.2 Fragmented Size

It is felt that India has many commercial banks that are very small. That is of the 53 domestic banks (both public and private), the size of 16 banks at end March 2007 individually was less than 0.5 percent of size of the banking sector. (RBI, Report on Currency and Finance, 2006-08) Indian banking industry is highly skewed and almost

67 banks have a less than 2.0% market share in India. "In the long run it is advisable that consolidation should happen in both the private and public sector," HDFC Chairman Deepak Parekh told Reuters on the sidelines of the St. Gallen Symposium Parekh said there should be a small number of large banks rather than a large number of small banks so that Indian banks could keep up with the growing balance sheets of large Indian companies and play a role in big takeover deals.

2.3 To Attain Global Competitiveness

Indian banks are not able to compete globally in terms of fund mobilisation, credit disbursal, investment and rendering of financial services. The main reason behind it is the size of the industry. In 2008, there was only one Indian lender - SBI, at eighth place among the top 25 Asian banks. Industrial and Commercial Bank of China, the biggest Asian bank and the world‟s eighth biggest bank, is four times bigger than SBI, both in terms of tier-I capital as well as assets. Another recent study "Report on Currency and Finance"released by the RBI reveals that the combined assets of the five largest Indian banks - SBI, ICICI Bank, Punjab National Bank, Canara Bank and Bank of Baroda are just about half the asset size of the largest Chinese bank, Bank of China. The bank is 3.6 times larger than SBI in terms of assets, branches and profits.

Table 2 shows that Indian Banks though may not be bankers to the world but they certainly have improved their position due to strict regulatory regime by Reserve Bank of India in the worst recession for the global banking industry. There are 20 Indian banks in the Brand Finance Global Banking 500, an annual international ranking by UK-based Brand Finance Plc, this year. In terms of assets, SBI was the world's 70th largest bank in 2009, but due to global financial crises, several big daddies collapsed paving way for the sound and resilient Indian banks in the Top 500 list. SBI‟s brand value more than tripled to $4,551 million, up from $1,448 million in 2009 helping it grab the 36th spot in the list. On the other hand, ICICI Bank Ltd, the largest private sector lender was at the 110th position in 2009, joined in the top 100 list with 130 % jump in brand value. HSBC retained its top slot for the third year in a row. The number of Indian banks in the global list had more than tripled last year to 19 from six in 2007 but still, as was the case last year, the Asian top 10 banks are dominated by Chinese banks with the gap between the major Chinese banks and the rest widening (The Economic Times, February 1, 2010). The Finance Ministry had pitched for consolidation, stating that it would be "immensely beneficial" to the SBI Group as it would bring in economies of scale, reduce administrative overheads, help re-deploy and channelize trained manpower to business development. Hence, Indian banks can certainly do better by enhancing their size as well as efficiency, to emerge as a global power.

Table 2 Rank of Indian Banks in Top 500 Global List

2010	2009	Indian Bank
36	70	State Bank of India
70	110	ICICI Bank
141	153	HDFC

Though the empirical evidence shows that size does not lead to efficiency, and there is no direct relationship between size and profitability, for instance though SBI, is the largest bank in India but its return on assets is 1.04% for the year 2009 -10 below the national average of 1.16% and new private sector banks 1.70 % and its spread as % of assets is also less than the average of nationalized banks not to talk about private and foreign banks.(IBA,2009)

Table 1.3

In 2009-10	Return on Assets	Spread as % Assets
Nationalised banks	1.16%	**2.21%**
SBI	1.04%	**2.16%**

Therefore, the Indian banks have yet to attain optimum size, so as to enjoy economies of scale and scope and they can invest in latest technology and MIS ,systems& processes and can adopt appropriate strategies to compete in the globalised world. Hence, enormous opportunities exist in the future. India's financial sector is going to boom in a growing economy where millions of people will join the workforce and need bank accounts. 700 million people are financially excluded, banks will, therefore, need to plan for all this and learn basic survival skills. In a globalised economy, Indian banks need size as well as efficiency not only to compete with foreign banks but also going abroad and competing in other markets. One useful prerequisite for that is size. One measure for judging how competitive is the banking structure in India, share of top five and ten banks in assets can be considered. The competitiveness in the system has been improving in the post reform period as indicated by declining share in assets, deposits and income of the top five and ten banks. State bank of India which has 24 % share in assets in 1995-96 declined to 16 % due to the emergence of private banks like ICICI and HDFC, other public sector banks like Central bank of India and Union bank of India, Bank of India, have lost their position in first five ranks.

2.4 Mergers and Synergies

By marrying the banks by choice will lead to many synergies like cost reduction, risk management capabilities, human resource development, diversification and enhancement of shareholder value.

2.5 Cost cutting

Many branches and ATMs of various banks are flocked in the same areas leading to enormous outlay on premises, manpower and maintenance facilities. For example there is no fundamental difference between Union bank of India and Bank of India. Operating expenses can be reduced by redeployment and rationalization of such infrastructure, human resources and other administrative facilities. Consolidation will lead to cost efficiency which will enhance profitability. For instance mergers and acquisitions which have taken place in the US on an average in the last five years, 40 per cent of the cost of the target bank was reduced by the merger process. If you look at Asia and Europe, the cost reduction is about 37 per cent.

2.6 To Enhance Risk Management

Larger size improves the risk bearing capacity of a bank and strengthens its balance sheet. As per the study by Hannan and Pilloff, 2006 the merger also helps the banks to reduce the bankruptcy risk if the merger is carried over in a controlled manner. Craig and Santos also in their research paper have validated that risk gets reduced due to the diversification in the merger of the banks .This has been validated by the z score test done on default probability and by stock return volatility.

2.7 Geographical Spread

Banks can diversify the risk of concentrated lending through mergers. They can also have a greater market access thereby widening the deposit base. The number of branches can also increase which helps the banks increase their spread. For example the case of the HDFC and Centurion Bank merger .Centurion Bank was strong with around 390 branches in North and South of India. And HDFC with around 1100 branches mainly in north and western India has given the new entity a much wider spread. There is wider choice of better suitable human resource for the purpose of doing the job leading to efficiency. Increase in efficiency leads to decrease in cost which may be passed to the customer so as to increase the customer base.

2.8 Alignment of technology

The technology infrastructure, system platforms (Finnacle, Bank links etc), network architecture, database vendors and IT-enabled synergies (customer service, payroll, back office operations, risk management, etc) should be compatible in banks desiring to merge .Most of the public sector banks are at similar technology platform and consolidation will not be hindrance for them.

3. PREREQUISITES FOR MERGER

Chairman of the Prime Minister's economic advisory council, C. Rangarajan, says public sector banks should opt for mergers and acquisitions only if they stand to reap commercial gains and should not be compelled into consolidation. "Any process of consolidation must come out of a felt need for merger rather than as an imposition from outside," Rangarajan, a former governor of the Reserve Bank of India, said at Bancon, the bank industry's annual conference. "The synergic benefits must be felt by the entities themselves." The government and the regulator should only play the role of a facilitator in the commercially-driven process, he added (Jan 12, 2010,Mint). In future, the Indian banking system will be exposed to higher growth and competition. **Firstly**, there is a need for single banking legislation and separate legislative framework for public (SBI and Nationalised), private banks should be abolished, so as to encourage market driven consolidation or marriage by choice. **Secondly**, all the regulatory, accounting, legal and human resource issues must be sorted out. **Thirdly**, banks to be merged must be listed, so that post merger performance can be tracked. As the value of the merger lies in its synergies and these synergies are not released over a very short period of time but over a considerable period of time, hence, the effect of mergers must be considered after considerable period of time. Adaptability of the system to change is the only way of survival.

4. CONCLUSION

The banking sector reforms undertaken in India from 1992 onwards were basically aimed at ensuring the safety and soundness of financial institutions and at the same time at making the banking system strong, efficient, functionally diverse and competitive. The reforms included measures for arresting the decline in productivity, efficiency and profitability of the banking sector. Furthermore, it was recognized that the Indian banking system should be in tune with international standards of capital adequacy, prudential regulations, and accounting and disclosure standards. Financial soundness and consistent supervisory practices, as evident in our level of compliance with the Basel Committee.s Core Principles for Effective Banking Supervision, have made our banking system resilient to global shocks.

India has not faced any major economic/financial crises, though in 1990-91, there was some pressure on the external sector with the current account deficit and external debt servicing reaching large proportions. However, due to prudent macroeconomic policies, it was possible to return the country to a sustainable growth path. As well as the long history of regulation and supervision, Indian banks have limited exposure to sensitive sectors such as real estate, equity, etc, strict control over off-balance sheet activities, larger holdings of government bonds (which helps limit credit risk), relatively welldiversified credit portfolios, statutory restrictions on connected lending, adequate control over currency and maturity mismatches, etc, which has insulated them from the adverse impact of financial crisis and contagion. Banks in India have played a significant role in the development of the Indian economy. However, with the structural reforms initiated in the real economy from the early 1990s, it was imperative that a vibrant and competitive financial system should be put in place to sustain the ongoing process of reforms in the real sector.

The financial sector reforms have provided the necessary platform for the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. The reforms also brought about structural changes in the financial sector and succeeded in easing external constraints on its operation, introducing transparency in reporting procedures, restructuring and recapitalising banks and enhancing the competitive element in the market through the entry of new banks. The ongoing revolution in information and communication technology has, however, largely bypassed the Indian banking system given the low initial level of automation. The competitive environment created by financial sector reforms has nonetheless compelled the banks to gradually adopt modern technology, albeit to a limited extent, to maintain their market share. Banks continue to be the major financial intermediaries with a share of 64% of total financial assets. However, non-bank financial companies and development finance institutions are also emerging as alternative sources of funding.

In India, foreign banks account for only around 8% of the total assets of the banking system. Further, domestic households are not allowed to place deposits abroad. Similarly, conditions for accessing overseas capital markets by domestic corporates have been stringent, in terms of size, maturity, pricing, etc. The impact of the entry of foreign banks on domestic banks is likely to depend on various factors such as the structure, strength and competitiveness of domestic banks, the share of foreign banks, and the regulatory/supervisory framework. While the entry of foreign banks could definitely improve the competitive environment, they are not likely to weaken domestic banks. With better technology and expertise in offering specialised banking products such as derivatives, advisory services, trade finance, etc, the entry of foreign banks can enhance healthy competition and has a positive spillover effect on the domestic banks. The domestic banks would be under peer pressure to improve operational efficiency. It needs, however, to be recognised that the banking system in India is quite competitive with the presence of public, private and foreign banks.

Thus, the major forces for change in the Indian context have been the following:

- consistent and strong regulatory and supervisory framework;
- structural reforms in the real and financial sectors;
- commitment to adopt and refine regulatory and supervisory standards on a par with international best practices; and
- competition from foreign banks and new-generation private sector banks.