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WILL PSB MERGERS ALTER THE BANKING SCENARIO?

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Last week, the Centre announced a sweeping consolidation that would see 10 public sector banks being merged into four. While the government has touted the move as one that will enhance credit capacity, there are concerns that more large banks could make the banking system vulnerable. In a conversation moderated by **Suresh Seshadri**, T.T. Ram Mohan, Professor of Finance, IIM-Ahmedabad, and V. Srinivasan, a veteran banker, look at the challenges to successful integration. Excerpts:

T.T. Ram Mohan: How it benefits the economy remains to be seen. Because I think the case for the merger has not been articulated properly enough. We have some reference to Indian banks becoming global in size. But that sort of talk needs to be discounted. Because, even if you take the largest of the mergers that have been proposed, which is PNB combining with two other entities, it's going to give you a bank which is about one third the size of the 50th largest bank in the world, which is not saying much.

Second, the correlation between size and efficiency is suspect beyond a certain minimum size. And that size is quite low: say $10 billion in assets or so you get the necessary scale of economy. Beyond that, the empirical evidence does not suggest there are many great advantages to simply growing bigger. And we have seen this in the Indian context where the large public sector banks underperform in relation to private banks, which are much smaller. And of course, the classic comparison is between HDFC Bank and the consolidated State Bank of India, which is many times its size. The price to book value ratio of HDFC Bank is close to 4, whereas the price to book value of SBI is around 1.25. Therefore, the suggestion that getting bigger is going to, in itself, give you some benefits is not validated by experience, either internationally or within India.

V. Srinivasan: I would agree with the argument that, from a timing point of view, this does not seem an ideal time for going ahead with these mergers. Because, as all of us are aware, the economy is clearly going through a major slowdown. And it requires all hands on the deck. And whenever a merger of such scale happens, I think the senior management gets distracted in terms of trying to make sure who gets what. I think there's a lot of work to be done. Even though that may be done by several teams, ultimately human emotion will come into play here, where people are going to be looking at saying, "What's in it for me? Where am I headed as far as this action is concerned?" And therefore, in the short term, I think there is going to be some amount of disruption. That is something which you could have avoided in this sort of time. Consolidation is good, because from an administrative perspective, as people retire, you would see some economies of scale getting through, but just sort of putting banks together is not going to solve the problem as far as the credit flow is concerned.

TTR: The way to look at that question is to see the share of the top three or the top five banks in assets. And if that share is very large, then you have a concentrated banking system. If the share is too low, then you have a highly fragmented banking system. And I think it's fair to say that in India we were tending towards a high degree of fragmentation rather than concentration. So, I think so far as the increase in systemic risk is concerned, it's not going to be an immediate problem. Because if you look at the share of the top three or four banks in assets it was about 30-32%. That is not a very high degree of concentration.

But I do know that regarding the point that Srinivasan made, which is that in order to make a success of a merger, you need two conditions to be satisfied — you need a very high degree of managerial ability, and at least one of the entities in the merger must be financially strong — I'm afraid I can't see either condition being satisfied in the mergers that are being proposed. If you're not able to make a success of your operations and deliver the performance of your existing level of assets, how does the management propose to make a success of a much bigger and more complex entity? The question is not answered simply by citing the theoretical scale economy. Making a success of merger is a huge challenge.

VS: As far as Bank of Baroda (BOB), Vijaya Bank and Dena Bank are concerned, it's still very early days... I don't think the merger integration is complete. And clearly we have not seen much in terms of how exactly they have put things together and gone to the market, with a single value proposition. The way I look at it, this was something which has been on the table for a long time. I think they tried out BOB and just decided to go ahead.

The feedback from the BOB experiment was that things were not falling apart. And things seemed to be broadly business as usual, not very different from what was happening in the past. And they decided that this is something which we can go ahead with and do the rest of the previous plan, which was actually already, I think, part of the blueprint. I think that's how they have gone ahead with these mergers. The only thing here is, I don't think there's any identity which they have tried to create for each of these merged entities in terms of trying to say, one will be focusing on Corporate, one will be on Small and Medium Enterprises, one will be Retail. There's been no thinking in terms of any or each of these banks' focus on a particular theme, particular skill-set and developing expertise in a space which is important as far as the overall economy is concerned. Basically, I think they've said, every bank falls broadly in the same template, and there's not much to choose from in terms of who goes with whom.

TTR: In terms of resolution of NPAs there is some merit in having the merger because there are coordination problems involved when you have multiple banks trying to resolve NPAs which are common to all of them. So, you have the middle and senior management deputed for meetings, where they have discussions with their counterparts from other banks. And then they have to go back to the top management for a decision, come back again for a meeting, and it goes on and on. Therefore, the resolution of NPAs becomes difficult when you have so many banks trying to arrive at an understanding amongst themselves. So, to the extent that the discussion is happening among fewer banks, I think the resolution of NPAs will be facilitated. That could be one argument for the merger.

But I think the most important rationale is that the multiplicity of banks was making enormous demands on the bandwidth of the Finance Ministry in terms of appointments of chairmen, managing directors, executive directors, independent directors. Even though they have the banks board bureau to advise them on appointments, the process is extremely time-consuming. There were long delays in making the senior appointments, as a result of which these banks have been incurring substantial costs. When you don't have a person at the top or persons at the top, or even directors in play, it exacts its own cost on the bank. And so, collapsing the number of banks makes it easier for the Ministry to monitor the banks on its watch. I think that is probably one argument for the merger which I can sort of relate to.

The other argument is that having bigger entities enables people to make bigger loans, which would give them a degree of pricing power vis-a-vis corporates because corporates have been playing one bank off against the other under the multiple banking system. To the extent that you combine banks and they do a bigger amount of funding, it does improve the bargaining position

of the bank. Again, fee income that the banks get from selling mutual funds and insurance products can go up, because now the banks can command a much larger network and therefore demand a bigger commission from the people whose products they're selling.

The fundamental issue is a managerial issue with making a success of the merger, which is a challenge even in a developed economy, where you have a lot of flexibility in terms of laying off people, rationalising branches. Here, even if you rationalise the branches, a commitment has been given that people will not be laid off. That is one of the assurances given by the Ministry. And therefore, it's not clear how any cost economies will be effected... if people are to be retained and yet be redeployed for other purposes.

VS: I would think it is more the lending side which can get impacted on account of this rather than the customer on the deposit side. The deposit side, however weak the government-owned banks, they didn't face any risk of deposits sort of unwinding and they continued to have reasonably decent deposit growth, irrespective of whether they were figuring in the top quartile or the bottom quartile because the sovereign guarantee was clearly there. It will be business as usual. I don't think things will change as far as these banks are concerned. From a lending perspective, the impact will be felt more for the SMEs and small businesses, who have a lot to gain from the personal contact they have with a local person. And as that becomes a lot weaker, that can impact... That is something which we will know only as we go along. But there would be some amount of transition issues as things change.

VS: Clearly, a lesser number of banks means, hopefully, speedier decision-making across banks. That's the upside one can hope for. And the other thing which it can trigger is some consolidation in private sector banks. Because the private sector banks would now be falling behind in terms of scale compared to some of these banks. And therefore, to some extent, this can force the private sector banks to think of a similar consolidation.

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