Bank of Baroda, Vijaya Bank and Dena Bank Merger

- **Introduction**
  - The consolidation of the banking sector is being discussed since the recommendation was given by Narasimhan Committee in 1991 (these PSBs owned more than 90% of the market share then and today own more than two thirds of the market share). After the 1997 Asian Financial crisis many countries in Asia such as Malaysia went ahead with consolidation whereas in India as it was unaffected by the crisis did not go through this initiative. At that point of time, the private sector entry was promoted into the banking sector. Since the reforms in the banking sector were implemented, 32 bank mergers have taken place
  - The UPA government in 2007-08 also had proposed merger of PSBs, but because of some issues had dropped the idea
  - 5 associate banks with the Bharatiya Mahila Bank was merged with SBI (2017)
  - IDBI's majority stake was purchased by LIC (2018)

- **Reason for the merger**
  - The bank owns majority stake in the 21 PSBs. having said so these PSBs account for 90% of NPAs
  - 11 of these 21 are under one or the other scheme/program launched by RBI
  - Of 21 PSBs 19 are in losses because of NPAs
  - The capital requirements of these banks are higher. This will exert pressure on the finances of the government
  - Recommendations of Narasimhan committee - Three tier structure of the banks
    - 3 to 4 large banks
    - 8 to 10 National Banks
    - Local banks and Rural Banks

- **Genesis of the NPA issue**
  - **Till 2002, banks had only two types of lending**
    - Working capital loans for firms, production entities and farmers accounting for 76% of the total portfolio
    - Retail term loans to households for housing and durable goods accounting for less than 24%
  - From then the banks started aggressively lending term loans to the companies for fixed capital investments such as land, machine, building etc. this lending today accounts for about 38% of the total loan portfolio (working capital - 42% and retail loans at 20%)
  - Majority of the NPAs today are from the term loans given to corporates
  - The NPAs have increased because
    - Banks do not have the capacity to assess long term credit worthiness of borrowers
    - Banks have no tool to monitor the use of long term loans by borrowers. The problem with this is that
      - How and where these funds are used by them is very difficult to find
      - If the project is not completed, then the lender has the claim over the assets under the project not over the parent company
    - If the banks dragged the large borrowers to the court, the borrowers used all the resource at their dispense to fight such cases. As a result of this these cases went on for an average period of 7 to 10 years

        - In some of the cases, the banks themselves provided ever greening of loans (it is a practice wherein the lender/bank provides another loan to an existing borrower so as to ensure that his account does not become a NPA)
    - Added to this, the government promoted infrastructure through PPP model post 2002 and this led to huge demand for the institutional credit
    - Post this there was GFC (Global Financial Crisis) during which the banks again had to expand their lending

- **<u>Process to be followed in case of merger of Bank of Baroda (BoB), Vijaya Bank and Dena Bank</u>**
    - Proposal first has to be approved by board of directors of all the three banks
    - Government will prepare the amalgamation scheme
    - This has to be approved by the cabinet
    - Then it has to be approved by both the houses of parliament

- **<u>Rationality / viewpoint of the government</u>**
    - With merger of these banks benefits of economies of scale can be utilised
    - The new entity will have a large customer base, asset size will be large, lending base will increase etc
        - The new entity will have asset size of ₹14.8 tn
        - The number of branches will be close to 9500
        - CAR will be 12.25%
        - Tier-1 capital will be 9.32%
        - NPAs will be 5.71%
    - It doesn't make any sense for multiple banks owned by the government competing for the same customer

- **<u>Advantages/benefits</u>**
    - The government owned 21 PSBs. although it has been brought down even 21 is very high. This merger will further reduce the number of PSBs
    - The merged entity will become the second largest PSB (SBI and PNB) and the third largest bank in India (replacing HDFC)
    - The benefits of scale can be utilised. Customer base will increase, service base will also increase
    - Dena bank and BoB have a stronger base in Western India whereas the Vijaya bank has major presence in southern India. Bank such as BoB will benefit as it can penetrate well in states such as Karnataka, Maharashtra etc. on the other hand the other two banks can also benefit from this merger as BoB will bring lot of forex currency position, technology etc to the table
    - It has thrown a lifeline to Dena bank which has one of the highest NPAs at 22% (ending Q1FY19, the NPAs of this bank as of June 2018 were fifth largest amongst the PSBs) and has been kept under PCA. it has not been allowed to lend and hire new employees from May 2018
    - Lesser number of banks means better regulation and oversight by RBI
    - With the merger the financial assistance or capitalisation burden of the government will come down
    - Is it an indicator of things to come - will the Indian banks be counted amongst global banks

- **<u>Concerns/Issues/Challenges</u>**
    - The driving force for the mergers should have been synergies, growth potential, cost efficiency, complementary features etc. rather in this case it looks like the government wanted to wash off its hands from a weak bank

- Rationalisation of branches, human resources management, operational systems harmonisation. Difference in the policies such as asset recognition will affect the performance (for example BoB has one of the stringent measures for asset quality recognition and has recently started to reap the benefits of such measure. With the merger now its asset quality will be hit and the resources have to be diverted)
- Although all the three banks use Finacle CBS, BoB uses the latest version (Version 7 to 10) and the other two uses earlier version
- The merger of PSUs has not been very fruitful for India
- Merger with a weaker bank will pull down the profits of the other two banks
- The shareholders of BoB and Vijaya bank have already shown the displeasure as their assets are going to be valued down with the merger of weaker bank (the share price BOB and Vijaya bank whereas that of Dena bank increased on Monday)
- The bank unions are up in arms opposing this merger (AIBEA has opposed this merger)
- Duplication of branches
- This does nothing to take care of the NPAs which are already in the system. The merger does not address the biggest concern i.e. NPAs (the NPAs of five associate banks of SBI by end of FY17 were about ₹ 65,000 Cr and that of SBI ₹ 112,000 Cr which totalled to NPAs of ₹ 177,000 Cr. But after the merger SBI's NPAs for FY18 increased to ₹ 225,000 Cr)
- The bigger issue is interference of the government and the merger doesn't address that
- Spill over effect or contagion effect
- Although the government has said that the employee's interests will be protected, there will some operations wherein there will be overlap. If the SBI merger is any kind of indicator, then 4000 employees opted for VRS (Voluntary Retirement Services)
- The decision of mergers and acquisitions should be the prerogative of the boards of the banks. In majority of these cases it has been seen that the government enforces these decisions on them
- Moral hazard argument - the government is signalling that if you manage the bank well that we will thrust upon you a weaker bank and if you run the bank badly don't worry we will bail you out

- **Rajanomics - the previous governor of RBI opined that**
    - A merger of two (or more) unhealthy banks in the financial system will create an unhealthy entity that would lead to the creation of a bigger problem in the economy
    - Even in the case of the merger of an unhealthy bank with a large healthy bank, the merger would bring problems to the acquiring bank
    - The strong bank will not only have to deal with cultural problems but also the issue of NPAs
    - If the merger has to happen between a weak and a strong bank, then the it has to be done when the situation of the weaker bank improves
    - Talking of a merger when the management is preoccupied with some other issue is probably premature
    - The note submitted to parliamentary estimates committee mentions that
        - The private sector banks have moved out of lending to the promoters whereas the PSBs have continued to do that. This means that the PSBs are falling short in terms of monitoring of promoter and project health
        - The size of the frauds in the PSBs has been increasing
        - Risk management need substantial improvements in the PSBs

    - Compliance is still not adequate
    - Cyber risks need greater attention
    - The government has not recapitalized the PSBs with the urgency that was required
    - Without governance reforms recapitalization is not useful (reforms here refer to appointments, protecting commercial decision making from second guessing by investigative agencies etc)

- **<u>Way forward</u>**
  - The interference of the government has to be brought down. Although the government recently has said that the RBI has wide ranging powers to regulate the banking sector, the interference in the functioning of PSBs by DFS (Department of Financial Services) is very well known
  - The role/autonomy for RBI must be increased
  - The recovery under the IBC has to be increased (of 977 cases admitted only 34 have been resolved)
  - Reform to speed up or to provide rapid solution to the NPAs has to be implemented. The same was done in case of working capital loans. SARFAESI Act was passed in 2002, which resulted in gross NPAs declining from 19% in 2002 to 6% by 2006
  - Privatisation can be given a chance - it will lead to inflow of private capital and more importantly the management will be efficient and accountable
  - The merged entity should reduce its exposure in terms of lending to corporates and increase the investments
  - As of now under the Banking Regulation Act 1949, the banks are allowed to issue bonds only for raising their own capital whereas in developed economies such as Japan the banks are allowed to issue bonds to finance term loans also. The advantage of this is that the banks will be very cautious about using this capital, pricing of the loans will be market driven, since they are issuing bonds they will have to get the credit rating done regularly and this would push them to perform better etc (recently the government has announced that they can be market makers in case of masala bonds)
  - Implementation of Arvind Mehta Committee report recommendation
  - Raghuram Rajan Recommendations