Big Bank Reform: RSTV – Big Picture

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Context:

- Government of India has recently announced the **merger of ten Public Sector Banks (PSBs)** into **four large entities** and it is considered as the **most significant move** in the banking sector after the **nationalization of banks** that took place in 1969.
- The **mega merger** will bring down the number of PSBs from 27 (in 2017) to **12**.
- The set of PSBs being merged are as follows:
  - Punjab National Bank with Oriental Bank of Commerce and United Bank will merge together to form the **2nd largest PSB after SBI.**
  - Canara Bank and Syndicate Bank will merge together to form the **4th largest PSB**.
  - Union Bank of India with Andhra Bank and Corporation Bank will merge together to form the **5th largest PSB.**
  - The merger between Allahabad Bank and Indian Bank will result in the **7th largest PSB**

What are the Different Contours Involved in the Mega Merger?

- According to the Finance Minister, the **purpose of the consolidation of PSBs** is to strengthen the **national presence and the global reach** of these banks.
- The mega merger plan lays focus on **creating 'banks of scale'** so as to enable India to achieve the **goal of becoming a $5 trillion economy.**
- In the **past few years**, bank reforms were steady since the economic growth was steady too.
  - But, the banks are now required to keep pace as the economy is about to grow significantly. Mega merger of banks indicate such a **transformation**.

Why the Mega Merger is considered a Huge Reform after Bank Nationalization?

- The mega merger plan has been **on the pipeline since very long**. It is good that it has happened now. But it could have been carried out a few years earlier.
- While the **banking sector across the world** was busy introducing **reforms**, the PSBs in India were in a lazy mood with a mind-set that the government will take the responsibility of reforming them.

What is the Logic behind the Mega Mergers?

- In order to become a **$5 trillion economy** in the next 2 or 3 years, **industries** in India need to grow into a **corresponding scale**.
  - It will need people to become **entrepreneurs** which in turn need huge **inflow of credit**.
  - It is not possible for **small banks** to take too much risk on providing loans to a single entity due to the existence of **prudent norms** in giving out loans. Banks calculate the appropriate risk for each of the loan applicants based on a number of factors.
  - Thus, we need **strong capital based banks** to adequately fund the loan applicants.

- Even though people call them national banks or regional banks, there are **very few factors that distinguish** between the banks being merged.
    - Apart from the SBI, all the **other PSBs merge their differences under the single label of PSBs**.
    - The absence of differences means absence of competition in terms of attracting deposits and offering credit and other products.

<u>How did the Government Arrive at this Combination of Banks?</u>

- The core principle behind the selection of banks was the **minimisation of disruption in credit activities** during and immediately after the merger.
- The following two parameters were the **rationale** behind the selection of banks:

1. **Core Banking Software/System**: Those banks which share a common core banking software were selected for merger. Ex.: both Canara Bank and Syndicate Bank use **i-Flex** software, both Indian Bank and Allahabad Bank use **BaNCS**

- The remaining 6 banks were using a software called **Pinnacle**. Two separate banks were formed by merging 3 each of those banks, since the merger of 6 banks into a single entity is extremely disruptive.

2. Each of the banks have a **long history** at the regions where they operate. Synergy of such banks were unlocked considering the **complementing factors** such as **current capital availability**, level of **Non-Performing Assets** (NPA), and the **distribution of bank branches**.

- It is notable that these two were **not overriding parameters** and other factors like **geographical presence**, **line of activity** and extend of **CASA deposits** (Current Account and Savings Account) were also considered.

<u>How will the Merger Increase the Performance Matrix of the Banks?</u>

- Merging of banks has the history of **improved market capital and performance**. The merger of Bank of Baroda (BoB), Vijaya Bank and Dena Bank in 2018 had led to a first quarter (Q1) **profit** of Rs. 710 Cr. for BoB in the current fiscal year (2019-20) **compared to a loss** of more than Rs. 7000 Cr. **before the merger**.
- The better performance turned out to be **beneficial for both customers and employees**
- However, **merger alone wouldn’t improve the performance** of banks. It should be complemented with an additional set of measures such as:
    - Providing with **additional capital** so that lending capacity is increased.
    - Other reforms such as **Enhanced Access and Service Excellence** (**EASE**) versions 1 and 2 are meant to measure individual banks and release their **score card** (of performance) for the public to evaluate.
    - Ensuring that the reforms introduced at the **top level** of banks reach the bottom level employees as well. Ex.: **Unified messaging system**, expansion of **performance review** system, etc.

<u>How will the Mega Merger Impact Indian Economy at Large?</u>

- **Economic growth** needs inflow of **credit** (as debt) and **investment** (as equity). Banks are **intermediaries** which make the savings of some customers available to others in the form of credit. Bigger banks could **lend more** and have a stronger **presence**.
- Bigger banks can provide loans to **big projects** and individual **level small projects** Such projects in turn creates **more jobs**.

- Big projects in the past had to approach so many banks for loans, which were often not more than 1-2% of the project cost, since banks in the past had no capacity to fund them significantly.

- Bigger banks are able to invest in **innovative products** for retail customers (Ex.: The **SBI YONO app** allowed customers to use their mobile phones instead of cards for many banking transactions.)
- Bigger banks could focus more in the **foreign market** by leveraging the existing network of oversees banks.
    - Consolidation of PSBs leads to a steady state of 8 PSBs (including the 4 merged ones) with a **global aspiration and reach**.
    - Banks have the option of increasing their **Efficiency** by multiplying its presence in the selected **regions** where they find huge business opportunity. Such rationalisation ensures that they don't compete with each other outside India.

<u>What are the Objectives of Recapitalisation along with the Mega Merger?</u>

- The mega merger will be followed by a recapitalisation plan worth **55000 Cr.** for the merged banks and six other banks.
- An increased **lending capacity** is **not the only purpose** of the bank mergers.
- Recapitalisation is required to ensure that the banks have sufficient heft to invest in **technology** upgradation, **better customer connection and service**, **fraud detection**, etc.
- Recapitalisation of merged banks ensure not only the investment but also the **standardization** of customer services.

<u>What are the Concerns Associated with the Mega Merger?</u>

- Customers are concerned about a **slowdown in credit off take** after the merger.
- E.g. The credit flow declined immediately after the merger of BoB, Vijaya Bank and Dena bank in 2018 because the rate of interest was not attractive.
- But Dena bank was under RBI's **Prompt Corrective Action framework (PCA)** and the teething problem was solved when the credit growth touched 6% in the Q1 of this fiscal year (2019-20) itself, in spite of the economic slowdown.
- The banks selected for merging **differ** in the level of **profitability** and ability to manage **difficult loans**.
- The structure and selection of the **bank board** determines the confidence of the market about the banks. The bank boards have huge responsibilities, especially in determining the synergies of the merger.
- **Human resources** is a major capital for banks. But, management structure of PSBs is questionable in that their **CEOs** are not as impactful or popular as the private bank CEOs.
    - The former ones are often selected on the basis of **seniority** rather than their capacity and they **keep on changing**, in spite of comparatively longer terms.
- It must be ensured that merger doesn't turn into a **conglomeration of a number of bad banks** into one big bad bank.
- Determining the **salary structure** of the merged entities is difficult since some banks have already asked for the freedom to determine it separately.

<u>What are the Follow up Steps needed by the Mega Merger?</u>

- Government is required to ensure that the **leadership** of the merged entities is able to deliver the outcomes envisaged. Seniority should not be the single most criteria for the selection of leadership.
    - Finance Minister has announced the recruitment of **non-official directors** from the open market talent pool.
    - The **Bank Boards Bureau (BBB)** needs to continue the practice of inviting application for CEO post in some PSBs. In 2014-15, CEO post of certain banks were opened for recruitment

from the open market.

- It is required to ensure that customers will not face any inconvenience. Bank managements **need to discuss with each other** the blueprint of future course before **1st April, 2020**, the probable date for the enforcement of the merger.
- Top management of banks also need to **learn from the disruptions caused by earlier mergers**.
- The power of **bank boards** need to be increased in terms of decision making, reviewing, etc.

<u>What are the Reforms Remaining to be taken in the Banking Sector?</u>

- Reforms is a **continuous process** that can never be declared as complete. After every level, it moves on to the next level.
- Reforms need to continue in factors such as **product innovation**, investment in **technology**, improving **back end process** and reducing **turnaround time**.
- However, there is no possibility for the Government to tweak the laws to lower the **51% threshold** of Government stakes in PSBs.

<u>Conclusion:</u>

- The mega merger is a **huge step** in terms of overall banking sector reforms, since almost every aspect of the banking sector are looked into.
- **Governance reforms** need to follow up the mega merger in order to actualise the purpose of the reforms and to avoid disruptions in the market.