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Indian Banking Sector Reform: Right Move but Challenges Remain

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Summary

On 30 August 2019, the Indian government announced measures towards the long-awaited reform of state-owned banks by merging 10 banks into four larger entities. The move is also aimed at making their management accountable to their respective boards, and ensuring greater professionalism and longer tenures to higher executives. There are bound to be some short run challenges such as cultural differences among merging entities, manpower and branch redundancy and technological integration. It is very critical that urgent steps be taken in this direction to ensure the success of the merger exercise.

Mergers

In a major move towards reform of public sector banking in the country, the Indian government announced on 30 August 2019 the collapse of 10 banks into four larger banks. The Oriental Bank of Commerce (Delhi-based) and the United Bank of India (Kolkata-based) have been merged into the Delhi-headquartered Punjab National Bank. The balance sheet size of the combined entity will now be ₹17.94 trillion (S$36 billion), viz. around the same size as that of the privately owned HDFC bank. The Mangalore-headquartered Syndicate bank has been merged with the Bengaluru-based Canara Bank with the combined entity having a balance sheet size of ₹15.20 trillion (S$30.4 billion). The Mumbai-headquartered Union Bank of India has the Andhra Bank (corporate headquarters in Hyderabad) and the Corporation bank (Mangalore-based) merge with it. This combined entity of three banks will have a balance sheet size of ₹14.59 trillion (S$30 billion). These three entities are now larger than the private sector ICICI Bank and Axis Bank. The Kolkata-based Allahabad Bank has been merged with the Chennai-headquartered Indian bank, with the combined entity having a balance sheet size of ₹8.08 trillion (S$16 billion). It has been a declared policy of the present government to merge public sector banks which numbered 27 in 2017 into about six large banks. As a first step towards this, it had merged all the associate banks of the State Bank of India into the State Bank, thereby creating a large conglomerate with a business size of ₹52.05 trillion (S$104 billion). It had also merged the Vijaya Bank and Dena Bank into the Bank of Baroda in 2018. The consolidation process has left a total of 12 public sector banks in existence now with banks such as the Bank of Maharashtra (Pune), Punjab and Sind Bank (New Delhi), Indian Overseas Bank (Chennai), UCO Bank (Kolkata), Bank of India (Mumbai) and Central Bank of India (Mumbai) continuing to retain their independent identities.

Rationale

It has been the contention of the government that the exercise of merger has been driven by the need to have strong regional presence, reduction in cost of operation due to better branch rationalisation and technology integration such that fintech operations are not disrupted. The rationale behind the choice of banks for the merger was that, while the integrator was the larger bank, the technology-driven capacity of the other and the deposit franchise of the third were identified to bring synergy in the mergers (for example, United Bank's strong current account and savings base of 51 per cent and 29 per cent of Oriental Bank of Commerce – they could complement each other). Drawing from the experience of the Bank of Baroda-led merger last year, only banks with compatible technology platforms have been merged. Care has also been taken to ensure that the capital adequacy ratio of the merged entities is in the neighbourhood of 12 percent. The consolidation exercise will be supported by capital infusion of ₹55, 250 crores (S$110.5 million).

India had 28 public sector banks of varying sizes in 2016. Many of these entities were suffering from lack of capital, professionalism, technology and a work culture incapable of dealing with the complexities of modern-day banking. They had also run up huge non-performing assets and were unable to re-start lending activity due to stress on their balance sheets, necessitating urgent reforms. The roll out of bank reforms has come about five years after a committee headed by the then-Chairman of Axis Bank, Dr P J Nayak, had set out a road map for professionalising the management of public-sector banks and providing them autonomy from governmental control.

Challenges

Mergers are complex processes and throw up huge challenges. Having large-sized banks is not an end in itself. The objective is to make the banks agile and responsive to client needs, be technology driven and professionally managed. There are indeed very many softer dimensions required to make the process a success. These are in the field of human resources and management and board competency. Whilst the government has permitted banks to laterally hire risk management professionals from the market and pay them market-related salaries on a contract basis, there is also a need to provide such flexibility in credit, manpower and technology spheres. Boards have to be provided flexibility to ensure that wages and service conditions of employees can be linked with productivity and performance. The Board of Directors should also comprise competent domain experts such that the entity is professionally driven. The government has announced that chief executives will be given fixed tenures but the critical factor is continuity. About one-third of senior management seems to be retiring every year; hence, it is important to draw up leadership succession plans and ensure at least five-year tenures to executive directors and chief executives. To ensure a smooth transition, the government has announced that no retrenchment will take place. However, to facilitate branch and personnel rationalisation, it may become necessary to introduce a voluntary retirement scheme to facilitate the release of employees who are unable to cope with the complexities that newfound competition will offer.

Another important feature is the fact that banks were nationalised through statutes issued in 1968 and 1970. These legislations have become archaic and need to be re-visited to ensure flexibility and autonomy to the board/management. The scheme of directorship mandated in these legislations need to be reviewed urgently.

There is no denying the fact that the move of the government is in the right direction and if the merger process is implemented well, it can introduce much-needed structural benefits in the medium term to enable these public sector entities to compete more effectively and regain ground lost to other entities in the financial sector landscape. Larger entities will also be able to invest on technology upgrading, which was non-sustainable on small-sized balance sheets that the pre-merger scenario permitted.

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