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The DBS-Lakshmi Vilas Bank Merger and Far-Reaching Bank Recommendations in India

Vinod Rai

Summary

The Reserve Bank of India (RBI) has permitted the ailing Lakshmi Vilas Bank (LVB) to be merged with DBS India. This has come as a welcome relief to LVB and provided it much-needed capital infusion. The merger has also resulted in DBS acquiring a vast network of bank branches. The merger is a win-win situation for both. Separately, an internal working group of the RBI has put forward some very far-reaching recommendations for the banking landscape in India. These have generated intense interest and debate. This paper examines the strengths and weaknesses of these recommendations.

Introduction

The Reserve Bank of India (RBI) has announced a merger scheme according to which DBS India (its parent is the Singapore head-quartered DBS) will be permitted to infuse 2,500 crore (S$442 million) equity capital into the ailing and capital starved Lakshmi Vilas Bank (LVB). The scheme entails a write off of the entire paid-up share capital of LVB (institutional investors and retail investors own about 20 per cent and 45 per cent of the bank respectively). The RBI notified the scheme on 27 November 2020. While the merger will strengthen DBS' business prospects by providing it access to retail customers and small enterprises, the infusion of foreign capital and professional management into the ailing bank will provide it with a fresh lease of life. In the past, proposals for the takeover of Indian banks by foreign banks, despite having Indian subsidiaries, was not permitted.

There has been general acceptance of the merger scheme as it will help DBS acquire 563 branches owned by LVB while the latter will be able to survive despite facing liquidation. The added advantage is that DBS India is a highly digitised entity and the proposed merger will provide it the harmonious balance of electronic points of sale permitting it to grow steadily in the country. There will also be a rapid and healthy increase in its current and savings accounts through these branches enabling it deep market penetration. This is a definite win-win strategy for both banks as the merged entity can add new retail as well as micro, small and medium enterprise clientele. Shareholders of LVB have opposed the draft scheme and are exploring legal options. In its final order, the RBI has advised the writing down of Tier 2 bonds of LVB, amounting to about 318 crore (S$4.2 billion) before its merger with DBS.

The RBI had earlier advised the write down of Additional Tier 1 (AT1) bonds of Yes Bank too. A full write down would imply that investors in these bonds will not receive anything, akin to equity shareholders of LVB. These Basel III compliant bonds had offered an easy route for Indian banks to raise capital. It needs to be clarified that AT1 bonds have embedded in them a 'loss absorbency' clause which implies that in case of stress, banks can write off such

investments or convert them into equity. Similarly, in Tier 2 bonds, the principal can be written down. In both cases, the trigger is a 'point of non- viability' being reached. In the norms, it is indicated that a decision to reconstitute or amalgamate a bank would deem the bank to be approaching non-viability. To that extent, the central bank is legally well covered in its decision, though investors have been taken by surprise as it was perceived that the RBI would ensure that a situation of a bank approaching non-viability would be avoided.

This decision of the RBI has set a precedent. Unions have already gone to court opposing the merger though there is no strong legal ground in their favour. Unlike past practices of the RBI, in which Indian entities, largely from the public sector, such as the Life Insurance Corporation and State Bank of India, had been "persuaded" to invest in weak and tottering financial institutions such as Yes Bank, the present move will act as an incentive for foreign capital investment into similar entities.

The RBI's New Set of Recommendations

Following on the heels of the merger scheme, the RBI released a set of suggestions made by an internal working group (IWG) which had been set up to review extant guidelines and corporate structure for Indian private sector banks. The IWG was also *inter alia* mandated to review the eligibility criteria for applications for banking licence and norms for long-term shareholding in banks by promoters and other shareholders.

A few of the prominent recommendations made by the IWG include the entry of large corporate and industrial houses as promoters of banks, conversion of "well-run large non-banking finance companies (NBFCs) with an asset size of 50,000 crore (S$8.7 billion) and above, including those which are owned by a corporate house, may be considered for conversion into banks subject to completion of 10 years of operations and meeting due diligence criteria and compliance with additional conditions specified in this regard",[1] hike in promoter stakes from 15 per cent to 26 per cent in the voting equity share capital over a long run, viz 15 years. Those promoters who have decreased their share below 15 per cent will be allowed to increase it again.

The recommendation to grant promoter stakes to corporate entities has been made with certain conditions such as strengthening the supervisory mechanism for large conglomerates to avoid connected lending and exposure between banks and other financial and non-financial entities of the corporate. On non-promoter shareholding, the IWG has suggested a uniform cap of 15 per cent of the paid-up voting equity share capital of the bank to be prescribed for all types of shareholders. For payments banks intending to convert to a small finance bank, a track record of three years of experience as payments bank a payment bank is to be considered as sufficient. The minimum initial capital requirement for licensing new banks is suggested to be enhanced from 500 crore (S$87 million) to 1,000 crore (S$174.1 million) for universal banks, and from 200 crore (S$33.4 million) to 300 crore (S$50.2 million) for small finance banks.

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[1] RBI releases the Report of the Internal Working Group to Review Extant Ownership Guidelines and Corporate Structure for Indian Private Sector Banks 20 November 2020.

Corporates can Promote Banks

The suggestion to permit large corporate houses to promote banks has come as a radical reversal of the earlier RBI stance of not encouraging corporate houses to set up or manage commercial banks. It has attracted maximum reactions, mostly negative. Over the last three decades, there have been repeated attempts to liberalise entry into the banking space in India but the RBI has consistently taken a conservative approach in this regard. Only a handful of private sector banks could avail licences following the 2001 and 2013 guidelines for licensing. Thus, an internal group headed by an Executive Director, recommending such a fundamental change over, has raised many eyebrows. It is also surprising that despite all but one of the experts, which the group consulted, opposed the idea of permitting corporate entry, the group has still made the recommendation. Among the experts who have vociferously contested the suggestion are a former governor and deputy governor of the RBI.

In an article jointly written by Dr Raghuram Rajan and Dr Viral Acharya, the two have opined, "Yet its (IWG's) most important recommendation, couched amidst a number of largely technical regulatory rationalisations, is a bombshell: it proposes to allow Indian corporate houses into banking."[2] They have also questioned the timing of the suggestion. A very profound observation is "One can speculate endlessly. In the IWG's favour, it has suggested significant amendments to the Banking Regulation Act of 1949, aimed at increasing the RBI's powers, before allowing corporate houses into banking. Yet if sound regulation and supervision were only a matter of legislation, India would not have an NPA [non-performing assets] problem. It's hard not to see these proposed amendments as a subtle way for the IWG to undercut a recommendation it may have had little power over."[3] Global rating agency Standard & Poor, in a separate statement, has said: "Corporate ownership of banks raises the risk of intergroup lending, diversion of funds, and reputational exposure. Also, the risk of contagion from corporate defaults to the financial sector increases significantly."[4]

If the rationale for such a radical suggestion is the need to give access to capital that banks desperately need today, it could easily be done through the route of permitting foreign investors to buy into Indian banks. Presently, RBI norms permit up to 74 per cent foreign institutional investment in banks. Diversified shareholding pattern, like that of ICICI Bank, ensures that promoters or any particular group cannot exercise influence to benefit themselves without ascertaining how the decision would impact others. Holding by foreign institutional investors, mutual funds or insurance companies is also indicative of a higher confidence level in the bank. Such a move would have the added advantage of providing additional capital into the country. There is also the corporate bond route that large

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[2] Raghuram Rajan and Viral Acharya, "RBI drops a bombshell: Proposal to allow business houses into banking is fraught with risk for financial system", *The Times of India*, 25 November 2020. https://timesofindia.indiatimes.com/blogs/toi-edit-page/rbi-drops-a-bombshell-proposal-to-allow-business-houses-into-banking-is-fraught-with-risk-for-financial-system/.

[3] Ibid.

[4] Press Trust of India, "S&P skeptical of allowing corporate ownership in banks", *Live Mint*, 23 November 2020. https://www.livemint.com/news/india/s-p-skeptical-of-allowing-corporate-ownership-in-banks-11606126800813.html.

industrial houses can follow. However, they do not seem to be comfortable floating such bonds. The argument that industrial houses would bring in professional managerial expertise would be rather futile as managerial expertise is abundantly available within the country for an appropriate compensation package. We need to recognise the fact that hard-nosed investors do not need to be enticed. They make investment decisions based on the governance, balance sheet strength and other such factors indicative of the health of a company. There is also no dearth of genuine and credible investors. The only issue is whether they find the institution worthwhile to invest in. So, permitting industrial houses to own banks is a tried, tested and abandoned concept. It is thus felt that we need to learn from mistakes in the past and not tempt such misadventures.

Problems with Interlinked Lending

The Indian financial landscape has seen enough and more instances of connected and interlinked lending. The experience with Yes Bank, Dewan Housing Finance Corporation Ltd and Infrastructure Leasing and Finance Services Ltd has shown that despite the RBI's vigilance, it was not able to thwart such misdirected lending. In a corporate-held bank, the Board of Directors would be chosen by the industrial house. The bank's full-time professionals would find it difficult to ignore the directions of the promoter, and the directors may not find it easy to go against the wishes of the promoter and discourage risky/sub- prime lending. On the other hand, the regulator has not exhibited a track record of giving advance warning of impending faulty lending. Project appraisal for proposals which other banks may not find credit worthy would sneak in, thereby creating systemic problems as these are expected to be large industrial houses. Regardless of the regulatory fine-tuning of guidelines to thwart risky lending, large industrial houses with questionable standards of corporate governance, have managed to circumvent the guidelines. The stress on the balance sheet of Indian banks seen as of now, is in fact a consequence of such 'crony capitalism' prevalent in the pre-2010 era. It is assessed that in March 2018, Indian banks had an accumulated stressed book of 9.62 trillion (S$201 billion) of which 73.2 per cent or 7.04 trillion (S$167.4 billion) were on account of industry.[5] The propensity to 'ever green' loans or to grant further credit accommodation in case of impending default becomes all the more feasible in connected lending. Another fear, which is certainly not misplaced, is the fact that such convergence of capital in a few hands will lead to a consolidation of economic and political power. It is for this reason that most economies have shelved the practice of permitting large industrial houses to own banks.

There is another recommendation of the IWG which is again quite contrary to the stance taken by the RBI in the past. It recommends reducing the time limit, from five to three years, for industrial houses holding a payment bank licence and wanting to transform into a bank. This suggestion also seems to be hurrying into the direction of permitting entry of industrial houses.

The IWG has recommended that NBFCs with assets larger than 50,000 crore (S$8.7 billion) and in operation for over 10 years, be allowed to be converted to banks, irrespective of their

[5] Vivek Kaul, "Pros and cons of banking licenses for big businesses", *Live Mint*, 22 November 2020. https://www.livemint.com/industry/banking/pros-and-cons-of-banking-licences-for-big-businesses-11606064624498.html.

ownership by industrial houses. The long standing stance of the RBI has been to allow NBFCs to be owned by industrial houses and yet not permit them bank licences. The RBI's argument for such a policy prescription has probably been to ensure that retail deposits are not put to risk. The change in such thinking could be based on the belief that well-managed large NBFCs, whose track record has been closely watched, may perhaps continue banking activity in the same credible manner. Even if this was not seen as a possible back door entry to a corporate, we need to recognise that the RBI supervision has been weak in the past and the attempts to game the system have been detected far too late. Nevertheless, barring certain housing finance companies and public sector entities, not many in the financial sector would qualify. Possibly this experiment could be attempted with very stringent prudential norms, keeping these companies under strict observation and only after scrutinising their track record over the past decade.

Conclusion

There is a strong case for liberalising the Indian banking sector as there is a need for capital infusion. Attracting such capital from abroad will require some easing of the regulatory norms laid down by the RBI. However, before opening up the sector to foreign capital or corporate houses, it is necessary to shore up the regulatory and supervisory capabilities of the central bank and put in place a strong system of stringent checks and balances.

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Mr Vinod Rai is a Distinguished Visiting Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). He is a former Comptroller and Auditor General of India. He can be contacted at isasvr@nus.edu.sg. The author bears full responsibility for the facts cited and opinions expressed in this paper.