ISAS Brief

No. 463 – 11 April 2017

Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

Merger of Public Sector Banks in India: The Imperative to Make Haste Slowly

The State Bank of India's latest merger of five of its subsidiaries with itself raises India's profile in the global banking sector. Within India, however, it is not yet clear whether this step marks the beginning of a game plan for consolidating public sector banking through further mergers. Nonetheless, the government needs to follow up by creating four or five banks of comparable size to be able to compete with the SBI. The dynamics of that game plan have to be shaped by the SBI experience while its timing has to be determined by the resolution of the problem of non-performing assets.

Duvvuri Subbarao[1]

The State Bank of India (SBI), the country's largest commercial bank, has merged five of its subsidiaries (the State Banks of Bikaner & Jaipur, Hyderabad, Mysore, Patiala and Travancore) and the Bharatiya Mahila Bank with the larger entity. The merger will push the SBI a few notches up the global ranking of banks by size, giving India, for the first time, a

[1] Dr Duvvuri Subbarao is Distinguished Visiting Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He is a former Governor of the Reserve Bank of India. He can be contacted at subbarao@gmail.com. The author bears full responsibility for the facts cited and opinions expressed in this paper.

bank within the top 50 in the world. The merged bank will have assets close to US$500 billion and cater to a customer base in excess of 350 million.[2]

Just to get a perspective, it may be noted that the largest bank in the world is the Industrial and Commercial Bank of China (ICBC) with assets of US$3.6 trillion, over seven times the size of the SBI. Interestingly, China has four banks in the top 10, while India cannot account for that many even in the top hundred.

Bank Mergers

Mergers are a common business phenomenon, and mergers of banks too are quite routine the world over. India also has seen bank mergers in the past but only a few of them were organic mergers motivated by business considerations. Most of the mergers were inorganic, occasioned by the need to bail out a weak or problematic bank by merging it with a stronger one.

The SBI itself has been down this road before, having merged two other subsidiaries in the past – the State Bank of Saurashtra in 2008 and the State Bank of Indore in 2010. With the latest round of mergers, all associate banks of the SBI, originally set up in the pre-independence period by the princely states, stand merged with the parent entity. Which category this SBI merger falls into – organic or inorganic – depends on how one evaluates the reasons for the merger, not all of which are equally persuasive.

Banking Sector in India – A Brief Profile

India has a diversified banking structure by way of ownership, with public sector banks, private banks and foreign banks, totalling close to a hundred in all.[3] The public sector banks have dominated the commercial banking space, accounting for over 70 percent by way of assets although they have been rapidly losing market share to the private banks in recent years.

---

[2] Interestingly, the SBI's advertising slogan used to be 'The banker to every Indian'.

[3] In addition, there are cooperative banks and new types of banks like payment banks and small finance banks.

How many commercial banks, and of what size, India should have remains a debatable question. Various government committees in the past have recommended consolidation of public sector banks into larger entities to exploit economies of scale, and to be big enough to be able to finance large projects. On the other hand, there is an argument for a large number of small banks, too, on the ground that small banks can be more nimble, and also that competition among banks will further the cause of financial inclusion. Although the two arguments are not mutually exclusive, what should rank as a policy priority – consolidation of banks or licencing smaller banks – remains a relevant issue.

Consolidation of Banks – Pros and Cons

There are persuasive arguments both for and against consolidation of banks.

The strongest argument in favour of consolidation is that a large and growing economy like India needs at least a few banks of global size in order to meet the needs of large investors, both domestic and foreign. Indeed many countries see the presence of their banks abroad as a vehicle for marketing the country as a trading partner and an investment destination. Large banks also have a comparative advantage in financing large projects, especially in the infrastructure sector.

A main complaint against Indian banking has been that its growth has not kept pace with the growth of the corporate sector with the result that individual banks faced constraints in lending to large projects. Bank consolidation would bridge that gap as larger banks will be able to finance large projects on their own even while staying within the prudential lending norms imposed by the regulators. Large banks will have cost advantages, too, by way of economies of scale such as centralized back office processing, elimination of branch overlap and duplication of administrative infrastructure, better manpower planning, optimum funds management, savings in IT and other fixed costs.

As the predominant owner of public sector banks, the government may find bank consolidation attractive for other reasons, even if they are not explicitly spelt out. By far the most important such consideration is that consolidation will help the government augment the capital of a weaker bank with that of a stronger bank. This is a weighty issue if only because the most pressing task in India's economic management right now is the recapitalization of banks whose balance sheets have been impaired by non-performing assets

(NPAs). Besides, bank capital needs to be augmented to meet the Basel III norms before the deadline of March 2019. Estimates of the total cost of recapitalization vary, but a ballpark figure is US$ 90 billion for the entire banking sector, more than 80 percent of which is required for public sector banks alone. Given its fiscal constraints, the government will not have the resources to meet this huge demand, and sees consolidation as an avenue for reducing its share of the recapitalization burden without eroding its majority stake.

There are powerful arguments against consolidation too. First and foremost, as the world learnt from the 2007/08 global financial crisis, large banks entail the moral hazards of too-big-to fail and too-complex-to-fail entities with potentially huge and adverse impact on financial stability.[4] Indeed, the SBI was categorized last year by the Reserve Bank of India, the banking regulator, as a systemically important bank prone to such moral hazards.

Also, significantly large banks could resort to monopolistic practices that may result in unequal competition and distortive, even predatory, behaviour in the market. That could impair the efficiency of resource allocation and blunt monetary transmission.

Past experience with bank mergers has shown that the administrative and logistic challenges of inorganic mergers can be quite formidable. Harmonizing IT systems of different banks can be complex, costly and frustrating[5], while HR issues arising out of mergers can be ticklish, time consuming and morale sapping.

Issues on the Way Forward

The precise motivation for the merger of SBI subsidiaries with the parent bank is not clear. The lessons from past bank mergers have of course been internalized both within the government and the Reserve Bank of India (RBI). It is possible that the government weighed the costs and benefits as outlined above and determined that the net cost-benefit calculus of the SBI merger is positive. Like all public policy decisions, this too will be difficult to evaluate in the absence of a counterfactual.

[4] Experience, especially during the global financial crisis, has shown that large banks are prone to irresponsible behaviour on the assurance that the government will bail them out at taxpayer expense, should they get into trouble, simply because their failure will jeopardize financial stability. This too-big-to fail syndrome creates a moral hazard where banks can appropriate profits from the upside without any threat of penalty for reckless business decisions.

[5] This negative may be less so in the case of the SBI merger since the parent SBI and its erstwhile subsidiaries shared the same IT systems and ATMs.

Nevertheless, there will be ticklish challenges on the way forward. The merged SBI will have over 250,000 staff, ranking fifth in the world, in contrast to its rank at around 45 by way of asset size, clearly evidencing overstaffing as measured by international norms. The SBI management has assured agitating staff that nobody will lose jobs. Can the SBI become cost-efficient even as it carries an unviable staff-load?

Whether the government should push inorganic merger of banks with the motive of augmenting capital is also questionable. This is opportunistic behaviour but not necessarily benign. A strong bank's capital should be put to use to promote its business rather than to rescue a weaker bank.

It is also not clear whether the SBI merger is a one-off or whether it is part of a bigger game plan of public sector bank mergers. Timing is important. Given its size and complexity, bank managements should be giving their undivided attention right now to resolving the NPA problem. Now is not the time to distract them with mergers.

That said, the SBI merger, if not followed up with further consolidations, will remain unfinished business. The SBI, even before the recent mergers, was already way above the second largest bank in India in terms of market share. The merger will enhance the SBI's dominance with all the attendant risks of monopolistic and predatory behaviour. Having taken the first step, the government needs to follow up by creating four to five banks of comparable size to be able to compete with the SBI. The content of that game plan has to be informed by the SBI experience while its timing has to be determined by the resolution of the NPA problem.

. . . . .