Implications of Recent Bank Mergers

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On 30 August 2019, the Finance Minister of India sprung a surprise by announcing a major consolidation of state-owned banks that would involve ten of them being merged to four. The mergers are expected to be completely by mid-2020. Some banks have already started the action. For example, the Board of Allahabad Bank has approved, on 16 September 2019, the merger proposal with Indian Bank. This move will reduce the number of state-owned lenders to twelve from twenty seven in 2017- a reduction of more than 50% in two years. The chairman of the largest state-owned bank in India welcomed the recent consolidation announcement and stated that 'bigger banks have better ability to absorb shocks, reap economies of scale as well as the capacity to raise resources without depending unduly on the exchequer'[1]. The Finance Minister has outlined three objectives for the recent merger: (a) to strengthen a sector struggling with poor asset quality, (b) to create banks with strong national presence, and (c) to create lenders of global scale that can support the economy's target of $3 trillion GDP by 2024.

The idea of bank merger is nothing new in India. In fact, the Narasimham Committee (1998)[2] strongly recommended merger of *larger* Indian banks to make them big enough to support international trade and operate at a global scale. The recommendations of the Committee were even more specific: (i) establishment of three large banks with global presence (ii) eventually eight to ten state-owned banks should exist, and (iii) a large number of smaller regional and local banks. Therefore, the arguments put forward by the present Finance Minister in support of the bank mergers echo the sentiments of the Narasimham Committee. India has witnessed, since 1998, a modest attempt of state-owned and private sector bank mergers (Table 1). We had twenty seven state-owned banks by the end of 2017. There was no noteworthy bank merger during UPA-II regime (2009-2014) and Modi-led NDA-I regime (2014-2019). The only exception was merger of five associates of the State Bank with the State Bank of India in 2017. In that sense, the recent announcement of the Finance Minister is a significant step towards fulfilling the dreams of the Narasimham Committee. However, the Narasimham Committee had cautioned that merger should happen between banks of equivalent size and profitable banks should not be coerced to acquire loss-making banks. None of these warnings were heeded to in the recent merger announcements- Syndicate Bank (balance sheet size Rs.3.1 trillion) is merging with Canara Bank (balance sheet size Rs. 7 trillion), which is more than double its size and a loss making Allahabad Bank (net loss Rs. 83.3 billion in 2018-19) is merging with profitable Indian Bank (Net profit Rs. 3.2 billion in 2018-19).

Table 1: Bank Mergers: 1999-2017

[1] https://economictimes.indiatimes.com/news/economy/policy/big-bank-mergers-government-turns-ten-psbs-into-four/articleshow/70918585.cms?from=mdr

[2] Narasimham Committee II Report on Financial Sector Reform, 1998

Acquirer	Acquired	Year
Bank of Baroda	Banaras State Bank	2001
ICICI Bank	Bank of Madura	2001
Punjab National Bank	Nedungadi Bank	2003
Oriental Bank of Commerce	Global Trust Bank	2004
Centurion Bank of Punjab	Bank of Punjab AND Centurion Bank	2005
IDBI Bank	United Western Bank	2006
Indian Overseas Bank	Bharat Overseas Bank	2007
Centurion Bank of Punjab	Lord Krishna Bank	2007
HDFC Bank	Centurion Bank of Punjab	2008
State Bank of India	State Bank of Saurashtra	2008
State Bank of India	State Bank of Indore	2010
ICICI Bank	Bank of Rajasthan	2010
Federal Bank	Ganesh Bank of Kurudwad	2013
State Bank of India	State Bank of Bikaner and Jaipur AND State Bank of Hyderabad AND State Bank of Mysore AND State Bank of Patiala AND State Bank of Travancore	2017

Mergers in the Recent Past

One may wonder whether the past bank mergers have resulted in more financially sound institutions which would be able to compete at a global scale. A look at the bank mergers in the past ten years (2008-2018) reveals mixed results. During this period four bank mergers events happened- two each in the public and private sectors (Table 2). Though post-merger balance sheet size has grown, asset quality and profitability did not improve in all four cases. Take the case of Bank of Baroda, Vijaya Bank and Dena Bank merger. Asset quality of the merged entity (gross NPA) has deteriorated in three months post-merger. Similarly, the CASA has gone down- a sign of higher cost of funds. One may, however, argue that it is too premature to find any benefits of merger in this case as the effective date of merger was April 2019. This argument is not valid for the other public sector merger in 2017- State Bank of India and its five associates. In two years after merger, CASA has not improved, whereas cost-to-income ratio deteriorated with poor asset quality. Even capital adequacy was adversely affected. A higher cost-to-income ratio indicates that a bank's establishment costs (as a % of fee and net interest income) are on the rise. Kotak Mahindra and ING Vysya Bank merger was successful by all means- with higher CASA, lower cost-to-income ratio, and similar gross NPA.

Table 2: Bank Mergers in the past ten years: Performance Analysis

Acquirer Bank	Target Bank(s)	Effective Date	Indicator	Pre-merger (acquirer)	Post-merger (2018-19)
	ING Vysya Bank	1 April 2015	Balance Sheet Size	Rs. 1 trillion (acquirer)	Rs. 3 trillion

Kotak Mahindra Bank				Rs.0.6 trillion (target)	
			CASA(%)	36%	52.5%
			Profit per branch	Rs. 27 million	Rs. 32 million
			Net Interest Margin	4.9%	4.3%
			Cost-to-income Ratio	52%	47%
			Capital Adequacy Ratio	17.2%	17.5%
			Gross NPA	1.9%	2.1%
HDFC Bank	Centurion Bank of Punjab	1 April 2008	Balance Sheet Size	Rs. 1.33 trillion (acquirer) Rs.0.7 trillion (target)	Rs. 12.45 Trillion
			CASA(%)	54.5%	42.4%
			Profit per branch	Rs. 20.9 million	Rs. 41.3 million
			Net Interest Margin	4.35%	4.3%
			Cost-to-income Ratio	49.9%	39.7%
			Capital Adequacy Ratio	13.60%	15.78%
			Gross NPA	0.7%	1.36%
State Bank of India	Five SBI Associate Banks	1 April 2017	Balance Sheet Size	Rs. 27.1 trillion (acquirer) Rs.7.5 trillion (targets)	Rs.36.8 trillion
			CASA (%)	45.58 %	45.74%
			Profit per branch	Rs. 6.1 million	Rs. 0.4 million
			Net Interest Margin	2.84%	2.95%
			Cost-to-income Ratio	47.75%	55.7%
			Capital Adequacy Ratio	13.11%	12.72%
			Gross NPA (%)	6.90%	7.5%
Bank of Baroda	Vijaya Bank and Dena Bank	1 April 2019	Balance Sheet Size	Rs. 7.8 trillion (acquirer) Rs.3.0 trillion (targets)	Rs. 3 trillion

			CASA (%)	40.2%	36.55%
			Profit per branch	Rs 0.7 million	Rs. 3.0 Million*
			Net Interest Margin	2.72%	2.62%
			Cost-to-income Ratio	45.56%	49.17%
			Capital Adequacy Ratio	13.42%	11.5%
			Gross NPA (%)	9.61%	10.28% (June 2019)

Source: Company Annual Reports and Authors' estimates. *Adjusted for whole year

The Proposed Mergers

In this round of bank merger, ten public sector banks are merged to four. The Finance Minister, while announcing the recent bank mergers, has categorically mentioned that the merger would create stronger banks with better asset quality. While real picture would emerge only after a few years, a quick look at the financial indicators of the combined entities does not show any encouraging sign. For example, in this round weaker banks are merged to supposedly create a strong bank- a strategy strongly opposed by the Narasimham Committee. For example, Canara Bank with a meagre profit of Rs.3.5 billion during 2018-19 (it had reported a loss of Rs. 42.2 billion in the previous year) is asked to take over Syndicate Bank, which has reported a loss of Rs. 25.9 billion during 2018-19. This merger would have negligible impact on CASA, but would result in poor asset quality (gross NPA). Similarly, the profit making Indian Bank is taking over an ailing Allahabad Bank. The poor asset quality of the Allahabad Bank would significantly increase the NPA level of the combined entity. It is to be seen whether the management of Indian Bank is able to turnaround the merged bank.

Another interesting variable to note is the cost-to-income ratio. In three of the four proposed mergers, the cost-to-income ratio of the combined entity would increase resulting in weaker profit per branch. There are two principal ways to improve this ratio- (a) increase non-interest income, and (b) reduce establishment costs. Though the Finance Minister has emphatically mentioned that there won't be any job loss due the proposed mergers, it is to be seen whether the banks resort to manpower 'rationalization' in near future to reduce cost-to-income ratio.

Table 3: New Bank Mergers

Acquirer Bank	Merged Bank(s)	Effective Date	Indicator	Pre-merger (acquirer)	Post-merger (2018-19)
Canara Bank	Syndicate Bank	-	Balance Sheet Size	Rs. 7.0 trillion (acquirer)	Rs. 10.1 trillion

				Rs.3.1 trillion (target)	
			CASA(%)	30.9%	32.6%
			Profit per branch	Rs. 0.5 million	Rs. (2.2) million
			Net Interest Margin	2.6%	2.6%
			Cost-to-income Ratio	49.7%	55.2%
			CET 1 Ratio (%)	8.31%	8.62%
			Gross NPA	8.8%	9.7%
Union Bank Of India	Corporation Bank & Andhra Bank	-	Balance Sheet Size	Rs. 4.9 trillion (acquirer) Rs.4.6 trillion (target)	Rs. 9.6 Trillion
			CASA(%)	36.1%	33.8%
			Profit per branch	Rs. (6.9) million	Rs. (12.6) million
			Net Interest Margin	2.2%	2.7%
			Cost-to-income Ratio	48.8%	46.7%
			CET 1 Ratio (%)	8.10%	8.71%
			Gross NPA	15.0%	15.4%
Punjab National Bank	United Bank & Oriental Bank Of Commerce	-	Balance Sheet Size	Rs. 7.7 trillion (acquirer) Rs.4.2 trillion (targets)	Rs. 12.0 trillion
			CASA (%)	43.5 %	41.4 %
			Profit per branch	Rs. (14.3) million	Rs. (10.7) million
			Net Interest Margin	2.4%	2.4%
			Cost-to-income Ratio	47.0%	51.0%
			CET 1 Ratio (%)	6.20%	7.46%
			Gross NPA (%)	15.5%	14.9%
Indian Bank	Allahabad Bank	-	Balance Sheet Size	Rs. 2.8 trillion (acquirer) Rs. 2.5 trillion (targets)	Rs. 5.3 trillion
			CASA (%)	35.5%	42.2%
			Profit per branch	Rs 1.1 million	Rs. (13.1) million

			Net Interest Margin	3.0%	2.8%
			Cost-to-income Ratio	45.2%	52.5%
			CET 1 Ratio (%)	11.22%	10.53%
			Gross NPA (%)	7.1%	12.0%

Source: Company Annual Reports and Authors' estimates

More Systemically Important Banks?

Will the consolidation in the banking industry witness emergence of more systematically important banks, which need to be bailed out during financial crisis? Some important lessons learnt during the global financial crisis (GFC) in the last decade is worth mentioning. A 2009 Aite study[3] showed that while the largest banks saw a 3.23% decrease in lending in 2008, institutions with less than $1 billion in assets (small community banks) experienced a 5.53% growth in net loans and leases in the same year. Community banks in the United States are one of the most important financial institutions that support rural communities. Over 2500 community banks, as of 2009, were in business for more than a century[4] and these entities survived many economic downturn without any support of the government.

In fact, immediately after the GFC, general public in the United States had lost faith on large 'Wall Street' banks. The famous Move Your Money (MYM) movement urged people to withdraw deposits from large banks and put their money with local institutions like community banks and credit unions. Credit unions are not-for-profit cooperatives that serve the financial needs of the local community with focus on shared value rather than profit maximization. The share of commercial bank deposits (as % of total bank and credit union deposits) saw a significant drop in the United States following the GFC of 2007-08[5].

Therefore, the recent merger would definitely create more systematically important banks (twelve large state-owned banks in place of twenty seven large-, medium-, and small-sized banks) which would not be allowed to fail during major financial crisis. This implicit bailout guarantee may make the managers of these banks 'less careful' in taking credit decisions. Such an attitude may further deteriorate the asset quality of these banks.

What could have been done to improve the struggling banking sector? We offer five suggestions: (a) focus on improvement in asset quality with better credit approval, risk management, and lesser interference, like loan waiver/ moratorium; (b) greater use of technology to reduce cost-to-income ratio; (c) merge all loss making state-owned bankswith less than Rs. 5 trillion asset into a single entity with one-time recapitalization and the merged entity would not be allowed to expand geographically; (d) rationalize manpower of loss making banks with attractive VRS, and (e) allow profitable state-owned banks to go to market to raise capital, whenever required.

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[3] The effects of the economic crisis on community banks and credit unions in rural communities. Hearing before the Sub-committee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, United States Senate. July 8, 2009

[4] ibid

[5] Chatterjee, Aaron K., Luo, Jiao., and Seamans, Robert C. 2017 *Banks Vs. Credit Unions After the Financial Crisis.* Academy of Management Proceedings. Vol. 2015. No. 1