Banking

Now is the time for public Indian bank consolidation

The Indian government plans to bring the number of public sector banks down from 12 to just four. IFLR readers say it's a smart move that will offset some pandemic-related damage

By **Karry Lai**

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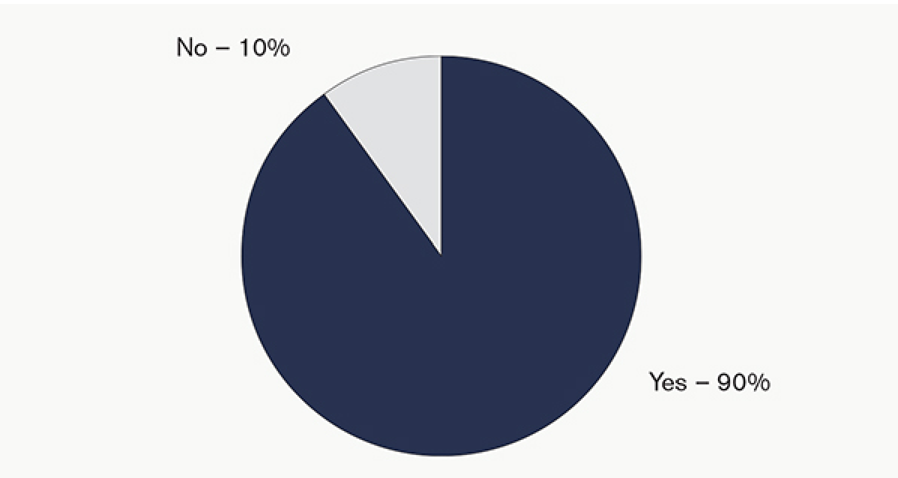
The pieces are all starting to come together in the Indian banking sector

According to a poll of IFLR readers, an overwhelming majority (90%) of the market believes that India's move to consolidate public banks is a good one.

The Indian government has plans to bring down the number of public sector banks from 12 to four in one of the biggest consolidation moves in the sector to date. Banking experts say that the exercise is welcome as public banks have been bogged down by bad debts – but ensuring operational synergies is only one of the challenges ahead.

It's also important to note that this is not the first time that India has consolidated its public sector banks. On April 1 this year, the number of public sector banks decreased from 21 to 12. The pandemic has triggered a further need to consolidate as the prolonged economic slowdown hits India.

Is India's move to consolidate public banks a good move?



Why now?

Avijit Banerjee, CEO and managing director at Argon Capital Advisors in Mumbai, says that the role of government should never be to run the banks, but to create frameworks and policies that will enable the efficient functioning of the banking system. He believes that there is no such thing as the right – or wrong – time to propose the initiative.

"Some may argue that the timing for such a move is bad because of the ongoing pandemic, because the bad loans of these state-owned banks, which were at 12.7% of total assets in September 2019, would balloon due to Covid-19," says Banerjee.

But he argues that this presents a fantastic opportunity for the overall banking system to improve. "Not only will it consolidate assets and strengthen the balance sheets of state-owned banks, it will also create market and operational synergies due to the classification and location spread of the customer base of these banks," says Banerjee.

In addition, such divestments will bring in money to government treasury. Banerjee admits that while it's easier said than done – and the banks themselves will have to work out the intricacies – the consolidation of banks will make the system much more efficient, and unlock more value in the long term.

The general counsel at an Indian private bank agrees, adding that with the non-performing loan problems that public banks are faced with, consolidation will create more structure for the industry and present an opportunity to clean up their balance sheets.

Banerjee expects M&A deals where the acquirer will be a private bank or financial institution, which will be followed by an open offer as mandated by the Securities and Exchange Board of India's guidelines.

The general view of IFLR readers is that any improvement in the banking system that presents not just transparency, efficiency and speed, but also an improvement in asset quality, is likely to have a positive cascading effect in all other sectors of the economy.

Rabindra Jhunjhunwala, partner at Khaitan & Co, also says that he doesn't see a better time than now: when the economy is struggling and in dire need of a shot of liquidity that does not involve increasing taxes.

The government has been clear that the target is to generate liquidity by encouraging banks to consider selling their non-core assets. This indicates that it is not aiming for mere mergers into other public banks, but possible privatisations via disinvestment.

"I see this as a good measure for the banking industry as it reduces the burden on the public deficit while bringing efficiencies," says Jhunjhunwala. "Given that the banks being considered are actual profit-making institutions, the offer will be lucrative for players who are looking to get into the banking industry, and market reaction should be positive in the short run, at least."

Meenal Maheshwari, lead commercial counsel at Indian oil company Essar, says that the consolidation of public banks could prove to be a good move as long as they are not merely paper mergers.

She adds: "The significant pro is putting in place strong risk management policies and processes that the banking ecosystem is in dire need of, such as laying explicit conditions to extend large loans and the due diligence that should be carried out before extending loans, plus the constant monitoring afterwards. A single strong policy should be developed and implemented fiercely across the banks."

Challenges ahead

Looking at the implementation challenges ahead, Jhunjhunwala says that the most pressing challenge is likely to be finding eligible bidders with the right credentials to ensure that the legacy of the institutions is not tarnished. Another challenge will be the integration of public employees into a private institution, and respecting the inherent cultural differences along the way.

The private bank general counsel agrees, adding that ensuring employee and systems integration will be key.

Banerjee adds that the first and the foremost challenge would be de-risking the balance sheets of state-owned banks. The question is who will take care of the burgeoning nonperforming assets, since it will impact valuation. The second difficulty will be market synergies in terms of penetration, cross-selling and upselling opportunities of the expanded customer base.

Operational synergies also need to be considered. "This is going to be the trickiest and most painful to handle, since the potential acquirer and the government will have to deal with the bank employees' unions, who in all likelihood will organise a series of nationwide bank strikes to derail this move," says Banerjee.

This is due to the ingrained fear that such a move will lead to significant job cuts – which opposition political parties are also likely to capitalise on.

Maheshwari adds that if the state-sanctioned merging of public banks is not executed carefully – and if it is only used as a way to bail out the weak banks – the merged entities will find it difficult to raise capital. Minority shareholders would be significantly hurt in the process.

On top of operational and cultural synergies, another barrier that will need to be considered are any potential anti-competitive issues. As the pool of banks serving customers shrinks, it will be essential for the Competition Commission of India to ensure that it limits any behaviour that restricts competition in the financial sector. The consolidation of market power in a few dominant firms may lead to concentration risks. This underscores the need for a strong authority to ensure free and fair competition throughout India's banking sector.