Can India's mega bank really keep up with all this hype? Here are the odds, for and against

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Post a Comment

Bank mergers are back on the agenda across the globe. With the economic recovery in Europe and the US from the clutches of global financial crisis and clean-up of bank balance sheets, Western banks are now looking to reap the benefits of stronger economy by growing in size and adding new products by way of mergers.

In the US, the number of bank mergers rose to 302 in 2017 from 296 the year before and this year, there could be more consolidation with the Trump administration incentivising it.

India has also set the ball rolling but the fundamental difference between the situation at home and that in the West is that New Delhi often faces the compulsion of sweeping the management inadequacies and inefficient allocation of capital at weak banks under the carpet.

RELATED COMPANIES EXPAND

vijaya bank	-0.20 (-0.44%)
dena bank	-0.20 (-1.29%)
bank of b...	0.95 (0.92%)

On paper, mergers create economies of scale and improve efficiency by cutting the flab in overlapping territories. The Indian government has just begun the long awaited process by pronouncing a three-way merger between Bank of Baroda, Vijaya Bank and Dena Bank as a test case.

The aim is to bring about operating efficiencies over time by lowering combined operating and funding costs while strengthening risk management practices. But here lies a risk because, as they say, a rotten apple can spoil the basket.

The challenges for the first set of merger would be to handle Dena Bank’s books saddled with 22% gross NPA, which would have a 20% weightage on the combined balance sheet.

ANXIOUS STAKEHOLDERS

Shares of Bank of Baroda, the biggest of the three, tanked 16%, the highest in past 14 years, the day after the announcement.

“The three concerns expressed by investors are about the quality of Dena Bank’s book, distraction from the growth journey for Bank of Baroda and Vijaya Bank, and whether the merged entity will be able to raise capital,” Bank of Baroda chief executive PS Jayakumar said in an interview.

Jayakumar, essentially a private sector banker, has now been at the helm of Bank of Baroda for three years. “The issue is whether Bank of Baroda will get distracted to the point that growth and transformational journey that we have undertaken will come to a standstill. There is also a concern whether the merged entity will find it difficult to raise capital,” Jayakumar said.

Unless the government infuses capital in the combined entity, it will face constraints in terms of growth. Bank of Baroda would have to subsidise weak fund allocation of Dena Bank, which faced an erosion of capital. The merger exercise aims to bail out Dena Bank, the weakest amongst the three, with negative return on its assets.

“While mergers are a longawaited imperative, I think the plan lacks solidity unless there is a serious quantification of capital impairment. Also, one needs to know what is the clear Tier 1 capital, haircuts and what is the government’s commitment toward further capital infusion.

These vital pieces of information are still awaited,” said Dhananjay Sinha, banking analyst at Emkay Global Financial Services. The swap ratio is not known either and this keeps investors guessing.

These are possibly left to be answered by the merging banks themselves, but one is not so sure whether the public sector bank managements have the bandwidth to handle these.

They did nothing in terms of taking the consolidation exercise forward, perhaps prompting the government to take its most decisive step on banking reforms on the lines of the recommendations by the Narasimham panel three decades back.

The government as the promoter of all three is within its right to force such a move, but will it yield result? Or is it going to derail the bigger and more stable banks' journey? In this case, Bank of Baroda's turnaround plan is at stake.

"In the short term, the slippages could increase as recognition of non-performing assets is harmonised and accelerated.

The proposed amalgamation may require significant bandwidth of management along with deft handling, so that operational aspects such as business growth and resolution of large stock of delinquent assets continue receiving adequate attention," said Jindal Haria, associate director at India Ratings & Research.

FUTURE ROAD MAP

If the three-way merger gets success, it will set the tone for future and pave the revival path for other weak PSBs, mainly those under the prompt corrective action framework. It will lessen the government's capital burden over long term, and enable better management of a smaller group of large government-owned banks. If the number of PSBs comes down, capital allocation, performance milestones, and monitoring would become easier for the government.

"Such consolidation will engender economies of scale, and can structurally improve operating efficiencies and governance. It will also help the merged entity to participate in credit growth opportunities and defend turf.

In the past five years, PSBs have ceded about 10% market share of banking assets to private banks, and could lose another 10% over the next three years if capital constraints continue," said Krishnan Sitaraman, senior director at Crisil Ratings.

Precedence of previous mergers, especially those forced under compulsion to save depositors like in the case of Oriental Bank of Commerce and Global Trust Bank, has never been encouraging. Integration process of any merger takes almost years to complete as challenges of addressing the diverse pressure groups and human resource rationalisation take centre stage.

THE FINANCIAL MATRIX

Here is how the combined entity of Bank of Baroda, Vijaya Bank and Dena Bank would look like. It would have 9,489 domestic branches,Rs 6.4 lakh crore of loan book, CASA ratio of about 34% onRs 8.4 lakh crore of deposits, ratio of gross bad loans over 12% and CRAR of 12.25%.

Based on the three banks' financials for Q1 of the fiscal year ending March 2019, key credit metrics of the merged entity, with the exception of profitability, will be broadly similar to that of BoB, said Moody's Investors Service. The gross and net non-performing assets ratio of the merged entity would to be 12.4% and 5.7%, respectively, while that of BoB is 12.5% and 5.4%.

Similarly, the CET1 ratio of the proforma entity will register 9.3%, while that of BoB is also at 9.3%. Moody's, however, said that profitability of the proposed entity will compare poorly with BoB, going by the financials of the three banks in the first quarter.

The Q1 numbers were impacted by a particularly high level of provisioning at Dena Bank, with the credit costs at an annualised rate of 7.1%. At the same time, because the loan loss coverage at Dena and also at Vijaya were lower than that for BoB, the profitability of the merged entity would be lower than what Moody's expects for BoB over the next 12-18 months.

Reading the Fineprint

Financials	PSU Banks (21)	Pvt Banks (19)
Interest earned (₹ cr)	6,60,371	3,01,852
Interest expended (₹ cr)	4,55,221	1,71,673
PAT (₹ cr)	-85,371	41,902
Gross NPA (₹ cr)	8,95,601	1,28,627
Net NPA (₹ cr)	4,54,473	63,645
Deposits (₹ cr)	79,93,115	29,67,160
Advances (₹ cr)	59,05,423	26,43,075
No. of branches	90,530	25,421
No. of employees	8,49,446	4,22,868
Average Ratios (%)		
Capital adequacy ratio-Basel III	11.20	15.15
Tier I capital-basel III	8.56	12.48
Tier II capital-basel III	2.21	1.43
ROA	-0.79	1.00
Business per employee	16.31	12.20

Source: **Capitaline** / Compiled by: **ETIG Database**

CORPORATE GOVERNANCE

The need for incremental capital from the government may come down if the merger improves efficiencies and leads to stronger internal accruals. This will then act as a road map for further consolidations in the public sector banking space. But the government needs to address the issue of governance in Indian banking and that is more structural.

Indian banking system inherently suffered from inefficiency of dual control by Reserve Bank of India and the government.

The RBI regulates both governance and prudential norms of private banks. For public banking group, which covers two-third of banking business, the government exercises the powers relating to governance while leaving prudential regulation to RBI.

“The government is fully responsible for perpetuating the problem of dual control for over 25 years. There must be reasons for this state of affairs. They are called political economy considerations,” former RBI governor YV Reddy said last month.

“Unless there are regulatory changes to enhance governance of the PSBs, these stories (of mergers) can at best create short-term excitement,” says Sinha of Emkay.

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