Public Sector Bank Mergers
A Reality Check

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The slowdown in the economy and the resultant rise in bad loans have led to criticism of public sector banks and questioning of their raison d’être. While there is a rush to find a quick solution by merging PSBs, it would be wise to examine the ground realities closely. India needs a mix of efficiently run PSBs and aggressive private banks to achieve growth and development along with social justice.

As chief of Microsoft, Bill Gates had famously said in 1994, referring to the technology revolution sweeping the banking sector, that “Banking is necessary, but banks are not.”

A similar view is now echoed in India in the context of public sector banks (PSBs): we need banking to expand, but we do not need many PSBs.

Following the recently concluded merger of five associate banks (ABs) with State Bank of India (SBI), the number of PSBs is now down to 21. The government is said to be mulling over whittling down the number to six by merging larger PSBs as well as by merging “weak” PSBs with stronger ones.

This article seeks to review SBI’s merger exercise, and whether a similar initiative can be considered by merging PSBs with one another, and other options.

**Bank Consolidation**

Consolidation of PSBs is not a new idea. Back in 1991, when PSBs had over 90% of the market share, the Narasimham Committee recommended a three-tier banking structure by merging PSBs, which lead to a count of three large banks that would have international presence, about 8–10 national banks, and several regional banks.

Following the Asian financial crisis in 1997, there were merger initiatives in many Asian countries, notably in Malaysia. As India remained unaffected by the crisis, and the regulators had just started licensing new private banks, there was no momentum to reorganise PSBs.

Since the onset of reforms, there have been 32 bank mergers, involving private sector banks. In 2004, the Reserve Bank of India (RBI) forced the problem-ridden privately owned Global Trust Bank (GTB), which was licensed during the first phase of reforms, to merge with the public sector Oriental Bank of Commerce (OBC).

There is only one instance of the merging of two PSBs: the takeover of New Bank of India by Punjab National Bank (PNB) in 1993. The RBI had forced this merger under Section 45 of the Banking (Regulation) Act, 1949 as New Bank of India reached a precarious state of liquidity. The merger was messy in more ways than one. PNB had been a strong bank with an uninterrupted record of profits, but it suffered a net loss of ₹96 crore in 1996, following the merger. It had to face several problems and litigation relating to absorbing the staff of New Bank of India in its stream. It reportedly took PNB five years and more to get over the merger effect.

**SBI Merger and Lessons**

The recent merger of five ABs with SBI is hailed as path-breaking. Three of the ABs were stock-listed entities in which SBI had dominant holdings, while the remaining two were wholly owned by it.

Known once as the “seven sisters,” the ABs had been established by princely states before the country’s independence to serve local populations. These came under the fold of SBI after the government passed the State Bank of India (Subsidiary Banks) Act in 1959.

Thus, State Bank of Bikaner and Jaipur (SBBJ) (which was a merger of banks belonging to two princely states, Bikaner and Jaipur) came into being as SBI’s subsidiary in 1963. Bank of Indore, originally established by Maharaja Tukoji Rao Holkar in 1920, became State Bank of Indore. The bank set up by the princely state of Bhavnagar in 1902 became State Bank of Saurashtra. The last Hyderabad Nizam’s bank, set up in 1941, was renamed State Bank of Hyderabad (SBH). Likewise, the banking outfits of the erstwhile princely states in Patiala, Travancore and Mysore became SBI’s subsidiaries.

The Narasimham Committee had envisioned in 1991 that SBI should progressively merge all the seven subsidiaries with itself. Long thereafter, in 2008, State Bank of Saurashtra was the first to merge with SBI, and two years later, State Bank of Indore was integrated. The government
As can be seen, the last fiscal, 2016–17, was one of the worst years for all banks, with their collective net loss of ₹11,865 crore, which is more than the net profit of SBI. Also, it was the year when the gross and net non-performing loans of ABS were at a historical peak. Thus, the merger may be viewed as effectively a drag on SBI, which was otherwise strongly positioned in the market.

Internal Exercise

SBI’s merger should actually be viewed as an internal reorganisation and not a classical merger exercise.

First, the ABS had enjoyed a common identity with SBI for long. They had shared SBI’s logo, a highly visible point of customer recall and a rallying point of group affinity.

Second, SBI had been exercising tight operational control of the ABS from inception. The SBI chairperson was presiding over the individual boards of the ABS, which were run by top executives of SBI sent on deputation. As a result, the banking products, operational systems and procedures and norms of business were all common.

Third, all ABS were operating under the same information technology platform as SBI. Since the time SBI launched massive computerisation in the mid-1990s to automate all branches, it had included the ABS in the exercise. In 2002, it had engaged Tata Consultancy Services to roll out a core banking solution covering the entire group, and the ABS were beneficiaries of the common code and linkages.

Fourth, the treasury operations of the ABS had been integrated with SBI for approval at the concerned AB’s board. This oversight had added a valuable layer and helped steer the asset portfolios of ABS on generally prudent lines.

While the formal merger of the ABS went through quickly, SBI’s task of fully integrating the new arrivals has just begun. While SBI would take considerable time to benefit from scale economies, its biggest challenge meanwhile will be on the human resources front. The combined headcount of employees at ABS, about 70,000, is a third of SBI’s aggregate strength, which is now the fifth largest employer in India. Integrating this huge number and deploying them productively would pose major issues. Besides the bloated employee costs, the pension and retirement benefits would make a large dent on SBI’s profitability for several years.

SBI is said to be evaluating the issue of rationalising the branch network post-merger. Early estimates might reveal that over 1,000 branches may need to be combined, or operations rationalised/relocated. There are challenges in enhancing skill levels of employees of erstwhile ABS who had so far had a regional focus with limited exposure.

While SBI has some bandwidth to face these and other challenges due to its trained executive pool and large capital resources, absorbing more than one bank at the same time would be a nightmare for other PSBs.

Merger of PSBs

It is well known that the consolidation exercise of PSBs has moved to the front pages of newspapers following their mounting non-performing assets (NPAs) and the pressures for infusing additional capital faced by the government. In the process, there is a visible sense of urgency to rush through a process that should have been spaced out in an orderly and well-thought-out manner from the time it was mooted more than two decades ago.

The excessive bad loans in some PSBs have not been a new phenomenon. The public sector Indian Bank, for example, was once saddled with a record loss of ₹1,336 crore in 1996, a result of faulty credit decisions in the past. There were suggestions to restrict Indian Bank as a “narrow bank.” The bank, however, did a remarkable turnaround in three years and bounced back to sustained profitability. It is now actively traded on the stock market.

There have been several learned discussions recently, that the high level of NPAs of PSBs is attributable to the general business cycle—the downswing in economic climate following the boom years of 2007–08. PSBs are faulted for their overzealous involvement in lending to the infrastructure sector following the vacuum created by the absence of development banks, without caring to build proper risk assessment and project monitoring capabilities on their own. By March 2015, NPAs in the infrastructure sector of PSBs were 22.8% of their aggregate problem loans.

As pointed out by former RBI Governor Raghuram Rajan, a large chunk of NPAs at PSBs relate to projects that are indeed viable. These projects have remained incomplete for several extraordinary reasons, such as problems in land acquisition and environmental clearances, which are hopefully being addressed by the concerned ministries. This is bound to improve the risk rating of NPAs in the period ahead.

While the bad loans have resulted in negative credit growth in PSBs and a general mood of risk aversion, the banks have, at the same time, stepped up personal lending activity, specifically housing loans. PSBs’ personal loan growth today has approached that of the private sector banks.

The exercise of consolidating PSBs should therefore be based on a sound analysis of every PSB, a granular analysis of its assets and liabilities, sector-wise loan exposures, security back-up, common loans among PSBs, etc.
A key factor to consider is whether the merger of any two PSBs would result in substantial value addition in the combined entity, or result in value diminution. Just the large size of a combined balance sheet cannot be a conclusive indicator.

It is also worth asking as to whether PSB mergers would make better sense once there is progress in resolving the current unconscionable levels of NPA. As they say, the best mergers get the timing right. Even in the case of the recent SBI mergers, SBI would possibly have preferred doing the merger at a time when the NPA of the ABS came down to realistic levels, so as to strengthen its market image.

PSB mergers might be more effective when the top brass is free from the unremitting stress of resolving NPA so that they can focus on reaping the economic benefits opened by the merger.

Key Challenges

It is useful to remember that in a growing and vibrant economy, there is scope to run an efficient and profitable bank without aiming to be a big-ticket lender or build a large balance sheet to come under global reckoning.

An independent assessment of the scope for mergers in PSBs should look into whether there are alternatives to consider for the long-term soundness of “weak” PSBs, which could also lessen the pressure for additional capital.

For a merger or any other restructuring option, PSBs face the foremost challenge of an acute talent deficit and absence of the right people in sufficient numbers. Almost every PSB on the merger radar lacks talented personnel to effectively manage even existing operations.

Several case studies have shown that merger announcements trigger confusion, anxiety and insecurity in staff, leading to slowdowns in business. Weak talent management and poor communications often exacerbate these challenges. PSBs need leaders with considerable vision, maturity, strong operational knowledge, along with persuasive skills and the ability to cobble a diverse team to effectively implement a blueprint.

The short tenure of senior leaders in PSBs comes in the way of launching any strategic initiative. Suggestions on bringing the right talent to PSBs at various levels and ensuring long tenures for the best personnel have remained on paper.

It should therefore be an immediate task to strengthen the talent in “anchor” institutions before initiating mergers. Recruiting the right people from the market, and attracting experienced executives from other banks by offering better pay packages, would deserve consideration among others.

A talented leadership should be able to work on integrating the cultures of two merging banks. Culture has remained a dominant barrier to effective integration worldwide. Despite an apparent uniform culture in PSBs, there are wide differences borne out of regional backgrounds and several intangible factors. While private sector banks have attempted to forge a uniform culture by taking some drastic measures, such as forcing employee severances (which was adopted by ICICI Bank towards Bank of Madura’s staff in the aftermath of their 2001 merger), this is seldom feasible in PSBs.

Integrating human resources in matters such as compensation, deployment and performance appraisal can be daunting in PSBs. While this was disastrous in the merger of PNB with New Bank of India, IDBI Bank in the recent past is known to have faced several issues while attempting to streamline human resource policies of staff of the erstwhile development bank with the commercial banking stream.

Another key challenge is on the technology front. Unlike the SBI merger, there is no uniformity in the information technology architecture in PSBs, each bank having engaged multiple vendors for developing its system. The banks are currently at varying stages of rolling out new initiatives with existing or additional vendors. To forge uniformity and implement a common system that would seamlessly cover all aspects of the banking business in the merged entity will be a challenge that can stretch out for a long time.

Careful Plans

It is, therefore, advisable to pursue the merger option carefully and with caveats. First, it would be wise to start with two anchor PSBs, each of them getting ready to take over one PSB each, preferably small ones. The aim should be to complete the integration within, say, 12 months, and create a template for further mergers.

A consideration in previous RBI-inspired mergers was to facilitate the acquiring bank to enlarge its footprint in regions where it did not have adequate presence. Thus, by asking OBC to take over GTB, it was argued that the latter’s branch network in the southern region, where OBC lacked presence, could help it to become a bigger national bank.

Such considerations are no longer relevant as alternatives to brick and mortar banking emerge. It would make sense to marry banks that have pronounced common identities that could help strengthen the cultural quotient and network streamlining. Thus, combining Punjab and Sind Bank with PNB, or Vijaya Bank with Canara Bank could make practical sense due to their common cultural identities and overlapping branch networks. There should be a directive that, post-merger, the branches should be rationalised to eliminate overlaps within a clear timeframe.

Second, ahead of the merger, non-banking investments of identified PSBs in areas such as insurance, broking and investment banking would need to be critically evaluated, with a view to requiring the banks to either exit from them, or offload the investment within a firm time frame. This may be necessary to focus on banking instead of dissipating scarce talent to pursue unrelated areas.

Third, it is relevant to consider whether one or more “weak” PSBs can be restricted to play a regional role, or in a specific segment, instead of continuing their pan-India presence, or as multi-functional entities. The private sector is already sensing good opportunities for small finance banks, or catering to small and medium enterprises (SMEs), trade financing, and agriculture. There is sound logic for some PSBs to be assigned exclusive roles in such segments. For example, Dena Bank, which was for several years a highly profitable
bank focused on trade financing, could be oriented as a bank exclusively for SMEs or traders.

Likewise, the “weak” Bank of Maharashtra could become a bank focused on rural Maharashtra, thanks to its intimate knowledge of the region and the brand equity it enjoys among the local population.

In such cases, the PSBs should shed branch networks outside the region, and aim to release resources blocked in real estate in dysfunctional corporate and planning offices.

On its part, the government should actively seek to dilute its holdings in PSBs to 52% as and when the banks’ fortunes improve. Currently, government holdings range from 100% in IDBI Bank to 61% in Allahabad Bank and Andhra Bank. There is large headroom for divesting and creating new owners to share the burden of capital infusion. This should be an “on tap” exercise so that the government can move quickly when market conditions and sentiments are favourable.

Meanwhile, it is important for the government to keep up the commitment to recapitalise and release funds in a timely way to support fresh lending by PSBs. The government should also seek to sustain and enhance value in PSBs by countering the trend of disparaging the PSB architecture that has served the nation’s interests well in the past.

India needs to maintain a right balance between private and public sector ownership in banking for quite some time. Even with 150 domestic commercial banks and the large number of cooperative banks, only about 40% of adults have formal bank accounts, and there are deep-rooted poverty issues and regional disparities to contend with. We need a mix of efficiently run PSBs and aggressive private banks to serve both development goals and social justice.