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Increased Non-performing Assets in Indian Banks leading to Consolidation as Remedy: A Study of Strategic Advantage and Compromise

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Abstract

Indian Banking Sector since inception has gone through a series of corporate restructuring. Starting from the age of Presidency Banks, the banking sector has taken up consolidation as a strategic move to enhance their competitiveness in the global arena. History reveals that India's Largest Bank, State Bank of India, is a product of mergers of the Presidency Banks. Post-nationalisation phase projects Reserve Bank of India (RBI) as a vital role player in the process of the mergers of the Indian Banks. RBI, being the apex bank of the country has come up with several directives forcing a strong bank to take-over the weaker banks which eventually tantamount to acquisition of Non-performing Assets (NPAs).

This paper endeavours to study the probable synergies arising out of the consolidations and how it has been strategically different from the mergers and acquisitions taking place globally. In the due course of establishing such fact, the paper has gone through an international case-study relating to takeover of ABN-AMRO Bank by the Royal Bank of Scotland and how the focus of such merger has been different from the Indian consolidations taking place. Focussing towards the Indian context, the paper has taken up few case-studies relating to the Indian banks to show how the Indian banks has undertaken corporate restructuring only to shift the burden of NPAs from a weaker bank to a giant. This strategy might not prove to be sustainable in future because the loan recovery system and the Debt Recovery Tribunals have already proved its incompetence in the past. Moreover, the Indian banking giants are also suffering from high NPA accumulation.

Under the above situation, this paper is an effort to prove that the consolidations taking place in the Indian Banking Industry might be a short-term remedy for the weaker banks to get out of their failure but cannot assure a future growth in the industry.

Key words: *Indian Banking Industry, Non-performing Assets, Consolidation, Merger & Acquisition, Debt Recovery Tribunals*

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1. INTRODUCTION

Nationalization in the Indian Banking Industry for the first time marked the beginning of a phased reform in the sector. Post-nationalization phase observed a restructuring and reincarnation of Indian Banks which eventually gave them the impetus to play in a competitive economic environment. But how far the reformatory actions have been successful remains a matter to be judged. With a series of bank failures after nationalization, questions have been often raised about the credibility of such reform measures. One of such reformatory step has been 'consolidation' or 'corporate restructuring'. This weapon, many a time have been used by the global banking industry as an effective tool towards their business expansion and improvement of competitive strength. But, the Indian Banks have used this tool mostly to support the weak and problematic banks suffering from high Non-performing Asset (NPA) ratio. However, reducing of NPA in the economy for the last two decades has been the cause of concern for many.

The consolidation in the banking industry has taken the driver's seat in the recent banking scenario of India and is likely to gather momentum in future. The Indian banking industry is set to open up fully to the foreign participants by April 2009 and consolidation of the problematic Indian banks with the foreign banks or with the Indian Banking Giants will have a huge impact on the sector.

Under the above circumstances, this paper has been an effort to establish whether the consolidation in the Indian Banking Sector helps in the reduction of NPA. In the course of the study, emphasis has also been given at the mergers and acquisitions taking place globally and how it differs from the consolidation of the Indian Banks.

1.1 Growth of Non-performing Assets: The Challenge to all Banks

Indian Banking Industry set up its pillar on piles of NPA. Several reformatory measures were adopted time to time, but the effort for NPA identification was either sluggish or remained undetected. It was first traced only after 1992 wave of liberalization. A rapid NPA rate of the Public Sector Banks (PSBs) was observed with it's rising to 80246 crore in 2002 from 47300 crore in 1997 (A Report on Non-Performing Asset…., 2011).

NPA has been the greatest complication for the Indian banking sector. The problem was predominantly acute in India with NPAs accounting to thousands of crores. The effect of large NPAs was devastating as it reduced interest income, additional provisioning, and erosion in capital and reduction in competitiveness. The government and the banks have put in a lot of effort to address the serious problem posed by the NPAs. Debt Recovery Tribunals (DRTs) were set up to recover the bad loans. The banks have also come up with One Time Settlement systems to settle the problems once and for all with the defaulting borrowers. Though these tribunals and schemes were partly successful, they did not go to the extent of solving the problem. Consolidation, therefore, seemed to be the only way to transform the existing banking sector into a commercially viable organization.

NPA issue in the financial sector has been the cause of concern for all economies and India is not an exception to it. Reduction in NPA has become synonymous with the functional efficiency of financial intermediaries. Although the value of NPA is reflected in the Balance Sheet and affects the financial position of the organisation, yet it had huge macroeconomic impact. If these assets are not recovered on time, the values will decline with the efflux of time and gradually the banks could only recover a negligible value. This in the long-run will affect the financial sector growth.

1.2 Indian Banking Sector and its need for Consolidation

M2odern banking in India began in the 18th century, with the founding of the English Agency House in Calcutta (later known as Kolkata) and Bombay (later known as Mumbai). In the first half of the 19th century, three Presidency banks were founded. After 1860, with the introduction of limited liability, private banks began to appear and the foreign banks entered the market. In the beginning of 20th century, the joint stock banks were introduced. In 1935, the presidency banks were merged together to form the Imperial Bank of India, which was subsequently renamed as the State Bank of India (SBI). In 1959, SBI acquired the state-owned banks of eight former princely states. By July 1969, 31% of scheduled bank branches throughout India were under the government control and became a part of the SBI Group (**Banerjee et al. 2004**).

The banking sector in India had undergone several phases of reform since its inception. The major initiative was taken up in July 1969 with the government nationalizing the existing banks in the country, having nationwide deposits of Rs.500 million. Reserve Bank of India (RBI) occupied the position of central bank of the country. After nationalization, the breadth and scope of the Indian banking sector expanded immensely achieving mass participation. The most significant achievement of the financial sector reforms had been the marked improvement in the financial health of the commercial banks in terms of capital adequacy, profitability, asset quality and credit risk management **(Annexure I).**

Commercial banking constituted the largest segment of the Indian financial system. So, majority of the regulatory and supervisory norms were initiated first for commercial banks and were later extended to other types of financial intermediaries. After the nationalization of major banks the Indian banking system became predominantly government owned by the early 1990s.

Banking sector reform consisted of a two pronged approach. There had been a constant improvement in the Indian banking system through the introduction of international best practices in prudential regulation and supervision. The idea was mainly to increase competition in the system gradually. Special emphasis was placed on building up the risk management capabilities of the Indian banks. Measures were also initiated to ensure flexibility, operational autonomy and competition in the banking sector. Active steps had been taken up in order to improve the institutional arrangements including the legal framework and technological system within which the financial institutions and markets operate. The supervisory system had been refurbished as it played a crucial role of effective supervision in order to improve efficiency and stability in the entire banking system.

Banking reform in India had not involved large-scale privatization of government-owned banks. The approach, instead, first involved recapitalization of banks from government resources to bring them up to appropriate capitalization standards. The second phase was attempted to increase capitalization through diversification of ownership to private investors up to a limit of 49%, thereby keeping majority ownership and control with the government (**Mohon, 2007**).

The deregulation in the banking sector has opened up new opportunities for banks to increase revenues by diversifying into investment banking, insurance, credit cards, depository services, mortgage financing, securitization, and so on. Liberalization on the other hand has brought greater competition among local and foreign banks. Positive fallout of competition has been the greater choice available to consumers, and the increased level of sophistication and technology in banks. The banks, compliance to Basel II Accord[1] by April 2007, have increased capital adequacy, prudential supervision norms and proper credit risk management policies. As banks benchmarked themselves against global standards, there has been a marked increase in disclosures and transparency in bank balance sheets as also greater focus on corporate governance.

Consolidation, therefore, is the "new mantra" as it proved to be the only way for the survival of the smaller banks, including the Urban Cooperative Banks (UCBs) and the problematic banks with high accumulated NPAs. In case of UCBs, consolidation has become inevitable due to the RBI's virtual ban on issue of fresh branch licenses to these cooperatives. Hence, consolidation in the banking sector might prove to be the best endurance strategy.

Foreign banks, on the other hand, can play an important role in this situation by strengthening the Indian financial market and develop the international aspect of Indian economy. With the restrictions on operations of foreign banks coming to an end after April 2009, the banking scenario would be dramatically changed. After the implementation of Basel II and heading towards Basel III norms and core banking solutions[2] in banking sector, smaller banks will face capital crunch and consolidation could only strengthen them.

1.3 A Case Study on a leading Cross-border Banking Consolidation
Acquisition of ABN AMRO: Tussle between Barclays and RBS Consortium

The tussle over ABN AMRO was significant for the global banking industry for numerous reasons. To start with, the tussle involved numerous banks from all parts of the world. As a result of which, it had obvious impact on the major banking markets worldwide. The bidding war was also significant due the degree of strategic movements involved in it.

The tussle between Barclays and RBS consortium had kept the options opened in front of ABN AMRO shareholders. On one side, Barclays would keep the bank's co-operations intact and the strategic operations with CDB might give them better accessibility in the growing Asian market. While on the other side, though RBS-led consortium would give them a high take-over price, but could also split the banks into three parts. The shareholders had to evaluate the purchase considerations led down by Barclays and RBS consortium (**Werdigier, 2007) (Exhibit I).**

Exhibit I: Snapshot of the Merger Proposition Barclays Vs RBS Consortium	
Barclays Purchase Consideration	**RBS Consortium's Proposal**
• The bank has lifted its offer to €67.5bn from €64.1bn	**RBS:** RBS will keep the entire ABN AMRO market of North America, global clients and

[1] In June 2004, the Basel Committee issued the final version of the New Basel Accord (Basel II), a framework for risk management with three pillars: capital adequacy, supervisory review and market disclosure.

[2] The platform where communication technology and information technology are merged to suit core needs of banking is known as Core Banking Solutions. Here computer software is developed to perform core operations of banking like recording of transactions, passbook maintenance, and interest calculations on loans and deposits, customer records, balance of payments and withdrawal are done. This software is installed at different branches of bank and then interconnected by means of communication lines like telephones, satellite, internet etc. It allows the customers to operate accounts from any branch if it has installed core banking solutions.

• €42.7bn will come in Barclays shares, with €24.8bn in cash • ABN Amro shareholders will get €13.5 in cash and 2.13 Barclays' shares • The new offer values each ABN Amro share at €35.73 **Conditions** • Regulatory compliance and tax clearances are prerequisites for the completion of the proposed merger. • Completion of employee consultations. **Synergies** • ABN and Barclays estimate that the combination will result in annual pre-tax synergies of approximately €3.5 bn by 2010.	wholesale businesses globally excluding Brazil, Asia and Europe excluding Antonveneta. **Fortis:** Fortis will carve out the business unit of Netherlands, business unit of private clients globally, business unit of asset management globally. **Santander:** Santander will get the Latin American retail and commercial banking businesses (excluding wholesale clients outside Brazil), Antonveneta, Interbank Consumer Finance. **RBS Purchase Consideration** € 71.1 bn with a 93% cash component and the remaining in shares. **Synergies** Minimization of execution risk and a global acceptability.

According to company sources, ABN AMRO's management preferred Barclays' offer. Moreover, apart from giving good value to the shareholders, it would also keep the company's core businesses intact. However, it was also believed that ABN had agreed to meet with the representatives of the RBS-led consortium ahead of the shareholders' meeting regarding their bid. In such a scenario, with the breaking up of scuffle between the two giants (Barclays Vs RBS consortium), the question of sustainability occupied the prime position. Measuring on a beam balance, both the banks might be endowed with same credentials.

The growing complications in the tussle between Barclays and RBS consortium proved to be a threat to the proposed takeover deal. From the monetary viewpoint, Barclays was never in a position to challenge the RBS bid. Barclay's could not even increase the bid value, as the sub-prime loan crisis was a major setback for the bank's overall operations. Finally, the wave of the sub-prime crisis pushed Barclays back from its bidding, leaving RBS to win the deal.

1.4 Case Studies on Consolidation in the Indian Banking sector

In this section, three case studies have been discussed focussing on their NPA position in the pre-consolidation and the post-consolidation phase.

I. Consolidation of Cooperative Banks in India: A Strategy to Survive

Consolidation of the cooperative banks in India has been on their cards for long. Most of the rural and some of the urban credit cooperatives suffered since their inception, owing to aggressive lending to the priority sectors, non-marketable asset, high non-performing assets, HR complications and lack of capital adequacy. Finally, with the Reserve bank of India (RBI) issuing guidelines for mergers and acquisitions in the cooperative banking sector, many banks, especially scheduled urban cooperative banks (UCBs), are showing keen interest in taking over sick cooperative banks. According to recent news in the business standard, in the last three years, fourteen cooperative banks in the different states of India went for mergers, clearly indicating consolidation in the entire Industry. Among the banks that had been merged, some were

Vibhagiya Nagarik Sahkari Bank, Tapi Cooperative Bank, Adajan Nagarik Sahakari Bank and so on. History reveals that none of the consolidation strategies of the financial institution in the past had felt the taste of success in Indian soil due to the complications relating to aggressive HR policies, accumulated losses of the acquired institution and stringent regulations of the regulatory bodies. But, consolidation seemed be the only remedial measure for the cooperative banks to survive and comply with internationally accepted Basel norms for banking supervision. The following case study focuses on such issue, concentrating on how a strong cooperative bank acquires a weak cooperative bank and in the process accumulates huge quantum of NPA.

Saraswat Cooperative Bank acquire the ailing Maratha Mandir Cooperative Bank

The Saraswat Cooperative Bank, an UCB, is planning to acquire the Maratha Mandir Cooperative Bank. This move was expected to, in the long run, ensure better protection to depositors. According to RBI directive, a cooperative bank can merge only with another cooperative bank situated in the same State or with a cooperative bank registered under Multi-State Cooperative Societies Act. This placed multi-State UCBs at an advantage since they can acquire cooperative banks from other States. Saraswat Cooperative Bank have multi-State presence. The Maharashtra government had cleared the way for Saraswat Cooperative Bank to acquire the ailing Maratha Mandir Cooperative Bank. The state government-controlled registrar of cooperative societies cleared the deal almost nine months after the acquisition was cleared by the RBI. The acquisition of Maratha Mandir Cooperative Bank added another 12 branches to the bank's network, 11 of which are in Mumbai and one in Chiplun. The deal on one hand provided a strategic advantage for Saraswat considering that the RBI had stopped issuing new branch licences to co-operative banks, but on the other hand the bank has to takeover huge quantum of NPA of Maratha Mandir. The Maratha Mandir Cooperative Bank is shouldering an NPA burden of Rs. 53.30 crores as on November 30, 2004. The acquirer bank was planning to offer voluntary retirement scheme for excess employees of sick banks. Furthermore, they had requested RBI to allow them to close overlapping branches of the entities they acquired and, in lieu of these, be granted the licence to open the same number of branches in other areas.

II. HDFC Bank Merges with Centurian Bank of Punjab

Independent joint valuers, global consultancy major Ernst & Young (E&Y) and chartered accountancy firm Dalal & Sons, made a presentation on the valuation parameters of the bank's proposed merger with HDFC Bank. The merger was the culmination of a search, done independent of each other, by HDFC Bank and Centurian Bank of Punjab (CBoP), to find a partner who could help them capture and ride the growth in the financial services industry more optimally. More particularly, HDFC Bank, the second-largest private sector bank in the country, had been scouting for a merger opportunity that would add scale to its operations, facilitate its expansion to every nook and corner of the country, and bring on board an experienced management team that would add to its management bandwidth. CBoP provided the perfect fit in terms of culture, strategy and approach to business.

However, the merger added certain disadvantage to HDFC Bank. Firstly, share of low-cost deposits would decline marginally as CBoP has a much lower portfolio of such deposits than HDFC Bank. Secondly, CBoP has high net NPAs of 1.31 per cent (Anand 2008). This will affect HDFC Bank's asset quality and HDFC Bank will have to take initiative for recovery of NPA.

Thirdly, employee integration would be a big issue as CBoP has a large workforce. Fouthly, technology integration would involve time and cost as the two banks operates on different platforms. Finally, to conclude with, HDFC Bank promoter HDFC had to pump in close to Rs 4,000 crore to maintain its stake at a little over 23 per cent (Anand 2008) **(Exhibit II)**.

Exhibit II: Financial Position of HDFC Bank & Centurian Bank of Punjab in the Pre-merger Phase

WILL THE NUMBERS ADD UP?

A look at the figures behind the merger.

PARAMETERS	HDFC BANK	Centurion
Revenues	8,464	1,673
Operating Profit	2,811	269
Net Profit	1,143	121
Capital	319	156
EPS	Rs 36.6 per share	Rs 0.82 per share
Deposits	68,297	14,863
Balance Sheet Size	91,235	18,482
Net NPAs	0.43%	1.31%
Return On Assets	1.25%	0.66%
Return On Capital Employed	19.46%	10.60%
Capital Adequacy	13.08%	11.05%

All figures are in Rs crore except where indicated and are for March, '07

Source: BT Research

Source: Anand A. , "Merging to Grow", http://businesstoday.intoday.in/story/merging-to-grow/1/1735.html, March 23rd, 2008

The merger would lower the quality of HDFC Bank's assets. During the merger, HDFC Bank had a net NPA level of 0.43 per cent, compared to the corresponding CBoP figure of 1.31 per cent. So, even after accounting for the latter's loan portfolio, there will be an increase in the net NPA level of the post-merger HDFC Bank. Moreover, NPAs typically surface 2-3 years into the tenure of loans. So the merger had been more of a compromise, rather than a consolidation.

III. Consolidation of SBI with its Associate Banks

India's Largest Bank State Bank of India (SBI), a major player in the banking segment of India has taken up the initiative to merge its entire seven associate banks in order to enhance its capital base and nationwide network strength. The consolidation strategy adapted by SBI involves the merger of all its associate banks – State Bank of Patiala (SBP), State Bank of Bikaner and Jaipur (SBBJ), State Bank of Hyderabad (SBH), State Bank of Travancore (SBT), State Bank of Indore, State Bank of Saurashtra (SBS) and State Bank of Mysore (SBM) by January 2009 (**Bhatt, 2007**). But in adapting this step, the bank had faced tremendous challenges not only from the employees union, but also due to the presence of high NPAs in the associate banks. It was never thought that SBI, the oldest bank of the country might face such challenges before adapting consolidation strategy in order to defend the upcoming foreign competition.

The stumbling block of SBI Group in its banking operation has been the high rate of NPAs. The bank has been working according to the state directives and has worked in various government projects having minimal repayment credentials. This has led to the accumulation of high NPAs. Though the government has taken up the initiative to eliminate these NPAs through creation of Asset Reconstruction Companies (ARC), but has negligible impact on the elimination of NPAs.

SBI has been active with its consolidation efforts and over the last two years acquired two of its subsidiary banks-State Bank of Saurashtra and State Bank of Indore.

2. CONCLUSION

From the comparison between the global and Indian case studies on banking consolidation, some of the issues may be put forward. Firstly, In case of the foreign consolidation, it turns out to be a war between the giants to win over another giant. There is no influence from the government or any other parties. But, coming to the Indian perspective, consolidation has been quite synonymous to compromise, wherein the apex bank of the country directs and the others have to abide by the directions. Secondly, In case of the international mergers, the major focus has been the acquisition of the net worth and network of the merging banks. However, in case of the Indian banks, one of the major reasons to consolidate is to take over the bad assets of the consolidating bank. This in due course increases the NPA of the merged entity. Thirdly, Consolidation in the foreign banks has been mainly due to the mutual understanding to strengthen each other position in the global market. But the domestic mergers usually take place under the RBI directives with the sole objective of rescuing a sick bank from becoming bankrupt. Hence, in due course, the major objective of the merger is lost. Finally, the global mergers were mainly initiated to acquire the technology including the risk management system of the other banks. But the domestic mergers had very little scope in terms of technological and risk management advances, because the proposed mergers mainly aimed at improving the technology of the weaker banks and setting up of proper risk management technique.

Annexure I Reforms in the Indian Banking Sector
A. Prudential Measures • Introduction and phased implementation of international best practices and norms on risk-weighted capital adequacy requirement, accounting, income recognition, provisioning and exposure. • Measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending, risk concentration, application of marked-to-market principle for investment portfolio and limits on deployment of fund in sensitive activities. **B. Competition Enhancing Measures** • Granting of operational autonomy to public sector banks, reduction of public ownership in public sector banks by allowing them to raise capital from equity market up to 49 percent of paid-up capital.

- Transparent norms for entry of Indian private sector, foreign and joint-venture banks and insurance companies, permission for foreign investment in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment, permission to banks to diversify product portfolio and business activities.

C. Measures Enhancing Role of Market Forces

- Sharp reduction in pre-emption through reserve requirement, market determined pricing for government securities, disbanding of administered interest rates with a few exceptions and enhanced transparency and disclosure norms to facilitate market discipline.
- Introduction of pure inter-bank call money market, auction-based repos-reverse repos for short-term liquidity management, facilitation of improved payments and settlement mechanism.

D. Institutional and Legal Measures

- Settling up of 'Lok Adalats' (people's courts), debt recovery tribunals, asset reconstruction companies, settlement advisory committees, corporate debt restructuring mechanism, *etc.*, for quicker recovery/ restructuring. Promulgation of Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI), Act and its subsequent amendment to ensure creditor rights.
- Setting up of Credit Information Bureau for information sharing on defaulters as also other borrowers.
- Setting up of Clearing Corporation of India (CCIL) to act as central counter party for facilitating payments and settlement system relating to fixed income securities and money market instruments.

E. Supervisory Measures

- Establishment of the Board for Financial Supervision as the apex supervisory authority for commercial banks, financial institutions and non-banking financial companies.
- Introduction of CAMELS supervisory rating system, move towards risk-based supervision, consolidated supervision of financial conglomerates, strengthening of off-site surveillance through control returns.
- Recasting of the role of statutory auditors, increased internal control through strengthening of internal audit.
- Strengthening corporate governance, enhanced due diligence on important shareholders, fit and proper tests for directors.

F. Technology Related Measures

- Setting up of INFINET as the communication backbone for the financial sector, introduction of Negotiated Dealing System (NDS) for screen-based trading in government securities and Real Time Gross Settlement (RTGS) System.

Source: Mohan Rakesh, "Financial Sector Reforms in India: Policies and Performance Analysis", Financial Sector and Economic Growth The Linkage, 1st Edition, (ISBN 81-314-0853-1), The Icfai University Press, 2007, pages 315-316

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