(Clockwise from left) The headquarters of Dena Bank, Vijaya Bank and Bank of Baroda in Mumbai, Bengaluru, and Vadodara, respectively.

MEGA BANK MERGERS AND THE FUTURE OF REFORMS

For a while it seemed the Modi government had a reforms plan for the banking system. But now it is left with mere optics

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LONG STORY

When the Modi government took charge in 2014, it was set to prove its admirers right, and the sceptics wrong, on banking reforms. The then Governor of the Reserve Bank of India (RBI), Raghuram Rajan, was halfway through his tenure and had independently started the clean up of the banking system by taking action wherever the remit of the RBI worked.

When it came to matters beyond the RBI's powers, Rajan worked with the government. The clean-up of balance sheets; recognition of non-performing assets; taking pro-active steps in default cases and strategic structuring of stressed assets were some of his initiatives. Rajan had also taken the initiative to set up the PJ Nayak Committee, which looked into the governance of public sector banks. The committee had drawn up a road map that was contemporary and relevant. The report was submitted just after the new government came in.

GOOD BEGINNINGS

One of the earliest large initiatives by the Modi Government was the Prime Minister's Jan Dhan Yojana, an ambitious financial inclusion plan rolled out through the public sector banks. Before completing a year in office, the government had called in all chiefs of the public sector banks to a two-day Gyan Sangam in Pune. By August 2015, there was even more hope in the minds of the admirers. The role of the chairman and managing director was split to have a non-executive chair, as suggested by the Nayak Committee. The government announced that they would look at hiring professionals laterally (from outside the public sector banking system) at least for five large banks. Why, the government actually appointed managing directors from the private sector for two large banks.

In February 2016 the government announced the setting up of the Banks Board Bureau (BBB) headed by Vinod Rai, the former Comptroller and Auditor General of India. This was followed up with another Gyan Sangam in Gurgram where another round of strategizing was done. The reform of the banking system was well on track.

Back to Rajan. In April 2014, two new private sector banks were licenced. Rajan was putting the recommendations of the Nachiket Mor Committee into action by putting up documents on the future structure of banking in India, inviting applications for new type of banks. By September 2015 there were announcements that RBI had given an in-principle licence to 11 payments banks and ten small finance banks—thereby initiating a significant change in the balance between privately owned banks and the state-owned banks. He was also changing the space for inclusive finance by encouraging private banks to do business profitably while not removing focus on the requirements of the priority sector (including agriculture and micro and small enterprises sector). There were structural and market friendly responses to each of these issues that needed to be addressed.

The only aspect that did not sound quite like reform was the PMJDY programme, which was rolled out without business considerations, on a whim, with implementation and saturation as the focus. But that was also seen positively as an agenda towards greater inclusion, as an investment in the architecture for technology enabled direct benefit transfers which would also help the banking system.

So far, the largest sectoral beneficiary of the new government looked like the banking and financial services. It also appeared that we were well on the way to implement the recommendations of the Narasimham Committee (the first committee on financial sector set up in 1991 and the second on the banking system set up in 1998) that had suggested consolidation of banking system, withdrawal of the government and a vibrant private sector banking operating in the market place.

> We need to examine the move to merge Bank of Baroda, Vijaya Bank and Dena Bank in a continuing context of taking ad-hoc decisions.

MINT SHORT STORY

WHAT

The government will merge three PSBs—Bank of Baroda, Vijaya Bank and Dena Bank—into one entity. The amalgamation is part of the centre's effort to move to 3-4 larger banks, with the state as a minority shareholder.

WHY

The approach of the government has been to tuck a weak Dena Bank with a relatively strong Bank of Baroda (BoB) and offer a lollipop of Vijaya Bank as a sweetener. At the end of it, we have a relatively weaker structure.

BUT

The reforms push also came before crucial steps like bringing these banks under the Companies Act by repealing the Bank Nationalisation Act and professionalizing governance by creating a distance between the bank and the ministry.

We already had private sector participation, we were on the road to professionalize the boards and they would hopefully lead the process of consolidation. The independent non-executive chairmen on the banks were reputed individuals and they would take charge of the governance function. While there were some issues about the sequencing of events—like the setting up of the BBB could have preceded the first appointments from the private sector—things appeared to be moving in a certain direction.

THREE ROADBLOCKS

And then, three unrelated events happened. Jayant Sinha, the then Minister of State for Finance who was spearheading the reform in the banking sector, was moved to the Ministry of Civil Aviation in July 2016; Raghuram Rajan's term as Governor ended in September 2016; and Prime Minister Narendra Modi announced the withdrawal of legal tender status for 86% of currency in circulation in November 2016. These three events took the foot off from the reform pedal.

The banking system had to play a pivotal role in the logistics of demonetization and remonetization. All the operational and strategic focus was on getting a new equilibrium of cash in circulation; digital architecture; cash logistics and dealing with the birth of two new denominations (₹2,000 and ₹200) and the withdrawal of one denomination—₹1,000.

The banking system at this stage was under operational stress. This was followed up by the build up of performance stress which started up in the aggressive recognition of non-performing assets—a process started under the leadership of Rajan and perused aggressively by his successor Urjit Patel. Possibly this is where the Modi government started losing the banking plot.

DISSECTING THE MEGA MERGER

We need to examine the current announcement of the government to merge Bank of Baroda, Vijaya Bank and Dena Bank in a continuing context of taking ad-hoc decisions without due consultation and value addition. While this high-profile decision has hit the news, do remember the government has also taken a decision to merge several Regional Rural Banks under the Phase III consolidation. This brings their overall numbers from 56 to 38. Both these decisions have been taken without due process, due diligence and with little regard to the governance processes. Therefore, there is little wonder that the markets have reacted negatively to the decision.

The approach of the government has been to tuck a weak Dena Bank with a relatively strong Bank of Baroda (BoB) and offer a lollipop of Vijaya Bank as a sweetener. At the end of it we have a relatively weaker structure. BoB declared losses in two of the last three years, but was able to absorb these because of its comfortable capital position. It has just finished a process of clean up of all known NPAs and undertaken significant re-engineering of its portfolio mix and business practices.

Vijaya Bank was one of the very few banks that continued to turn in profits when bank after public sector bank hit the red. There may be synergy in the BoB-Vijaya Bank merger, as the broad employee productivity is comparable even though the branch productivity of BoB (owing to its international footprint) is significantly higher. Vijaya Bank has 52% of its branches in the southern region while BoB has only 10% of its branches in South, thereby giving the amalgamated entity a better footprint.

But what does Dena Bank bring to the table? It adds branches in Gujarat, where BoB already has a very significant presence and then adds footprint in Maharashtra, another stronghold of BoB.

On its own, BoB is stronger in the Central Region (which covers Uttar Pradesh) and Northern Region (which covers Rajasthan). Dena Bank also adds three years of losses, a business that is not growing, and a clutter of branches in areas where BoB is already present. No person who would do a due diligence for a merger or an amalgamation would consider this to be a great buy on just these top line parameters.

Let us examine the large mergers that have happened elsewhere—ICICI Bank picked up Bank of Madura several years ago—and got a rural footprint, a footprint in the southern region and a ready priority sector portfolio that was relatively profitable. Kotak Mahindra Bank picked up ING Vysya bank recently and got a footprint and business in the southern states. While in both these cases the cultural differences were deep, they were able to manage business without value destruction. In the current instance Dena Bank being a part of this triad just does not make any sense.

IN CONCLUSION

We need to ask, who are taking these whimsical decisions under the garb of reform? If one was looking at structural reforms, the process should have continued from 2016 through now using the larger intellectual argument of the Narasimham Committee. The committee advocated 3-4 large banks but with government being a minority shareholder. The PJ Nayak committee made fundamental recommendations of bringing these banks under the Companies Act by repealing the Bank Nationalisation Act and professionalizing governance by creating a distance between the bank and the ministry. This was sought to be done through the BBB.

Whether disinvestment should precede reforms or coincide with reforms is a moot question. Given the current scenario, it is clear that reform should happen first before value is unlocked in disinvestment. Professionalisation can happen without necessarily moving towards privatization. That aspect was proved by Modi himself when power sector reforms were undertaken in Gujarat during his tenure. Unfortunately we cannot credit his government at the centre of adequately addressing the reform process and getting the sequence right.

The BBB led by Vinod Rai had a series of recommendations for the government on how the reform process could be phased. The document put out by the first BBB as they demitted office is telling as it showcases eager intent on one side and the stonewalling by the ministry. There were ideas for reform, they were articulated by BBB. However, the work of the BBB was falling on deaf ears—which had turned deaf in the din of demonetization and a flawed roll out of GST. As the NPA monster keeps raising its head to push the banking system into deeper and deeper crisis, the government has yet again diverted its attention.

We are moving from asking hard questions on reforms to the cosmetics of announcements that the government has packaged as reforms. In this instance the government has not only got the sequence wrong, they have got the timing and the combination wrong.

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Now each of these three banks will go through a charade of putting this proposal through their boards. We will find back ended justifications that lead to the front-loaded decision. We will continue to pay lip service to corporate governance; inform the stock exchanges and destroy the value of the minority shareholders. But who cares? There is little time left and some optics of reform come in handy.

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