How can Bank Mergers Lead to Stakeholder Value Creation?

Mrs. Arundhati Bhattacharya

(Chairman, State Bank of India)

The Fourteenth Nani A. Palkhivala Memorial Lecture

September 2017

Published by

Nani A. Palkhivala Memorial Trust

NANI A. PALKHIVALA
MEMORIAL TRUST

We hardly need to introduce you to the life and work of the late Nani A. Palkhivala. He was a legend in his lifetime. An outstanding jurist, an authority on Constitutional and Taxation laws, the late Nani Palkhivala's contribution to these fields and to several others such as economics, diplomacy and philosophy, are of lasting value for the country. He was a passionate democrat and patriot, and above all, he was a great human being.

Friends and admirers of Nani Palkhivala decided to perpetuate his memory through the creation of a public charitable trust to promote and foster the causes and concerns that were close to his heart. Therefore, the Nani A. Palkhivala Memorial Trust was set up in 2004.

The main objects of the Trust are the promotion, support and advancement of the causes that Nani Palkhivala ceaselessly espoused, such as democratic institutions, personal and civil liberties and rights enshrined in the Constitution, a society governed by just, fair and equitable laws and the institutions that oversee them, the primacy of liberal economic thinking for national development and preservation of India's priceless heritage in all its aspects.

The Trust is registered under the Bombay Public Trusts Act, 1950. The Trustees are: Y.H. Malegam (Chairman), F.K. Kavarana, Bansi S. Mehta, Deepak S. Parekh, H. P. Ranina, Soli J. Sorabjee and Miss S.K. Bharucha.

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Miss S. K. Bharucha, *Trustee*
Nani A. Palkhivala Memorial Trust
C/o. Forum of Free Enterprise
Peninsula House (2nd floor),
235, Dr. D. N. Road, Mumbai – 400 001.
Tele: 91-22-2270 3426 Telefax: 91-22-2261 4253
E-mail: ffe@vsnl.net

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Wadala, Mumbai – 400 031.
Tel.: 91-22-2412 2755/56
E-mail : anand@ipworks.in

INTRODUCTION

The Nani A. Palkhivala Memorial Trust was privileged to have Mrs. Arundhati Bhattacharya deliver the 14th Nani A. Palkhivala Memorial Lecture at the Y. B. Chavan Auditorium on Tuesday, 22nd August 2017 on the subject, *"How can bank mergers lead to stakeholder value creation?"*

The subject of the lecture is both topical and important and Mrs. Bhattacharya is uniquely qualified to deal with this subject. With 39 years rich experience in the Indian financial sector across various roles in diverse national and international locations, she possesses a deep understanding of the Indian banking scenario. Even more importantly, as the Chairperson of the State Bank of India, the largest Indian bank – a position in which she has enjoyed the confidence of the Government and the respect and admiration of her peers, as also recognition of the global media – and as the person who has only recently guided the merger of the five Associate Banks and the Bharatiya Mahila Bank into the State Bank, she has hands-on experience of large bank mergers.

In a wide-ranging lecture, she has surveyed the landscape of bank mergers both globally and in India and has identified the imperatives which were behind these mergers. These imperatives cover a wide range, from the post-crisis mergers in the United States engineered by the Government, the need for strategic repositioning in Europe, the concern to regulate unacceptable levels of concentration in Canada, the need of foreign banks to take control of domestic banks following the East Asian crisis in Thailand, to the establishment of the Indonesian Banking Reconstruction Agency for the reconstruction measures such as successive takeovers of the ill-performing banks and gaining full control over banks through change of management in Indonesia.

It is in the context of this global experience that Mrs. Bhattacharya identifies and discusses the issues that consolidation of public sector banks in India could create. She believes that while geopolitics will shape the future course of banking in the Asia Pacific Region and while the Government has repeatedly stressed that consolidation of public sector banks is imperative to make Indian banks globally competitive, she cautions that pure strategic gains can often mask commercial considerations and wonders whether government ownership will provide banks with the resilience and flexibility needed in the evolving environment.

In the course of her brilliant lecture, Mrs. Bhattacharya has highlighted some very relevant issues. First, will systemic risk increase if consolidation leads to greater concentration of payments and settlement flows in the financial sector? Second, in the context of the realisation after the 2008 financial crisis, can too few banks become a part of the problem in a future financial crisis? Finally, in the clamour for consolidation, is there a risk that we may ignore the important role played by small and niche banks in last mile connectivity and grass root innovation?

According to her, the true measure of success of bank consolidation will be if it translates into lower cost for customers and more stable markets. As she has pointed out, whereas in developed countries less than 70 % of the bank's resources are provided by deposits and the rest out of market funds, in India, deposits constitute 97% of the bank's resources. Therefore, reduction in lending rates is not possible unless interest rates on deposits are significantly reduced.

Reduction in interest rates, however, have different consequences in India as compared with developed countries. Whereas in developed countries there is often an identity between depositors and borrowers through

home loans and credit card operations, in India the two classes are quite distinct, depositors being pensioners and small-income individuals whereas borrowers are seldom depositors. Therefore, whereas in developed countries on a reduction in interest rates what the individual loses as a depositor he gains as a borrower, in India there is a huge social cost for depositors as a class. This is an issue which is often overlooked in the continuing debate between the Government and RBI on the trade-off between inflation and growth and the resultant interest-rate policy.

The consolidation of public sector banks can play an important role if it results in the reduction of operating costs and reduces the pressure to reduce interest rates. This will be possible only, as Mrs. Bhattacharya has pointed out, if mergers result in the elimination of duplication in administrative set-ups, branches and ATMs, multiple treasury units and in the risk and compliance functions allied with significant investments in technology. This will need political will to take the inevitable hard decisions as it could result in surplus manpower. Mrs. Bhattacharya believes this can be avoided since there is significant depth in the entire Indian sub-continent where banking can be extended. However, even if this is true, the problems of geographical relocation of staff and the upgrading of skills will remain a major problem.

The issues which Mrs. Bhattacharya has identified in her brilliant lecture need a national debate as the Government embarks on the consolidation of public sector banks. It is with a view to stimulating this debate that the Nani A. Palkhivala Memorial Trust is publishing this lecture and giving it the widest distribution.

Y.H. Malegam
Chairman
11th September 2017 Nani A. Palkhivala Memorial Trust

NANI A. PALKHIVALA

16th January 1920 - 11th December 2002

NANI ARDESHIR PALKHIVALA

In 1972-73 the full Bench of thirteen judges of the Supreme Court of India heard with rapt attention a handsome lawyer argue for five months before them that the Constitution of India, which guaranteed fundamental freedoms to the people, was supreme, and Parliament had no power to abridge those rights.The Judges peppered him with questions. A jam-packed Court, corridors overflowing with members of the Bar and people who had come from far-away places just to hear the lawyer argue, were thrilled to hear him quote in reply, chapter and verse from the U.S., Irish, Canadian, Australian and other democratic Constitutions of the world.

Finally came the judgment in April 1973 in *Kesavananda Bharati v. State of Kerala, popularly known as the Fundamental Rights case.* The historic pronouncement was that though Parliament could amend the Constitution, it had no right to alter the basic structure of it.

The doyen of Indian journalists, Durga Das, congratulated the lawyer: "You have salvaged something precious from the wreck of the Constitutional structure which politicians have razed to the ground." This "something precious" - the sanctity of "the basic structure" of the Constitution - saved India from going down the totalitarian way during the dark days of the Emergency (1975-77) imposed by Mrs. Indira Gandhi.

Soon after the proclamation of the Emergency on 25th June 1975, the Government of India sought to get the judgment reversed in an atmosphere of covert terrorization of the judiciary, rigorous press censorship, and mass arrests without trial, so as to pave the way for the suspension of fundamental freedoms and establishment of a totalitarian state. Once again, braving the rulers' wrath, this lawyer came to the defence of the nameless citizen. His six-page

proposition before the Supreme Court and arguments extending over two days were so convincing, that the Bench was dissolved and the Court dropped the matter altogether. Commented a Judge: “Never before in the history of the Court has there been a performance like that. With his passionate plea for human freedoms and irrefutable logic, he convinced the Court that the earlier Kesavananda Bharati case judgment should not be reversed.”

This man who saved the Indian Constitution for generations unborn, was Nani Ardeshir Palkhivala. His greatness as a lawyer is summed up in the words of Justice H.R. Khanna of the Supreme Court: “If a count were to be made of the ten topmost lawyers of the world, I have no doubt that Mr. Palkhivala’s name would find a prominent mention therein”. The late Prime Minister, Morarji Desai, described him to Barun Gupta, the famous journalist, as “the country’s finest intellectual”. Rajaji described him as, “God’s gift to India”.

Nani A. Palkhivala, was for four decades one of the dominant figures in India’s public life. An outstanding jurist, redoubtable champion of freedom and above all a great humanist.

Born on 16th January 1920, Nani Palkhivala had a brilliant academic career. He stood first class first in both his LL.B., (1943) exams and in the Advocate (Original Side) Examination of the Bombay High Court.

Nani Palkhivala was Senior Advocate, Supreme Court of India; Professor of Law at the Government Law College, Mumbai; Tagore Professor of Law at the Calcutta University; and a Member of the First and Second Law Commissions. He was elected in 1975 an Honorary Member of the Academy of Political Science, New York, in recognition of his “outstanding public service and

distinguished contribution to the advancement of political science."

Nani Palkhivala argued a number of historical cases in the Courts of India and abroad, including the cases between India and Pakistan before the U.N. Special Tribunal in Geneva and the International Court of Justice at the Hague.

He authored a number of books including *The Law and Practice of Income-Tax*, a monumental work, which is the definitive treatise on the subject. His other books included Taxation in India, published by the Harvard University in the *World Tax Series; The Highest Taxed Nation in the World; Our Constitution Defaced and Defiled; India's Priceless Heritage; We, the People and We, the Nation*.

His expositions on the Union Budget in Mumbai and other places were immensely popular and attracted attendance in excess of 1,00,000. He eloquently espoused the cause for a more rational and equitable tax regime.

Nani Palkhivala was India's Ambassador to the U.S.A. from 1977 to 1979. He was in constant demand during this period and delivered more than 170 speeches in different cities, which included speeches in more than 50 Universities, on subjects as varied as Gandhi, the nuclear issue, human rights, India's foreign policy, civil liberties in India, Indian agriculture, apartheid and the Third World.

Two American Universities – Lawrence University, Wisconsin and Princeton University, New Jersey - bestowed honorary doctorates on him. Princeton was the first to do so on 6th June 1978. The citation reads:

"Defender of constitutional liberties, champion of human rights, he has courageously advanced his conviction that expediency in the name of progress, when at the cost of freedom, is no progress at all, but retrogression. Lawyer,

teacher, author and economic developer, he brings to us as Ambassador of India intelligent good humor, experience, and vision for international understanding. As we see the bonds of trust and respect grow between our two countries, Princeton takes pride in now having one of its own both in New Delhi and in Washington."

Lawrence University honoured him with a doctorate of Laws on 28th March 1979. The citation said:

"What is human dignity? What rights are fundamental to an open society? What are the limits to political power? Ambassador Palkhivala, you, more than most, have pondered these great questions, and through your achievements have answered them.

As India's leading author, scholar, teacher and practitioner of constitutional law, you have defended the individual, be he prince or pauper, against the state; you have championed free speech and an unfettered press; you have protected the autonomy of the religious and educational institutions of the minorities; you have fought for the preservation of independent social organizations and multiple centres of civic power.

As past president of the Forum of Free Enterprise and as an industrialist, you have battled stifling economic controls and bureaucratic red tape. You have always believed that even in a poor and developing country, the need for bread is fully compatible with the existence of liberty…

You are also an enlightened patriot and nationalist. You have successfully defended your country's cause in international disputes before the special tribunal of the United Nations and the World Court at the Hague.

Never more did you live your principles than during the recent 19 month ordeal which India went through in what was called 'The Emergency'. When those who had eaten

of the insane root, swollen with the pride of absolute political power, threw down the gauntlet, you did not bow or flinch. Under the shadow of near tyranny, at great risk and some cost, you raised the torch of freedom…"

In 1997 Nani Palkhivala was conferred the Dadabhai Naoroji Memorial Award for advancing the interests of India by his contribution towards public education in economic affairs and Constitutional law. In 1998 he was honoured by the Government of India with PADMA VIBHUSHAN. The Mumbai University conferred upon him an honorary Degree of Doctor of Laws (LL.D.) in 1998.

Nani Palkhivala was associated with the Tata group for about four decades. He was Chairman of Tata Consultancy Services, Tata International Ltd., Tata Infotech Ltd., A.C.C. Ltd., and Director of Tata Sons Ltd. He was President of Forum of Free Enterprise from 1968 till 2000, and Chairman of The A. D. Shroff Memorial Trust from 1967 till his death.

MRS. ARUNDHATI BHATTACHARYA

Arundhati Bhattacharya (Indian, born in 1956) has 39 years of rich experience in India's financial sector working across varied roles and diverse national & international locations.

Taking over as the first-ever woman Chairman of State Bank of India, a Fortune 500 company, she has stamped her imprint in the financial world not just in India but globally as well.

Bhattacharya has expertise and deep understanding of all aspects of banking spanning credit, forex, treasury, retail operations, mergers and acquisitions besides the capital & bond markets.

Before taking charge as Managing Director, she was MD & CEO of SBI's investment banking arm, SBI Capital Markets. Earlier, as Dy. Managing Director in SBI, she headed the largest Human Resources Department of the Banking Industry consisting of a work force of over two lakh employees, which includes 65,000 Officers.

In her extensive service in the Bank, she has had the opportunity of working in Metro, Urban and Rural areas

across the length and breadth of the country. She has handled forex, treasury, retail operations, HR and investment banking portfolios and large Corporate Credit. As Chief General Manager (New Businesses), Mrs. Bhattacharya was involved in setting up several new companies / initiatives of the Bank including SBI General Insurance, SBI Macquarie Infrastructure Fund, SBI SG Securities Ltd, etc., as well as the launch of new IT platforms such as Mobile Banking and Financial Planning in the Bank. As Chief General Manager, Bengaluru Circle, she took keen interest in promoting Financial Inclusion and financing of Self Help Groups. She also had a stint in the Bank's New York office where she was in charge of monitoring branch performance, overseeing External Audit and Correspondent Relations.

Under her leadership, Global Finance Magazine from USA has adjudged **State Bank of India** as (i) Best Bank in India, (ii) Best Trade Finance Providers in India and (iii) Best Sub-Custodian. The same Magazine has adjudged State Bank of India as **Best Bank in India (Emerging Economy) Asia-Pacific**. Forbes magazine has ranked her 25th in their list of "Most Powerful Women in the World" and 5th in "The Most Powerful Women in Finance" category in 2016. She has also been featured in the Fortune List of Top 50 globally most powerful women in business and ranked among the top 5 in the Asia-Pacific region.

She has been ranked 26th in the fourth edition of Fortune's World 50 Greatest Leaders list, becoming the only Indian corporate leader to be featured in the list.

Her interests include reading and travel. She is also associated with various initiatives and institutions for empowering the challenged and differently abled with the aim of integrating them in the society.

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Mrs. Arundhati Bhattacharya
(Chairman, State Bank of India)

Good evening, everybody.

Respected trustees of the Nani A. Palkhivala Memorial Trust, distinguished guests invited for today's evening, other notable personalities of Mumbai city and fellow Mumbaikars.

It is my honour and pleasure to be amongst you all this evening.

First of all, sir, my sincere thanks to the Nani Palkhivala Memorial Trust, particularly you, Shri. Y.H. Malegam, the widely respected chairman of the Trust, for extending me this signal honour of delivering the Palkhivala Memorial Lecture for this year. I am conscious that many eminent thought leaders have delivered this memorial lecture in the past and I attach a lot of value to adding my name to that very select list.

The late Mr. Nani Palkhivala is remembered as a personality of unmatched charisma, a charisma derived by the sheer aura of his vast knowledge and expertise in

* *The author is Chairman, State Bank of India. The text is based on the Fourteenth Nani A. Palkhivala Memorial Lecture delivered under the auspices of Nani A. Palkhivala Memorial Trust on 22nd August 2017 in Mumbai.*

the field of law. He commanded respect equally among his fellow colleagues and his critics. A man of principles, who rose from very humble origins by capitalizing on every big and small opportunity that came to him on the back of sheer hard work, obsessional time management and professionalism. Who would have believed that a studious child who loved reading but had a stammer in his childhood, would one day mesmerize the judges with his unrivalled command over the language.

'The presiding judges would take a week to come out of the spell Palkhivala would cast with his power of words', was said by Justice Late H. R. Khanna. I will only say that the spell cast by Mr. Nani Palkhivala continues to this day.

As a banker, I will remember Mr. Palkhivala for one other reason. On July 19th, 1969, when the President of India promulgated the ordinance nationalizing 14 banks, it was Mr. Palkhivala who moved a petition before the Supreme Court on behalf of R.C. Cooper. R.C. Cooper versus Union of India popularly known as the Bank Nationalization case will forever be remembered in the history of Indian jurisprudence as a turning point in the interpretation of fundamental rights and scope of judicial review.

What interests me most is the argument that Mr. Palkhivala advanced during his submissions. He compared banking structures in countries like Canada, Japan, France, the US and the UK and went on to argue that even the acquisition of all the private banks in India would not suffice to meet the development needs of the country. Was Mr. Palkhivala right? To an extent, yes, he was, India did discard socialism in 1992, but it is only after the success of the recently conducted Jan Dhan Yojana beginning in 2016 that India can say banking has at last reached the common man.

I reflected quite a bit on an appropriate topic for a lecture to honour the memory of such an eminent public

intellectual. I was also cognizant of the fact that this will possibly be my last public lecture as the Chairman of State Bank of India. Given the Palkhivala context that I just recollected, my thoughts started centring around the topic ‘Bank Mergers and Shareholder Value Creation’. In two years’ time, we will be observing the 50th year of the bank nationalization and this year is the 25th year of the first generation reforms initiated in 1992 in respect of banks. In the spirit of Mr. Palkhivala’s commitment to liberal economic thinking which became the touchstone of our policy making in 1990s, I feel this topic must be addressed in a proper perspective.

Mergers and acquisitions among financial institutions are a worldwide phenomenon, and the rapid pace with which industry underwent consolidation has been compelling. The United States leads as it does in so many other ways, with the largest number of M&As in the world. Bank mergers drove the long term downward trend in the number of banks in the US since 1985. Even in the crisis periods of 1980s, 1990s and even in 2007 through 2009, the number of mergers in the US exceeded the number of failures every year. About 90% of the 1500 mergers since 2007 in the US involved a bank with less than US$ 1 billion in asset. In general, acquired banks were often smaller, less profitable, less efficient, and in weaker conditions than their non-acquired peers.

In Europe, the merger and consolidation in banks were significant during the decades of ‘90s and 2001, mainly due to the introduction of the Euro. Over the two decades the European banking sector witnessed significant structural changes that resulted in its consolidation and increased crossholdings. As a result the number of credit institutions in the EU dropped from approximately 12,000 at the end of 1990 to just over 7000 at the end of 2004, with the majority of M&As being domestic deals. The peak in M&A activity in Europe was recorded in 1999. It is also

worth noting that during the 1990s the majority that's about 80% of bank M&A deals, in Europe took place in the four member states of Germany, Italy, France and Austria. And again, involved small and very small banks as these were keen to achieve adequate size to allow survival.

The increased number of deals between larger banks evolved from the need of strategic repositioning rather than that of survival. All through these years the pace of merger has never been uniform across various advanced countries and local policy objectives have normally guided the eventual outcome. For instance, in Canada, domestic banks traditionally controlled a large share of the banking sector owing to dominance of a few banks in the industry. Consolidation in Canada is regulated through a guideline established in 2000 to ensure that it does not lead to unacceptable levels of concentration, drastic reduction in competition and reduced policy flexibility. Thus, in Canada, not much consolidation has taken place since the 1990s. Nevertheless, the 2007 financial crisis has dramatically slowed down the consolidation rate in the banking world across the world. New proposals now call for much more rigorous research. Mergers among banks between the years 2000 and 2010 were usually large and characterized by high transaction values. Mergers among the US banks had a combined transaction value of more than $375 and the total value of intra-European transactions exceeded $330 billion. As you are well aware, during the financial crisis many of the largest bank consolidations were actually driven by government mandate. Be it the consolidation between the Bank of America and Merrill Lynch or the takeover of Wachovia by Wells Fargo or that of Washington Mutual by J.P. Morgan, all of these were actually engineered by the government. In fact, Sir, I remember the head of our treasury at that point of time, one Mr. Barua, told me that his son who was in Citi had always told him that, you know, being in a

public- sector bank was not where anybody should be. On the night when the government of the US funded Citibank, he called him at 12 in the night and said, son, welcome to the public sector. So there are times when these things have to be done and in the US during that period at least most of these bank consolidations, though large in number, were actually driven by the need for survival rather than for strategic repositioning.

Asia also witnessed a bank M&A wave during the same period but due to a different set of reasons. In Japan, the consolidation in banking occurred after the bubble burst in 1989. In 1998, the Japanese government responded to the crisis by launching a comprehensive bank bailout plan, followed by a consolidation leading to the formation of some of the largest bank behemoths in Asia like the Bank of Tokyo Mitsubishi. Following the East Asian crisis, banking in many South East Asian countries also came under severe stress. This led to a variety of responses depending upon the local conditions in consonance with IMF prescriptions. For instance, in Thailand foreign banks took control of two domestic banks. The foreign ownership was also most noticeable in South Korea, where foreign entities took 51% stake in Korea First Bank. By 2001, five out of 12 large Korean banks were foreign owned. Indonesia which was one of the worst affected by the crisis however followed a very different path for bank consolidation. In consultation with the IMF, the Indonesian government formed the Indonesian Banking Restructuring Agency as a confidence building measure. Immediately after its establishment, the IBRA introduced restructuring measures such as successive takeovers of ill-performing banks and gaining full control over banks by changing its management. On the other hand, it supplied liquidity to prospective banks and promoted business restructuring in the healthy banks. The plan although not perfect initially, succeeded eventually in restoring confidence in the

banking system. During the period 1997 to 2000, 19 banks were consolidated and 4 merged banks were formed. In 2004 the IBRA was disbanded. Subsequently, with the dissolution of the IBRA in February 2004, the Indonesian banking sector came back to normal. At present, Indonesia has one of the healthiest banking systems in Asia with the highest equity to asset ratios amongst Asian banks and a manageable bad loan ratio of less than 4%.

While going through these various experiences of various countries, I found that the Indonesian experience probably most closely resembles what we are going through in India, and therefore there are lessons that we can learn from the experience that they went through. Consolidation of banks through M&As in the Indian context, is also not a new phenomenon. In fact, since the beginning of modern banking in India, the first significant merger was in respect of the pre-independence era of the three presidency banks founded in the 19th century which were brought together in 1921 to form the Imperial Bank of India that is our predecessor. In 1959, SBI acquired the state-owned banks of 8 former princely states. In order to strengthen the banking system, the Travancore Cochin Banking Inquiry Commission recommended (this was set up in 1956) for closure/ amalgamation of weak banks. Consequently, through closure/amalgamations that followed, the number of reporting commercial banks declined from 561 in 1951 to only 89 in June 1969. During ’61 to ’69, 36 weak banks both in the public and the private sector, were merged with other banks. There have been several bank amalgamations in India in the post reform period as well. In all, there have been 44 M&As since the nationalization of 14 major banks in 1969. Of these mergers, 26 involved mergers of private sector with public sector banks, while in 13 cases, mergers were between private sector banks and in 5, they were between public sector banks. Out of the 44, 21 M&As took place during

the post reform period, with as many as 22 mergers and amalgamations taking place during 1999 and after. Prior to 1999, the amalgamation of banks was primarily triggered by the weak financials of the banks being merged, whereas in the post 1999 period there have also been mergers between healthy banks, driven by business and commercial considerations. One such was the merger of the Kotak Mahindra Bank that we witnessed just a year or two ago.

Merger and amalgamations involve relatively small banks. The largest number of mergers took place with ICICI Bank, Bank of Baroda and Oriental Bank of Commerce. ICICI Bank replaced many entities to become the second largest bank in the Indian banking sector, after SBI. But with the present merger of the five associate banks and the Bharatiya Mahila Bank, SBI will continue to lead the pack for a long time to come. With this mega merger for which, Sir, we have sought the Guinness Book of World Records, I've mentioned therein.

The number of PSU banks is down to 21. And the vision of Narasimhan Committee of 1991 that SBI progressively merge all the seven subsidiaries with itself, stands achieved, albeit 26 years after it was first envisaged.

Consolidation in Indian banking was also visible beyond the commercial banking space. Following the recommendations of the Vyas Committee 2005, the National Bank for Agriculture and Rural Development amalgamated 196 regional rural banks established under the multi-agency approach to rural lending in the country during a 15-year period till 1990 into 64 banks by 2013. This amalgamation has as yet met with only partial success as the RRBs are still far from achieving the objectives for which they were created in 1975.

If mergers in banking have been so common, the critical question that arises is how should their success be

measured. What are the deciding factors that make a merger proposition stressful, sorry, successful and value creating. Normally it is considered that merger and acquisition activity results in overall benefits to the shareholders when the consolidated post-merger firm is more valuable than the simple sum of the two pre-merger firms. The primary cause of the gain in value is supposed to be the performance improvement following the merger. The notion of performance gains has focused on improvements in any one of the following areas namely efficiency improvements, increased market powers or heightened diversification. Thus, in order to measure the success of M&A amongst banks, the three most prominent methodologies in empirical research are events studies, efficiency studies and performance studies. The event study approach directly measures the impact the merger or acquisition has on shareholders' wealth. Therefore, a successful M&A transaction is one, in which shareholders receive significant positive abnormal returns. Efficiency studies on the other hand, judge an M&A transaction to be successful, if the post-merger efficiency of the combined institution moves closer to the efficient frontier which is usually considered to be the most efficient institution in the sample. Finally, the performance studies consider improved accounting ratios to be a sign of successful M&A transaction. Here I must say, that the only issue that we have in India is that all of these, at least the media and the analysts feel, should be achieved in 90 days, which is really not possible. We need to give any merger time for them to display what I have just talked about. All the methodologies are correct from their particular point of view but none is complete because each one of them adopts different definition of success. The methodologies largely focus on the owners, that is the shareholders of the acquiring institution, to evaluate the success of a merger. Yet it is not clear whether shareholder wealth

creation, increased efficiency or better accounting ratios are actually the best measure to judge the success of an M&A.

Sir, as you rightly said, successful mergers must actually translate into lower cost for consumers and more stable financial markets, and that should be the true measure of success of a merger. This particular question as yet remains largely un-investigated. If one surveys such studies for the US and European market, their conclusions have been rather mixed. Some studies show gains while others don't and their results are sensitive to the time period chosen. But what is evident is, that as banking markets matured over time in these regions, it ought to become more difficult for the acquiring institution to outperform its peers. The takeover market is also very competitive and a bidding bank may be forced to pay a high premium for a target. This in turn will lead to a more critical judgement of the value proposition of transactions by capital markets and will also likely be a drag on the financial performance of the newly combined institution.

After the 2008 western financial crisis, international western banks are downsizing or withdrawing from the Asia Pacific Region. As a result, the ensuing vacuum will be filled by domestic and regional banks with a wave of new competitors, hot on their heels. And this is something that we are seeing in India already. The region is already witnessing new types of competitors from the rapidly developing Fintech sector offering new banking, payment and financing options. Mega banks' rise across the APR will be hastened by the market integration promised also by the upcoming ASEAN economic community which will enable banks to operate more easily across borders. In many countries, therefore, smaller players will need to consolidate if they are to compete against banks from other markets. Governments are introducing a carrot and stick regulation to encourage the emergence of national

champions that can compete more effectively domestically and across borders. Thus, the ultimate deciding factors underlying the success of mergers involves a complex nexus between the characteristics of the partners and transaction specific factors such as geographic focus or product focus and environmental features such as deregulation, government policy and economic conditions. Amongst the most important drivers behind a successful merger in the banking industry are large efficiency and performance differentials between the acquirer and the target, prior acquisition experience, financing M&As with cash rather than stock, and high regulatory efficiency and quality. There is no clear conclusion on whether geographic or product focus or geographic or product diversification is more beneficial for M&As amongst banks.

Furthermore, in the context of banking consolidation process, the report of the Committee on Fuller Capital Account Convertibility observed that some of the smaller banks which specialised in certain areas of business or regions may have a comparative advantage over larger banks by virtue of their core competence. As such emphasis merely for consolidation to mean larger banks, merely by these sorts of mergers may not actually lead to strengthening of the banking system. In other words, there is no immutable relationship between size and additional efficiency.

Now, I will try to address the question whether mergers create values and what is the relevance of bank mergers in India going forward. This is not an easy question to answer. Because the available empirical literature is rather inconclusive on the benefits and as far as Asia is concerned such literature itself is rather sparse. Bank merger and hence consolidation will occur in Asia but the drivers will be different from Europe. In the present geopolitical context, health of the banking sector is invariably the most vital indicator of financial stability as

also currency stability. This is partly dictated by the past history of banking crisis in this region. If the banking sector is government owned, its strength is an expression of national power itself. As John Kenneth Galbraith argued in his book, 'The Anatomy of Power' economics divorced from consideration of the exercise of power is without meaning and certainly without relevance. The example of large government owned Chinese banks who have yielded enormous financial power across various countries in Asia, Africa and Latin America, thus shaping China's foreign policy, becomes obvious from this angle. It is, therefore, my contention that geopolitics will shape the course of banking in APR. But will government ownership provide the banks with resilience and flexibility? A state has the capacity to absorb short term losses in its quest for long term strategic gains. If this principle is exercised through state dominated banks, how far can we take this?

India, the second largest economy in Asia and an aspirant for super power status cannot actually escape this reality. Thus, government has repeated many a times that consolidation in public sector banks is imperative so that Indian banks are globally competitive. It is also essential that domestic banking undergoes some consolidation before we finalise our free trade agreements with ASEAN, so that the cost of the fund advantage is preserved. The reasoning goes equally for other possible FDAs and multilateral agreements that India may sign in the future. However, pure strategic gains can often mask commercial considerations. The success of bank mergers viewed from strategic angle is limited particularly in the Indian context where there are many stakeholders. Besides the government as the largest stake holder, QIPs, customers, employees and the Reserve Bank itself are all important stakeholders in this project. The primary objective of the Reserve Bank and the government in the process of consolidation is to ensure that mergers are not detrimental

to the public interest of the concerned bank's depositors and shareholders. And also, that they do not impinge on financial stability. The Reserve Bank ensures that after a merger, acquisition, re-construction or takeover, the bank or banking group has adequate financial strength and the management has sufficient expertise and integrity.

From a shareholder's point of view that includes both government and institutional investors, mergers must result in shareholder value creation. From a government point of view, besides an increased stream of dividends which forms a part of its non-tax revenues, mergers must also deliver by reducing the dependence of the merged entity on the government for future capital infusion. Mergers in PSU banks must increase the role of internal and market resources and thus reduce government dependence. The efficiency of public resources deployed in PSU banks must increase. From an institutional investor point of view, the available market float of banks shares must appreciate after a merger. These considerations have at least guided the merger decision of SBI and their associate banks. Since capital is the limiting factor in so far as bank business is concerned, after the merger, SBI has moved to an ROE based budgeting along with risk based budgeting in managing its portfolio. The duplication of resources such as in its administrative setup, its branches and ATMs, multiple treasury units as well as duplication of investment in risk and compliance function, will now be reduced. As a merged entity, SBI can now optimise on spatial scale, the deployment of its resources and consolidated man power. Coupled with technology integration, these efficiencies will show up in the future financial and overall business growth.

Sir, you posed a question regarding the reduction of human resources. This is actually an area where the government has very clear ideas. They are not at all keen to see a reduction of human resources employed by the

bank. But luckily India is one of those few countries where banking has still not reached its peak. There is a lot of depth in the entire Indian sub-continent where banking can be extended in very many ways to very many people. And, therefore, we at the present moment do not see any reason for undertaking a cut in resources. However, what will happen will be the reallocation of the human resources in areas that will be more value accretive rather than in areas which are only in the nature of handling transactions. The merger of any two entities throws up this complex issue of human resource management, the employee integration and above all the psychological and perception management. This is true for any type of merger. But in case of banks which are man power intensive, loss of morale after mergers is of a serious consequence. To add to this, there are costs of integration on the employee front. As far as SBI is concerned, HR integration cost was only in respect of VRS. The additional superannuation fund provision for employees of associate banks would be just about Rs. 25 crore a month, which is insignificant given the size of the bank. However, this may not be a case in respect of all future mergers of PSU banks.

Here I would like to say that this is one particular area of merger which received enormous importance in the bank. From day one, we have started a communication exercise to advise the entities getting merged that each and every one of the people would be cared for and their interests would be looked after. Technology has been a huge enabler in this. We have created several blog sites where we could directly put our thoughts and any and everybody of the merged units' employees could also write to us. Grievance portals were put up, FAQ sites were opened and there was a time when our people were answering more than 200 questions on a daily basis, put up by the employees of the entities getting merged. In fact, very recently one of the newspapers pointed out

that the entire market was surprised that there were no employee disturbances or employee grievances that have come to the fore to any great extent. In fact, out of all the promotions and the postings that we have done, we have received only 25 letters of grievances. So, to that extent what was done was to reach out to people, to have people who acted as mentors for the incoming entities and to ensure that whatever were their requirements that we took note of them and within the constraints of the organisation tried to take care of it to the extent possible.

Now the impact of merger on the customers of the entity getting merged in all its dimensions is again not a well-researched area. In case of bank mergers, it is expected that the merged entities will pass on to the customers the efficiency gains. It is also expected that economies of scale will favourably affect the pricing of its products. In case of SBI merger with associate banks, these factors are indeed favourably placed though it will take a little time to play out. After the merger, the cost of funds for the merged entity have only marginally increased by 10 basis points. This too is expected to reduce as the costlier resources of the merged entities get re-priced over time. This is because the merged entities being smaller in size, they would take customer deposits at a higher rate than would be available to the larger entity. It is expected that there will be no adverse impact on the pricing of credit portfolio as the pooling of funds under the common treasury and the rationalisation of branches all over the country will bring down the operational cost and this will compensate for the 10 basis points rise in cost of funds.

From the technology point of view, SBI was way ahead as compared to its erstwhile associate banks. Hence, the erstwhile associate banks' 70 plus million customers will have the advantage of access to better technologies after the merger.

However, I feel that one larger question still remains unanswered. What will be the impact of the bank consolidation on the wider economy as 40% of the domestic savings are parked in bank deposits? Sir, you raised the same question. This is one of the peculiarities of the Indian banking system. We have actually thought about this time and again. If you compare a bank in a developed economy, normally not more than 70% of the resources are deposits. In fact, at the time of Lehmann crisis, it was only 50% that came from deposits. The rest came from the markets and in fact because it came from the markets at the time of the Lehmann crisis, because the market froze and people refused to lend, that banks got into such a crisis. However, what it does do if you have lesser deposits and more market borrowings, is that it makes the ability to transmit the monetary policy signals into the markets that much easier.

In respect of the banks in India, 97% of our resources come from depositors, only 3% are market borrowings. Now, should the Reserve Bank of India cut rates or raise rates, it impacts only that 3% and obviously therefore it is very difficult for us to pass this on to our customers when the actual impact on our cost of funds is so minimal. So, therefore, there is a question that if this is the way our economy is, how will the bank mergers help or hinder whatever is happening in the country.

Consolidation will lead to greater concentration also of the payment and settlement flows among fewer parties within the financial sector. Now is this also going to be a hindrance or is this going to be beneficial? Given the cyber security risks that we currently run, probably this could also be beneficial. However, operational risk could increase with the size of operations as the distance between management and the operational personnel is greater in a larger company and the administrative systems are more complex. There is also a view that the

exercise of market power by the banks resulting from the consolidation could also alter the monetary transmission operating through bank lending to borrowers without direct access to financial markets. In a nutshell, bank merger may increase the systemic risks and therefore mergers guided only by pure capital adequacy considerations are ill advised. Another aspect of bank mergers in the Indian context is the role of Banks in infrastructure lending. After the phasing out of the development financial institutions which catered to long term lending and the persistent lack of liquidity and lack of depth in corporate bond markets, the responsibility of infrastructure lending should not be completely devolved onto the merged banks, because remember, with the merged banks their ability to take bigger bite-size of the loans that are being syndicated will actually increase. Even if the merged entities are better placed in terms of fund mobilisation and cost of funds, the exposure of the banking system to the infrastructure sector and associated asset liability mismatches would not be easy to tackle. In fact, they may become more complex and difficult to handle in a post-merger scenario.

Let me now conclude, over the course of this lecture I have looked at various aspects of bank mergers. Nevertheless, the process of consolidation through mergers and amalgamation gained momentum in India during the latter part of the 1990s, contemporaneously with the global wave of M&As in banking which led to a decline in the number of banks. Mergers and amalgamations were largely market driven with the regulator merely acting as a facilitator. With 36 mergers, there is really no sign that there was loss of competition in Indian banking. In fact, banking in India is still more competitive than most of the advanced markets. The present merger of SBI with its associate banks may, therefore, be a template for future consideration for consolidation of PSU banks. The logic for consolidation in India was based on two explicit or

implicit assumptions. First, there are too many banks in India, second, if the banking sector is to be assessed in the international context, size is an important factor. After the 2008 crisis, we have to live with the reality that too few banks can also be part of the problem and the size of the bank need not always guarantee its survival. Further, size can be both a weakness and strength in the context of the huge changes in technology that we are witnessing on a daily basis. A small nimble bank may be able to evolve rapidly to keep up with the change but may lack the financial strength to continuously incur the required level of spends on technology. A large bank on the other hand may have the financial heft but may lack the ability to internalise change at the speed required. It is, therefore, those institutions that can do both that are likely to come out on top. And as such M&A between banks needs to necessarily answer the question as to the likelihood of the merged entities being capable of being both nimble and yet large.

Lastly, the Indian banking sector is at a critical juncture and is faced with several challenges and issues. These relate to the nature in extent of further consolidation, the changed environment for public sector banks and capital constraints faced by them due to government ownership as well as the further opening up of the banking sector to competition from banks and non-bank entities. The reordering of international trade relations will heighten the need for bank consolidation to preserve our competitiveness. It is important that in the clamour for consolidation we do not ignore the role of small and niche banks. They too have important roles to play in last mile connectivity and grass root innovation. Within this limited context there is indeed scope for consolidation partly dictated by domestic need and partly by national interest.

Before I conclude, I would take this opportunity to state that it has been an enormous privilege for me to serve as the Chairman of State Bank of India.

There were taxing times, testing times and anxious times. But as the joke goes in the community of lawyers, the best case-law emerges from the trial of the most seasoned crook. In the same way, I had a chance to oversee a unique merger in the history of world banking and it is my belief that the successive generation of leaders at SBI as well as in the industry will identify and reap its benefits.

Thank you all.

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