Big Banks not a Solution*

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On August 30, as the media waited for the release of the second quarter growth figures that would reveal severe growth deceleration, Finance Minister Nirmala Sitharaman sought to pre-empt any adverse response with a major policy announcement. Ten public sector banks (PSBs) were to be merged in different combinations to reduce them to 4. The aim, clearly, was to convey an impression of decisive and far-reaching action. That came through when, by adding on the merger of the State Bank of India with its subsidiaries and the Mahila Bank and the forced merger of Dena Bank and Vijaya Bank with the Bank of Baroda, she claimed that the NDA government had reduced the 27 PSBs that existed in 2017 to just 12. But why consolidation of PSBs is a meaningful, let alone a heroic, achievement was left unclear.

The timing of the announcement did suggest that the intention was to present this as an effort to combat the growth slowdown; as one more of a set of stimulus measures, the first round of which had been announced at a press conference held a week earlier. “Having done two rounds of bank consolidation earlier, this is what we want to do for a robust banking system and a $5-trillion economy. We are trying to build next-generation banks, big banks with the capacity to enhance credit,” Sitharaman declared. With larger resources at their disposal, it was claimed, the merged banks would be willing to lend more and bring down the cost of credit, thereby, presumably, spurring growth.

While the choice of which banks to bring together has ostensibly been determined by potential synergies with respect to locational spread and use of technology, the main point being made is that banks are being made bigger through consolidation. Punjab National Bank, Oriental Bank of Commerce and United Bank of India would come together to become the second largest bank after the State Bank of India. The merger of Canara Bank and Syndicate Bank, both with significant southern presence, would make the merged entity the fourth largest. Union Bank of India, Andhra Bank and Corporation bank would when merged be the fifth largest. And Indian Bank and Allahabad Bank together would stand seventh.

Needless to say, domestic ranks do not say much about size when compared with global counterparts, which would still be substantially larger. Yet, consolidation is being presented as a means to improving credit flow and reducing cost. This despite the fact that there is little by way of convincing evidence globally which says that there are generalised economies of scale and scope in banking. A few big banks may help, but only when combined with many medium and small banks with jurisdictional limits and well defined mandates of lending to segments other than large conglomerates, as is the case in Germany and Japan, for example. If not, credit would tend to flow only to larger “established” borrowers, adversely affecting other sectors. Moreover, the big banks would require more regulation. While size does not guarantee better performance, bigger banks tend to be ‘too big to fail’ because of the ripple effects of their closure on the rest of the economy.

The argument that the volume and cost of credit that are crucial for sustaining demand and growth comes from consolidation is misleading for other reasons too. Mergers do not by any means increase the volume of credit that the banking system as a whole can provide. They only increase the average size of loans that a merged entity could provide, when compared with its pre-merger component banks. And being in a position to provide larger loans need not be altogether a good thing, because as the early cases taken up as part of the Insolvency and Bankruptcy Code mandated process showed, a very high proportion of the non-performing assets (NPAs) were multiple large loans provided to a few large corporate groups. In the event, these lending decisions adversely affected solvency of the banks concerned. Taking such loan decisions would be easier now, increasing the potential for similar default.

Further, the cost of lending in India is not fundamentally driven by the costs of intermediation. Even when repo rates are reduced, and banks encouraged to link their lending rates to the repo rates, they have been unwilling to do so. This is partly because they need to make up for losses stemming from NPAs by garnering larger spreads from performing loans. In fact, one measure which the Finance Minister referred to, in the 'stimulus package' she unveiled, is pressure on banks to link lending rates to repo rates so that the structure of rates is lowered as the Reserve Bank of India reduces policy rates over time.

Another way in which consolidation is expected to restore credit growth is by overcoming the drag that accumulated non-performing assets exert on lending. The intensity of this drag is determined by two factors. First, the dampening effect that the sheer burden of NPAs has on the willingness of lenders to lend, especially to areas where NPAs are high. Second, the fact that when the NPA ratio exceeds a certain level, the bank concerned is subject to the RBI's Prompt Corrective Action (PCA) framework, which imposes restrictions on the level and kind of exposure that is possible, reducing the volume of lending.

It should be clear that since mergers do not automatically reduce NPA volumes, the effect of mergers on credit growth would largely result from the fact that the post-merger NPA ratio of the merged entity would be some weighted average of the NPA ratios of the merging entities. This would mean that the highest NPA ratios would be eliminated, making the task of keeping banks out of the PCA framework easier to ensure. Thus, the net NPA ratio of the merged entity with Punjab National Bank as anchor is placed at 6.6 per cent, as compared with 6.55 percent, 5.9 per cent and a high 8.7 per cent of its three components. A similar reduction of the merged entity's NPA ratio relative to the highest NPA of the merging entities would hold in the other cases as well. Add on to this the effort to immediately release Rs. 55,250 crore of the Rs.70,000 crore budgeted for this year for recapitalisation, of which Rs. 38,300 core are earmarked for five of the ten banks identified for this round of mergers, and they are for the time being kept from drowning in their NPA stocks.

The merger may also hasten the process of bad debt resolution through the IBC framework, as the merger of creditors would also consolidate the voting shares in the committee of creditors consisting of the consortium of lenders exposed to the defaulting firm. Since a minimum proportion of votes are required to approve a resolution plan, having those concentrated in the hands of fewer decision makers could help hasten the process. But, as in the case of a merged bank being in a position to provide larger loans, this need not be a good thing. Under pressure to clear their

books of NPAs, the consolidated entities may accept larger than warranted "haircuts", since they are in a position to bear the losses using the benefit of capitalisation funds financed by current and future tax payers. Recognising this possibility, the large and powerful corporate defaulters and bidders in asset auctions, who have already won themselves lucrative deals, may look for larger gains at the expense of the banks and the ordinary tax payer.

All that said, the real problem with the reliance on consolidation to address the stress on public banks resulting from accumulated NPAs, with the hope that successful resolution would revive credit growth, is that it does not address the question as to why large NPAs arose in the first place. The evidence is clear that this happened because the government gave up its role as principal investor in large, long-gestation, capital intensive projects and turned into a facilitator of private investment in such areas. The private sector could be coaxed into undertaking such investments only by promising it reasonable returns and getting the public banking system to overextend itself to finance those activities which were highly leveraged or debt-financed. In practice, not all of those private sector-led projects proved profitable and the firms concerned chose to default on their loan commitments despite repeated rounds of debt restructuring.

The government has not found any alternative way, such as increased tax revenue generation, of financing those capital intensive activities, especially in infrastructural areas where investment requirements are huge and enhancement of capacity critical for development. Just as private investors are unwilling to enter without government support, private finance is unlikely to step in to fill the gap for capital. The most likely way this would be resolved in the immediate future is by the government using its power over a fewer number of larger banks to ensure provision of bigger loans to set off another investment cycle, till the next NPA crisis arrives.

To absolve itself of the responsibility of having to resolve another such crisis the government may decide to give up its ownership of banks, by extending the privatisation drive to the banking sector. Already equity dilution has reduced the government's share in public bank equity considerably. Full privatisation of the banks, after having partially cleaned their books and recapitalised them, would help the government recover part of the capital it outlaid and hand over the responsibility of financing crucial investments to the domestic business groups or foreign banks who may choose to acquire the banks concerned. However, if experience is any guide, foreign controlled banks are unlikely to touch the infrastructural area. And, domestic business groups, if handed control, would as in the past use the banks as conduits for mobilising depositors savings as means of financing their own projects. That would only increase the probability of default and likelihood of bank failure. This would force the state to step in to resolve the banking crisis, rendering the whole trajectory pointless.

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