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GLOBAL FINANCIAL CRISIS AND STRENGTHENING THE BANKING INDUSTRY IN INDIA THROUGH MERGERS AND ACQUISITIONS

MISAL D.M.*

Department of Economics, C.S.P.M. Arts Senior College, N-11, CIDCO, Aurangabad- 431 002, MS, India.
*Corresponding Author: Email- dilipmisal2012@rediffmail.com

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Abstract- This paper studies the impact of financial crisis and Indian policy response to it. It also discusses the role of mergers and acquisitions to deal the financial crisis. India too has to withstand the negative impact of the financial crisis. It is the collective challenge for the bankers, and the RBI to respond to this extraordinary situation effectively and return India to its path of growth and poverty reduction. Consolidation through M&A may be requirement of future. M&A of future should aim at creation of strong entity and to develop ability to withstand the market shocks instead of protecting the interests of depositors of weak banks. The M&As in the banking sector should be driven by market related parameters such as size and scale; geographical and distribution synergies and skills and capacity.

Keywords- Competition, Banking, Globalization, Consolidation

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Introduction

Globalization has ensured that the Indian economy and financial markets cannot stay insulated from the present financial crisis in the developed economies. The global financial crisis of 2008-2009 is an ongoing major financial crisis. It became prominently visible in September 2008 with the failure, merger or conservatorship of several large United States-based financial firms.

The impact on the financial markets will be the following: Equity market will continue to remain in bearish mood with reduced offshore flows, limited domestic appetite due to liquidity pressure and pressure on corporate earnings; while the inflation would stay under control, increased demand for domestic liquidity will push interest rates higher and we are likely to witness gradual rupee depreciation and depleted currency reserves. Overall, while RBI would inject liquidity through CRR/SLR cuts, maintaining growth beyond 7% will be a struggle. Banks around the world, including those in India, are in the forefront of managing the challenge of crisis resolution.

Banking scenario since 1991 has been a process of transformation and consolidation. With financial sector reforms implementation, the overall environment of banking sector has undergone radical change. Consolidation in the banking sector is crucial from various aspects. The factors inducing consolidation include technological progress, excess retention capacity, emerging opportunities and deregulation of geographic, functional and other restrictions. A strong banking sector is critical for sound economic growth. Since more than one decade, the banking industry has been transformed throughout the world from highly protected and regulated industry to a competitive and de-regulated one. Especially globalization coupled with technological development, has shrunk the boundaries by which financial services and products are being provided to customers residing at any part of the globe. Further due to innovation and improvements in service delivery channels, the trend of global banking has been marked by twin phenomena of consolidation and convergence. The trend towards consolidation has been driven by the need to attain meaningful balance sheet size and market share in the face of intensified competition whereas the trend towards convergence is driven across the industry to provide most of the financial services such as banking, insurance, investment, cash management, etc. to the customers under one roof and moving towards universal banking.

This paper studies the impact of financial crisis and Indian policy response to it. It also discusses the role of mergers and acquisitions to deal the financial crisis.

Impact of the Crisis on India

The global financial crisis, brewing for a while, really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fell, large financial institutions collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.

On the one hand, many people think that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelihoods of almost everyone in an increasingly interconnected world. The problem could have been avoided, if ideologues supporting the current economics models weren't so vocal, influential and inconsiderate of others' viewpoints and concerns.

India too has to withstand the negative impact of the crisis. As the impact on India unfolds, there are two frequently asked questions: First, how is that India is affected when it came out of the Asian crisis relatively unscathed? Second, why is India affected even when its exports account for only 15% of its GDP? The answer to both the questions lies in globalization. Going by the common measure of globalization, India's two-way trade (merchandise exports plus imports), as a proportion of GDP, grew from 21.2% in 1997-98, the year of the Asian crisis, to 34.7% in 2007-08. The ratio of total external transactions (gross current account flows plus gross capital flows) to GDP, has increased from 46.8% in 1997-98 to 117.4% in 2007-08. These numbers are clear evidence of India's increasing integration into the world economy over the last 10 years.

There is also another important difference between the crisis in the advanced countries and the developments in India. While in the advanced countries the contagion spread from the financial to the real sector, in India, the slowdown in the real sector is affecting the financial sector, which in turn, has a second-order impact on the real sector.

The Financial Crisis and the Indian Response

After the international financial crisis even the most ardent market fundamentalists now recognize that markets often fail, and the governments have to correct the markets equitably and efficiently. During the current financial crisis the government seems to be following a similar conventional approach of market management, without directly addressing the source of the problem. Traditionally during a financial crisis, the Central banks act as lenders of last resort, lending liquidity to the banks. In India, RBI is returning some of the liquidities of the banking system that it held as reserves. As a lender of last resort, RBI would provide such liquidity only to those banks that needed them.

No doubt our banks are suffering from liquidity crunch for some time, caused by our earlier policy of liquidity withdrawal to manage inflation. The RBI's attempts to contain the fall in the exchange rate of rupee by selling dollar is also withdrawing rupees. Most important however is in falling stock markets, FII investors take away dollars by surrendering rupees. But injection of rupee by the RBI into the system will not necessarily increase bank lending unless borrowers have the confidence in the sustainability of our economy to induce them to increase their investment and the banks have the confidence that these borrowers will be able to pay back.

The Indian banking system is not directly exposed to the sub-prime mortgage assets. It has very limited indirect exposure to the US mortgage market, or to the failed institutions or stressed assets. Indian banks, both in the public sector and in the private sector, are financially sound, well capitalized and well regulated. The average capital to risk-weighted assets ratio (CRAR) for the Indian banking system, as at end March 2008, was 12.6%, as against the regulatory minimum of 9% and the Basel norm of 8%. Even so, India is experiencing the knock-on effects of the global crisis, through the monetary, financial and real channels all of which are coming on top of the already expected cyclical moderation in growth.

The Reserve Bank's monetary policy stance has consistently been to balance growth, inflation and financial stability concerns. When inflation surged earlier this year, the RBI had moved quickly to tighten policy. Then again, reflecting the unfolding global situation and expectation of decline in inflation, RBI has adjusted its monetary stance over the last couple of months. The endeavour of our monetary stance has been to manage liquidity-both domestic and FOREX liquidity-and to ensure that credit continues to flow for productive activities.

The RBI has taken several measures aimed at infusing rupee as well as foreign exchange liquidity and to maintain credit flow to productive sectors of the economy. Measures aimed at expanding the rupee liquidity included significant reduction in the cash reserve ratio (CRR), reduction of the statutory liquidity ratio (SLR), opening a special repo window under the liquidity adjustment facility (LAF) for banks for on-lending to the non-banking financial companies (NBFCs), housing finance companies (HFCs) and mutual funds (MFs), and extending a special refinance facility, which banks can access without any collateral. The Reserve Bank is also unwinding the Market Stabilization Scheme (MSS) securities, roughly synchronized with the government borrowing programme, in order to manage liquidity.

Our financial markets - equity market, money market, forex market and credit market - have all come under pressure mainly because of what we have begun to call 'the substitution effect' of:

- Drying up of overseas financing for Indian banks and Indian corporate;
- Constraints in raising funds in a bearish domestic capital market; and
- Decline in the internal accruals of the corporate. All these factors added to the pressure on the domestic credit market.

Need for Consolidation

In India, we have large number of small banks. As of March 2004, the number of scheduled Commercial banks in the country was 90. As a result Indian banks lack global size. The list of the world's top 1000 banks has only 20 Indian banks, out which only 6 are in the top 500. At present out of so many banks in India, only one i.e., SBI, figures in the largest 200 banks of the world. Even a small country like Taiwan has many bigger banks when compared to the biggest bank of India [8]. Indian market is over banked but under serviced. The existence of too many banks splitting customer accounts has resulted in low profitability per customer per bank and higher pricing for customers.

The efficiency ratio is also low due to policies relating to employees and social obligations are preventing leveraging of technology, market based compensation and international levels of profitability. Therefore from the point of view of the financial systems, we need consolidation. The objective would be strengthening of banks, economies of scale, global competitiveness, cheaper financial services and retaining of employees for emerging skill sets.

The consolidation in banking industry has further become important due to the reasons such as: Unhealthy competition among banks; expansion of branches, unviable branches; clusters of branches of various banks at particular centers, regional imbalance/unequal URS; improper deployment of staff; inter-zone transfer policy of officers up to specified scale in various banks; uneven promotions; and computerization/installation of ATMs/ Networking/ Core banking solution. Mergers and Acquisitions (M&A) in Indian banking is not new and dates back from Imperial Bank of Indian which was formed by the amalgamation of the three banks-the Bank of Bengal, the Bank of Bombay and the Bank of Madras, in 1921 [9]. Few mergers have taken place thereafter primarily to protect the interests of de-

positors of weak private banks. The mergers were not for economic considerations and usually distress mergers, eg. Mergers of Bank of Cochin and Kashinath Seth Bank with SBI, merger of New Bank of India with Punjab National Bank, merger of Laxmi commercial Bank with Canara Bank, Bank of Karad with Bank of India, Nedungadi Bank with PNB, Global Trust Bank with Oriental Bank of Commerce, and IDBI with IDBI Bank. But the Times Bank merger with HDFC Bank and Bank of Madhura with ICICI Bank, created new wave of consolidation in the Indian banking industry for mutual benefit. These mergers are created by market driven forces and are not bail out mergers.

Currently, Large Indian banks such as State Bank of India, Bank of Baroda and ICICI Bank are planning their strategies to increase their balance sheet size through M&A. Medium sized banks such as HDFC Bank, Corporation Bank, PNB are looking out for suitable merger targets. Small banks such as UTI Bank and Vysya Bank are also in the fray for acquisition of banks. Bank of Baroda is on the look out for a bank with presence in north, east and south. Bangalore based Vijaya Bank is keen on buying a northern bank while PNB is looking southwards. The Chennai based Indian Bank has already begun the process of identifying two new targets [6]. The bank consolidation/merger process should come voluntarily from the banks themselves, depending on the organizational synergy and market share.

The Indian banking industry expects consolidation to bring in several future benefits. But many fear that the desire for size is leading to unhealthy creation of super banks. Sectoral consolidation and reduction in competition do not give immediate benefits for customers or staffs who are directly affected by rationalization of jobs. A study by the Bank for International Settlements (BIS) reports the experience of majority of the mergers as "disappointing" with organizational problems almost inevitably underestimated and most acquisitions overpriced, noting the creation of banks "too big to fail" [12]. Such super banks may encourage complacency and also may lead to inefficiency. When such banks fail, the host Governments may be forced to use taxpayers money to bail out such banks. As a result such banks are encouraged to pursue imprudent credit and investment policies, and may also carry systematic risk along with them.

Conclusion

Developments in the real economy, financial markets and global commodity prices point to a period of moderation in growth with declining inflation. What is heartening though is that the fundamentals of our economy continue to be strong. Once calm and confidence are restored in the global markets, economic activity in India will recover sharply. But a period of painful adjustment is inevitable. It is the collective challenge for the bankers, and the RBI to respond to this extraordinary situation effectively and return India to its path of growth and poverty reduction. Consolidation through M&A may be requirement of future. M&A of future should aim at creation of strong entity and to develop ability to withstand the market shocks instead of protecting the interests of depositors of weak banks. The M&As in the banking sector should be driven by market related parameters such as size and scale; geographical and distribution synergies and skills and capacity. The emerging market dynamics like falling interest rate regime which makes the spread thinner; increasing focus on retail banking, enhanced quest for rural credit, felt need for increasing more profits especially from operations, reduction of NPA's in absolute terms, need for more capital to augment the technology needs, etc are the major drivers for mergers and acquisitions in the banking sector.

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