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Banks should grow, not merge

Public sector banks need to make acquisitions overseas to build a multinational presence that matches what their customers are demanding

As one of the well-deserved survivors of the financial mess of the past three years, India has earned the right to conduct the debate about the future shape of its financial system on its own terms. There is no need to fling open capital markets, plan for full convertibility, allow immediate foreign takeovers of banks, or any of the other heresies proposed by visiting grandees who are now out of job. But there is an urgent need to ensure faster economic growth, and make sure that Indian banks are freed up to help deliver it.

Getting more capital into the balance sheets of banks to enable wider extension of credit throughout the economy has long been the obvious solution, which government policies still resolutely oppose. There is the old taboo against public ownership below 51 per cent, the barrier against new entry by private entrepreneurs into banking (though Pranab Mukherjee seems to have relented on this in his budget speech), the curb on expansion by foreign banks, the compulsory deficit financing via government bonds masquerading as prudential liquidity requirements.

The budget speech did point to some progress. New bank licences will be awarded after a five-year standstill, and the government is sensibly using World Bank money to meet a short-term requirement to contribute its share of capital increases in public sector banks. In the longer run, there is no way to reconcile continued control of public sector banks and the government's shortage of money – and equally, almost no prospect of either of these constraints being removed.

Will the still-dominant public sector banks eventually suffer the same fate as certain other Indian institutions like Air India that could neither be effectively privatised nor reconciled with public ownership? In these cases, India has ended up building new privately owned institutions alongside the old unreformed public sector entities, and has then allowed the state sector, as Karl Marx once expressed it, to wither away.

This is the threat that prompts industry leaders such as State Bank of India's O.P. Bhatt to argue for freedom to consolidate among Indian banks, as well as removal of constraints on growth. India does need banks that are big enough – the size of SBI or ICICI or larger, but

not necessarily giants – to follow the biggest Indian companies as they expand into world markets. Public sector banks will, like their privately controlled competitors, need to make acquisitions overseas to build a multinational presence and capability that matches what their customers are demanding. And, as their relative position weakens, at least some public sector banks will also need to combine to defend themselves against the growing power of private banks.

Consolidation will therefore be a useful strategic response for particular public sector banks, responding to specific commercial pressures, as the industry develops – to their disadvantage – over the next few years. But a general consolidation of the industry is not a useful policy for the government to pursue as it tries to resolve its own self-contradictory interventions in the banking sector.

The experience of other countries suggests that Indian industry does not need a financial system led by giant banks to prosper, and would be better off without them. Germany, the world's largest exporter, has managed to produce only one ocean-going multinational bank. Attempts to create others were undermined by state subsidies to regional banks, which served local customers well, but had the unintended consequence of preventing the growth of big national private-sector deposit-taking banks.

In the UK, businesses have worried for nearly a century that excessive concentration in banking stifles entrepreneurs and local initiative. These worries were ignored while the banks prospered from international markets, but the UK has ended up in 2010 with 80 per cent of personal bank accounts, 75 per cent of retail savings and 50 per cent of personal loans and mortgages in the hands of just four overstretched and over-centralised banks.

Chidambaram teased SBI's chairman recently by saying that India's biggest bank had missed a chance to buy Citi when it was trading at \$1 a share. Thank goodness it was only a joke. Gordon Brown wasn't joking when he urged Britain's Lloyds TSB Bank to buy excessive market share on the cheap by taking over the stricken HBOS late in 2008. The deal brought what had been one of the country's best managed banks close to ruin. ♦