REVIEW PAPER

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Competition, Consolidation and Convergence in the Indian Banking Industry- A path to $5 trillion economy

Anukriti Agrawal[1], K.K. Agarwal[2]

[1]Research Scholar (JRF), Department of Commerce, Mahatma Gandhi Kashi Vidyapith, Varanasi

[2]Professor, Department of Commerce, Mahatma Gandhi Kashi Vidyapith, Varanasi

Abstract

Banking is the backbone of any economy as it has a direct bearing with financial and economic development. India is currently $3.469 trillion economy. To achieve the target of $5 trillion economy, policy changes for India must include the reforms in the banking sector. In the banking industry, competition is crucial for maximising efficiency. The banking sector is going through unprecedented consolidation efforts through mergers and acquisitions. Financial inclusion is aided by consolidation. This gives banks greater resources with which to lend money and make investments and expand their geographical reach. The financial sector's convergence is expanding quite quickly. Financial convergence aids banks in portfolio diversification. Financial Convergence relates to all types of interfaces between financial suppliers and the demand of all types of financial products and services. In this paper we have specifically discussed about convergence between banking sector and insurance sector. This paper highlights various approaches to assessing competition, models of bancassurance, benefits and challenges of bancassurance for banks and the expected value of bancassurance market by 2027. This paper has analyzed the changes in various financial ratios like Gross Non Performing Assets (GNPA), Net Non-Performing Assets (NNPA), Common Equity Tier- 1(CET-1) etc. of Union Bank of India after merger. This paper aims to study that how a more competitive, consolidated and convergent banking industry would contribute in making India a $5 trillion economy.

Keywords: Competition, Consolidation, Mergers, Convergence, Bancassurance

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Introduction

The aim of the banking sector reforms undertaken in India from 1992 onwards was to make the banking system more safe, sound, efficient, diverse and competitive. The financial sector reforms have provided the necessary platform for the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing productivity and profitability. Competition boosts innovation by both existing and entrant firms, allows consumers to buy at lower prices and choose among different producer of goods and services which ultimately benefits the society. Promoting competition is one of the key objectives of financial sector reforms. The deregulation process has brought in more competition in the banking sector, resulting in delivery of innovative financial products at competitive rates. It is very important to assess the level of competition in the banking industry. When competition intensifies, there has to be inevitable changes such as mergers. The net result in any field is either the crowding out of the weaker players or their amalgamations with the stronger ones. It helps the banks in strengthening their balance sheets as assets and liabilities of all the banks in question are merged. The pace of consolidation in the banking industry is increasing. The next five years would make the past five years look tame as a new banking industry structure would take place. Because Mergers & Acquisitions (M&A) is one of the most effective ways to stake out territory, it is a critical issue on any management agenda today. Mergers help in exploiting synergies, reducing overlap in operations, right-sizing and redeploying surplus staff either by retraining or alternate employment or voluntary retirement. In countries where the boundaries between the different sub-sectors have broken down, the majority of the banks and insurance companies have engaged in cross selling each other's

Corresponding Author: Anukriti Agrawal, Research Scholar (JRF), Department of Commerce, Mahatma Gandhi Kashi Vidyapith, Varanasi, E-mail: anukritiagra18@gmail.com

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products.. Bancassurance arrangement is advantageous for both the firms. It strengthens the product portfolio of banks. The financial services industry is undergoing a drastic change through consolidation and convergence. Banking industry's contribution in India's GDP can be raised by making it more massive and diverse.

Review of Literature

Azem Ahmed Khan (2011): The authors focused on explaining the various motives for mergers and acquisitions in India. The results of this study witnessed that mergers and acquisitions helped in declaration of dividends to equity shareholders.

Baumol (1982): The theory of contestable markets provides the theoretical rationale for competition studies. The theory tells that in a contestable market there are no entry or exit barriers.

Kotnal Jaya Shree (2016): In the paper titled "The economic impact of mergers and acquisitions on profitability of SBI", various motives of merger in Indian Banking Industry were studied. It also compared pre-merger and post-merger financial performance of merging banks with the help of financial parameters like gross profit margin, net profit margin, operating profit etc.

Krishnamurthy, Mony, Jhaveri, Bakhshi, Bhat and Dixit (2005): The authors concluded that penetration of bancassurance depends on quality of services provided by the banks and awareness of insurance products to meet the needs of customers.

Prasad and Ghosh (2005): This study computed the Panzar and Rosse H-statistic of Indian banks using data of 64 commercial banks for the period 1997-2004 and found that the Indian banking market demonstrated a monopolistic competition.

Research Gap

After reviewing many literatures, it was found that none of the researches have been done which has combined all the three C's (Competition, Consolidation and Convergence) of banking industry and explained their contribution in making India a $5 trillion economy.

Objectives of the study

- To review the approaches to measuring and assessing competition.
- To analyze some of the financial parameters of Union Bank of India post-merger.
- To critically examine the strategy of Bancassurance.
- To assess the contribution of a competitive, consolidated and convergent banking structure in making India a $5 trillion economy.

Research Methodology

Research Design-

The study has followed a descriptive research approach.

Collection of Data-

The data collected is secondary in nature. Various official websites, journals, newspapers, conference proceedings have been referred.

Sample-

Union Bank of India has been taken as a sample.

Time period-

F. Y's 2020-2021, 2021-2022 and the first quarter of F.Y 2022-2023 has been taken into consideration.

Tools and Techniques-

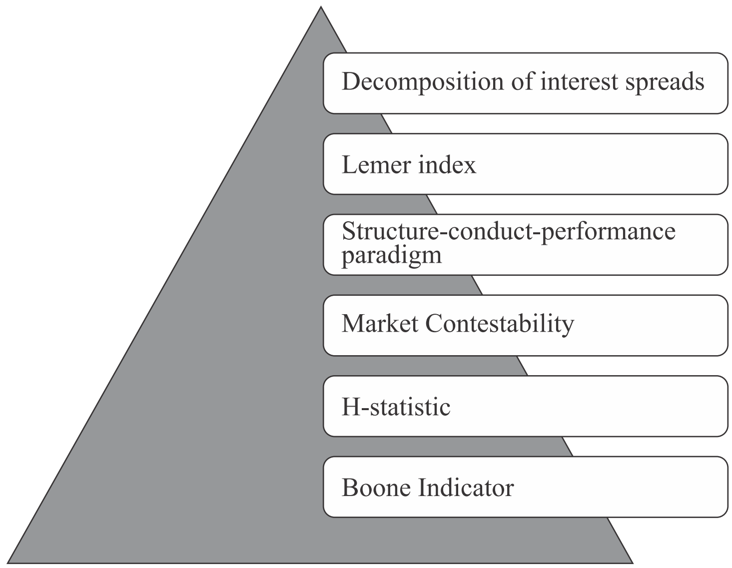
M.S Excel has been used for calculating ratios and preparing charts and graphs. The various financial ratios that have been analyzed are Gross Non Performing Assets (GNPA), Non-Performing Assets (NNPA), Common Equity Tier-1(CET-1), Provisioning Coverage Ratio(PCR), Return on Equity and Earnings Per Share and Compounded Annual Growth Rate(CAGR).

Competition in the banking sector

The global financial crisis reignited the interest of policy makers and academician in bank competition. Competition in the banking system is desirable for efficiency and maximization of social welfare. It is important to ensure that banking sector is not only competitive and efficient, but also stable. Competition is supposed to make banks more efficient and stimulate financial innovation by opening up of new markets.

Competition does not mean that banks cannot enter into strategic alliances. The clearing house is one form of strategic cooperation already in place. Some areas where banks can enter into strategic alliances are Technology related, marketing related and organization related.

Approaches to measuring and assessing competition

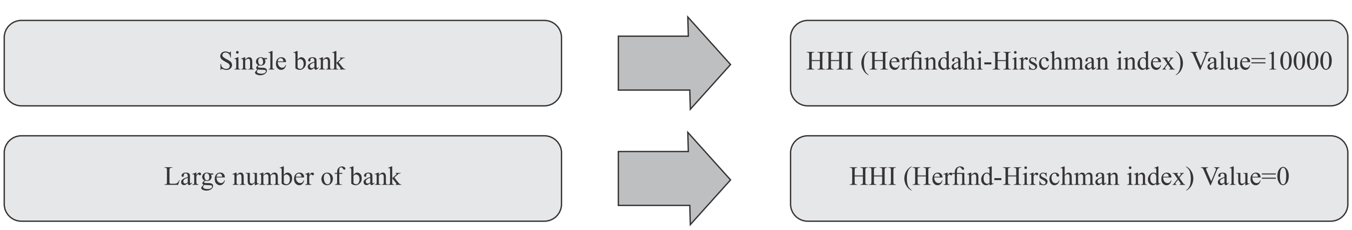


Decomposition of interest spreads-

Spreads are outcome measures of efficiency. Cross country differences in spreads can reflect macroeconomic performance, the extent of taxation and bank specific factors such as scale and risk preferences. These effects need to be controlled for before analyzing competition.

Structure-conduct-performance paradigm-

This paradigm assumes that there is a stable, causal relationship between the structure of the banking industry, firm conduct and performance. In this framework, competition is negatively related to measures of concentration. According to this approach, banking concentration can be approximated by the concentration ratio—the Herfindahl-Hirschman index (HHI), the sum of the squared market share of each bank in the system. The concentration ratio varies between nearly 0 and 100.



Market contestability-

The behaviour of banks in contestable markets is determined by threat of entry and exit. Banks are pressured to behave competitively in an industry with low entry restrictions on new banks and easy exit conditions for unprofitable institutions.

H-statistic-

It captures the elasticity of bank interest revenues to input prices. It is calculated in two steps. Firstly, running a regression of the log of gross total revenues on log measures of banks' input prices. Secondly, adding the estimated coefficients for each input price. Input prices include the price of deposits, the price of personnel and the price of equipment and fixed capital. Higher values of the H-statistic are associated with more competitive banking system.

In Monopoly an increase in input prices results in fall in output and revenue leading to H-statistic<=1.

In Perfect Competition an Increase in input prices results in rise in output and revenue leading to H-statistic=1.

Lerner index-

It is defined as the difference between output prices and marginal costs. Prices are calculated as total bank revenue over assets whereas marginal costs are obtained from an estimated translog cost function with respect to output. Higher values of the Lerner index signal less bank competition.

Boone indicator-

It measures the effect of efficiency on performance in terms of profits. It is calculated as the elasticity of profits to marginal costs. The more negative the Boone indicator is, the higher the level of competition is in the market, because the effect of reallocation is stronger. (The World Bank, 2016)Consolidation in the Banking Sector

The world is being affected by the rapidly changing technology and the forces of globalization. Companies are exploring different strategies in order to grow internally as well as externally. The Indian banking system has achieved various milestones in a relatively short amount of time. It is the part of the agenda of the government to reform the banking sector by repositioning and integrating it into the global financial system. In the past years, there have been various reforms and successful mergers which have had a positive impact on the banking sector.

Various motives behind mergers and acquisitions in banking sector are-

Internal Motives	**External Motives**
To increase capital/shareholders' equity.	*Economic-* To respond to the changing economic conditions in a bank's environment.
To achieve efficiency through economies of scale.	*Legal & political-* To obtain tax benefits, to gain government support.
To gain access to better and greater resources.	*Technological-* To enhance learning and obtain new knowledge, to combine superior technology.

Various mergers and acquisitions have been taken place in the past years. In August 2019, merger of 10 public sector banks into four entities was announced. The total number of Public Sector Banks reduced to 12 from 27.

Oriental Bank of Commerce and United Bank of India were merged with the Punjab National Bank. Punjab National Bank is now the 2nd largest bank.

Syndicate Bank was merged with Canara Bank. Canara Bank is now the 4rth largest public sector bank.

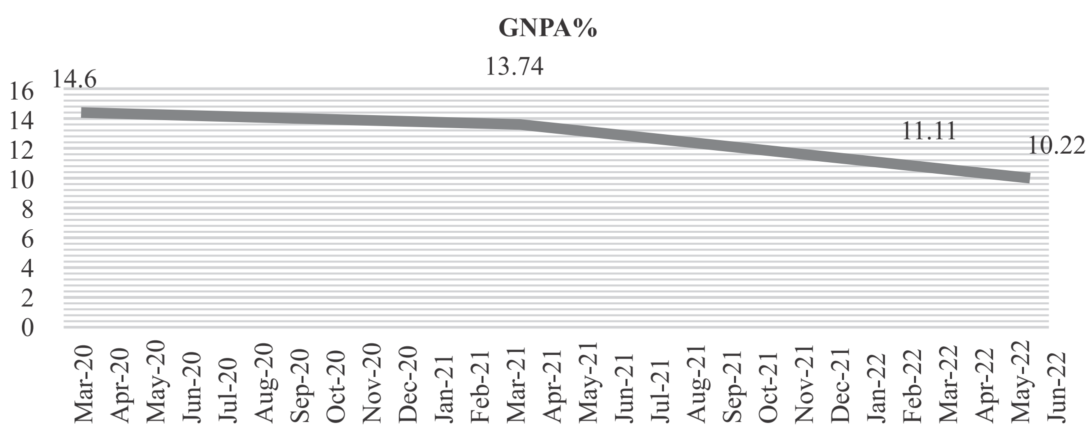
Andhra Bank and Corporation Bank were merged with Union Bank of India. Union Bank of India is now the 5th largest public sector bank.

Allahabad Bank was merged with Indian Bank. Indian Bank is now the 7th largest public sector bank.

Data Analysis and Interpretation

Amalgamation of Andhra Bank and Corporation Bank into Union Bank of India Scheme came into force on April 1,2020.

Here we have analysed the changes in financial parameters like GNPA%, NNPA%, CET-1%, PCR%, Return on Equity and Earnings Per Share of Union Bank of India post merger.

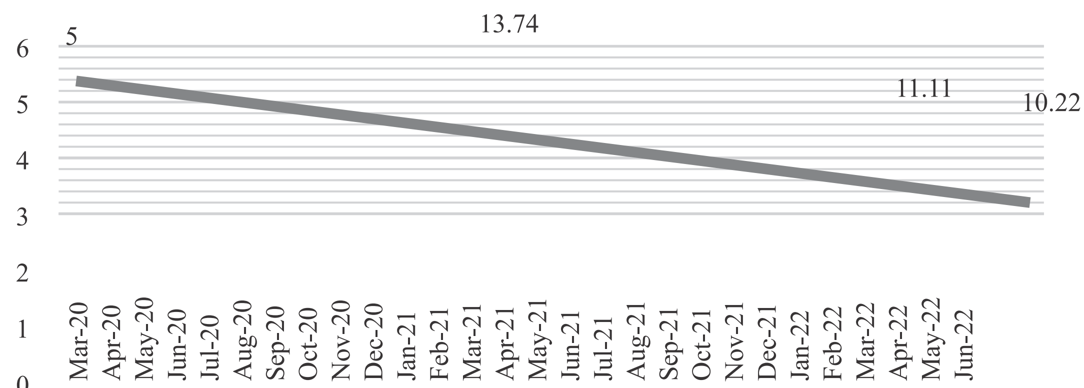


	Mar-20	Mar-21	Mar-22	Jun-22
GNPA(%)	14.6	13.74	11.11	10.22

Source: Annual Report, United Bank of India

The **Gross Net Performing Assets**(GNPA)%was 14.6% in March 2020. GNPA% decreased to 13.74% in March 2021 and further decreased to 11.11% in March 2022 and further to 10.22% in first quarter of FY 2022-2023. Thus there is improvement in GNPA% YoY. Lower the GNPA ratio, better would be the asset quality of banks.

NNPA%

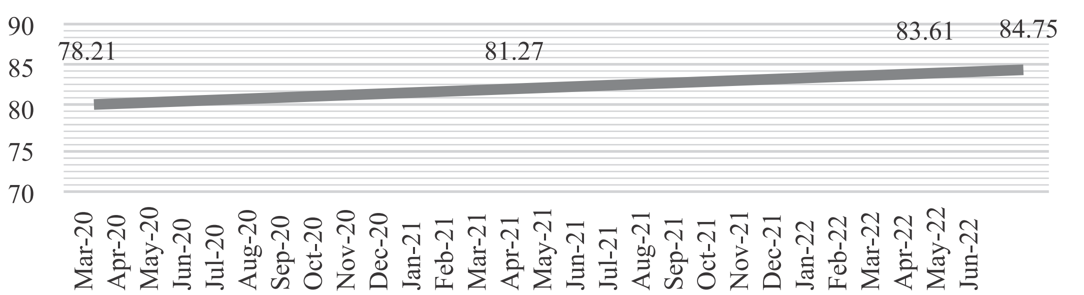


	Mar-20	Mar-21	Mar-22	Jun-22
NNPA(%)	5.22	4.62	3.68	3.31

Source: Annual Report, United Bank of India

The *Net Non-Performing Assets* (NNPA) was 5.22% in March 2020. NNPA% decreased to 4.62% in March 2021. It further decreased to 3.68% in March 2022 and further decreased3.31% in first quarter of F.Y 2022-2023. This indicates improvement in NNPA% YoY. NNPA% must constantly decrease as it affects the profitability and liquidity position of banks.

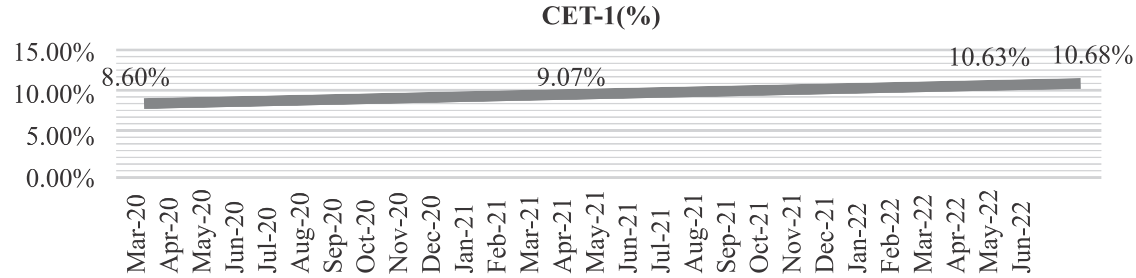
PCR%



	Mar-20	Mar-21	Mar-22	Jun-22
PCR(%)	78.21	81.27	83.61	84.75

Source: Annual Report, United Bank of India

The figure above shows that the *Provisioning Coverage Ratio* (PCR) is 78.21% in March 2020. The PCR% increased to 81.27% in March 2021. It further increased to 83.61% in March 2022 and further to 84.75% in the first quarter of F.Y 2022-2023. Thus we can say that there has been continuous increase in the PCR% after merger. A higher PCR ratio means most asset quality issues have been taken care of and the bank is not vulnerable. It can be beneficial to banks to buffer themselves against losses if the NPAs start increasing faster.



	Mar-20	Mar-21	Mar-22	Jun-22
CET-1(%)	8.60%	9.07%	10.63%	10.68%

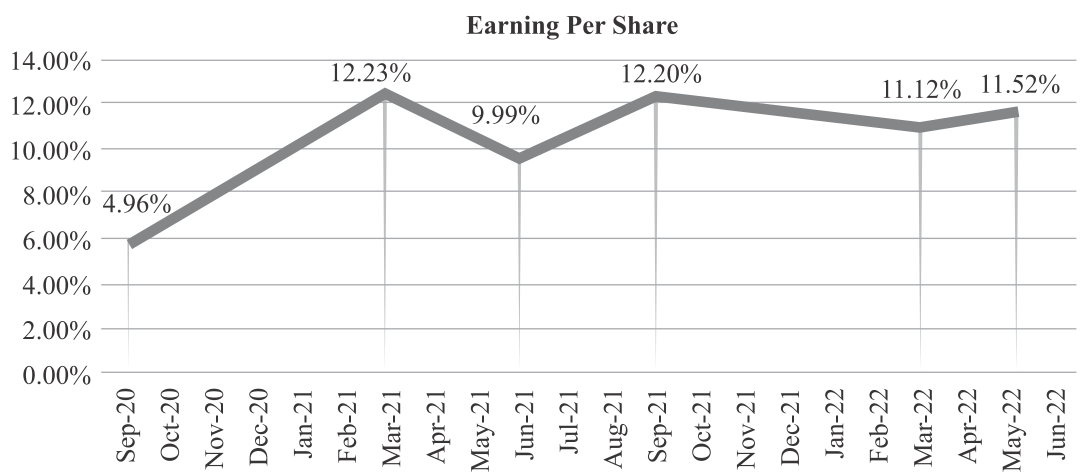
Source: Annual Report, United Bank of India

The figure above shows that the *Common Equity Tier 1* is 8.6% in March 2020. The Tier 1 capital ratio increased to 9.07% in March 2021. It further increased to 10.63% in March 2022 and further to 10.68% in first quarter of F.Y 2022-2023. It shows that continuously two years after the merger till the first quarter of FY 2023, the CET-1% has been increasing. A higher ratio indicates that a bank can absorb a reasonable amount of losses without risk of failure.

	Sep-20	Mar-21	Jun-21	Sep-21	Mar-22	Jun-22
Return on Equity(%)	4.96%	12.23%	9.99%	12.20%	11.12%	11.52%

Source: Annual Report, United Bank of India

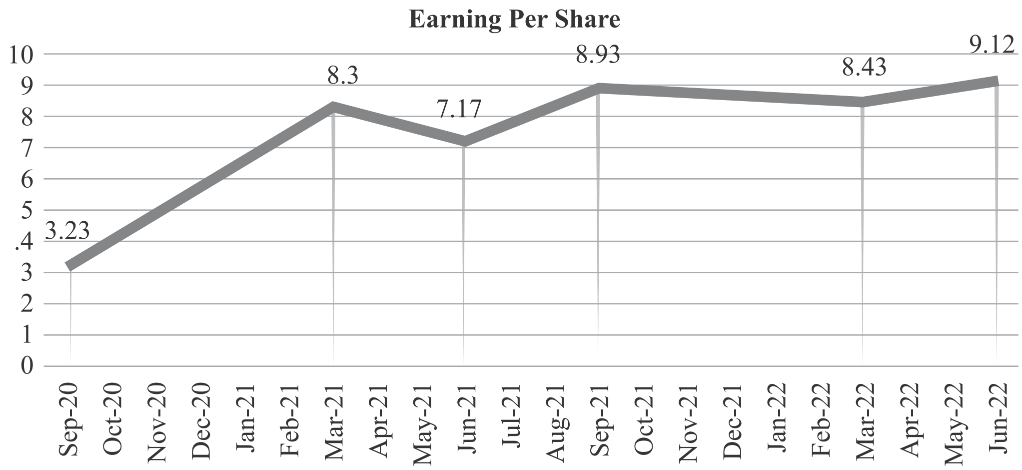
The figure above shows that the *Common Equity Tier* 1 is 8.6% in March 2020. The Tier 1 capital ratio increased to 9.07% in March 2021. It further increased to 10.63% in March 2022 and further to 10.68% in first quarter of F.Y 2022-2023. It shows that continuously two years after the merger till the first quarter of FY 2023, the CET-1% has been increasing. A higher ratio indicates that a bank can absorb a reasonable amount of losses without risk of failure.



	Sep-20	Mar-21	Jun-21	Sep-21	Mar-22	Jun-22
Return on Equity (%)	4.96%	12.23%	9.99%	12.20%	11.12%	11.52%

Source: Annual Report, United Bank of India

The above table shows that the *return on equity* was 4.96% in second quarter of FY 2020- 2021 and it increased to 12.20% in second quarter of FY 2021-2022. The half yearly return on equity was 4.08% in FY 2020-2021 and it increased to 10.82% in FY 2021-2022. The return on equity was 9.99 % in first quarter of FY 2021-2022 and it increased to 11.12% in fourth quarter of FY 2021-2022 and it further increased to 11.52% in first quarter of FY 2022-2023. A higher Return on equity signals that a company efficiently uses its shareholder's equity to generate income.



	Sep-20	Mar-21	Jun-21	Sep-21	Mar-22	Jun-22
Earning Per Share	3.23	8.3	7.17	8.93	8.43	9.12

Source: Annual Report, United Bank of India

The table also depicts that the *Earnings Per Share* was 3.23 in second quarter of FY 2020- 2021 and it increased to 8.93 in second quarter of FY 2021-2022. The half yearly earnings per share was 2.65 in FY 2020-2021 and it increased to 8.07 in FY 2021-2022. The Earnings Per Share was 7.17 in first quarter of FY 2021-2022 and it increased to 8.43 in fourth quarter of FY 2021-2022 and it further increased to 9.12 in fourth quarter of FY 2022-2023. There has been rise and fall in the Earnings Per Share. A higher Earnings Per Share indicates greater value because investors will pay more for a company's shares if they think the company has higher profits relative to its share price.

Convergence in the Banking Industry

The growing convergence in the financial services industry and more particularly the convergence between the banking and insurance industry has received widespread attention in both academic as well as in business literature. Bancassurance is the strategy of a bank to cross sell insurance products branches through its own distribution channels usually branches.

Models of Bancassurance

Full integration	Strategic Alliance	Joint Venture Model	Financial Services Group
This arrangement entails a full integration of banking and insurance services. The insurance activities are deeply integrated within the processes of bank. All of the insurance products are sold under bank brand thereby acting as complete solution of financial services required by customers. The alliances of SBI Life and ICICI Prudential fall in this category, where the customer database of SBI and ICICI gives the leads for the insurance companies to work upon.	There is a tie up between a bank and insurance company. The bank only markets the products of the insurance company.. Here, the infrastructure of banking company is leveraged by insurer who in return provides a source of fee income to banks. This model is characterized by low level integration in between product and distribution channel management. An example of this model would be HDFC bank working with HDFC ERGO general insurance and HDFC Life Insurance Company.	In this model, there is active participation of bank in product as well as distribution design. All decisions are jointly taken by bank and insurance company. There is high system integration for utilization of infrastructure. The banks generate higher level of profits by operating as insurance distributor instead of producer. It is low- cost model where insurer exercise no control over distribution. For example - there is joint venture among India's first Life Insurance Co. and Bank of Baroda (44%), Andhra Pradesh (30%) and UK investment company known as Legal and General (26%).	This model serves as one-stop shop for all financial product and services. All the customer needs are available under same roof. This model involves low cost and customers get convenience as they are able to fulfill all needs at single place.

Benefits of Bancassurance to Banks

- With bancassurance, insurance is added to the mix of financial products being offered by banks. This diversifies the portfolio of customers.
- It is one of the best ways to offer another source of income for banks. Banks get additional fee based profits.
- There is increase in efficiency and profits of banks.
- Providing integrated financial services strengthens customer relationships and builds better customer loyality and retention levels.

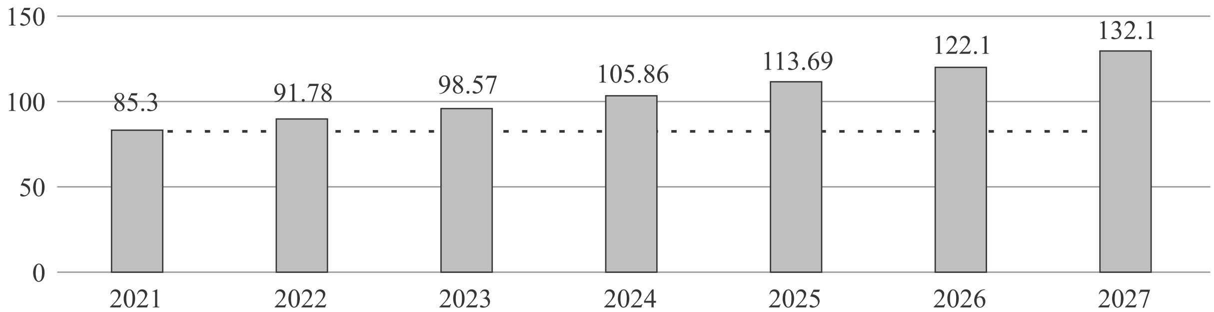
Challenges of Bancassurance

- Needs cooperation between banks and insurance firms.
- Increases the workload of employees.
- Difficult to identify legal responsibility in case of default.
- High initial investment in systems,processes and training of people.

Indian Bancassurance Market

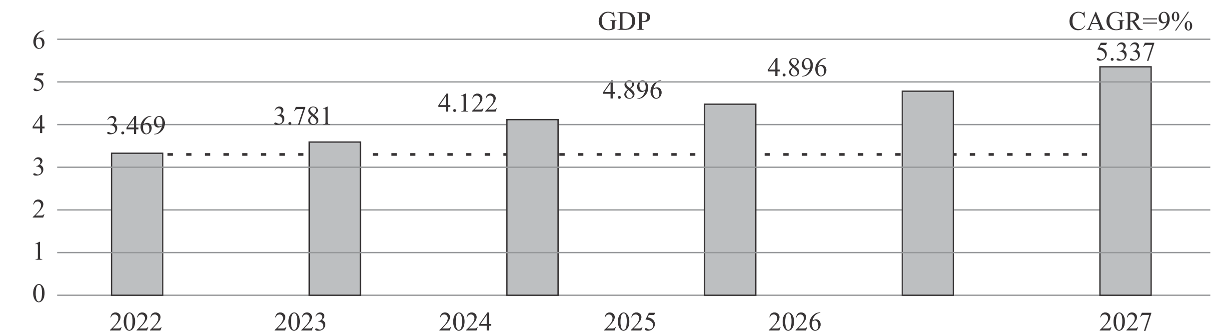
Market Value in 2021	US$ 85.3 Billion
Expected Market Value by 2027	US$ 132.1 Billion
CAGR	7.41%

Indian Bancassurance Market (Value in US$ Billion)



Source: *Author's own calculation*

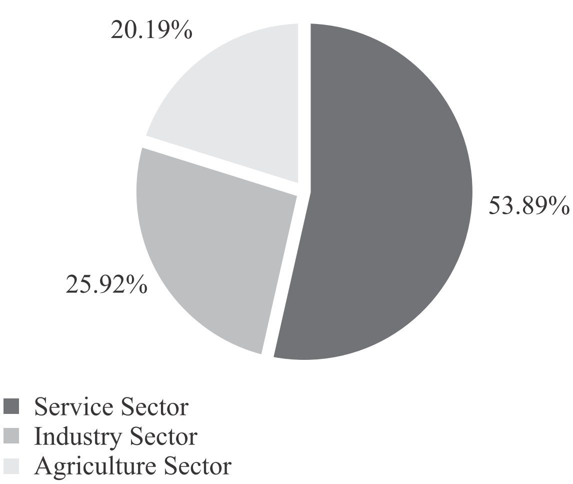
India's mission of $5 trillion economy



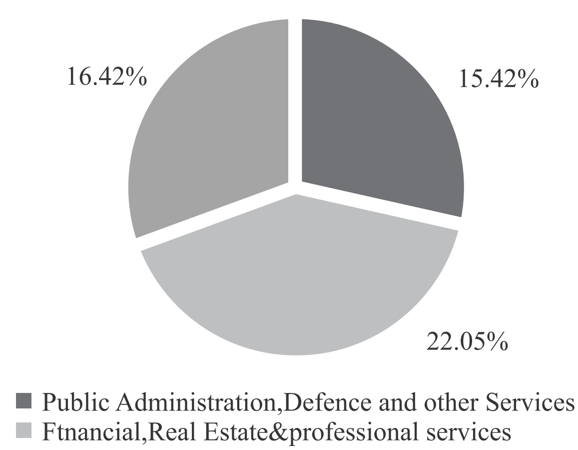
Source: *Author's own calculation*

India is presently a $3.469 trillion economy. A CAGR of 9% for 5 years will make India a $5 trillion economy by 2027.

Contribution of different sectors in total GVA in 2020-2021



Service Sector



Source: StatisticsTimes.com

The service sector is the largest sector of India. The service sector accounts for 53.89% of total India's GVA (Gross Value Added) of 179.15 lakh crore. In the service sector, contribution of financial, real estate & professional services is 22.05% which is the largest. Therefore, growth in the financial sector will contribute a lot in the total GDP of the country.

"India needs more global sized banks to help the country achieve $5 trillion economy by 2024-2025".
- KV Subramanian, Chief Economic Advisor.

"The government's decision to consolidate 10 public sector banks into 4 mega state owned lenders will act as a building block for achieving $5 trillion economy target".
- Rajiv Kumar, Finance Secretary.

"Financial sector must grow at 16-184 for India to become $10 trillion economy by 2030".
-Ajay Piramal, Chairman, Piramal Group.

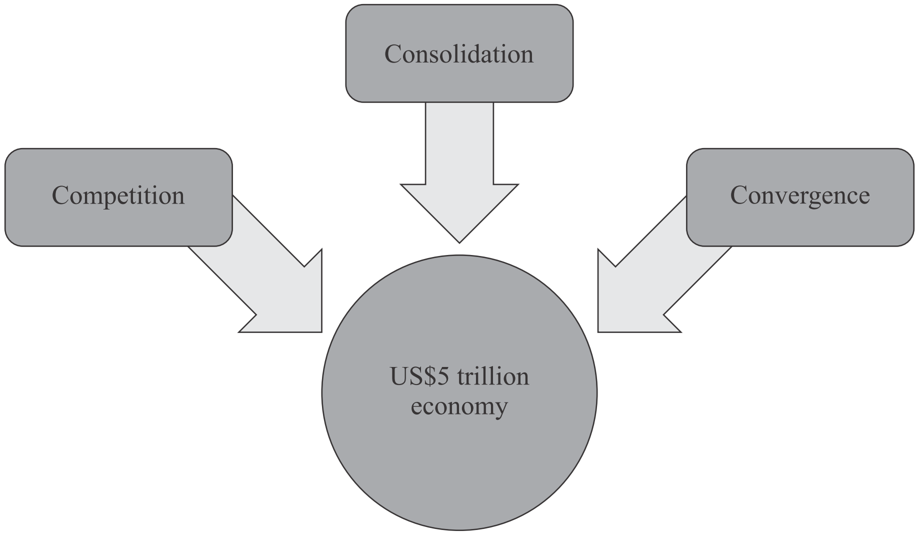
- Inclusive and Sustainable
- Better utilization of public fund
- Better meeting of credit needs
- Economics of Scale
- Increase in Foreign Direct Investment

Risks of Bank Mergers:

1.	Merger of banks may hamper credit services in rural areas due to inability to manage from centre.
2.	Large banks might be more vulnerable to global economic crisis. A failure of bank would have bigger and larger impact.
3.	Stronger banks might be burdened to cover up the weaknesses of inefficient banks. This may lead to inefficiencies and delays.
4.	Weaknesses of small banks might get transferred to bigger banks.
5.	There might be clash of different organisational cultures. Conflicts may arise in the area of systems and processes.

Governance of banks needs to be improved before making any significant change in the architecture of banks. Bigger banks may make the banking sector more resilient but factors like strong credit appraisal and risk control system cannot be overlooked.

Three C's of banking sector



Conclusions

Empirical studies must deal with the difficulty of measuring competition in the financial industry. Both the structural and non-structural measures of competition are found to be positively and negatively associated with financial stability depending on the country and the sample analysed. Competition is not the end rather it is a means to the end. Consolidation is a huge instrument in maintaining liquidity, ensuring transparency in business and in effective administration. As analyzed, the percentage of Non-Performing Assets of Union Bank of India has been decreasing after merger. The Return on Equity and Earnings Per Share has been fluctuating after amalgamation. The role of banks is shifting towards value added services. The role of bancassurance is evolving. The number of tie ups between banks and insurance companies are increasing over the period. The end objective is efficiency. Our objective of reforms should be equaling global standards to compete effectively and to make a respectable place for ourselves in the fast progressing global financial sector. An explicit growth strategy of combination and convergence of banks is a necessity for making India a $5 trillion economy.

Suggestions

- Regulation, supervision and compliance management needs to be strengthened to create a robust framework of financial stability.
- Banks need to be given more autonomy to add to the competitive strength of the banks.
- Risk-return trade off should be improved for granting new credit.
- Merged banks should focus on improving the asset quality and ensuring the capital adequacy.
- For sustainability in the long run, compatibility in the business cultures and technology platforms of the merging banks must be considered.
- There must be deep integration and synergy between banker and insurer for the success of bancassurance.

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