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India's Plan for Bank Mergers Ignores History and International Consensus

BY SAMPAD PATNAIK ON 03/09/2017 • the wire

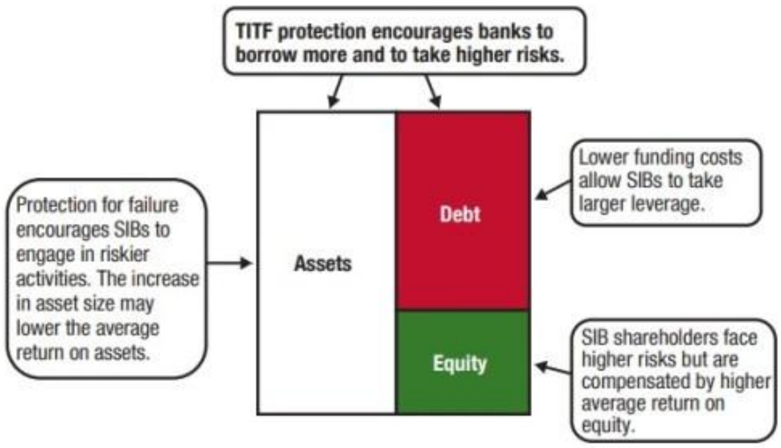
Obese banks are generally unhealthy for the economy. But the government is happily fattening banks thinking they are becoming "stronger" in the process.

Increasing the size of SBI is a poor banking policy. Credit:

The Union cabinet's decision to merge-and-consolidate India's public sector banks (PSUs) is in direct opposition to the post-2008-crisis consensus that big banks are a systemic risk to their national economies. In the US and the UK, political campaigns have been run advocating break-up of big banks.

The term 'too important to fail' (TITF) is increasingly used in mainstream media coverage of the global economy. In 2014, the International Monetary Fund (IMF) published a paper listing all the risks associated with big banks, a study explicitly linking bigger size with riskier behaviour, forced government subsidies and even weakening of national sovereignty. After multiple investigations into the 2008 US economic crisis, leading bankers across the world have now said banks stay nimble and serve the economy better when small in size.

One of the most dangerous outcomes of bank consolidation is the embedded incentives in favour of risky behaviour. Once banks get to the TITF stage, they realise that they will be bailed out by respective governments even if their risks backfire. The case for bailing a reckless bank becomes even more compelling when they are systemically important banks (SIBs). An SIB is a financial entity whose collapse can seriously threaten the stability of the national economy.



Effect of TITF protection on a simplified bank balance sheet. Source: Global Financial Stability Report 2014, IMF

The State Bank of India (SBI) has been already denoted as an SIB by the Reserve Bank of India. Increasing the size of SBI is a poor banking policy. Earlier in 2017, SBI has merged operations of five of its associate banks and Bharatiya Mahila Bank signaling a determined push towards consolidation in the sector, following the bad loans crisis. The merger has reduced the number of state-controlled banks to 21 from 26.

The principal advisor to the finance ministry, Sanjeev Sanyal, has reportedly said that the government is seeking ways to reduce the number of existing public sector banks to a range between ten and 15. He has said consolidation will not be taken too far so that the numbers of PSUs come down to four or five, lest the new banks become TITF. However, Sanyal has not clarified the basis on which he has calculated that four-five are TITF and not ten-15.

He has also not clarified how exactly a bank becomes 'stronger' when it is bigger, and how exactly size solves the problems of bad loans. Under the Indradhanush plan, the bigger banks will be recapitalised by the government. So if it actually recapitalisation helping banks become stronger, then why not recapitalise existing banks without merging them?

Proponents of bank consolidation argue that size should not be linked to risky behaviour, which they cite as an independent variable. They also cite the role of rating agencies that will flag risky behaviour of banks with lower ratings, thereby monitoring risk. However, as per the IMF, size is absolutely linked with risk – size insulates entities from disciplinary action by the government and if any organization realises there is no downside to risk, it is prone to indulge in it.

Secondly, rating agencies can no longer be trusted for effective vigilance of institutional behaviour. Their disastrous recordin the run up to the 2008 financial crisis is well known in international banking circles. Some of the world's most respected rating agencies had assigned AA ratings to American banks days before the latter collapsed. The reasons, given for this failure of the rating agencies, range from incompetence to collusion.

Media propaganda in favour of bank consolidation

There are a number of other weak reasons supporting big banks, which are repeated by sections of the media eschewing critical examination. For example, a *Quartz* article quoted the following statement from an auditor without verifying the veracity of the claim or even deconstructing what it meant.

"Consolidation will help by marrying two banks that have similar structures and are chasing the same goal. The banks will be able to better channelise the resources and function more smoothly if they are being controlled by one strong management team."

This kind of reasoning is basically arguing in favour of monopoly by the service provider, a decision which is not in consumers' interest. If two entities servicing the same set of people merge, then they naturally lose the incentive to compete with one another. Secondly, as a merged entity they become even more difficult to discipline in case of predatory behaviour. And lastly, if the risky behaviour of the merged entity backfires, then it is difficult to let them self-destruct because they are the only player in the market. Hence, bailouts using taxpayer money follow –

a chain which clearly demonstrates that when special interests make mistakes, society bails them out – but when ordinary individuals find themselves in the same position, the invisible hand of the market metes out visible punishments.

The same article goes on to argue

The mergers are also expected to reduce the pressure on the government to secure capital for PSBs. State-owned lenders may need Rs1.8 lakh crore of capital infusion by FY19, it has been estimated. Of this, Rs 70,000 crore will be pumped in by their largest shareholder, the government. The onus to raise the balance is with the banks themselves. The merged, stronger, and competitive entities will, thus, be better placed to attract funds lead to operational efficiency and economies of scale.

The last part of the paragraph warrants scrutiny. If the worldwide consensus has stated undesirability of big banks, two important questions follow. Which institution would invest in an already risky structure? If an institution invests anyway, what guarantees have been given for it to recover money should things go wrong?

Bleaker future

The government's poor ideas on banking reform do not stop at consolidation and bloated structures. The government is going out of its way to promote risky behaviour by also aiming to diversify holding patterns in bank shares. Finance minister Arun Jaitley has been quoted saying, "… we have announced a policy that government holdings [in banks] to be brought down to 52%."

This intent if implemented, will also manipulate ownership patterns in a way that incentivises risky behavior. A diverse holding pattern of bank ownership actually creates the free rider problem. This scenario implies that when multiple entities hold ownership in an institution, every individual owner has limited agency in controlling risky behaviour of the management. By divesting their stake, governments insulate themselves from criticism of mismanaging major public institutions. Every major shareholder blames 'the board' excluding its own involvement, and when the music stops taxpayers find themselves holding the bag they must now fill.

Sampad Patnaik is a freelance journalist.

Demonetisation - a Needless Surgical Procedure Performed on an Unhealthy Economy

Rs 15.28 lakh crore out of the Rs 15.44 lakh crore in currency that was rendered invalid on November 8, 2016 has come back into the Indian banking system. Credit: PTI

The patient was the Indian economy.

Among the 176 countries that have been ranked by Transparency International on a scale from 100 (very clean) to zero (highly corrupt), India ranks in the second half of the list at 79, with the illegal money of sizeable proportions.

The central government, which was elected on the promise of a cleaner government, is worried about coming to power again. With the impending election two years away, it had to do something drastic: a much-dreaded surgery with uncertain consequences.

That was the November 2016 decision of demonetising Rs 500 and Rs 1000 currency notes in order to curb black money.

No doubt, the demonetisation exercise had to be kept a secret for its full effect to be realised, ruling out any possibility of wide discussions and weighing of pros and cons. It is reported that even the chief economic adviser was caught unaware, though the Reserve Bank of India (RBI)'s top management was prepared for it.

Unrealised windfall

The demonetisation was clearly aimed at eliminating black money. It was thought that some Rs 5 lakh crore (Rs 5 trillion) would be declared illegal; RBI's liabilities would be extinguished, giving rise to larger than usual annual profits and they would be turned over to the government as dividend for funding planned social welfare schemes and infrastructure projects.

The windfall did not materialise.

Early this week, it was announced that of the estimated Rs 15.44 lakh crore (Rs 15.44 trillion) of currency that was rendered invalid due to demonetisation, Rs 15.28 lakh crore or Rs 15.28 trillion has come back into the Indian banking system. Does it mean that the so called "illegitimate money" that has now been legitimised was, in fact, a close 99%? The unreturned money of about Rs 0.16 trillion is just 1%.

The question is: was the team of surgeons, minimum in number for secrecy purposes, competent enough? Or if a member expressed a contrary view, was it given due consideration?

That will remain a secret for some time.

For every fait accompli decision, there are always two views, one supportive and another opposed, whether one likes it or not.

Is the achievement worth the effort?

The price of "achievement" following the November 2016 demonetisation has now been measured. Economic growth rates have been falling. Though not big falls and of course the growth rates are positive.

In the April-June 2017 quarter, the gross domestic product (GDP) grew at 5.7% - a three-year low, much below the 7.9% GDP growth in the corresponding quarter of 2016 and lower than 6.1% recorded in the January-March quarter of 2017.

It is a clear downward trend.

GDP growth can always be attributed to not one but a combination of factors in a developing economy. The most important component of aggregate demand is domestic consumption. Falling demand is also influenced by decreased external demand for domestic output and competitiveness of India's exports and, of course, investment demand.

The government's chief statistician was in a hurry to point out that it would be incorrect to attribute it to 'demonetisation effect'. He laid the blame on the impact of GST roll out on the industry.

The government should have handsomely accepted the failure.

All along, ever since the November decision was announced, the growth momentum has been halted. The fears of economic doom have gripped the nation. The middle class has been rudely shaken.

The International Monetary Fund (IMF) in January 2017 updating the earlier October 2016 World Economic Outlook lowered its estimate of India's growth. It said India would grow only at 6.6% as against its earlier estimate of 7.6% on account of the "temporary negative consumption shock, induced by cash shortages and payment disruptions associated with the currency note withdrawal and exchange initiative."

The IMF hoped demonetisation would strengthen India's institutional framework by reducing tax avoidance and corruption and would support efficiency gains.

The World Bank, while echoing the IMF's view, made it clear that the reason behind the move was "to curb corruption, tax evasion and counterfeiting". It added the move would "broaden the tax base" and help revenues which will "eventually go up, besides reducing the size of the informal economy."

The finance minister Arun Jaitley is now keen to highlight tax avoidance, broadening the tax base and reducing the size of the informal sector and other likely gains, and continues to downplay the main purpose behind the demonetisation decision. "People with inadequate understanding of how to tackle black money linked note ban with money returned to system," said Jaitley, adding "deposits in banks don't legitimise" black money.

"Money has now been identified with its owner"

It is touted that not only has liquidity been restored but that now there is an excess of it. Bhupal Singh and Indrajit Roy of RBI in their working paper on 'Demonetisation and Bank Deposit Growth' note an unusual increase in cash deposits of about Rs 1.7 lakh crore and the excess of the order of Rs 2.8-4.3 lakh crore.

The interest rate has fallen with the RBI cutting repo rate by 25 basis points. The commercial banks should pass on the full portion of rate cuts to borrowers if the effects of transmission mechanism are to be fully felt and benefits realised.

Last month, RBI deputy governor Viral Acharya referred to an unintended outcome of demonetisation decision: a benefit indeed. It is the shift away from bank deposits to financial assets.

Bloomberg reported that funds have moved from low-cost current account and savings accounts to other financial instruments. Mutual funds are among the beneficiaries with their assets at Rs 18.96 lakh crore as of June 2017, compared to Rs 16.28 lakh crore in October 2016.

The FM is keen to get on with his work, apparently, he does not want to spend any more time discussing why the windfall did not materialise and why only one percent of the Rs 15.44 trillion liabilities were extinguished.

He has no time to waste on the elusive black money.

FM's job is now cut out

The latest State Bank of India Ecoflash of September 1 notes that the incremental bank credit in the current fiscal year is declining. It is now less by 1.37 lakh crore from last year's figure during the corresponding period of April to August: it is a negative growth of 1.8%, which is a historical record.

"The deceleration in credit growth also highlights the role of supply side factors - stressed assets and capital constraint - in hindering a revival in the credit cycle. The sectoral data on flow of credit indicate that deceleration in credit, though broad-based, is characterised by a sharp contraction in exposure to industry", the Ecoflash adds.

The banks are unwilling to lend anymore because of the mounting corporate debt.

The only solution is urgent cleaning up of the public sector banks: the twin balance sheet problems; mounting corporate debt; commercial banks' piling up non-performing assets; the poor flow of bank credit and speeding up proposed bank mergers.

With the return of the 99% of the so-called black money, liquidity is no more a hurdle. RBI knows money stock has risen with unexpected deposits.

M3 has risen; RBI has to be on guard against inflationary conditions.

Instead of plodding the RBI for another cut in policy rate in the next October meeting of Monetary Policy Committee, the government should resume good governance.

It has to raise investor confidence.

It must bestow full autonomy on RBI in the pursuit of its mandated goal: price stability.

T.K. Jayaraman is a research professor under International Collaborative Partner programme at University of Tunku Abdul Rahman, Kampar, Perak, Malaysia. Bhanu Prakash is a Visiting Associate Professor, Bengaluru School of Management Studies, Bengaluru.

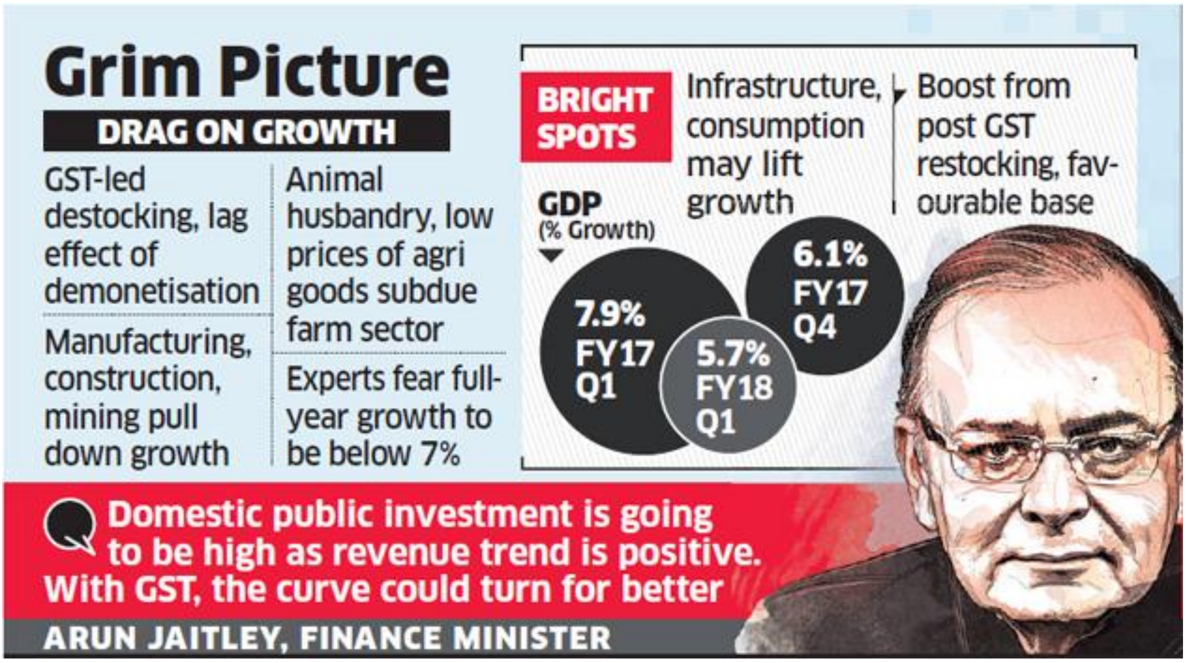
India's Q1 GDP slips to 5.7% from 7.9% in the same quarter a year ago

NEW DELHI: Our Bureau New Delhi: ECONOMCI TIMES

India's GDP growth unexpectedly slumped to a threeyear low in the June quarter as manufacturers sought to get rid of stocks, rather than making more of them, ahead of the July 1rollout of the goods and services tax (GST) amid the lingering impact of demonetisation. This is the slowest pace of economic growth since the January-March quarter in 2014.

GDP slowed to 5.7 per cent in the April-June period from 6.1 per cent in the preceding quarter. The core sector, however, held out hope of a recovery, growing 2.4 per cent in July compared with 0.8 per cent in June as natural gas, steel, electricity and coal production increased in the month. GDP and core sector data were released separately on Thursday evening.

"The major sector which has seen a sharp decline is industry," chief statistician TCA Anant said with regard to the growth slowdown. Finance minister Arun Jaitley expressed concern about the numbers but said the economy was well placed for revival with GST in place.



"Domestic public investment is going to be high as the revenue trend is positive," he said. "With GST now implemented, the curve could turn for better." He pointed to manufacturing's role in the slowdown. "Data throws up challenges for the economy," he said.

"We need to work more on policy and investment in the coming quarters... Agriculture GDP is in the normal range of 2 per cent . Investment services have improved but it is manufacturing that has bottomed out. Manufacturing slump (is) due to the transition to the GST regime." Data released by the Central Statistics Office on Thursday showed total gross value added (GVA) in the first quarter of FY18 at 5.6 per cent against 7.6 per cent in the year earlier. Anant attributed the decline in GVA to the high prices of intermediate goods and reduced inventory.

Economists had expected GDP growth at 6.5 per cent . Most are now looking at revising estimates for the year.

IDFC Bank has revised its forecast downwards for full-year GDP growth to 6.6 per cent from the earlier projection of 7.2 per cent.

"This is on account of investment continuing to remain weak and net exports expected to stay negative. Also, government will have to crunch its expenditure in some time," said Indranil Pan, chief economist at IDFC Bank.

Ratings agency ICRA said the likelihood of growth surpassing 7.0 per cent in the current fiscal year has diminished after the Q1 reading. India Ratings said its forecast of 7.4 per cent GDP in FY18 will get revised downwards.

"Q2 FY18 growth may also remain muted. Overall, it remains to be seen whether the GDP growth for the current fiscal stays below 6.5 per cent ," said Soumya Kanti Ghosh, group chief economic advisor, State Bank of India.

Manufacturing growth (GVA) in the first quarter of the current financial year plummeted to 1.2 per cent from 10.7 per cent in the year ago. However, gross fixed capital formation (GFCF), a proxy for investment, rose 1.6 per cent on year, pointing toward a mild improvement in India's investment rate.

"The turnaround in GFCF, to growth of 1.6 per cent in Q1 2017-18 from the 2.1 per cent contraction in the previous quarter, offers a modicum of encouragement, even as private sector investment activity remains muted," said ICRA principal economist Aditi Nayar.

Anant expressed confidence that manufacturing will see a rebound in the second quarter and said the GDP slowdown was an effect of normalisation of the wholesale price index (WPI) and not because of demonetisation affecting demand. With regard to the future trajectory of WPI, Anant said there might not be a further increase in the number, given the greater degree of convergence between it and the consumer price index (CPI) at 3-4 per cent levels.

However, he said it will be wrong to link the entire decline in economic activities to demonetisation, as GVA was declining from the second quarter of the last fiscal, much before the November 8 decision of the government to wipe out high-value currency notes.

CORE SECTOR

The eight core sectors grew 2.4 per cent in July compared with 0.8 per cent in June led by a favourable base effect for steel, cement, fertilisers and electricity. Electricity generation accelerated to 5.4 per cent in July from 2.2 per cent in June, reflecting a favourable base effect, as well as some improvement in industrial demand after GST took effect.

Natural gas output rose 6.6 per cent in July while steel production and power generation rose 9.2 per cent and 5.4 per cent , respectively. The production of crude oil declined 0.5 per cent , refinery products 2.7 per cent , fertiliser 0.3 per cent and cement 2 per cent , showing mixed trends for industrial production in July.

ET View:

Future tense QI GDP growth estimates lack lustre, but it is quite likely that the economy will pick up speed during the year. The sharp drop in the growth figure to 5.7 per cent , down from 7.9 per cent in the like period last fiscal, seems almost entirely due to significant slowdown in the manufacturing sector. The growth in Gross Value Added (GVA) in manufactures has dropped precipitously to a mere 1.2 per cent during April-June, down from 10.7 per cent GVA growth in the same period last year. But the sharp deceleration maybe in the run up to GST and stock clearance, in changing over to the new indirect tax regime. Consumption expenditure remains buoyant.

BANKS BACHAO – DESH BACHAO

SAVE BANKS – SAVE INDIA

MORCHA TO PARLIAMENT

15TH SEPTEMBER, 2017

CLARION CALL FROM

UNITED FORUM OF BANK UNIONS

WRITTEN REPLY IN PARLIAMENT ON 4-8-2017

There is no such proposal under the consideration of Government for consolidation of Public Sector Banks

CABINET DECISION ON 23-8-2017

TO MERGE THE BANKS

HOW TO BELIEVE THIS GOVERNMENT

WE DEMAND EXPANSION OF BANKS AND NOT MERGERS

BE A PART OF THE HISTORIC MORCHA TO PARLIAMENT

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ALL INDIA BANK EMPLOYEES' ASSOCIATION

Central Office: PRABHAT NIVAS

Singapore Plaza, 164, Linghi Chetty Street, Chennai-600001

Phone: 2535 1522 Fax: 2535 8853, 4500 2191

e mail ~ chv.aibea@gmail.com

Web: www.aibea.in