RBI repudiates the first ever merger attempt between a bank and a NBFC

written by Akshay Ramesh | November 4, 2019

A merger between the banks is not a new trend in the Indian banking sector. In fact, the very first merger in the Indian banking sector took place in the year 1921 between the three presidency banks namely the Bank of Bengal, the Bank of Bombay and the Bank of Madras when the three banks merged to form a new bank known as Imperial Bank of India, which was renamed as State Bank of India soon after the independence.

However, this financial year has made its place in the history of the Indian banking sector due to the first-ever attempt made for the merger between a bank and the non-banking financial company. But this merger attempt has failed due to Reserve Bank of India's ("RBI") stringent regulations. With a blind hope of getting the merger approval, the Lakshmi Vilas Bank and Indiabulls Housing Finance Limited (a non-banking financial lender) announced their plan of merger in April, 2019 and applied for the RBI's nod in May.

Reasons for Merger

Every merger that happens in the banking sectors more or less has the desirable interest of accomplishing financial stability. The merging entities i.e., Lakshmi Vilas Bank and Indiabulls Housing Finance Ltd too had dreamt of achieving financial stability through this merger.

The merger was crucial for Lakshmi Vilas Bank as it was in desperate need of funds since its CAR at the end of 31 March, 2019 was 7.72%, way below the regulatory requirement of RBI.

At the same time, the merger was equally important for the Indiabulls Housing Finance Ltd. as it would have given access to low-cost funds during the situation when the non-banking financial sector faces the crisis of confidence with banks.

Finally, through this merger, both Lakshmi Vilas Bank and Indiabulls Housing Finance Ltd. had plans of raising low-cost funds through public deposits which were struck by the RBI.

Reason for Rejection

Unfortunately, both Lakshmi Vilas Bank and Indiabulls Housing Finance Ltd were caught in the web of RBI's regulatory mechanism which did not favour the merger plan. Due to this very reason, Lakshmi Vilas Bank had to face the Prompt Corrective Action ("PCA") initiated by RBI due to its high level of bad loans, insufficient Capital Adequacy Ratio ("CAR") and a negative Return on Assets ("RoA").

Interestingly, as of March 31, 2019, the Lakshmi Vilas bank's net non-performing assets stood at 7.49%, CAR at 7.72% and RoA at -2.32%. However, as per RBI norms, every Indian scheduled commercial bank is required to maintain a minimum CAR of 9% which was not achieved in the case of Lakshmi Vilas

Bank.
On the other hand, Indiabulls Housing Finance Ltd, a non-banking financial lender, which intended to merge with Lakshmi Vilas Bank, did not meet the *‘fit and proper criteria’* of the banking regulator for the said merger.
On a whole, these two main reasons altered the scenario wherein the regulator bank i.e., RBI vide a letter dated October 9, 2019[1], expressed its strict non-acceptance for the merger between these two entities, which no doubt has disappointed both Lakshmi Vilas Bank and Indiabulls Housing Finance Ltd.
Response of expected merging entities on such rejection.
Though the disapproval of the merger has disrupted the future plans of both entities, the Indiabulls Housing Finance Ltd. has taken a positive lead by stating that they are firmly back on the growth path to become a robust housing finance company soon. However, on the other hand, the sentiments of the investors on Indiabulls Housing Finance Ltd. (“IBHF”) have drifted negatively since its shares dropped by 66 percent at Rs. 220 in the Bombay Stock Exchange (“BSE”).
Also, the public interest litigation filed against Indiabulls Housing Finance Ltd., on the issues of financial irregularities, siphoning off funds and regulatory violations has created a hassle in the minds of the investors. However, the true picture of the IBHF’s non-performing assets at this movement remains unrevealed. Now, the question that remains in the mind is how IBHF will succeed in its asset/liability management to boost fresh home loans in the upcoming days.
At the same time, IBHF has claimed that it is well-capitalized at this stage with cash equivalent reserves of INR28,511 crores as on August 2019. Meanwhile, the Lakshmi Vilas Bank will now have to independently explore options for raising capital to help lift the restrictions placed on it.
Legal Provisions with respect to mergers in the Indian Banking Sector.
Reserve Bank of India (Amalgamation of Private Sector Banks) Directions, 2016[2], guides the mergers of private sector banks in the Indian banking sector. The provisions of these directions shall apply to all private sector banks licensed to operate in India by the RBI and to the Non-Banking Financial Companies (NBFC) registered with the RBI.
These guidelines shall cover two types of amalgamations, one is the amalgamation of two banking companies and the other is the amalgamation of an NBFC with a banking company.
The RBI has discretionary powers to approve the voluntary amalgamation of two banking companies under the provisions of Section 44A of the Banking

Regulation Act, 1949. The voluntary amalgamation of an NBFC with a banking company is governed by sections 232 to 234 of the Companies Act, 2013.

- Approval by Board of Directors for the Merger.
  Boards of the concerned banks play a crucial role while dealing with the amalgamation proposals between two banking companies or between a banking company and an NBFC. The decision of amalgamation has to be approved by a two-thirds majority of the total board members and not just of those present and voting.
- Merger of two banking companies
  In terms of Section 44A of the Banking Regulation Act, 1949, the draft scheme of amalgamation shall be approved by the shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of the shareholders, present in person or by proxy at a meeting called for the purpose.
  However, before convening the meeting for the purposes of obtaining the shareholders' approval, the draft scheme of amalgamation has to be approved by the Boards of Directors of the two banking companies separately.
  In terms of Section 44A of the Banking Regulation Act, 1949, after the scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of the Section, it shall be submitted to the Reserve Bank for sanction.
- Merger of a bank with an NBFC
  When an NBFC proposes to amalgamate with a banking company, the banking company has to obtain the approval of the Reserve Bank of India after the scheme of amalgamation is approved by its Board and the Board of NBFC. Wherein, the RBI may or may not approve the said merger. For instance, in the above-discussed case, the RBI refused to give its permission for the amalgamation between Lakshmi Vilas Bank and Indiabulls Housing Finance Ltd.
- Answers to the following questions must be obtained by the Banks before it accepts the merger with NBFC
- Whether the NBFC has violated/is likely to violate any of the RBI / SEBI norms and if so, shall ensure that these norms are complied with before the scheme of amalgamation is approved.
- Whether the NBFC has complied with the "Know Your Customer" norms for all the accounts, which will become accounts of the banking company after amalgamation.
- Whether the NBFC has availed of credit facilities from banks / FIs, whether the loan agreements mandate the NBFC to seek the consent of the bank / FI concerned for the proposed merger/amalgamation.

Conclusion

The Indian banking sector from the past two decades has witnessed many banking mergers. This is due to the increasing competition amongst the banking companies. The Government of India is also striving towards the achievement of financial inclusion in India. This has resulted in immense competition amongst the banking companies to acquire the market share. As a result of which, many banking companies and non-banking financial companies are opting for the mode of the merger to expand their service base in the Indian banking sector. However, the banking regulator, RBI, is also cautious enough in implementing its regulations, so that the mega-mergers won't affect the Indian banking system.

Henceforth, RBI is strict enough in considering the financial status of the amalgamating entities including private banking companies, public-sector banks, and NBFCs. As a matter of fact, the amalgamating baking companies have to first make sure that they have achieved the requisite CAR as per the RBI norms. A bank with less CAR and huge NPA problems shall end up facing the PCA by RBI, as we have witnessed in the merger case of Lakshmi Vilas Bank and Indiabulls Housing Finance Ltd.

On the backdrop of the various scams and defaults occurring in the Indian financial sector, recently the RBI has decided to operationalize 'unified departments for supervision and regulation' of commercial banks, urban co-operative banks (UCBs) and non-banking financial companies (NBFCs) which will be in effect from November 1, 2019[3].

All these recent developments in the Indian banking sector have rejuvenated the hope amongst the banking customers that the banking platform has no impediments that would risk their hard-earned money as deposited with the banks.

- [1] https://www.livemint.com/industry/banking/rbi-rejects-merger-of-lndiabulls-housing-finance-with-lakshmi-vilas-bank-11570632473456.html
- [2] https://m.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10364
- [3] https://www.thehindubusinessline.com/money-and-banking/rbis-depts-for-unified-regulation-to-be-operationalised-from-november-1/article29682972.ece

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