Business Group Ownership of Banks:
Issues and Implications

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ABSTRACT

This paper introduces the phenomenon of business groups in the theory of financial intermediation by banks, developed by Diamond (1984) with a view to analyzing their impact on the result of financial intermediation. Two kinds of business groups are distinguished, depending on the relationship between the firms and the bank comprising the group. It is argued here that the result of financial intermediation depends on the type of business groups. Diverse historical experiences relating to India and Japan are found to support the theoretical formulation. Contemporary experience in India, analysed in the paper in three case studies, also validates the above theory. The theory developed in the paper and the evidence in its favour leads to rejection of the idea of business group-owned banks in India.

Key words: Bank, Business Groups, Corporate Governance.

JEL Codes: G21, G3.

I INTRODUCTION

Banks perform the critical role of financial intermediation between households (savings surplus economic units) and firms (savings-deficit units), whereby they mobilize and aggregate small savings, and package and deliver them in the form of structured or securitized funds to firms. Deposits mobilized from households comprise bank liabilities and advances made to the firms and comprise their assets. The difference between the interest charged from firms and the interest provided to the depositors comprises the spread, which is an element of profit. There is a two way endogenous relationship between bank liabilities and assets. On the one hand the banks' ability to create credit is dependent upon deposits. On the other hand, the quality of assets has a direct bearing on their solvency. Should the banks have an extraneous consideration in their lending operations for any reason, it can potentially temper the effectiveness of their role as a financial intermediary as well as their profitability and solvency. However, what if such a situation perpetually prevails in cases where the banks are owned and controlled by business groups or the bank's own businesses? Does it not result in usurpation of the role of financial markets? Does it not open the possibility of deliberate manipulation of the bank's performance to suit underlying business interests and, thereby, step up governance related risks, especially in view of the dominant economic position that these business groups occupy, owing to the existence of pyramidal structures and cross-holding of investments? Is it not that because of these potential hazards of a nexus between banks and the borrowing businesses that regulators worldwide have, from time to time, sought to check such linkage?

It may be pointed out that diversified business groups, consisting of legally independent firms, with some commonality of ownership and management or by family members, operating in multiple markets, are ubiquitous in emerging markets and even in some developed economies. Business groups are commonly looked upon by Western observers as a prime example of 'crony capitalism'. Corruption in the business world is usually prevented by the urgent prudential motives of financial analysts, shareholders, regulators, and banks. Some forms of business groups, such as commercial banks owning construction companies, are banned under US Regulation. Likewise, the Glass-Steagall Act of 1933 banned certain types of business associations in financial services. The object was to create 'firewalls' between certain financial functions, so that banks may be prevented from replacing financial markets with money laundering scams. It is argued that intra-group lending helped inflame the 1997 Asian Financial crisis. Relational banking was considered to be the essential glue of opaque, inefficient, and unfair crony capitalism which led to the establishment of the superior Anglo-Saxon style of an arm's length financial system.

India restricts industrial conglomerates from owning more than ten per cent of equity in banks. However, a few Indian business groups own a bank as a legacy from their past. The Tarapore Committee on Capital Account Convertibility has favoured the ownership of banks by industrial groups when this is endorsed by two leading business groups. The Indian government is facing increasing pressure, particularly from US financial groups, which like other foreign institutions presently cannot acquire domestic banks and are subject to tight restrictions on the number of new branches they can open each year. Clearly, there exists a controversy around ownership of banks by industrial houses. This paper seeks to contribute to the debate drawing from theory, cross-country historical experiences, and lastly from the three current case studies.

Section II provides the theoretical framework of the paper while Section III draws diverse examples from India and Japan to provide support to this framework. Section IV focuses on case studies drawn from the current Indian experience. Section V develops the hypothesis and describes the methodology of the empirical exercise. The results are presented in Section VI. Lastly, Section VII gives the summary and conclusions of the study.

II THEORETICAL FRAMEWORK OF THE STUDY

One of earliest theories of banking intermediation is provided by Diamond (1984). This section analyses the theory to examine whether it provides any clue to ownership of banks by business groups. In the traditional neo-classical approach, borrowers and lenders interact through a perfect and complete market and there is no role for banks. This means that firms and households do not need financial intermediaries in order to trade with each other more efficiently. Freixas and Rochet (1997) use a general equilibrium model of resource allocation a la Arrow-Debreu under the assumption of perfect and complete financial markets. With perfect and complete markets, there are no transaction costs and information is symmetric. Hence, this general equilibrium model, with complete financial markets, can not rationalize the existence of banks which have no role in the efficient allocation of the resources.

The Arrow-Debreu paradigm is at odds with reality because banks have clearly played a central role in the transformation of household savings into investments for firms since ancient times. Such an unrealistic result is due to the unrealistic assumptions of complete and perfect financial markets used in the model. Any market is plagued persistently by the presence of information asymmetry and transaction costs, and this is more so for a financial market.

Scholars trying to rationalize the existence of banks have begun by giving up the unrealistic assumption of perfect and complete markets. The theory of transaction cost explains firms but an explanation for the existence of a bank has to take care of the peculiarities of a financial market, over and above an ordinary market. The presence of transaction costs is characteristic of all markets including the goods market and it does not distinguish between a goods market and a financial market. What distinguishes a financial market from an ordinary market is the peculiar nature of exchange characterizing it. What is exchanged here is not goods for money, but the trading of money itself for a promised return of the amount after a stipulated period, along with the agreed rate of interest. The issue of trust gains more relevance in a financial market as opposed to an ordinary market. Information asymmetry manifesting in adverse selection and moral hazard are typical features of a financial market. Thus, any attempt to rationalize the existence of banks has to demonstrate how banks solve the problems relating to information asymmetry.

The much celebrated model of Diamond (1984) gives an asymmetric information explanation for the existence of banks. The basic idea is that lenders can directly trade with entrepreneurs in the market. However, because of asymmetric information, lenders cannot observe the output of the firm's projects. Entrepreneurs would not have the incentive to reveal their true efforts and would like to keep the benefits to themselves. An appropriate solution would be a contract between the two parties that involves penalties to entrepreneurs if they do not deliver the agreed payments to the lenders. However, this could bring losses to the entrepreneurs if their projects are not successful. Hence, this solution is not efficient. Another way would be that investors observe the output of a firm's projects and control the payments that they have to get. The costs of doing so are called monitoring costs and they would be too high if there was only one lender to each entrepreneur. However, these expenses increase with the number of investors and for this reason it would be optimal if only one firm would monitor the borrowers on behalf of the others. Therefore, a financial intermediary is introduced, who lowers these costs by assuming the job of delegated monitoring. Financial intermediaries such as banks can centralize costly monitoring and avoid duplication in the effort of monitoring the borrowers by small investors.

The downside is that along with cost advantage, delegated monitoring causes an agency incentive problem as well. However, this time, it is between entrepreneurs and the intermediary. The person doing the monitoring as agent now has private information. It is not even verifiable whether the monitoring has been undertaken. In simple words, the costs of delegation arise due to the collaboration between the intermediary and entrepreneurs. The cost incurred in solving the agency incentive problem, between the monitor and the entrepreneur, is called cost of delegation. Delegated monitoring leads to delegation costs and the costs of financial intermediation includes the cost of delegation over and above the cost of monitoring.

In contracting situations involving a single lender and a single borrower, one compares the physical cost of monitoring with the resulting savings of contracting costs. Let K be the cost of monitoring and S the savings from monitoring. When there are multiple lenders involved, either each must be able to monitor the additional information directly at a total cost of $m \times K$, where m is the number of lenders per borrower, or the monitoring must be delegated to someone. Let D denote the delegation cost per borrower. A complete financial intermediary theory, based on contracting costs of borrowers, must model the delegation costs and explain why intermediation leads to an overall improvement in the set of available contracts. That is, delegated monitoring pays when $(K + D) < \min [S, m \times K]$ where $K + D$ is the cost using an intermediary, S is the cost without monitoring, and $m \times K$ is the cost of direct monitoring.

The law of large numbers implies that if the bank gets sufficiently diversified across independent loans with expected repayments in excess of the face value of bank deposits, then the chance that it will default on its deposits gets arbitrarily close to zero. In the limit of a perfectly diversified bank, the bank would never default. The delegation cost for the bank approaches zero, and the only cost of intermediation is the (unavoidable) cost of monitoring. Therefore, diversification within the intermediary can be seen as the main reason to understand the intermediary theory with asymmetric information. The delegation cost from excessively limited diversification leads to increased probability of bank failure, which may also have contributed to the historical political pressure for deposit insurance. Anything that limits bank diversification removes much of the technological advantage of the banking contract.

The above theoretical framework developed by Diamond may be restated in brief before introducing complications. It is shown that lenders can not directly trade with entrepreneurs in the financial market because of information asymmetry and the prohibitive costs of monitoring. However, a financial intermediary called the bank can make such trade possible because of a lower cost of monitoring and insignificant delegation costs made possible through diversification.

In theory, there exist two independent entities: the bank and the entrepreneur. The only link between the two, in the theory, is that banks have lent to the borrower. This standard scenario will change in the presence of any other relationship apart from the borrowing relationship. It is clear that introduction of any additional relationship will be made to influence the act of return of debt to the bank. It will tilt the balance in favour of either party: the bank or the entrepreneur. Two scenarios of complications in the simple banking model may be introduced. In the first scenario, the borrowing firm seeks to control the bank either directly, through direct ownership, or indirectly, through a third entity which owns and controls both the borrowing firm and the bank. In the second scenario, the bank gets a considerable control and influence over the borrowing firm in exchange for long-term security and support. Both these scenarios are at variance with the bank in the standard theory of banking where a stand alone bank lends money to a company in which it has no direct ownership, involvement, or commercial interaction. The actual scenario regarding the relationship between the bank and the borrower firm depends on the institutional specificities.

The two scenarios envisaged above have fundamentally different implications for the bank. In the first case, the bank is an entity whose interest is subservient to the group interest, and the second is a symbiotic relationship, mutually beneficial to both the firm and bank. It is possible to visualize the two types of business groups involving two different types of relationship between bank and firm. In the first scenario, a bank is basically treated as a means to further the interests of firms comprising the group. In such a case, the private interest is promoted at the cost of public interest because a bank, however it is owned, remains a public financial institution. In the second case, the interests of the bank and the firms in the group go together. The bank will benefit only if the group firms it is lending to return the debt as per the contract. The control of the bank over the firm ensures the return of the debt. Thus, both the bank in the group and the group firms gain, leading to a Pareto superior situation for both the entities. In the case of a stand alone bank in banking theory, a return of the loan by the borrowing firm depends on how efficiently the bank rides over the problem of adverse selection and solves the problem of moral hazard through delegated monitoring, given the institutional specificities. The ultimate outcome of financial intermediation depends on rules, beliefs, and norms, which influence repayment of the loan.

Let us examine a scenario in which a business group owns a bank. It may be argued that group ownership and control of a bank produces an adverse impact on the functioning of a bank. The objective of control in a group is to secure the maximization of profits for the whole group, which is likely to be at the cost of the bank. There is no rationale for a group to own a bank unless it can use the services of the bank, which either are not available to the group or are available to it at a higher cost. To the extent that these benefits of group ownership of banks extend to the group without external diseconomy, the economy will reach a Pareto superior point through group ownership of banks. It will be argued below that benefits accruing to a group due to ownership and control of a bank will either accrue at a cost to the bank or to agents not related to the group.

It may be argued that group ownership will not allow a bank to function in the appropriate fashion. While a stand alone bank will be able to screen the potential borrowers independently to solve the problem of adverse selection, the same is not likely for a group-owned bank. It has to accept the dictates of the agents in control of the group in selection of its borrowers, a part of which are likely to be group companies. Lending to group companies provides an important rationale for the ownership and control of banks by business groups, particularly when financing by financial intermediaries is not easy because of the group risk or project risk that it entails. But such a loan transfers the risk of the group firms to the banks.

The financing of a group firm by a group bank is not likely to occur at a rate of interest justified by the risk profile of the project. This has adverse implications for the depositors and other borrowers who would be subsidizing the group through receipt of a lower rate of interest and the payment of a higher rate of interest, respectively. In such a case, the flow of deposit into the bank and flow of advances out of the bank will suffer, which will adversely influence the basic function of financial intermediation. The spread of the bank also may suffer, depending on the situation relating to elasticity of demand for deposit and lending. However, given the competitive pressures exerted by stand alone banks in the deposit and loan market, it may not be possible for the group-owned bank to reduce the interest rates on deposits and raise the interest rate for borrowers. In such a case, letting the group borrowers borrow at less than market rates will lead to a squeeze in the spread for the bank. With the fall in spread adversely impacting profitability, the stock price of the bank is likely to fall and it will be difficult for the bank to raise resources from the stock market. In such a case, the group may prop up the stock prices artificially by using group firms to buy the stock of the bank, transmitting a perverse signal to the ordinary stock holders of the bank.

When the bank is forced to lend to its group companies at rates not reflecting the risk profile of the loan, it faces an additional risk which is not faced by a stand alone bank. There may be an extreme situation where the loan is not returned at the behest of those in control of the group. The money from the bank will be transferred to a group owned firm where the productivity of its use is highest and it is easiest to be appropriated by the controlling interest. This will lead to the formation of NPAs (non-performing assts), which will further adversely influence the risk-bearing capacity of the bank through erosion of its capital base. This will impact the profitability of the bank, leading to losses by minority shareholders not in control of the bank.

The all-important function of monitoring a loan to tackle the problem of moral hazard does not arise when a group-owned bank lends to a group firm simply because the interest of the bank gets superseded by the controlling interest of the group. Lastly, unlike a stand alone bank, which will attempt to get sufficiently diversified across independent loans, a group-owned bank can not obtain maximum diversification due to the compulsion to lend to group firms. The theory of banking has pointed out that maximum diversification is the key to safety of the deposits. The more the group firms are financed by the group bank the more it compromises diversification of its lending portfolio, exposing itself to more risks. This may have implications for the stability of the group-owned banks.

It is known that banks are the major institutions responsible for channelizing funds from depositors, who save, to investors, who are surplus spenders. In this manner, banks are allocators of funds. Hence, the responsibility that devolves upon the banking system is that it must allocate funds efficiently. If deposits collected by the bank are used to serve controlling interests, the banks' autonomous monitoring role is compromised. Thus, group membership will have an adverse impact on corporate governance in a bank and, consequently, lead to allocative inefficiency in the economy. It may be interesting to draw a distinction between a firm and bank in this context. The profits of a firm belonging to a group are likely to be overstated or understated, depending on the impact of cross subsidization within the group, leading to perverse signals for resource allocation. Similar things also happen to a bank when it is part of a group. However, an additional adverse impact on resource allocation is generated in the case of a group owned bank. This is not likely to happen to a stand alone bank because it screens the applicants to get rid of the problem of adverse selection and monitors the projects of the borrowers to tide over moral hazards. Clearly, there exists a double-edged adverse impact of group ownership on a bank.

There may be other parallel motives for group ownership of firms. A group might like to own a bank so that it can provide the group firms' underwriting facilities at less than market fees. When a closed group of firms goes public for the first time by floating an IPO, it entails additional risk which is unlikely to be borne by a stand alone bank. Thus, a group may derive certain benefits from owning a bank which either is not available to it at all, or may be available only at higher price. If the loss in dealing with a group's firms is not compensated by dealing with non-group firms, the bank will have to take a knock in its profitability with adverse consequences. It is argued in the literature that a bank loan is unique and the issuance of a loan from a bank, as opposed to a non-banking financial institution, creates a favourable impact on the stock prices of the firm borrowing from the bank.

Recent literature has argued that financial intermediaries like banks accelerate economic growth by improving the probability of successful innovation. The growth of an economy may be driven by an endogenous impulse when financial intermediaries evaluate prospective entrepreneurs, mobilize finance for the most promising productivity enhancing activities, diversify the risks associated with these innovative activities, and reveal, thereby, the expected profits from engaging in innovation rather than producing existing goods with existing methods. Financial sector distortions reduce the rate of growth by reducing the rate of innovation. Clearly, a group-owned bank with its compulsion to serve group companies will raise distortions in the financial sector.

It is argued by Eric Tsai (2007–09) that risk may transfer to the banking components of non-financial, family-run groups primarily through two channels. First and foremost, it has to do with reputational risk. The banking industry survives and thrives on trust, while the depositors' faith in a bank is a prerequisite for sustaining the bank's safe and sound operation. Therefore, when a bank affiliated with a family-run group displays a low degree of transparency and complex organization and financial operations, the negative financial information originating from the group's non-bank members will easily make the depositors' trust in the bank evaporate, causing a bank run. Second, there is also a transactional aspect of the risk transfer phenomenon within a family group. Even absent non-arm's length transactions or bad faith conduct in siphoning off bank funds for family members' personal interests, in the pursuit of maximizing the interest of the group as a whole as opposed to that of its banking component per se, may occur. It is not an unusual practice for a family group to use the depositor's funds for making up the group's non-bank member's losses so that these losses are shouldered by the banking component, which is protected and subsidized by the national deposit insurance and other protective measures.

To summarize, all the standard functions of a bank which justify the existence of a bank including screening in order to meet the adverse selection problem, monitoring to take care of the moral hazard problem, and maximum diversification of loan portfolio to ensure safety of the deposits, suffer in the case of a group ownership of banks. The risk profile of the bank increases when it provides certain facilities to the group which are either not forthcoming from other banks or are available at a higher cost. A rise in the risk profile of the bank is likely to have an adverse impact on its stability. If the loss incurred through transactions with the group companies can be compensated by transactions with non group entities, the non group entities transacting with the bank will suffer. If this is not possible, the profitability of the bank will suffer, the price of stock will be adversely affected, and resource mobilization through stock market will take a hit. The maximum adverse impact can be generated if money which is loaned out to group companies is not returned to the bank. Cleaning the balance sheet will wipe out capital, reducing the capital adequacy ratio while adversely affecting the risk bearing capacity of the bank. Apparently, no benefit occurs to the bank as a result of being owned by a group. Group ownership will adversely impact transparency and the trust that needs to be reposed by the public in a public financial institution. A bank is owned by a group to benefit the group firms and not otherwise. As a result of group ownership, a dual adverse impact impinges allocative efficiency in the economy.

The above example of relational financing relates to crony capitalism, where collusion between agents in an economy impedes free operation of the market forces. However, there exist instances of another form of relational financing, conceptualized as 'bank-based relational-contingent governance' in the comparative governance literature (Aoki 2001). This leads one to appreciate the second scenario where a business group is so constituted that a bank is at the centre stage. As opposed to the earlier example of a bank owned by a firm belonging to a business group, the bank in this case is generally a major shareholder in the corporation and provides its corporate client with loans as well services related to bond issues, equity issues, settlement accounts, and related consulting services. The symbiotic relationship between the bank at the centre and the firms around it ensures convergence of their interests and mutual growth.

III CROSS COUNTRY HISTORICAL EXPERIENCE

Pre-Independence Banking Experience in India

It is necessary to draw from country specific experience in support of the theoretical framework developed in Section II. We begin with a historical analysis of the Indian experience of business group-owned banks in India. India provides a very interesting example, where an economic activity as risky and basic as banking emerged with hardly any regulation regarding its formation or operations. During the first phase in the development of banking, the English agency houses in Calcutta and Bombay began to conduct banking business in addition to their commercial business, on the basis of unlimited liability. The primary concern of these agency houses was trade, but they branched out into banking as a sideline to facilitate the operations of their main business. Thus, banking activity originated in India as a part of group activity. One often witnessed a run on the bank whenever a problem occurred with the related firm. The banking industry in the colonial period continued to be ravaged by a combination of banking with trading in the form of acquisition of control of non banking companies as well as interlocking of the bank with other concerns. It may also be pointed out that the managing agency managing non-banking and banking business simultaneously were the early incarnations of group-owned banks in India.

A costly lesson from the turmoil in banking during the pre-independence banking era has been the separation of banking from non-banking activity. This led to the passage of regulation that prevented banks from participating in non-banking activities. Thus, instability in the non-banking business was stopped from adversely impacting the business of banking and making it unstable. The soundness of a financial system has been elevated to a status of a public good. This implies that extreme caution and restraint has to be the hallmark of any policy regime for banks. It may be argued that the impact of ownership of banks by business groups will be similar to allowing a bank to do non-banking business. When banks are owned by business groups, as already argued in Section II, then at least some amount of risk faced by the group firms will have to be borne by the bank, making it more unstable compared to a stand-alone bank, which has to deal with risk emanating only from the business of banking.

Post-Independence India: Nationalization to Deregulation

It is perhaps useful to re-visit the arguments in defence of nationalization in the pre-nationalization phase of banking, when banks were owned by groups. Before several banks were nationalized in 1969, the Tatas were reported to be actively involved with the Central Bank of India. The Thapar group controlled the Oriental Bank of Commerce. In the pre-independence days, strong visible and invisible links between the captains of industry and trade and those who ran the banking system were present. The advantages flowing from these links far outweighed the disadvantages and it was important that some methods were devised to bring about a delinking. Some changes were introduced as part of a social control scheme by passing necessary legislations amending the prevailing laws. They succeeded in snapping the visible links but the invisible links remained.

It appears that Hazare (1966) came across instances of invisible links between industry and banks in his celebrated attempt to analyse the ownership and control pattern of business groups in India. He observed that the banks held large blocks of shares in many companies including in some private companies. It was an open secret that 90 percent of such holdings did not belong to banks as beneficial owners, but were held in various capacities on behalf of their clients. Registration of shares in the names of the banking companies was widely used for concealing the ownership and control of companies. The mystery of ownership and control in business groups forced a painstaking researcher like Hazare to concede that analysis of control, in quantitative terms, is rendered more difficult than the analysis of ownership. This because a deliberate effort was made to conceal the proportion of capital held by the controlling interests. It is clear that a very complex and opaque issue like ownership and control of business houses in India had been rendered more obscure by the invisible link between the industry and banks. Over the years the endeavour of the government has been to ensure that both visible and invisible links are eliminated so that the banks support all productive endeavours strictly on the basis of merit as opposed to links. The failure of social control led to nationalization. People in favour of group ownership of banks have to provide a valid counter argument to balance the adverse impact of visible and invisible links between industry and banking if they have to establish their view point.

In the current deregulated regime, the nature of banking has become very complicated as it has to grapple with a number of risks. It is simply out of question to expose a bank to new kinds of risk when the social rationale of a business group owned bank is far from clear. It is clear that business group owned banks imply the presence of visible and invisible links between industry and the bank which creates a financial system that does not favour an entrepreneur willing to take new risks, an activity that is so fundamental to growth of the economy. It hinders free operation of market forces, creates crony capitalism and goes against the spirit of a deregulated regime.

Japanese Experience of Keiretsu and Main Bank

To understand the invisible link between the remarkable strength and success of Japanese companies today, it is necessary to examine the functions of the *keiretsu* or business group, in terms of the role of the main bank at its core, and its impact on the present and future strength of Japanese firms. Before World War II, several large industrial groups dominated Japanese economic activity. They were centrally owned and controlled with common interlocking directorships. After the war, the United States forced Japan to dissolve these groups as they contravened anti-monopoly and anti-combine regulations. Since that time, a number of major groups, or *keiretsu*, have re-formed. Today each group is clustered together in voluntary association with a central bank at the core. An example of these powerfully related companies is the Mitsui Group, vying with Mitsubishi as one of the two largest *keiretsu*. Mitsui is representative of the key characteristics in these associations which include a large industry range, ostensible independence of member companies, central role of a major bank, nebulous definition of membership, and dynamic nature of relationships. The integrating mechanisms of the *keiretsu*, which holds its affiliated companies together, include cross-shareholding, commercial transactions, personnel movement, and strategic coordination.

The main bank system and the *keiretsu* are two different yet overlapping and complementary elements of the Japanese model of corporate governance. Almost all Japanese corporations have a close relationship with a main bank. The bank provides its corporate clients with loans as well services related to bond issues, equity issues, settlement accounts, and related consulting services. The main bank is generally a major shareholder in the corporation. In Japan, the bank acts as a virtual guarantor of the long-term liability of the companies which belong to its own group. The phenomenon describes a long-term supportive relationship that is rarely found in our own society. Support from the bank during troubled times and the resulting bank control over the firm are the two features of the institution of *keiretsu* analysed below.

In case of financial difficulties, when a company cannot meet its interest and principal repayments, the bank will allow deferment of repayment and will continue making new loans to that company. The bank does not foreclose the loan even when a company is no longer financially viable. On the contrary, it engineers a merger and draws the ailing company under the wing of one or more of the other members in the family. Human resources are absorbed within the other companies and physical assets are also incorporated into other operations. The main bank will ensure that all creditors are paid off in full and if there are losses, the bank will absorb the losses. A different situation exists when a Japanese company does not belong to a *keiretsu* and has no main bank relationship. In such a case, no obligation exists on the part of the Japanese bank.

In exchange for long-term security and support, the bank at the core of the *keiretsu* gets considerable control and influence over the firm. Traditionally, numerous Japanese companies have been financed almost exclusively by bank loans. The bank participates directly in corporate management decisions and has an implicit veto power.

An important difference between the Japanese *keiretsu* and Indian business groups is that the *keiretsu* are characterized by a main bank providing both equity capital and debt to its members. They tend to be run by professional mangers rather than members of an extended family and are considerably less tightly controlled than a typical Indian business group institution. In Japan, the main bank has an incentive to protect the loans it has provided to a low performing *keiretsu* firm.

IV CASE STUDIES OF BANKS OWNED BY BUSINESS GROUPS IN INDIA

A glance at the ownership of private banks in India reveals that very few of them belong to a group. These banks include the Bank of Rajasthan, the erstwhile Centurion bank of India, IndusInd Bank, and the Kotak Mahindra Bank. The cases exhibit two types of bank based relational financing. First, a firm (financial or non-financial) owns a bank and, second, a holding company owns both the bank and firms. The Bank of Rajasthan and the erstwhile Centurion Bank provide examples of the former while IndusInd Bank exemplifies the latter type. While the Bank of Rajasthan has passed into the hands of the Tayals from the Bangurs, the IndusInd Bank is controlled by the NRI Hinduja group through a holding company based in Mauritius. The third bank was promoted by a listed entity known as the Twentieth Century Finance Corporation. It needs to be empirically examined as to what extent group membership has produced an adverse impact on corporate governance in these banks. We discuss in detail the first three banks and leave out Kotak Mahindra Bank, as unlike the rest, it is of a very recent origin.

Established in 1943, the Bank of Rajasthan (hereafter referred to as BOR), the state's oldest private sector bank, began getting enmeshed in controversies in the 1990s. It was one amongst the top five private banks in the country till 1997 in terms of market share. It provides a very interesting example of the adverse impact exerted on a public financial institution by group ownership on the one hand and a squabble between two business groups for cheap public money on the other. An account of corporate governance in the bank is complicated enough to merit a detailed discussion. An analysis of the affairs of the bank is conducted in terms of certain points to facilitate easy comprehension.

A discussion of corporate governance in banks is generally subsumed under a general discussion of corporate governance in firms, which revolves around the presence of conflict between owners, who own but do not control the firm, and management, who control the firm but do not own it. However, the literature on corporate governance (Murthy, 2008) in banks refers to the existence of conflict of interest at multiple levels. Corporate governance in banks refers to a resolution of conflict between shareholders and regulators, on the one hand, and between shareholders and depositors, on the other. It also refers to resolution of conflicts between majority and minority shareholders as well as between equity holders and debt holders. Analysis of the affairs in BOR is conducted in terms of the above conceptual framework to reveal how group ownership has led to a creation of conflicts at the levels mentioned above. We start with a discussion of how conflict between the promoter and regulator was shaped in BOR which leads to examples of how a promoter develops conflict with depositors, employees, minority shareholders, and debt holders. Lastly, it is shown how the presence of independent directors was of no consequence in the resolution of the above conflicts.

Diversion of Funds from the Bank to the Group/Front Companies of Former BOR Promoter

The RBI severely indicted the management of BOR led by the Bangurs for fund diversion and mismanagement, after inspecting the accounts of the bank in 1998. The RBI removed Keshav Bangur and S. N. Bangur from the Board of directors of BOR. They were also debarred from holding directorship in any banking company for five years. In August 2000, the Central Bureau of Investigation revealed a diversion of Rs 69.155 cr to the group/front companies of the former BOR promoters, the Bangurs. An enquiry was ordered by the Rajasthan High Court following allegations of fund diversion to the tune of Rs 277 cr by the former promoters. In its interim report, submitted to the High Court, CBI said, 'funds were sanctioned by BOR to front companies of Keshav Bangur from where they were further diverted to Bangur Finance through various intermediaries. The report has listed five front companies of Keshav Bangur: Commodity Exchange Corporation, Xitiz Exim, Shanoo Exports, Gangaur Nirman, and SM Commercial, which got Rs 29.50 cr by way of packing credit. Moreover, Rs 15.105 cr was sanctioned as ICD/short-term loan to front companies of Bangur by Rajasthan Bank Financial Services, a subsidiary of BOR. Besides, nine companies were sanctioned Rs 14.255 crs, part of which was transferred to front companies of Bangur. The bulky report has given details of fund diversion and how it reached various Bangur companies through various transactions. According to the probe report, Bangur and his family members had substantial shareholding in many of these front companies. Most of the funds transferred to Bangur Finance were stated to be towards repayment of ICDs and investment in stock market.... no exports were made against packing credit limits by most of the companies. In the case of packing credit limits, the amount was not utilized for the purpose for which it was sanctioned and the entire amount is outstanding.' The probe also touched on the acquisition of stake by the Bangurs in BOR. In January 2003, however, based on a writ petition filed by bank employees, Bangur was arrested for defrauding the bank of Rs 300 crs. The case is still being heard in the Rajasthan High Court and the CBI is yet to submit its final report.

Dubious Means of Securing Control by Tayals

Bangur had enabled Tayal to take a loan of Rs 25 cr from the BOR. Tayal used Rs 7.50 cr from this to buy BOR shares. The Finance Ministry's Central Economic Intelligence Bureau (CEBI), located within the Department of Revenue, Ministry of Finance, found prima facie evidence of dubious transfers from the Tayal Group of Companies to various fictitious companies that were owned by Tayal himself. According to CEIB, Rs 300 cr was transferred to Shree Krishan Polyester Ltd, Shree Krishna Petroyarns Ltd, Shree Krishna Texport Industries Ltd, and Shree Krishna Knitwear. This amount was raised by siphoning off funds from banks, financial institutions, and public money raised through public issues. The funds transferred to these companies were then lent to other fraudulent firms that existed only on paper. According to CEIB, Rs 210 cr was transferred in this manner. The intent of this second transfer was to enable these firms to purchase shares of BOR. These firms then gave proxies in favour of Tayal. In this manipulative and strategic manner, misusing public funds, the Tayals ousted Bangur from the post of part-time chairmanship of BOR and was appointed non-executive chairman of the bank. The Ministry of Finance acknowledges that there are 'complaints about irregularities committed by Tayal through BOR.' The ministry's Department of Economic Affairs, Banking Division, stated the following:

> The allegations related to acquisition of shares of the Bank by the Tayal group by having *benami* transactions, delay in remittance of allotment money by the Tayal group as a result of which the bank lost an amount of Rs 28.80 lakhs towards interest, irregularities in the issue of right shares, forged proxies and carrying out transactions using forged stock invest.

RBI had informed the ministry that in the matter of acquisition of shares of Bank of Rajasthan by the Tayal group, SEBI had observed violation of its Regulations 3(4) and 7 and the same was referred for adjudication. The adjudication proceedings regarding the violation of Regulation 3(4) were completed and penalty, of a mere Rs 1 lakh, was imposed by SEBI on the Tayal group of companies, with a turnover of Rs 2,500 cr to legalize their control of the bank. The adjudication proceedings regarding the violation of Regulation 7 are still in progress by SEBI. Apart from SEBI, the role of Shri Tayal in the malfunctioning of the BOR is also being enquired into by various other agencies like RBI, CBI, etc. This led to a refusal by the IDBI to sanction its application for a term loan of Rs 50 cr and a direct subscription to equity of Rs 30 cr for partial financing of an expansion scheme of one of the Tayal group of companies.

Violation of the RBI Directive of Arms-Length Relationship between the Bank and Its Promoter

A confidential note issued by the RBI regarding the role of directors and part-time chairmen of private banks clearly states that 'part-time chairman as well as directors should distance themselves from activities which are inconsistent with their role…the objective in allowing the appointment of a part-time non-executive chairman in a banking company is to enable it to have the benefit of association of eminent persons of valued experience.' Tayal's record is certainly not eminent. He has violated the RBI's directive that there should be an arm's length relationship organizationally and operationally, between the Bank and its promoter. A few examples of violations follow.

Tayal shifted the regional office of the bank in Mumbai from Grant Road, Mumbai, to his own premises at Raghuvanshi Mills Compound, Lower Parel, Mumbai, immediately after his induction on the Board. To tighten his grip on the bank further, the promoter established the bank's corporate office in Mumbai, although it was headquartered outside Maharashtra. All the significant departments, viz., the departments of credit, investment, treasury, recovery, as also the board secretariat, the office of the managing director as well as deputy managing director, and executive director were situated right behind the administrative offices of the non-bank businesses run by the promoter.

Conflicting Interest of Depositors, Employees and Small Shareholders with the Promoter

The apprehension of the depositors was communicated by a Member of parliament to the then CBI director. Two delegations of bank officers' also voiced concerns before the Finance Minister, Jaswant Singh. The delegation requested Singh to initiate an investigation of the bank's functioning under section 36D(IV) of the Banking Regulations Act, 1949, without delay. Representation has also been received from a small shareholder of the bank in September 2003. He had levelled allegations about the connivance of the officers of the Reserve Bank of India in helping Shri P. K. Tayal in the malfunctioning of the affairs of the Bank of Rajasthan. Tayal acquired 90 lakh shares in a completely illegal manner by making a payment of Rs 2 per share instead of Rs 10 per share.

Passive Independent Directors and Nominee Directors from RBI

Both RBI and SEBI state that no promoter can run a bank or any business arbitrarily because it is run by a board of independent directors. But the actual issue is how 'independent' are these directors when they are related to the promoter? There were two nominee directors from the RBI. It is very surprising that such directors did not raise any concern about the goings on in the bank.

The episode of the bank may be very briefly summed up as follows. While the Bangurs diverted funds form the bank to his group, Tayals used controversial, manipulative, and illegal means to acquire control. Tayals ran the bank with scant regard for RBI norms, harming the interest of all the stakeholders in the bank: depositors, employees, and small shareholders. While this happened, independent directors and directors appointed by RBI watched from the sidelines. Apprehensions of subjugation of interest of debt holder's interest to the promoters led to the refusal of IDBI to sanction a term loan to a company belonging to the Tayal group. It may be justly said that the functioning of the bank has made a mockery of corporate governance. Group interest was promoted at the cost of the interest of the bank. As will be seen later, the situation is similar with new group owned banks.

Centurion Bank and IndusInd Bank are the only banks with group affiliation among the new banks. Centurion Bank was promoted by Twentieth Century Finance Corporation (TCFC) and later merged into Centurian Bank Ltd., in 1995. Similarly, Ashok Leyland Finance Ltd., a group company was amalgamated with IndusInd Bank in 2004. A major portion of TCFC's assets are doubtful in nature owing to its large exposure to equipment leasing. After merger, the capital adequacy ratio (CAR) of the bank has come down to 4.16 per cent, less than half the RBI norm of 9 per cent.

With significant asset addition also in the corporate finance segment, it was expected that the merger would establish CBL as a major player in the consumer finance market. The strong access to low-cost funding that Centurion Bank coupled with the high growth-high margin retail financing business that TCFC is involved in, shall provide a strong foundation for a consolidated operation. It is also expected that the merger will result in other synergies including reduction in cost of funding, achievement of economies of scale, elimination of duplication of businesses and an all-India presence for the bank. However, it may be convincingly argued that these were not the real reasons. TCFC, once highly rated on its deposit schemes, had taken a tumble with the rating agencies rapidly downgrading it. Instead of tackling a sick NBFC, the promoters chose the route of a reverse merger with a new entity promoted by them. The strategy obviously was to ensure an adequate performance by the new bank that could nullify the effects of the troubled promoters' past. In this case, the underlying objective of the promoter in promoting the bank was to salvage itself through the de-merger route. The ratio of exchange of shares of the bank and the finance company was fixed at 1:1. The rationale behind such an exchange in terms of benefit to the bank is not clear. Such an exchange has obvious adverse implications for non-promoter shareholding which had to suffer because of a cleaning of the balance sheet of the new entity due to bad assets carried over from the finance company.

IndusInd Bank belongs to the Hinduja group of companies. IndsInd Bank merged with Ashok Leyland Finance Ltd in 2004. The impact of the merger, as in the earlier case, will be examined in a subsequent section. However, it is well known that the group is controversial and it is also alleged that the public shareholders of the bank have been shown to include corporate bodies which are possibly related to its promoters (Rao 2008: 44). If the promoters' share is hidden amongst non-promoter shareholding, the transparency of a public financial institution like a bank will suffer. Moreover, the promoter share revealed by the data will be an underestimate of the actual promoter share. The promoter share is a very critical variable in any econometric analysis of corporate governance. Use of an understated promoter share in an empirical analysis will provide misleading results. This does not augur well for research on corporate governance in the country. This calls for extra vigilance on the part of the researchers in using the data provided by a group owned company on promoter shareholding. One has to adjust the data in order to arrive at a numerical figure of promoter shareholding close to the actual shareholding.

V HYPOTHESES AND METHODOLOGY

In the absence of any study which analyses the impact on group ownership of banks in India, this section begins with an observation to work out a hypothesis to be tested in the study. Business groups exploit the bank through various means. However, there are feasible limits to such exploitation due to a close monitoring of the health of banks by RBI. The business group would like to use the bank for the benefit of the group but such a use needs to be dictated by a sense of balance, which is in the interest of the group itself. Continuous overuse of the bank for the benefit of the group is likely to attract the attention of RBI leading to loss of control over the bank. It appears that the optimal strategy likely for the group is to subject the bank to alternate phases of redistribution of profit. An adverse impact on the profitability on the bank will be followed by a favourable impact, leading to higher variation in the profitability of a group-owned bank compared to stand-alone bank. This brings us to the following hypothesis to be tested in the study. A larger variation in profitability of group owned bank exists relative to stand alone banks.

The presence of only few banks that are group owned, constrains the choice of the methodology. It is clear that no rigorous econometric technique can be used due to the small number of group owned banks. However, the results of a simple comparison between group banks and non group banks will be suggestive enough to reinforce the moral of the case studies provided in Section IV. The exercise does not establish any causal relationship or even a one-to-one association between group ownership of a bank and its conduct and performance. These results, even while they remain tentative, will constitute a useful starting point for subsequent analysis. Basically, the methodology consists of a comparison of each group-owned bank with its stand-alone peer bank, which does not belong to any business group. Three components of methodology used in the study are as follows. In the first leg a comparison of the old group-owned bank is made with a similar stand-alone old bank in terms of two variables, NPAs and profitability. Next, a comparison of the change in ranks of group-owned new banks is made with other new banks, with regard to the above variables. Lastly, the coefficients of variation of profitability of the new and old group of banks with stand-alone banks are compared over the period covered by the study.

VI RESULTS OF THE STUDY

We begin with a comparison of the only old group-owned bank with its peer bank. The bank which is closest to the bank of Rajasthan in terms of asset size is picked up for comparison. It is noted that the asset size of the bank varies over time, leading the change in the identity of its peer bank. Two variables are chosen for comparison: non performing assets and profitability.

It is observed in Table 1 that over the period from 1992 to 1996, the Bank compared favourably with its peer bank in terms of profitability and NPAs. In 1997, the deterioration set and it went into the red during 1998 and 1999. It was during this period that the Tayals were invited by the Bangurs to join the bank as co-promoters and soon ousted the Bangurs from control of the bank. The Bank did not compare favourably with its peer bank for a major part of the period from 1997 in terms of profitability and NPAs. What matters here is not whether the Bangurs or Tayals controlled the bank. Both have exploited the bank and the cost to the bank and to the economy as a result of improper governance in the bank, due to group ownership, becomes apparent.

Unlike the Bank of Rajasthan, the peer group for Centurion Bank and IndusInd Bank consists of the entire set of new banks with whom these banks need to be compared. We report the profitability of these banks along with their peers in four tables provided below. The data is presented in such a way that the impact of group ownership on these group-owned banks vis-à-vis stand-alone banks becomes apparent. The group-owned banks are provided in bold letters to facilitate easy identification.

It may be observed from above that Centurion Bank was the highest profit making bank during 1995–96. A group finance company was merged with the Bank in 1995 and a major adverse impact on its profit was recorded the following year. The Bank nosedived to the sixth position in a group of nine banks. The profit made by the Bank in 1996–97 was only one third of its profit in the previous year. The status of the Bank with regard to profitability remained unchanged during 1998–99. Subsequently, the profit of the Bank resumed its southward journey to emerge as one of two the worst performers in the set of new banks during the last years covered by the study. It may be noted that profits of the Centurion Bank turned negative during 2001–02 and remained so for the next two years. While the bank did not have any NPAs during the initial the two years of its existence, it degenerated enough to emerge as one of the three banks with the highest NPAs from 1999–2000 onwards. The situation with regard to NPAs further degenerated from 2005–06 onwards, when its level of NPAs were just below that of the IndusInd Bank, the worst performer relating to NPAs. Such a situation suggests an association between this downturn of the Bank with its amalgamation with TCFC in 1995. The adverse impact of the amalgamation

Table 1—Non-performing Assets and Profitability of Bank of Rajasthan and Its Peer Banks: 1992–2007

Year	Name of Bank	Assets	nnpa/nad	Profits/Assets
1992	Bank of Rajasthan	122,739	N.A.	0.009679
1992	Karnataka Bank	86,563	N.A	0.007613
1993	Bank of Rajasthan	141,494	N.A.	0.004142
1993	South Indian Bank	109,620	N.A.	0.002199
1994	Bank of Rajasthan	180,444	N.A.	0.008363
1994	South Indian Bank	138,169	N.A.	0.007708
1995	Bank of Rajasthan	243,286	N.A.	0.0204
1995	Jammu and Kashmir Bank	274,979	N.A.	0.005811
1996	Bank of Rajasthan	311,581	4.4	0.014972
1996	Jammu and Kashmir Bank	347,199	5.09	0.005297
1997	Bank of Rajasthan	340,598	8.82	0.002322
1997	Karnataka Bank	289,401	3.12	0.014067
1998	Bank of Rajasthan	341,076	9.14	-0.025754
1998	Bank of Madura	339,347	5.7	0.010075
1999	Bank of Rajasthan	367,111	9.5	-0.018376
1999	Bank of Madura	362,833	6.23	0.008304
2000	Bank of Rajasthan	412,864	9.61	0.0029235
2000	South Indian Bank	444,361	8.67	0.0058263
2001	Bank of Rajasthan	434,414	7.62	0.0074169
2001	Karur Vysya Bank	423,990	4.73	0.0169933
2002	Bank of Rajasthan	480,339	8.86	0.008392
2002	Karur Vysya Bank	511,012	6.3	0.0212343
2003	Bank of Rajasthan	612,952	6.8	0.0111624
2003	Karur Vysya Bank	617,880	4.2	0.0202256
2004	Bank of Rajasthan	845,533	2.99	0.0081641
2004	South Indian Bank	925,406	4.55	0.0091117
2005	Bank of Rajasthan	915,468	2.5	0.0038265
2005	South Indian Bank	947,750	3.81	0.000918
2006	Bank of Rajasthan	985,362	0.99	0.0015466
2006	Karur Vysya Bank	900,789	0.81	0.0150257
2007	Bank of Rajasthan	1,209,700	0.24	0.0091403
2007	South Indian Bank	1,365,258	0.98	0.0076264

Table 2A—Ratio of Profits to Assets for New Banks: 1995–96 to 1997–98

Bank	1995–96	Bank	1996–97	Bank	1997–98
CB	0.030	ICICIB	0.023	HDFCB	0.022
BOP	0.029	HDFCB	0.022	GTB	0.021
HDFC	0.026	GTB	0.022	BOP	0.021
INDSB	0.024	BOP	0.021	**INDSB**	0.018
GTB	0.018	**INDSB**	0.021	ICICIB	0.015
ICICI	0.014	**CB**	0.012	**CB**	0.013
TB	0.012	UTIB	0.009	TB	0.010
UTI	0.009	TB	0.007	IDBIB	0.009
		IDBIB	0.005	UTIB	0.006

Table 2B—Ratio of Profits to Assets for New Banks: 1998–99 to 2001–02

Banks	1998–99	Banks	1999–2000	Banks	2000–01	Banks	2001–02
HDFCB	0.019	GTB	0.014	HDFCB	0.013	HDFCB	0.012
BOP	0.015	IDBIB	0.014	BOP	0.009	UTIB	0.009
GTB	0.014	BOP	0.010	GTB	0.008	BOP	0.009
ICICIB	0.009	HDFCB	0.010	ICICIB	0.008	IDBIB	0.008
IDBIB	0.009	ICICIB	0.009	UTIB	0.008	GTB	0.006
TB	0.009	UTIB	0.008	**INDSB**	0.005	**INDSB**	0.005
UTIB	0.008	**INDSB**	0.007	IDBIB	0.004	ICICIB	0.002
CB	0.007	**CB**	0.007	**CB**	0.001	**CB**	-0.023
INDSB	0.006						

Table 2C—Ratio of Profits to Assets for New Banks: 2002–03 to 2004–05

Banks	2002-03	Banks	2003-04	Banks	2004-05
UTIB	0.010	**INDSB**	0.017	**INDSB**	0.013
INDSB	0.009	ICICIB	0.013	HDFCB	0.013
IDBIB	0.009	HDFCB	0.012	ICICIB	0.012
ICICIB	0.011	UTIB	0.012	UTIB	0.009
HDFCB	0.013	IDBIB	0.010	**CB**	0.005
GTB	-0.036	BOP	0.008	BOP	-0.012
CB	-0.007	**CB**	-0.030		
BOP	0.007	GTB	-0.113		

Table 2D—Ratio of Profits to Assets for New Banks: 2005–06 to 2006–07

Banks	2005–06	Banks	2006–07
HDFCB	0.012	HDFCB	0.013
ICICIB	0.010	ICICIB	0.009
UTIB	0.010	UTIB	0.009
CBP	0.008	**CBP**	0.007
INDSB	0.002	**INDSB**	0.003

Table 3A—Ratio of Net NPAs to Net Advances for New Banks: 1995–96 to 1998–99

1996	nnpa/ nad	1997	nnpa/ nad	199834	nnpa/ nad	9933	nnpa/ nad
GTB	0	GTB	4.47	UTIB	5.63	**INDSINDB**	**7.2**
UTIB	0	UTIB	3.66	**INDSINDB**	3.96	UTIB	6.32
IDSINDB	0	**IDSINDB**	2.08	GTB	2.98	**CB**	4.67
ICICIB	0	ICICIB	1.73	TB	1.41	BOP	3.66
BOP	0	BOP	1.59	HDFCB	1.18	GTB	3.33
IDBI	0	IDBI	1	ICICIB	1.14	TB	3.01
TB	0	TB	0.46	BOP	1.14	ICICIB	2.88
HDFCB	0	HDFCB	0	**CB**	0.38	IDBIB	1.28
CB	0	**CB**	0	IDBIB	0.32	HDFCB	0.34

Table 3B—Net NPAs to Net Advances Ratio for New Banks: 1999–2000 to 2001–02.

2000	nnpa/nad	2001	nnpa/nad	2002	nnpa/nad
INDSINDB	5.98	INDSIND	5.25	GTB	9.23
UTIB	4.71	IDBIB	5.24	INDSIND	6.59
CB	3.88	UTIB	3.76	**CB**	6.09
BOP	2.32	GTB	3.75	ICICI	5.48
IDBIB	1.96	**CB**	3.52	UTI	3.46
ICICIB	1.53	BOP	2.31	BOP	2.93
HDFCB	1.1	ICICIB	2.19	IDBIB	2.21
GTB	0.87	HDFCB	0.45	HDFCB	0.5

Table 3C—Net NPA to Net Advances Ratio for New Banks: 2002-03 to 2003-04

2003		2004	
Bank	**Ratio**	**Bank**	**Ratio**
GTB	19.77	GTB	27.99
CB	7.51	BOP	4.69
BOP	7.17	**CB**	4.43
ICICIB	5.21	**INBSINDB**	2.72
INDSINDB	4.25	ICICIB	2.21
UTI	2.39	UTIB	1.29
IDBIB	1.18	IDBIB	0.2
HDFCB	0.37	HDFCB	0.16

Table 3D—Net NPAs to Net Advances Ratio for New Banks: 2004–05 to 2006–07

2005		2006		2007	
Bank	**Ratio**	**Bank**	**Ratio**	**Bank**	**Ratio**
BOP	4.64	**INDSIND**	2.09	**INDSINDB**	2.47
INDSIND	2.71	**CBP**	1.13	**C BP**	1.26
CB	2.49	UTIB	0.98	ICICIB	1.02
ICICIB	1.65	ICICIB	0.72	UTIB	0.72
UTIB	1.39	HDFCB	0.44	HDFCB	0.43
HDFCB	0.24				

on profits was immediately reflected in the year subsequent to merger. However, the adverse impact of amalgamation on NPAs was not immediately apparent as the accounts were merged only over a period of time. The complete adverse impact was visible from 1998–99 onwards, after the completion of the process of merger. It is interesting to note that the bank degenerated from a status with zero NPAs and highest profitability to a status where it had the dubious distinction of the second highest NPAs and second lowest profitability. Putting the two pictures relating to NPAs and profitability together, it may be safely argued that the adverse scenario with regard to the Bank in the post-merger period is not likely to be completely independent of merger.

IndusInd Bank tells us a similar story. A group finance company known as Ashok Leyland Finance Ltd. was merged with the bank in 2004. The post-merger scenario turned out to be distinctly unfavourable to the bank. It was relegated to the bottommost position from being a top performer with regard to profitability preceding the merger. While the Bank's NPAs were not quite favourable during the period of the study, it turned out to be one with largest NPAs in the last two years covered by the study. It has already been observed that in these two years, the Bank had the lowest profitability as well. To recapitulate, the two group-owned banks ended up at the bottom among new banks with regard to two most important indicators of health: profitability and NPAs. Such an adverse position of group-owned banks during the last phase of the study is not unrelated to group membership. However, this discussion is only suggestive in nature and needs to be supplemented with rigorous methodologies. It only provides a mere prelude to a more intensive research on the issue of group owned banks.

It may be added that the adverse impact on the health of banks after their merger with NBFCs, as observed in the case of Centurion Bank and IndsInd Bank, had led to a concern by RBI. Though, such mergers give banks an advantage in terms of size of assets, there are issues concerning their quality, income recognition, asset classification, and provisioning norms. As the situation now obtains, the boards of a bank and an NBFC consider and approve the scheme of amalgamation. The scheme comes into effect, subject to necessary consent and approval of shareholders and creditors of both the financial entities. Thereafter, approval of the relevant high court(s), the Reserve Bank of India, and other statutory authorities is sought. Following the central bank's directive, banks now will first have to obtain the regulator's in-principle approval for amalgamation/merger. This move is aimed at ensuring that the post-merger bank continues to be in compliance with the legal provisions contained in the Banking Regulation Act, 1949, and other relevant statutes and also the regulatory prescriptions of the central bank.

We now arrive at the last component on the current section which analyzes the Indian scenario relating to banks as part of business groups. To test the impact of group ownership on the stability of group owned banks vis-à-vis stand alone banks, we calculate the coefficient of variation of profitability of all banks over 1994-95 to 2006-07. The result is reported in Table 4.

Table 4—Coefficient of Variation in Profits to Assets Ratio During 1994–95 to 2006–07

Name of Bank	Coefficient of Variation in Profits to Assets Ratio
South Indian Bank	–3.80
City Union Bank	0.17
TamilNad Mercentile Bank	0.17
Karur Vyasa Bank	0.18
Karnataka Bank	0.20
UTI Bank	0.22
Federal Bank	0.38
HDFC Bank	0.42
Laxivilas Bank	0.44
ICICI Bank	0.45
Nainital Bank	0.45
Jammu and Kashmir Bank	0.48
South Indian Bank	0.50
IndsInd Bank	0.62
ING Vyasa Bank	0.84
Dhanalaxmi Bank	0.86
Catholic Syrian Bank	0.93
Ratnakar Bank	0.99
Lord Krishna Bank	1.29
Bank of Rajasthan	3.41
Centurion Bank of Punjab	5.37

The table provides evidence in support of our hypotheses made in Section V. It shows that among all the banks, Centurion Bank has had the maximum variation in profitability over the period 1994–95 to 2006–07, followed by the Bank of Rajasthan, and IndusInd Bank. Amongst the new banks, the highest variation in profitability is reported by Centurion Bank and IndusInd Bank, which are the only the banks belonging to business groups. These results confirm the hypothesis of periodic exploitation of banks by the controlling interest of business groups.

VII CONCLUSION

The paper examines the theory of banking intermediation by Diamond and the impact of introducing business groups on the result of financial intermediation through banks. It argues that the impact on banking intermediation depends on the type of business group, bank centric or firm centric. The theoretical analysis is supported by historical experiences from India and Japan. Detailed case studies relating to business group-owned banks in India point towards the chaotic nature of corporate governance in these banks. Given such a situation, it is apparent that a beneficial role in corporate governance, as has been seen in the case of *keiretsu* and other main banks in Japan, is not present in the group-owned banks of India. Group ownership has exposed the banks to risks which cannot be rationalized from the standpoint of society. While stand-alone private banks in the country have been compared to the Augean stables in the literature on the subject, there is mention of additional adverse influences on corporate governance in a bank, emanating from group ownership. Group-owned banks create crony capitalism, hamper transparency, and go against the spirit of the current deregulated regime. Lastly, succession squabbles currently observed in the country militate against the idea of putting a public financial institution at the centre of a private family feud. The regulatory framework is perfectly justified in not allowing a bank to be controlled by an industrial house.

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APPENDIX

Table A1—Abbreviated Name of Banks

Names of Banks	Abbreviated Name
Bank of Rajasthan	BOR
Catholic Syrian Bank	CSB
Centurion Bank	CB
City Union Bank	CUB
Centurion Bank of Punjab	CBP
Dhanalaxmi Bank	DB
Federal Bank	FB
HDFC Bank	HDFCB
ICICI Bank	ICICIB
IndsInd Bank	INDSB
Jammu and Kashmir Bank	JKB
Karur Vyasa Bank	KVB
Karnataka Bank	KB
Laxmi Vilas Bank	LVB
Lord Krishna Bank	LKB
Nainital Bank	NNB
Ratnakar Bank	RB
Sangli Bank	SB
South Indian Bank	SIB
TamilNad Mercantile Bank	TMC
UTI Bank	UTIB
Vyasa Bank	VB