The Merger of HDFC Limited with HDFC Bank

Synergy or Concentration?

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The merger of HDFC Limited with its associate, HDFC Bank, has further increased the size of the latter and benefited it from various organisational synergies. At the same time, the nature of the bank, being retail- and transaction-oriented, may have also changed as it moves towards higher exposures in wholesale and corporate banking. There may be, therefore, consequent impacts from the rise in industry concentration as well as systematic risk for the bank, and hence a need for enhanced corporate governance and regulatory oversight.

Views are personal.

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On 1 July 2023, HDFC Limited merged with its associate, HDFC Bank, creating the second largest bank in terms of asset size in India. Set up in 1977 for the purpose of housing mortgage finance, the company established the bank with a universal banking licence in 1994. With their founding years set apart by almost two decades, both organisations pioneered best practices and innovations in housing finance and banking, raising their sectors' size, efficiency and performance. The merger has led to the transformation of HDFC Bank into a financial services conglomerate with subsidiaries in non-banking activities such as life and general insurance, asset management, etc.

This commentary probes into the benefits and impacts of the merger of HDFC Limited with HDFC Bank. It took place as several disrupting events unfolded in the respective sectors of both entities. While the economic reason for their consolidation, to create a bigger and better bank, may be sound, their merger may have other consequential impacts. The post-merger size and structure of HDFC Bank group may have bigger and long-term ramifications, and hence must be ensured to be more robust and resilient.

HDFC Group: Corporate Structure and Conglomeration

Until the merger, the corporate structure of the HDFC group had HDFC Limited as the holding company for investments in subsidiaries and associate companies, including HDFC Bank. While the shareholding in HDFC Limited had 66.20% with foreign portfolio investors, 21.07% with domestic mutual funds and insurance companies, and 9.34% with resident individuals, its exposures in subsidiaries and associates, along with their profiles and market capitalisation, are shown in Table 1. The company had 20.87% ownership in HDFC Bank, while foreign institutional investors had 26.30%, American depository shareholders had 18.43% and domestic financial institutions, banks, and mutual funds had 16.27% among other shareholders. The bank's shareholding pattern has been widely dispersed across a variety of domestic and overseas institutions with a ceiling on voting rights as per regulation.

As associates, both entities gained certain synergies from their business lines and operational relatedness. For example, in the mid of 2003, HDFC Bank entered into an arrangement with HDFC Limited to sell home loan products of the latter through its branches. As per the arrangement, the bank originated home loans that were approved and disbursed by the latter, for which the former received a sourcing fee. Besides, the bank had the option to purchase up to 70% of the fully disbursed loan either through the issue of mortgage-backed pass-through certificates (PTCs) or by direct assignment. In 2021–22, HDFC Bank originated almost 50% of its home loan portfolio and purchased around 33.66% of the same as direct assignment from HDFC Limited. However, such benefits from the corporate structure may have moved due to changes in the business environment, including shifts in regulation and changes in the banking industry structure.

Table 1: Profiles of Companies in the HDFC Group before the Merger (As of 31 March 2022)

Company	Year of Incorporation	HDFC's Shareholding (%)	Market Capitalisation ($ Billion)	Total Assets/AUM (₹ Bn)
HDFC	1977	–	57	6,409
HDFC Bank	1994	21	107	21,229
HDFC Asset Management	1999	52.6	6	4,080
HDFC Life Insurance	2000	47.8	15	2,042
HDFC Ergo General Insurance	2002	49.9	–	41
HDFC Credila	2006	100	–	91
HDFC Capital Advisors	2015	100	–	62
HDFC Sales	2004	100	–	4

Source: Annual Report of HDFC Limited, 2021–22.

Changed Business Environment

The merger of the two entities happened following two significant events in the banking and financial services sector: (i) a shift in regulation in the housing finance sector, and (ii) consolidation in Indian banking.

Shift in the regulation of the housing finance sector: HDFC Limited was earlier a housing finance company (HFC) under the regulatory ambit of the National Housing Bank (NHB). For various aspects, such as prudential norms with respect to income recognition, asset classification, higher loan-to-value (LTV) limits, lower risk weights and provisioning requirements, etc, HFCs enjoyed a differential regulation as compared to the banks, which provided them with greater flexibility to accept new borrowers.

In August 2019, the Reserve Bank of India (RBI) assumed the regulatory charge for the non-banking financial company (NBFC) sector following which the HFCs came to be reclassified as NBFC–HFC and became regulated in a manner duly harmonised with the banking sector. With newly issued regulations and operational directives, the various exemptions granted to erstwhile HFCs were withdrawn. For example, as per the new norms, the first condition for an entity to be recognised as an NBFC–HFC was that its housing portfolio should be a minimum 60% of its total portfolio. The second condition was that the share of lending to individuals should be a minimum 50%.

Besides, Scale Based Regulations were made effective from October 2022, which categorised the NBFCs into different layers based on their asset size. These regulations entailed further alignment of regulations of NBFCs with those applicable to banks on internal capital adequacy assessment process, concentration of credit/investment, large exposure framework, role of the chief compliance officer, senior management compensation and adoption of core financial services solution, among others.

As a specialised lender, HDFC Limited had built upscale to enjoy lower cost of operations with significantly lower delinquency rates and non-performing assets, and hence a lower risk-weighted housing finance portfolio. The company was consistently rated as AAA, which enabled it to have access to low-cost funds from the market. Its favourable cost structure allowed it to provide benefits to the customers in terms of highly competitive lending rates.

However, with the shift to the NBFC–HFC category, requirements such as the need for maintaining statutory liquidity ratio (SLR), increasing the liquidity coverage ratio (LCR), the requirement for high-quality liquid assets (HQLA) and higher-level capital for concentration risk became imposed. HDFC Limited needed to comply with various aspects of regulation as by the end of March 2022, it had 59.2% and 54.7% of its total assets towards housing finance and housing finance for individuals, respectively. Its LCR was, however, 80% as against the required minimum of 50%. Based on its asset size, the company could have been potentially categorised as an NBFC upper layer and a systemically important entity and subject to further regulatory requirements.

Consolidation in Indian Banking

After the global financial crisis, the Basel guidelines for bank regulation and supervision have become more stringent raising the norms for the level and quality of bank capital and liquidity along with sophistication in the determination of capital, as well as increased requirements of disclosures and other regulatory compliances. More particularly, certain banks came to be identified as systemically important banks (SIBs) for their potential risk to the stability of the financial system with extra-regulatory requirements, including higher Common Equity Tier I capital. The effect of all these has been to increase the cost of doing business, lowering of return on equity and, therefore, the need for economies in the use of capital. This set into motion several actions that have changed the structure of the banking industry. In response, the banking industry concentration in the United States, which grew significantly before the global financial crisis, moderated thereafter (DiSalvo 2023).

The Indian banking industry had been relatively unscathed from the global financial crisis and enjoyed a period of booming performance. However, increasing exposures to the infrastructure sectors, particularly in the public sector banks (PSBs), followed by a growing shadow banking sector, subjected the industry to considerable stress. In 2017, the State Bank of India (SBI) merged all its associate banks followed by the merger of 10 PSBs into four large banks between 2019 and 2020. The later mergers led these banks to become significantly large but not risky enough to be recognised as domestic SIBs. The mergers also changed the structure of the banking industry towards becoming even more monopolistic, with these banks as stronger competitors.

HDFC Bank has been one of the leaders in the industry with stellar growth in profits, increased efficiency and innovation. The bank gained a market share of core customer franchises in households, businesses and institutions, both organically and inorganically, to increase its CASA deposit and government accounts. It had been recognised as one of the domestic SIB entities in 2017 along with other banks such as the SBI and ICICI Bank Limited, which were identified earlier. The bank had one of the highest systemic risk measures among its peers, but was well capitalised to address the same (Roy 2023).

In the pre-merger model, there may have been regulatory issues in the corporate structure of the group. For example, while regulation of domestic SIBs needs to be directly under the banking regulator, with HDFC Limited as the promoter company and regulated by NHB, this may have led to regulatory arbitrage. Later with the RBI assuming regulatory charge of the housing finance sector, both the promoter and the associate could have become categorised as systemically important individually and subject to higher regulatory requirements, including that of increased capital adequacy. The erstwhile structure,

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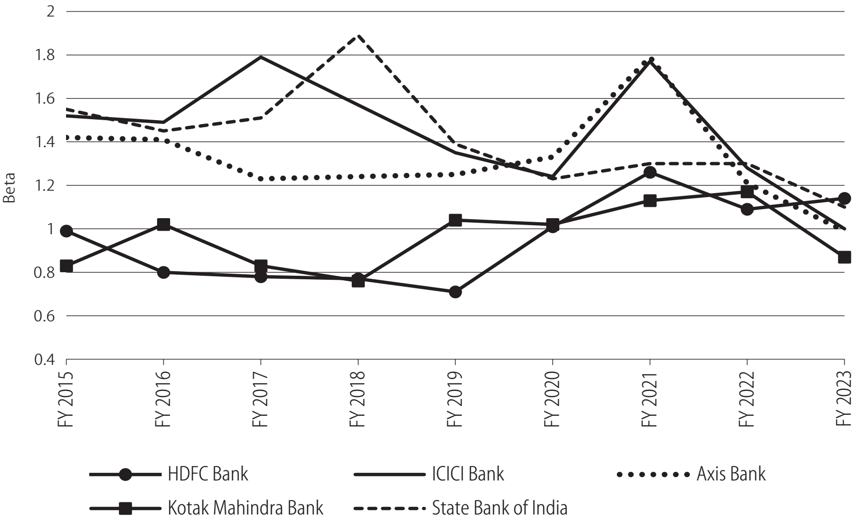
therefore, had clearly become inefficient for the group.

Figure 1: Equity Beta of Peer Banks



Source: Ace Equity v2.

Implications of the Merger

Following the changes that occurred in the banking industry, the logic of the erstwhile corporate structure of the HDFC group may not have remained significantly beneficial and became considered for replacement by the merger of the entities. The merger has potential organisational, industry and systematic risk implications, some of which are as follows.

Organisational-level synergies: In the pre-merger structure, there were limited opportunities of synergy to the extent of portfolio-building for both organisations. That structure did not provide for joint profit maximisation as customers of both entities were separate and could not be tapped for serving the full range of banking services. The discussion on the rationale for the merger in HDFC Bank's Annual Report of 2021–22 highlights this as an important missing element in their corporate structure. With the merger, other synergies and long-term benefits from cross-selling product lines have now become possible. For example, the level of unsecured loans in the lending portfolio of HDFC Bank had risen from 26.7% in FY 2010 to 30.5% in FY 2022, and also, the level of residential mortgages which had declined from 10.31% to 6.10% can be corrected. The merger will enable the bank to shift its portfolio towards lower risk-weight assets, such as the secured and granular residential mortgage, leading to freeing up capital for venturing into other more economically attractive business lines.

Whether all the above benefits could have meant significant value for shareholders is unclear. The reaction of the market analysed from the data of daily returns of the two stocks on the day of the announcement, 14 trading days before and 14 days after shows that the response was positive. The stock price of HDFC Bank increased by 7.02% on the date of the announcement, while that of HDFC Limited increased by 14.05%. Between 31 March 2022 and 30 June 2023, the last day before the merger came into effect, the market capitalisation of HDFC Bank and HDFC Limited grew by 12.9% and 15.1%, respectively. Table 2 indicates the comparative sizes and performances of both entities, which may be indicative of the gains from potential synergies. Becoming an even bigger bank and a domestic SIB, the HDFC Bank has to raise its capital and operational efficiencies, as it meets the higher regulatory capital as well as reserve requirements.

Industry concentration effects: Following the mergers of the PSBs, the industry concentration measured as the percentage of assets held by the top three banks increased from less than 30 in 2015 to 40.9% in 2021.[1] The merger of HDFC group entities may have further increased the concentration level, which could affect the outreach of banking and credit for certain sectors. For example, the contribution of the housing finance sector to GDP in India, at 11.7% now, is low compared to mortgage outstanding as 40% of GDP in China,[2,3] where the concentration of the banking industry is around 38.32%[4] despite having some of the largest banks in the world.

The housing finance sector's contribution to GDP in India was almost stagnant at about 7% between 2006 and 2009 when the market shares held by HFCs and banks were around 25% and 75%, respectively. In the following years, the sector's contribution grew as HFCs enlarged their market share by increased numbers as well as a higher focus on affordable housing. A report by CRIF High Mark (2021) informs that HFCs had 37% of the value of the housing loan market, while PSBs had 45% and private banks had 17%. The market share of HFCs has been declining, and post this merger, it would indeed be much lower. As the largest HFC, HDFC Limited provided leadership for the ecosystem development of the housing finance sector. Its exit may require similarly focused and dedicated institutions to continue the growth of the sector.

Systematic risk and governance: HDFC Bank's systematic risk may have undergone a significant change as observed from the trends of its equity beta (Figure 1).[5] For several years before the merger, despite being a domestic SIB, the stock of

Table 2: Operational Data of HDFC Limited and HDFC Bank

Entity Name	HDFC Limited	HDFC Bank
Financial Year Ending	FY 2023	FY 2023
Size of assets (₹ trillion)	7.26	24.66
Risk-weighted assets (₹ trillion)	4.75	15.86
Loan outstanding (₹ trillion)	6.08	16.01
Number of branches	737	7,821
Number of employees	4,017	1,73,222
Cost of fund (%)	6.70	3.58
Yield on advances (%)	8.99	10.10
Yield on investments (%)	6.36	5.94
Cost to income ratio (%)	9.2	40.4
Net interest margin (%)	3.6	4.1
Gross non-performing assets (%)	1.18	1.12
Capital adequacy ratio (%)	24.3	19.3
Return on asset post-tax (%)	2.5	2.07
Return on equity (%)	12.8	17.4

Source: Ace Equity v2.

HDFC Bank had been steadier than the market with a beta value lower than the peer banks. But since 2021, the market beta for the bank has increased, and post the merger, volatility of its stock has become higher than others, in spite of reduced leverage and the synergies gained. This rise interestingly coincides with the bank increasing the composition of its assets in the wholesale segment from a more balanced distribution with retail and treasury segments earlier. With the announcement of the merger with HDFC Limited, having a portfolio with a predominantly retail housing mortgage, the beta may have declined initially but has increased as the bank transformed itself into a type of conglomerate more like its peers.

The bank has turned from being associated with an institutional promoter to one with 100% public shareholding. It is also a parent company for various non-banking subsidiaries now. In a study of corporate governance of private banks in India, Roy and Mukherjee (2022) observe the need for board structures with institutional nominee directors for levying checks and balances upon the power and influence of the executive and whole-time directors, in regard to various decisions of growth rate, level of retail assets, capital adequacy, provision coverage, etc. HDFC Bank may have gained much from its parent's oversight and guidance earlier. But now, the bank may need to institutionalise the necessary board-level strategies to preserve its track record of governance.

In Conclusion

The merger of HDFC Limited with HDFC Bank has been based upon positive effects from various short- and mid-term synergies between the two organisations. It also has opened up the opportunity to unlock capital, to enable the bank to make significant changes in its lending portfolio for higher shareholder value creation. However, with the merger, the nature of HDFC Bank may also become transformed. From being a predominantly retail bank, it seems to be moving towards higher exposure to the wholesale segment. As the merger is going to raise the degree of concentration in the banking sector, how far it increases the systemic risks remains to be seen.

NOTES

[1] https://tradingeconomics.com/india/bank-concentration-percent-wb-data.htm/.

[2] https://www.statista.com/statistics/1385763/india-housing-loans-as-a-share-gdp/.

[3] https://carnegieendowment.org/chinafinancialmarkets/87664.

[4] https://tradingeconomics.com/china/bank-concentration-percent-wb-data.html/.

[5] Equity beta is the measure of investment risk. It indicates the volatility in stock prices vis-à-vis volatility in the market index. Results presented in Figure 1 are the volatility in the stock prices of the respective banks vis-à-vis the volatility in the values of Nifty50 Index.

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