International Journal of Trend in Scientific Research and Development (IJTSRD)
Volume 6 Issue 6, September-October 2022 Available Online: www.ijtsrd.com e-ISSN: 2456 – 6470

Merger of Banks with Reference to Central Government Scheme

Dr. Anurag Agarwal

Head, Faculty of Commerce, Swami Shukdevanand (PG) College,
Shahjahanpur, affiliated with MJP Rohilkhand University, Bareilly, Uttar Pradesh, India

ABSTRACT

The Banking Companies(Acquisition and Transfer of Undertakings)Acts of 1970 and 1980 provide that the Central Government, in consultation with the Reserve Bank of India (RBI), may make a scheme, inter alia, for the amalgamation of any nationalised bank with any other nationalised bank or any other banking institution Various committees, including Narasimhan Committee (1998) constituted by RBI, Leeladhar Committee(2008) chaired by RBI Deputy Governor, and Nayak Committe (2014) constituted by RBI, have recommended consolidation of Public Sector Banks (PSBs) given underlying benefits/synergies. Taking note of this and potential benefits of consolidation for banks as well as public at large through enhanced access to banking services, Government, with a view to facilitate consolidation among public sector banks to create strong and competitive banks, serving as catalysts for growth, with improve risk profile of the bank, approved an approval framework for proposals to amalgamate PSBs through an Alternative Mechanism (AM). AM, after consulting RBI, in its meeting held on 17.9.2018, approved that Bank of Baroda, Vijaya Bank and Dena Bank may consider amalgamation of the three banks. Banks have since considered amalgamation and the Board of Dena Bank has recommended the same, while Boards of Bank of Baroda and Vijaya Bank have given in-principle approval therefor. RBI has furnished bank-wise total income of PSBs and private sector banks in the financial year FY 2017-18 in this regard, which is given in Annexure.

Over the last four and half years, Government has pursued a comprehensive approach for addressing non-performing assets (NPA) issues. Key elements are as under:

Recognising NPAs transparently: Forbearance has been ended and stressed assets classified as NPAs under the Asset Quality Review (AQR) in 2015 and subsequent recognition by banks. Further, restructuring schemes that permitted such forbearance have been discontinued in February 2018. As a result, as per RBI data, Standard Restructured Assets (SRAs) of Scheduled Commercial Banks (SCBs) have declined from the peak of 6.5% in March 2015 to0.49% in September 2018.

Resolving and recovering value from stressed accounts through clean and effective laws and processes: A fundamental change has been effected in the creditor-debtor relationship through the Insolvency and Bankruptcy Code, 2016 (IBC) and debarment of wilful defaulters and connected persons from the resolution process. A sizeable proportion of the gross NPAs of the banking system are at various stages of resolution in National Company Law Tribunal(NCLT). To make other recovery mechanisms as well more effective, Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI)Act has been amended to provide for three months imprisonment in case borrower does not provide asset details, and for lender getting possession of mortgaged propertywithin30 days, and six new Debts Recovery Tribunal (DRTs) have been established. As a result, NPAs of PSBs reduced by Rs. 2,61,359 crore over the last four and a half financial years. Further, PSBs reported record recovery of Rs. 60,713 crore in the first half of FY 2018-19 (H1 FY 2018-19), which is more than double the recovery made in the first half of FY 2017-18, and gross NPAs have begun declining with a reduction of Rs. 26,798 crore in H1 FY 2018-19. 30-day plus overdue account (Special Mention Accounts (SMA) 1 and 2) have also reduced steadily to around 39% over five quarters (from Rs 2.25 lakh crore in June 2017 to Rs. 0.87 lakh crore in September 2018 for PSBs), indicating significant and sustained reduction in risk of fresh NPAs. Thus, improvement in asset quality is evident with GNPAs having peaked recognition

How to cite this paper: Dr. Anurag Agarwal "Merger of Banks with Reference to Central Government Scheme" Published in International Journal of Trend in Scientific Research and Development (ijtsrd), ISSN: 2456-6470, Volume-6 | Issue-6, October 2022, pp.2003-2015, URL: www.ijtsrd.com/papers/ijtsrd52200.pdf

IJTSRD52200

Copyright © 2022 by author(s) and International Journal of Trend in Scientific Research and Development Journal. This is an Open Access article distributed under the terms of the Creative Commons Attribution License (CC BY 4.0) (http://creativecommons.org/licenses/by/4.0)

nearly over, and the amount in SMA 1 and 2 reducing by 61% over five quarters. Further, with substantial provisioning, the provisional coverage ratio(PCR)o SCBs has risen steadily to 67.17% as of September 2018, from the pre-AQR level of 49.3% in March 2015,cushioningbank balance-sheets to absorb the impact of NPAs.

INTRODUCTION

Amalgamation of 10 public sector banks into four big banks. After this the total number of Public Sector Banks in the country will come down to 12 from 27 banks in 2017. Apart from this the government announced Rs 55,250 crore upfront capital infusion in the PSBs.

In big banks merger, Sitharaman announced that government has decided to merge Punjab National Bank, Oriental Bank of Commerce and United Bank; Canara Bank and Syndicate Banks; Union Bank of India, Andhra Bank and Corporation Bank; and Indian Bank and Allahabad Bank.[1]

Government also announced Rs 55,250 crore upfront capital for credit growth & regulatory compliance to support economy. PNB will get Rs 16,000 crore; Union Bank Rs 11,700 crore; Canara Bank Rs 6,500 crore; Indian Overseas Bank Rs 3,800 crore; Central Bank of India Rs 3,300 crore; Bank of Baroda Rs 7,000 crore; Indian Bank Rs 2,500 crore and Uco Bank Rs 2,100 crore.

Reforms include-

- number of lenders in consortium restricted by requiring minimum of 10%, for better managed consortium lending,
- ring-fencing of cash flows for prudent lending,
- monitoring of loans above Rs. 250 crore through specialised agencies for effective vigil,
- use of technology and analytics for comprehensive due- diligence across data sources,
- comprehensive checking of all accounts of Rs. 50 crore and above that turn NPA for wilful default and fraud,
- strict enforcement of conditions of loan sanction,
- establishment of Stressed Asset Management Verticals in banks for focussed recovery and timely and effective management of stressed accounts,
- collection of passport details of borrowers for loans above Rs. 50 crore, and
- enactment of the Fugitive Economic Offenders Act, 2018 in order to deter economic offenders from evading the process of Indian law by remaining outside the jurisdiction of Indian courts.

As regards employee issues, bank branches and other bank-related issues, the same fall within the purview of the bank concerned, subject to RBI's guidelines/instructions and Board-approved policies of the bank concerned.

The financial services industry, particularly the banking industry, has undergone significant transformation all over the world since the early 1980s under the impact of technological advances, deregulation and globalisation. An important aspect of this process has been consolidation as a large number of banks have been merged, amalgamated or restructured. Although the process of consolidation began in the 1980s, it accelerated in the 1990s when macroeconomic pressures and banking crises forced the banking industry to alter its business strategies and the regulators to deregulate the banking sector at the national level and open up financial markets to foreign competition. This led to the blurring of distinctions between banks and non-bank financial institutions, various products and the geographical locations of financial institutions. The resulting competitive pressures on banks in the emerging economies led to deep changes in the structure of the banking industry, including, among others, privatisation of state-owned banks, mergers and acquisitions (M&As) and increased presence of foreign banks. The financial value involved in the M&As multiplied over the years. As a result of these M&As, the number of banks has declined substantially both in advanced and emerging market economies (EMEs).[2]

The motives of consolidation have depended on firm characteristics such as size or organisational structure across segments, or even across lines of business within a segment (BIS, 2001). In developed countries, market forces have been the prime driving force behind M&As. Globalisation and deregulation led to decline in bank spreads, and consequently, profitability. In order to offset the decline in profitability, there were mergers between banks and between banks and non-banks to reap the benefit of economies of scale and scope. On the other hand, in many EMEs, mergers and amalgamations have often been driven by governments in order to restructure the banking systems in the aftermath of crisis. Financial consolidation has implications not only for competition but also for financial stability, monetary policy, efficiency of financial institutions, credit flows and payment and settlement systems. Given the diverse nature of financial institutions, different levels of financial development, legal framework and other enabling environment, the causes and impact of

financial consolidation have also tended to vary across the countries. For instance, financial consolidation led to higher concentration in countries such as US and Japan, though they continue to have much more competitive banking systems as compared with other countries. However, in several other countries, the process of consolidation led to decline in banking concentration, reflecting increase in competition. This was mainly because banks involved in M&As were of relatively small in size. The Indian banking sector has not remained insulated from the global forces driving M&As across the countries. M&A activity in the Indian banking sector is not something new as it took place even before the independence. However, economic reforms introduced in the early 1990s brought out a comprehensive change in the business strategy of banks, whereby they resorted to mergers and amalgamations to enhance size and efficiency to gain competitive strength.

Against the above backdrop, this chapter, drawing on the theoretical perspective and country experiences on consolidation and competition, assesses various aspects of consolidation and competition in the Indian banking sector. The focus of the chapter is to examine the extent and nature of the process of consolidation and its impact on competition in the banking sector and efficiency of the merged entities. Some important issues that have arisen in the process of ongoing consolidation process have also been discussed. The chapter is organised into eight sections. Section II briefly sets out the theoretical underpinnings of the banking consolidation process[3]. It also spells out the motives and factors driving M&As and the various methods of consolidation. Trends in M&A activity in various countries and the progress in banking consolidation in India are detailed in Section III and Section IV, respectively. The impact of the consolidation process on competition in the Indian banking sector and efficiency of the merged entities is analysed in section V. Section VI addresses the issues arising out of the ongoing process of competition and consolidation such as (a) future course of the process of consolidation that is underway; (b) role of public sector banks in the changed economic environment; (c) further opening the banking sector to foreign competition; and (d) combining of banking and commerce. Section VII makes some suggestions as a way forward, while Section VIII sums up the main points of discussion.

There are several alternative methods of consolidation with each method having its own strengths and weaknesses, depending on the given situation. However, the most commonly adopted method of consolidation by firms has been through M&As. Though both mergers and acquisitions lead to two formerly independent firms becoming a commonly controlled entity, there are subtle differences between the two. While acquisition refers to acquiring control of one corporation by another, merger is a particular type of acquisition that results in a combination of both the assets and liabilities of acquired and acquiring firms (Halperin and Bell, 1992; and Ross et al.,1995). In a merger, only one organisation survives and the other goes out of existence. There are also ways to acquire a firm other than a merger such as stock acquisition or asset acquisition. Mergers generally take place in three major forms, viz., horizontal merger, vertical merger and conglomerate merger. Horizontal merger is a combination of two or more firms in the same area of business. Vertical merger is a combination of two or more firms involved in different stages of production or distribution of the same product, and can be either forward or backward merger. When a company combines with the supplier of material, it is called backward merger, and when it combines with the customer, it is known as forward merger. Conglomerate merger is a combination of firms engaged in unrelated lines of business activity. M&As in the financial sector, in particular the banking sector, are undertaken mainly either to maximise the value of firms or for personal interest of managers. As is the case with any firm, the value of a financial institution is determined by the present discounted value of expected future profits. Mergers can increase expected future profits either by reducing expected costs or by increasing expected revenues or a combination of both. Cost reduction through M&As could arise for several reasons[4] including economies of scale, economies of scope, infusing efficient management, reduction and diversification of risk due to geographic or product diversification, access to capital markets or a higher credit rating because of increased size, and entry into new geographical or product markets at a lower cost than that associated with de novo entry. M&As could also enable banks to make the provision of additional services making them capable of facing competition from larger banks. By this way, mergers can also lead to increase in revenue by allowing larger size firms to better serve large customers, offering "one-stop shopping" for a variety of different products, increased product or geographical diversification, leading to expanded pool of potential customers and enhancing the risk-taking abilities. M&As could also be used as a deterrent against unwanted possible acquisitions, particularly hostile takeovers, by other larger banks in the future.

Managers' actions and decisions, however, are not always consistent with the maximisation of a firms' value. In particular, when the identities of owners and managers differ and capital markets are less than perfect, managers may take actions that further their own personal goals and are not in the interests of the firm's owners. In some cases, managers may get engaged in consolidation simply to enhance their firms' size relative to competitors. Deregulation, improvements in information technology, globalisation, shareholders' pressures and accumulation of excess capacity or financial distress have been some of the important factors that have encouraged consolidation of financial institutions. While new technologies embody high fixed costs, they enable provision of a broad array of products and services to a large number of clients over wider geographical areas at faster pace and quality of communications and information processing. In other words,[5,6] it confers economies of scale by spreading the high fixed costs across a larger customer base and motivates mergers of firms operating at uneconomical scales. Further, new tools of financial engineering such as derivative contracts, off-balance sheet guarantees and risk management may be more efficiently produced by large institutions. Some new delivery methods for depositors' services such as phone centers, ATMs and on-line banking networks may also exhibit greater economies of scale than traditional branching networks (Radecki et al., 1997). Deregulation influences the restructuring process in banking through effects on market competition and entry conditions, approval/ disapproval decisions for individual merger transactions, limits on the range of permissible activities for service providers, through public ownership of institutions and efforts to minimise the social costs of failures. Over the past two decades, as a response to technological advances and financial crises, governments, after reconsidering the legal and regulatory framework in which financial institutions operate, have relaxed many official barriers to consolidation. This has resulted in accelerated pace of M&As in the financial sector. At the same time, ceilings on interest and deposit rates have been removed leading to narrowing of interest rate spreads of banks. M&As wave has also been a response to increased competition that threatened profits. To offset the impact of decline in bank spreads on profitability, banks responded by expanding volume (economies of scale) and diversifying their activities (economies of scope). The removal of restriction on geographical areas for banking operations and on diversification of activities provided the opportunities for banks to consolidate among themselves and non-bank financial firms. Globalisation, which is a by-product of technology and deregulation in many respects, has its bearing on economies of scale and consequently, influences consolidation strongly among the firms engaged in the provision of wholesale financial services. M&As have also been a frequent option for banks seeking to build a global retail system[7,8]. It is felt that by acquiring an existing institution in the target market, the acquirer gains a more rapid foothold than would be possible with an organic growth strategy. Increased access to the capital markets, both domestic and international, has increased the importance of shareholders relative to other stakeholders. On the other hand, increased competition has led to squeeze in the profit margins of financial firms, resulting in shareholders' pressure to improve performance. Financial firms have been adopting a simpler strategy of M&As to improve performance instead of achieving the same through business gains, productivity enhancement or more effective balance sheet management.

When there exist excess capacity in an industry or local market, firms, for several reasons, are rendered inefficient as they operate below the optimum level or below the efficient frontier of production. Consolidation through M&As can solve these inefficiency problems more effectively than bankruptcy or other means of exit by preserving the pre-existing franchise value of the merging firms. Similarly, consolidation is employed as an efficient way of resolving problems of financial distress, with weak or inefficient firms being taken over by stronger ones. In short, mergers of banks may help reduce the gestation period for launching/promoting new businesses, strengthen the product portfolios, minimise duplication, and gain competitive advantage, among others. They are also recognised as a good strategy for enhancing efficiency. Ideally, mergers should be aimed at exploiting synergies, reducing overlap in operations, right-sizing and redeploying surplus staff either by retraining, labour restructuring or voluntary retirement. Consolidation in the banking industry, on the other hand, can be impeded by regulations, differences in corporate culture and governance regime and inadequate information flows. The legal and regulatory environment represents a substantial potential impediment for consolidation in the banking industry, as it directly affects the range of permissible activities undertaken by financial firms. In some countries, antitrust laws constitute an important impediment,[9,10] mainly for domestic consolidation within sectors. Prudential regulation may hinder cross-border consolidation through differences in

capital requirements. Regulatory impediments to consolidation include protection of national champions, government ownership of financial institutions, competition policies and rules on confidentiality. The differences in corporate governance, which encompasses the organisational structure and the system of checks and balances of an institution, could also be deterrents to M&As. There are significant differences in the legislative and regulatory frameworks across the countries with regard to functions of the boards of directors ("supervisory") and senior management. These differences affect the inter-relation of the two decision-making bodies within an institution and relations with the firm's owners and other stakeholders, including employees, customers, the community, rating agencies and governments. There are also cultural differences and the related information asymmetries. These differences act as strong impediments to cross-border and cross-product levels of consolidation and in the hostile takeovers of financial institutions. Information asymmetry faced by stakeholders may hinder M&As as the inadequate information flows increase the uncertainty about the outcome of a merger. Such information asymmetry would arise due to incomplete disclosure or large differences in accounting standards across countries and sectors, lack of comparability of accounting report, difficulties in asset appraisal and lack of transparency. Consolidation, among others, has implications for financial stability and monetary policy. With the increase in the size of banks and concentration of banking activities in a few megabanks, various types of risks such as operational risk, contagion risk and systemic risk could increase. Consolidation impacts market power which can have adverse effects on the yield curve by impeding interest rate arbitrage, lending to borrowers and the value of collateral, in turn, affecting the channels of monetary policy transmission

Discussion

Banking consolidation, irrespective of the motives and types, gives rise to several challenges, of which the implications on financial stability and monetary policy are important ones. It is emphasised that even though there are several potentials for reducing the financial risk through geographical and product diversification at the individual firm level, consolidation leading to creation of megabanks could heighten various types of financial risks at the macroeconomic level. In fact, understanding the financial stability implications of evolving state ownership of banks after consolidation and also increasing presence of foreign banks is a high priority in policy makers' agenda in various countries. Operational risk could increase with the size of operations, as the distance between management and operational personnel is greater in large companies and the administrative systems are more complex. The transparency of the operations could also deteriorate with increase in size, particularly with regard to cross-border mergers, rendering detection of potential crises in time by the authorities difficult. The contagion risk, i.e., problems arising in an individual bank spreading to others, also increases with size, as banks' exposures against one another rise along with the size of operations. Evidence suggests that the inter-dependencies, which are positively correlated with consolidation, have increased among large and complex financial institutions. Further, the consolidating institutions are found to shift their portfolios towards higher risk-return investment.[11] Consequently, the concerns about systemic risk are heightened, as concentration of banking activities in few megabanks would mean that given their wholesale activities, any shock could have repercussions to the financial system and the real economy. For a small host nation, cross-border financial integration would mean increase in possibility of even a medium-sized foreign bank becoming a source of instability, and also increased probability of losing domestic ownership of its major banks.

The increased potential for systemic risk further intensifies the concerns for these banks being considered 'too-big-to-fail', which gives rise to the problem of moral hazard. Because of the increased potential systemic instability from impairment of such large banks, whatever be the ex ante declaration, the perception of the general public would be that the Government would not allow these banks to fail, and therefore, ex post provide bailout. Because of this perceived implicit or explicit guarantee by the Government, the risk taking behavior of these banks could increase, thereby further enhancing the systemic risk. It is, however, not possible to formulate a specific criteria on when a bank becomes 'too big to fail', though it may be concluded that there is a certain critical level with regard to the bank's importance in the economy and the financial system.

Consolidation leads to greater concentration of payment and settlement flows among few parties within the financial sector. Such concentration implies that if a major payment processor were to fail or were not able to process payment orders, systemic risks could arise. The emergence of multinational institutions and specialised service providers indulging in payment and settlement systems in different countries coupled with increasing inter-

dependence of liquidity among them accentuate the potential role of payment and settlement systems in the transmission of contagion effects.[12,13]

Monetary policy decisions are influenced by the behavior of financial firms and markets. The consolidation process by altering them has also a number of implications in the conduct of monetary policy. Consolidation can reduce competition in the markets, increase the cost of liquidity for some and impede the arbitrage of interest between markets. The performance of the markets could also be affected if the resulting large banks behave differently from their small predecessors. The impeding of arbitrage along the yield curve due to reduced competition would affect the monetary policy channel of transmission effected through interest rates across financial markets. The exercise of market power by the banks resulting from consolidation could also alter the monetary transmission operating through bank lending to borrowers without direct access to financial markets. Consolidation could also affect the way monetary policy affects the value of collateral, and, thus, on the availability of credit to those requiring collateral to obtain funds.

The number of M&As increased in the advanced countries in recent years. Insofar as EMEs are concerned, while in some countries M&As activity accelerated in recent years, in some other countries, it slowed down. However, the value of M&As increased manifold in several countries, including those where M&As activities slowed down

Much of the consolidation activity in France took place during the 1990s among small banks leading to a large reduction in the total number of banking institutions. Similarly, in Germany consolidation took place among smaller savings and co-operative banks and the number of banks declined by about a third during the 1990s. Following consolidation, the number of banks in Italy also declined by more than a third during the same period. A combination of dismantling of restrictions on interstate and intra-state banking, removal of interest rate ceilings on small time and savings deposits and permission on diversification of activities paved the way for mergers between banks and non-bank financial companies in the US during the 1990s. The consolidation that followed resulted in substantial growth, in both absolute and relative terms, by the largest institutions. In the UK, the regulatory reforms during the 1980s and the 1990s removed restrictions on financial institutions to compete across traditional business lines. This enabled the development of universal banking and led to growth of international banking and conversion of building societies into banks. Consequently, the number of banks in UK increased substantially before declining by almost 20 per cent following subsequent consolidation.

Table 8.1: Cross-Country Bank Mergers and Acquisitions

	Number		Value (US $ million)	
Country	1995-1999	2000-04	1995-1999	2000-04
1	2	3	4	5
UK*	7	52	1,137	20,376
Germany*	22	84	13,100	34,023
Italy*	36	121	12,953	153,348
Japan*	18	58	8,892	41,069
Hong Kong	0	14	0	–
Singapore	8	8	2,900	11,400
Korea	11	7	14,360	27,410
Indonesia	1	0	–	0
Malaysia	2	18	20	3,020
Philippines	2	13	6,900	17,740
Thailand	5	2	57,700	28,000
Chile	5	6	870	1,220
Colombia	9	11	40	33
Mexico	8	5	81,900	170,600
Czech Republic	9	3	–	–
Hungary	11	9	8,620	17,990
Poland	23	30	–	–

* : Based on Bloomberg database for the sub-periods 1997-2000 and 2001-2007. Value may not necessarily represent the amount of all deals.

– : Not Available

Source : BIS (2006) and Bloomberg.

In Canada, domestic banks traditionally controlled a large share of the banking sector. Owing to the dominance of the banking industry by a few banks, consolidation is regulated through a guideline established in 2000 to ensure that it does not lead to unacceptable level of concentration and drastic reduction in competition and reduced policy flexibility in addressing future prudential issues. Thus, not much consolidation took place during the 1990s and the number of banks did not decline much from the substantial increase observed during the 1980s due to entry of foreign banks. In Japan also, little consolidation took place during the 1990s and there was only a modest reduction in the number of banks at the end of the 1990s following some bank failures.

The banking industry in Sweden during the 1990s experienced the merger of co-operative banks into one commercial bank and transformation of the largest savings banks into one banking group. Further, there was consolidation among all the major banking groups. While all the above mergers reduced the number of banks, the total number of banks increased somewhat due to entry of foreign banks and the establishment of several 'niche banks' around the same time.

The banking consolidation since the 1990s resulted in a substantial decline in the number of banks in many emerging market and advanced economies. In US, about 25-30 per cent of banks have closed or merged due to consolidation in last two to three decades (Nitsure, 2008). In fact, the banking systems in EMEs have generally continued to evolve towards more private and foreign-owned structures, with fewer commercial banks and often smaller number of bank branches. In some countries, these trends have been the result of post-crisis weeding-out of weak financial institutions, and mergers encouraged by the authorities (for instance, Indonesia, Malaysia and Thailand). Elsewhere, these developments have been mostly market-driven (for instance, central Europe and Mexico) (Table 8.2).

The banking sector reforms undertaken in India from 1992 onwards were aimed at ensuring the safety and soundness of financial institutions and at the same time making them efficient, functionally diverse and competitive. Financial sector reforms[14]

Table 8.2: Number of Commercial Banks

Country	2001	2005	Percentage Variation
1	2	3	4
Advanced Economies			
Denmark	190	161	-15.3
France	444	294	-33.8
Germany	304	251	-17.4
Greece	44	21	-52.3
Italy	830	784	-5.5
Japan	234	215	-8.1
Korea	20	13	-35.0
Singapore	128	110	-14.1
Spain	285	272	-4.6
UK	398	333	-16.3
US	8,075	7,515	-6.9
Emerging Economies			
Peru	15	12	-20.0
Philippines	42	41	-2.4
Poland	69	54	-21.7
Argentina	86	71	-17.4
Brazil	180	161	-10.6
Chile	27	26	-3.7
Mexico	32	29	-9.4
Egypt	53	43	-18.9
India	100	88	-12.0
Israel	26	15	-42.3
South Africa	59	34	-42.4

Source: World Bank Database on Regulation and Supervision.

provided banks with operational flexibility and functional autonomy. Reforms also brought about structural changes in the financial sector by recapitalising them, allowing profit making banks to access the capital market and enhancing the competitive element in the market through the entry of new banks. Apart from achieving greater efficiency by introducing competition through the new private sector banks and increased operational autonomy to public sector banks, reforms in the banking system were also aimed at enhancing financial inclusion, funding of economic growth and better customer service to the public.

The Government and the Reserve Bank provided the enabling environment through an appropriate fiscal, regulatory and supervisory framework for the consolidation of financial institutions and at the same time ensured that a few large institutions did not create an oligopolistic structure in the market (Talwar, 2001). Competitive conditions in the Indian banking sector were strengthened by relaxing entry and exit norms and the increased presence of foreign banks. In February 2005, with a view to further enhancing the efficiency and stability of the banking system, a two-track and gradualist approach was adopted by the Reserve Bank. One track was consolidation of the domestic banking system in both the public and private sectors. The second track was gradual enhancement of the presence of foreign banks in a synchronised manner (Annex VIII.1). The regulatory framework, however, varies for different segments of the banking sector in India.

Mergers and Amalgamations: Regulatory Framework
The regulatory framework for M&As in the banking sector is laid down in the Banking Regulation (BR) Act, 1949. In the post-Independence era, the legal framework for amalgamations of banks in India was provided in the Act. The Act provides for two types of amalgamations, viz., (i) voluntary and (ii) compulsory. For voluntary amalgamation, Section 44A of the BR Act provides that the scheme of amalgamation of a banking company with another banking company is required to be approved individually by the board of directors of both the banking companies and subsequently by the two-thirds shareholders (in value) of both the banking companies. Further, Section 44A of the BR Act requires that after the scheme of amalgamation is approved by the requisite majority in number representing two-third in value of shareholders of each banking company, the case can be submitted to the Reserve Bank for sanction. However, the Reserve Bank has the discretionary powers to approve the voluntary amalgamation of two banking companies under section 44A of the BR Act.

The experience of the Reserve Bank has been, by and large, satisfactory in approving the schemes of amalgamation of private sector banks in the recent past and there has been no occasion to reject any scheme of amalgamation submitted to it for approval. There have been six voluntary amalgamations

between the private sector banks so far, while one amalgamation between two private sector banks (Ganesh Bank of Kurundwad and the Federal Bank) was induced by the Reserve Bank in the interest of the depositors of one of the banks. Most of these voluntary mergers was between healthy banks, somewhat on the lines suggested by the first Narasimham Committee. The Committee was of the view that the move towards the restructured organisation of the banking system should be market-driven and based on profitability considerations and brought about through a process of M&As (Leeladhar, 2008)

Insofar as compulsory amalgamations are concerned, these are induced or forced by the Reserve Bank under Section 45 of the BR Act, in public interest, or in the interest of the depositors of a distressed bank, or to secure proper management of a banking company, or in the interest of the banking system. In the case of a banking company in financial distress, the Reserve Bank under Section 45(2) of the BR Act may apply to the Central Government for an order of moratorium in respect of a banking company and during the period of such moratorium, may prepare a scheme of amalgamation of the banking company with any other banking institution (banking company, nationalised bank, SBI or its subsidiary). Such a scheme framed by the Reserve Bank is required to be sent to the banking companies concerned for their suggestions or objections, including those from the depositors, shareholders and others. After considering the same, the Reserve Bank sends the final scheme of amalgamation to the Central Government for sanction and notification in the official gazette. The notification issued for compulsory amalgamation under Section 45 of the BR Act is also required to be placed before the two Houses of Parliament. The amalgamation becomes effective on the date indicated in the notification issued by the Government in this regard.

In the case of voluntary merger or acquisition of any financial business by any banking institution, there was no provision under the BR Act for obtaining approval of the Reserve Bank. In order to revisit the regulatory, legal, accounting and human relations related issues, which may arise in the process of consolidation in Indian banking system, the Working Group (Chairman: Shri V. Leeladhar) was constituted by the Indian Banks' Association. The Group in its Report titled "Consolidation in Indian Banking System" submitted in 2004 highlighted the need for making an omnibus provision in the BR Act requiring any banking institution to obtain prior approval of the Reserve Bank before acquiring any other business or any merger or amalgamation of any other business of banking institution or non-banking financial institution, with absolute right to the Reserve Bank to finalise the swap ratio which should be made binding on all concerned.[15]

The Reserve Bank, on the recommendations of the Joint Parliamentary Committee (2002), had constituted a Working Group to evolve guidelines for voluntary mergers involving banking companies. Based on the recommendations of the Group, the Reserve Bank announced guidelines in May 2005 laying down the process of merger proposal, determination of swap ratios, disclosures, the stages at which boards will get involved in the merger process and norms of buying/selling of shares by the promoters before and during the process of merger. Voluntary amalgamation of a non-banking company with a banking company is governed by sections 391 to 394 of the Companies Act, 1956 and the scheme of amalgamation has to be approved by the High Court. However, to ensure the continued strenght of merged entity, it has been provided in the guidelines that in such cases, the banking company should obtain the approval of the Reserve Bank of India after the scheme of amalgamation approved by its Board but before it is submitted to the High Court for approval.

In both situations, whether a non-banking company amalgamates with a banking company or amalgamation is among banking companies, the Reserve Bank ensures that amalgamations are normally decided on business considerations. For this, the Reserve Bank also laid down guidelines, to which boards of directors should give consideration during the merger process. These guidelines mainly relate to (i) values of assets and liabilities and the reserves of amalgamated entity proposed to be incorporated into the book of amalgamating banking company; (ii) swap ratio to be determined by competent independent valuers; (iii) shareholding pattern; (iv) impact on profitability and, capital adequacy of the amalgamating company; and (v) conformity of the proposed changes in the composition of board of directors with the Reserve Bank guidelines in that context (Box VIII. 2).

The statutory framework for the amalgamation of public sector banks, viz., nationalised banks, State Bank of India and its subsidiary banks, is, however, quite different since the foregoing provisions of the BR Act do not apply to them. As regards the nationalised banks, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980, or the Bank Nationalisation Acts authorise the Central Government under Section 9(1)(c) to prepare or make, after consultation with the Reserve

Bank, a scheme, inter alia, for the transfer of undertaking of a 'corresponding new bank' (i.e., a nationalised bank) to another 'corresponding new bank' or for the transfer of whole or part of any banking institution to a corresponding new bank. Unlike the sanction of the schemes by the Reserve Bank under Section 44A of the BR Act, the scheme framed by the Central Government is required, under Section 9(6) of the Bank Nationalisation Acts, to be placed before the both Houses of Parliament. Under this procedure, the only merger that has taken place so far relates to the amalgamation of the erstwhile New Bank of India with Punjab National Bank, on account of the weak financials of the former. As regards the State Bank of India (SBI), the SBI Act, 1955, empowers the State Bank to acquire, with the consent of the management of any banking institution (which would also include a banking company), the business, including the assets and liabilities of any bank. Under this provision,the consent of the bank sought to be acquired, the approval of the Reserve Bank, and the sanction of such acquisition by the Central Government are required. Several private sector banks were acquired by State Bank of India following this route. However, so far, no acquisition of a public sector bank has taken place under this procedure. Similar provisions also exist in respect of the subsidiary banks of the SBI. Thus, there are sufficient enabling statutory provisions in the extant statutes governing the public sector banks to encourage and promote consolidation even among public sector banks through the merger and amalgamation route, and the procedure to be followed for the purpose has also been statutorily prescribed.[14,15]

Box VIII.2
Guidelines on Mergers and Amalgamations of Banks

The guidelines on merger and amalgamation announced by the Reserve Bank in May 2005, inter alia, stipulated the following:

- The draft scheme of amalgamation be approved individually by two-thirds of the total strength of the total members of board of directors of each of the two banking companies.
- The members of the boards of directors who approve the draft scheme of amalgamation are required to be signatories of the Deed of Covenants as recommended by the Ganguly Working Group on Corporate Governance.
- The draft scheme of amalgamation be approved by shareholders of each banking company by a resolution passed by a majority in number representing two-thirds in value of shareholders, present in person or by proxy at a meeting called for the purpose.
- The swap ratio be determined by independent valuers having required competence and experience; the board should indicate whether such swap ratio is fair and proper.
- The value to be paid by the respective banking company to the dissenting shareholders in respect of the shares held by them is to be determined by the Reserve Bank.
- The shareholding pattern and composition of the board of the amalgamating banking company after the amalgamation are to be in conformity with the Reserve Bank's guidelines.
- Where an NBFC is proposed to be amalgamated into a banking company in terms of Sections 391 to 394 of the Companies Act, 1956, the banking company is required to obtain the approval of the Reserve Bank before the scheme of amalgamation is submitted to the High Court for approval.

In short, the primary objective of the Reserve Bank/Government in the process of consolidation is to ensure that mergers are not detrimental to the public interest, bank concerned, their depositors and shareholders, and also that they do not impinge on financial stability. Thus, the Reserve Bank ensures that after a merger, acquisition, reconstruction or takeover, the bank or banking group has adequate financial strength and the management has sufficient expertise and integrity.

Results

Consolidation of banks through M&As is not a new phenomenon for the Indian banking system, which has been going on for several years. Since the beginning of modern banking in India through the setting up of English Agency House in the 18th century, the most significant merger in the pre-Independence era was that of the three Presidency banks founded in the 19th century in 1935 to form the Imperial Bank of India (renamed as State Bank of India in 1955).

In 1959, State Bank of India acquired the state-owned banks of eight former princely States. In order to strengthen the banking system, Travancore Cochin Banking Enquiry Commission (1956) recommended for closure/amalgamation of weak banks. Consequently, through closure/ amalgamations that followed, the number of reporting commercial banks declined from 561 in 1951 to 89 in June 1969. Merger of banks took place under the direction of the Reserve Bank during the 1960s. During 1961 to 1969, 36 weak banks, both in the public and private sectors, were merged with other stronger banks.

There have been several bank amalgamations in India in the post-reform period. In all, there have been 33 M&As since the nationalisation of 14 major banks in 1969. Of these mergers, 25 involved mergers of private sector banks with public sector banks, while in the remaining eight cases, mergers involved private sector banks. Out of 33, 21 M&As took place during the post-reform period with as many as 17 mergers/ amalgamations taking place during 1999 and after (Table 8.3)[1] . Prior to 1999, the amalgamations of banks were primarily triggered by the weak financials of the bank being merged, whereas in the post-1999 period, there have also been mergers between healthy banks, driven by the business and commercial considerations (Leeladhar, 2008).[13,12]

Table 8.3: Banks Amalgamated since Nationalisation of Banks in India

Sr. No.	Name of Transferor Bank/Institution	Name of Transferee Bank/Institution	Date of Amalgamation
1	2	3	4
1.	Bank of Bihar Ltd.	State Bank of India	November 8, 1969
2.	National Bank of Lahore Ltd.	State Bank of India	February 20, 1970
3.	Miraj State Bank Ltd.	Union Bank of India	July 29, 1985
4.	Lakshmi Commercial Bank Ltd.	Canara Bank	August 24, 1985
5.	Bank of Cochin Ltd.	State Bank of India	August 26, 1985
6.	Hindustan Commercial Bank Ltd.	Punjab National Bank	December 19, 1986
7.	Traders Bank Ltd.	Bank of Baroda	May 13, 1988
8.	United Industrial Bank Ltd.	Allahabad Bank	October 31, 1989
9.	Bank of Tamilnadu Ltd.	Indian Overseas Bank	February 20, 1990
10.	Bank of Thanjavur Ltd.	Indian Bank	February 20, 1990
11.	Parur Central Bank Ltd.	Bank of India	February 20, 1990
12.	Purbanchal Bank Ltd.	Central Bank of India	August 29, 1990
13.	New Bank of India	Punjab National Bank	September 4, 1993
14.	Kashi Nath Seth Bank Ltd.	State Bank of India	January 1, 1996
15.	Bari Doab Bank Ltd.	Oriental Bank of Commerce	April 8, 1997
16.	Punjab Co-operative Bank Ltd.	Oriental Bank of Commerce	April 8, 1997
17.	Bareilly Corporation Bank Ltd.	Bank of Baroda	June 3, 1999
18.	Sikkim Bank Ltd.	Union Bank of India	December 22, 1999
19.	Times Bank Ltd.	HDFC Bank Ltd.	February 26, 2000
20.	Bank of Madura Ltd.	ICICI Bank Ltd.	March 10, 2001
21.	ICICI Ltd.	ICICI Bank Ltd.	May 3, 2002
22.	Benares State Bank Ltd.	Bank of Baroda	June 20, 2002
23.	Nedungadi Bank Ltd.	Punjab National Bank	February 1, 2003
24.	South Gujarat Local Area Bank Ltd.	Bank of Baroda	June 25, 2004
25.	Global Trust Bank Ltd.	Oriental Bank of Commerce	August 14, 2004
26.	IDBI Bank Ltd.	IDBI Ltd.	April 2, 2005
27.	Bank of Punjab Ltd.	Centurion Bank Ltd.	October 1, 2005
28.	Ganesh Bank of Kurundwad Ltd.	Federal Bank Ltd.	September 2, 2006
29.	United Western Bank Ltd.	IDBI Ltd.	October 3, 2006
30.	Bharat Overseas Bank Ltd.	Indian Overseas Bank	March 31, 2007
31.	Sangli Bank Ltd.	ICICI Bank Ltd.	April 19, 2007
32.	Lord Krishna Bank Ltd.	Centurion Bank of Punjab Ltd.	August 29, 2007
33.	Centurion Bank of Punjab Ltd.	HDFC Bank Ltd.	May 23, 2008

Source: Report on Trend and Progress, RBI, Various Issues.

More recently the process of M&As in the Indian banking sector has been generally market driven. Given the policy objective of mergers, most of the mergers between banks in India have taken place voluntarily for strategic purposes. Given the difficulty of small banks to compete with large banks, which enjoy enormous economies of scale and scope, the Reserve Bank has been encouraging the consolidation process, wherever possible. Most of the amalgamations of private sector banks in the post-nationalisation period were induced by the Reserve Bank in the larger public interest, under Section 45 of the Act. In all these cases, the weak or financially distressed banks were amalgamated with the healthy banks. The over-riding principles governing the consideration of the amalgamation proposals were: (a) protection of the depositors' interest; (b) expeditious resolution; and (c) avoidance of regulatory forbearance. The amalgamations of the erstwhile Global Trust Bank and United Western

Bank with public sector banks are recent examples of such mergers. Even in such cases, commercial interests of the transferee bank and the impact of the amalgamation on its profitability were duly considered. The mergers of many weak private sector banks with the healthy ones have brought the Indian banking sector to a credible position, as the CRAR of all private sector banks in the country was more than the minimum regulatory requirement of nine per cent as at end-March 2007.

M&As in India have also been used as a tool for strengthening the financial system. Through a conscious approach, the weak and small banks have been allowed to merge with stronger banks to protect the interests of depositors, avoid possible financial contagion that could result from individual bank failures and also to reap the benefits of synergy. Thus, the Indian approach has been different from that of many other EMEs, wherein the Governments were actively involved in the consolidation process. For instance, in East-Asia, after the banking crisis in 1997, the Government led the process of bank mergers in order to strengthen capital adequacy and the financial viability of many smaller and often family-owned banks. In these crisis ridden countries, the involvement of the Government was inevitable, as viable but distressed institutions were hardly in a position to attract potential buyers without moving some non-performing loans to an asset management company and/or receiving temporary capital support. Such intervention also proved more cost-effective than taking the bank into public ownership. However, with the intensification in competition through deregulation, privatisation and entry of foreign banks in the emerging markets, consolidation is becoming more market-driven (Box VIII. 3).

The consolidation process in the banking sector in India in recent years was confined to mergers in the private sector and some consolidation in the state-owned sector. After nationalisation of banks in 1969, India did not allow entry of private sector banks untill January 1993, when barriers to entry for private sector banks were removed. India also liberalised the entry of foreign banks in the post-reform period. These liberalised measures resulted in entry of many new banks (private and foreign). Accordingly, the number of banks increased during the initial phase of financial sector reforms. However, the pace of consolidation process gathered momentum from 1999-2000, leading to a marked decline in the number of private and foreign banks (Table 8.4). In February 2005, providing a comprehensive framework of policy relating to ownership and governance in private sector banks, the Reserve Bank prescribed that the capital requirement of existing private sector banks should be on par with the entry capital requirement for new private sector banks prescribed on January 3, 2001, according to which, banks are required to have capital initially of Rs. 200 crore, with a commitment to increase to Rs.300 crore within three years from commencement of business. In order to meet this requirement, all banks in the private sector should have a net worth of Rs. 300 crore at all times. Thus, post-2005 period, amalgamations/ mergers have resulted partly from these guidelines. The number of scheduled commercial banks (SCBs) declined to 82 at end-March 2007 from 100 at end-March 2000 due to merger of some old private sector banks. In recent years, in the case of some troubled banks, the only option available with the Reserve Bank was to compulsorily merge them with stronger banks under section 45 of the Banking Regulation Act, 1949. These included amalgamation of Global Trust Bank with Oriental Bank of Commerce in August 2004, Ganesh Bank of Kurundwad Ltd. with Federal Bank Ltd. in September 2006 and the United Western Bank with IDBI Ltd. in October 2006.

Mergers and amalgamations involved relatively smaller banks. The largest number of mergers took place with ICICI Bank, Bank of Baroda and Oriental Bank of Commerce (each one of them was involved in three mergers). ICICI Bank replaced many entities to occupy the second position in the Indian banking sector after State Bank of India. In the Banker's list of the top 1000 banks of the world (July 2007), there were 27 Indian banks (as compared with 20 in July 2004). Of these, 11 banks were in the top 500 banks (as compared with 6 in July 2004) (Table 8.5). Even within Asia, India's largest banks, viz., SBI and ICICI Bank held 11th and 25th place, respectively.

Box VIII.3
Market driven versus Government-led Bank Consolidation: Cross-Country Experience

While the rationale and the driving factors behind the consolidation process might have undergone change inter-temporally and varied across countries, two distinct dimensions broadly emerge from the history of bank consolidations, viz., market driven vis-à-vis government led consolidation.[11]

A large number of banking consolidations since the early twentieth century followed from the Government policy to consolidate either on account of efforts to restructure inefficient banking systems or from intervention following the crisis. In Japan, the Bank Law of 1927 set the minimum capital criterion for banks, which came as a powerful measure for the Government to promote bank consolidation.

Likewise, during the 1920s in the US, agriculture distress produced a wave of small bank failures, necessitating the repeal of many State laws prohibiting branch banking. In the emerging markets of South-East Asia and Latin America, much of the banking consolidation since the 1990s has been government-driven following the need to redress the distress within the financial system. During the financial crisis in 1997, the Korean Government accorded the top priority to financial sector restructuring through the earliest possible resolution of unsound financial institutions. The Government acted swiftly and decisively to close down financial institutions deemed non-viable after an exhaustive review of their financial situations. Somewhat similar phenomenon was observed in Malaysia, Indonesia and the Philippines. The Taiwanese Government also promoted consolidation in the financial sector in recent years. Similarly in Latin America, following numerous episodes of financial sector crises, the number of banks in the region declined significantly mainly through government efforts to restructure and consolidate the banking system. In Japan, realising the emergence of NPLs and lack of prudent risk management, Government steered some of the mergers in the overcrowded Japanese banking system during the 1990s.

Conclusions

On the other hand, the bank consolidation process since 1984 in the US, though facilitated by some legislative changes, was also an outcome of market-led forces. During the 1980s, many banks in the US experienced large loan losses and profits associated with depressed economy and excessive risk taking (Shull and Hanweck, 2001). Bank failures rose to high levels resulting in substantial number of mergers and acquisitions by better capitalized and profitable banks. These developments led to substantial improvements in profitability and capitalisation of banks in 1990s. With the onset of improved performance of banks, the number of mergers attributable to bank failures decreased but the number of mergers continued to increase on account of policy permissiveness in the US. The strict regulatory environment that existed before the 1980s largely precluded any dramatic consolidation within the US banking industry. Consolidation of the banking industry began in the earnest only after the regulatory constraints were relaxed in the early 1980s through a decade-long process of deregulating the banking and thrift industries so that they could be more responsive to marketplace realities (Jones and Critchfield, 2005). The removal of geographical restrictions on bank branching and holding company acquisitions by the individual states by the Reagle-Neal Interstate Banking and Branch Efficiency Act of 1994 greatly facilitated bank consolidation. Most of the bank acquisitions were carried out with the aim of securing consistent earnings growth in the future. The saturated markets offered limited organic growth potential, while the banks' balance sheets were strong. Thus, there was the need to grow via mergers and acquisitions for ensuring long-term earnings. This trend sometimes also led to increased market pressure for banks and financial institutions in other mature economies to keep pace and consolidate in their home markets. In the case of EU commercial banks, the banks responded to the new operating environment by adapting their strategies, seeking new distribution channels and changing their organisational structures. Thus, increased competition has been considered the main driving force behind the acceleration in the consolidation process in the EU economies (Casu and Girardone, 2007).[10,11]

In Central and Eastern Europe and Mexico, the bank consolidation process that started in the late 1990s, has also been more market-driven with the foreign banks playing an important role. Political action, however, has influenced the process of consolidation in some but not all European markets. For instance, the very good performance of big Italian banks was enabled by the privatisation of the savings banks. Similarly, domestic consolidation in France was encouraged through the formation of "national champions". It is being observed that multiple forces have been at play to motivate consolidation deals, both within European countries and cross-border. These forces resulting in market driven consolidation process included the fragmented market, foreign competition, deregulation, technological innovation and the introduction of a single currency. For instance, 'Bank Consolidation Program' in Poland involved pooling of state-owned banks in order to increase their market share and efficiency.[15]

References

[1] Casu, Barbara and Claudia Girardone (2007). "Does Competition Lead to Efficiency? The Case of EU Commercial Banks." University of Essex Discussion Paper No. 07-0, University of Essex.

[2] Jones, Kenneth D. and Tim Critchfield (2005). "Consolidation in the U.S. Banking Industry: Is the 'Long, Strange Trip' About to End?" Federal Deposit Insurance Corporation Banking Review, Vol.17, No. 4.

[3] Shull, Bernard and Hanweck, Gerald A. 2001. "Bank Mergers in a Deregulated Environment: Promise and Peril". Quorum Books. USA.

[4] Prager, and Hannan. 1998. “The Relaxation of Entry Barriers in the Banking Industry: An Empirical Investigation.”

[5] Journal of Financial Services Research, 14(3). Berger, Allen N. and Timothy H. Hannan. 1989. “The Price-Concentration Relationship in Banking’.” Review of Economics and Statistics, Vol. 71.

[6] Claessens, Stijn and Laeven, Luc, 2003. “What drives bank competition? some international evidence.” Policy Research Working Paper Series 3113, The World Bank.

[7] Bikker, Jacob A. 2004. “Competition and Efficiency in a Unified European Banking Market.” Edward Elgar Publishing.

[8] Gutiérrez de Rozas, Luis. 2007. “Testing for Competition in the Spanish Banking Industry: The Panzar-Rosse Approach Revisited.” Banco de España Research Paper No. WP-0726, August.

[9] Panzar, J. and Rosse. J. 1987. “Testing for monopoly equilibrium.” Journal of Industrial Economics, Vol.35, pp. 443–56. Prasad, A. and Ghosh. 2005. “Competition in Indian Banking, IMF Working Paper No. WP/05/141.

[10] Andrews, A. Michael. 2005. “State-Owned Banks, Stability, Privatisation, and Growth: Practical Policy Decisions in a World Without Empirical Proof.” IMF Working Paper No. WP/05/10.

[11] Boehmer, E.Nash, R.C. and Netter, J.M. 2005. “Bank Privatisation in Developing and Developed Countries: Cross-sectional Evidence on the Impact of Economic and Political Factors.” Journal of Banking and Finance, Vol.29.

[12] Mihaljek, Dubravko. 2006. “Privatisation, Consolidation and the Increased Role of Foreign Banks.” BIS Papers No. 28, August.

[13] Bank for International Settlements. 2004. “Foreign Direct Investment in the Financial Sector of Emerging Market Economy.” CGFS, Publication No. 22, March.

[14] George, Clarke et al. 2002. “The Effects of Foreign Entry on Argentina’s Domestic Banking Sector.” World Bank, Washington.

[15] Eisenbeis, R.A. and Kaufman, G. 2005. '; Bank Crises Resolution and Foreign-Owned Banks.'; Economic Review, 90-4. Federal Reserve Bank of Atlanta.