ISSUES RELATING TO BANK CONSOLIDATION AND ITS FUTURE IN INDIA

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Sabyasachi Banerji

CENTER FOR ECONOMIC STUDIES AND PLANNING
SCHOOL OF SOCIAL SCIENCES
JAWAHARLAL NEHRU UNIVERSITY
NEW DELHI-110067
INDIA
2005

CENTRE FOR ECONOMIC STUDIES & PLANNING
SCHOOL OF SOCIAL SCIENCES
JAWAHARLAL NEHRU UNIVERSITY
NEW DELHI-110067, INDIA

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Certificate

This is to certify that the dissertation entitled "**Issues Relating to Bank Consolidation and Its Future in India**" submitted by me in partial fulfillment for the award of **Master of Philosophy** has not been previously submitted by any other degree of this or any other university.

(Sabyasachi Banerji)

We recommend that his dissertation be placed before the Examiners for evaluation.

Dr. C.P. Chandrasekhar
(Supervisor)

Dr. Jayati Ghosh
(Chairperson)

Phone : 91-11-26717676, 26717557 Ext. 4421/26704421 Cable : JAYENU Fax : 91-11-26717603, 26717585, 26717586

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Introduction

Banking markets during the 1980s and 1990s in particular have been influenced greatly by a union of several exceptionally powerful forces like deregulation and re-regulation, disintermediation, the introduction of new technology and product innovation, cross border market integration, and greatly increased competition and consolidation across the globe. Mergers and acquisitions of banks throughout the world have increased substantially. As a result, the banking industry across the world is undergoing a rapid and sometimes disconcerting process of consolidation which is realized occasionally by hostile takeover bids but more often by friendly mergers between institutions that were once stern competitors. The reconstruction of a banking group, or mergers within a banking group, or the acquisition of subsidiaries, joint ventures and branch offices by banks or their controlling companies are on the rise in developed countries as well as in emerging economies.

Banking sector reform and the implementation by the Government of India and Reserve Bank of India of a liberalisation programme in the Indian banking sector is allowing public sector banks as well as domestic and foreign private banks to undertake programmes of merger and acquisition with limited restriction. The merger and acquisition process of banks in India involves the following forms: (i) mergers of banks coordinated by the RBI; (ii) friendly mergers between banks or reverse mergers of development financial institutions with banks created by them; and (iiii) substantial acquisition of shares of domestic banks by the foreign banks. The resulting merger movement in the banking sector in India since the 1990s has contributed to an increase in concentration of banking, with far-reachning and long-lasting implications for financial sector efficiency, bank stability, and competitiveness. This

concentration by enlarging the size, market power, and profits of banks triggers further expansion and diversification that enhances concentration in the sector.

This paper searches for to explore the reasons and impacts of such mergers and acquisitions in the Indian banking sector during the early 1990s associated with the continuing transition of policy regime. It also seeks to investigate the extent the merger and acquisitions have reached in Indian banks and whether it is favouring the India by any chance or not. This paper consists of three sections. The first section discusses the global banking mergers and acquisitions scenario from the time it started. The second section explains the exposure of banking merger and acquisitions in India with reference to the change in policy regime and its impact. The third section analyses the factor that determines merger and acquisition in banking .This section also explains potential directions India might move arising from the impacts of the merger and acquisitions.

CHAPTER 1

POLICY TRANSITION AND MERGERS AND ACQUISITIONS OF BANKS IN THE WORLD ECONOMY

Merger and amalgamation takes place when two or more companies combine to form a new entity and after merger the merging companies lose their individual identities. A merger can also be defined as an amalgamation if all assets and liabilities of one company are transferred to the transferee company in consideration of payment in the form of equity shares of the transferee company or debentures or cash or a mix of the above modes of payment. On the other hand acquisition is basically a process of capturing control of the acquired company by buying a controlling block of its share capital . There are various ways in which the acquisition process is put into effect. One way is through negotiation with the persons holding a majority interest in the target company's management. The other process is through purchasing shares in the open market or purchasing new shares of the target company by private treaty. The last way of acquisition is through a direct take-over offer to the general body of shareholders of the target company. Takeover is fundamentally an acquisition wherein the transfer of shares from transferred to the transferee company is in return for payment in cash.

There are a variety of reasons that an acquiring company may wish to purchase another company. By definition some takeovers are opportunistic. An opportunistic takeover occurs when the target company is simply very reasonably priced and for one reason or another, the acquiring company decides that target company will be important to it. As a consequence of this decision the acquiring company expects to ultimately end up making money by purchasing the target company. The motive behind the takeover is normal profitability. On the other hand takeovers can be strategic. In strategic

takeovers the motivation for acquisition involves a secondary effect beyond the simple effect of increasing the profitability of the acquiring company as a result of the absorbing the target company. For example, an acquirer may decide to purchase a company that is profitable on its own accord but also has good distribution capabilities in new areas which the acquirer can utilise for its own products as well. A target company might be attractive because it allows the acquiring company to enter into a new market with a running start and without having to take on the risk, time, and expense of starting a new division. The result is that the acquiring company would compete in this new market as a potential competitor. An acquiring company could decide to take over a competitor not only because the competitor is profitable, but in order to eliminate competition in its field and make it easier, in the long term, to raise prices. There may be other factors driving the takeover of the target company. The combined company could be expected to be more profitable than the two companies taken separately due to a reduction of redundant functions. If an acquiring company has a major competitor it wants to attack, it may purchase a target company which already competes with that major competitor in some other area or product line.

In a purely legal sense, a banking merger is just the same as the merger of any two companies, except that it involves banks. It will in all likelihood involve one of the following three basic structures. Firstly the acquiring bank (the purchaser) acquires the shares of the target bank (the target); secondly, the purchaser bank acquires the business (or part of the business) of the target; and lastly, Bank A and Bank B enter into a joint venture or shareholders' agreement whereby Bank A and Bank B become shareholders in a new bank, Bank C.

Synergy is an important factor influencing mergers and acquisitions in banking too. Rationality suggests that mergers and acquisitions occur when the resulting business combination is expected to yield more profits than the sum of the profits of the individual firms that were combined. This may occur either through revenue enhancement or cost reduction. The basic concepts and

definitions of mergers and acquisitions in banks and companies are almost similar. But bank M&A and M&A of companies should not be put in the same framework as there is a fundamental difference in the ownership structure, competition and performance between the two.

The most significant point in ownership, competition and performance of banks is that a bank is not similar to a manufacturing or even a services sector firm. Unlike a manufacturing or services sector firm, a bank helps mobilise domestic savings for subsequent investment in various on-going and new projects, and thereby also serves as the medium for transmission of monetary policy. Indeed, it is stylised in the literature that the intermediary role of the banks plays an important role in fostering economic growth, even though in some countries a well-functioning credit market has also had the unwelcome effect of fostering growth by way of debt accumulation rather than by way of improving total factor productivity (Gertler and Gilchrist, 1993; Ketkar, 1993; Ma and Smith, 1996; Bulir, 1998; Caranza, 2000; Acemoglu, 2001; Bell and Rousseau, 2001; Da Rin and Hellman, 2002; Jeong, Kymn and Kymn, 2003). In other words, while for manufacturing and services sector firms the best possible use of productive resources remains the objective of rational owners/managers and the size of the output *per se* is less important, both the size of the output (i.e., credit) and the allocation of this output matter in the case of banks. If bank credit is allocated to the most productive projects, the probability of project failure and, therefore, probability of banks losing money on their advances is not significant. But the opposite case is also there. The ability of banks to allocate credit to the most productive projects at a low cost to themselves, in turn, is believed to be dependent on their ownership structure and the extent of competition they face. According to Stiglitz and Weiss, 1981 if profit maximising banks, facing an uncertain economic environment, are apprehensive about the possibility of adverse selection with respect to their loan portfolio, they are likely to ration credit and refuse credit to potentially risky borrowers. This implies that the extent of credit rationing

exercised by a bank is clearly an increasing function of its degree of risk averseness. Otherwise there may be the possibility that the failure of one bank to settle net transactions with other banks will trigger a chain reaction, depriving other banks of funds and, in turn, preventing them from closing their positions. The consequence is frequently loss of confidence in the whole banking system. Therefore the dilemma for policymakers is most acute in the context of banks which results in substantially regulated banking activities in the globe. It is such a fundamental part of the financial system that activities to make it more efficient and profitable have a far reaching impacts on the financial as well as real sectors of the economy. That is the reason why US banking, though emerged as one of the biggest banking industries in the world from 1920s, remained regulated up till 1970s. Several countries that allowed foreign bank entry in 1920 restricted it between 1920 and 1980. At the same time, no country that forbade foreign entry in 1920 opened up over the same period. Many banking systems in many devolved as well as emerging economies are very careful about their banking sector policy regimes due to this. The banking configurations therefore should obviously orient towards developing a well functioning financial system keeping in mind the real sectors, depositors, lenders, employees associated with the system. Finally above all it should take into account the impact of contagion risk, systemic risk, and too-big-to-fail factor. As, if by any chance one bank fails it has an instant induction effect on the other banks turning out to a crisis situation in an economy due to the fragility and tremendous sensitivity factor of bank.

Nowadays banks operate in a highly competitive environment resulting in part from the development of new markets, instruments and techniques. These developments throw challenges to central bankers in attaining the appropriate balance between risk and stability in the financial system. It is the central bank's responsibility to provide a financial system in which the users of financial services can benefit from healthy competition between financial institutions, but, at the same time, to ensure public confidence in the monetary

system as a whole such that strategies adopted by banks as financial services institutions and the objectives set by the regulator have to be consistent with each other. As the banking markets become more developed and competitive, increasing market share or margins is becoming difficult. In this environment it is becoming more likely that banks will seek to expand and cut costs by way of acquisitions and mergers. As a matter of fact new players from abroad, seeking to obtain a foothold in the particular emerging markets would be more likely to buy a bank rather than develop a new business from the beginning. One of the fundamental motives that entice mergers is impulsive growth. Organisations that intend to expand need to choose between organic growth and acquisitions driven growth. Since the former is very slow, steady and relatively consumes more time, the latter is preferred by firms which are dynamic and ready to capitalise on opportunities. On account of these factors there is an acceleration of banking mergers and acquisitions across the globe, initially in the developed countries and then in the emerging market economies.

The 1990s have seen a mergers and acquisitions wave (M&A) of extraordinary intensity in both the United States and Western Europe (with around twenty times fewer mergers, Japan was only a very distant third).With more than 1000 billion US dollars in annual deal value during the second half of the 1990s and double of this number during the 1990s up to 1999, the merger wave of the century easily outpaced the investment in machinery, equipment and corporate R&D (Hans Schenk, 2000). Towards the late 1990s, a rising share of the merger activity consisted of the getting together of firms that were ultimately large thanks to earlier mergers. Side by side a substantial number of mergers concerned the takeover of small, innovative banks too. When regarded from the wider perspective, a wave spanning more than half a decade affected all industries, be they young or mature; with far-reaching effects. Banking mergers would therefore merely appear to be a part of a larger phenomenon.

During the 1980s, more than 5,000 US banks lost their independence due to take over, followed by the disappearance of another 3,000 during 1990-1997, implying that almost half the number of banks in existence in 1980 had been acquired twenty years later. American banks spent in excess of $65 billion to acquire other banks in 1997. Similarly, EU banks spent around $ 100 billion in 1998, which was up from $70 billion in 1997 and an average of $ 15 billion during 1994-96 (Hans Schenk, 2000). Interestingly, the average size of mergers within banking has also increased substantially both within the US and the EU. The number of so-called banking "supermegamergers" (involving institutions with assets of over $100 billion each) increased markedly.

In US the Riegle-Neal Act of 1994, which allowed bank holding companies to acquire banks in any state, opened the door to pairings—such as Bank of America and NationsBank or Norwest and Wells Fargo—that previously would have been difficult or impossible. Consequently, the banking industry progressed toward a natural endgame in which a handful of nationwide banks began to emerge. The top ten institutions like Bank of America, Citibank, U.S. Bancorp, and Wells Fargo, increased their share of US deposits from 27 percent in 1994 to 44 percent in 2002 (Kevin P. Coyne, Lenny T. Mendonca, and Gregory Wilso, 2004). The European financial services industry is also becoming substantially more consolidated as financial institutions engage in merger and acquisition (M&A) activity within individual European nations. Thus, between 1990 and 1997, the total number of credit institutions in France fell by 33% from 779 to 519. Other major European nations had similar consolidation over this interval, with the numbers of credit institutions in Germany, Italy, the Netherlands, Switzerland, and the U.K. falling by 26%, 12%, 17%, 21%, and 13%, respectively (Bank for International Settlements data). Most of the very largest bank M&As announced in Europe in recent years – such as the UBS-Swiss Bank Corp., BNP-Paribas, Royal Bank of Scotland-National Westminster M&As (as well as the ill-fated Deutsche

Bank-Dresdner Bank M&A) increased concentration within a single nation of Europe(Allen N. Berger, Robert DeYoung and Gregory F. Udell, 2000).

Great banking houses such as Baring Brothers, Chase Manhattan, Dillon Read, Dresdner Bank, First Boston, Industrial Bank of Japan, Kidder Peabody, Kuhn Loeb, Midland Bank, J.P. Morgan, National Westminster Bank, Alomon Brothers, Union Bank of Switzerland, and Yamaichi Securities all disappeared into mergers or liquidation. The 1980–2000 years were a difficult time for many banks, but a time of great opportunity for others. For their clients, however, it was a time of prosperity in which the pendulum of profitability swung from favoring the manufacturers of financial services to their users.

It has been observed that this phenomenon was particular concentrated among banking firms, that this type of consolidation accelerated during the last three years of the 1990s, and that most M&As occurred within national borders. As a consequence of that many countries (e.g. Australia, Belgium, Canada, France, the Netherlands and Sweden) reached a situation of high banking sector concentration or faced a further deterioration of an already previously concentrated sector, whereas a few others (notably Germany and the United States) remained relatively unconcentrated (Elena Carletti., Philipp Hartmann.and Giancarlo Spagnolo, 2002).

It has been argued that the origins of the merger movement are found, inter alia, in technical progress, especially the progress in communications technology and in deregulation in the wake of general globalisation. As a result of these developments, financial firms are facing competitive challenges from others all over the developed world, further, monetary integration in Europe made the proceedings more operationally flexible for merger and acquisitions in banking sectors. Efficiency and competitiveness of bank intermediation, massive market liquidity and financial stability and the working of monetary policy gave rise to such an extensive consolidation process. And it became the

focal attraction for policy makers, market participants and researchers about what are the consequences of this scenario.

The merger and acquisition market (sometimes thought of as the market for corporate control) has also experienced considerable integration since the mid-1980s, when mergers outside the United States first came to be significant. In 1985, for example, 89.4% of all global merger and acquisition transactions occurred within the United States or involved either a U.S. buyer or seller. In 1995 that percentage had decreased to 58.8%, and by 2001 to 48.8%. Indeed, after 1999, more mergers occurred outside the United States than within. For the entire period from 1985 through 2001, $12.8 trillion of global mergers and acquisitions have been completed, of which $5.5 trillion were within the United States, $1.9 trillion involved cross border deals in which one side was a U.S. bank, and $5.3 trillion of completed transactions occurred outside the United States, of which $5.0 trillion occurred within Europe (Roy.C.Smith, 2002). The merger market requires a healthy supply of willing parties, an availability of capital to finance the deals, transactional know-how and an environment free of impediments to takeovers in order for deals to be done. For international deals, these requirements must apply globally, which, for the most part, they have. The last set of conditions, freedom from barriers to takeovers, does not exist everywhere nor does it exist anywhere in completely pure form. But there are so many countries, such as Japan, Germany, and several emerging markets in which cross-shareholdings are considerable; and access to corporate control is not always available in the market. Over the years, however, barriers to takeovers have been falling and specific barriers to takeovers by foreign corporations are disappearing quickly. For the developing economies it is freeing as days progress.

While domestic mergers and acquisitions (M&A) in banking have risen steadily for the past two decades, international mergers and acquisitions remained relatively rare for so a long time up till the consequences of cross border merger and acquisitions became transparent to the interested parties.

Between 1980 and 2000, about one sixth of all bank mergers around the world involved partners headquartered in two different countries. However, this share varies greatly according to region. In Europe, about one third of all bank mergers involved partners from different countries, with 20 percent of all cross-border mergers involving two European institutions. In Asia, about 40 percent of all bank mergers involved a partner headquartered in a different country, but only about 10 percent of bank mergers in the Americas involved a foreign partner. Growth in the percentage of cross-border bank mergers has also varied by region. Compared to the 1980s, such mergers in the 1990s accounted for 10 percentage points more of all mergers worldwide. In the Americas, the share of bank mergers that were cross-border increased 5 percentage points between the two decades. In Europe, the share remained constant, and in Asia, the share of such mergers fell by 18 percentage points (Claudia M. Buch and Gayle L. DeLong, 2001).

But the response of the Asian countries has started to change from the second half of 1990s. Crispin et.al. (2000) remark that regulators across the region are directly and indirectly encouraging banking industry consolidation, in part because it is easier to keep an eye on a dozen rather than several dozen banks and finance companies. The Philippines' government started to use a regulatory carrot to encourage a rapid market-led consolidation of the banking industry. Malaysia, too, planned consolidation around 10 "anchor" banks, but there are serious doubts about the ability of local banks to survive if their long-standing protection against competition from foreign banks is lifted. Consolidation has already started in Singapore, with the mergers of OUB and UOB, and Keppel Capital Holdings and OCBC. In Singapore, the government has opened the door a little wider to foreign banks and urged local banks to smarten up fast. This practice showed the way by hiring an American executive to overhaul the state-controlled Development Bank of Singapore. In Thailand, foreign banks have taken control of Thai banks to both rescue them and to gain an entry into the market in the wake of the Asian financial crisis. Examples

include UOB's acquisition of Radanasin Bank and Standard Chartered Bank acquiring Nakornthon Bank. In Korea, similar moves have seen foreign entities take sizeable equity stakes in Korean banks, with, for example, Newbridge Capital acquiring a 51% stake in Korea First Bank and a consortium made up of JP Morgan and the Carlyle Group taking a 40.7% stake in Koram Bank (Philip Gilligan, John Banks and Alastair Timblick, 2002).

International mergers between financial institutions, it may seem, are one feature of the globalization of financial markets. Headline-cases such as the take-over of the U.S. commercial bank Bankers Trust by the German Deutsche Bank in 1999, the acquisitions of U.S. financial institutions by Japanese banks in the late 1980s, or the inroads of U.S. investment banks into European financial markets remind us of the global scale the banking industry is operating at these days. Yet, when looking at the numbers in more detail, it becomes evident that international mergers of financial institutions are recent phenomena. According to Thomson Financial Securities Data, cross-border mergers that were announced and completed between 1978 and 2001 where at least one of the partners was a commercial bank totaled 2,357. The number of international bank mergers has steadily increased over time, but the percentage of bank mergers that are cross-border has been small. The process started off slowly and reached a plateau of around 15 percent in the 1980s. However, since the mid-1990s, the share has grown steadily to reach over 30 percent in January 2001. (Claudia M. Buch and Gayle L. DeLong, 2001). Recent studies accessed a list of some countries such as Belgium, Canada, Germany, Japan, the Netherlands, Singapore, and Switzerland predominantly tend to have banks that acquire, whereas countries such as Brazil, Chile, Hungary, Latvia, Mexico, and Poland tend to have banks that are the targets of cross-border mergers.

Thus the picture of banking mergers and acquisitions across the world do is not the same. US banking merger and acquisitions are mainly characterised by domestic mergers and acquisitions, though cross border merger acquisitions have significant presence side by side. For European

countries, domestic mergers and acquisitions in banking industry have increased significantly. But cross border merger and acquisitions are very large in number compared to US banking cross border mergers. This is explained by the prevalence of single currency in European countries after the formation of the European Union (EU). The creation of EU facilitates all banks of Europe to undertake the concerned banking activities in all EU countries under the purview of a single market. Associated with it, the removal of restrictions on cross-border entry and the harmonization of regulatory and supervisory environments, which make it relatively easy for managers to cross international boundaries.

In emerging market economies, bank mergers and acquisitions have got various dimensions. Some mergers in emerging economies are state driven, since the state finds it necessary to restructure their weak banks by merging with strong banks already existing in the economy. Financial liberalisation had begun in the developing countries some time after the developed world's "awakening", but it quickly "unleashed" the banking system in the emerging economies. As a matter of fact, domestic bank mergers took a new shape as international competition drove the banks to consolidate with strong banks in order to compete in the international banking market. Financial liberalisation encouraged all competitors to develop an interest in the emerging markets for goods and services that are developing in India, China, South Asia, and Latin America. Foreign banks making use of the liberalization of the regulatory regimes in the developing countries enhanced their presence by substantial acquisition of shares in domestic banks.

Mergers between banks or between banks and other financial institutions, though uncommon in India, have been popular in many countries, where it is a potent means and a visible symbol of financial sector consolidation. At a global level, consolidation through mergers or takeovers has taken place creating gigantic financial institutions. Size is surely a desirable criterion for withstanding competition and to increase the reach of traditional

banking services and more recently to measure up to the regulatory requirements. Mergers have been driven by stock market forces - the relative valuations of the two banking companies coming into play. The experiences of the developed economies do matter to a large extent. In India banking merger and acquisition is becoming a common event and this practice is spreading throughout the economy extensively. But the question is do they offer tailor made solutions for emerging economies such as India? Specifically will the merger and acquisition route (M&A) spur banking and financial sector consolidation in India? As the Reserve Bank of India released Report on Trends and Progress of Banking in India (2000-01) pointed out, the conditions here are similar to those of many emerging economies. The banking system is fragmented in terms of the number and size of the institutions, ownership, profitability and competitiveness, use of modern technology and certain other structural features. Thus the extent of involvement in and the susceptibility of the Indian banking sector to the merger and acquisition wave are an issues of interest.

CHAPTER 2

BANKING MERGERS AND ACQUISITIONS IN INDIA

As an emerging market economy, India has also witnessed various types of mergers and acquisitions in the banking sector. Prior to the initiation of financial liberalization, mergers and acquisitions in the banking sector in India occurred because of the need to restructure weak banks which were entirely supported and directed by the Government of India and the Reserve Bank of India. This practice continues to run even after liberalisation. However, in the wake of liberalization, market driven merger of private banks in India gained ground as they sensed the need to consolidate to ensure stability and sustainability in the new competitive atmosphere both inside India as well as overseas. The growing presence of foreign banks in India has also increased the potential for acquisition of domestic banks. A cabinet decision raised the FDI limit for foreign investors in domestic banks to 74 per cent, but correspondingly there has been no change yet on any single entity having more than a 10 voting stake. There are restrictions that can be relaxed on a case-by-case basis, also on how much equity one private bank can hold in another which is not more than 5 per cent. Foreign banks already in India cannot hold more than 5 private in a domestic private bank either. So, acquisition of shares of the banks in India by the foreign banks has not yet developed too much.

This brief overview on the potential for consolidation of banks in India raises two questions. Firstly, how far have bank mergers gone till now and how has the emphasis in policy changed as a result of the merger incidents during the 1990s? And secondly, what are the impacts of mergers and acquisitions keeping the policy proposals of the government as a background?

To consider the direction of mergers and acquisitions of banks in India it is necessary to discuss the dawn of this practice in India. Mergers of banks that

took place in India in the 1960s under the direction of the Reserve Bank of India were entirely based on preserving banking stability. The mergers were driven by the fact that there were so many banks which had undergone bank run due to shortages of resources. Uncertainty among the depositors was on the rise as there was no deposit insurance. On the other hand the banks had no ultimate rescuer resulting in the closure of many banks. Based on these growing uncertainties in the banking sector RBI resorted to mergers or amalgamations of some existing banks which were in need of protection. From 566 reporting commercial banks out of which non-scheduled banks were 474 at the end of 1951, the number came down to 292 of which 210 were non-scheduled at end 1961. And the number came down to 100 (27 non-scheduled) at the end of 1966; and to 85 (14 non-scheduled) by the end of 1969. The number of bank offices increased sharply during this period: from 4151 in 1951 to 5012 in 1961, to 6593 in 1966 and to 9005 in 1969 (Vasudevan, 2004). The branch offices of scheduled commercial banks increased over this period while those of non-scheduled commercial banks declined. Unviable banks were picked out of the system, as recommended by the Travancore-Cochin Banking Inquiry Commission (1956). This meant either closure or amalgamation with other, relatively strong banks. The process got a pause as the policy formulators decided to nationalise banks in 1969. But it started in a new form after 1969, when weak banks making a huge loss in their balance sheet due to non performing loans were merged with the big nationalised banks under the direction of RBI. The massive accumulation of non-performing loans in these banks partly accounted for the policy pressures on the government.

Besides the above, there have been a spate of banking mergers and acquisitions involving private banks, driven by market forces unleashed after liberalisation and accentuated by foreign banks' acquisition of Indian private banks more recently. From 1969 till today five banks\ NBFCs were merged with "State Bank of India". They are Bank of Bihar in 1969, National Bank of Lahore in 1970, Krishnaram Baddeo Bank Ltd in 1974, Bank of Cochin in

1984-85 and Kashinath Seth Bank in 1995-96. Currently SBI is planning to consolidate with its seven associates: State Bank of Patiala, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Saurashtra, State Bank of Mysore, State Bank of Hyderabad and State Bank of Travancore. The case of mergers with another big public sector bank, Bank of India, is two till now. They are Parur Central Bank in 1989-90 and Bank of Karad in 1994. Three banks have been merged with another big public sector bank, Union Bank. The first was the Belgaum Bank in the year 1976, Miraj State Bank in the year 1986 and Sikkim Bank Ltd. in the year 1999. Similarly, in the case of Punjab National Bank, three banks have been merged with it until now. They are Hindustan Commercial Bank in 1986, New Bank of India in 1993-94 and Nedungadi Bank in 2003. Four banks have been merged with Bank of Baroda since nationalisation. Traders' Bank Ltd. was merged with it in 1988, Bareily Corporation Bank was merged in 1999, Benaras State Bank in 2002 and South Gujarat Local Area Bank in 2004. In the case of Canara Bank, Indian Bank, Allahabad Bank, Indian Overseas Bank and Central Bank of India the number of banks merged with each of them is one. They are Laxmi Commercial Bank in 1984-85, Bank of Thanjavur in 1989-90, United Industrial Bank in 1989-90, Bank of Tamilnad in 1989-90 and Purvanchal Bank in 1990-91 respectively. There are three cases of bank mergers involving Oriental bank of Commerce: Bari Doab Bank and Punjab Cooperation Bank both in the year 1997 and Global Trust Bank in 2004. SCICI and ITC Classics are the two bans which were acquired by ICICI in the consecutive years 1996 and 1997 and it acquired Bank of Madura in the year of 2001. Finally ICICI consolidated with ICICI Bank in 2002. Times bank merged with HDFC bank in the year of 2000 and British Bank of Middle East merged with HSBC in the year 1999. Taken as a whole, between 1969 and 1980 the banking sector witnessed five cases of bank mergers. This number increased to nine in the period between 1980-90. The number of bank merges further increased to 14 in the next decade, i.e. 1991-2000. From 2000 to 2004 there are six cases of bank mergers, all of which indicates that bank mergers are on a rising trend across time.

Acquisition of the shares of banks in India by foreign banks also took place after India opened its door to these banks. Entry of foreign banks initially referred to a process through which foreign banks set up operations in the country by either opening up a branch or a subsidiary. After the beginning of the 1990s by virtue of liberalisation foreign banks increased their operations in India as well as resorted to acquisitions, which expanded both the geographical reach as well as the range of products and services they offered. By then the time had became ripe in the country for introduction of new technology in a big way and even the trade union opposition that had held back the process (in foreign banks too) had to give way. In fact, since then a number of foreign banks have showed interest in acquiring a stake in Indian banks. Bank Brussels Lambert (BBL), a subsidiary of the Dutch ING Group, soon expressed its intent to take control of Vysya Bank. The promoters of Global Trust Bank, now merged after closure by the RBI, are believed to have approached ABN Amro Bank for share acquisition. Citibank and ABN Amro are reportedly negotiating for a stake in Bank of Punjab. And, Citibank, ABN Amro and HSBC have acquired sufficient stakes of UTI bank and are aiming to acquire UTI bank.

From the above overview it becomes transparent that from the 1990s mergers and acquisition activities in the banking industry have accelerated. This is partly because the regulators believe that the consolidation of the banking industry in India is necessary and inevitable for three reasons.

The **first** reason is the need to restore financial stability. It is very clear that at the bottom end of the Indian banking sector we do have weak banks that are a threat to the system. So consolidation is seen as needed here. Instances such as the merger of New Bank of India in 1993-94 and Nedungadi Bank in 2003 with Punjab national Bank, and the merger of Bareily Corporation Bank and Benaras State Bank in 2002 merged with Bank of Baroda illustrate the adoption of the merger route to protect weak banks.

Secondly, consolidation is seen as needed for making the Indian banks competitive in the international market. Considering the increasing presence of foreign banks in India and dominance of foreign banks in the international banking market as well, the government feels that if nationalised banks are consolidated they would have a capital and asset base sufficient to compete both in the domestic market and overseas. Union Bank and Bank of India are being considered for merger for that reason. Similarly, State Bank of India is planning merge with its seven associates.

Finally, consolidation is seen as needed from the point of view of the customers also. Intermediation costs in India remain high because there is relative inefficiency in the system. Whether it is the small and medium enterprise segment or the retail market segment or the agricultural segment – all the sectors are under-served. India has sub-scale banks that cannot invest and serve their customers. So to reach the entire customer population, keeping in mind the viability of the banks, consolidation is seen as needed.

These motivations that drive the regulators to go in for consolidation in the banking sector of India after liberalisation is not at all similar to the approach adopted towards banking sector mergers in the eighties. Even though there are nine cases of bank mergers in the eighties, these mergers were entirely motivated by the need to bail out weak banks. Actually during the mid eighties policy formulation in banking sector was mostly governed by the need restructure banks. The commercial banks gained a lot by expanding their operations. Despite the resort to mergers and acquisitions of commercial banks, they aimed at combining an increase on the quality of their services with an attempt to bring as larger a customer base as possible within their ambit. At this point of time, 90 per cent of the commercial banks were in the public sector and closely regulated in all respects. The banks had no power to exert their influence in determining the prices of assets and liabilities especially the rates of interest on deposits and advances to the customers. The policy regime was such that these were fixed by RBI. Prices of services were fixed uniformly by

Indian Banking Association (IBA). Composition of assets was also some what fixed and directed towards priority sector lending, small loans etc., which after meeting CRR/SLR requirements amounted to 40 per cent of advances. Locations of branches were approved by the RBI; salary structures were negotiated by the IBA and approved by the Government of India. So thinking of mergers or take over of banks to boost profitability was not even a possibility.

A lot has changed since 1991. There are three categories of banks that are seeking to resort to M&A activities inspired by recent changes in policies. First, there are banks (like Indian Bank) that have survived on the government's assistance in the form of thousands of crores of recapitalisation bonds. They are now keen to take over banks to become strong and acquire widespread reach. In the second category are two types of banks. In one group are reasonably strong public sector banks (like Union Bank) that want to acquire a bank with an overseas presence to become global entities. The other type consists of banks that have been looking at increasing their domestic presence. For instance, Bank of Baroda, which has a solid presence in western India, has started looking out for opportunities in the north, east and south. Vijaya Bank, which is based in Bangalore, intends to pick up a northern bank .On the other hand Punjab National Bank, headquartered in Delhi, is looking to south India for the similar reason. In the third category, are "make-believe" M&As that are purely personality-driven. These are banks headed by CEOs who were denied opportunities to head big banks and are believed to be taking the initiative to acquire other banks so that they can prove their leadership qualities.

A completely different reason why banks in India are engaged in acquisition activities is because of the acquisition of shares by foreign banks in private banks in India. HSBC is increasing its stake in UTI. ABN Amro, Citibank, Standard Chartered are also engaged in acquisition processes extensively. In the process, institutions like the Life Insurance Corporation of India (LIC), has also played a major role as far as consolidation goes. This is

because, it holds a 26.7 per cent stake in the Mangalore-based Corporation Bank, a 6.23 per cent stake in Oriental Bank of Commerce and a 13.41 per cent stake in UTI Bank.

If the transition in policy regarding banking sector mergers in India is examine closely from the very beginning of banking sector reform, we observe that a major motivation for consolidation has been a growing interest in the size of the banking firm. The undercurrent of thinking is that larger the bank the higher its competitiveness and better its prospects of survival. This argument implies that Indian banks are not in a position to compete for business internationally in terms of funds mobilisation, credit disbursal, investments and rendering of financial services. The reason for that is that banks are essentially of relatively small size than the banks in other countries. In the present context of global financial market integration, Indian banks are seen as needing an international presence by exploiting the economies of scale.

But banking stability is much more important in this context. The more important point is that the banking system should not lower the number of banks to levels that destroy competition in the system. The Banking Commission recommended in 1972 that national banks be reorganised into two or three all-India banks and six other entities, each specialising in developing services in a broad region. This was not pursued. But there is need for intense research on the issue, before one takes a judgmental view about the number of Indian banks that could have international presence and could compete for international banking business. Therefore the question about the optimal number of banks in the country, and the associated issues of their capital adequacy and their capacity to help universalisation of banking are matters to be yet settled. But right after the 1990s the numerous mergers of banking firms in the wake of changing policy made some issues very clear. Firstly, banking institutions needed to be strengthened financially. Secondly, mergers helped avoid complex processes of restructuring weaker units to foster financial stability.

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The Effects of Banking Reform

Needless to say, merger and acquisition in banking has gained ground after the launch of banking sector reform. Starting with the recommendations of the Narshimham committee on banking sector reforms what we observe is an emphasis on changes suitable for increasing the global exposure of Indian banks and on the adoption of information and communication technology in the banks. The committee felt that requisite success needed to be achieved in the areas like automation of banks, planning, standardisation of electric payment systems, supporting the telecom infrastructure and creating a data warehousing network. As regards mergers and acquisitions in the banking sector the committee recommended that mergers between banks and Developmental Financial Institutions (DFIs) and Non Banking Financial Corporations (NBFCs) needed to be based on synergies and should make a sound commercial sense. It also opined that mergers should not be seen as a means of bailing out weak banks. A weak bank could be nurtured into a healthy units. Merger could also be a solution to a weak bank, but the Committee recommended such merger only after cleaning up their balance sheets. It also said that if there is no voluntary response to a takeover of such banks, a restructuring commission for such PSBs can consider other options such as restructuring, merger and amalgamation, or, if not, closure.

In the post-reform period the government has encouraged both private and foreign investment in the banking sector. So it is only natural to expect consolidation in the industry through M&As. But banking is not like any other industry where a free-for-all can be permitted. Banking is seen as a system of financial intermediation which acts as a vehicle for savings and investment in the economy. So the RBI, at all times, retains strong discretion in regard to licensing of new private banks. It exercises utmost caution when it comes to assessing the promoter's antecedents and so on. The RBI, therefore, necessarily follows a merit-based approach in every case before issuing a licence to a private bank. It stands to reason that it wants to follow the same logic in the

case of those wanting to acquire a private bank through the open market route. But as regards the legal framework, the Reserve Bank was not very comfortable with the lack of clear statutory provisions regarding takeover of management of banks. In 1970, the Reserve Bank issued directions to the banks requiring them to seek the Reserve Bank's permission or acknowledgement before effecting any transfer of shares in favour of any person which would take the holding of shares to more than one per cent of the total paid up capital of such banking company. Subsequently, the RBI made it mandatory for investors to seek its approval before acquiring more than 5 per cent stake in an existing bank. The Narshimham committee also recommended that, while licensing new private sector banks, the initial capital requirements need to be reviewed. It also emphasised the need for a transparent mechanism for deciding the ability of promoters to professionally manage the banks. It also remarked that a minimum threshold capital for old private banks deserved attention and mergers could be one of the options available for reaching the required threshold capital.

The second Narshimham committee recommended the dilution of government stake in nationalised banks to below 50 per cent. The other major recommendations of the committee were:

1) Promoting consolidation of the banking industry through mergers and amalgamations (M&As);

2) Separating the Reserve Bank of India's (RBI) role as the country's monetary authority from that of a regulator of the banking system;

3) Reducing the 40 per cent stipulation for priority-sector lending;

4) Creating an exit route for surplus staff in the banking industry; and

5) Setting up an asset reconstruction fund (ARF) for the recovery of the banking sector's non-performing assets (NPAs).

Some of the suggestions are similar to the ones made by Narasimham in the earlier report submitted in 1991. The committee aimed to dilute government stake to less than 50 per cent in order to make banks' decision-making more autonomous which would have the far reaching impact that as of banks would be freed from scrutiny by the Central Vigilance Commission. The committee is also believed to have pressed for a dilution in the role of the finance ministry leaving micro issues to bank managements and concentrating only on macro management.

Much of the general literature on mergers in banking relates to private banking. The complexities involved in mergers of public sector banking are rarely discussed. In the early 1990s Government has endeavored to find a solution to bail out the weak banks after clearing out their huge NPAs, and passed an ordinance on September 4, 1993, and took the initiative to merge New Bank of India (NBI) with Punjab National Bank (PNB). Ultimately, this turned out to be an unhappy event. Actually when the National Bank of India was merged with Punjab National Bank, problems of employees' incorporation cropped up. After this experiment, public sector bank mergers were not contemplated. On the other hand, there were private banks mergers since about the late 1990s for diverse reasons including building up of financial strength, capturing larger portion of the growing retail business and securing better regional presence in the Indian banking market.

The interests of private sector banks was taken care of while on January 22, 1993, the RBI issued guidelines on the entry of new private sector banks to be registered as public limited companies under the Companies Act, 1956.There are so many cases of mergers of private banks with public sector banks after that, the prominent among them being the mergers of Benares State Bank with Bank of Baroda in 2002; Nedungadi Bank with Punjab National Bank in 2003; and, more recently, Global Trust Bank with Oriental Bank of Commerce. But these mergers were at the initiative of the authorities, undertaken for preserving banking stability. The above examples of mergers

have been facilitated to a large extent by banking sector reforms. These mergers have helped to relax some of the restrictions on asset portfolio distribution. Also, to an extent the advances in information technology have given banks the incentive to consolidate to scale up operations.

With the removal of entry barriers, in 1995, the emergence of nine private sector banks has given a new glamorous outlook to the banking industry. Technological know-how, customer oriented service and innovative products have become the basic ingredients to emerge as a potential competitor in the market. Therefore, the private sector banks, in order to compete with large and well established public sector banks, are not only focusing on the information technology aspect, but also shaking hands with suitable banks to establish themselves in the market. One of the first initiatives was taken in November, 1999, when HDFC and Times bank shook hands and created history. The proposed amalgamation between Timesbank and HDFC bank was the first successful merger after the case of merging New Bank of India (NBI) with Punjab National Bank (PNB). These two profitable private sector banks agreed to merge on a negotiated basis. This merger signalled that the Indian banking sector had also joined the M&A bandwagon facilitating the HDFC Bank to emerge as the largest private sector bank in India. Under the scheme of amalgamation, shareholders of Timesbank received one share of HDFC bank for every 5.75 shares of Timesbank. The merger brought in both synergies of operations and volumes. HDFC bank stood to gain in terms of savings on technology, faster growth, an expanded consumer base, increased market-share and reduced costs. The merger enabled HDFC bank to leverage the use of its alternative delivery channels (phone banking, Internet banking, etc) and provide cross-sell opportunities across a wider product range and to a larger customer base.

The reason behind the merger was also the increase in size of HDFC after merger based on the post-merger balance-sheets of the bank as of September 30 1999. HDFC recorded total deposits of around Rs 6,900 crore

and a combined balance-sheet size of over Rs 9,000 crore which automatically made it the largest private bank at that time. One more advantage to the bank was the expansion of the branch network. The strategy adopted by HDFC in setting up branches has been that of incurring lowest cost with about 6-8 employees per branch who will look after both the servicing and marketing functions. Since setting up of a new branch is a costly affair, acquiring a readymade branch network is easier. Therefore, on account of merger, the networks of HDFC and Times Bank would be in a single pocket leading to enlarged potential market in that aspect.

In India banking mergers are looked at as amalgamations in which guidance is taken from the Narasimham's committee conclusions. Here the acquiring company acquires the assets and liabilities of the target company (or amalgamating company). Typically, shareholders of the amalgamating company get shares of the amalgamated company in exchange for their existing shares in the target company. There may be the case that one bank (or financial entity) acquires another bank like the merger of ICICI Bank and Bank of Madura, wherein after merger, the target bank, Bank of Madura ceases to exist and the acquirer continues to exist. In this case, the acquirer ICICI Bank exists.

After liberalisation banking reform has also encouraged banks to be more selective about asset quality and they are often uninterested in a bigger branch network if it brings with it bad loans and dubious banking practices. In fact, technology has reduced the emphasis on a big branch network. ICICI Bank, immediately after it converted from a development finance institution to a bank, needed the leverage of a big branch network. So it acquired Bank of Madura and also expanded rapidly after the late 1990s. In the initial phase, ICICI decided to merge three of its subsidiaries, ICICI Capital Services, ICICI and Web Trade and ICICI personal Finance into a single company to restructure its subsidiaries. This consolidation came in the wake of a Reserve Bank of India direction to bring down the total number of subsidiaries as it felt that the supervision of the group's activities is a difficult task for the central

bank. On April 1, 1999, in order to provide a sharp focus, ICICI Bank finally consolidated its business into three branches namely, corporate banking, retail banking and treasury. This restructured model enabled the bank to provide cross-selling opportunities through ICICI's strong relationships with 1000 corporate entities in India. As on March 31, 2000, the bank had a network of 81 branches, 16 extension counters and 175 ATMs. The capital adequacy ratio was at 19.64 percent of risk-weighted assets, a significant excess of 9 percent over RBI's benchmark. ICICI Bank had been investigating for a private banker for merger, with a view to expand its asset and client base and geographical coverage. Though it had 21 percent of stake, the choice of Federal bank, was not profitable due to the employee size which was 6600 and per employee business which also was low at Rs.161 lakh. Technical upgradation was expected to be sluggish too if Federal Bank was chosen. Comparatively, Bank of Madhura had an attractive business per employee figure of Rs.202 lakh, a better technological edge and had a vast base in southern India when compared to Federal bank.

Keeping in view these factors ICICI Bank announced a merger with the 57-year-old Bank of Madura, with 263 branches, out of which 82 were in rural areas, with most of them in southern India. The swap ratio had been approved in the ratio of 1:2 – two shares of ICICI Bank for every one share of BOM. The bank's comfortable Capital Adequacy Ratio (CAR) of 19.64 percent declined to 17.6 percent. But the merger had ensured an increase of asset base to over Rs.160 billion and of deposit base to Rs.131 billion. The merged entity had 360 branches and a similar number of ATMs across the country and also enabled the ICICI to serve the large customer base of 1.2 million customers of BOM through a wider network, increasing its customer base to 2.7 million.

Apart from the market driven mergers of private banks there is another type of merger which is directed by the RBI. It may be the case that there are enough signals that there is something wrong with a particular bank in terms of its borrowing and lending activities, which warrant protecting the interest of

shareholders. Of course, an opportunity has to be given by the RBI to correct those problems in the beginning. But, when the regulator finds that the problem is becoming serious and its intervention is necessary, a freeze has to be imposed. Otherwise, there can be a run on the bank. To prevent the run action has to be taken under the under section 45 of the Banking Regulation Act, and a temporary freeze on the operations is applied only to ensure that the deposits are not at risk. There could also be a possibility that a run on the bank can have systemic effects. This was just the case with Global Trust Bank (GTB) necessitating its amalgamation with Oriental Bank Commerce (OBC). As, if something had gone wrong with Global Trust Bank, then ICICI Bank could have been in trouble, Syndicate Bank could have been in trouble, Canara Bank could have also been in trouble and so on. That is there could have been a contagion effect on other banks. To deal with the situation RBI imposed an Order of Moratorium on July 24, 2004 and arranged for a merger with Oriental Bank of Commerce.

The amalgamation came into force on August 14, 2004. All the branches of Global Trust Bank Ltd. function as branches of Oriental Bank of Commerce with effect from this date. Since the Global Trust Bank is a south-based bank, it would give Oriental Bank of commerce the much-needed edge in the southern part of the country. After the immediate sanctioning of the draft of amalgamation forwarded by the two concerned banks the depositors were permitted to withdraw only up to Rs. 10,000 from their savings bank account or current account or any other deposit account through any of the branches of the Bank which was increased over time.

In other cases, Bank of Baroda completed a directed acquisition of Benares State Bank. An old private sector bank, Nedungadi Bank merged with Punjab National Bank. It may be the case that some banks have little success in finding a strategic partner or raising equity when merged for the first time. Then RBI directs a second merger of that bank to give a second helping hand to the merged entity. For example, in the year 1999, the RBI allowed the merger

between Centurion Bank and one of its major promoter groups, the non banking financial company, 20th Century Finance. The NBFC was not exactly in the best of shape and the merger merely helped paper over weaknesses that could have precipitated a crisis. The subsequent proposal for merger with Andhra Bank may be a case of second-time bail-out for the Centurion group. In this case, Andhra Bank may get a branch network with a good degree of automation.

As discussed above foreign banks have expanded their presence in Indian banking sector after the liberalisation. This was aided by policy, In February 2002, the banking rules that once restricted foreign ownership in Indian private sector banks were eased. It raised hopes of consolidation among India's 32 private banks. Foreign banks that had operations in India were allowed to possess up to 49 per cent of a private bank. The foreign ceiling on FDI applied to all forms of acquisition of shares (IPO's or initial public offers, private placements, American depository receipts and global depository receipts and acquisition from existing shareholders). The clarification also stated that even foreign branches having branch presence in India can undertake FDI investments in private and public sector banks, subject to approval from the Reserve Bank of India (RBI). The FDI limit by the foreign banks has been restricted to 20 per cent in case of public sector banks.

The liberalisation of FDI caps, in private banks, notwithstanding, there are some hindrances to acquisitions by foreign investors. Under the Section 12 (2) of the Banking Regulation Act the maximum voting rights per shareholder was set at 10 per cent of the total voting rights for a private. This resulted in an implicit curb on increases in foreign stakes as the foreign partners will not be able to raise their equity stake to and simultaneously obtain a proportionate voting right. A similar problem afflicts the relevant legislative decision of increasing commercial autonomy of the public sector banks by bringing down the Government's stake in each of the PSBs to 33 per cent. Yet the move has signaled the start of the process of increasing foreign bank presence in public

sector banks. As only a minority of the government owned banks are listed on the stock exchanges the general outlook for the PSBs is not bright as far as the stock markets are concerned .So the process has not yet taken shape in practice.

Further, given the policy guideline that existing foreign banks can acquire only up to a 10 per cent stake in a private bank, the Reserve Bank of India prevented Hongkong and Shanghai Banking Corporation (HSBC) from buying over a 20 per cent stake in the private UTI Bank. It permitted HSBC to purchase just over 14 per cent of the bank's equity for Rs 90 per share, so that management control or board representation in UTI Bank was not possible as HSBC expected. But in December'2003 HSBC acquired a 20 per cent stake in UTI bank from the Commonwealth Development Corporation (CDC). HSBC bought the 20.08 per cent stake from two private funds - 12.37 per cent from CDC Financial Services (Mauritius) Ltd and 7.71 per cent from the CDC-controlled South Asia Regional Fund. This acquisition of a stake is soon likely to exceed 20 per cent since HSBC would, as per SEBI guidelines, have to make an open offer to other minority shareholders, and end up acquiring another bunch of shares. At the time of acquisition, the shareholding pattern of the bank involved a substantial foreign presence: Citicorp Banking Corporation held 3.83 per cent, Chryscapital held 3.83 per cent, Karur Vysya Bank held 1 per cent, South Asia Regional Fund held 7.71 per cent and 16.91 per cent was with the public. HSBC is driven by the objective of reaping the benefits of economies of scale in the Indian market and this would be feasible only if it works towards a merger with UTI bank by picking up more minority stakes. However, the process is currently paused because the debate over changing local regulations has still to go its way.

UTI Bank has about 217 branches; about 15 per cent of their loan books are SME borrowers and retail borrowers account for about 19per cent. More importantly, its annual post-tax profits have grown by 50 per cent in the past four years, most of which has come from healthy fee income. The view of industry observers is that HSBC effort to buy into UTI's stake is explained by

the availability of professional management and good quality assets which can help capture a larger market. With assets of around $4.5billion HSBC is the third biggest foreign bank in India today, after Standard Chartered and Citigroup. Therefore were HSBC to buy out UTI, HSBC-UTI Bank could emerge as the biggest foreign bank in India. But as the Reserve bank of India has turned down HSBC's request to acquire a further stake in UTI, restricted change in directorship and set certain other restrictions on transactions with UTI Bank the process is yet to come to fruition.

Though HSBC's acquisition of shares of UTI bank is the most prominent case of a foreign acquisition, the first foreign bank to acquire an Indian bank was ING. A few foreign banks, such as Citibank, ABN Amro and HSBC, had looked at Centurion, an ailing private bank, they have backed off. In September 2002, ING raised its stake to 44 per cent in Bangalore-based Vysya Bank, a move that led to it gaining management control from Vysya's Indian core shareholders. ING bought out Vysya's promoters and a 5 per cent stake in the bank. ING followed a similar strategy in buying out its joint venture partner in Poland. It first bought a small stake in a publicly listed bank and then steadily increased this, to take over the bank. When ING had bought a 20 per cent stake in Vysya in the mid-1990s, it had an eye on India's insurance market which was ready for deregulation. That happened a couple of years ago when ING forged a life insurance joint venture with Vysya, of which it owns 26 per cent, the maximum allowed for a foreign investor. Private Indian insurance companies had been in business for just under a year in February 2004 when the rules of foreign ownership in private Indian banks were eased, allowing ING to buy control in Vysya. Promoters of Vysya Bank have sold 20 per cent stake to Bank Brussels Lambert (BBL), part of the Dutch ING Group, and are likely to offer a controlling stake to the foreign bank. Since the International Finance Corporation, promoted by the World Bank, has a 10 per cent stake in the bank, BBL can increase its stake by only 19 per cent because of the 49 per cent ceiling on foreign stake in Indian banks.

Vulnerability at home may finally be the fundamental factor for a foreign bank operating in the host countries where it decides to shed its operations through sale to other foreign banks. For, indirectly, the need for banks then was perhaps not to stretch them too much in the pursuit of growth without consolidating. That was the major problem for ANZ Grindlays as it probably made sense for it to shed certain operations and conserve resources for the prospective battle at home. This led to the take over of the oldest foreign bank, ANZ Grindlays by the Standard Chartered Group in India. The main factor behind the decision to drop the India operations may be that ANZ Grindlays was characterized by considerable overlap of portfolios and branches. Thus for instance, the bank had five branches in and around the Fort area in Mumbai. ANZ Grindlays probably fell into the trap that public sector banks often find themselves which involves mistaking physical presence for greater reach and business volumes. The geographical reach did not translate into higher returns, weighed down as it was by its large workforce of 3,337 employees. Net profits for ANZ Grindlays had declined to Rs. 176 crores in 1998-99 from Rs. 230 crores in 1997-98. Therefore the inability to reap the benefits of economies of scale in terms of cost reduction stood up as the major impediment for ANZ Grindlays.

Effective from September 1, 2002, StanChart operated in the country as a single entity by the name of Standard Chartered Bank. The completion of the merger has made StanChart the largest foreign bank in the country with an asset base of Rs 29,000 crore and total deposits stand at Rs 15,439 crore as on March 31, 2002. At first after the immediate merger the StanChart group operated in the country through two entities - Standard Chartered and Standard Chartered Grindlays. Though StanChart chose to drop Grindlays from its name, it continued to use it for branding specific retail products and delivering significant benefits in terms of network, products and customer service.

The steps towards the transformation of financial intermediation in India into universal banking and the long-run prospects of it are also increasing

though there might not be profits forthcoming in the short run due to the switching costs incurred in moving to the new businesses. There seems to be a lot of interest expressed by banks and financial institutions in universal banking as most of the groups have plans to diversify in a big way. By diversifying the bank entails less cost in performing all the functions by one entity instead of separate specialized bodies and saves cost compared to the case of different entities catering to the different needs of the same clients. That is a way a big bank can reach the remotest client without having to take recourse to an agent. Development Financial Institutions (DFIs) can turn themselves into banks, but have to adhere to the statutory liquidity ratio and cash reserve requirements meant for banks. Even then, some groups like the HDFC (commercial banking and insurance joint venture with Standard Assurance), ICICI (commercial banking) etc., have already started diversifying from their traditional activities through setting up subsidiaries and joint ventures. The Insurance Regulatory and Development Authority (IRDA) allows commercial banks to enter insurance business either by acting as agents or by setting up joint ventures with insurance companies. And the RBI allows banks to only marginally invest in equity (5 per cent of their outstanding credit).

The leader of the banking sector in India, State Bank has so far sidestepped the merger issue by pointing out that the associate banks of SBI are growing faster than it and so should not be merged with it. But all of them are not listed entities and their balance sheets are not under public scrutiny. Given this the State Bank of India may not very far behind in the consolidation process as SBI has also intended and started to implement a ‘‘virtual merger’’ with its seven associates. The move finally is to physically merge the seven associate banks with SBI itself and which has no relation with branch merger. But initially the plan is for all the entities in the SBI Group to share information and have common strategies across their forex and rupee treasuries. But till October 2004 there is not very much detailing of how the process will evolve,

but indications are there that SBI and its associates will have the same technology and common treasury operations.

At present, the associate banks - State Bank of Patiala, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Saurashtra, State Bank of Mysore, State Bank of Hyderabad and State Bank of Travancore operate through separate branches. The identity of individual banks would continue but the financial operations may be merged for better synergies between the parent and the associates. The ATM network of the SBI and its associates is also the same as also practices such as retailing insurance policies of SBI Life and New India Assurance and products of mutual fund schemes.

In a recent move, the Life Insurance Corporation increased its stakes in Corporation Bank and is planning to sell insurance to the customers of the Bank. Corporation Bank itself has been planning to set up an insurance subsidiary since a long time. Even a specialized DFI, like IIBI, is now talking of turning into a universal bank.

From the standpoint of emerging as universal big banks, State Bank of India (SBI) remains too big to be part of any race, but there is suddenly a lot of jostling for the second position that is currently occupied by the aggressive ICICI Bank. On the basis of the four points: leadership, technology, branch rationalisation and asset origination ICICI has grown aggressively to capture leadership in most retail businesses that it targeted; and a is now in consolidation mode. If HDFC Bank had consolidated, with Housing Development Finance Corporation (HDFC), its parent organisation two years ago, ICICI Bank may not have had the space to grow into its present leadership position, especially in retail banking according to some top bankers. Another top player arising out of the consolidation is IDBI. With IDBI Bank, IFCI, IIBI and maybe another public sector bank under its fold, it'll be ready to give SBI a run in terms of size, and seek to build on its development banking strength,

remain focused on infrastructure funding and still try to match the profitability of its more responsive competitors.

The recent positive attitude to bank mergers of the government which has even offered tax concessions for the purpose is lending credibility to every merger rumour. The biggest is the reported merger of Union Bank of India and Bank of India that is planned to take place. The merger of these two with an asset base of more than Rs.1.43 lakh crores - Rs.84, 860 crores belonging to the Bank of India, and Rs.58, 317 crores belonging to Union Bank - would created the second largest bank in India after the State Bank of India (SBI). The share swap ratio for the merger is expected to be 1.8:1 which means for every 18 shares of Bank of India only 10 shares of Union Bank will be issued. But the main impediment to this type of consolidation is that government has not yet made any provision to address the issue of possible capital erosion that may emerge out of these types of bank mergers. Since the swap ratio of other banks are different dependent on the bank's balance sheet and quality of the assets of they own, the government should have to provide either a comprehensive approval for sacrificing its capital or deal with it on a case-to-case basis. Like in the case of Indian bank, which has a capital base of Rs 4573 crore and is wholly owned by the government, merger with other banks will certainly lead to an erosion of a substantial amount of capital. The proposed merger between of Indian Bank with Andhra Bank and Vijaya Bank are not enough to compensate the capital erosion of the later, as each of them have a paid up capital less than one third of Indian Bank going in their favour in terms of the swap ratio. Therefore it is increasingly being felt that takeover stories are just a means to keep stock prices buoyant. If the possibility of bank mergers is what is keeping stock prices up, then it is worth examining what makes for a successful merger and whether mere announcement of a merger means much which is substantially different from the traditional view of matching the work cultures of the two organisations and to increase the geographical spread of the new entity.

The Indian Banks' Association, the premier bankers' body in the country, has made a strong appeal for corporatisation of all commercial banks (excluding regional rural banks) to facilitate mergers and acquisitions on the banking turf. The IBA report on M&A in banking, submitted to the finance ministry recently, has suggested that corporatisation would make all banks come under the Companies Act, 1956 and, therefore, ensure a common legal framework. If such corporatisation is done, all public sector banks would become banking companies and would be governed by the provisions of the Companies Act and the Banking Regulation Act. Once banks are corporatised, mergers will need approval of RBI under Section 44A of the Banking Regulation Act and it will not be necessary to obtain approval of the High Court. So as a whole starting from the 1990s the policy regime seems to be continuously changing towards more and more banking consolidation regardless of whether they are PSBs or private banks or foreign banks in India.

One thing that becomes very clear from the above discussion is that bank mergers in India, sporadic as they have been, do not reveal any pattern. None of them has been purely market driven and none arose out of a hostile bid. Even the all stock swap mergers of banks arose out of a friendly arrangement. And reverse mergers are an inventive way for financial institutions to get the universal bank status. The point is none of the usual circumstances that propel banks to come together is readily found here. It will need a special policy or regulatory push to propel banks towards consolidation. Currently the banking sector in the country is strongly fragmented and hence with further policy changes taking place in the sector, consolidation is likely to take place at a faster rate. However there is this subject of the removal of the ceiling on voting rights, which would be required to ensure that private sector and foreign banks will be in a much better position to carry out acquisitions in the banking sector. A hike in FDI capital limits for the foreign banks up to 74 per cent would further go a long way in the process of consolidation.

Apart from this the Indian banking system is in the midst of a technological revolution as far as customer offerings are concerned. Banks are offering value added services including ATMs, telephone banking, online banking, web-based products, call centers, etc which have become increasingly popular. The private sector banks are on the threshold of improvement, the Public Sector Banks (PSBs) are slowly contemplating automation to accelerate and cover the lost ground. To contend with new challenges posed by Private Sector Banks, PSBs are pumping huge amounts to update their IT. But still, it looks like public sector banks need to shift gears, accelerate their movements in the right direction by automating their branches and providing Internet banking services. Although large PSBs are slowly venturing into new areas, a few old big-sized banks are still encountering problems of unionized staff though in the milder way, and the employees are still finding their feet in new technologies. And unemployment in the labour market of the banking sector due to the technological upgradation creeps in massively side by side.

From the above discussion it should be also be clear that recent trends in the policy regime are sending out clear signals to Indian banks to go in for mega-mergers and "think big and act globally". Going global would mean competition with established banks, such as Citigroup, J.P. Morgan Chase, Barclays, Deutsche Bank, Bank of Tokyo and Credit Suisse Group. The combined assets of the five largest Indian banks – the State Bank of India, ICICI Bank, Punjab National Bank, Canara Bank and Bank of India on March 31, 2003 were less than the assets of the largest Chinese bank, China Construction Bank, which is roughly 7.4 times the size of the State Bank of India. The Banker's list of the top 1000 banks of the world (July 2004) has 20 Indian banks. Only six of them come in the top 500 group. The State Bank is positioned 82nd, ICICI Bank 268th, Punjab National Bank 313th, Canara Bank 405th, Bank of Baroda 425th and Bank of India 474th. Associated with this problem of size is the fact that the entry of Indian banks into foreign markets especially in western countries is immensely restricted. Regulatory procedures

are very tight whether it is to open a branch or subsidiary. As a result, the think and act global move of Indian banks, while increasing the size of the banks involves increased risk as well because the Indian banking system gets linked with the world system and is susceptible to any volatility abroad. On the other hand there are few benefits to be reaped abroad. . As India is opening up, we have to do what the rest of the world is doing, although Indian banks gain little in the international market.

In the wake of liberalisation old foreign banks are expanding in and new foreign banks have been entering India and as discussed earlier after acquiring domestic banks increasing the ambit of their activities in the economy. The contemporary laws and regulations are not sufficient enough to regulate these foreign banks. Though in general, they would have to meet the regulatory norms. Foreign banks after the entry in India do not fully meet norms relating to the priority sectors, especially agricultural sector, so that the priority sector lending has deteriorated substantially. The fact that Indian banks, were under serving all sectors and especially the priority sectors, encouraged the regulators to go in for further consolidation. But in practice after consolidation the picture seems to be somewhat different. There is a reduction of priority sector lending by the public sector banks as well as foreign banks.

Government has substantially reduced its control in areas like seeking approval to merge with other banks as it would not force any bank to go in for mergers or alliances but "will bless the marriage if it comes through". The government also intends to lift the 10 per cent cap on voting rights in private banks by reintroducing a Bill to remove the voting rights cap after holding consultations with all (coalition) partners. The standing committee has already recommended that the 10 per cent cap be removed. According to K J Udeshi, Deputy Governor, RBI, "We are slowly but surely moving from a regime of 'large number of small banks' to 'small number of large banks',". But concentration is not of a degree that the leader banks can compete with foreign bank on Indian soil as well as in the international market. Once international

banks open branches in India, Indian banks will wake up to the more competitive atmosphere. Rationally they have to be large to compete with say, Citibank or Hong Kong Bank, in the case of whom in almost all such comparisons the scale of assets is 10 times the size for a like-to-like domestic operation. Foreign entities also look at whether there are labour unions, which would restrict their ability to reduce costs; the cultural fit and the quality of information systems in terms of service delivery and ability to improve profitability of products. The depth and future impact of this issue is entirely dependent on the regulatory approaches and policy structures that should protect Indian banking keeping in mind that banking is far too important a tool for social and economic development. RBI should work out separate guidelines for foreign banks as if regulation won't stop foreign banks from coming in it should at least ensure that they meet certain requirements. We should not be feeling guilty as a country to serve our national interest.

Summarising the whole section leads to the following conclusions. The recent policy regime for consolidation of the units encourages the merger of the two public sector banks who are on average in robust good health at the time of consolidation. Implication of this is larger size of the merged entity which would have significant potential to carry out its operations globally. The directed merger by the RBI for those units which were doing badly before merger or takeover with strong public sector banks have stepped down in the preference schedule of policy formulators. As size of the banks becomes the desirable criterion for consolidation, priority is shifting towards merger of two stronger banks. After that weak banks are considered to be merged with strong banks. But it has to be acknowledged that weak units that were sold off fared much better after the sell-off than before.

From the borrowers perspective consolidation may have cost or revenue efficiency effects. Revenue scale economies may occur because some customers may need or prefer the services of larger institutions. To the extent that larger portfolios result in improved risk diversification, there may also be

revenue scale economies because customers place higher value on financial guarantees, such as loan commitments or derivative contracts issued by safer institutions. Any improvement in risk diversification may also increase the opportunity to engage in higher risk-higher expected return activities because of reduced pressure from market participants and government supervisors and regulators. Universal-type consolidation may also have revenue scope efficiency effects, depending upon whether customers prefer and are willing to pay more for the convenience of one-stop shopping for financial services versus preferring and paying more for the more tailored services that might be provided by the banks. Improved diversification may increase cost efficiency by reducing risk premiums on debt by solving informational financial problems, lowering the expected costs of financial distress, and/or lessening the costs of prudential regulation and supervision. There is enough potential to study these aspects especially with reference to India.

CHAPTER 3

THE DETERMINANTS AND IMPACTS OF BANKING SECTOR MERGERS AND ACQUISITIONS IN EMERGING MARKETS AND INDIA

In a nutshell, throughout the world, banking industries are undergoing a speedy and sometimes astonishing process of consolidation, encouraged sporadically by hostile takeover bids, but, more often, by friendly mergers between institutions that were once competitors. Several reasons that drive banks to merge can be identified:

Firstly, banks are fighting with the same technology, delivery and customer-service issues that have become pressing for major international banks. Banks are feeling forces of globalisation and technological change. Consequently, now they must invest huge amounts in their own information technology systems. The electronic revolution also challenges the traditional role of banks as intermediaries between borrowers and savers, in the process of reducing banks' profits. This, in turn, is forcing banks to cut costs more urgently, and a merger with another bank becomes an attractive option for a bank.

Secondly, in Europe, legal changes since 1970 as part of the transition to economic, monetary and financial union has implied increased competition among banks and is forcing them to seek ways to cut costs and to increase market share and enhance revenue. Particularly, cross border mergers between banks in European nations increased significantly under the purview of single market programme.

Thirdly, it is believed that banks might become too small to compete effectively either in terms of products or geographically. In several countries,

governments and regulators are urging banks to merge not because the merger would make them better, safer or more profitable, but because it would allow them to compete internationally with the main American and European banks. In emerging economies like India liberalisation has started to create a similar tendency.

From the above it should be clear that there is a deep-rooted tendency towards mergers and acquisitions in the banking system in recent years. In the wake of globalisation banking consolidation has been motivated by two main factors under which all the reasons can be clustered around. Revenue enhancement and cost reduction are the central reasons quoted in defence of consolidation, with far reaching and long lasting implications for financial sector efficiency, bank stability, industrial competitiveness, and the policies, regulations and institutions essential for long run economic growth. Financial sector efficiency and economies of scale drive bank mergers and acquisitions that increase concentration. Policymakers use concentration as a means of competition. But it does not mean that some degree of monopoly power in banking is natural and beneficial. Rather mergers and acquisitions stress the importance of increasing returns to scale in the production of banking services. With increasing returns, greater concentration may increase bank efficiency through more efficient scale, better organization and management, increased scope, and improved product mix. According to this view, commercial bank concentration will be positively associated with measures of banking sector efficiency and financial development.

The thinking is that the larger the bank, higher its competitiveness and better its prospects of survival in terms of funds mobilisation, credit disbursal, investments and rendering of financial services. The banks of small size in the present context of global financial market integration are, according to this view, unable to compete with those large banks as their ambit of performance, geographically, would not be adequate as compared to large banks. When banks join hands and merge into a single entity they expand their size and also

the realm of their service area. The need for revenue enhancement drives the banks to expand their network and they begin to expand their local operations. The bigger banks now dominating the market due to consolidation naturally lie in the higher revenue rung. Whereas the others are thrown out of the market as they have not got deep pockets and can't sustain their business; their losses will mount and they will fall by the wayside in the pricing battle. The increase in competition increases the volatility in earnings and lowers spreads, which further exerts significant pressure to increase volumes to survive in the market. At the end of the day the big banks after taking over small banks remain in the market. The big banks with their large capital and asset base may evade the fragility of the system.

However, there are many disadvantages associated with large size in banks is the other part of the story relating lies in the reduction of cost. There is a large number of studies that examine the impact of M&A on bank costs. These studies consider changes in X-efficiency – changes in the distance from the efficient cost frontier. The studies show little or no improvements in cost efficiency from bank consolidation (Rhoades, 1993; Peristiani, 1997). As Boyd and Graham (1998, p. 133) conclude after reviewing the literature, research finds "... little evidence that consolidation of the US banking industry has been helpful over any performance dimension." Evidence from Europe provides similar results. Goldberg and Rai (1996) do not find a robust relationship between concentration and bank efficiency in European banking. Thus, while acquiring banks tend to be more cost efficient than target banks on average (Pilloff and Santomero, 1998; Rhoades, 1998), the evidence does not support the view that there are large cost savings from bank consolidation.

Yet, overall studies on the banking sector relating to economies of scale and the issue of cost reduction find underperformance of banks to be the major determinant of mergers and acquisitions. The arguments can be reconciled as follows. Banks always try to perform better by expanding to achieve the economies of scale in operation. As banks grow in size by merging with other

banks, economies of scale are reaped. The quantum of resources used for the provision of a given quantum of services by the single larger entities is much less than before. The more a bank expands its capital base and diversifies, the greater are the economies of scale realized, resulting in reduction of cost. The advent of liberalisation necessitates drastic improvements in technology as competition makes clear that innovation improves performance by on the one hand enhancing revenue and on the other reducing cost. Revolution in information technology and demands of high income investors to access the service result in a sea change in banking structure in general. Cost reduction through introduction of new technology is associated with a substantially increased coverage as well. A large number ATM centers and internet banking throughout the country accompanies the creation of larger banking entities. So the extraordinary advancement in communications and data processing technology over the last two decades is the single most important underlying force driving mergers in banks. Cost savings came as these advances were exploited to manage information databases far less expensively and more efficiently. A key point here is that these cost savings accrue most significantly in the management of very large databases: in sharing information among a large number of users and over wide distances. In other words, the benefits of the technology revolution accrue most fully to very large-scale banks. The ability to share customer and product information via computer networks has greatly lowered the cost of maintaining and managing distant branches and of operating centralised call centers. All this has increased the relative advantage of being a big bank. More narrowly - but also on a technology note - some recent mergers may have been motivated in part by the desire of some banks to share the costs.

The birth of large banks from consolidation motivated through the revenue expansion and cost reduction has some disconcerting features. Bank concentration's biggest impact may be through its impact on the political economy of a country. A few, large powerful financial conglomerates may

successfully lobby for policies that protect their interests to the detriment of society as a whole. Concentrated banks may be able to influence commercial bank regulations, taxes, foreign bank entry, and policies toward industrial competition. Large banks may not want excessive competition in banking, nor in industry. Powerful banks may corrupt the political process and may spoil efforts to create more transparent, accurate accounting standards. Powerful banks may favor taxes on dividend income rather than taxes on personal income. Bigger banks are not necessarily safer than smaller ones. In a report published recently by the Bank for International Settlements, it is stated that the current restructuring of the banking industry could cause constraints as competitive pressures interact with stubborn cost structures and heightened incentives for risk taking. This trend is especially dangerous since bigger banks are more likely considered to be "too big to fail". Side by side, bigger, politically connected banks may become more leveraged and take on greater risk since they can rely on policymakers to help when adverse shocks hurt their solvency or profitability.

In sum, concentration may not only lead to banks that are too-big-to-fail and too-big-to-discipline, concentration may create banks that disproportionately shape society's policies, regulations, and institutions governing banking sector activities.

However, the impact on the degree of competition of consolidation in banking size may not be unique over all the countries of the world. After financial liberalisation big banks from the developed countries started to enter and acquire overseas banks in developing emerging market countries. The most notable difference between the consolidation process in developed and emerging markets is the overwhelming cross-border nature of mergers and acquisitions towards the end of the last decade. In particular, cross-border merger activity in continental Europe and also between US and European institutions has been more of an exception rather than the rule. In contrast, there has been a sharp increase in foreign ownership of some emerging market

banks due to processes of privatisation often associated with crises and large foreign banks often have something to do with the crises in those emerging markets. There are so many instances where foreign entry has weakened domestic banks, diminished the ability of local regulatory and monetary authorities to influence bank behavior, unduly exposed the host country to economic shocks of the entrants' home countries, and implied less credit for certain market segments, such as small and medium- sized enterprises (SMEs), or at certain key times, such as during crises.

Thus, for example, in Indonesia between 1969 till the onset of financial sector deregulation in 1988, the Indonesian government issued no licenses for branches of foreign banks. Starting in 1988 the government permitted foreign banks to form joint-venture subsidiaries. Subsequently foreign banks established a large number of these joint ventures. The 1988 liberalisation also resulted in a rush by domestic private parties to establish banks. As a result, Indonesia entered the crisis with 160 private domestic commercial banks alone. The Asian Crisis resulted in widespread bank failure. Of the largest banks, the seven original state banks and the 10 largest formerly private banks all failed. Some continue to operate under their original names but only after receiving a government bailout. The net cost to the government of the bailout may be of the order of 40 per cent of GDP (Fane and McLeod 2002). The Indonesian government has been slower to sell banks than the Thai or Korean governments, and even more reluctant to permit foreigners to acquire the banks it was selling. Since the crisis, the government has permitted foreign banks to convert joint ventures to wholly owned subsidiaries, and has started to move towards permitting foreign banks to acquire domestic banks. However, in 1999, Standard Chartered Bank of the UK called off its agreement to buy a stake in Bank Bali after a dispute with the staff of the bank (Adrian E. Tschoegl, 2003).

In Malaysia From 1966 on, the Malaysian government banned existing foreign banks from opening new branches. The government also limited foreign shareholdings in individual domestic banks to 10 per cent for an

individual and 20 per cent for a corporation, and aggregate ownership to 30 per cent. In 1998 the government took a number of measures to deal with the banking sector. It announced a plan to consolidate the 51 domestic banking institutions into just ten banking groups around 10 anchor banks by end-2001. The ten anchors or merged banks control the banking sector though some of the 10 anchors are not strong so that further mergers are very likely. In 2001 Malaysia took the view that it has no commitment under World Trade Organization accession to open its domestic banking sector to more foreign competition and wished to improve the efficiency and effectiveness of the financial sector before opening it up to greater foreign competition. In 2000 there were 14 foreign banks with approximately 140 branches between them (Adrian E. Tschoegl, 2003). Even though during the crisis and immediately thereafter the foreign banks gained percentage shares of assets but perhaps the domestic banks are now regaining lost ground.

Despite a doubling in its share, in Thailand the foreign bank presence remains limited. The domestic banks in Thailand were not well run. They engaged in liability and currency mismatching, borrowing long and lending short, and borrowing in US dollars and lending in Baht (monetary unit of Thailand). Once the crisis began, rather than shutting the banks down, the Bank of Thailand gave them two years to increase their capital. Still, dealing with the crisis involved the government taking over six banks. The government now owns three banks, which account for about 27 per cent of banking system assets. Foreign banks acquired three banks from the government (Adrian E. Tschoegl, 2003). As a result, the share of foreign owners in banking system assets approximately doubled but, relative to the situation in Latin America, remained small. Even in several banks where the owning families managed to retain control, foreign ownership increased when the banks sought additional capital.

Experiences of these countries coupled with past scenarios in Latin American countries provide a lesson to the states that are trying to open up

their economies to foreign banks and encouraging consolidation in banks. An important difference emerges out in this context with respect to the role played by the authorities in the financial sector consolidation process. Particularly in emerging markets, consolidation has started long after it has been started in developed countries. The primary reason behind the consolidation drive in banks was more or less same in all the emerging economies. Mergers and acquisitions are encouraged predominantly as a way of resolving problems of financial distress, with the authorities playing a major role in the process. But the attitude to this drive is not the same in all the emerging states. Basically in the emerging markets the role of states in the financial sector consolidation is of two fold.

Firstly, there are states which play a very proactive role in the consolidation drive and take on the risk of financial sector consolidation through liberalisation. Consequently these types of state-driven moves to consolidate banks have faced serious setbacks and crisis situations emerged as we have seen earlier in some of the economies. The reason behind this failure is the fragile banking market and the fact that those states cannot overcome the contagion effect of bank failure. The big banks after mergers may face a run for too big to prevent failure.

Secondly, there are states which act as the role of followers of the proactive states regarding the attitudes towards the financial sector consolidation. The process of consolidation in these states is very slow as they have the information of the crises that the proactive states experienced in past.

Merger processes caused by the urge for revenue enhancement and cost reduction from economies of scale have also one drawback which is of immense concern. The use of the technological revolution to improve customer services in large banks, reach the farthest investors' both at home and abroad, and reduce cost in order to restore market share, has a far reaching impact on the employment scenario in the banking sector. Huge increases in the capital

base to ensure reduction in cost are actually accompanied by massive job losses in the banks. This can't be neglected as it is a matter of serious concern, gaining urgency as day's progress. Therefore a job loss in the labour market of the banking industry is a matter that needs to be considered when assesses the mergers and acquisitions wave.

This pattern though common in developed and emerging markets is, however, not uniform within world regions. So discussions of the issues of revenue expansion and cost reduction when assessing mergers and acquisitions based on developed country experience do not usually take into account the job loss scenario. Lack of special categorisation of this aspect is much more in developed countries than in the emerging countries. Though this is actually a very special feature of banks that does not really explain the causes underlining mergers and acquisitions but it should be taken care of. Of course it has some significance as there are some researches saying that banks in developed countries with large asset base and global outlook have normally a greater tendency to reduce employment in order to enhance revenue and reduce cost through mergers.

Finally, a banking system in its properly functioning mode touches on almost every individual in an economy who intends to save his income or lend from it for investment. So mergers impact societies when ownership changes occur. When a bank is taken over, its customers often complain that the quality of service is not what they had come to expect from their old bank. The mix and pricing of products is likely to change with the merger, so customers preferring the old product mix will be less satisfied. The economies of scale that make large banks cost-effective depend on the standardisation of products and service. Without standardisation the information sharing that drives mergers would be inefficient at best. And cost savings would be lost if, with each merger, the acquirer added a new set of products or different versions of the same product. Attention has also been directed at the new or higher fees some customers must now pay for some banking services, which has led many

to believe that the new merged banks charge unreasonably high fees. Clearly, banks have become more aggressive in their assessment of service charges and fees over the last decade, and big banks have moved to increase these charges sooner than smaller banks.

According to J. Alfred Broaddus, Jr. (1998), many of the fees have resulted from an unbundling of services: that is, charging explicitly for particular services rather than providing a bundle of services to all customers at one price. Customers who are more costly to serve are now charged higher fees, which allows lower-cost customers to be charged lower fees than would otherwise be possible. In the less competitive banking market of the past, banks covered most of their costs via their interest margin rather than by charging fees. They paid below-market rates of interest for deposits but invested them at market rates. They compensated depositors for the low deposit rates by offering them a largely undifferentiated bundle of free services. Before the early 1980s, ceilings on deposit interest rates reinforced this arrangement. But equal service levels for all customers meant that high-balance customers were often subsidizing low-balance customers.

According to some observers due to the merger wave new type of anxieties emerge that the trend could adversely affect the availability of credit, particularly for small businesses. Smaller banks are a primary source of small-business credit. As large banks absorb small banks, small businessmen lose access to entities who will finance them. Again, technology and competition are forcing banks to specialize in the way they serve customers, including small-business borrowers. Large banks, for the most part, are not abandoning small business. Rather, they are now offering small businesses a menu of standardised, quick-turnaround loan products. Because of the cost advantage in offering homogeneous products, large banks are likely to dominate such lending. Community banks retain an advantage over large banks in serving these customers, since smaller banks enjoy short lines of communication between lending officers and borrowing company owners and managers. This

close communication permits community banks to customise products and employ borrower information in ways that large bank reporting and monitoring systems cannot easily accommodate.

The Indian Experience

In the previous chapter we introduced the pros and cons of banking sector mergers and acquisitions in India. Financial liberalisation has created new motivations for banks to merge in the expectation of revenue enhancement and cost reduction. Associated with this, there are so many other motivations which drive mergers and acquisitions in India that have little relation with the general explanation behind merger and acquisitions. Thus the question whether the direction in which India is moving forward is same as that in other emerging economies has gained importance. Though India has not faced any crisis till now but the effects of the emergence of large banks discussed earlier in this chapter may exert its impact on Indian banking. Hence, the possible direction in which Indian banking sector consolidation is moving needs to be discussed.

One aspect of the consequences of the transition to a new policy regime regarding banking sector consolidation in India needs to be stressed. According to the RBI's Trend and Progress of Banking 2001 report, public sector banks have remained dominant despite the transition, accounting for about 80 per cent of deposits and assets in the commercial banking sector. Foreign banks account for only at 7-8 per cent. The share of private sector domestic banks has also increased substantially. The public sector banks in India lead the banking market while foreign banks have just started to expand in the arena. Industry estimates indicate that out of 274 commercial banks operating in India, 223 banks are in the public sector and 51 are in the private sector. The private sector bank grid also includes 24 foreign banks that have started their operations here.

However, the advent of liberalisation has begun to introduce changes Deregulation in the banking sector have made public sector banks more and more exposed to foreign and domestic market forces, even thou the impact of foreign banks on India's banking sector is limited at this stage. The motive of the policy formulators behind permitting entry of foreign banks into the market in India was to improve domestic banks' management and balance sheets. But the motives of the foreign banks are not the same as that of the policy formulators. Foreign banks instead of setting up an entirely new infrastructure to ensure a permanent presence obviously prefer acquiring weak private and public sector banks, through which they can capture a market share in the geographical area of the bank's activity and exploit the goodwill of the acquired bank. But there is an impediment to such moves stemming from the rule restricting individual (including foreign institutional investors) voting rights to a maximum of 10 per cent. Foreign banks and private banks are constantly pressurising RBI to further liberalise rules regarding foreign bank expansion. In expectation of India moving towards capital account convertibility, foreign banks not having a presence recently in India hope that an equity stake will help control their correspondence banking. There lies the interest of the foreign banks to expand in India. They find it easier to acquire existing banks to strengthen their position in Indian banking sector.

Till now foreign banks generally engage in the wholesale market and do not participate actively in intermediation in India. In this sense, the impact of foreign banks on India's banking sector is limited, since they do not compete in the same retail market with domestic banks. The banks with which foreign banks are merging may have the different kind of services offered before merger. As a result of that the private sector banks acquired by the foreign banks may be forced to change their lending practices to raise the "profitability" and "efficiency" of the foreign bank.

Public sector banks in India have accumulated a huge amount of NPAs. There are so many big borrowers in India who often fail to repay the loan

which resulted in excessive bad loans in the public sector banks. This has lowered the profitability of public sector banks and contributed to an accumulation of NPAs to the public sector banks. This has turned many of the public sector banks into loss making weak banks. The government has given authority to the banks to deal with the borrowers who have failed to repay their loans. The initiative is targeted at bringing down the Rs 51,000 crore Non-Performing Assets (NPAs) of the banking sector. This fact also discourages banks, particularly foreign banks, to carry out its lending activities in similar areas. Private and foreign banks are more inclined towards investing their resources in worthwhile fields which will bring profit to them. Consequently the banks acquired by the foreign banks have seen a decline in their lending to sectors like agriculture, which was a preferred sector before takeover. Total agricultural advances of these banks as a share of net bank advances fell by 2.3 per cent to 15.7 per cent, as compared with the norm of 18 per cent.

The expansion of foreign presence in the name of profit maximising baheviour sets off a similar tendency in the public sector banks. Public sector banks are trying to "match up" to the performance of private domestic and foreign banks. This reduces access to credit in rural areas that were well-served by the post-nationalisation branch expansion drive, and worsens the tendency towards reduced provision of credit to the agricultural sector. The impact of this is likely to be adverse in the future. The Indian banking sector is encouraging demand through consumer financing and generating resources in industrial development of India through lending in the recent era. Banks have recognised the realities of a customer preference which is entirely market driven. They started offering customised products to cater to various customers. A slowdown in the corporate segment has forced banks to increasingly concentrate on the retail segment (especially the housing loans market) in order to grow their business.

Public sector banks, getting carried away by foreign banks, are also slowly venturing into high risk high return projects as they search for ways to

meet official targets for reduction of their huge NPAs by allocating funds from their balance sheet. The net NPAs of Indian banks have dropped substantially over the last few years not on account of any dramatic improvement in the quality of assets or better credit appraisal and monitoring but because of huge provisioning. That merger of some of the public sector banks into single merged entities can generate profits, by permitting participation in a range of financial activities, is an accepted fact. But the increase in profits from treasury operations after banks merge may not be substantial enough even to compensate for its increased exposure to bad loans. For example State Bank of India (SBI), the lead bank of the Indian banking industry, has increased its profits from treasury operations to Rs.3,073 crores in 2003-04 from Rs.1,696 crores in 2002-03. But, during 2002-03, SBI's NPAs increased by Rs.4,688.57 crores; in 2003-04, the incremental accretion to NPAs amounted to Rs.5,721.34 crores. Despite this, SBI's net NPA fell from 4.50 per cent to 3.48 per cent because it used its profits to provision for. The massive exposure to bad loans

With the fall in interest rates, the vulnerability of the Indian banks will once again be exposed and some banks may once again need government help to stay buoyant. But the recent changes in policy regime are reducing the inclination of the government to intervene in favour of public sector banks. In the absence of high treasury income in the weak banks, their profitability will be hit and they will not be able to make large provisions to bring down their net NPAs further. If they want to continue to make large provisions for NPAs, their profitability will be squeezed even more. Hence, consolidation of some of the weak banks with stronger ones is one of the policies of the Government. But even strong banks as, for example, SBI, are to some extent exposed to excess NPAs even now. Consequently to remain competitive in the Indian banking sector dominated by a small number of large banks they have to shift their operations to risky fields where probability of profit is more.

Based on this the public sector banks are encouraged to diversify and adopt more risky high profit lending practices keeping pace with foreign and

private banks' activities. Banks, in order to remain competitive in the market, consolidate and diversify its operations in various financial activities. Crisis situation may emerge in the form of share market crash where banks lend their resources to the share market players to get a higher return. The past experiences with stock market scams reveal that some banks may face a massive blow. Public sector banks after consolidation, gaining economies of scale and cutting the huge costs, trying to get bigger in size and diversify into various activities to sustain in the market may also be adversely affected by these types of stock market scams. The depositors may face huge amount of uncertainties as there arises a possibility of not getting their money from bank in time of scam.

Yet recent policy changes encourage public sector banks to access markets to raise resources in ways in which non-government stakeholders would get a representation on the boards in these banks. Correspondingly the government is loosening its control in terms of holding of equity stakes. If it loosens more and public sector banks continue to incline towards high risk, high return projects, the big public sector banks after merger and consolidation would not be protected from the impact of contagion risk once crisis emerges. The banking sector is very fragile and till now public sector banks dominate the scene in India. So the effect will be severe.

Despite these potential effects the perspective on foreign bank presence has entirely changed and foreign banks have been increasing their presence through mergers with and takeover of domestic banks. It is even possible that in case of a loss of confidence foreign investors could decide to close down the activities of an acquired bank, since foreign institutional investors (FIIs) are holding significant in certain banks.

Another serious problem the banking sector may face because of the higher levels of concentration centers on a possible shift of the focal areas of activity of banks in India. Fewer banks, less competition, and greater pressure

to generate quick profits could well result in an escalation in the cost of credit which have a very adverse impact on retail as well as wholesale customers. Mergers and acquisition of banks has resulted in a focus on larger urban corporate borrowers and on avoiding the spread of their credit portfolio among the large number of borrowers the banks once used to lend to. This could result in adverse consequences for small borrowers. Service quality could suffer, and fees could also rise.

The mergers and acquisitions wave in the banking sector has also affected the labour market. There has been a decline in permanent employment, increased job instability and insecurity, and rapid growth of various non-standard forms of work, including part-time and temporary employment in the banking sector of India. And employment is expected to decline further as competition progresses as a result of consolidation. Over the last five years job tenure has been on the decline, especially for those who have not systematically upgraded their skills and improved their general employability in the banks. In 2001, about 11 per cent of the over-800,000 strong bank employees opted for the first-ever voluntary retirement scheme in the state-run banking industry. The consolidation drive will make more employees redundant. The pressure to reduce costs, especially fixed costs and to adopt flexible staffing and work methods has had a pervasive effect on employment in India. And it may imply more insecurity for the employees of the banks day by day. Besides, it will also call for large-scale redeployment of a significant percentage of remaining employees. Traditionally, employees in public sector banks are reluctant to move from one table to another of the same branch. Now the trade unions seem to be willing to allow mobility for employees within a district. Mergers will force them to move from one state to another.

Finally, when foreign banks are allowed to takeover local private banks to realize branch expansion and growth in business, a higher flow of foreign exchange into the country is the result. A large inflow of foreign capital leads to a substantial relaxation of restrictions on foreign exchange utilisation. The

capital account has not yet been made fully convertible in India. But the process is slowly leading towards full convertibility. If that happens the possibility of capital flight in times of crisis arises. Diversification of the banks after consolidation has brought about close linkage of the banking sector with capital markets in India. Financial liberalisation has also been increasing the stake held by foreign investors in Indian banks. If this continues, in keeping with the motive of making the capital account fully convertible, the Indian banking system could become vulnerable to failure when a crisis situation arises in future. The East Asian crisis witnessed the collapse of the banking system through contagion effect. However, at the time of East Asian crisis the Indian economy remained untouched by its disastrous effects elsewhere. One of the possible underlying reasons is that the process of banking liberalization had not proceeded far at that time. Conservative banking practices allowed Indian banks to be insulated partially from the Asian currency crisis. Now the Indian government is in favour of the policies of financial sector reform and full currency convertibility. But one can't have full convertibility till the banking sector is strong. And even then the consequences can be adverse.

Conclusion

This dissertation seeks to demonstrate that a new phase of reforms in the banking sector is unfolding the world over. The banking industry of all economies are seeking to exploit the "benefits" of globalisation in terms of deregulation and advancement of technology. The resulting changed competitive atmosphere in the banking sector decreases the market share of the banks which necessitates them to increase revenue and cut costs. The transformation of a bank in this competitive environment is supposed to be one of the determinants of bank's efficiency. As a part of this transformation, a bank may want to adopt new products, technological innovations, and management skills to enhance revenue and reduce its costs. A bank is able to decrease costs by increasing the volume of output of products and services it already produces. Associated with it, by expanding into new territory, a bank increases its potential client base and could enjoy economies of scale. Diversification of banks also lower costs through simultaneous provision of a range of services to customers. As a result of all this, banks become interested in engaging in consolidation, if the the process could diversify the earnings of the acquirer. Banks also want to offer products and services that they may not be permitted to provide at home to enhance revenue. This encourages them to go in for cross border mergers. Further, the concept and definition of bank mergers itself changes after the advent of globalisation. Till now all the bank mergers involved at least one commercial bank. But now the partner could be any type of firm. The partner may be a commercial bank engaged in different kind of services, a securities firm, an insurance company, or another type of firm.

The dissertation examines how the operating cost of banks has become one of the important factors determining the structure of the banking system in terms of the number of banks, the size of the banks, and the number of branches of banks

and possible mergers and acquisitions in any economy. The efficient allocation of resources of a bank in an economy depends on the extent to which the bank controls its input costs by exploiting the economies of scale. To maintain operating costs at a low level the employment services in the banks is severely hit which results in massive reduction in the employment with or without early retirement programmes. Human resource development, therefore, should be taken care of in economies of scale driven mergers and acquisitions among banks. In pursuing new priorities, the fact that banking is a tool for social and economic development should not be forgotten.

Banks from developing countries are more often targets of acquirers after they start to liberalise. Banks from more developed countries (presumably more efficient banks) tend to take over banks in less developed countries. Having high government involvement in the financial system clearly lowers the incentives of foreign banks to merge with domestic banks. The governments of emerging economies have opened the door to foreign banks fully or partly. The foreign banks' pressure to make them entirely operationally flexible in the host countries is increasing correspondingly after they have gained a growing presence in the emerging economies. Even though the effect is not so deep rooted till now in all the emerging economies, but the pressure on the domestic banks to smarten up to compete with the international banks has increased. As a result of that bank mergers that increase consolidation and unleash new forms of competition are on the increase. The merger and acquisitions scenario is now supporting the creation of bigger banks through merger that would be propelled into the big league. Foreign-owned banks hold a competitive advantage in the consumer-banking arena due to their advanced technology and consumer marketing skills. Based on the commodity nature of consumer-banking products, they are very easy to replicate. Because they are high-profit, high margin products, all banks are pushed in that direction seeking to maximise profit and remain competitive.

Mergers and acquisitions do create banks large in size that are able to best exploit economies of scale. The large the size of the bank activities make up a significant portion of a country's payment system, credit-granting process, or other key financial roles. The large banks after consolidation engage in diversified activities which may be of conflicting interests such that to satisfy one set of customers they have to underserve other sets of customers. As for example in managing diverse activities as securities underwriting, insurance underwriting, and real estate investment, banks may attempt to "dump" securities on or shift risk to ill-informed investors so as to assist firms with outstanding loans [Edwards (1979), John, John, and Saunders (1994) and Saunders (1985)]. To the extent large banks engage in venturing out into more risky areas, the provision of deposit insurance intensifies moral hazard problems. As a result, any substantial disruption in the particular institution's operations would be likely to have a serious effect on a country's financial markets, either preventing the markets from operating properly or raising questions about their integrity. It could result in a credible threat to the whole banking system of an economy.

Unfortunately we observed that in order to become a part of the international banking community size becomes the compelling logic in every financial institution of India. However, the desire to acquire size through consolidation becomes so dominant that it is often forgotten that India needs to serve millions of people who are not banking at any bank till now.

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