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Pre-Post Impact of Merger and Acquisition of Banking Sector in India

Monika Pandey[1]* Dr. Mukesh Joshi[2]

[1]Research Scholar

[2]Associate Professor R.H. Govt. P.G College, Kashipur

Abstract – Mergers and Acquisitions (M&AS) continue to be a significant force in the restructuring of the financial services industry. The Indian Commercial Banking Sector, which has played a pivotal role in the country's economic development, is currently passing through an exciting and challenging phase. With the onset of economic reforms, the banking sector in India has embarked upon mergers and acquisitions to capture the synergistic benefits like economies of scale and scope, in the face of increasing competition from domestic as well as foreign players and rapid technological developments. Several research studies examine merger related gains in banking and these studies have adopted one of the two approaches, based on either accounting information or market prices.

The Indian economic environment provides an advantage to banks and also uniquely accretes value to M&A based transactions proving benefits to bidders unlike in other Bank M&A regimes in the USA. This work provides deeper insight into the linkages between Bank M&A and M&A literature with Indian Banking M&A and reviews the evidence.

Mergers and Acquisitions encourage banks to gain global reach and better synergy and allow banks to acquire the stressed assets of weaker banks. A complete combination of two separate corporations involving in a business is referred as business merger. Acquisitions on the other hand are take-over. In this case one company actually buys another company. Through Mergers and Acquisitions banks not only get established brand names, new geographies, complementary product offerings but also opportunities to cross sell to new accounts acquired.

The process of Mergers and Acquisitions is not a new to the Indian Banking. The main objective of this paper is to assess the impact of Mergers and Acquisitions in Indian Banking Industry, their position before and after Mergers & Acquisitions and finding out the reasons behind these Mergers & Acquisitions. For the study secondary data is used which has been taken from articles from magazines, newspapers, books and Websites.

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INTRODUCTION

Mergers & Acquisitions remain an attractive inorganic strategy for banks to scale up in product markets and support the economy from within an efficient and well-regulated banking system.

Banking M&A remains specialized from other M&A because of industry specific features of banks including their valuation, their means to profit and their treatment of capital, using deposits and funds as raw material for profit generating products.

Despite mixed evidence from event studies, event studies remain an effective analysis tool to value mergers. The gains from M&A are shared between bidders and targets. The M&A strategy becomes key for growth in Emerging Markets and Asia. Our references to economic gains and strategy are implied in reference to the Corporate Finance literature spawned in the tradition of Jensen and Meckling (1976) Agency Theory, O'Hart and Moore (1990), Property rights and Ownership of the Firm and Williamson (1988). The merger waves are described as proven by Rhodes-Kropf et al (2004) and the neo classical theory evidenced first in Maksimovic and Philips (2001).

Banking Mergers & Acquisitions are frequently criticized as a large ticket strategy that does not deliver gains. Frequent problems cited in M&A relate to post closing integration and lack of synergy gains; planned growth in profitability not panning out because of unseen roadblocks; intractable attempts at reduction in operating costs and the harassment and issues around labor cuts. Agency explanations of M&A strategies adduce conflicts of interest between managers' and owners' interests and support information and power motives. These take on interesting dimensions in the presence of institutional shareholders. Banking valuations and merger financing however separate the study of other M&A in Corporate Finance from Banking M&A. This is backed by event study data for India where merger gains are not seen to be obfuscated by near zero or negative returns to acquirers while the undervalued target or the smaller target company frequently walks away with gains. We also employ a market model based event study, including an information leakage period, to capture the diffusion of information into prices before the eventual deal announcement. The success of an M&A strategy gets tougher to recognize in some industries vis-a-vis others. As mentioned before, In Banking challenges arise because of a perfect horizontal merger being in both market and tender transactions and valuations involving intangible assets and human capital.

Globally mergers and acquisitions have become a major way of corporate restructuring and the financial services industry has also experienced merger waves leading to the emergence of very large banks and financial institutions. The key driving force for merger activity is severe competition among firms of the same industry which puts focus on economies of scale, cost efficiency, and profitability. The other factor behind bank mergers is the "too big to fail" principle followed by the authorities. In some countries like Germany, weak banks were forcefully merged to avoid the problem of financial distress arising out of bad loans and erosion of capital funds. Several academic studies for an excellent literature review) examine merger related gains in banking and these studies have adopted one of the two following competing approaches. The first approach relates to evaluation of the long term performance resulting from mergers by analyzing the accounting information such as return on assets, operating costs and efficiency ratios. A merger is expected to generate improved performance if the change in accounting-based performance is superior to the changes in the performance of comparable banks that were not involved in merger activity. An alternative approach is to analyze the merger gains in stock price performance of the bidder and the target firms around the announcement event. Here a merger is assumed to create value if the combined value of the bidder and target banks increases on the announcement of the merger and the consequent stock prices reflect potential net present value of acquiring banks.

There are two modes of growth for any corporation, the first being the organic mode and the second being inorganic. In organic mode, high industrial utility is achieved by the sales-profit ratio and therefore, a company is said to be growing if it has increasing net sales index. In inorganic growth mode, the corporations undertake mergers, takeovers and joint-venture operations to strengthen their business presence and monopolies the market supply to the maximum extent possible. However, this is a view from a corporate perspective. Banks do not fall in such category, principally because of the fact that they are no-doubt companies, but are under the supervision of their master regulator for all business purposes. Be it appointment of directors or expansion of business, almost everything is supervised and sometimes dictated by RBI in consultation with its Department of Banking Supervision. Banks are the sole institutions that are efficient to 'credit creation', are privileged borrowers and are the best practitioners in balancing profitability with liquidity. They are entrusted with the high duty to comply with the demands of depositors, as and when they arise.

Improvement of operational and distribution efficiency of commercial banks has always been an issue for discussion in the Indian policy milieu and Government of India in consultation with Reserve Bank of India (RBI) have, over the years, appointed several committees to suggest structural changes towards this objective. Some important committees among these are the Banking Commissions, 1972 (Chairman: R.G. Saraiya) and 1976 (Chairman: Manubhai Shah), and the Committee for the Functioning of Public Sector Banks, 1978 (Chairman: James S. Raj). Further, the second Narasimham Committee (1998) had also suggested mergers among strong banks, both in the public and private sectors and even with financial institutions and Non-Banking Finance Companies (NBFCs).

These all being ideal prudential norms set by RBI; do not attract much of our attention primarily because they are voluntary mergers or friendly takeovers. However, we need to undertake specific power vested with RBI to implement a 'forced merger' of one bank into another bank, specifying the reasons as it may desire. This not only attracts legal issues of compliance but invokes some human and ethical issues as well. This has only led to value erosion but also several other consequences to be debated upon.7 RBI's recent move in taking out bank mergers outside of the scope of CCI is another question which needs to be answered. Miscellaneous interpretations about the Bill has given a considerable hike to the question- Is over-regulation beneficial to the financial market or mere supervision would increase the business and profitability of banking companies? RBI moreover, attempts to gain a significant position in approving or imposing penalties in lieu of the amalgamation schemes or merger proposals forwarded for its approval. RBI has no doubt, been the most successful regulator of its business in India but whether is competent to over-ride issues of competition, takeover etc under the umbrella of

‗core-banking operations‘ is a generic question which attracts considerable thought of the intelligentia. Many commentators have for example, commented upon the 'prudential regulation‘ of banks and ‗allied regulation of banking companies‘ in India. The complex structure of M&A deals in banking is because of the fact that government is generally the owner of both sides in such a scheme. One of the major reasons that they are urged to be kept out of the purview of CCI is that RBI does consider 'competition‘ to be harmful for the banking sector and with such a view deeply regulates the banking enterprise and its business presence. Mergers in such a scenario are rarely voluntary and mostly are marriage shots fired by RBI in lieu of consolidation to improve supervision over the financial sector. However, the sudden announcement of merger between HDFC bank & Centurion Bank of Punjab was recorded as a merger of strength and the merger was held as a merger of strength amongst two healthy banks, thereby creating an exception to the foregoing vision. The recent move of Central Government in propelling the merger of Regional Rural Banks (RRBs) has also attracted debate among the officers of All India RRB Officers‘ Federation (AIBOC).

MERGERS AND ACQUISITIONS

Mergers and acquisitions activity can be defined as a type of restructuring in that they result in some entity reorganization with the aim to provide growth or positive value. The abbreviation of merger is as: M= Mixing, E= Entities, R= Resources for, G= Growth, E =Enrichment and R= Renovation From a legal point of view, a Merger is a legal consolidation of two companies into one entity, whereas an Acquisition occurs when one company takes over another and completely establishes itself as the new owner (in which case the target company still exists as an independent legal entity controlled by the acquirer). Mergers and Acquisition play a crucial economic role of moving resources from zones of under-utilization to zones of better utilization.

Poorly run companies are more prone to being taken over by the powerful and managers have an incentive to ensure that their company is governed properly and resources are used to produce maximum value.

Mergers and acquisitions in the banking sector is a common phenomenon across the world. The primary objective behind this move is to attain growth at the strategic level in terms of size and customer base. This, in turn, increases the credit-creation capacity of the merged bank tremendously. Small banks fearing aggressive acquisition by a large bank sometimes enter into a merger to increase their market share and protect themselves from the possible acquisition. Banks also prefer mergers and acquisitions to reap the benefits of economies of scale through reduction of costs and maximization of both economic and non-economic benefits. The process of merger and acquisition is not a new happening in case of Indian banking. Grind lays Bank merged with Standard Chartered Bank, Times Bank with HDFC Bank, Bank of Madura with ICICI Bank, Nedungadi Bank Ltd. with Punjab National Bank and Global Trust Bank merged with Oriental Bank of Commerce. As the entire Indian banking industry is witnessing a paradigm shift in systems, processes, strategies, it would warrant creation of new competencies and capabilities on an on-going basis for which an environment of continuous learning would have to be created so as to enhance knowledge and skills.

M&A IN INDIAN BANKING INDUSTRY

The Indian economy has undergone a major transformation and structural change following the economic reforms introduced by the government of India in 1991. Since then, the M&A movement in India have gained momentum. " In the liberalized economic and business environment, 'magnitude and competence' have become the focal points of every business enterprise in Indian as companies have realized the need to grow and expand in businesses that they understand well to face the growing competition. Indian corporate has undertaken restructuring exercise to sell off non-core business and to create stronger presence in their core areas of business interest. M&A emerged as one of the most effective methods of such corporate restructuring and have, therefore, become an integral part of the long-term business strategy of corporate India."

The banking industry is an important area in which mergers and acquisitions do make enormous financial gains. As a result of changes in the expectation of the corporate customer, banks are now constrained to rethink their business and devise new strategies. "The Indian banking sector is going through a process of restricting, mainly driven by pervasive trends such as deregulation, disintermediation, technological progress, innovation and severe competition." To gain competitive cost advantage, consolidation of operation in the form of M&A is one of the effective strategies widely adopted by the bankers. Mergers in banks are considered for the purpose of:

1. Expansion/diversification

2. up gradation of technology

3. Loss making bank merged with another healthy bank for revival

4. Healthy bank merged with another healthy bank to become financially stronger, to meet competitive pressures

5. Growth in profits

6. Increase market share, etc.

Banks allocate resources and control internal processes by effectively managing their employees, facilities, expenses, and sources and uses of funds while working to maximize earning assets and total income. M&A are not new to the Indian banking sector. Between 1961- 2004, 71 mergers took place among various banks in India.

PRE AND POST MERGER AND ACQUISITION

Banking industry plays a very important role in the economic growth of a country. Mergers and Acquisitions have become a positive way for growth in the size of banks which in turn play a significant role in entering the competitive global financial market. The Indian banking sector can be divided into two eras, the pre liberalization era and the post liberalization era. In preliberalization era government of India nationalized fourteen banks on 19 July 1969 and later on six more commercial banks were nationalized on 15 April1980.Inthe year1993 government merged The New Bank of India and The Punjab National Bank and this was the only merger between nationalized Banks, after that the numbers of nationalized Banks reduced from twenty to nineteen. In post liberalization regime, government had initiated the policy of liberalization and licenses were issued to the private banks, which lead to the growth of Indian Banking sector. Mergers and Acquisitions in Indian banking sector have been initiated in response to the various economic reforms introduced by the government of India since 1991, in its move towards liberalization, privatization and globalization. On the recommendation of Narshimam Committee I (1991), Narshimam committee II (1997) and Verma Committee (1999) policy makers cautiously introduced various reforms in the Indian Banking Sector. The main objective of these reforms was to improve the efficiency of the Indian banks and to promote a diversified and competitive financial system.

REGULATORY FRAMEWORK FOR M&A IN BANKING

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

The experience of the Reserve Bank has been, by and large, satisfactory in approving the schemes of amalgamation of private sector banks in the recent past and there has been no occasion to reject any scheme of amalgamation submitted to it for approval.18 Most of these voluntary mergers were between healthy banks, somewhat on the lines suggested by the first Narasimham Committee. The Committee was of the view that the move towards the restructured organization of the banking system should be market-driven and based on profitability considerations and brought about through a process of M&As.

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

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

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

In both situations, whether a non-banking company amalgamates with a banking company or amalgamation is among banking companies, the Reserve Bank ensures that amalgamations are normally decided on business considerations. For this, the Reserve Bank also laid down guidelines, to which boards of directors should give consideration during the merger process. These guidelines mainly relate to (i) values of assets and liabilities and the reserves of amalgamated entity proposed to be incorporated into the book of amalgamating banking company; (ii) swap ratio to be determined by competent independent valuers; (iii) shareholding pattern; (iv) impact on profitability and, capital adequacy of the amalgamating company; and (v) conformity of the proposed changes in the composition of board of directors with the Reserve Bank guidelines in that context. The statutory framework for the amalgamation of public sector banks, viz., nationalized banks, State Bank of India and its subsidiary banks, is, however, quite different since the foregoing provisions of the BR Act do not apply to them. As regards the nationalized banks, the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980, or the Bank Nationalization Acts authorize the Central Government under Section 9(1)(c) to prepare or make, after consultation with the Reserve Bank, a scheme, inter alia, for the transfer of undertaking of a _corresponding new bank' (i.e., a nationalized bank) to another _corresponding new bank' or for the transfer of whole or part of any banking institution to a corresponding new bank. Unlike the sanction of the schemes by the Reserve Bank under Section 44A of the BR Act, the scheme framed by the Central Government is required, under Section 9(6) of the Bank Nationalization Acts, to be placed before the both Houses of Parliament. Under this procedure, the only merger that has taken place so far relates to the amalgamation of the erstwhile New Bank of India with Punjab National Bank, on account of the weak financials of the former. As regards the State Bank of India (SBI), the SBI Act, 1955, empowers the State Bank to acquire, with the consent of the management of any banking institution (which would also include a banking company), the business, including the assets and liabilities of any bank. Under this provision, the consent of the bank sought to be acquired, the approval of the Reserve Bank, and the sanction of such acquisition by the Central Government are required. Several private sector banks were acquired by State Bank of India following this route. However, so far, no acquisition of a public sector bank has taken place under this procedure. Similar provisions also exist in respect of the subsidiary banks of the SBI. Thus, there are sufficient enabling statutory provisions in the extant statutes governing the public sector banks to encourage and promote consolidation even among public sector banks through the merger and amalgamation route, and the procedure to be followed for the purpose has also been statutorily prescribed.

PREDICTING THE FUTURE OF M&A IN BANKING

As per the objectives of the government that have been discussed in foregoing portions of the paper, it could be settled that consolidation has been aimed as a tool of creating world size banks irrespective of the challenges that have been posed. When initially incorporated as a provision in the Banking Regulation Act, 1949; the prime objective was to create a mechanism so that weak banks could be prevented from serious consequences of liquidation and dissolution. Failing of one bank would lead to failure of the banking industry and for this caution; RBI was entrusted with the power to compulsorily merge the weak banks with the healthy ones in order to escape losses and liabilities. But as evident from the case studies, M&A in banking is being sought for some other purposes. No doubt, consolidation is a big tool in maintain liquidity, ensuring transparency in business and effective supervision, but the fact that a single bank would be exposed to uncertain and unpredicted systemic risk.

It is interesting to note that the government aims of few international banks through the consolidation process, whereas banks view some of them to be exposed to international competition. Despite all the factors taken into consideration and analysis, consolidation through M&A is a boon for the industry in the times of need. However, the journey to _international banks‘ is still far as there had been a few mergers in the Indian banking space, it had happened due to exigencies‘ and were rather _forced consolidation‘. The financial sector reforms have brought about significant improvements in the financial strength and the competitiveness of the Indian banking system. The prudential norms, accounting and disclosure standards, risk management practices, etc are keeping pace with global standards, making the banking system resilient to global shocks. The consolidation and convergence of banks in India has, however, not kept pace with global phenomena. The efforts on the part of the Reserve Bank of India to adopt and refine regulatory and supervisory standards on a par with international best practices, competition from new players, gradual disinvestment of government equity in state banks coupled with functional autonomy, adoption of modern technology, etc. are expected to serve as the major forces for change. In the emerging scenario, the supervisors and the banks need to put in place sound risk management practices to ensure systemic stability.

METHODOLOGY OF THE STUDY

It is an empirical study undertaken to analyze the performance of the merger banks that had gone for structural change during the post financial sector reform period in India. A comprehensive analysis on three dimensions of M & A Deal was undertaken to meet the objectives of this empirical study. It has been made by collecting relevant secondary data from the CMIE database pertaining to the operating performance; share price and market index of the merged banks and also derived the employees' perceptions. The researcher has confined his study only to 8 merged banks during the period 1993-1994 end 2004-2005 for the final analysis, discussion and inferences. The researcher has restricted the selection of merged banks up to 2004-05 in order to analyze the post-merger performance at least for a period 3 years and 5 years. A briefing about objective-wise methodology is given below:

To analyze the pre and post-merger performance of banks - Performance of the merger banks during the pre and post-merger period was reviewed with the secondary information cited from CMIE data base through which analyzed the efficacy of those merger deals. CAMELS' rating scanning has also been done to derive efficacy of M&A Deal.

Data Collection - Secondary data on performance for merged banks was extracted for 3 year before and after (short run performance) as well as 5 year before and after (long run performance).

DATA ANALYSIS –

(i) Pre and post-merger operating performance ratios of selected study units were computed and compared. These data were analyzed for trends and patterns in terms of performance ratios for a definite period of time frame (in the short term and long term period). Comparison on the various ratios between pre and post-merger period of three and five years' time intervals were compared using parametric t-test.

(ii) Uniform financial institutions rating system popularly called as CAMELS as advocated by Basel I & II norms has been also been used to measure the post-merger performance of selected banks during the period of 2005-06 to 2011-12.

CONCLUSION

The post-merger integration process is a difficult and complex task. It comes along with long lists of activities and tasks that have to be fulfilled within a short time and partly with incomplete information (e.g. formation of new teams and departments). There are many opportunities to exploit and many decisions to take. However, we can divide various challenges and issues in three phases i.e. pre-merger phase, acquisition phase and post-merger phase, which has scope for further research.

Mergers and Acquisitions played a very important role in Banking Sector. The small and medium size banks are working under threat from the economic environment which is full of problems for them, viz, inadequacy of resources, outdated technology, on-systemized management pattern, faltering marketing efforts, weak financial structure, technique obsolescence and lack of product innovations. Their reorganization through merger could offer re-establishment of those in viable banks of optimum size with global presence. Merger and acquisition in Indian banking so far has been to provide the safeguard and hedging weak bank against their failure. The merger cult in India has yet to catch fire with merchant bankers and financial consultants acquiring skills in grinding the banks to absorb unviable banks and put them again on successful operations. All the merged entities after mergers and acquisitions are continuously growing rather than before the merger. There is increase in no. of branches and ATMs as well as in deposit amount, their net profit and worth.

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Corresponding Author

Monika Pandey*

Research Scholar

E-Mail – monikapandey25@gmail.com