IJARSCT

ISSN (Online) 2581-9429

International Journal of Advanced Research in Science, Communication and Technology (IJARSCT)

International Open-Access, Double-Blind, Peer-Reviewed, Refereed, Multidisciplinary Online Journal

Impact Factor: 6.252

Volume 2, Issue 1, February 2022

Analysis of Non-Performing Assets and Factors Influencing the Restructuring of Indian Public Sector Banks

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Abstract: *The recent restructuring of Public Sector Banks (PSBs) has generated significant interest among various economic stakeholders, including as investors, depositors, borrowers, bank staff, and the executive teams of the merging organizations. Depositors aim to ensure their financial stability, while borrowers from merging companies are looking for other loan choices that provide reduced interest rates and faster processing. Investors will prioritize a higher rate of dividend payments and an appreciation in the value of their assets, while employees would prioritize the enhancement of working conditions. The senior leadership will want greater independence to effectively oversee and operate their diverse banks, with the aim of expanding and maximizing profitability. The initial Narasimham Committee proposed in 1991 that robust banks should merge. After an extensive period of 28 years, the Indian government finally acted upon the committee's vital recommendation. The substantial quantity of non-performing assets (NPAs) maintained by public sector banks and the subsequent need for their frequent recapitalization are commonly believed to be the reasons for this sluggish response. Any government that regularly provides more capital to public sector banks (PSBs), while also being the majority shareholder and having full administrative control over their boards and senior management, is participating in a moral hazard and engaging in poor economic practices. The allocation of taxpayer funds, which are intended for the economic development of the country, to support Public Sector Banks (PSBs) in meeting the regulatory capital requirements set by international standards and the provisioning needs mandated by the Reserve Bank of India, is questionable. The government's objective for the merger is to enhance the size and global competitiveness of PSBs, while also improving their access to capital markets for funding purposes. The need to restructure Public Sector Banks can be ascertained by examining the increase of Non-Performing Assets (NPAs) and the subsequent financial deterioration of PSBs over time, as it may be necessary to implement similar government interventions in the future. The determination of whether the Government of India's restructuring legislation will result in the creation of globally powerful "too big to fail banks" will depend on the improvement in financial performance indicators of PSBs in the coming years.*

Keywords: stakeholders, recapitalization, government, restructuring, NPA

I. INTRODUCTION

Banks worldwide are responsible for the task of financial intermediation. Customers who have surplus funds deposit their money in banks, while those who need credit for various purposes borrow from them. Banks get their main revenue from the interest rate spread between the income they earn from lending activities and the interest they pay on deposits. In addition to income from lending, banks also generate money from commissions and exchange rates on remittances, letters of credit, guarantees, and sales of third-party products. In India, the banking sector remained largely unchanged until the late 1960s. It was under the dominion of private industrial enterprises that only prioritized their own interests. Based on the RBI's data, in 1967, scheduled commercial banks allocated 64.3 percent of their total advances to the industry sector, while only 2.2 percent was allocated to the agriculture sector. In 1969, the top five cities in the country - Ahmedabad, Delhi, Mumbai, Kolkata, and Chennai - accounted for around 44% of bank deposits

and 60% of total outstanding bank credit. Among the 2700 towns in the country, a significant number of 617 did not have access to commercial banking services. Similarly, out of the 600,000 villages, only 5000 had banks.

The Indian government observed that banks mostly focused on serving prominent manufacturers and dealers, neglecting small-scale farmers, small businesses, and the economically disadvantaged in metropolitan areas. The general people was unable to avail themselves of essential banking services such as money storage or emergency borrowing. Farmers depended on moneylenders or grain merchants to meet their financial needs for both consumption and output. Obtaining a loan for consumption needs, purchasing a car, or building a home was unattainable. In 1969, the Indian government made the decision to nationalize 14 privately-owned banks in response to this realization. These banks were largely used to assist social objectives like as poverty eradication and overall development. They achieved this by establishing branches in disadvantaged communities and offering loans to essential industries, including small-scale manufacturing, agriculture, and small firms. In 1980, the government nationalized six more banks after realizing that taking control of private banks would help achieve its objective of economic development. Over time, the size of these banks expanded as a result of economic expansion and societal needs. In India, Scheduled Commercial Banks encompass several types of financial institutions, including Public Sector Banks such as the State Bank of India and Nationalised Banks, Foreign Banks, Regional Rural Banks, and Other Scheduled Commercial Banks. This category also includes Private Sector Banks, both old and new generation, Small Finance Banks, and Payment Banks.

In the early stages, there was limited public engagement with banks in India, and banks established personal relationships with their clientele. This facilitated the easy retrieval of consumer deposits and enabled lending to a certain cohort of borrowers with whom these banks had a sense of ease and confidence. One notable characteristic of this banking period was the infrequency of loan defaults. The act of defaulting on a bank loan was perceived as socially reprehensible.

As the economy expanded and financial demands for firms and sectors rose, borrowers sometimes failed to fulfill their responsibilities to their institutions. The proliferation of deceit and avarice in society contributed to this phenomenon. Due to intense competition among banks to increase credit and generate more interest revenue in the future, non-performing loans, sometimes referred to as bad loans, emerged.

Non-performing assets, sometimes known as NPAs, have been a global concern for commercial banks. The problem of non-performing loans has significantly exacerbated in India in recent years. According to RBI policy criteria, a loan, advance, or bill is considered non-performing when the interest and/or principal instalment is overdue for more than 90 days. The duration of agricultural loans is determined based on the types of crops, whether they are short-term or long-term. NPAs are commonly classified into two distinct categories: gross and net.

Gross non-performing assets (NPA) refer to the outstanding amount of principle and interest that remains unpaid as of the date of categorization. As per the guidelines set by the Reserve Bank of India, Net NPA refers to the difference between Gross NPAs and the provisions made for those NPAs. Banks classify their non-performing assets into three categories, namely Sub-standard, Doubtful, and Loss assets, in compliance with the guidelines provided by the Reserve Bank of India (RBI). This classification is based on factors such as the age of the asset and the securities held in the account. Equity capital serves as a protective buffer to withstand losses arising from a bank's subprime loans. The capital must be sufficient to absorb anticipated losses and support the banks' financial stability. Previously, the Government of India had to frequently inject additional capital into public sector banks in order to meet international capital rules called BASLE Norms and safeguard unsecured creditors, such as depositors. In order to mitigate the frequent need for recapitalization of the PSBs, the government had to undertake a restructuring of these institutions.

II. REVIEW OF LITERATURE

Numerous research has looked into how NPAs affect bank efficiency. Some researchers discovered that a high level of NPAs has an impact on bank capital as well as efficiency and loan growth. On the other hand, banks with larger bank capital tended to take on more credit risk, which ultimately led to higher NPAs. The effects of NPAs on Capital Adequacy and other important financial measures of Public Sector Banks that require their restructuring have not yet been adequately investigated by researchers. The following studies are discussed:

Reddy (2002) conducted a country-by-country investigation of the causes of NPAs in China, Thailand, Korea, Japan, and India. According to the report, real estate, crony capitalism, directed loans, and a lack of prudential standards are

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Impact Factor: 6.252
Volume 2, Issue 1, February 2022

the main reasons, which differ dramatically between nations. Additionally, he discovered that all nations had poor judicial systems that delayed the timely settlement of issues. On the other hand, the issue was brought about by the notion that when banks were in trouble, the government would have to bail them out. 27 public sector banks were the subject of a study by Rajaraman and Vasistha in 2002 to look at variances within a class that is uniform in terms of ownership. They noted that operational restructuring together with recapitalization of Indian Bank and United Bank of India (designated by Verma Committee as weak banks) may not be a solution because there was still an issue even after accounting for operating efficiency. By discovering a link between GNPA and ROA of Public Sector Banks, Jayakkodi and Rengarajan (2016) came to the conclusion that GNPA has a negative impact on ROA. Singh (2016) examined NPAs in scheduled commercial banks between 2000 and 2014 and found that they have an impact on bank profitability since Indian banks are heavily reliant on interest revenue from loans. Additionally, as compared to international banks, the NPA level of our institutions is still high. In their 2017 study, Dhananjaya and Raj examined the build-up of non-performing assets (NPAs) and the provision coverage ratio (PCR) of several banking groups, including the State Bank Group, Nationalised Banks, Private Sector Banks, and Foreign Banks. They were particularly concerned with the public sector banks' declining asset quality. Tandon et al. (2017) assessed the macroeconomic factors that affect non-performing loans and the profitability of banks in particular. It was determined that NPA management in public sector banks requires attention since it has a significant negative impact on productivity and profitability. NPAs and financial performance (ROA) of a few public and private sector banks were compared by Rashmi et al. (2017). Based on the banks' market capitalization, they were chosen. In India after liberalisation, Sengupta and Vardhan (2017) studied two high bank NPA occurrences. The study explains the causes of these crisis times as well as their effects and solutions. These researchers contend that timing is crucial for crisis resolution since prompt identification and intervention can lessen a crisis's negative effects.

In an effort to determine if the measure of recapitalization of PS Banks will lower these banks' NPA levels, Kokane and Nerlekar (2017) noted that the Capital Adequacy Ratio is declining as NPA levels rise. The data was collected between 2009 and 2015, a period before the significant recapitalization of public sector banks. According to Gulati's (2018) research, foreign banks, new private sector banks, and existing private sector banks all saw less of an impact from NPAs on profitability than public sector banks. Numerous studies were performed by Nachimuthu and Veni (2019) to determine how NPAs affected the profitability of the scheduled commercial banks. Garg (2019) said that it has become challenging for banks to fund new projects in the private sector due to the presence of a sizable collection of NPAs. To reactivate lending, several corrective actions must be conducted. One of the most important is to encourage new capital through recapitalization, but this approach faces several difficulties, including a negative impact on bond rates and inflation as well as a moral hazard. According to V Agarwala and Nidhi's critical analysis of non-performing assets in the Indian banking sector published in 2019, the increase rate in the NPA level indicates that the issue affects both small and large banks equally. The NPAs have an effect on the shareholders' wealth in addition to the banks' degree of profitability. Devika (2020) (2020) The lending practises of public sector banks are flawed because they do not adhere to fundamental principles. Banks in the public sector gain from the recapitalization, which also lowers the stress level of loans. However, increasing non-performing assets will reduce the effectiveness and value of capital injected for a little time.

Review of literature on Restructuring of Banks:

Numerous research studies on bank restructuring have been conducted both domestically and abroad. These studies largely blame the rise in NPAs for the decline in all banks' financial health. Therefore, quick action is required to manage impaired assets through new institutional arrangements, various restructuring techniques, the evolution of competition after bank restructuring, the importance of macroeconomic policies to make restructuring successful, the clash of corporate cultures affecting the merger process, and the reason why mergers occur at all. Studies on banking crises have raised questions about the expected involvement of government. The following study findings are highlighted:

According to Shang (1990), the majority of banks collapse due to the excessive leverage of their corporate borrowers, as well as due to their own undercapitalization, poor asset quality management, and perhaps fraud. The banking system's vulnerability to macroeconomic shocks or the errors of bad government policy was primarily caused by a lack

ISSN 2581-9429 IJARSCT

of capital depth (including improper bank accounting that covered up the risks and exposure of the asset portfolio). Rhoades (1993) examined the impact of bank mergers on efficiency and discovered that acquiring banks are often more effective than the target banks. According to the findings, horizontal bank mergers between 1981 and 1986 did not often lead to increased efficiency. The characteristics of the economic environment that tend to breed banking sector fragility and susceptibility and cause systemic banking crises were examined by Kunt and Detragiache in 1997. While bank restructuring programmes may be started and effectively carried out during a period of economic stagnation, good growth aids banks in resuming lending and returning to profitability, according to Dziobeck and Pazarbasioglu (1997).

According to Daniel and Saal (1997), successful restructuring necessitates both financial and operational restructuring of banks in order to prevent the need for recurring efforts. Additionally, it should improve accounting procedures, management procedures, and guarantee proper responsibility and disclosure. Therefore, reforming systemic banks is a multi-year process. After researching the bank restructuring in Hungary, Abel and Szakadat (1998) found that recapitalizing the banking industry was fairly expensive, in part because moral risks were not avoided. However, there are also some encouraging indicators. The respective portfolios of banks greatly improved, making it feasible to privatise state-owned commercial banks.

According to Milbourn et al. (1999), banks must expand in size in order to benefit from economies of scale. Additionally, when margins in traditional commercial banking are squeezed by competition, banks are enticed to explore for alternative sources of profitability, which are often found outside of the traditional commercial banking industry. Therefore, there is a rush to broaden the scope in order to provide consumers with a wider range of financial services under one roof.

In his thesis on the effectiveness of merger and acquisition in the Indian banking industry, Kalaichelvan (2011) examined the pre- and post-merger performance of banks that underwent mergers from 1993–1994 to 2004–2005, after the financial sector reform. It is discovered that mergers don't have a significant impact on the company's profitability levels or financial situation. According to Benzekkoura et al. (2014), restructuring gains come from increased bank performance brought on by cost management measures and the deployment of technology for product development. Siauwiijaya (2017) conducted research on bank efficiency in Indonesia's banking sector in the post-Merger period. The CAMELS ratings of the chosen banks indicate that private sector merging banks outperform their public counterparts.

Vo and Nguyen (2018) investigated the relationship between bank restructuring and bank efficiency and discovered that state involvement, mergers and acquisitions, and the privatisation of state-owned commercial banks do not significantly increase efficiency. Because of transition costs as well as the effects of other environmental factors like the financial crisis or a slowing domestic economy, bank efficiency suffers during this time. In 2019, Kithinji (2019) investigated how Kenyan commercial banks' financial performance was impacted by bank restructuring. Conclusion: Bank restructuring has an impact on financial performance through asset and capital restructuring. Profitability may be increased by adding more capital, while improving asset quality lowers bank earnings.

Six crucial criteria for bank mergers are highlighted by the Deloitte consultant firm in 2019: digital capabilities, a larger client base, regional expansion, culture and management, risk and regulatory compliances, and lastly the integration of people, processes, and technology.

According to Bersch et al. (2020), troubled mergers—typically the last resort when other capital support measures have failed—as well as traditional supervisory rescue measures like capital assistance, such as capital injections and guarantees, are commonly used to identify bank distress. It was also noted that early capital support happens more frequently in the run-up to a merger than it does in the absence of a merger. Control group research is made much more challenging by mergers since the size and regional emphasis of the banks before and after the merger will differ greatly from one another.

III. ANALYSIS AND INTERPRETATION

The restructuring of thirteen public sector banks was carried out secretly by the Indian government. Researchers have already used CAMELS Model analysis to address the problem of banks' financial performance. However, it is unknown whether there is a connection between the financial success of various PSBs and their merger. There is still no clear response to the query.

Thirteen public sector banks will be reorganised by the Indian government through a merger. The privatisation of two more public sector banks has been decided. In the future, it will be necessary to reorganise more public sector banks through mergers, privatisation, or a reduction in the government of India's ownership position. It would be fascinating to see if the restructuring process succeeds or fails now that it has started, given the government's stated goal for taking such action.

IV. METHODOLOGY AND APPROACHES

As was previously mentioned, the Reserve Bank of India had to intervene due to the significant slippage of accounts from scheduled commercial banks into NPAs and place many of the banks (which had high capital erosion due to poor asset quality and poor profitability to support capital accretion) under PCA. These banks are not allowed to open new branches, increase the size of their risk-weighted assets, add new business lines, or access high-cost deposits. The Reserve Bank's Revised PCA Framework at one point included twelve banks, including eleven in the public sector and one in the private sector. PCA was enforced on these banks between February 2014 and January 2018. Only three banks—the Central Bank of India, Indian Overseas Bank, and UCO Bank—are now covered by the PCA framework.

Banks were subject to PCA in order to help them save capital.

Up until around 2014, PCA institutions' gross and net NPA ratios were nearly identical to those of non-PCA banks in terms of asset quality. However, following the Asset Quality Review (AQR) by the RBI, the PCA banks' acknowledgment of NPAs has resulted in a more rapid increase in gross NPAs as compared to non-PCA institutions, particularly private banks. It is obvious that the RBI's asset quality assessment forced banks to disclose their secret NPAs.

V. IMPACT OF NPAS ON FINANCIAL PERFORMANCE OF PUBLIC SECTOR BANKS

The rapid approval of projects that were poorly evaluated led to an increase in NPAs. The fact that the RBI had to introduce programmes like the 5:25 scheme and Strategic Debt Restructuring, which make provisions for taking into account infrastructure projects' lengthy gestation periods and the Sustainable Portion of Debt, which could only be repaid with cash flow from these projects, is evidence of how poorly banks rated projects. The dishonest promoters profited from it. The identical projects that are currently being sold by the banks through the NCLT mechanism only bring in 25–35 percent of the loan amounts that were previously financed by the banks after a 65–75 percent haircut. The capital of practically all Public Sector Banks has been diminished by NPAs. PSBs make up approximately 85%, or Rs. 8.84 lakh crore, of the nation's total NPAs, with bad loans reaching Rs 10.40 lakh crore in March 2018. Bad loans were Rs. 2.23 lakh crore at the biggest PSB State Bank of India. Nearly all of these banks' financial parameters, including the Capital Adequacy Ratio, CASA deposits, Net Interest Margin, Return on Assets, Return on Equity, and Credit Deposit Ratio that management often harps on in investor meetings, are likely to have been harmed by the prevalence of NPAs. In the last several years, the government of India has invested around Rs 3.5 lakh crore in recapitalizing PSBs so that banks may restore their vitality by improving qualitative lending while maintaining an appropriate CAGR. Because PSBs frequently require recapitalization, the government has been pushed to reorganise them in the hopes that larger banks will benefit from economies of scale by reducing their need for people, technological upgrades, and loss-making branch closures. The sheer scale of such companies could attract investors' attention and aid them in raising financing when they need it.

VI. FUTURE OF PUBLIC SECTOR BANK: ISSUES AND CHALLENGES

The government has reorganised banks in an effort to strengthen them after accumulating non-performing assets severely damaged their financial standing. With reorganisation, the issue with public sector banks has not been solved. From this point forward, the threat will be felt more strongly. In the next two to three years, the effects of Covid on the economy and the subsequent dispensation made possible by incremental government-guaranteed limitations and account restructuring are projected to result in NPAs totalling more than 10 lakh crore. Even further, some economists have said that Indian PSBs are sitting atop a ticking time bomb. The issues facing banks, especially PSBs, that are still heavily governed and regulated by the government include increasing productivity and profitability.

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Volume 2, Issue 1, February 2022

An analysis of bank mergers in the USA revealed that customers suffer as a result of the bank consolidation (Kress 2020). A single major bank experiencing trouble also poses a much bigger danger to the economy than numerous smaller banks experiencing trouble with comparable total assets. The author underlines that the three statutory principles of financial stability, the public interest, and financial and managerial concerns are ignored by the bodies in charge of merging banks.

The government has conducted restructuring for PSBs in an opaque manner, but the success of the same would depend on the improvement in macroeconomic conditions, which the government must commence through relief packages to address COVID effect. It is important to remember that the economy is not expanding at a rate that allows banks to extend more loans. As a result, as of March 2021, the credit growth for all PSBs is minimal and is primarily driven by the application of interest. NPAs cannot decrease if economic growth does not increase. The value of the collateral pledged with the banks is increased by inflationary tendencies and the surge in real estate values. Borrowers are able to obtain a greater price for the sale of securities charged to the banks to liquidation their NPA accounts as the economy expands and real estate prices rise. Therefore, it is crucial that the government act to resurrect the housing, real estate, and industrial sectors through greater incentives. There is a sizable vacuum in the affordable housing market that has to be addressed (Mission housing for all). The government would be wise to continue offering incentives under the program me after 2022.

Additionally, PSBs must be given more freedom to operate with big credit disbursements being overseen remotely. To create a holding company for public sector banks, many ideas have been made by various committees. Although a Bank Board Bureau has been established, it has yet to be given the intended task of helping banks reorganise their business plans and deal with stressed asset difficulties. The selection of board members for various PSBs was required. However, because there are still many open jobs, it has been unable to quickly identify qualified candidates for the top PSB posts of Chairman, Managing Director, and Executive Directors. For a few more quarters, RBI's monetary policy also has to be accommodating to ensure that banks have ample liquidity for lending. Through technological initiatives, banks themselves must increase their internal control systems and risk management instruments. In FY 20, frauds cost banks Rs.1.86 lakh crore, of which public sector banks made up 80%. Therefore, great attention is required to prevent past errors in project assessments while aiming for double digit credit growth and making profits. The most important aspect is fraud prevention, especially in borrowable accounts. A public sector bank almost lost all of its capital to a fraud of the Nirav Modi type, which makes it imperative to close gaps in systems and procedures by creating clear job manuals. Vigorous training is also necessary to bring staff members of merging banks who are using various sets of computer software and job procedures up to par. It may be important to emphasise that Malaysian experience has shown that integrating a varied set of people and processes into a new institution has proven to be far more challenging than anticipated (Shang 1991).

Maintaining current consumers of amalgamated companies in a good mood while they adjust to new counter staff, branch locations, and processes is a key goal of restructured entities. Thus, monitoring client satisfaction will be a top concern for the institutions that underwent restructuring. It is recognised that customers are having a very tough time working with new entities following restructuring since the locations of their branches have changed as a result of branch optimization. Additionally, the consumers have noticed that the staff members they had an excellent relationship with have been relocated. In order to determine the degree of customer satisfaction following the merger of public sector banks, the Reserve Bank of India conducted a customer survey. The findings about client satisfaction levels are likely to surprise the banks. These banks' CASA (Current and Savings) deposits are expected to have an influence on their financials, particularly so in terms of loan distribution. The credit culture of restructured banks is likely to be influenced by changes in corporate culture. There is a chance that accounts may move to private sector banks, whose proportion of the banking industry is growing. According to data from the RBI, private banks' market share in loans rose from 21.3 percent to 36 percent while PSBs' declined from 74.3 percent in 2015 to 59.8 percent in 2020.

VII. CONCLUSION

The Government conducted the reorganisation of Public Sector Banks in an opaque way. The decision to group together various banks may be influenced by regional factors or the use of similar technological platforms. It is acknowledged that corporate cultures and the human dimension were not taken into account while the merger was being planned. Two

additional banks will probably be privatised in addition to the thirteen nationalised banks that have already merged. There is talk about privatising the Central Bank of India and the Indian Overseas Bank (IOB). Both of them fall within the RBI PCA framework. However, the ultimate decision can be based on how these institutions' financial situation has improved. Any government sale of its stake in public sector banks has to entice value-seeking investors. Additionally, the government ought to be able to profit as anticipated from the divestiture or sale of shares. Banks that are going through privatisation are thought to have more toxic assets, which might lead to a decrease in their market value. Therefore, it may be said that a bank's financial health ultimately depends on how it manages its non-performing assets. Therefore, further restructuring of public sector banks will depend on strong financials and room for development.

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ISSN (Online) 2581-9429

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Impact Factor: 6.252

Volume 2, Issue 1, February 2022

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