BANK PRIVATIZATION:
A bane or a boon

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Overview

The Indian public was rooted in their seats to hear the honourable finance minister introduce the budget on the floor of the people's house. Two years of Covid, economic inactivity, and a fall in growth rates conglomerated to raise the expectations from the Budget 2022. The budget did not disappoint. The Finance ministry played on the principles of macroeconomics to push government spending and increase the aggregate demand in the economy, which had taken a hit in the past two years. The announcement of the National Infrastructure Pipeline and PM Gati Shakti's master plan presented the government's intention to take the economy out of a slump. From a Banking perspective, the Indian government turned towards a blend of technology fused with modernity. The introduction of the digital rupee and the announcement of privatizing two public sector banks was an announcement that India would now give up on the old idea of the government being in business and let the private firms do what they are best at, that is, improving the efficiency of the banking sector. Even though the announcement was made in the 2021 budget speech, we cannot ignore that this reform may shape a new banking sector in India. With this motivation, we aim to look at the pros and cons of privatization of banks in India, its effect on NPA's, efficiency, ease of doing business, etc. We also aim to delve into the intricacies of how and why Nationalization occurred and what are the various reasons for privatization now. In the end, we will conclude by analyzing the move of privatization and get insights into the future of the Indian Banking system.

Nationalization in the Indian context:

Looking at the term in an introductory manner, Nationalization is the process by which the government takes over a large chunk of privately owned assets. The government becomes the single largest shareholder of the private asset, which means the government enters the business world. The most prominent example in the news recently was Air India, which the TATA group recently took over. India just won a hard battle to throw the British out. The government now had a humongous task to shape the country's economic future. The prime minister at that time was greatly influenced by the Soviet-style Socialist economy where the state owned all the factors of production. The evidence was the concrete steel plants set up at Bokaro and Durgapur. India was still nascent in its economic history and wanted to mobilize funds to the different sectors so economic activity could boom. This meant that a strong foundation for a line of credit had to be set up to provide accessible funds to all the sectors of the economy. The Indian government believed that if they oversaw this line of credit directly, then the availability of the same would be carried out efficiently. That was the motivation behind the Nationalization of the banking sector in India, to promote efficient economic growth. As the 20th century began, joint stock banks got introduced to the banking sector.

Consequently, in 1935, the presidency bank was merged into the Imperial Bank of India, followed by the setting up of the Reserve Bank of India. The year 1959 saw a takeover of 8 former princely state banks. The final blow came in July 1969 when the government nationalized all the banks with deposits over Rs 500 million, making the government the sole owner of 84% of all the bank branches in India. (Bannerjee et al.).

Prakesh Tandon, a former chairman of the Punjab National Bank (nationalized in 1969) describes the rationale for nationalization as follows:

"Many bank failures and crises over two centuries, and the damage they did under "laissez-faire" conditions; the need of planned growth and equitable distribution of credit, which in privately owned banks was concentrated mainly on the controlling industrial houses and influential borrowers; the needs of growing small-scale industry and farming regarding finance, equipment, and inputs; from all these there emerged an inexorable demand for banking legislation, some government control, and a central banking authority, adding up, in the final analysis, to social control and nationalization". (Tandon 1989, pg-98)

Post-1969, India saw more than 56000 bank branches open. By 2003, these banks constituted a chunk of deposits which also led to their expansion in rural areas. The announcement of nationalization was not received well by the trade industry but was celebrated by the ruling and the communist party at that time. We just saw the motivation behind nationalization above, which was directed towards providing easy credit to the Economy, but did the move solve this problem efficiently? In the next section, we will look at how Nationalized banks posed problems that laid out the field for bank privatization.

The 1990s came as an impactful year for the Indian Economy. It was the era of Liberalization, Privatization, and Globalization in the Indian Economy. However, prior to that, we were facing many problems. The fiscal deficit was at an all-time high, and our balance of payment situation worsened. The pressure started building up on the government to act and revive the Economy from this grave situation. For inflow of FDI's, it was recommended to open up the Economy, let go of the license raj and introduce the Economy to competition. For doing this, some reforms were introduced mainly to relax the restrictions curbing the market's functioning. The basic principle of the new reforms was to make India's financial sector competitive enough to promote more significant investments. Even the banking sector had to be reformed. For this, the government formed two committees with M.Narsimhan as the chairman, and the reports gave recommendations to make the Indian banking sector at par with the international standards. Some notable recommendations included joint ventures between public and private banks, encouraging Indian banks to indulge in merchant banking, mutual funds, etc. This laid out the base for a liberal initiation of the banking sector. In this paper, we will look into the condition of the banking sector post-independence and then analyze whether or not the privatization policy would make sense in the Indian setup.

The situation of the banking sector: 1947-67

Most of the banks were privatized. This included the Imperial Bank of India, Central Bank of India, Punjab Bank of India, etc. All these banks held public deposits of close to Rs-100 crore (RBI report). Apart from these, other banks also held deposits but less than Rs 50 Crore. RBI was also not completely state-owned and was done after the Bank of India Act of 1948.

Table 3.10: Number and Deposits of Indian Banks – End-December 1947

Category of Reporting Banks	Number	Deposits (Rs. crore)
1	2	3
A. Scheduled Banks	**97**	**1090**
Imperial Bank	1	287 (22.8)
Other Banks (A1 Banks)	81	623 (49.4)
Exchange Banks*	15	180 (14.3)
B. Non-Scheduled Banks	**557**	**89 (7.1)**
i) Class A2	65	52
ii) Class B	185	29
iii) Class C	119	5
iv) Class D	188	3
C. Co-operative Banks	**395**	**82 (6.5)**
D. All Banks - Total	**1034**	**1261**

* : Data relate to Indian operations of foreign exchange banks.

Note :
1. Figures in parentheses are percentage shares in total.
2. Class A1 were banks with capital and reserves greater than Rs.5 lakh and included in the second schedule to the RBI Act 1934.
3. Class A2 were non-scheduled banks with capital and reserves of greater than Rs.5 lakh.
4. Class B were non-scheduled banks with capital and reserves greater than Rs.1 lakh but lower than Rs.5 lakh.
5. Class C were non-scheduled banks with capital and reserves of Rs.50,000 to Rs.1 lakh .
6. Class D were banks with capital and reserves of less than Rs.50,000.

Source : Statistical Tables Relating to Banks in India, 1947.

The year 1948 became a waking-up call for the economy. Over 45 relatively large banks failed. The primary reason was the opening up new branches in different areas of the country. This also included giving out bad loans, resulting in these banks becoming deficient in resources. Another reason was the weak capital base on which the institution was built. Both these factors amalgamated together to amplify bank runs in that period. This scenario shook people's trust in financial institutions, so the public started investing their savings into the postal department, which became a safe avenue for the people.

RBI stepped in. The introduction of the Banking Companies Act of 1949 helped improve the condition of bank runs. The act pushed towards making banks efficient entities. This included measures to protect the interests of investors. The legislation also gave power to the RBI to open more branches, keep a strict check on bank books, and ensure no lousy credit was given out. It also gave power to the central bank to inspect banking companies at any time to check for legal compliance with RBI rules and regulations. Since RBI was trying to fight off the bank-run scenario, they decided to shut down insolvent banks or merge them with big banks. Pushing off insolvent banks was not a good idea since it meant playing with investors' savings, so mergers were decided to improve efficiency.

The Banking Companies Act 1961 proved to be an initial step in improving the prevailing condition. This required banks to amalgamate with the State Bank of India or its subsidiaries. This led to the first step toward nationalization. Between 1954 and 1966, several banks were either amalgamated or otherwise ceased functioning, or their liabilities and assets were transferred to other banks. However, between 1960 to 1966, as many as 217 banks were amalgamated under different provisions such as Section 45 of the BR Act 1949 (compulsory amalgamation) and Section 44 A of BR Act 1949 (voluntary amalgamation). **The policy of strengthening the banking sector through compulsory amalgamation and mergers helped consolidate the banking sector. The success of this could be gauged from the visible reduction in the number of non-scheduled banks from 474 in 1951 to 210 in 1961 and 20 in 1967. Their branch offices declined from 1504 in 1951 to 622 in 1961 and 203 in 1967. (RBI)**

Table 3.15: Scheduled and Non-Scheduled Commercial Banks in India

(End-December)

Category of banks	1961	1966	1967
1	2	3	4
1. Number of Banks (Reporting)	292	100	91
(a) Scheduled Banks	82	73	71
(b) Non-scheduled Banks	210	27	20
2. Number of Offices of Banks in India	5012	6593	6982
(a) Scheduled Banks	4390	6380	6779
(b) Non-scheduled Banks	622	213	203

Source: Banking Commission 1971 and Statistical Tables Relating to Banks in India (various issues).

As mentioned above, the role of banks was to support different sectors of the economy. Banks were seen as developmental institutions, but the public sentiment said otherwise. Due to a lack of awareness about banking and allied services, the period saw reliance on small-scale borrowers. According to the India Rural Credit Survey Committee, the total borrowing of the farmers has estimated at Rs.750 crore in 1951-52. Commercial banks provided only 0.9 per cent. Agriculturist moneylenders provided 24.9 per cent, and professional money lenders another 44.8 per cent. Thus, the financial system at the time of independence was typically underdeveloped (RBI).

The period from 1961 to 1967 proved challenging for the sector. The two wars and a crop failure compelled the government to check for funds mobilization in the right direction. Also, in 1966, banks followed selective credit control policies due to which most of the credit was concentrated in the hands of some sectors. Thus the second responsibility of the government was to enlarge the spectrum of borrowers. This laid out a field for nationalizing banks in the coming years.

1967-1992:

Even though the economy saw an improvement in the condition of bank runs, it still faced other problems. **One problem was the collusion between banks and industrialists, due to which agriculture was neglected. The second problem was that access to the banking sector was concentrated in the hands of few businesses.** According to the RBI, such concentration of banking power would have jeopardized the interests of other depositors as well. The aftermath was that the ratio of paid-up capital and reserves to deposits declined by more than 75% (from 9.7% in 1951 to 2.2% in 1969).

The government adopted social control over banking to counter these concerns. This was done through the Banking Law amendment act 1968. This act compelled every bank to have a chairman who came from a professional banking background. Also, around 51% of the board members should have specialized knowledge about rural economy, banking cooperation, accountancy, etc. This act also gave RBI the power to dismiss the CEO, CFO, or bank director. This was done to ensure widespread and target-specific mobilization of credit.

Thus it was decided that 14 banks having deposits over 50 crores would be nationalized. It proved to be advantageous on many fronts. First, supplemented by the Lead Bank scheme, the government and RBI successfully opened bank branches in unbanked regions of India. This increased the share of rural bank branches from 17.6 % in 1969 to 36.3% in 1975. From the table below, we can see that the population per bank office fell in subsequent years, indicating a proper credit distribution among newly opened banks. So nationalization was successful in increasing bank branches as well as reducing stress on each branch.

As at end	Rural Centres	Semi-urban Centres	Urban Centres	Metropolitan Centres/Port Towns	Total	Population per Bank office
1	2	3	4	5	6	7
June 1969	1,443 (17.6)	3,337 (40.8)	1,911 (23.3)	1,496 (18.3)	8,187	65,000
December 1975	6,807 (36.3)	5,598 (29.9)	3,489 (18.6)	2,836 (15.1)	18,730	31,660
December 1980	15,105 (46.6)	8,122 (25.1)	5,178 (16.0)	4,014 (12.4)	32,419	20,481
December 1985	30,185 (58.7)	9,816 (19.1)	6,578 (12.8)	4,806 (9.4)	51,385	14,381
December 1990	34,791 (58.2)	11,324 (19.0)	8,042 (13.5)	5,595 (9.4)	59,752	13,756

Note : Figures within parentheses are percentage shares in total.
Sources : Banking Statistics 1972 for data for the year 1969 & Handbook of Statistics on the Indian Economy 2006-07 for other years.

Second, this decision increased the confidence of people in the banking sector. This was deduced by seeing an increase in household savings and financial savings being deposited in banks. Since it was a time of the green revolution as well, nationalization worked in tandem with it. The green revolution increased income which led to more deposits in banks.

Period	Growth Rates of Demand Deposits	Growth Rates of Time Deposits	Growth Rates of Aggregate Deposits
1	2	3	4
1960-65	15.1	7.0	10.5
1965-70	12.6	15.8	14.3
1970-75	17.3	19.7	18.7
1975-80	8.1	30.6	21.9

Source : Handbook of Statistics on the Indian Economy, 2006-07 (RBI).

Year (April-March)	Household sector Financial savings	Household sector Physical savings	Total Household Savings (2+3)	Household Savings as percentage of GDP
1	2	3	4	5
1968-69	795	2,327	3,122	8.5
1970-71	1,371	3,000	4,371	10.2
1974-75	2,374	5,294	7,668	10.6
1979-80	6,081	9,747	15,828	14.3

Source : Handbook of Statistics on the Indian Economy, 2006-07 (RBI).

The growth rate of deposits, as well as household savings, increased which improved the condition of the banks, thereby improving the condition of the economy.

Problems prevailing in the sector:

Even though the preliminary measures like the growth rate of deposits and savings indicated a healthy banking sector, all was not right. The main aim of having a good line of credit is to provide loans at an attractive rate so that it is not expensive for the borrower. Here came the problem. The banks began charging a low rate from priority customers while charging higher from other customers. This meant that big businesses which needed loans cheaply used to come into the good books of banks and get loans cheaply, while the people who required it had to pay an increased interest on the loan acquired. Adding to this, India had to recover from the British economic slump. For this, they had to rely on borrowings from banks to acquire necessary resources and set up factories and other institutions. **Thus interest rate flexibility became a problem since it affected the cost of borrowing. Then came the problem of horizontal inequity**. The oil shock in 1970 put an upward inflationary measure on the economy, due to which the central bank was forced to raise the interest rate. The RBI imposed a minimum lending rate of 10% except for the priority sector. To fight inflation, other banks raised the interest rates very high, so the RBI put a cap on interest rates. This led to the formation of many anomalies. **Since a range of interest rates now govern the banks, different banks offer loans and advances at different rates in the same area, thereby creating horizontal inequity (RBI).** This differential administered interest rates made the line of credit complex and phased out the role of market forces. This complex financial structure resulted in a financial downturn. **NPA's of banks increased sharply, which led to a decline in the profitability of banks,**

(per cent)

Year (January-December)	SBI	Nationalised Banks	Other Indian Scheduled Commercial Banks	Return on Assets
1970	0.48	0.64	0.65	0.59
1975	1.19	0.57	0.59	0.77
1980	0.86	0.56	0.59	0.66
1985	0.08	0.06	0.13	0.07
1989-90 @	0.12	0.15	0.23	0.15

* : Net Profit before tax as percentage of total assets.
@ : April-March.
Source : Statistical Tables Relating to Banks in India, various issues.

As we can see, due to this complexity, the net profit for banks fell in the 1989-90 period compared to 1970. Even the return on assets showcased the same trend. Therefore this whole episode gave the necessary push for liberal reforms, which saw the initiation of Liberalization, Privatization, and Globalization.

Banking Sector reforms:

In the previous section, we understood that banks were not allowed to set the interest rates according to the quality of the borrower, which affected credit disbursement. To tackle this, the government started easing out norms for the banks.

The SLR and CRR were reduced from 38.5% to 25% in 1997 (RBI). Due to this, the artificial constraint on liquidity was removed, which improved the banks' profitability. The financial institutions were given the freedom to set their interest rates. All these initial steps led to a fall in NPAs. The performance of nationalized banks was particularly significant as they registered a net profit of Rs.270 crore during 1994-95 compared with a net loss of Rs.4,705 crore in 1993-94. As a result, the profitability of the banking sector (scheduled commercial banks), measured by return on assets, which had declined from 0.4 per cent in 1991-92 to (-)1.1 per cent in 1992-93, improved to 0.8 per cent by 1997-98 (RBI).

Year (April-March)	No. of profit making SCBs	No. of loss making SCBs	Overall profit/ loss (-) (Rs. crore)	Return on Assets (per cent)	
				SCBs	PSBs
1	2	3	4	5	6
1992-93	59 (15)	14 (12)	-4,150	-1.08	-0.99
1993-94	60 (15)	14 (12)	-3,625	-0.85	-1.15
1994-95	73 (19)	13 (8)	2,154	0.41	0.25
1995-96	80 (19)	14 (8)	939	0.16	-0.07
1996-97	92 (24)	8 (3)	4,504	0.67	0.57
1997-98	92 (25)	11 (2)	6,502	0.82	0.77

SCBs – Scheduled Commercial Banks.
PSBs – Public Sector Banks
Note : Figures in parantheses indicate number of public sector banks

Competitiveness within banks increased. Private banks were now allowed to enter the market, which compelled PSBs to ramp up innovation. The move also allowed banks to set up branches where they seemed fit. Banks were even given the freedom to set up ATMs. An inflow of foreign private banks worked wonders for the economy. **Asset quality began to improve, and credit growth, which had decelerated significantly between 1996-97 and 2003-04 partly because of risk aversion, began to pick up from 2004-05.** Credit growth, initially concentrated in the retail segment, soon became broad-based, encompassing agriculture, industry, and small-scale sectors. Credit growth accelerated to over 30 per cent in 2004-05 and remained more or less at that level in the following two years (RBI). Along with this, the banks put in a proper system for risk detection to reduce the number of NPAs operating.

End-March	Gross NPAs as percentage to Gross Advances		Net NPAs as percentage to Net Advances	
	SCBs	PSBs	SCBs	PSBs
1	2	3	4	5
1993	–	23.2	–	–
1994	–	24.8	–	–
1995	–	19.5	–	10.7
1996	–	18.0	–	8.9
1997	15.7	17.8	8.1	9.2
1998	14.4	16.0	7.3	8.2
1999	14.7	15.9	7.6	8.1
2000	12.7	14.0	6.8	7.4
2001	11.4	12.4	6.2	6.7
2002	10.4	11.1	5.5	5.8
2003	8.8	9.4	4.0	4.5
2004	7.2	7.8	2.8	3.1
2005	5.2	5.5	2.0	2.1
2006	3.3	3.6	1.2	1.3
2007	2.5	2.7	1.0	1.1

'–' : Not available.
SCBs - Scheduled commercial banks.
PSBs - Public sector banks.

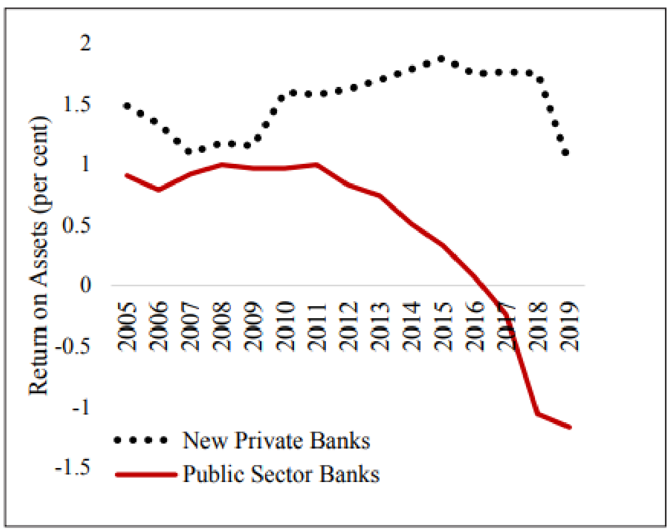
The above table shows a fall in NPA's for public and private banks, but private sector banks fare well.
Private banks initiated the usage of technology for transactions which proved efficient for the customers. The share of electronic transactions increased subsequently.

Banks started diversifying by providing corporates custodial, depository, and advisory services, increasing their non-interest-based income. So easing off the pressure from banks and letting them operate independently definitely exhibited some positive results for the economy.

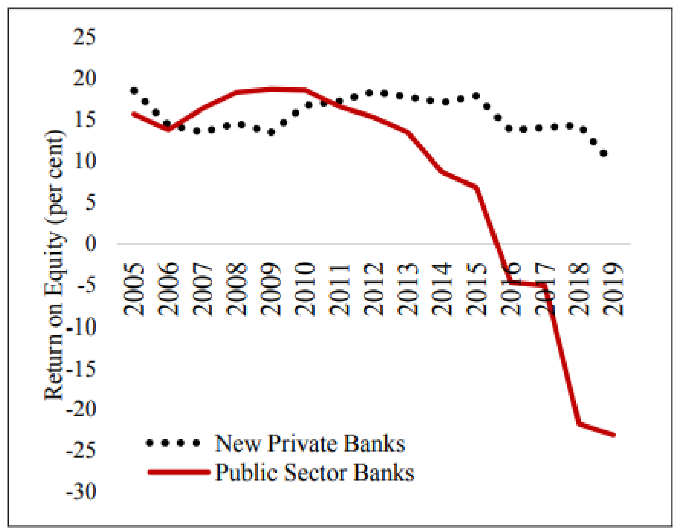
Should Banks be privatized then?

Recently the Finance Minister announced the privatization of two public sector banks apart from IDBI. It is a good move if we take the historical evidence into account. First, we saw that government control of interest rates and forceful credit access led to a complex nature of interest rates, leading to falling profitability. **On the other hand, when private banks entered the market with complete freedom of operations, we saw a rise in the number of profit-making commercial banks. Second, giving banks the freedom to operate, decide where to open branches and what kind of services to provide ensures total efficiency in implementing policies**. This is because, in the end, banks have to look after their profit, which ensures efficiency in their operations. **Thirdly, the government is a multi-dimensional war horse. It has to look after education, health, and welfare which requires funds. If a government-run bank faces losses, it will force them to direct funds to save the bank from failing, which they otherwise would have used in another sector.** Privatization takes the responsibility of efficiently managing the institution. Thirdly, privatization can give the government access to healthy banks, giving them various credit acquiring options. This would enable the government to borrow easily in a fiscal deficit. **Lastly, privatization would give the banks the freedom to select their board members who are technically proficient and understand the modern banking requirements. It would also increase the quality of employment in banks.** On the contrary, the PSBs always see a civil servant who may or may not belong to the financial sector. Also, the workforce is not highly motivated to work efficiently since they have job security. Privatization will thus push the banks to improve their employees, force R&D, respect the market forces, and improve the health of banks. This would mean an efficient source of credit which will work wonders for the economy. Following the Make in India initiative, it would improve the ease of doing business and give a push to the startup culture.

When we look at the recent performance of public sector banks, we see a downward spiral. In 2019 public sector banks reported gross and net NPAs of ` 7.4 lakh crore and ` 4.4 lakh crore, respectively, amounting to about 80 per cent of the NPAs of India's banking system. The gross NPAs of PSBs amount to a significant 11.59 per cent of their gross advances (Economic Survey 19-20). In 2019, PSBs lost more than Rs 661 billion against a profit of Rs 421 billion earned by other private banks. The Reserve Bank of India (RBI) found that PSBs account for 92.9 per cent of the 5,835 cases of fraud and 85 per cent of the fraud amounts of about ` 41,000 crores reported in 2017-2018 (Statistics from chapter VI of the RBI Annual Report released on August 29, 2018).



Source: RBI Data and Survey Calculations



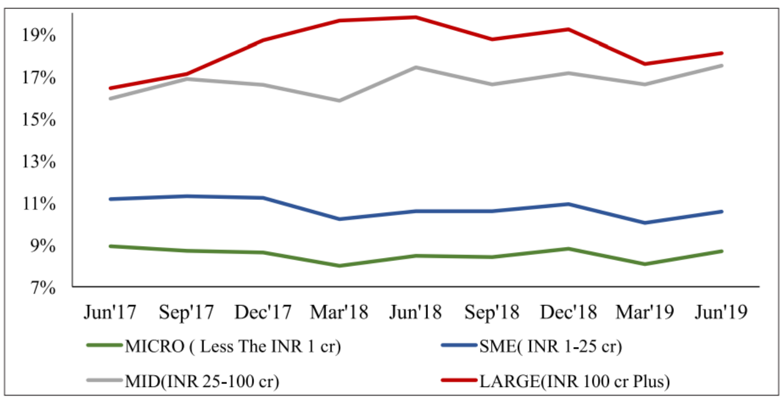
Source: RBI Data and Survey Calculations

These facts make a strong case for implementing the privatization of banks in India, but is that easy to do so?
Even though privatization seems a lucrative option to improve return on equity and reduce NPAs, it has shortcomings. **First, there would be job losses, especially for those who belong to the SC/ST class.** PSBs, give job reservations to the backward classes, which the private banks will not do. This would mean increased unemployment which would prove inadequate for the economy**. Secondly, the private banks will be fuelled by profit which makes it equally dangerous.** These institutions would focus more on providing services to the affluent, making financial exclusion of the weaker section of the society. **Thirdly, even though the Indian economy saw bank failures during independence post nationalization, no PSB has faced a bank failure. On the contrary, in recent years, prominent private institutions like Yes bank, Lakshmi Vilas Banks, etc have faced failures.** Privatizing the whole sector will jeopardize the household savings of an average Indian who wants to play a safe bet on his/her savings, which PSBs give.

Way Out:

From the Indian setup, the PSBs, as well as private banks, have to move together. Giving one the monopoly over the banking sector will prove to be inefficient. The government should focus on improving the efficiency of PSBs by strengthening credit analytics. In the present context, with a uniform GST tax policy, Aadhar UIDAI and a developed mobile network, the PSBs can increase their efficiency. The government-owned banks have comprehensive connectivity to the rural areas, understand the local markets well and have a trustworthy image in the eyes of an average Indian. **Thus increased investments in collecting data and analyzing them using Machine Learning and AI would help distinguish a good borrower from a bad one, estimate potential NPAs, and future Return on Equity to make policies accordingly. This will help in PSBs to provide services more accurately.** Also, it would prevent NPAs from increasing due to bad corporate lending.

Figure 20: Non-Performing Asset (NPA) Rate by Size of the Loan



Source: TransUnion Cibil-Sidbi

Second, the PSBs should focus on creating a PSB Fintech hub using modern computer science techniques. This would increase transparency between different PSBs to share information and data through a single entity or the Fintech hub, reducing the workload of analyzing the credit trends repeatedly. This would considerably reduce the inefficiency of banks arising from information collection. Also, the banks can use government resources to develop AI-ML models to develop a credit rating system for corporates to segregate borrowers and improve the credit availability to good borrowers. **Thirdly, to motivate employees, the government can provide them with stakes in the banks and their fixed salaries.** This would ensure accountability as now the employees would be motivated even more to work well, increase the banks' profits and earn a good return on their stake.

If we talk about privatization, there should be a compliance mechanism to ensure all sections of society get credit quickly. This can be done through constant annual checks on the functioning of the banks by RBI. **Secondly, to reduce bad corporate lending, every bank must be required to develop credit rating models similar to the one recommended for PSBs to reduce the possibility of extensive loan defaults.** Thirdly, it can get into a mutual agreement with the existing public sector banks wherein they can help PSBs develop efficient technology and efficient services while using the latter's contacts and assistance to set up banks in rural areas. **Lastly, if the public sector banks get privatized, the responsibility will fall on the private player to train the existing employees and absorb them into the workforce. This would prevent job losses.**

These recommendations might provide a balance to the co-existence of both the public and private sectors. In the Indian context, we need to set up a sound financial structure to increase the efficiency of credit providence and other related services. The recent announcement to privatize IDBI bank will prove as a pilot to shape the banking future of the country. Whatever the future holds, the policymakers must keep in mind the recommendations above for a smooth banking sector transition.