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DENATIONALISATION OF BANKING IN INDIA

Kumar Anand
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Abstract *

Economic Freedom of the World Report published every year by the Fraser Institute measures “the degree to which the policies and institutions of countries are supportive of economic freedom” (EFW 2013, v). Among many indicators and sub-indicators (factors) considered by authors of the report, one is “ownership of banks”. India’s score on this indicator on a scale of 1 to 10 has been stuck at 2 since 1995. Before 1995, it used to be zero. This is reflective of the predominantly ‘public’ character of banking in India, however, it wasn’t always so. Since India’s independence in 1947, private banks have been nationalised at regular intervals in the pursuit of ‘national objectives’.

This paper is an attempt to demonstrate both the obvious and implicit costs to the economy, of India’s government-owned banking model. Using research findings of other scholars, the paper also demonstrates that the so-called social or national objectives have not been achieved even after more than 40 years of India’s experiment with nationalisation of the sector, despite the huge amount of money paid by Indian taxpayers all this time. The paper concludes by calling for an immediate denationalisation of Public Sector Banks in India (PSBs).

*Special thanks to Manan Vyas for his help with research and to Parth Shah for his comments on the drafts of this viewpoint.
Introduction

“An Ordinance to provide for the acquisition and transfer of the undertakings of certain banking companies in order to serve better the needs of development of the economy in conformity with national policy and objectives and for matters connected therewith or incidental thereto.”

So read the preamble of the Ordinance 8 of 1969, transferring ownership of 14 named private commercial banks to corresponding new public banks, set up under the ordinance. Public ownership of banks has been the cause of several ills facing India today. Government’s stated policy of maintaining a majority share in public sector banks in order to maintain their ‘public sector character’ has come at a huge cost. The various costs are mostly unseen as they are difficult to quantify.

Capital infusion into public sector banks by the government is a regular phenomenon. Capitalisation of these banks using taxpayer’s money puts stress on government resources which have several competing and more immediate uses. Access to unlimited resources without any need to meet performance criteria is a recipe for inefficient behaviour. The absence of a level playing field for PSBs versus private/foreign banks damages the robustness of the entire banking sector in India. With no disinvestment policy in sight, this is a long term drain on Indian taxpayers which they can ill-afford.

While more than 70 percent of banking business in India is carried out by PSBs, their incentives are so aligned that they discourage profit-driven lending (RBI 2013, 16). The flow of credit comes to be determined by the government, and not by the profitability of a particular line of business. When hard earned savings of people are channeled into unproductive schemes rather than into investments which are most urgently needed, it is not surprising that India’s growth story has come to be seen as unsustainable.

After the global financial crisis of 2008, policy makers in India claimed that India escaped the crisis due to its prudent regulations and the largely “public character of banks”. It is true that no public sector bank has been closed till date. While the government claims these as evidence of their success, it is
important to point out the financial repression and the fact that the huge opportunity cost is borne by none other than Indian taxpayers.

The public debate in India hardly ever questions the rationality behind government-run banking business. Since the subject does not find any mention in public debate or mainstream media, it is high time that the negative effects of public ownership of banking are brought back into the limelight in the public debate.

Financial Repression

While there are a number of rules and regulations governing banking sector in India that causes financial repression, these rules and regulations apply equally to all scheduled commercial banks, public and private alike.

Measures such as mandatory holding of up to 40 percent of net demand and time liabilities as government securities (popularly called Statutory Liquidity Ratio (SLR)), up to 12 percent of net demand and time liabilities as cash reserve ratio (CRR), up to 40 percent of net advances to mandated sectors called priority sector lending (PSL), need for prior-permission from RBI to open a bank branch, etc. lead to many seen and unseen (both intended and unintended) consequences for the Indian financial sector.

Distortions in the market have been caused by the various regulations by the government and the RBI, however, we shall leave the analysis of financial repression for another paper. This paper aims only to evaluate the success or failure of the ‘public’ character of ownership of banks in India under the existing banking sector regulations.

Nationalisation of Banks: A Brief Background

On 19 July 1969, 14 banks were nationalised, each having a deposit of INR 500 million or more. The official reason stated for the sudden nationalisation of banks was that “public ownership of the major banks will help most effectively the mobilisation and development of national resources and its utilisation for productive purposes in accordance with the Plans and priorities”. 
On 15 April 1980, six more private sector banks having demand and time liabilities of not less than INR 2 billion each, were nationalised.

**Table 1: List of Banks nationalised in 1969 and 1980**

<table>
<thead>
<tr>
<th>Banks Nationalised in 1969</th>
<th>Banks Nationalised in 1980</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Central Bank of India Ltd.</td>
<td>The Andhra Bank Ltd.</td>
</tr>
<tr>
<td>The Bank of India Ltd.</td>
<td>Corporation Bank Ltd.</td>
</tr>
<tr>
<td>The Punjab National Bank Ltd.</td>
<td>The New Bank of India Ltd.</td>
</tr>
<tr>
<td>The Bank of Baroda Ltd.</td>
<td>The Oriental Bank of Commerce Ltd.</td>
</tr>
<tr>
<td>The United Commercial Bank Ltd.</td>
<td>The Punjab and Sind Bank Ltd.</td>
</tr>
<tr>
<td>The Canara Bank Ltd.</td>
<td>Vijaya Bank Ltd.</td>
</tr>
<tr>
<td>The United Bank of India Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Dena Bank Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Syndicate Bank Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Union Bank of India Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Allahabad Bank Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Indian Bank Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Bank of Maharashtra Ltd.</td>
<td></td>
</tr>
<tr>
<td>The Indian Overseas Bank Ltd.</td>
<td></td>
</tr>
</tbody>
</table>

The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 that transferred the undertaking of these six banks to six corresponding new banks, in its preamble read:

“An Act to provide for the acquisition and transfer of the undertakings of certain banking companies, having regard to their size, resources, coverage and organisation, in order further to control the heights of the economy, to meet progressively, and serve better, the needs of the development of the economy and to promote the welfare of the people, in conformity with the policy of the State towards securing the principles laid down in clauses (b) and (c) of Article 39 of the Constitution and for matters connected therewith and incidental thereto.”

Also, a closer look at the government policies and events leading up to the nationalisation suggests that it was the desperate need for resources to feed
into various priorities of the government as outlined in the five year plans, that caused government to nationalise banks, both in 1969 and 1980. Table 1 lists the names of all the banks nationalised in 1969 and 1980.

There were many who saw flaws in such a step and tried to raise concerns but these contrarian views to government’s plan for nationalisation were outright dismissed or ignored.

**Nationalisation of Banks: Sane Voices Ignored**

Historian Ramachandra Guha in his book *India After Gandhi* has pointed out the dissent and scepticism of the then Finance Minister Morarji Desai on the issue of bank nationalisation (Guha 2007, 437). Desai’s remarks were however ignored.

“On returning to Delhi Mrs Gandhi divested Morarji Desai of the Finance portfolio. He was a known opponent of bank nationalization, once telling Parliament that it would ‘severely strain the administrative resources of the government while leaving the basic issues untouched’. The state takeover of banks, believed Desai, would reduce the resources available for economic development, and increase bureaucracy and red tape.”

Similar sentiments were demonstrated by Minoo Masani, one of the few voices of reason in the Indian parliament during the time.¹

“Opposing the measures on both economic and political grounds, Mr. Masani said that the economic effects of nationalisation would be disastrous. Confidence in India abroad was bound to be shaken and may adversely affect the availability of foreign capital the country needed. At home, the depositors would be scared. Nationalisation had so far meant bureaucratic inefficiency, political influence and corruption and financial losses. Just as permits and licenses had so far been sold, so depositors would fear that loans and overdrafts from now on would become a channel of political graft” (Freedom First 1969).

Also writing at the time was Professor B R Shenoy. While referring to the issue of bank nationalisation, Shenoy in his response to the Economic Policy Note of the Prime Minister appended to the Economic Policy Resolution of the Congress party at its Bangalore session of 1969 said,
“These measures do not add to savings; they would merely shift investments, without enhancing the overall resource availability. Nor will they correct the wastage and misdirection of savings. Bank nationalisation and changes in the criteria of credit-worthiness may accentuate these maladies through, among other ways, diverting bank funds into extravagant and low return public sector projects at the expense of more lucrative outlets; and through piling up bad and dubious debts” (Shenoy 2004, 16).

According to Shenoy, bank nationalisation and other measures—such as a change in the criteria of credit-worthiness for the grant of loans, special efforts to favour backward regions, and provision of more credit to agriculture—would divert savings into the politically favoured sectors, with less than due regard to the danger of this to the national product and to the relative soundness of the investments. Shenoy concluded by saying that we cannot achieve economic development by an organised dissipation of savings—which is exactly what the nationalisation of banks promised to achieve. Slow rate of growth for India over the next 20 years (1970 to 1990) owes in no small measure to this phenomenon of government organised dissipation of savings.

Let us first see how the PSBs measure on their own scale of success.

Performance of Public Sector Banks

It is widely conceded that PSBs are unprofitable, earning less than a normal rate of return, sometime even negative returns. But it has been argued that profit maximisation should not be the only criterion through which the performance of the PSBs should be judged. Banks were nationalised in 1969 and 1980 for the purposes of greater access of institutional credit and other banking services to un-banked poor, especially in the rural areas, which in itself may admittedly not be a profit maximising endeavour.

RBI in one of its recent discussion paper has enumerated the objectives of social control that led to nationalisation of banks as follows (RBI 2013):

1. Achieve a wider spread of bank credit;
2. Prevent its misuse;
3. Direct a larger volume of credit flow to priority sectors; and
4. Make bank credit an effective instrument of economic development.

Success or failure of public sector banks on all the above four objectives can be broadly assessed under the heads of financial inclusion and directed credit.

Let us see how these PSBs fare on these objectives, putting aside their profitability. The report of the high level committee on financial sector reforms set up by the Planning Commission under the chairmanship of Raghuram Rajan in 2008 documents PSBs performance on serving public policy objectives of (1) financial inclusion, and (2) directed credit (Planning Commission, 2008). Some of the observations of the committee in its detailed report on these objectives are as follows:

1. **Financial Inclusion**

   a. Noting that the past strategies to expand inclusion are reaching diminishing returns, the Rajan Report says that more rural branching in itself cannot be the way to reach the poor, since the poor in richly branched urban areas have no more access than the poor in rural areas.

   b. Data analysis for the period between 2000 and 2005 shows that there is no systematic relationship between improvement in the regional credit disbursement and public sector bank presence.

   c. In rural areas where private banks are present, they do not discriminate against the poor, at least not significantly more than the PSBs. In other words, even in markets where the bankable population is small, private/foreign banks go after nearly every credit-worthy party that the public sector reaches out to.

   d. Additional rural branching is not very profitable, and when given a choice, everyone stays away from it—public sector banks and private sector banks alike.

The report concludes by saying that the answer to inclusion is not to rely solely on the ‘public spirit’ of the PSBs but to make the poor worth competing for. When universal credit disbursement rules are mandated for all commercial
banks, innovation and efficiency takes a back seat. For example, priority sector lending requirements mandates every commercial bank to allocate 40 percent of net bank credit to the priority sectors of the economy. Within this, sub-targets of 18 percent and 10 percent of net bank credit respectively, have been stipulated for lending to agriculture and weaker sections. When-to-lend, who-to-lend-to, how-to-lend, and how-much-to-lend of lending business is government mandated and there is little scope for entrepreneurs to innovate and come up with services that serve newer customers profitably.

We will never know, when all banks are controlled by such micro-lending requirements, what banking entrepreneurs might come up with in the way of new business plans to serve the hitherto unbanked poor thus leading to greater financial inclusion. The history and development of Banking Correspondent model of expansion of banking services is case in point. The same arbitrary and prohibitive rules and regulations continue, rationalised by the lack of financial inclusion perpetuated by these very rules and regulations themselves.

2. Directed Credit

a. The committee report acknowledges, that in recent years, private banks have actually done better than PSBs in terms of fulfilling the overall priority sector quota.

b. In terms of the impact of the additional agricultural credit from PSBs, agricultural investment and output growth do not reflect any effect of increased agricultural credit either, thus raising questions about the end-use of agricultural credit provided by the PSBs.

c. In terms of loan timing, in times of draught in a district, private sector banks appear to provide more agricultural loans, while PSBs provide more consumption loans.

d. As regards the quality of directed lending, the share of non-performing loans in the priority sector lending has been higher for nationalised banks than for the private banks with some indication that political interference has reduced credit quality.
All this suggests that both in terms of quality and quantity, private sector banks have performed at least as well as or better than the PSBs on various indicators of directed credit applicable to both. Noting that once mandates are imposed equally across banks, the differences in bank ownership have limited influence on whether the public purpose is served, the Rajan Report questions whether there is any purpose in continuing the status quo for PSBs.

The Report’s proposals to reform the PSBs, while being unorthodox for a government-commissioned report, stops just short of the one reform that takes care of almost all others, i.e., denationalisation of banks in India. In brief, the report proposes stronger board for PSBs and delinking of banks from the government as an interim solution until the political will is found for outright sale of PSBs.

When nationalisation of banks actually took place in 1969, many thought that such a move was politically infeasible or just speculation. In fact, the government had clearly mentioned in 1950s that it had no intention of taking over banks. We should not judge political will of the government, as also there is no scientific way to do so. But we must say what needs to be done unequivocally—such as mounting costs and few benefits leaving little option but to suggest denationalisation of PSBs.

Recurring Capital Infusion in PSBs: Direct Cost to Taxpayers

Banks need capital to grow. Writing for Economist Ajay Shah’s blog, Harsh Vardhan, a partner and head of India financial services practice at Bain & Company, has succinctly explained the different needs and incentives that guide private and public sector banks while attempting to grow.

“Most privately owned banks are under constant scrutiny of investors and analysts. When they go to external investors for raising capital, they have to satisfy these investors on number of critical aspects of the business — profitability and its sustainability, efficiency of capital use, quality of management team, cost efficiency, etc. In other words, private banks face a market test; they do not get capital for free. Only well run private banks get equity capital that is required for growth.”
Thus we see that private banks have to compete for scarce resources and demonstrate the viability of their business when raising capital for banks to grow; whereas PSBs do not face these worries. Harsh Vardhan in the same post explains the incentives (or rather the lack of it) that guide PSBs when attempting to raise capital for their banks to grow.

“None of these questions get asked when government puts capital into a PS bank. One has never heard a senior government official commenting on the Return on Asset (RoA) or Return on Equity (RoE) of PS banks. The decision to put capital into PS banks is treated as a mechanical and administrative decision. This absence of a market test has systemic consequences. PS banks have ~70% share of the Indian market. When the majority owner is asking no or very few questions on performance, and is assuring an almost unlimited supply of capital, these banks have little incentive to improve financial metrics such RoA and RoE. This hurts the overall banking industry. For example, PS banks can underprice loans compared to their private sector peers. Such behavior would migrate the whole business to lower returns. It is hard for a private bank to be profitable when facing rivals that are not concerned about return on capital.”

In the absence of such market tests, it is only natural that PSBs disregard efficient use of scarce resources. And why should they not? After all, their survival and growth is guaranteed at someone else’s cost.

It should be noted that capital infusion is not a one-time unnecessary burden on the Indian taxpayers. By virtue of being the majority owners of public sector banks, Indian government has regularly been capitalising these PSBs.

Table 2 below shows that between 1985-86 and 2013-14, total net capital contribution of the government in these PSBs has been INR 874.3 billion.
Table 2: Public Sector Banks recapitalisation by the Government of India

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital contributed by the government (in Rupees billion)</th>
<th>Capital returned (in Rupees billion)</th>
<th>Net capital contributed by the government (in Rupees billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985-86 to 1992-93</td>
<td>40.00</td>
<td>0.00</td>
<td>40.00</td>
</tr>
<tr>
<td>1993-94</td>
<td>57.00</td>
<td>0.00</td>
<td>57.00</td>
</tr>
<tr>
<td>1994-95*</td>
<td>43.63</td>
<td>0.00</td>
<td>43.63</td>
</tr>
<tr>
<td>1995-96</td>
<td>8.50</td>
<td>0.00</td>
<td>8.50</td>
</tr>
<tr>
<td>1996-97</td>
<td>15.09</td>
<td>8.42</td>
<td>6.67</td>
</tr>
<tr>
<td>1997-98</td>
<td>27.00</td>
<td>1.38</td>
<td>25.62</td>
</tr>
<tr>
<td>1998-99</td>
<td>4.00</td>
<td>0.00</td>
<td>4.00</td>
</tr>
<tr>
<td>1999-00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>2000-01</td>
<td>0.00</td>
<td>0.48</td>
<td>-0.48</td>
</tr>
<tr>
<td>2001-02</td>
<td>13.00</td>
<td>1.76</td>
<td>11.24</td>
</tr>
<tr>
<td>2002-03</td>
<td>7.70</td>
<td>3.86</td>
<td>3.84</td>
</tr>
<tr>
<td>2003-04</td>
<td>0.00</td>
<td>1.10</td>
<td>-1.10</td>
</tr>
<tr>
<td>2004-05</td>
<td>0.00</td>
<td>0.88</td>
<td>-0.88</td>
</tr>
<tr>
<td>2005-06</td>
<td>5.00</td>
<td>0.00</td>
<td>5.00</td>
</tr>
<tr>
<td>2006-07</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>2007-08</td>
<td>99.96</td>
<td>0.00</td>
<td>99.96</td>
</tr>
<tr>
<td>2008-09</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>2009-10</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>2010-11**</td>
<td>186.17</td>
<td>0.00</td>
<td>186.17</td>
</tr>
<tr>
<td>2011-12</td>
<td>120.00</td>
<td>0.00</td>
<td>120.00</td>
</tr>
<tr>
<td>2012-13</td>
<td>125.17</td>
<td>0.00</td>
<td>125.17</td>
</tr>
<tr>
<td>2013-14</td>
<td>140.00</td>
<td>0.00</td>
<td>140.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>892.22</td>
<td>17.88</td>
<td>874.34</td>
</tr>
</tbody>
</table>

* Excluding INR 9.25 billion as a part of tier - II capital
** Includes Recapitalisation through World Bank loan of INR 126.17 billion

Source: Report on Currency and Finance 2006-08, RBI and Union Budget Documents

What is worrying is that there is no end in sight. Based on some conservative estimates, the then RBI governor D Subbarao had estimated in a public lecture in September 2012 that if the government opts to maintain its shareholding in PSBs at the current level, the recapitalisation burden on the
government will be of the order of INR 900 billion. By committing to remain the majority owners and showing no signs of reducing its stake in these PSBs, Government of India has made a long-term commitment to something that is totally inefficient and unnecessary (Subbarao 2013).

These resources do not exist in isolation. When the government goes to the market to raise funds for capital infusion in PSBs, they whisk away resources from other competing uses. The opportunity cost of these throwaways is the real cost of crime by the government of continuing to persist in the business of banking.

Now an argument can be made that PSBs are profit making bodies and therefore a source of regular income for the government exchequer as they receive regular dividends from them. But this argument also falls flat in the face of evidence.

Table 3 below compares the government receipts from and government contribution to PSBs over the last eight financial years.

**Table 3: Government receipt of dividend vs. government contribution of capital to PSBs**

<table>
<thead>
<tr>
<th>Year</th>
<th>Government receipt of equity dividend released by PSBs (in Rupees billion)</th>
<th>Net capital contributed by the government (in Rupees billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006-07</td>
<td>17.2</td>
<td>0.0</td>
</tr>
<tr>
<td>2007-08</td>
<td>28.1</td>
<td>100.0</td>
</tr>
<tr>
<td>2008-09</td>
<td>35.2</td>
<td>0.0</td>
</tr>
<tr>
<td>2009-10</td>
<td>41.3</td>
<td>0.0</td>
</tr>
<tr>
<td>2010-11</td>
<td>49.2</td>
<td>186.2</td>
</tr>
<tr>
<td>2011-12</td>
<td>55.8</td>
<td>120.0</td>
</tr>
<tr>
<td>2012-13</td>
<td>66.5</td>
<td>125.2</td>
</tr>
<tr>
<td>2013-14</td>
<td>24.2</td>
<td>140.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>317.5</strong></td>
<td><strong>671.3</strong></td>
</tr>
</tbody>
</table>

Source: RBI, Union Budget Documents, CMIE and CCS calculations

The data above shows that over the last eight years, government has contributed more than twice as much as they have received from PSBs. Once again proving that government’s presence in banking is a lose-lose proposition for Indian taxpayers.
Absence of a Level Playing Field

When an unlimited supply of capital is assured by the government, (by their commitment to continue to be a majority shareholder), PSBs can afford to under-price loans and other banking services to their customers compared to their private sector counterparts. What is unseen is that Indian taxpayers are the ones who are subsidising this behaviour.

An efficient banking system must have a level playing field so that different institutions compete to provide for consumer’s wants in the most efficient manner. Competition on a level playing field ensures that resources are allocated efficiently among its competing uses. However, when some institutions enjoy certain government granted privileges and others don’t, there is no meaningful competition left. Rules of the game are not the same for the two sets of banks in India; while competing for customers and business, PSBs enjoy benefits that private sector banks do not.

The biggest distortion of them all is the “belief that PSBs can never fail”. This belief is borne by the fact that the Indian Bank Nationalisation Act provides an explicit guarantee that all obligations of PSBs will be fulfilled by the Indian government in the event of a failure. Given the vast resources available with the government (through its ability to raise tax revenues and RBI’s role as government’s banker), this kind of explicit guarantee renders the probability of failure of a PSB almost negligible.

Viral Acharya in one of his recent papers has demonstrated that in the post-2008 period when the global financial markets were just hit by the crisis, while private sector banks with higher vulnerability to a crisis experienced deposit contractions, the reverse was true for PSBs. Using the RBI time-series deposit flow data, Acharya demonstrates that when the crisis initially hit India in 2008, both private and public sector banks had similar deposit growth rates. However, as the crisis worsened, the disparity between public and private sector was evident. In Q1 2008, deposits for both sectors grew by 10 percent. However, PSBs deposit grew by 1.7 percent (Q2), 5.5 percent (Q3), and 5.2 percent (Q4) as against a much lower growth of 0.0 percent (Q2), 1 percent (Q3) and -0.3 percent (Q4) for private sector banks (Acharya 2012). This clearly suggests that investors treated public and private banks
differently during the crisis based on their perceived risk valuations (owing in no small measure to the explicit and implicit guarantees enjoyed by the PSBs). Acharya’s research also finds that PSBs benefited from deposit growth even when they had greater vulnerability to a crisis.

Even with all these special privileges showered over them, PSBs have slowly and gradually been ceding ground to their private sector counterparts, as is evident by the decline of PSBs share in the Indian banking business. Clearly, in the absence of such privileges their decline will be even faster, not to mention desirable.

Thus we see that even with regular government support—both in terms of regular capital infusion and government guaranteed privileges—performance of PSBs has remained poor even against their own stated objectives. Let us now see how strong the reasoning behind nationalisation was.

**Spurious Reasoning Behind Nationalisation of Banks**

Various books and research papers have ascertained reasons for nationalisation of banks in India; they all broadly refer to the same causes. One such report is the RBI’s 2005 draft technical paper by the Internal Working Group on the priority sector lending. The report said:

“... One of the objectives of nationalisation of 14 major commercial banks was to ensure that no viable productive endeavor should falter for lack of credit support, irrespective of the fact whether the borrower was big or small.”

If in the absence of nationalised banks and centrally planned credit distribution, relatively little credit is available for rural areas, it does not follow that this is a bad thing for the economy as a whole, or even for the rural areas themselves. Imagine a world where all banks are privately owned and there are no government-mandated allocation of credit in a particular sector which leaves rural areas with “not enough credit”. The banking industry is
freely competitive, we should presume that relatively few rural borrowers are credit-worthy.

It should also be noted that when urban entrepreneurs with access to credit invest in producing goods, this benefits not only people who live in cities but also people who live in villages. There is an increase in the quantity and reduced price of various goods and services sold in villages and an increase in their quality and variety. The rural-urban divide is an illusion. Goods and services consumed by people living in cities and villages are similar. No wonder that the consumption basket—that comprises consumer price index (CPI) calculated every month by the Ministry of Statistics and Planning Implementation—are exactly the same for both CPI-Urban and for CPI-Rural.

Banks are institutions that collect savings from people with disposable income and low time-preference who want to save now and consume in future and channel these savings to people with high time-preference who want to consume/invest now. If the savings of people in villages stayed in villages, they wouldn’t be able to earn as much on their savings, and all of us will be worse-off as a result.

Money does not differentiate based on colour, religion, ethnicity or income. An unfettered financial market is blind to geographical factors and other such classifications. In a free market, savings in the form of bank credit chases its highest-valued use. That use may or may not be in a village. When capital from around the world comes to India, it’s only because they see a higher return for their savings here. They do not do this out of some sense of benevolence; as a result, both the person who brings in the capital and the place of business he/she prudently invests in prosper. Similarly, people in rural areas can benefit by trading with other productive parts of the country through the same financial system—for example by investing in shares and mutual funds. This process will work more effectively through private banks than through PSBs.

So it makes little sense to continue to subsidise these PSBs and keep them alive on the pretext that they are needed for credit allocation to the poor. What these PSBs actually achieve, through their priority sector lending goals
and other social objectives, is inhibit the movement of scarce savings/credit to its most valued uses.

**Profit: Not a Dirty Word**

Now that it has been established that not only did PSBs fail in achieving their stated “social goals” of financial inclusion but they also inefficiently allocated scarce credit, it is important that the pivotal role of ‘profit’ is not discounted altogether.

Profits are at the heart of economic activity. Actions and policies that depress profits cannot be good. It might hold good for someone who directly gets the proceeds of the depressed profits in the short-run, but in its long-term repercussions, it leaves us all poor. There can be no growth without profits—and to the extent that profits are depressed or forgone in the pursuit of some higher altruistic goal of ‘financial inclusion’—there will be neither growth nor inclusion. We hardly ever hear a politician or a bureaucrat talk about profits, except when they would like to tax profits more.

Somewhere in our public discourse on entitlements, corruption, social goals, development, inclusion etc., we have forgotten that it is profits that make the world go round.

None of the guardians of ‘development’ explicitly address the issue of how to generate more profits and then produce the conditions under which these profits will be spent in the accumulation of new capital, thus leading to more jobs which in turn produce income and which ultimately result in increased consumption. Speaking at the inaugural Bastiat Prize for Journalism 2002 ceremony, the winner Sauvik Chakraverti had said that the Indian society has a long culture of celebrating ‘profits’,

“We point out that Hinduism and Islam, the two major religions of India, both believe in the free market. Hindus discovered Adam Smith’s ‘invisible hand’ in just two little words: Shubh Laabh, which means profits are auspicious and augur well for society. And the Prophet Muhammad, peace be upon him, was a free trader who once said: ‘He who makes money pleases God’.
The Incentive Problem

If you know that you are going to be bailed out, no matter what, chances are you are not going to do a good job of serving consumers.

Public Sector Banks by definition are owned by the government or at least majority-owned by the government. The incentives of the management of the PSBs are not to maximise profits for their shareholders as they are not directly answerable to the Indian taxpayer, the real owners of these public sector banks. They are bureaucrats who are answerable to their political masters of the day. Since in a democracy, the governments keep changing, in the long-term they become answerable to no one. There is no rap on the knuckles if they fail to generate profits or if they sanctioned some loans that turned out to be bad. The value creation (maximisation) takes a back seat.

PSBs do not operate for maximisation of profits (as has been articulated many times by various apologists of PSBs). This does not give them an incentive to serve their customers in the best possible way. Regular bailing out of PSBs through capital infusion only makes it worse. Thus, as we see it, people are being taxed to help PSBs grow in operation to achieve goals that they have not been able to achieve in the past 44 years. This is despite the fact that these banks are guaranteed privileges that are not enjoyed by their private sector counterparts.

The great benefit of financing something using taxpayer’s money is that only a small fraction of the total cost is borne by an individual. While any one person only bears a small fraction of that cost, this means that the principle of dispersed costs and concentrated benefits comes into play. Thus, no one person or group is ever going to have the incentive to lobby against these banks, but it doesn’t negate the huge costs in any way.

So, is there a plan to correct past mistakes? Apparently not.

Non-existent Disinvestment Policy

The stated disinvestment policy of the government is to retain majority shareholding, i.e., at least 51 percent and management control of the public sector undertakings.
The government uses public funds for its various activities. Thus, it is the duty of the government to allocate these public funds to the best use possible. The government’s shareholding in public sector banks presents an opportunity cost in terms of the alternate usage of such funds. Moreover,

“The cross-country evidence on the impact of bank nationalization is not very encouraging. For example, La Porta et. al. find in a cross-country setting that government ownership of banks is negatively correlated with both financial development and economic growth. They interpret this as support for their view, which holds that the potential benefits of public ownership of banks, and public control over banks more generally, are swamped by the costs that come from the agency problems it creates: cronyism, leading to the deliberate misallocation of capital, bureaucratic lethargy, leading to less deliberate, but perhaps equally costly errors in the allocation of capital, as well as inefficiency in the process of mobilizing savings and transforming them into credit” (Banerjee, Cole and Duflo 2004, 2).

Thus we see that the international experience with public ownership of banks is not conducive for economic growth and has other far-reaching negative effects.

In a recent discussion paper by the RBI titled “Banking Structure in India — The Way Forward”, the recurring and frivolous cost to the government exchequer is acknowledged and some diluted version of total disinvestment is suggested.

“The Narasimham Committee had recommended reducing the government ownership in public sector banks to 33 percent. The contention is that it will help the government to reduce its allocation of scarce funds to recapitalize the banks from time to time. So, it is argued that as a prudent economic decision, there is a case for government to reduce its ownership stake in the PSBs. Reduction in fiscal burden on account on recapitalization of the PSBs can also be achieved by considering issue of non-voting equity shares or differential voting equity shares. Government could also consider diluting its stake below 51 percent in conjunction with certain protective rights to the government by amending the statutes governing the Public Sector banks.”
In Table 4 below, we have calculated the opportunity cost of the government’s shareholding in PSBs in terms of total realisable sum from the sale of government stake in PSBs under three different scenarios.

### Table 4: Realisable capital from the sale of government stake in public sector banks

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Name of the Bank</th>
<th>Current Government Shareholding</th>
<th>Total Market capitalisation (in Rupees billion)#</th>
<th>Government earning on retaining 51% stake (in Rupees billion)*</th>
<th>Government earning on retaining 33% stake (in Rupees billion)**</th>
<th>Government earning with 0% stake (in Rupees billion)***</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Central Bank of India</td>
<td>85.31%</td>
<td>58.9</td>
<td>20.2</td>
<td>30.8</td>
<td>50.2</td>
</tr>
<tr>
<td>2</td>
<td>United Bank of India</td>
<td>82.23%</td>
<td>13.3</td>
<td>4.2</td>
<td>6.6</td>
<td>11.0</td>
</tr>
<tr>
<td>3</td>
<td>Bank of Maharashtra</td>
<td>81.24%</td>
<td>26.8</td>
<td>8.1</td>
<td>12.9</td>
<td>21.8</td>
</tr>
<tr>
<td>4</td>
<td>Indian Bank</td>
<td>80.00%</td>
<td>40.1</td>
<td>11.6</td>
<td>18.8</td>
<td>32.0</td>
</tr>
<tr>
<td>5</td>
<td>Punjab &amp; Sind Bank</td>
<td>79.86%</td>
<td>11.8</td>
<td>3.4</td>
<td>5.5</td>
<td>9.4</td>
</tr>
<tr>
<td>6</td>
<td>Indian Overseas Bank</td>
<td>73.80%</td>
<td>48.0</td>
<td>10.9</td>
<td>19.6</td>
<td>35.4</td>
</tr>
<tr>
<td>7</td>
<td>IDBI Bank Ltd.</td>
<td>71.72%</td>
<td>92.4</td>
<td>19.1</td>
<td>35.8</td>
<td>66.2</td>
</tr>
<tr>
<td>8</td>
<td>UCO Bank</td>
<td>69.26%</td>
<td>55.4</td>
<td>10.1</td>
<td>20.1</td>
<td>38.4</td>
</tr>
<tr>
<td>9</td>
<td>Canara Bank</td>
<td>67.72%</td>
<td>117.6</td>
<td>19.7</td>
<td>40.8</td>
<td>79.6</td>
</tr>
<tr>
<td>10</td>
<td>Syndicate Bank</td>
<td>66.17%</td>
<td>52.0</td>
<td>7.9</td>
<td>17.3</td>
<td>34.4</td>
</tr>
<tr>
<td>11</td>
<td>Bank of India</td>
<td>64.11%</td>
<td>132.2</td>
<td>17.3</td>
<td>41.1</td>
<td>84.7</td>
</tr>
<tr>
<td>12</td>
<td>State Bank of India</td>
<td>62.31%</td>
<td>1,285.6</td>
<td>145.4</td>
<td>376.8</td>
<td>801.0</td>
</tr>
<tr>
<td>13</td>
<td>Corporation Bank</td>
<td>59.82%</td>
<td>46.6</td>
<td>4.1</td>
<td>12.5</td>
<td>27.9</td>
</tr>
<tr>
<td>14</td>
<td>Andhra Bank</td>
<td>58.00%</td>
<td>34.1</td>
<td>2.4</td>
<td>8.5</td>
<td>19.8</td>
</tr>
<tr>
<td>15</td>
<td>Oriental Bank of Commerce</td>
<td>58.00%</td>
<td>56.7</td>
<td>4.0</td>
<td>14.2</td>
<td>32.9</td>
</tr>
<tr>
<td>16</td>
<td>Union Bank of India</td>
<td>57.89%</td>
<td>80.2</td>
<td>5.5</td>
<td>20.0</td>
<td>46.4</td>
</tr>
<tr>
<td>17</td>
<td>Punjab National Bank</td>
<td>57.87%</td>
<td>201.6</td>
<td>13.9</td>
<td>50.1</td>
<td>116.7</td>
</tr>
<tr>
<td>18</td>
<td>Bank of Baroda</td>
<td>55.41%</td>
<td>283.8</td>
<td>12.5</td>
<td>63.6</td>
<td>157.2</td>
</tr>
<tr>
<td>19</td>
<td>Allahabad Bank</td>
<td>55.24%</td>
<td>46.9</td>
<td>2.0</td>
<td>10.4</td>
<td>25.9</td>
</tr>
<tr>
<td>20</td>
<td>Dena Bank</td>
<td>55.24%</td>
<td>20.1</td>
<td>0.9</td>
<td>4.5</td>
<td>11.1</td>
</tr>
<tr>
<td>21</td>
<td>Vijaya Bank</td>
<td>55.02%</td>
<td>21.0</td>
<td>0.8</td>
<td>4.6</td>
<td>11.5</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>2,725.0</strong></td>
<td><strong>324.0</strong></td>
<td><strong>814.0</strong></td>
<td><strong>1,713.7</strong></td>
<td></td>
</tr>
</tbody>
</table>

Notes:

#: Market capitalisation figures as on 1 November 2013 (Source: www.moneycontrol.com)

*: Retaining at least 51% stake in PSUs is the stated goal of Government of India (Source: www.finmin.nic.in)

**: Retaining 33% stake was recommended by the Narshimhan Committee

***: We recommend an immediate and complete sell-off of the government stake in PSBS
In Table 4 the total realisable sum from the sale of government stake in PSBs is to the tune of INR 1.7 trillion. Add to that one of the most conservative estimates of the amount needed for public sector bank recapitalisation over the next five years (by the former-governor D Subbarao) of INR 900 billion and we are looking at a sum total of INR 2.6 trillion of public money available with the government exchequer in terms of revenues from the sale of PSBs, as well as in terms of money not having to spend on PSBs recapitalisation.

Clearly, there are better uses of this money than continued recapitalising of incompetent PSBs. It would have made sense if there were no private individuals or organisations willing to provide the banking service. Historically world over, as in India’s case, it has been the other way round. First, private enterprise innovate and compete to provide a good or service in a mutually beneficial trade and then later the government comes in to either usurp the enterprise itself (as in the case of bank nationalisation) or impose prohibitive regulations that makes it difficult for businesses to operate, all in the name of ‘greater good’ or achieving some arbitrary ‘social goals’.

This is definitely not something that the government should be doing.

**Conclusion**

Given the huge cost involved in the continued government ownership of the banks, both direct and indirect, it is high time the government gets out of the business of banking completely. None of the stated goals have been achieved even after 45 years of the first wave of nationalisation of banks in 1969. Throwing good money after bad is not a very smart thing, especially for a capital-starved country like India.

While the idea of privatisation of PSBs may seem politically impossible today as it will need a simple majority of MPs agreeing to support the requisite amendment to the Bank Nationalisation Act of 1970 and other related laws, the far-reaching consequences make it imperative that we press ahead with such an idea. India has come a long way from the dark days of 1969-70, when the first set of banks were nationalised. It is much more acceptable today to talk about disinvestment in public sector enterprises and for a greater role of private enterprise in all walks of life. The mainstream public discourse in India
has not yet started talking about denationalisation of banks. However, some encouraging signs are becoming visible, as in the case of recent discussion paper by RBI.

The words ‘enterprise’ and ‘government’ do not go together at all. Given that banking is an enterprise just like any other, it would be best if it is left to the private entrepreneurs and institutions to provide this service and government should get out of it altogether. In view of the various seen and unseen costs involved, and with no apparent benefits associated with public ownership of banks, we call for a complete and immediate denationalisation of banking in India.
References


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Viewpoint 14: Denationalisation of Banking in India

AUTHOR

Kumar Anand
Senior Associate, Research
Centre for Civil Society
Contact: kumar@ccs.in

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