NEXT IAS

DAILY EDITORIAL ANALYSIS

TOPIC

PRIVATISATION OF BANKS IN INDIA

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Context

- Speaking recently at a FICCI forum, Chairman of the 16th Finance Commission, advocated Privatisation of Banks as a crucial reform to break free from the cycle of non-performing assets (NPAs) in India.

About the Privatisation of Banks in India

- **Privatisation** refers to the process of transferring ownership, property, or control of a business or entity from the government to the private sector.
- In recent years, the Indian government has been contemplating the **privatisation of public sector banks (PSBs)** as part of broader economic reforms that aims to enhance efficiency, improve governance, and attract private capital.
- However, the debate around bank privatisation is nuanced, with both proponents and critics voicing their opinions.
- **State-owned banks** provide stability and certainty to the banking environment. Their role extends beyond mere profit-making; they **serve as pillars of economic growth and financial inclusion**.
    - In contrast, **private banks** operate primarily for profit, which can lead to risky behaviour and short-term decision-making.

Historical Context

- India's banking landscape underwent a **major shift in 1969** when the government **nationalised 14 private banks**, followed by **six more in 1980**. It transformed the sector, making it more inclusive and focused on priority sectors like agriculture, employment, and rural development.
- India embarked on its journey of privatisation during the landmark economic reforms of 1991, known as the **'New Economic Policy' or the LPG (Liberalisation, Privatisation, Globalisation) policy.**
- PSBs became the backbone of India's economy, supporting growth, development, and financial inclusion.

Policy Consideration

- **Narasimham Committee-I (1991):** It was set up during a time of economic crisis in India. Its recommendations aimed to reform the banking sector that include:
    - **Creating a 4-tier hierarchy** for the Indian banking system, with major public sector banks at the top and rural development banks at the bottom.
    - **Establishing a quasi-autonomous body** under theRBI for supervising banks and financial institutions.
    - Deregulating interest rates and ensuring full disclosure of banks' accounts.
    - Setting up an **Asset Reconstruction Fund.**
- **Narasimham Committee-II (1998) (aka Banking Sector Committee):** It reviewed the progress of reforms and proposed further strengthening measures:
    - Recommended the merger of major public sector banks **to enhance international trade.**
    - Introduced the **concept of "Narrow Banking"** for banks with high NPAs, allowing them to invest in short-term and risk-free assets.
    - Advocated reforms in the **RBI's role as a regulator.**

Recent Push for Privatisation

- **Profitability and Consolidation:** Over the years, several rounds of consolidation have resulted in fewer but larger PSBs. These banks have turned profitable, prompting policymakers to consider privatisation. The goal is to create a leaner, more efficient banking system.
- **Equitable Growth:** Nationalised banks played a crucial role in equitable regional growth, extending services to neglected areas. Rural branches multiplied, reducing dependence on moneylenders.
    - Moreover, PSBs supported green, blue, and dairy revolutions, contributing significantly to infrastructural development.

Recent Developments

- **Privatisation Plans (2021):** In the Union Budget for FY 2021-2022, it was announced **to privatise two public sector banks** aimed to bring focus to low-performing PSUs, grant lenders autonomy, and boost the banking and NBFC sectors. However, the specific banks for privatisation are yet to be finalised.
- **RBI's Acceptance of Recommendations (2021):** An internal working group submitted recommendations on the ownership and corporate structure of private sector banks.
  - The RBI accepted 21 out of 33 recommendations, including raising the cap on promoters' stake from 15% to 26% over 15 years. The group also suggested a monitoring mechanism to ensure fit and proper control of promoting entities.

Arguments Favouring Bank Privatisation

- **Efficiency and Profitability:** Private banks are perceived to be more profit-oriented and nimble, which could lead to better management practices, streamlined operations, and improved financial performance.
  - However, it's essential to recognise that public banks play a critical role in ensuring financial inclusion. They extend banking services to previously underserved regions, sectors, and marginalised groups.
  - While private banks may appear more efficient in terms of pure profitability, public banks excel when financial inclusion indicators are considered.
- **Government's Monopoly:** The government ownership in the Public Sector Banks (PSBs) account for almost 70 percent of the banking assets. This has led to a kind of virtual monopoly and hence reduced competition, and inefficiency.
- **Previous Experience:** The strategic disinvestment has led to an increase in overall efficiency gains, which later translated into higher returns for the shareholders. Possibility of leveraging MFIs and NPBs for Social causes such as DBT, MGNREGA Wages, Pradhan Mantri Jan Dhan Yojana, etc.
- **Reduced Burden on Public Exchequer:** Reduce the burden on the Government by doing away with the need for undertaking their recapitalisation to comply with the higher BASEL III requirements.

Arguments Against Bank Privatisation

- **Monopoly Concerns:** Privatisation could lead to concentration, cartelization, and reduced competition. Ensuring affordable banking services for all remains a challenge.
  - However, PSBs serve a broader social purpose beyond profit. They support vulnerable sections, rural areas, and priority sectors.
- **Financial Exclusion:** When public sector banks (PSBs) are privatised, there's a risk that private banks may focus more on profitable urban areas, neglecting rural and underserved regions. PSBs have historically played a crucial role in providing banking services to remote and marginalised communities.
- **Security Concerns:** Privatisation removes the sovereign guarantee behind PSB deposits. Some worry that this could make household savings less secure. When people deposit money in PSBs, they often trust the government's backing. Privatisation might erode that confidence.
- **Underreporting of Non-Performing Assets (NPAs):** In the past, there have been instances of underreporting of NPAs by both private and public sector banks. Critics argue that privatisation might exacerbate this issue, as private banks may have incentives to downplay NPAs to maintain their image and stock prices.
- **Monopoly and Cartelisation Risks:** Privatisation concentrates banking power in the hands of a few private entities. Critics fear that this could lead to monopolistic practices and cartelization. A lack of competition might harm consumers by limiting choices and potentially increasing fees and charges.

Case Study: Bank Failures in the US

- Even in the United States, where private banks dominate, failures are not uncommon. In 2023, several significant banks collapsed. This pattern has persisted for decades, affecting hundreds of private banks.
- The very ownership model that Panagariya recommends for India—privatisation—has seen repeated failures elsewhere.

Conclusion and Way Forward

- **Selective Approach:** The government's proposed plan focuses on smaller PSBs, leaving out major players like State Bank of India, Punjab National Bank, and Bank of Baroda. This targeted approach aims to balance efficiency gains with social objectives.
- **Regulatory Vigilance:** Regardless of ownership, robust regulatory oversight remains crucial. RBI must continue to ensure stability, transparency, and prudent lending practices.
- **Public-Private Partnership:** Perhaps a hybrid model—where PSBs retain their social mandate while partnering with private players for efficiency—could be explored.
- **Balancing Reform and Stability:** Addressing NPAs is crucial, but it's equally vital to maintain a stable banking system. State-owned banks can be reformed without necessarily privatising them entirely.
  - Striking the right balance between efficiency, accountability, and public interest is the key.
- Privatisation of banks in India is a tightrope walk. Striking the right balance between efficiency, social responsibility, and financial stability is essential.

Source: BL

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Mains Practice Question

[Q] Analyse the role of privatisation in transforming the Indian banking sector. How does the privatisation of public sector banks align with the government's goals of financial inclusion. Discuss with relevant examples.