CHAPTER - 4

PSU BANKS AND THE BANKING INDUSTRY IN INDIA – A PROFILE

4.1 Types of banks in India

The Indian banking sector has two kinds of scheduled banks i.e. scheduled commercial banks and scheduled co-operative banks. Under the first category of scheduled banks, four types of entities are found in India based on their establishments and legal obligations. They are:

i) Public Sector Banks - PSU Banks (26),

ii) Private Banks (25),

iii) Foreign Banks working in India (29) and

iv) Regional Rural Banks (91)

The second category of scheduled cooperative banks consists of:

i) Scheduled Urban Co-operative banks (55) and

ii) Scheduled State Co-operative Banks (16)

(Note: figures in brackets denote the number of banks in each category)
Under public and private sector, banks are more clearly defined according to nationalization and privatization. The banks under public sector (PSU banks) are Nationalized Banks (20) and State Banks of India (with its associates, the number comes to 6). Under Private Banks category, banks are divided into two types i.e., Old private banks (17) and New-private banks (8).

The first phase of financial reforms resulted in the nationalization of 14 major banks in 1969 and resulted in a shift from Class Banking to Mass Banking. This in turn resulted in a significant growth in the geographical coverage of banks. Every bank had to earmark a minimum percentage of their loan portfolio to sectors identified as “priority sectors”. The manufacturing sector also grew during the 1970s in protected environment and the banking sector was a critical source. The next wave of reforms saw the nationalization of 6 more commercial banks in 1980.

After the second phase of financial sector reforms and liberalization of the sector in the early nineties, the PSU banks found it extremely difficult to compete with the new private sector banks and the foreign banks. The new private sector banks first made their appearance after the guidelines permitting them were issued in January, 1993. These banks due to their late start have access to state-of-the-art technology,
which in turn helps them to save on manpower costs and provide better services.

4.2 Reforms and the Banking System

In the post liberalization-era, Reserve Bank of India (RBI) has initiated quite a few measures to ensure safety and consistency of the banking system in the country and at the same point in time to support banks to play an effective role in accelerating the economic growth process. One of the major objectives of Indian banking sector reforms was to encourage operational self-sufficiency, flexibility and competition in the system and to increase the banking standards in India to the international best practices (Reddy 2002). Although the Indian banks have contributed much in the Indian economy, certain weaknesses, i.e. turn down in efficiency and erosion in profitability had developed in the system. In view of these conditions, the Committee on Financial System (Narsimham Committee) was formed.

Reserve Bank of India has implemented banking sector reforms in two phases. The first reform focused on introduction of several prudential norms, major changes in the policy framework, and formation of competitive atmosphere. The second phase of reforms began in 1997 with aim to reorganization measures, human
capital development, technological up-gradation, structural development which helped them for achieving universal benchmarks in terms of prudential norms and pre-eminent practices.

The reform process has shifted the focus of public sector dominated banking system from social banking to a more efficient and profit oriented industry. While the reform process has resulted in the private sector replacing the government as the source of resources for PSU banks, the infusion of private equity capital has led to shareholders challenges to bureaucratic decision making. PSU banks also face increasing competition not only from private and foreign banks but also from growing non-banking financial intermediaries like NBFCs, mutual funds and other capital market entities. The competitive pressures to improve efficiency in the banking sector has resulted in a switch from traditional paper based banking to electronic banking, use of information technology and shift of emphasis from brick and mortar banking to use of ATMs.

4.3 Current Scenario

The industry is currently in a transition phase. On the one hand, the PSU banks, which are the mainstay of the Indian banking system are
in the process of shedding their flab in terms of excessive manpower, excessive Non Performing Assets (NPAs) and excessive governmental equity, while on the other hand the private sector banks are consolidating themselves through mergers and acquisitions.

PSU banks, which currently account for a majority of the total banking industry assets are saddled with huge NPAs, falling revenues from traditional sources, lack of modern technology and a massive workforce while the new private sector banks are forging ahead and rewriting the traditional banking business model by way of their sheer innovation and service. The PSU banks are currently working out challenging strategies even as around 20 percent of their massive employee strength has dwindled in the wake of the successful Voluntary Retirement Schemes (VRS) schemes.

The private players however cannot match the PSU banks' great reach, great size and access to low cost deposits. Therefore one of the means for them to combat the PSU banks has been through the merger and acquisition (M&A) route. For instance, HDFC Bank’s acquisition of Times Bank, ICICI Bank’s acquisition of ITC Classic, Anagram Finance and Bank of Madura. The UTI bank- Global Trust Bank merger however opened a pandora’s box and brought about the realization that all was not well in the functioning of many of the private sector banks.
Private sector banks have pioneered internet banking, phone banking, anywhere banking, mobile banking, debit cards, Automatic Teller Machines (ATMs) and combined various other services and integrated them into the mainstream banking arena, while the PSU banks are still grappling with disgruntled employees in the aftermath of the VRS schemes.

Meanwhile the economic and corporate sector slowdown has led to an increasing number of PSU banks focusing on the retail segment. Many of them are also entering the new vistas of insurance. PSU banks with their phenomenal reach and a regular interface with the retail investor are the best placed to enter into the insurance sector. Banks in India have been allowed to provide fee-based insurance services without risk participation, invest in an insurance company for providing infrastructure and services support and set up of a separate joint-venture insurance company with risk participation.

4.4 Performance of the Banking Industry

The Indian banking sector is competitive and recorded as growing in the right trend (Ram Mohan, 2008). Indian banking industry has increased its total assets more than five times between March 2000 and March 2010, i.e., US$250 billion to more than US$1.3 trillion. The banking industry recorded CAGR of 18 percent as compared to country's average GDP growth of 7.2 percent per
annum during the same period. The commercial banking assets to GDP ratio has increased to nearly 100 percent while the ratio of bank’s business to GDP has recorded nearly twofold increase, from 68 percent to 135 percent. The overall development has been lucrative with enhancement in banking industry’s efficiency and productivity. It should be underlined here that financial turmoil hit the western economies in 2008 and the distress effect widened to the majority of the other countries but Indian banking system survived the distress and showed stable performance. Indian banks have remained stable even throughout the height of the sub-prime catastrophe and the subsequent financial turmoil.

4.5 Governmental Policy

After the first phase and second phase of financial reforms, in the 1980s commercial banks began to function in a highly regulated environment, with administered interest rate structure, quantitative restrictions on credit flows, high reserve requirements and reservation of a significant proportion of lendable resources for the priority and the government sectors. The restrictive regulatory norms led to the credit rationing for the private sector and the interest rate controls led to the unproductive use of credit and low levels of investment and growth. The resultant ‘financial repression’ led to decline in productivity and efficiency and erosion of profitability of the banking
sector in general. There was very little for the PSU banks to do in the area of credit risk management due to the highly regulated environment.

This was when the need to develop a sound commercial banking system was felt. This was worked out mainly with the help of the recommendations of the Committee on the Financial System (Chairman: Shri M. Narasimham), 1991. The resultant financial sector reforms called for interest rate flexibility for banks, reduction in reserve requirements, and a number of structural measures. Interest rates have thus been steadily deregulated in the past few years with banks being free to fix their Prime Lending Rates (PLRs) and deposit rates for most banking products. Credit market reforms included introduction of new instruments of credit, changes in the credit delivery system and integration of functional roles of diverse players, such as, banks, financial institutions and non-banking financial companies (NBFCs). Domestic Private Sector Banks were allowed to be set up, PSU banks were allowed to access the markets to shore up their CARs.
4.6 **Implications of Some Recent Policy Measures**

The allowing of PSU banks to shed manpower and dilution of equity are moves which lent greater autonomy to the industry. In order to lend more depth to the capital markets the RBI had in November 2000 also changed the capital market exposure norms from 5 percent of bank's incremental deposits of the previous year to 5 percent of the bank’s total domestic credit in the previous year. A few private sector banks however went overboard and exceeded limits and indulged in dubious stock market deals.

The move to increase Foreign Direct Investment FDI limits to 49 percent from 20 percent came as a welcome announcement to foreign players wanting to get a foot hold in the Indian Markets by investing in willing Indian partners who are starved of networth to meet CAR norms. Ceiling for FII investment in companies was also increased from 24.0 percent to 49.0 percent and have been included within the ambit of FDI investment.

4.7 **Credit Policy Implications for PSU banks**

PSU banks that imbibe new concepts in banking, turn tech savvy, leaner and meaner post VRS and obtain more autonomy by keeping governmental stake to the minimum can succeed in effectively taking on the private sector banks by virtue of their sheer size. Weaker PSU
banks are unlikely to survive in the long run. Consequently, they are likely to be either acquired by stronger players or will be forced to look out for other strategies to infuse greater capital and optimize their operations.

### 4.8 Banking Regulation and Supervision

Banking is one of the most heavily regulated businesses in India since it is a very highly leveraged (high debt-equity ratio or low capital-assets ratio) industry. In fact, it is an irony that banks, which constantly judge their borrowers on debt-equity ratio, have themselves a debt-equity ratio far too adverse than their borrowers! In simple words, they earn by taking risk on their creditors’ money rather than shareholders’ money. And since it is not their money (shareholders’ stake) on the block, their appetite for risk needs to be controlled.

The main goal of all regulators is the stability of the banking system. However, regulators cannot be concerned solely with the safety of the banking system, for if that was the only purpose, it would impose a narrow banking system, in which checkable deposits are fully backed by absolutely safe assets – in the extreme, currency. Coexistent with this primary concern is the need to ensure that the financial system operates efficiently. Banks need to take risks to be in business despite a probability of failure. In fact, Alan Greenspan puts it very
succinctly, 'providing institutions with the flexibility that may lead to failure is as important as permitting them the opportunity to succeed’

The twin supervisory or regulatory goals of stability and efficiency of the financial system often seem to pull in opposite directions and there is much debate raging on the nature and extent of the trade-off between the two. Though very interesting, it is outside the scope of this research to elaborate upon.

4.9 Bailouts

A major recent development in the Indian Banking Industry is the phenomenal increase in bailouts and restructuring of loans. In India banks and successive governments have bailed out sectors and companies in trouble (Business Standard 26th Nov., 2011). Banks have restructured debt of Rs. 1,21,150 crore of 259 companies from 2001-02 to September, 2011. The top bailouts in the last decade were as under:

1. Power (2003): To clear Rs. 37,000 crore of dues owed by SEBs to central utilities such as NTPC, 24 States issued tax-free bonds with a 8.5% interest after a three-way deal between the Centre, States and RBI. As per a formula, the surcharge was waived off on these dues;
2. Steel (2003): When new steel projects were in trouble, banks restructured Rs. 20,000 crore debt of Essar Steel Ltd., Ispat Industries Ltd. and Jindal Vijayanagar Steel Ltd. (now JSW). Interest rate was reduced by 5% while equity of these companies was written off 40%.

3. Banks restructured debt worth Rs. 10,000 crore of both listed and unlisted real estate companies. The central bank allowed banks to roll over loans without treating these as non-performing assets. Beneficiaries: DLF, Unitech, HDIL, Omaxe, Sobha Developers.