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NEED FOR PRIVATE SECTOR BANKS' CONSOLIDATION IN INDIA

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A sound banking system is the backbone of any nation for the economic upliftment and meeting the social objective of equality, free enterprise and opportunities for growth. To meet this objective Government of India first nationalised the fourteen major private banks in 1969 as the private banks in the country did not serve all sections of society. These banks belonged to various business houses and catered largely to their financial requirements / interests.

The takeover of these private banks resulted in easy reach of masses to banking services for their savings and credit requirements. Having assessed the positive impact of nationalisation another round of takeovers was implemented in 1980. In this phase six more private sector banks were nationalised taking the total nationalised bank number to twenty.

Post liberalization of Indian economy in 1991 the government appointed various committees to review the banking sector and recommend appropriate policy changes. Recommendations of Narasimham Committee I (NCI) and (NC II) laid the roadmap for reforms in banking sector. NC I was primarily constituted to examine all aspects relating to structure , organisation, and functions and procedures of the Indian financial system. The suggestions of NC-I related to reforms in the Banking, Capital Markets and Insurance Sector. These reforms are popularly known as 'Structural Adjustmments' or Liberalization. The major recommendations included Reduction in Liquidity Ratio, Abolition of Directed Credit Programmes, Free Determination of Interest Rates , Improvements in Accounting System of the Banks. Reconstitution of the Banking System, Abolition of Branch Licensing , Ending Dual Control of Banks by Ministry of Finance and Reserve Bank of India and Liberalization of the Capital Markets. However one significant recommendation was that The banking system should be restructured so as to have 3 or 4 large banks which could become international in character.

Simultaneously Government announced a New Economic Policy on July24, 1991 ushering the early phase of reforms. The new policy deregulated industrial economy in a substantial manner. Through introduction of international best practices in risk-based capital requirement standards and uniform accounting practice for income recognition and provisioning requirements for bad debts in line with Basle I norms the competition in banking system was enhanced considerably. The competition had been enhanced by way of transparent norms for entry of Indian Private Sector, Foreign and Joint Venture Banks. Also permission for foreign direct investment (FDI) in financial sector was granted.

Banking business though looking very attractive and profitable has its own challenges. The foremost being to keep the deposits mobilised from Public safe and returning it to them timely on demand with the contracted rate of return. Profits have to be generated by judicious deployment of capital and the deposits (liabilities) in avenues which give higher return than to be paid to depositors and the shareholders on their equity. Public sector banks have the added responsibility to do social lending, the objective for which these were nationalised. Private and foreign banks too had such social targets but they either purchased portfolios from Public Sector Banks or preferred to pay penalties.

As a result of the liberalization of the financial sector in 1991 many new private sector banks sprang up. These attracted customers of Public Sector Banks with spacious air-conditioned premises, Internet Banking, ATMs and debit cards. Many of these banks even though technologically better, were devoid of hardcore professionalism of public sector banks and the larger private sector banks. Consequently, they faced challenges to survive and decided to exit timely by selling their newly acquired banking business. The economy witnessed many post-liberalisation mergers between these banks and smaller private sector banks. The mergers took place as the weak banks could not withstand competition from new generation banks.

There were 22 mergers between 1993 to 2015. A public sector New Bank of India which was a weak bank was merged in Punjab National Bank at the instance of Government of India. This brought the number of nationalized banks to nineteen.

After the liberalization of the banking sector a new phase of healthy competition between private and public sector banks evolved and their loan books started growing rapidly. The loan book of public sector banks alone grew to Rs.18 lakh crore by 2008. This was the time when new sectors of economy were being opened viz. Infrastructure and Industrial sectors like Coal Mining, Iron Ore mining, Steel making , Roads and Ports construction and Telecom. Since Private Sector banks had a single point agenda to boost their fee based income they wore the mantle of loan syndicators and aggregators. Though mainly public sector banks aggressively participated to take a share in project financing the private sector banks too took some share to broaden their balance sheets to look attractive to investors. The growth of advances of public sector banks, private banks and foreign banks from 2010 to 2020 is given in Table 1.

It can be observed that private sector banks shyed away from lending during the economic boom period in the cyclic downturn after 2008. Their share in total advances portfolio of Scheduled Commercial Banks was only 21.26 percent by 2015 which went up significantly to 36.04 percent by 2020 which was the period when many Public sector banks were put under AQR (Asset Quality Review) and subsequently under Prompt Corrective Action (PCA) of Reserve Bank of India. The large spurt of advances in private sector banks put these banks in difficulty later.

Table 1. Share of Different Groups Of Banks in Advances in Percentage

Year	Public Sector Banks	Private Sector Banks	Foreign Banks
2010	77.24	18.08	4.68
2015	74.28	21.26	4.46
2020	59.80	36.04	4.16

Source: Reserve Bank of India.

The government of India amalgamated some nationalized banks into twelve big banks to avoid need for their frequent recapitalization as it had to put in a huge amount of Rs.2.11 trillion in Oct.2017 in these banks. This was necessitated to supplement capital of these public sector banks which had been eroded substantially due to burgeoning non-performing loans (NPLs).

Most of the smaller weak banks are having poor financials and management issues making them suitable candidates for sale through mergers or acquisitions. A sample study of three important financial ratios of seven private lenders for the last five years (2017 to 2021) describes the poor financial condition of some of them as under:

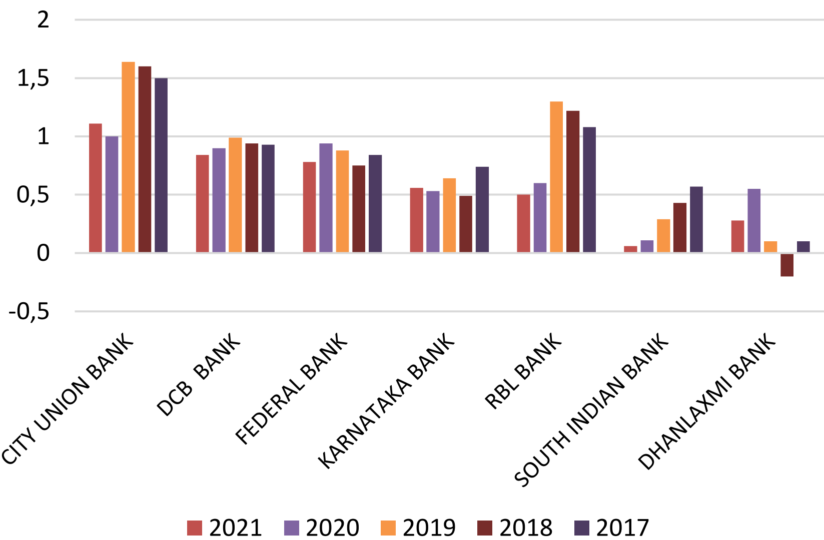

Figure 1. Return on Assets

Source: Reserve Bank of India.

Return on Assets provides insight on how effectively a company generates profits from its assets. Banks with high ROAs derive better profits from the same amount of assets than others with low ROAs. The stocks of banks with high ROAs are more likely to perform well over the long term. The ideal ratio for banks is considered to be 1 and above. It can be observed from Fig.1 that Return on Assets which is one of the important parameters of a banks' financial assessment continues to be poor for banks like Dhanlaxmi Bank, South Indian Bank, RBL Bank and Karnataka Bank whereas it is at a better level for City Union Bank, DCB Bank and Federal Bank for the years under analysis.

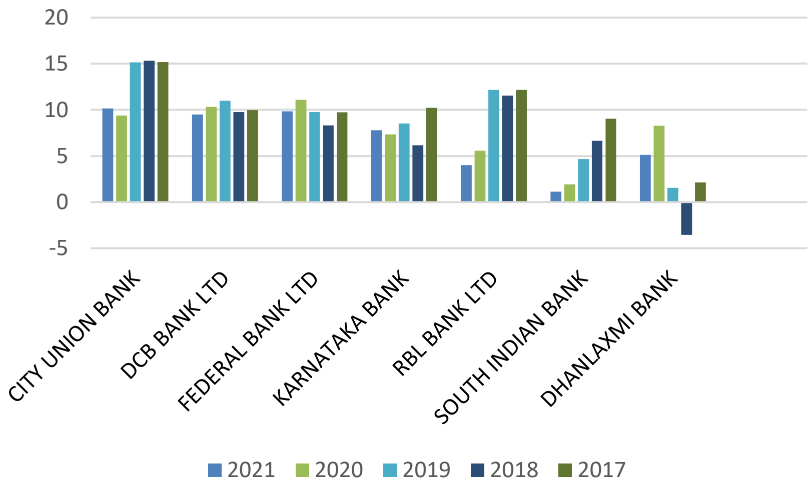

Figure 2. Return on Equity

Source: Reserve Bank of India.

Return on equity (ROE), also known as return on common equity (ROCE), is a measure of a business's profitability. Specifically, it is a ratio describing the rate of profit growth a business generates for shareholders and owners. The ideal ratio is considered to be in the range of 10-15 percent. This ratio the Return on Equity is unsatisfactory for RBL Bank, South Indian Bank and Dhan Laxmi Bank for the years between 2017-2021 as reflected in Fig.2. It is going down below 5 percent for all the three banks for the current financial year 2021.

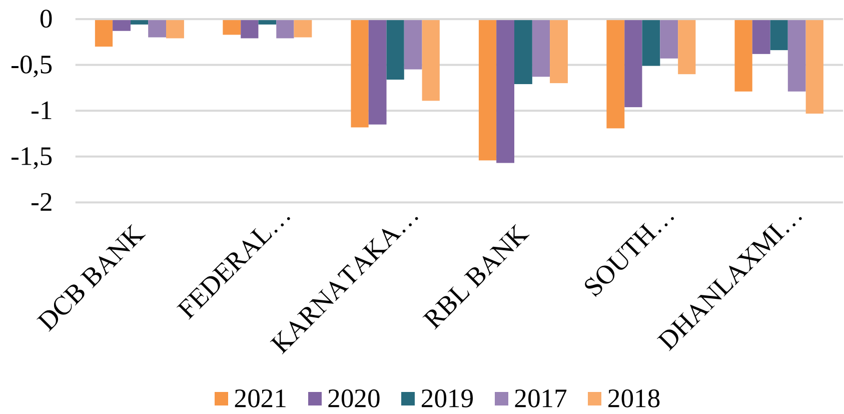

Figure 3. Operating Profit

Source: Reserve Bank of India.

Operating profits is an indirect measure of efficiency. The higher the operating profit, the more profitable a banks' core business is. Several factors can affect the operating profit. These include the pricing strategy of the business, cost of borrowings (Deposits) and yield on advances. It can be observed that almost all banks under study are having negative operating profits. It is however highly negative for Karnataka Bank, RBL Bank, South Indian Bank and Dhanlaxmi Bank. Also the operating results of private banks indicate that City Union Bank, RBL Bank, South Indian Bank and Dhanlaksmi Bank are having very high ratio of NPLs in the range of 5 percent and above.

There are many studies in India and in other countries which emphasize that governments have to be transparent in dealing with restructuring of banks. Also, any forbearance should be avoided as the delays in recognizing the banking problems makes it worse with time lag. Also, it is to be borne in mind that failure of a banking entity has a spiral effect on the economy and the depositors lose faith in the system. In India there have been recent cases of stress at Yes Bank, Lakshmi Vilas Bank (LVB) and PWC Bank where government had to intervene and take steps to ward off insolvency of these banks. Some of the private sector lenders are having stress in their operations as reflected by their ROA, ROE, Operating Profits and NPLs. It is high time that Government of India and Reserve Bank of India give due attention to this area and amalgamate the weak private lenders with the strong ones like ICICI bank, Kotak Mahindra Bank and HDFC Bank.