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Public Sector Banks in India: Analysis of the Current Crisis and the Road ahead

GAYATHRI S PILLAI[1]

ABSTRACT

Public Sector Banks in India have shouldered many reforms in the past decades. Currently, public sector banking is undergoing a huge crisis. The objective of this research paper is to provide solutions for establishing a safe and stable Public sector Banking in India. In order to provide proper solutions, a brief history has been explained, and also statistics has been used to analyse the current situation. The challenges are mentioned by categorising them under different heads dealing with issues of NPAs, recapitalization burden, governance issues, lack of quality of human resource, etc. Considering these mentioned challenges as the basis, recommendations have been provided for governance reforms and finance reforms. An attempt was made to critically analyse the situation by providing examples from foreign countries, taking into account Indian background. On a concluding note, solutions have been provided in such a manner keeping the character of Public Sector Banks as such, without focussing much on privatisation. Emphasis has been given to radical reconstruction policies. Best efforts have been undertaken to address the major issues faced by PSBs.

I. INTRODUCTION

"Public Sector Banks are the lifelines of the Indian economy. If their health is not good, then economy at large will also suffer"-this was the statement made by Arun Jaitley, India's former Union Minister of Finance & Corporate Affairs, at the Conference on 'Reforms Journey for EASE in Public Sector Banks (PSBs).' [2]

The fundamental question that arises from seeing this statement is "what is the huge role these banks perform?" Public sector banks are the banks in which the government holds ownership of more than 50%. Government ownership provides a sense of security to the customers. This results in them having a huge customer base.[3]

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[1] Author is a student at National University of Advanced Legal Studies, India.

[2] Arun Jaitley, *Public Sector Banks are lifeline of Indian economy, says the Union Finance Minister, Shri Arun Jaitley*, PRESS INFORMATION BUREAU (Feb. 28, 2019, 5:12PM), https://pib.gov.in/Pressreleaseshare.aspx?PRID=1566653.

[3] *What is Public Sector Bank? Definition, Working, Advantages and Disadvantages*, ASK ANY DIFFERENCE, (last visited March 17,2021), https://askanydifference.com/what-is-public-sector-bank/.

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In India, the role played by banks in economic growth and development is beyond par. Public sector banks have played an enormous role in spreading banking services to India's most rural and remotest parts. Considering the enormous welfare measures shouldered by PSBs, it is essential to maintain its credibility and importance. Deep research is required to provide practical solutions to the challenges faced by PSBs and ensure a steady banking system in the country.[4]

II. A BRIEF HISTORY

India had a well-established commercial banking system even at the time of independence. In 1949, RBI became a state-owned institution and also witnessed the enactment of banking regulation. It contained the legal framework for the supervision of commercial banking activity in our country. The committee of all India rural credit survey report was the first step towards nationalization and is still the locus classicus on this topic. The primary recommendation was one integrated commercial banking system with a particular focus on rural credit. The government took the imperial bank, and it was renamed as state bank of India, and many banks of the princely states became its subsidiary. This happened during the 1950s. The 1950s and 1960s were the periods that witnessed considerable progress in the banking system, and it catered to the needs of industries and commerce at that time.

Social control in the banking sector emerged in 1967. The objective was to change the distribution of credit by commercial banks. The close connection between big business and big banks was meant to be cut down. The appointment of a full-time chairman with special practical knowledge was meant as a measure of professionalism. It also had provisions for the takeover of banks under exceptional circumstances.

Political issues led to inadequacies of social control. This resulted in the government nationalizing 14 major scheduled commercial banks in 1969. It was a measure to cater to the development of the economy, incorporating national principles and objectives. After 11 years, six more banks were nationalised. These banks were above the cut-off size. A number of development financial institutions which were entirely state-owned were set up at the national and the state level. Refinance institutions also came into existence in the field of agriculture and industry. Insurance also became a state monopoly.[5]

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[4] Charan Singh, *An Essay on Banking and Macroeconomics: Role of Public Sector Banks in India*, INDIAN INSTITUTE OF MANAGEMENT BANGALORE (last visited March 17,2021), https://www.iimb.ac.in/node/1676.

[5] Y V Reddy, *Public Sector Banks and the Governance Challenge: Indian Experience*, (Apr. 18, 2002), https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/28065.pdf.

In 2016, the insolvency and bankruptcy code was enacted. Jurists and business people looked this up as this had a huge potential to change the situation. It was implemented to change the insolvency resolution. [6] Various committees like the PJ Nayak committee and the Narasimhan committee were constituted to introduce banking reforms. Projects like Sashakt was introduced. In 2021, PSBs in India include 12 nationalized banks. In all these banks government of India is the major stakeholder. The biggest bank in India is the public state bank of India. In 2020, SBI recorded sales worth 2.5 trillion rupees. In the last decade, India has merged with those associate banks.[7]

III. Critical analysis of the current scenario through the lens of statistics

Currently, India is undergoing a very decisive phase in its financial sector. It is almost close to a breaking point. These government-owned banks have been struggling under the accruing NPAs. Looking into the statistics would help in creating a comprehensive picture. NPAs at PSBs are at least 6.8 trillion rupees in the year 2020. [8] As per FICCI-IBA, NPA is expected to rise in the first half of 2021. The survey showed that "However, in terms of outlook, nearly 68 percent of respondent bankers expect the NPA levels to be above 10 percent in the first half of 2021". The financial stability report by the reserve bank, released in January 2021, showed that the gross NPAs might have a rise up to 13.5 percent by September, under the baseline stress scenario.[9]

Even though there has been a slight decrease compared to the previous year, it is still a strong indicator of the weaker situation. All the national banks except SBI and IDBI have been trading at a loss. In the years 2016 and 2017, taxpayers have witnessed a loss of 400 billion rupees. Compared to Europe, the criteria used to measure the situation is somewhat limited, so these values may not be the actual condition.[10]

These statistics are indicative of the critical condition of the banking industry of our country. Even the measures adopted by India are short-term oriented. The need of the hour is a

[6] *Short Note on Insolvency and Bankruptcy Code, 2016 (IBC, 2016)*, IBC LAWS (July. 30,2019), https://ibclaw.in/short-note-on-insolvency-and-bankruptcy-code-2016/.
[7] *Gross non-performing asset value of public sector banks in India from financial year 2018 to 2020*, STATISTA, (Mar. 19, 2021), https://www.statista.com/statistics/1064657/india-gross-npa-public-sector-banks-india/.
[8] *Id.*
[9] *NPAs expected to increase in first half of 2021: FICCI-IBA survey*, ET AUTO.COM (Mar. 18,2021), https://auto.economictimes.indiatimes.com/news/industry/npas-expected-to-increase-in-first-half-of-2021-ficci-iba-survey/81566004.
[10], *India's Public Sector Banking Crisis: Whither the Withering Banks*, OLIVER WYMAN (last visited March 19, 2021), https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2017/aug/Indias_Public-Sector_Banking_Crisis_Whither_The_Withering_Banks.pdf.

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sustainable approach to deal with this crisis. The questions which are posed before us on observing these statistics are plenty. A healthy discussion and deep research considering the Indian situation are critical. It should take into consideration questions like

-What are the reasons which left Indian public sector banks in such an extreme condition?

-How much damage it has inflicted upon the economy so far?

-What approaches have India adopted so far, and what were the reasons for its failure?

-What should be incorporated to develop a long-term sustainable state, especially governance reforms. Addressing these questions will be the starting point for the reforms needed in the sector. It is not easy to develop a single policy that will address these issues. It is essential to take a step-by-step approach.

IV. CHALLENGES FACED

"The challenge with public sector banks is that there are many internal organizational issues that are not being addressed or resolved," says Ashvin Parekh, a financial advisor. "The whole system has been in gradual decay over the years." [11] The first step toward solving the issue is to analyze the challenges and issues faced by the sector.

A rough look at the public sector banks' issues will make us believe that it is the competition faced by the private sector and modern technology. However, more profound research shows that the challenges are many and often have a long history. Some of the challenges faced by the PSBs are as follows:

(A) Granting long-term loans leading to mounting NPAs: Since the collapse of the Lehman brothers in 2008, which resulted in a global financial crisis, the Indian banking sector has also been facing many issues. To escape from this, Indian banks introduced policies involving lower interest rates and large-scale lending by banks. This phase resulted in big companies taking big loans. Even though the spending helped in quick recovery, the long-term effect was the mounting NPAs. It completely eroded the stable and healthy nature of Indian public sector banks. As per 2018, of the total NPAs, 85 percent are on PSB loans. These mounting NPAs will lead to sluggish lending. The ability to produce further credits diminishes. [12]

(B) Recapitalization burden: Bank recapitalization, in simple terms, means infusing capital into the PSBs. This is done in order to meet the capital adequacy norms. This is done using

[11] MG Arun et.al., *Fixing the banking mess*, INDIA TODAY (Dec 18,2020, 11:40 PM), https://www.indiatoday.in/magazine/cover-story/story/20201228-fixing-the-banking-mess-1750945-2020-12-18.

[12] *Id.*

different methods.[13]

The recapitalization results in creating a massive burden on the budget as it is costly and done frequently. This is one of the strongest arguments made against PSBs. [14] Although recapitalization is done to restore the stable position of PSBs, it is costly and not at all a sustainable option. There is no reason for the taxes paid by taxpayers being used to maintain an investment, where there are comparatively no returns.[15] This financial burden has consequences like the government will have to reduce the expenditure made in other sectors and increase borrowing. This shows that the requirement of additional capital is detrimental to the economy.

(C) Poor choice of top management: In the case of public sector banks, the government holds a significant stake. Senior officials of the government hold even the top positions in these banks. Often, they have political banking and will hence result in inadequate government standards. This will affect the credibility of the banking sector and lead to mounting NPAs. The RBI controls all commercial banks by the provisions of the Banking regulations Act of 1949. However, the section dealing with the powers to remove management and directors does not apply to the scenario of public sector banks. This shows the upper hand of the government over the powers of RBI.[16]

(D) Asset quality deterioration and additional capital requirement: RBI prepares financial stability reports. It mentions the asset quality of the public sector banks. Assets include loans and investments made by banks. Asset quality specifies the number of loans repaid in the form of principal and interest by the borrowers. [17]According to the financial stability report, the asset quality is deteriorating. It implies that the quality of loans is coming down. It means that it is turning into stressed assets. Stressed assets are comprised of NPAs, written-off assets, and restructured loans.[18]The government will have to infuse more capital in order to boost the performance of the PSBs. As already mentioned, it adds to the financial burden.

(E) Capital adequacy requirement: Potential strength of nationalized banks is indicated by

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[13] What is bank recapitalisation and how is it done?, THE ECONOMIC TIMES (Dec. 30, 2020, 03:53 PM), https://economictimes.indiatimes.com/budget-faqs/what-is-bank-recapitalisation-and-how-is-it-done/articleshow/73264682.cms.
[14] Acharya, Shankar,*'A Vision for Banking'*, THE ECONOMIC TIMES, (Dec 6,2001)
[15] K.B.L Mathur, *Public Sector Banks in India: Should they be privatised*, 37 ECON.POLITICAL WKLY2245, 2246-47, https://www.jstor.org/stable/4412218.
[16] Ashwini Mehra, *Testing times for public sector banks' leadership*, MINT (Sep. 6,2017,01:05 AM), https://www.livemint.com/Opinion/MfVNtOKsNJi7TiZykQ1lbP/Testing-times-for-public-sector-banks-leadership.html.
[17]Tojo Jose, *What is stressed assets?*, INDIAN ECONOMY(Feb. 14,2016), https://www.indianeconomy.net/splclassroom/what-is-stressed-assets/.
[18] *Id.*

the profitability and capital adequacy position showed by RoA and CRAR.[19] According to the RBI estimates, the capital adequacy ratio can fall to 13.3% by March 2021 from its year-ago under the baseline and 11.8 % under the very severe stress scenarios.[20] A higher value of CRAR indicates a higher ability to absorb risks. However, in the case of PSBs, it is lesser than the standard requirement. It shows the crisis of PSBs.

(F) Lack of quality of human resources: Even in the technological era, human resources add to any organization's advantage. Private sector banks have rightfully incorporated human resources in order to gain an advantage. Even after the absence of a level playing field in terms of age, quality, talents, etc. PSBs continue to suffer from the issue of a highly centralized and regulated HR system. Their training system lacks clarity and did not help in developing appropriate skills needed for the sector. The promotions under the standardized regulations have resulted in several irregularities and discrepancies in various cadres. PSBs can also not contain the flight of talented people to other newer banks because of PSB's skewed compensation structure. There is much rigidity in staff deployment as the bank, and industry-level settlements govern them. PSBs have also been following a common one fit for all formats in the case of performance appraisal of officers. This does not take proper care of the individual, organizational needs. [21]Summing up, PSBs have a long way to go in terms of HR development.

(G)Increased competition and modern technology: The digitalization of the world has also affected the banking sector. Competition has evolved from NBFCs, fintech companies, and the newer banks. PSBs lack in this respect and regulatory restrains further adds on to worsen the situation. Digitization has provided opportunities for the customers to compare the price and service provided. Nowadays, customers are transaction-driven. This will make them less beneficial for the PSBs.[22]

(H) Debates on privatization: Public sector banks are often compared with their foreign counterparts. It is based upon financial measures of performance. These comparisons have paved the way for the idea of privatization of PSBs.[23] The proposal for privatization of PSBs arises from the financial burden and the earlier mentioned reasons. The government will have

[19] Mathur, *supra* note 15, at 2252.
[20]Manojit Saha, *Why public sector banks are struggling to raise capital but private banks are having it easy*, THE PRINT (27 Aug. 2020, 2:12 PM), https://theprint.in/economy/why-public-sector-banks-are-struggling-to-raise-capital-but-private-banks-are-having-it-easy/490029/
[21] Anil K. Khandelwal, *Criticality of HR Reforms for Public Sector Banks in the New Era*, 40 ECON.POLITICAL WKLY 1128,1128-29(2005), https://www.jstor.org/stable/4416360.
[22] Mehra, *supra* note16.
[23] T. T. Ram Mohan & Subhash C. Ray, *Comparing Performance of Public and Private Sector Banks: A Revenue Maximisation Efficiency Approach* ,39 ECON.POLITICAL WKLY 1272,1272 (2004), https://www.jstor.org/stable/4414806.

to pump money into the system to keep the public sector banking sector alive. The mounting NPAs and recapitalization burden adds to the issue. The PJ Nayak panel committee in 2014 recommended bringing down the stake of government in these banks.[24] This led to only two consequences-either to privatize the PSBs or radically reconstruct the whole system.

V. WAY FORWARD-RECOMMENDATIONS FOR GOVERNANCE AND FINANCE REFORMS

"Why do we need public sector banks taking into consideration these many challenges?"- this is a question that will probably arise considering the grave situation Indian public sector banks are in. However, it is imperative to acknowledge its role in society. Private entities may be helpful in the development of the country. Nevertheless, considering India's population and societal structure, public sector banks are essential for ensuring the welfare of the common people. PSBs play an essential role in transmitting resources even to the remotest and rural areas of our country.

Often, international sources cite the benefits of privatization. However, when it comes to India, the grounds satisfying privatization is not enough. It cannot be assured that the private sector cannot go through a banking crisis. It should be acknowledged that the effects of the crisis on private entities will be much higher than public sector banks if the legal framework is not strong enough to support them. [25] So it is better to keep the public sector banks as such by radically reconstructing the same. Our aim should be to create a stable public sector banking system that is more specialized and oriented towards public welfare with a proper strategy. These reforms can be mainly be categorized into two- financial sector reforms and governance reforms

(A)Financial reforms: As already discussed, mounting NPAs is one of the primary reasons behind the falling PSBs. So, we have to take measures in order to address it. These financial reforms are often short-term measures. In all these matters, the decisions of the central government play a dominant role.

Firstly, the closing of non-profitable segments would prove helpful. In order to meet the capital adequacy norms, government recapitalizes banks. In order to make the recapitalization more effective, non-profitable segments and branches can be closed. This will reduce the transfer of resources into unwanted areas. A proper committee could be set up to analyze the non-

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[24] C.R.L. Narasimhan, *Nayak panel stirs up a row*, THE HINDU (June 7,2016 ,7: 37 AM), https://www.thehindu.com/opinion/columns/C_R_L__Narasimhan/nayak-panel-stirs-up-a-row/article6044614.ece

[25] Mathur, *supra* note 15, at 2255

profitable areas of the public sector banking system.

Secondly, securitizations are one of the practical plans to pump credit. When many struggles are going on in the financial market, reactivating the securities market can benefit. Some of the securitizations guaranteed by public institutions necessitate the beneficiaries to reinvest some of the invested funds in new loans. It will ensure the adequate flow of money in the economy. It will also help in risk reduction, thereby enabling the banks to lend loans.

Thirdly, the sale of loan portfolios is another excellent measure that can be implemented. It will help the banks to focus and cater to their most significant tasks. This practice of selling NPL exists in Nordic and Anglo-Saxon countries. In Spain also, most of the banks have a non-performing asset management unit. [26]India could also adopt such measures and create units to tackle the specific issue.

Fourthly, bank mergers are also a viable solution. India has already witnessed the merger of various banks in the recent past. One such example is the merger of Dena Bank and Vijaya Bank with the Bank of Baroda. Bank mergers have various benefits. It helps in the pooling of resources. It also helps in reducing the total expenditure. Although common people will have to face some initial difficulties owing to transition, it will be pretty helpful in the long run.

Fifthly, instruments similar to central public sector enterprises exchange-traded funds and bank investment companies should be used. Exchange-traded funds should be used to recapitalize the banks. Such recapitalization will not increase the fiscal deficit and will not dilute governmental control. It will help to reduce the government's stake in public sector banks. A bank investment company could also be established in which all the public sector holdings could be transferred. Such a company could meet capital requirements, and they could infuse the raised funds into the banks.

Sixthly, plans could be adopted from our foreign counterparts. Infusion of such ideas should be tailored according to the needs of Indian society. One such example is the asset protection scheme of the UK government. In this, the government insures a set of distressed assets. The bank will retain the first portion of losses, but the government will provide protection for the losses which are unexpected. This will be beneficial for reducing the risk of the bank from losses and help in recapitalizing itself. Such measures could be incorporated for capitalization without any ill effects, which we normally face while recapitalization. [27]

[26] Miriam Gidron & Reyes Pariente, *Getting a bank's balance in shape*, BBVA (last visited March 20,2021), https://www.bbva.com/en/getting-banks-balance-shape/.
[27] *Supra* note 10, at11-12

Some other measures like change in reserve requirement and injection of the capital in a limited matter are also beneficial. It should be noted that financial measures often have only short-term validity and be returnable. If we could tailor policies that will reduce costs from the government, it would be a considerable achievement.

(B) Governance reforms: Considering the radical reconstruction of the banking structure, governance reforms play a significant role. The recommendations of the PJ Nayak panel committee would be of huge significance here.[28]Some of the governance reforms which can be introduced are as follows:

Firstly, reducing the stake of government in PSBs will be a huge reform. This has already been mentioned in the PJ Nayak committee recommendations. [29]It would be beneficial because the dominant role of the government will be sustained. At the same time, it will give the banks the freedom to operate more freely.

Secondly, the top management of these banks should be made more efficient. Rather than selecting people having political backing, people should be selected based on merit.

Thirdly, the rigidity of the system should be reduced. Currently, the enormous governmental role keeps away certain investors. This affects capital investment.

Fourthly, the most crucial HR reforms have to be introduced in the banks. The importance of HR in organizational change is a widely recognized fact. Factors like management credibility, execution of corporate strategy, innovation, etc., are directly linked to HR. PSBs should develop a written policy for HR reforms. The CEO should ensure capability building. The productivity level of the employees should be improved by massive skill upgradation. A sound leadership development system has to be ensured. [30]PSBs could also introduce a reward system based on the performance of employees.

Summing up, sound corporate governance principles have to be followed. It should include good top management, board overall responsibility and should formulate its policies and formulas.

VI. Conclusion

Reconstructing the Indian banking scenario will be a continuous process. The PSBs should make amendments in policies relating to the issues coming up. The strong will from the part of

[28]Report of the committee to review governance of boards of banks in India, https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/BCF090514FR.pdf
[29] *Id.*
[30] Khandelwal, *supra* note 21, at 1131-32.

the government is essential to create a stable and healthy environment for the growth of the PSBs. The system as a whole should be made more flexible to adapt to future needs.

As already mentioned, financial reforms alone will not be sufficient to ensure the smooth running of PSBs. The role of government is very crucial for such reforms. Considering the history and the welfare provided by PSBs, it is vital to keep them safe. India is still a developing country. In order to shoulder welfare policies, strong public sector banking is inevitable. The recommendations mentioned in this research paper will be useful for assisting the reform measures of PSBs.

It may, therefore, be safely concluded that maintaining the character of the public sector banks is crucial for development. However, the current crisis must be resolved using a robust legal system, strong governance reforms, and financial reforms. If actions are taken on a war footing approach, rather than focussing on privatization, Indian PSBs could be brought back to their glory.

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