ANNUAL SPECIAL ISSUE

PSBs
Challenges Ahead

The government's reform blueprint—deeper consolidation, reduced bureaucratic constraints on boards, access to global capital, and strengthened legal and governance frameworks—is directionally sound. However, as international experiences suggest, scale and capital deliver results only when anchored in genuine board autonomy, professional management, and rigorous accountability.

Ajay Chandra Pandey, Former AGM and Faculty, State Bank of India Academy, Gurugram

After six quiet years, discussions around a fresh round of Public Sector Bank (PSB) reforms have resurfaced. Between 2017 and 2020, the government undertook a sweeping consolidation drive, reducing the number of PSBs from 27 to 12 through a series of carefully calibrated mergers. These moves, supported by the Indradhanush Plan and a series of structural reforms, bolstered capital strength, enhanced governance, and created institutions with the scale needed to serve a rapidly growing economy. Combined with the clean-up brought by the Insolvency and Bankruptcy Code (IBC), these reforms helped stabilize the PSBs and rebuild public and market confidence in them. But the landscape is shifting rapidly. With Viksit Bharat as the overarching national aspiration, credit demand accelerating, and technology fundamentally rewriting the rules of financial intermediation, several foundational questions relating to PSBs that had faded into the background have returned to center stage: How large should PSBs become in a fast-expanding economy? What is the right ownership and governance model that can balance public purpose with competitive efficiency? How much operational autonomy is required for innovation and agility? And are their risk management and digital capabilities future-ready? Together, these questions have revived the debate on whether PSBs now need a more ambitious reform push—that can equip them not just to keep them in the race, but to lead in an increasingly dynamic and technology-driven financial ecosystem.

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Merger 2.0

As India heads toward becoming the world's third-largest economy by 2027-28, the Viksit Bharat 2047 vision sets an ambitious goal: to develop a select group of PSBs into truly global-scale institutions. The aspiration is to elevate at least two PSBs to a stature comparable with the world's leading banks—reflecting India's growing economic weight and financial influence. At present, no public or private sector bank features among the world's top 20 banks. State Bank of India—the country's largest PSB—ranks 43rd globally by assets. Finance Minister Nirmala Sitharaman has repeatedly underscored the need for world-class Indian banks that can stand shoulder-to-shoulder with global peers. Strengthening and scaling up PSBs is increasingly viewed as a strategic necessity. Bigger, stronger PSBs would be far better positioned to finance Indian companies going global, expand India's footprint in international markets, and anchor the country's growing influence in the global financial system. Further consolidation of PSBs is one pathway to achieving this scale—creating institutions large enough to compete for a place among the world's top 20 banks. Recent media reports indicate that the government is actively assessing the possibility of a new consolidation round—potentially aimed at creating two or three PSBs with the scale required to enter the world's top 20 by size. Various permutations and combinations are being discussed. Although initial consultations with the Reserve Bank of India (RBI) are reportedly underway, the government has clarified in Parliament that no formal proposal for mergers or consolidation has been initiated. Should consolidation move forward, a detailed roadmap is expected to crystallize around 2026.

Is bigger better for PSBs?

In an economy aiming for global leadership, India needs banks with balance sheets that reflect the scale of its ambition. Larger PSBs would be far better positioned to finance the big-ticket infrastructure, manufacturing, renewable energy, logistics, and digital projects that will shape the country's next phase of growth. Technology is no longer a choice—it is the foundation of resilience, competitiveness, and future-ready banking. Larger PSBs will have the scale to invest in cloud migration, cybersecurity, artificial intelligence (AI)-driven credit models, and full enterprise-architecture renewal—investments that smaller banks often struggle to fund. Mergers can sharpen operational efficiency by eliminating overlaps in branch networks, staff functions, IT systems, and back-office processes. This rationalization directly improves productivity, strengthens cost-to-income ratios, and enhances overall profitability. Consolidation also tends to reinforce governance: larger entities benefit from stronger boards, unified risk frameworks, and more rigorous control systems—all of which help curb fraud, limit non-performing assets (NPA) slippages, and reduce operational vulnerabilities.

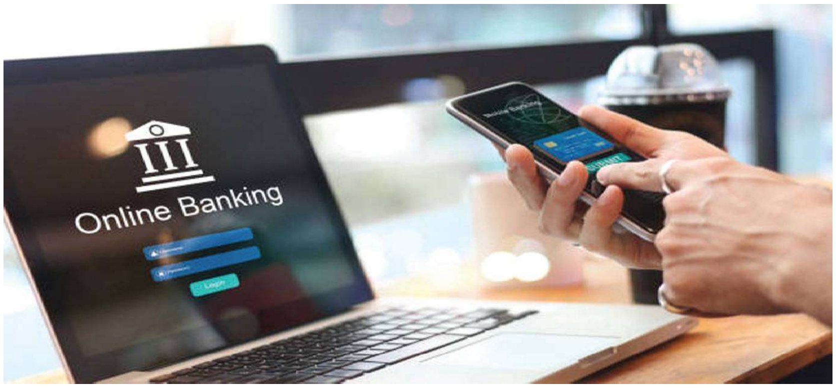
Ajay Chandra Pandey

While consolidation may help create globally competitive PSBs, large mergers bring substantial integration challenges. Differences in culture, processes, and technology platforms can lead to operational disruptions, IT-migration risks, and temporary deterioration in customer service. Near-term financial performance may also weaken due to merger-related costs and the absorption of weaker balance sheets, which can leave the stronger bank carrying legacy asset-quality stress for years. HR and industrial-relations issues add another layer of complexity, as uncertainty around redeployments, seniority, transfers, and promotions often affects staff morale and productivity. Another concern is the rise in concentration risk. As PSBs grow larger, they risk becoming "too big to fail," heightening systemic vulnerabilities and increasing the government's implicit burden of support. The recent IndiGo fiasco is a telling reminder: when one dominant player stumbles, the shockwaves can jolt an entire sector. It underscored a broader truth—over-concentration, whether in aviation or banking, can turn the failure or mismanagement of one institution into a sector-wide disruption. While bigger may seem better, thinning the banking herd comes with significant trade-offs. Reducing the number of players risks stifling competition and narrowing the field for innovation and customer choice. The most acute danger, however, lies in the potential for geographic and sectoral credit gaps. As merged giants chase higher margins and global ambitions, they often streamline branch networks, leaving rural heartlands and MSMEs—who rely on deep-rooted, local relationships—in the cold. This shift toward corporate and international lending threatens to sideline priority sectors like agriculture, potentially stalling years of progress in financial inclusion.

Managing very large banks introduces its own set of challenges. Scale demands advanced governance, risk management, and ALM capabilities—areas where many PSBs are still maturing. Technology and cybersecurity risks rise as well, with complex integrations of legacy systems increasing the likelihood of cyber vulnerabilities.

FDI In public sector banks

Another reform that could materialize in the second half of 2026 is an increase in the foreign direct investment (FDI) limit for PSBs. Several credible reports—including some citing government and RBI officials—indicate that the idea of raising the cap to 49%, while retaining at least 51% government own-



ership in a phased manner, has been discussed at various levels. Officially, the Ministry of State for Finance has clarified that no such proposal is under active consideration at present, as the government seeks to maintain a careful balance between pursuing reform momentum and exercising prudent caution. Even so, the issue is expected to remain part of the wider policy dialogue in 2026 as PSB reforms progress.

Recent developments strengthen this possibility. The government's decision to raise the FDI ceiling in the insurance sector from 74% to 100% signals a broader openness to foreign capital in strategic financial industries. At the same time, major foreign investors have shown renewed interest in India's private banking sector—with Blackstone investing in Federal Bank, Emirates NBD taking a majority stake in RBL Bank, and SMBC acquiring a stake in Yes Bank. These moves demonstrate a strong global appetite for Indian banking assets and may encourage policymakers to revisit FDI norms for PSBs as part of a larger reform package. Raising the FDI cap in PSBs from 20% to 49% could reduce their reliance on periodic government recapitalization while opening access to global capital, technology, and managerial expertise. Yet, only raising the FDI limit by itself will not attract serious investors unless accompanied by governance reforms—most importantly, easing or removing the 10% voting-rights cap to better align ownership with influence. Bringing PSBs closer to regulatory parity with private lenders—where foreign ownership can reach 74% and voting rights up to 26%—could unlock meaningful investor interest and spur inflows into large institutions such as SBI, Bank of Baroda, and Punjab National Bank. Again, without credible governance reforms, serious long-term capital will not flow into PSBs. The government needs to shift to an arm's-length governance framework that grants PSBs autonomy and accountability comparable to private banks.

However, greater foreign participation could complicate governance within a public-sector framework and heighten concerns around financial security and data protection. While global capital can strengthen balance sheets and impose market discipline, it may also reduce the government's flexibility to deploy PSBs as public policy instruments, especially in downturns. Political sensitivities and potential union resistance add to the challenge.

Other operational reforms

Greater operational and decision-making autonomy for PSB boards is firmly on the reform agenda to enable faster, commercially sound decisions and strengthen governance standards. This would involve reconstituting boards with a higher share of truly independent directors experienced in relevant fields and giving fresh momentum to lateral hiring—an initiative that has so far been implemented only on a limited scale. The reform roadmap also envisages wider use of market-based capital-raising tools, such as qualified institutional placements and selective stake dilution, to bolster PSB balance sheets while preserving government control. In parallel, governance and legal reforms are being considered to professionalize management, enhance board accountability, and streamline decision-making by updating banking laws and reducing administrative oversight. Taken together, these measures aim to bring PSBs closer to market discipline and global best practices, without compromising their public sector character.

Survival to relevance

Today, PSBs have largely moved past the balance sheet stress of the last decade. Asset quality has improved, capital buffers are stronger, and profitability has stabilized across most large PSBs, allowing them to regain financial stability. But stability is not the finish line; it is merely the starting block. The real challenge has shifted from financial repair to strategic relevance in a landscape that no longer waits for the slow-moving. For PSBs to remain central to India's $5 tn growth ambition, reform must move decisively from intent to implementation. The government's reform blueprint—deeper consolidation, reduced bureaucratic constraints on boards, access to global capital, and strengthened legal and governance frameworks—is directionally sound. However, international experience is unequivocal: scale and capital deliver results only when anchored in genuine board autonomy, professional management, and rigorous accountability.

If implemented with clarity, conviction, and careful sequencing, these reforms can yield fe wer but substantially stronger PSBs—institutions capable of financing India's global ambitions while competing credibly with private and international peers. Their enduring relevance will hinge on whether reform momentum delivers genuine autonomy, market discipline, and accountability. The coming three to five years will be decisive in determining whether PSBs emerge as resilient national champions or slide into a gradual loss of competitiveness. ■

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