GS FOUNDATION FOR CSE 2024
ECONOMY-7
RBI, BANK NATIONALIZATION, BANK CONSOLIDATION

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2. RBI

1) **KEY FUNCTIONS –** DISCUSSED IN PREVIOUS BOOKLET

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- **Background:**
  - **Where does RBI gets its Revenue from?**
    - **Foreign exchange transactions** (RBI buys when dollar is cheap and sells when it is expensive (i.e. high in demand)
    - **Interest Income** (from government bonds, Liquidity Adjustment Facilities etc.)
    - It also earns a **management commission** on handling the borrowing of state governments and the central government.
  - **Where does RBI spend money?**
    - Most of the RBI's expenditure is on printing of currency notes, and on staff, besides the commission it gives to banks for undertaking transactions on behalf of the government across the country and to primary dealers, including banks, for underwriting some of these borrowings.

- The **Surplus (Revenue - Expenditure)** is used for transfers to government and increasing the RBI reserves.
  - **Section 47 of the RBI Act, 1934**: "After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation fund [and for all other matters for which] provision is to be made by or under this Act or which are usually provided for by bankers, **the balance, of the profits shall be paid to the Central Government**"
  - **Section 48 of the RBI Act, 1934** exempts the bank from paying any income tax, wealth tax or super tax.

- **RBI's Reserves:**
  - The RBI has three mains funds that together comprise its reserves. These are:
    - **Currency and Gold Revaluation Account** (CGRA) (basically the Economic Capital Buffer)
      - It is mantained by RBI to take care of currency risk, interest rate risk and movement in gold prices risk.

        - Unrealized gains or losses on valuation of foreign currency assets (FCA) and gold are not taken to the income account but instead accounted for in the CGRA. Net balance in CGRA therefore varies as per the size of the asset base, its valuation and movement in the exchange rate and price of gold.
        - When CGRA is not sufficient to fully meet exchange losses, it is replenished from the CF.
        - **The balance** of CGRA increased from Rs 664,480 crores in June 2019 to Rs 977,141 crore as on June 30, 2020. It was mainly due to depreciation of rupee and the rise in the international prices of gold.
        - It is by far the **largest** reserve account of RBI and makes up the significant bulk of RBI's reserve.
    - **Contingency Fund** (CF):
        - It is a provision meant to meet **unexpected and unforeseen contingencies**, including depreciation in the value of securities, risks arising out of monetary/exchange rate operations, systematic risks and any risk arising on account of the special responsibilities enjoined upon the Reserve Bank.
        - The CF is the **second biggest fund** of RBI after the CGRA
    - **Asset Development Fund** (ADF)
        - It makes up a much smaller share of reserves and is also focused on contingent times.

- **Other RBI Accounts**
    - » **Investment Revaluation Account - Foreign Securities** (IRA-FS): The unrealized gains or losses **on revaluation of foreign dated securities** are recorded in the IRA-FS.
    - » **Investment Revaluation Account - Rupees Securities (IRA-RS):** The unrealized gains or losses on revaluation of Rupee securities (IRA-RS) is accounted for in Investment Revaluation Account - Rupee Securities (IRA-RS).

- In 2018, there was a difference between RBI and Finance Ministry on the amount of reserve RBI should keep.

- Following this, **RBI in consultation with the Central Government,** had constituted a **committee chaired by former RBI governor Bimal Jalan to review the Extant Economic Capital Framework (ECF) for the RBI**.
    - **Key Recommendations of the Revised Economic Capital Framework** (ECF) for the RBI:
        - » Make a **distinction** in the economic capital of the RBI between '**revaluation reserves**' and '**realized equity**'.
            - **Revaluation Reserves** are risk buffer against market risks and not available for transfers.

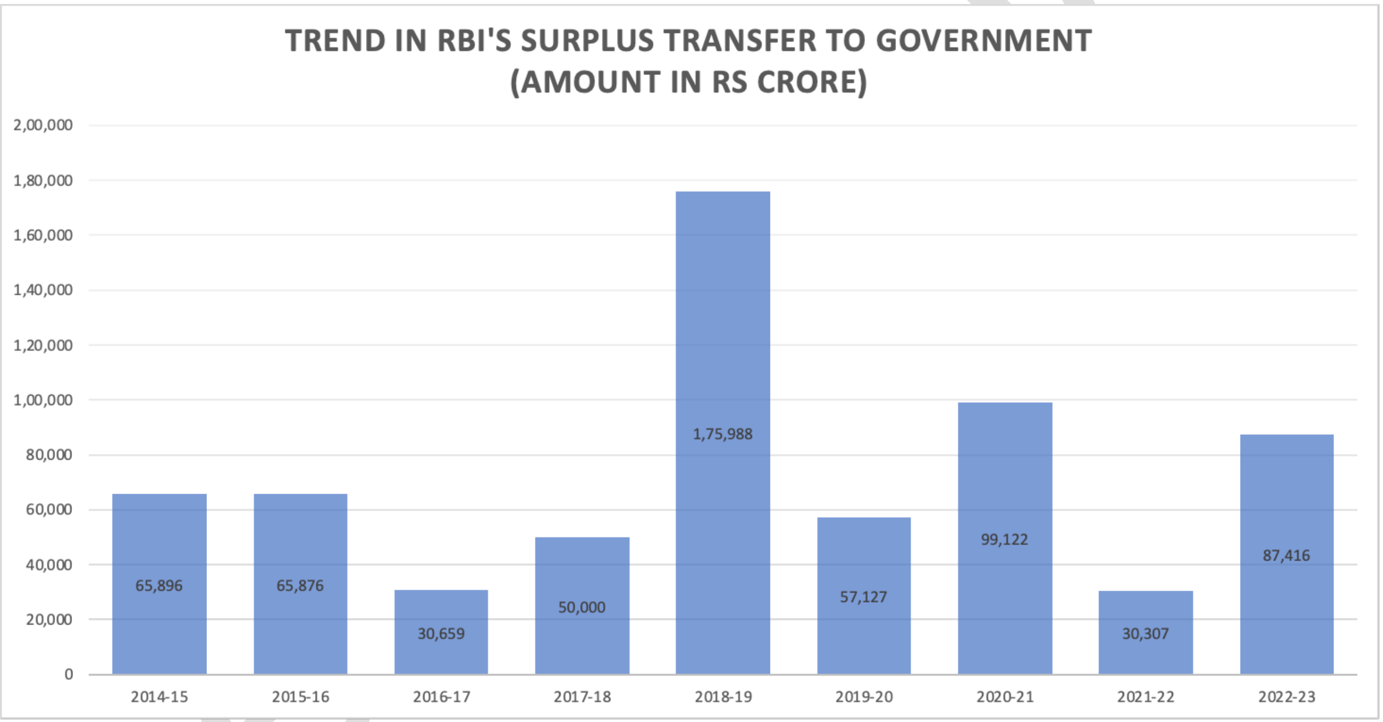
» **Economic Capital Levels** (basically CGRA) should be in the <u>range of **20-24.5%** of the balance sheet</u>

» <u>RBI should maintain a **Contingent Risk Buffer**</u> - which mostly comes from CF - of <u>between **5.5-6.5%** of the Central Bank's Balance Sheet</u>. **The excess amount** should be transferred to government.

» <u>A transfer of surplus</u> from the RBI to the government in a <u>phased manner</u> in accordance with the existing practice

- **The committees recommendations** were based on the <u>consideration of the role of central banks' financial resilience, cross-country practices, statutory provisions and the impact of RBI's pubic policy mandate and operating environment on its balance sheet and the risk involved</u>.

- In Aug 2019, **RBI board accepted all the above recommendations of the Bimal Jalan Panel committee to transfer Rs 1.76 lakh crore of surplus to government**.



– **RBI's Central Board** approves the transfer of surplus (i.e dividend) to the Union government for every accounting year.

– **Analysis: Positives**

i. **As RBI's only shareholder** government has rights over the profits of RBI.

ii. **Further, RBI is** amongst **the most capitalized central banks** in the world, so reduction of excess capital shouldn't be a bad idea.

iii. **More productive utilization of RBI's Cash**: Excess capital in the reserves of RBI is in a way underutilization of resource which could have been used in infrastructure development or other constructive purposes having higher multiplier effect.

iv. **Helps government deal with economic slowdown**

- For e.g., the transfer of 87,416 crores in FY23 boosted the fiscal position amid slowing disinvestment.

– **Analysis: Negatives**

i. **Strong RBI Buffer** is crucial to deal with crisis situation in the situation of financial catastrophe. With less reserves, RBI will have less wiggle room in the event of financial catastrophe.

ii. **Excess release of** money by RBI may also add to **inflationary pressure**.

iii. Further, the huge transfer may **also indicates erosion of RBI's independence**.

– **Conclusion1:**

» Jalan committee appears to have maintained a balanced approach in ensuring enough capital with RBI for contingencies and providing relief and maneuverability to the beleaguered Centre. The decision of RBI board should be welcomed, but at the same time, government should be prudent in using these funds.

– **Conclusion2**:

» RBI's surplus transfer isn't just a financial transaction. It's a testament to the institution's role in economic stability and a window into the dynamic relationship between the central bank and the government.

3. BANK NATIONALIZATION

– **Banking Structure: Nationalization to today**

» India's public sector banks (PSBs) are essentially legacy banks from the colonial period that were subsequently nationalized.

- For e.g.: **State Bank of India** was founded as Bank of Calcutta in 1806, took the name Imperial Bank of India in 1921 and became **state owned in 1955**.
  - Within 4 years, its seven subsidiaries were also amalgamated into the SBI branch.

» The **remaining PSBs** in India were formed through **two waves of Nationalization**, one in **1969** and the other in **1980**.

- On **19th July 1969**, the Indira Gandhi government promulgated an ordinance to nationalize 14 largest private banks of the country having deposits of at least Rs 50 crore. (foreign banks were excluded from the list). The ordinance was later replaced by **The Banking Companies (Acquisition and Transfer of Undertaking) Act, 1969**.
  - **List:** Central Bank of India, Bank of India, Punjab National Bank, Bank of Baroda, UCO Bank, Canara Bank, United Bank of India, Syndicate Bank, Dena Bank, Union

Bank of India, Allahabad Bank, Indian Bank, Indian overseas Bank and Bank of Maharashtra (in the order of total deposits).

- There were **three compensation options:** Cash; ten-year central government securities at par carrying 4.5% interest per annum, and thirty year central government securities at par carrying interest at 5.5% percent per annual.

» **The 6 banks** which were nationalized in 1980s included Punjab and Sind Bank, Vijaya Bank, Oriental Bank of India, Corporate Bank, Andhra Bank and New Bank of India.

– **Declining Share of PSB**

▪ After the 1980 nationalization, **PSBs** had 91% share in the national banking market with the remaining 9% held by "**Old Private Banks**" (OPBs) that were not nationalized.

▪ **As of 2019**, **PSBs** represent between 65%-70% of the aggregates for all scheduled commercial banks operating in India.

▪ The decline in PSBs share has been largely absorbed by **"new Private banks" (NBPs)**, which were licensed in early 1990s after a liberalization of licensing rules that earlier regulated the bank entry.

– **Why was nationalization done?**

» To **sync the banking sector with the goals of socialism** adopted by the Indian government after independence. Nationalization was done to **energize priority sector** at the time when large businesses dominated credit profiles.

» **Ending class banking:** there was a long standing perception that bankers were not ready to give loans to farmers. Further, since most of these banks were owned by industrialists, they ensured that a large section of money went to these industries.

» **Share of rural and semi-urban bank branches** were not going up i.e. banks were not willing to serve in rural areas.

– **Advantages of nationalization/ Achievements**

» The third volume of Reserve Bank of India's history termed nationalization of banks as the "single most important economic decision taken by any government since 1947. Not even the reforms of 1991 are comparable in their consequences - political, social, and of course, economic.

» **Between 1969 - 1980**:

○ The **number of rural branches** increased ten fold from about 1,443 in 1969 to 15,105 in 1980 compared to two fold increase in urban and semi-urban areas.

○ **Credit to rural areas** increased from Rs 115 crore to Rs 3,000 crore **[20 fold increase]**.

○ **Credit to agriculture expanded 40 fold**.

○ These growths represented a significant correction to the undersupply of credit to farmers that drove nationalization.

- The key goals of nationalization such as energizing priority sector lending, ending class banking and promoting more bank branches in rural and semi-urban India have more or less been achieved.

» Some **immediate advantages of Bank Nationalization** were:

- **Rise in financial savings** (as banks opened branches in earlier unserved rural and semi-urban areas). **Gross domestic savings almost doubled** as a percentage of national income in 1970s.

» In fact, some recent flagship initiatives like **Jan Dhan Yojna** have been successful because of the presence of so many Public Sector Banks.

- Of the 46 crore accounts, only **2.82%** of them are in private sector.

– **Limitations of nationalization/ Failures**

- Some experts say **that stunted growth of India's banking sector** has the bank nationalization as one of the key factors.
  - For e.g. As of 2020, India has only 1 bank in top 100 banks of the world (SBI at rank 55).
- **Governance of the PSBS, political interference, incentive structure and lack of strict profit** goals have negatively impacted the Public Sector Banks. This can be seen in high % of NPAs accumulating in these PSBS.
  - Further, bank officials are avert of taking risks as that may lead to corruption cases against them.
- **Financial inclusion** was also not very effective till 2014. It is only PMJDY which has ensured bank accounts to almost all households in the country.
- **Expensive for government** - Government has had to investment several lakh crores for recapitalization of these banks in last decade only.

– **Conclusion**

- The bank nationalization may have been necessary at the time, but now its time to provide more autonomy to PSBs. From a larger perspective of efficiency and better utilization of capital, it may be a good idea to move state-owned banks towards a more market-based framework.

1) BANK NATIONALIZATION CASE IN SUPREME COURT: RC COOPER CASE

– In response to nationalization of banks, **Rustom Cavasjee Cooper**, the majority shareholder of Central Bank & Bank of Baroda filed a writ in the Supreme Court for **violation of fundamental rights** mentioned under articles 14, 19(1)(f) & 31(2).

– **Judgment: 10:1 majority**

» The court found that the impugned act was in **violation of the Article 31** since the act failed to comply with said provisions.

- The said provision provided that the in case any **property** is acquired by the government then they have to provide compensation to the property owner.

        - The court held that compensation to be awarded 10 years later that too in bonds is too much illogical and detrimental to the affected parties. It is probable that some citizens will not be able to realize the fruits of the agreement due to reasons of emergency situation such as death.
        - **Therefore,** the court struck down the said act.
    - The court also held that the act was in **violation of Article 14(c)** since **only these 14 banks were restrained from conducting banking business** in the future while other banks including the foreign banks were allowed to continue Banking in India.
    - But the court found the act to be **not violative of Article 19(1)(f)**.
        - The court said that the act is not violative of the freedom to carry trade & business. State can always create a partial and absolute monopoly

- **The Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970**
    - Later, the parliament enacted this new law which included the specific amount of compensation to be paid to each bank.

- **25th Constitutional (Amendment) Act, 1971**
    - Further, to negate the impact of RC Cooper case, the Parliament amended the constitution.
        i. The parliament in order to clarify their stance that **they are not bound to adequately compensate the landowners** amended Article 31(2) in case their property is acquired by the state. The word "*amount*" was placed instead of compensation in the provision.
            - Thus the amended permitted the acquisition of private property by the government for public use, on the payment determined by parliament.
            - The word amount can be interpreted as any figure of money and that is not necessarily an adequate, equitable amount.
        ii. Article 19(1)(f) was delinked from Article 31(2).
        iii. Article **31 C**, a new provision was added to the Constitution to remove all difficulties that
        i. Articles 14, 19 & 31 are not to be applied to any law enacted under the fulfilment of objectives laid down under Article 39(b) & 39(c).
        ii. Any law to give effect to Article 39(b) & 39(c) will be immunized from court's intervention.

4. CONSOLIDATION (MERGER) OF BANKS

- **Introduction**
    - **Narsimhan Committee** on financial sector, set up in **1991**, had recommended consolidation of the banking system by creating 3-4 larger banks which will be comparable to major global banks and around 10 smaller banks to have a national footprint.
    - As of July 2022, India has 12 PSBs. Government has plans to further reduce this number to bring it down to 3-4 large PSBs.
- **Recent Mergers:**
    - Currently, there are 7 larger public sector banks and five smaller ones (**total: 12)**. The aim is to have 4-5 large banks as large and strong as the country's biggest lender SBI.
        - **Note:** In 2017, there were 27 PSBs which have now been reduced to 12.
    - **Mergers So Far in Public Sector:**

- **Merger of SBI and Associate Banks**: In April 2017, SBI merged five associate banks and Bhartiya Mahila Bank with itself. This move projected SBI into the global banking sphere's top 50.
- **Vijaya Bank & Dena Bank** merged with **BoB in 2019** : This created India's third largest public sector bank. It also led to significant operational expansion and improved efficiency of Bank of Baroda.
- **2020 say the beginning of Mega Consolidation exercise**:
  - **Oriental Bank of Commerce** and **Union Bank of India** were merged with **PNB** (making PNB the second largest Public Sector Bank)
  - **Syndicate bank** was merged with **Canara** Bank.
  - **Andhra Bank** and **Corporation Bank** merged into **Union Bank of India**
  - **Allahabad Bank** merged with **Indian Bank**.

» **Mergers in Private Sector**:

- **The Unification of HDFC and HDFC Bank**: The Indian coporate ecosystem was treated to a historic event on July 1, 2023, when HDFC Bank and Housing Development Finance Corporation (HDFC) concluded a merger valued at a staggering $40 billion.
  - With its extraordinary market capitalization of around $172 billion, the newly unified entity holds an impressive global standing, challenging the incumbency of behemoths such as HSBC and CitiGroup.
- **Impact**:
  - **Banking Sector Consolidation gathers pace after HDFC merger**:
    - For e.g. Days after HDFC merger, IDFC First bank, announced its merger with its parent firm IDFC.
      - Note: IDFC Bank made its foray into the banking sector after IDFC limited, an infrastructure financing institution, received a banking license from the RBI in 2014.
    - Experts believe that mergers and acquisition in the financial services sector to continue as it would help them to get capital and increase their reach of new customers.

– **Advantages of consolidation / Bigger banks**

1. **Cost Advantages -> Economy of Scale -> Efficient use of Resources** -> Efficient Operations.
   - Centralized back office processing, elimination of branch overlap, eliminating redundancies in administrative infrastructure, better manpower planning, optimum fund management, and savings in IT and other fixed cost.
   - PSBs also target similar clients in same areas, which leads to unnecessary marketing burden and other extra cost.

- As per an RBI report in 2023, the Banking mergers in India have been beneficial to the banking sector: RBI Paper
    - Mean technical efficiency of acquirers increased from 90.88 in the pre-merger period to 93.80 three years post-merger, and 94.24 five years after merger.
  - **Merging of weaker, smaller bank into higher performing bigger banks** improves the functioning of smaller banks

2. **Alleviate capital requirements**
   - Reduction in the number of banks to a manageable count is expected to reduce the demand of capital infusion by government progressively because of increased efficiency and with more well capitalized banks.
3. **Capable of giving larger loans:** Can give larger loans and thus help in revival of the economy.
4. **Less susceptible to takeovers:** Bigger banks are less susceptible to being taken over by outsiders (if government ever ceded control)
5. **Globally significant bank**.

– **Disadvantages / Limitations of Mergers/ concerns**

1. **Increased Vulnerability of Banking Sector -> too big to fail.**
2. Mergers may **accentuate the strains**. A bank merger is never easy but when both banks have strained balance sheets, it can lead to a collapse.
3. **Eats up a lot of top management time** - IT system, organizational structures, risk systems, exposure limits and product portfolios need to be aligned.
4. **Larger banks doesn't necessarily means more efficient**.
   - E.g. the top banks in China, still end up following directions from the government and have recently faced a lot of issues.
5. **Reduces Competition and thus perhaps efficiency**
6. **Corporate governance Issues**
   - These mergers in India are generally forced by government who is the majority shareholders in PSBs. The views of minority shareholders are ignored.
   - Further, the decision making through ministerial mechanisms amount to an imposition from above. This attenuates the functional autonomy of the bank boards.
7. **Job losses**
   - Merger of banks generally leads to off laying of employees and closure of branches
8. **Negatively affects Financial Inclusion**
   - As the number of branches decrease, the reach of the banking sector decreases. India already has less number of bank branches per capita population when compared to our developing counterparts.
9. **Diverts attention from Other Bank Reforms**
   - Current focus should be on poor governance in public sector banks.

- **Way Forward**
  - While consolidation of the banking system may be a good idea, but the **focus from other banking reforms** like ending political interference, creating more autonomous boards by reducing governments shareholding, promoting more professionalism, giving more regulatory authority to RBI etc. should not be sidelined.
  - The **consolidation should also be done on commercial grounds** rather than for political reasons. The consolidation should be driven by complementarities, growth potential or cost efficiency.
  - The initiative should come from bank board, instead of being imposed from the top.
  - Allow natural failures - In a market economy, some banks would fail and thus will ensure that only the good performing once would survive. It is important that these failures should be allowed without creating a systematic shock for the economy.
  - And finally, the employees, in case being laid off, should be given a good golden handshake, so that their welfare is not hampered.

- **Conclusion**
  - Mergers will be beneficial only if the deep structural flaws which are being faced by banks are properly addressed.