Private Banks and Financial Inclusion

C.P. Chandrasekhar and Jayati Ghosh

In the context of the decision to permit entry of corporate houses into private banking, a view has been expressed that the move would favour financial inclusion. A respected former deputy governor of the Reserve Bank of India, the Chairman and Managing Director of a leading public sector bank and a host of analysts and media commentators have espoused that view. The need to push for financial inclusion is obvious. While India has close to 650,000 villages only around 36,000 have a commercial bank branch. Only two-fifths of the population has a bank account, even though the government has decided to shift to a bank-based direct benefit transfer scheme for any of its welfare programmes. The situation with regard to insurance and other financial services is only worse.

The argument that private banks could contribute to quickly resolving this problem is based on a number of arguments. The first is that inclusion is promoted by augmenting the number of banks, since competition would drive players to under-banked and unbanked areas. The second is that since large corporate houses have rural reach and deep pockets, they would stretch themselves to tap this large market where per capita income has crossed some critical threshold. The third is that the guidelines for those seeking licences to establish private banks have made clear that they have to meet financial inclusion requirements. Assuming there is much profit to be made from banking in areas conventionally targeted by private banks, the latter are expected to meet the inclusion requirement to get a hand in the till.

The problem is that past experience provides conclusive evidence that private, especially corporate players do not behave the way these arguments expect them to. Financial inclusion involves ensuring that (i) the reach of banking is geographically widespread; (ii) the banking sector is successful in mobilising an adequate and rising volume of deposits and use it as the base for expanding credit availability; and (iii) the allocation of credit is not sectorally skewed, with adequate flow to agriculture and the small-scale sector.

The heyday of corporate presence in banking was the period spanning from 1947 to bank nationalisation in 1969, when the skew in India's banking development under the British in favour of the colonial government and British business at the expense of Indian capital was corrected and the banking sector came under the control of Indian business, excepting for the State Bank of India and its subsidiaries. Immediately after India won independence the Imperial Bank of India that was subsequently nationalised to create the SBI accounted for close to a quarter of the deposits of the formal banking system. The cooperative banks accounted for another 6.5 per cent, leaving the rest with the private banks, domestic and foreign. This was followed by a period when the failure of a number of unviable banks that had come up in the inter-War period and during the Second World War failed or were amalgamated with others, resulting in a substantial reduction in the number of banks from 566 in 1951 to 210 in 1961 and 85 in 1969. Among the banks that remained were those controlled by one or other business group. Examples are, Punjab National Bank, Universal Bank of India and Bank of Lahore by the Sahu Jain group; United Commercial Bank by Birla, Oriental Bank of Commerce by Thapar,

Hindustan Commercial Bank by Juggilal Kamlapat and Indian Overseas Bank by Muthia. Many of these banks featured among the top 20 of that time.

The impact that this corporate control over banking had on the business of banking is well known. One was of course the skewed distribution of credit across sectors, with industry capturing an overwhelming share of incremental credit. The Dutt Committee found that in 1960 the top 20 private sector banks accounted for 61.7 per cent of all scheduled bank deposits and 73.2 per cent of scheduled bank advances. Around 10 per cent of the aggregate advances made by these banks went to companies in which their directors had an interest. In nominal terms bank credit rose from 547 crore in 1950-51 to Rs. 3,396 crore in 1968-69. During this period, the share of scheduled bank advances going to industry rose from 33.6 at the end of 1950-51 to 52-7 per cent at the end of 1961 and as much as 61.5 per cent in March 1965 (Table 1). On the other hand, the share of agriculture fell from 2.1 per cent, to 0.4 per cent and a negligible 0.2 per cent in those three years, when the share of agriculture and allied sectors in GDP stood at 52, 48 and 44 per cent respectively. There could not be more stark evidence of exclusion.

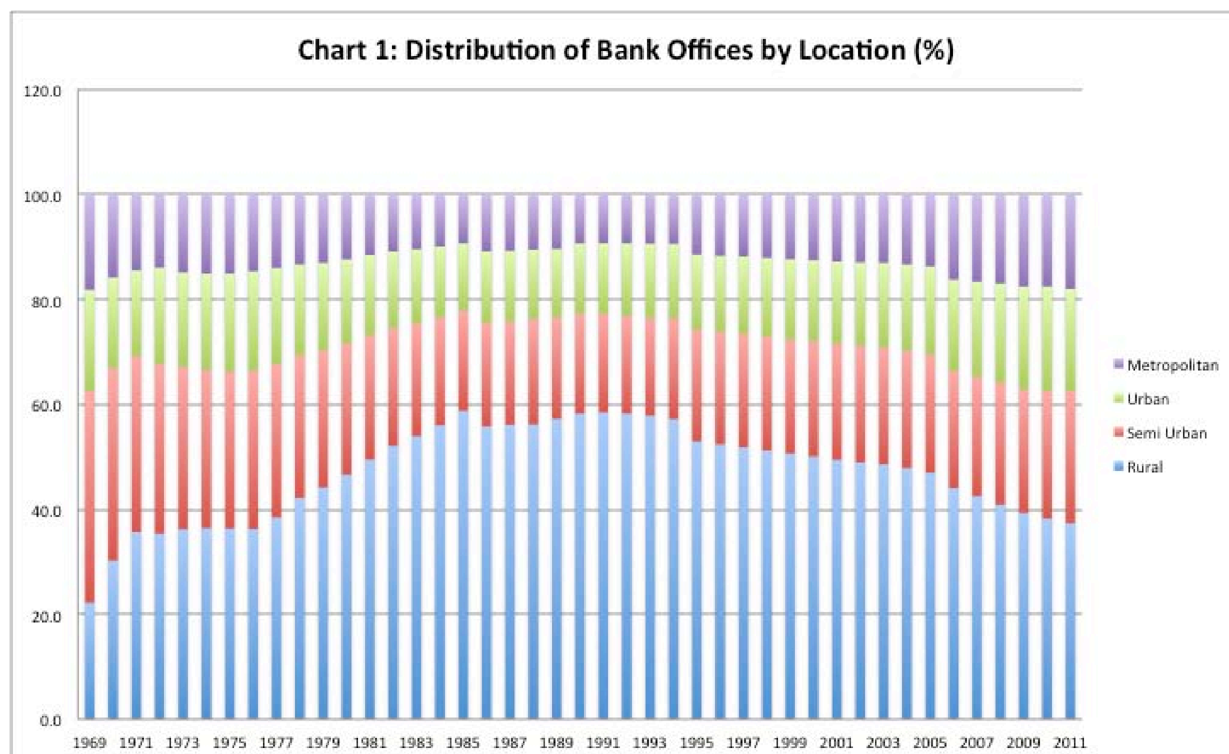
Table 1: Sectoral Deployment of Scheduled Bank Advances 1951-65

	March-end 1951	March-end 1961	March-end 1965
Industry	33.6	52.7	61.5
Commerce	53.1	31.3	25.6
Finance	..	5.1	4.5
Agriculture	2.1	0.4	0.2
Personal and Professional	7.3	7.5	5.8
Others	4	2.9	2.4

Further, most Indians did not have access to banking facilities at all. The population per branch in the country was at a high of 87,000 in 1951 and rose to as much as 98,000 in 1958 (because of closures of banks), before coming down to 88,000 in 1964 and 64,000 in 1969. Even this was huge when compared to the figure of around 6500 for the US in the late 1960s.

A corollary of this was the lack of any correspondence between the geographical distribution of bank branches and the population. At the end of the 1960s, when around 80 per cent of India's population was located in rural areas, only 22 per cent of bank branches were in rural areas. Further the distribution of branches in semi-urban and urban areas was also skewed. There were as many as 617 towns without any commercial bank, of which 444 had no bank branch at all. This is not surprising. Out of 1,772 new branches established between 1959 and 1964, as many as 1,208 were in centres that were already banked. At the other pole, the five metropolitan

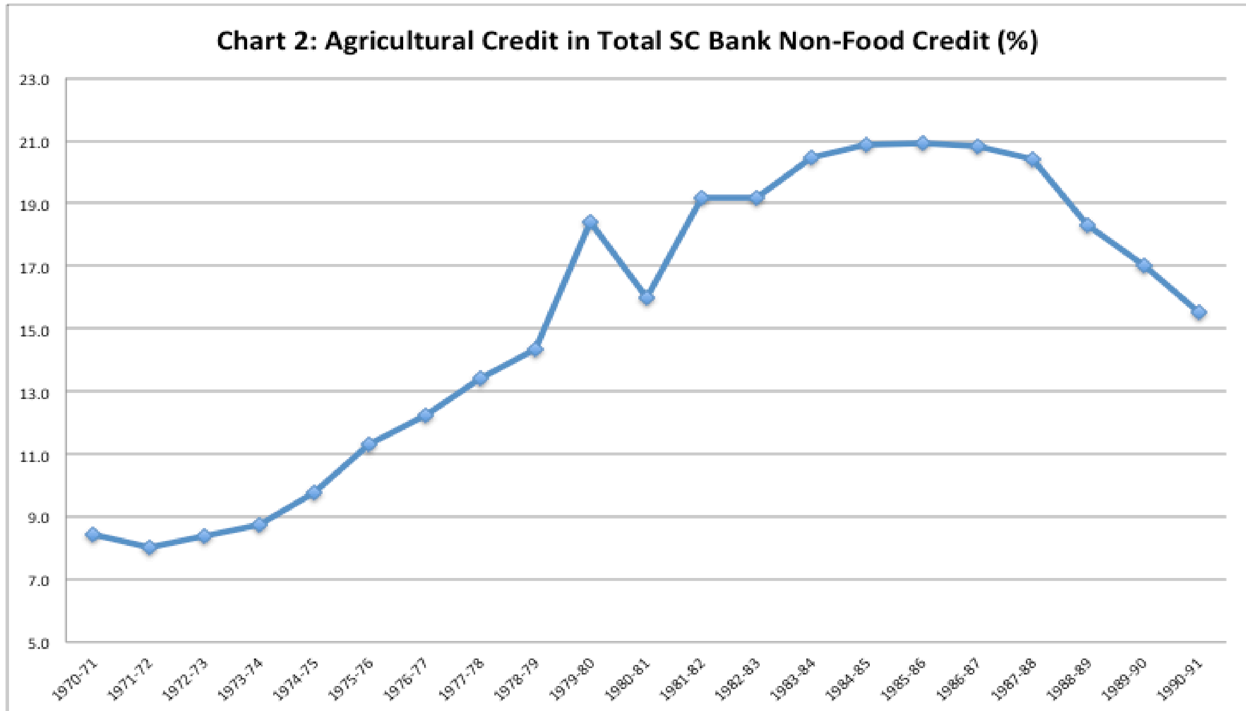
centres (Ahmedabad, Bombay, Calcutta, Delhi and Madras) accounted for 18 per cent of bank branches, 46 per cent of total deposits and 65 per cent of bank credit.



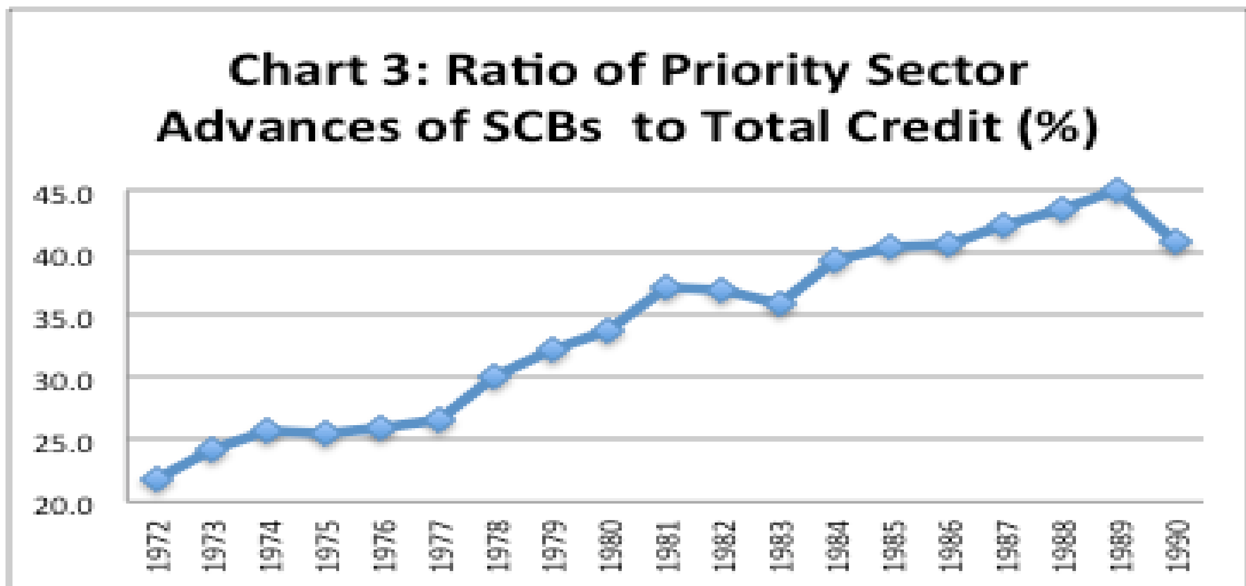
After the nationalisation of 14 large commercial banks in 1969, things changed dramatically. There was a huge expansion in banking, with the population per branch falling from 37,000 at the end of 1972 to 18,000 at the end of 1981 and 14,000 by March 1991. Partly as a result of the creation of the category and the establishment of regional rural banks, the number of scheduled commercial banks rose from 74 in 1972 to 270 in 1990. As Chart 1 shows, the share of rural branches in total scheduled commercial bank branches rose in tandem from 22 per cent in 1969 to 58 per cent in 1990. The share of agricultural credit in total non-food credit also rose sharply from 2 per cent before nationalisation to 8.5 per cent in 1970-71 and close to 21 per cent in the mid 1980s, before falling to 17 per cent by the end of the 1980s (Chart 2). Small scale and other priority sector advances also rose, resulting in the increase in the share of priority sector advances in total credit from 22 per cent in 1972 to as much as 45 per cent at the end of 1980s (Chart 3). In sum, public ownership, the end of corporate control over banks and the turn to social control over banking resulted in dramatic progress in the direction of social inclusion.

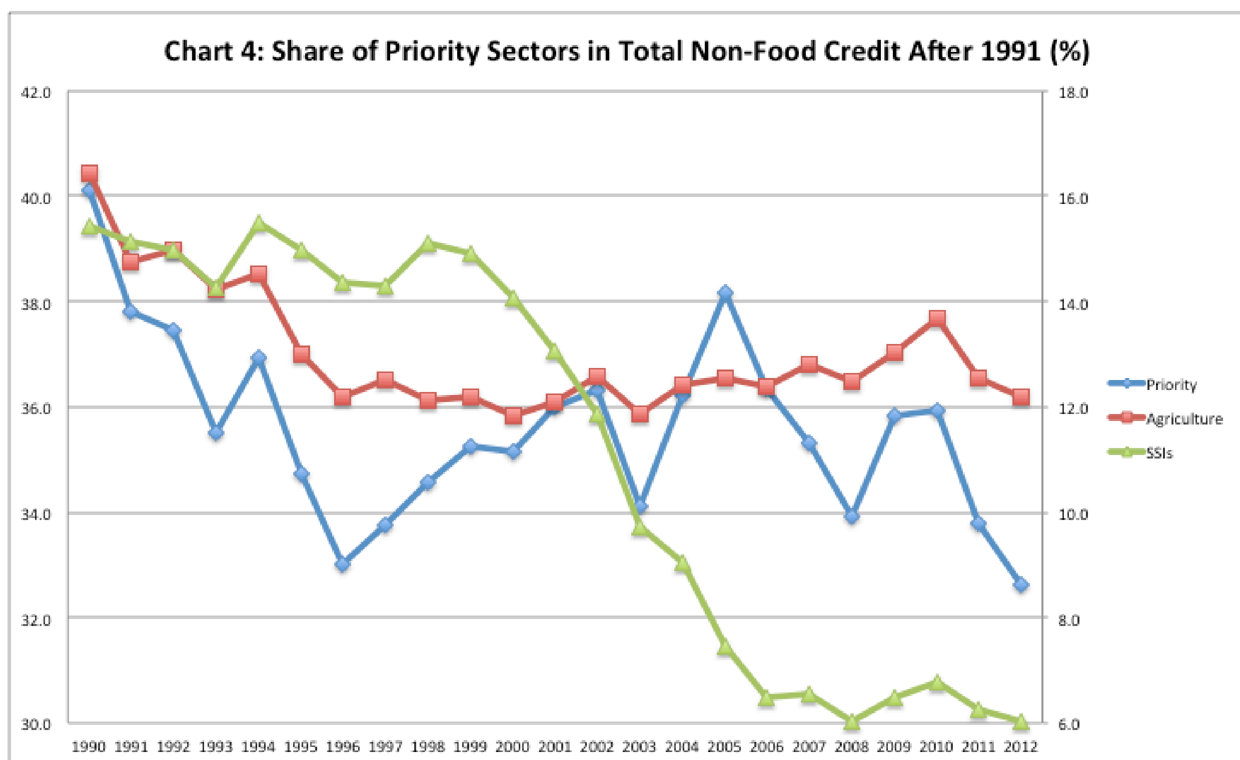
The importance of the end of corporate control and turn to social banking comes through when we examine developments in the period after 1991, when financial liberalisation was begun, social control diluted and foreign and domestic private banks (though not corporate entities) were permitted to enter. The number of scheduled commercial banks that rose from 270 in 1990 to 302 in 1999 has since declined to 165 in 2011 as banks were closed on grounds of non-viability. The axe fell more heavily on branches in rural areas, resulting in a decline in the share of rural branches in the total from 58 per cent in 1990 to 37 per cent in 2011. The population per

bank branch rose from 13,700 in 1991 to 15,200 in 2001 and close to 16,000 by the end of the first decade of this century.



The impact of the turn to private initiative and away form social banking principles was visible also in a decline in the share of priority sector advances in total non-food credit, from 40 per cent in 1990 to 33 per cent in 2012. The figures for the shares of agriculture and the small-scale industrial sector were 16.4 and 15.4 in 1990 and 12.2 and 6 per cent in 2012 respectively (Chart 4).





Thus the changes prior to and after 1969 and prior to and after 1990 establish quite clearly that corporate exclusion, public ownership and social control are crucial for financial exclusion, and the dilution of public control aggravates exclusion. These trends question the arguments advanced by the advocates of corporate entry into banking. This is to be expected. Financial inclusion requires providing access to services and credit to a large number of highly dispersed and often remotely located individuals and agents. This raises transaction costs considerably, which if passed on to clients in the form of higher interest rates would price them out of the market. So the returns from inclusive banking tend to be much lower and occasionally negative. This is also true of inclusive sectoral lending since the interest charged to borrowers for productive purposes in the agricultural and small industrial sector must be "reasonable" when compared with the returns that can be earned in those sectors.

Public sector banks often meet these requirements, even when provided some interest cost subvention by the government, by resorting to cross-subsidisation—using high returns in some areas to balance for low returns or even small losses in others. That of course means that even if profits are positive, they are much lower than what would be earned if financial inclusion was not an objective. To expect private banks to settle for this lower profit margin and rate, is to forget the nature of private incentive. It is only by presuming that private operators will not behave like private operators and have changed character since the 1950s and 1960s that the entry of the corporate sector into banking be seen as an instrument to advance financial inclusion. Evidence from elsewhere in the economy shows there are no grounds for that presumption.

*** This article was originally published in the Business Line on 15 April, 2013.**