

Banking Sector Reforms in India

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POLICY BRIEF

Introduction

The Centre for Policy Research (CPR), Delhi in collaboration with the BSE Ltd., Mumbai has started a monthly Macro Economic Seminar Series. The objective of these Seminars is to generate fresh analytical insights into the Indian macroeconomic issues for potential use by policy makers.

The third seminar of the series was 'Banking Sector Reforms in India'. A panel of Dr. P.J Nayak, Prof T.T. Rammohan and Ms Usha Thorat , moderated by Dr Rajiv Kumar presented their views and interacted with the select.

Public Sector Banks (PSBs) in India are struggling with high NPAs (Non-Performing Assets) which have been rising steadily since 2009-10. These banks continue to face the dual problem of significant asset quality stress and inadequate capitalisation, which has impacted their growth. Around 27 PSBs wrote off a staggering Rs 1.14 lakh crore of bad loans during FY12-15. The Punjab National Bank (PNB), the fourth largest state-owned bank by assets, announced that its gross NPAs touched 8.5% of the loan book in December 2015, highest in eleven years. Without government recapitalisation, some of these banks may find its lending activity squeezed.

On 14 August 2015, the Government launched a seven pronged plan – Indradhanush - for revamping PSBs. These seven elements include: Appointments of Bank MDs and Chairman, Bank Board of Bureau, Capitalisation, De-stressing, Empowerment, Framework of Accountability and Governance Reforms. The government proposed to infuse Rs 70,000 crore in PSBs over four years, while banks are expected to raise Rs 1.1 lakh crore from the markets to meet their capital requirements in line with Basel III norms. This has opened up a debate on whether Indradhanush framework is a much diluted version of earlier committee reports on Banking Sector and may not be enough to help strengthen PSBs and banking sector in India.

Summary of the Panel Discussion

Presently over two- third of the assets of Indian banking system are with public sector banks (PSBs) which generated less than one-third of total banking sector profit. Private sector banks have a Return on Assets (RoA) that is four times higher than that of PSBs.

However, it was pointed out that such a snapshot comparison is misleading. Various empirical studies indicate a trend towards convergence in performance between public and private sector banks over a long period between 1994 and 2011. The divergence in performance started after 2008 which became marked after 2011. The present difference in productivity and competitiveness between PSBs and private sector banks can be attributed to both internal and external factors some of which are described below.

The PSBs do not have independent and fully empowered boards like their private counterparts. All major recruitments are done by the Government of India (GOI), the majority stakeholder. Non-executive directors are usually air-dropped without consultation with the boards. Until Indradhanush, the GOI used to invariably choose a CEO from within the pool of PSB executives without considering any external talent. Acts governing the PSBs (Bank Nationalisation Act, SBI Act) create a non-level playing field for them as they face dual regulators - GOI and RBI. PSBs also come under vigilance and RTI Act unlike private sector banks. HR and Technology policies, and IT schemes are homogenised across PSBs rather than be custom built as should be the case. In contrast, private sector banks who strategize deeply on these issues and ensure highest bang for their buck in these critical areas.

There are various reasons for high level of NPAs in the banking system. The pain is also beginning to be felt even in large private sector banks but some of them were able to exit much earlier or their involvement in bad loans was relatively small. Some of the reasons for high NPAs specially in the PSBs are: First, The prolonged period of easy fiscal and monetary conditions since 2008 resulted in easy liquidity, low interest rate which prompted PSBs to lend aggressively as they vied with each other for balance sheet growth. This led to serious dilution of underwriting standards. Second, Infrastructure lending undertaken in 2010 and 2011, some at the behest of the GOI, with optimistic assumptions resulted in unviable projects. Some of these were stalled for lengthy periods due to unavailability of raw materials, land acquisition problems or lack of other clearances. These have now morphed into stressed assets. Third, misuse of CDR (Corporate debt restructuring) between promoters and bankers prolonged the NPA problem as banks did not want to show stressed assets in their books, which would have required higher provisioning that would result in low profitability while borrowers were permitted additional borrowing for servicing their debt. Fourth, recent spurt in NPAs is due to the attempt by banks to clean up their books as directed by RBI to do so by March 2017. It is actually a legacy issue.

It was pointed out that there has been a paradigm shift in the way the banking sector is viewed after the global financial crisis and this needs to be taken into account while formulating policy for the sector. Some studies have pointed out that the private banking system is congenitally prone to periodic failures. Empirical evidences shows that there have been 110 banking crisis in 80 economies, that are dominated by private sector banks. The cost of such crisis has been in the range of 1% to 3% fo GDP in terms of lost output in the economy.

The PSBs backed by the sovereign are seen as a force of stability as, being risk averse, these banks introduce heterogeneity in the risk management model which helps stabilise the system. These banks may underperform and be less competitive compared to private banks but they will be sufficiently competitive to survive in the business and deliver a stock return which is not significantly different to that of private sector bank.

At micro level, PSBs could be inefficient but at macro level, they are a factor for stability. There will be some trade-off between efficiency and stability. Moreover, government ownership increases public confidence despite banking being a risky business by the very nature of it. There are already many built-in checks for management in PSBs through CVC, RTI etc. However, it was counter argued that banking crisis had happened due to innovations running ahead of regulation. Crisis was never precipitated by boring banking and so in the context of India, it will be wrong to say that private sector banks are prone to failures.

The panel agreed unanimously that immediate infusion of capital is imperative. The bank recapitalisation cost in India over the last two decades has been about 0.025% of average GDP annually – one of the lowest in the world. This is also much lower than cost of 1% to 3% of GDP post crisis imposed on taxpayers in jurisdictions dominated by private banks. So, a pre-emptive recapitalisation of banks where one infuses capital from time to time ahead of crisis is better as one ends up bearing lower cost. This is also known as Chinese model. China had recapitalised its four largest state owned banks through 1990s and 2000s and helped in selling their NPAs. These four banks are considered the largest in the world. However, the panel highlighted that accountability is the issue in the recapitalisation process. There should be some kind of incentive that prevents misuse of this capital.

There were concerns that the Rs 70,000 crores to be infused in banking sector by the government may not be enough to recapitalise as PSBs may find difficult to raise the rest Rs 1.1 lakh crores from the market under the present conditions. But many studies have concluded that there has been substantial return on investment in the PSB stocks over time. So, as an alternative, we can have a system to actively manage PSB portfolios whereby limited stocks can be sold from time to time that can be used for recapitalisation which can lower pressure on the exchequer.

The panel debated extensively whether dilution of government stake below 50% is essential to improve governance and give PSBs a level playing field. The government can continue to be the majority stakeholder even if the stake comes down. Dilution of GOI stake below 50 percent was first recommended in 1998 by the M Narasimham committee. This would free PSBs from dual regulators, central vigilance and RTI. However, some members of the panel suggested that it is possible to deal with governance issues by empowering boards, separating board and management, revamping the recruitment process, allowing external talents, customising HR, IT schemes, and reducing government interference within the present framework. The required skill-set to improve performance is already available within the PSBs

Appointment of Regulators should be more transparent and people with domain knowledge should be given preference. The sudden rise in NPAs in PSBs is due to excessive lending to Infrastructure projects in 2010-2011 which helped in boosting growth. So, if banks are attacked now for bad loans, they should also be given credit for helping growth at that time though this could have perhaps been achieved with lesser recklessness..

Questions were raised regarding wilful defaulters. It was proposed that exemplary punishment to a few large defaulters is necessary to drive home the point that nobody can take the PSBs for a ride. The much awaited Bankruptcy code is a right step but would take some time to become operational.

Indradhanush, announced by the government, is a welcome move but much more is needed to improve the competitiveness of PSBs. It is just a statement of intent. Nothing much has happened in past 5 months since its announcement last year.

Conclusion

- While the public sector banks could be criticised for their relatively lower productivity and profitability, they are a strong factor for providing much needed stability in the financial system. Private bank dominated systems have seen banking sector crisis with monotonous and costly regularity. The cost of recapitalising PSBs, estimated at 0.025% of the GDP is far lower than 1-3% of GDP that it has cost to bail out the banking systems after each of the 110 crisis in 80 countries..
- Cleaning up of the bank balance sheets is essential and urgent to boost growth in coming years. High NPAs will squeeze the lending capacity of the banking sector and economic growth would be hampered.
- A system should be put in place where a fund manager, appointed by the government, will be mandated to actively manage the PSB stocks held by the government. The fund manager can sell limited stocks from time to time that can be used for recapitalisation of these banks. This will lower pressure on the exchequer and eliminate the use of taxpayers' money to bail out banks.
- There should be some kind of incentive that prevents misuse by the recapitalised banks of fresh capital infused by the Government.
- List of large wilful defaulters should be announced. Exemplary punishment to a few large defaulters is necessary to drive home the point that nobody can flout the rules for self-benefit.
- As legislative changes are not easy at this stage, so productivity of PSBs needs to be improved under the current statutory structure. Steps must be taken to empower PSB boards, give more autonomy in recruitment process, allow hiring of external talents, separate board and management, customise HR, IT schemes, and most importantly reduce government interference.
- Within the PSB universe, State Bank of India (SBI) has been outperforming its peers in the PSBs and its performance is almost comparable to new private sector banks. The best practises of SBI can be replicated in other nationalised banks.
- The presence of RBI directors in PSB boards should be discontinued. Regulators should not be members of commercial bank boards
- Appointment process of regulators should be revamped and made more transparent. Instead of just appointing retired government officials, emphasis should be on selecting someone with appropriate domain knowledge.
- In order to increase the reach of banks, there is an urgent need to enable "on tap" applications for banking license and also a need for transparent mechanism with high standards. As we are desperately short of banks, a limited window to hand out licenses is not a good policy and is poor economics. The RBI Governor has himself acknowledged the need to move to a rolling acceptance of applications. Moreover, RBI's rejection of bank applications without any hearing and without stating any reasons is both non-transparent and against the rule of law, as no recourse is left for a person to file a review of such a decision which has big implications not just for the bank applicants but for the economy in general. A clear standard, backed by a transparent and open decision ought to take its place.