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Market Watch

What Modi govt can do to save PSU banks

BY SALONI SHUKLA, ET BUREAU | UPDATED: JUL 24, 2019, 11.04 AM IST

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Just a day before Neil Armstrong and Edwin Aldrin took a 'giant leap for mankind' to leave the first human footprints on another world half a century ago, Indira Gandhi's India embarked on an uncharted journey to reform its failure-prone banking system through state ownership. But even five decades later, the need for reforms is as urgent as on the eve of nationalisation.

Indira Gandhi's successor as India's first full-time woman finance minister, Nirmala Sitharaman, meant as much in her maiden budget speech earlier this month. And problems dogging the state-run banking system – bad loans, frequent federal bailouts, and poor underwriting skills – have refused to go away even more than a century after John Maynard Keynes, the original proponent of a central bank in India, described the country as “so dangerous for banking.”

India now holds the dubious distinction of having the worst nonperforming loan ratio among the world's major economies. Not a single Indian bank features in the global list of systemically important banks. State Bank of India, the mainstay of local banking, ranks a lowly 55th on the list of the world's largest financiers.

North Block has infused Rs 2.5 lakh crore in the banks it owns since FY15, and it aims to infuse another Rs 70,000 crore this year. Yet, the market capitalisation of state-run banks is barely around Rs 5 lakh crore. So, the Street's decision to ignore frequent federal capitalisations while valuing government lenders points to the need for structural reforms that go beyond periodic injections of money. Instead, these reforms must encompass organisational culture, structure, technology, talent management, autonomy, oversight and governance.

Only non-financial reforms could, therefore, burnish the appeal of state-run lenders with investors, who are willing to pay significant premiums for private lenders but would not bet on their state-controlled peers.

“In which private sector bank does the CEO change every one or two years? What is the compensation level of senior management? Why is the CEO age cap at 60, even the central bank rules set the ceiling at 70 years? Unless you address the issue of tenure, compensation and age, you cannot overhaul governance at [PSU banks](#),” said DK Mittal, former financial services secretary.

“We have highly politicised boards. Why can't the government say we have nothing to do with PSU bank boards? Go ahead and choose people on merit. You can have as many 'Gyan Sangams' as you want, you can infuse as much money as you want, but only non-financial steps will give you the best results.”

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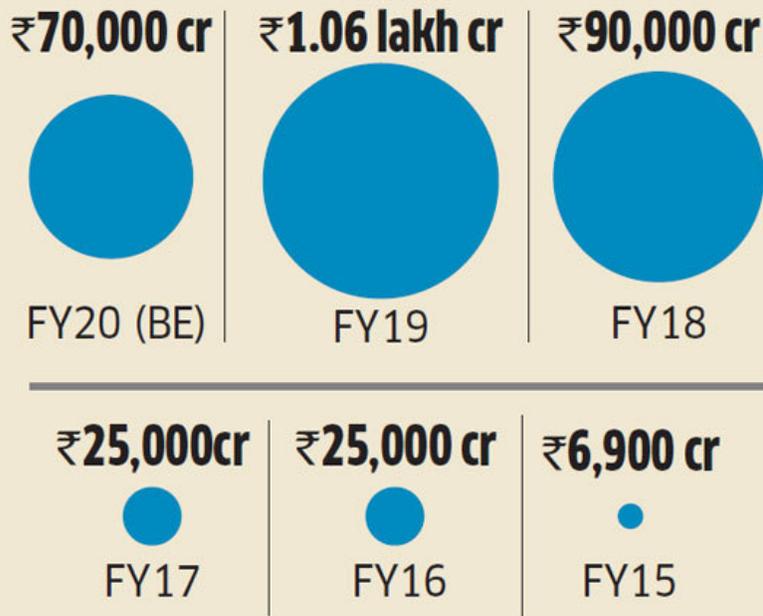
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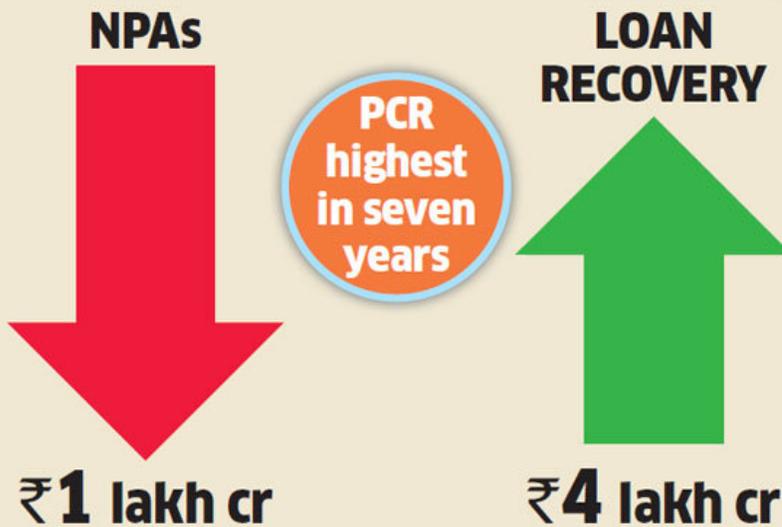
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GRIME AND DIME

PSBs have also set a horrible record of holding 90% of the bad loans, while providing credit to 70% of the people. And they have also been under-reporting frauds. Central bank data showed that 91% of frauds reported by banks in FY19 occurred between 2000 and 2018, and PSU banks were to blame for a large part of this under-reporting. With such reputation preceding them, state-run lenders face a tough task in convincing Mumbai to lend them money.

“High capital infusion by the government puts additional responsibility on the banks: I have told the PSU bank chiefs that the true efficiency of a bank will be measured not by an improvement in the bad loan ratio, which naturally gets better by capital infusion by the government,” central bank governor Shaktikanta Das told ET in an interview. “A truly efficient bank is one that accesses capital from the markets.”

Former central bank governor [Urjit Patel](#) in a recent lecture, his first after abruptly leaving Mint Road in December last year, said that the dismal state of Indian banking was a failure on the part of banks, the government and the regulator until 2014 – a collective failure that got banks into the current bad-loan mess and low capital buffers.

“The supervisor had failed to acknowledge and rectify government banks’ inability to identify poor performing assets; and restructure and react quickly to improve recovery and cut losses. The regulator failed in gauging when extant assumptions were getting stretched and needed revision,” Patel said at the event on Indian Economic Policy at Stanford University on June 3.

Asset quality slippage can be traced to the 2006-11 credit boom, when lending grew at an average of over 20%. To clean up the banking system, the regulator ordered an Asset Quality Review (AQR) in 2015. This led to a sharp rise in gross [NPA](#) ratio from 4.3% at end-March 2015 to 7.5% at end-March 2016. It reached the peak of 11.5% in March 2018, and declined to 9.3% as on March 2019.

THE BIGGER, THE BETTER

“The government is working toward creating mega-banks because today most PSU banks are carbon copies of each other. So it makes sense to create size and scale,” said Kuntal sur, partner, financial services at PwC.

“Banks that have come out of the PCA will have to now demonstrate their ability to generate internal capital, get quality assets and these will become acquisition targets for larger banks. In these mega banks, we need to have stricter governance that evaluates the role of the management and the board.”

In May 2014, a committee headed by PJ Nayak, former chairman and CEO of Axis Bank, came out with a report that laid out a road map for setting public sector banks free from state ownership. It proposed stake dilution to 50% of paid-up capital, revamp of bank boards, and absence of federal influence in CEO appointments, elements that form the bedrock of the Banks Board Bureau (BBB).

When the [Narendra Modi](#) government gave the responsibility to Vinod Rai, former Comptroller and Auditor General, to run the BBB in 2016, the move was seen as a major reforms journey that would strengthen governance and bring state-run banks on a par with their privately-run peers. About four years later, the reforms remain stillborn.

GOOD MONEY AFTER BAD

“Infusing capital year after year is not going to solve any problem. State-run banks are riddled with different laws, different governance requirements, and none of the real clean-up has happened,” said Somasekhar Sundaresan, a member of the Nayak committee. “The BBB was just a precursor for the bank holding company, but it has been made completely useless.”

The panel had also suggested moving all government shareholding in PSBs to a holding company to limit state interference. The proposal remains on paper even after five years. “The proposal to set up a bank holding company has gone nowhere. The government is sitting and deciding on mergers. It could have just set up a holding company, and that could have taken care of the mergers. But it doesn’t have the intention to implement the proposal,” said Mittal.

In 2017, former RBI governor Raghuram Rajan had said that the department of financial services under the finance ministry should withdraw from banking administration so that the BBB is effective.

THE SUNSET CLAUSE

“It seems to me the time or the indication for achieving that (independence of PSU banks) will be the day when you close down the department of financial services in the government of India, whose job really is to monitor these PSU banks,” Rajan had said at the launch of his book ‘I do what I do’ in Mumbai.

“I think it tends to impose sameness on these banks, which we probably over time need to find ways to get out of.”

In its first run, the Modi administration experimented with several [banking reforms](#). It brought private talent. Former Citibanker PS

Jayakumar was brought into Bank of Baroda on expectations of a turnaround. Rakesh Sharma, who heads IDBI Bank, was also hired in 2015 from the private sector to lead big state-run banks. But the changes did little to change governance.

"A PSU bank board is looking at (all sorts of) irrelevant stuff, like location of branches and ATMs. Should a board sit and decide this? Bank boards should have new-age expertise on cyber-security and digital banking. They can't be compulsorily sitting and discussing agriculture and labour issues... If the board (discussions) are so badly done, the governance of that bank is going nowhere," says Sundaresan.

Then there is the constant threat of probe agencies. In a recent case, the sitting CEO of Bank of Maharashtra and other senior officials were arrested by Pune police, but the Centre failed to intervene. The bankers were eventually exonerated, but only after being publicly accused of corruption.

In another case, the Central Bureau of Investigation (CBI) examined seven officials, including former RBI deputy governor HR Khan, on the 80:20 jewellery import rule after the fraud at [Punjab National Bank](#).

"PSU bank managements are under constant fear of investigative authorities. Please recall the Bank of Maharashtra case. It was nonsensical that the Union government did nothing to stop it. If they don't have enough confidence, they will never grow business. Is the government looked upon as a leader and a protector? No, we are not," Mittal said.

THE HANDS-OFF POLICY

The Modi government has so far kept its promise of not interfering in the functioning of banks, which is reflected in the aggression with which banks are chasing defaulters. There are no more complaints of "calls from Delhi" for loans to large corporate promoters. But increasing credit push to the MSME sector could compromise the financial health of banks, warn experts.

"Whether large corporates or Mudra loans, if you can evaluate the risk, go ahead. When the economic cycle is good, everything is hunky-dory. But when the cycle turns bad, the volumes of these Rs 10-15 lakh loans hurt banks," said PwC's Sur.

"Lending is a risk-taking business. The government has now implemented one-day MSME loans. It sounds very appealing but what is the due-diligence behind that?"

REFORM OR PERISH

To improve the functioning of PSB boards, Das recently signaled that it was important to enhance their quality and stability by streamlining recruitments, succession planning and compensation. These aspects could be evaluated by bank boards and reviewed by the BBB.

"We have made suggestions to the government with regard to tenure, compensation, accountability. I have also said that bank boards should play a better role in performance evaluation of chief executive officers, which needs to be made robust. Either the board of directors can do it through a committee, or they can form an expert review committee of peer groups," Das said.

The government and RBI also want to create a pool of independent directors across various areas of expertise, want bank boards to closely monitor the performance of bank chiefs, and set up an effective performance evaluation system to improve their financial and operating parameters.

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