NovaDhruva

State run Banks: How to let them run

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April 2018

Fourteen years back, on a Saturday afternoon my neighbor had come running to me – he was perspiring heavily and had almost fainted. Global Trust Bank had just gone into difficulty, and this man had significant deposits with the bank. In 2001, GTB had lent heavily to individuals speculating in the stock market; and when the market crashed in an aftermath of the Ketan Parekh scam, the bank suffered extensive losses. Though the bank continued to add branches and pay higher interest rates on deposits, over the next few years its net worth had turned negative. Its efforts to recapitalize itself also did not yield results. While a solution was soon found, and Oriental Bank of Commerce acquired GTB, the shareholders in GTB received nothing for their shares; depositors, however, suffered no loss.

While GTB was a private bank, one clear learning that the GTB episode gave was that if there is a need to restructure weak banks, the same should be done proactively – before the situation escalates to a level where the depositors' and shareholders' money is at risk. Further, if the shareholding is public money, one has to be extra vigilant. I believe that these factors bring us to the urgent need to restructure Government owned banks –from both capital and operational perspective. And, evidently, both these perspectives are two sides of the same coin.

Banks are in the business of taking credit risk and NPAs are a part of the lending business. However, NPAs resulting out of poor credit decisions, willful defaulters and issue related to propriety shouldn't be exonerated. At the same time, operational efficiency and oversight is integral to the success of any bank. PSU Banks have been vulnerable to rogue debtors and willful defaulters because of ineffective checks and balances. The latest PNB fraud only adds insult to the injury of already battered PSU banks grappling with NPA issues. Both the issues point to a direct failure of operational and the credit risk management system at every level in these banks.

Given the key role that public sector banks have been playing in enhancing the inclusive banking in India, and in financing the much needed infrastructure and industrial sector of the country, creation of a conducive environment for these banks to make fair and rationale credit decisions, would help intrinsically strengthen them.

The core problem, as identified by the P.J.Nayak Committee Report in 2014, is that the public sector banks in India are being run similar to that in China, where the government controls four of the country's largest banks. The government controls these banks, appoints senior personnel in the bank and recapitalizes it in case of stress. While this obviously puts the onus on the State in case any failure of these banks, as a corollary, it does not cast any responsibility or accountability on the employees and management of the banks to perform well. Consequently, the management's focus on risk management, processes, controls, compliance and earnings suffers.

To overcome this challenge, way back in 1998, the Narsimham Committee-II rightly suggested that a greater autonomy to banks would enable them to compete with their private peers, and an upgradation of training and enhancement of remuneration would attract and retain professional management. If banks which are in a position to access the capital markets at home or abroad are encouraged to do so, it would reduce the burden on the State and would make the management answerable to the public at large. Our political leadership at that time had also recognized the need for change and some of these suggestions were acted upon - for example, most of the public sector banks were listed thereafter.

The Narsimham Committee had also opined that the laws regarding minimum 51% Government holding in public sector banks, constrains PSBs from raising additional capital from the market. It suggested that the minimum shareholding of the Government in the equity of nationalized banks should be brought down to 33%. In fact, in the 2000-01 budget speech, the then finance minister had announced the government's decision to reduce the requirement of minimum shareholding by Government in nationalized banks to 33% without changing the public-sector character of banks by ensuring that fresh issue of share is widely held. He had also spoken about giving more autonomy to the Boards of these banks.

The appointment of Boards and top executives of public sector banks by the Government is derived from its majority holding. If the majority holding itself were to be given up, the appointment of Chairmen and Managing Directors should be left to the Boards of the banks, and the Boards themselves left to be elected by shareholders. A reduction in Government holding would go a long way in ensuring that the RBI oversight and ensuing actions are uniform and unbiased across public and private sector banks. Of course, it would also provide a level playing field for public sector banks in matters of vigilance enforcement, employee compensation and the applicability of the right to information.

An interim solution could be to split ownership and governance. An independent governance structure with a regulatory oversight can be created to evaluate the performance of the banks. A similar attempt was made in the power and electricity sector where the states despite keeping the ownership let go of some of the governance responsibility to a regulator.

Another issue that the Narsimham Committee had highlighted was the lack of employee incentives at public sector banks, which reduces their ability to hire the right talent Public sector banks are handicapped in attracting talent as they don't have the flexibility in matching the compensation structure of their private sector peers. Accordingly, it was recommended that upto 5-10% of the equity of a PSU bank may be reserved for the employees of the bank with a provision to introduce stock options in future.

A case in point, in this regard, is the evolution of Axis Bank. When Axis Bank commenced its business, it was owned by UTI and other insurance companies. Today, it has approximately 30% government holding through SUUTI, LIC, GIC and other Government companies. The CEO is appointed by a strong independent board which sets employee compensation. Even though, the promoters are government owned entities, with ~70% public ownership an independent board and management has successfully transformed the bank into one of the leading banks in the country. This theme can be played at the public sector banks where an independent board and a professional management with right incentives can transform the bank without political interference. This governance mechanism, if implemented at the Indian public sector banks, would ensure that these banks are put back on track.

In conclusion, it needs to be understood that the ownership, governance and operational reorganization of PSU banks are intertwined. A reduction in Government holding will lead to a greater managerial autonomy and responsibility. For these banks to survive and thrive, segregation of ownership and governance with a regulatory oversight is a big imperative. Most of all, it would enable mindful and responsible business by a motivated and talented set of employees!

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