Our Views

Bringing value in public sector banks

The Bihar state assembly election results and the recent by-polls in a few states indicate that the Indian electorate are backing the various reforms and developmental agenda of the present government at the center. These elections, taking place soon after the announcement of some of very major politically sensitive reforms such as agriculture and labor reforms, reaffirms the electoral support that the government must continue with the reform process.

The government has indeed taken decisive policy steps for real sectors and areas such as power, agriculture, infrastructure, manufacturing, and labor. And just as I sit down to write this weekly note recommending financial sector as the next focus area for reforms, the Reserve bank of India (RBI) has issued a consultative paper with a new set of recommendation for the ownership in the banking sector. If implemented, the proposed suggestions could trigger an influx of deep-pocketed long-term capital from new sources thereby transforming the banking sector.

Continuing with my thoughts on reforms in financial sector, and more specifically in Public Sector Banks (PSBs), it is important to look at some of the performance parameters relating to them. After consolidation, we now have 12 PSBs. Interestingly, the top 4 PSBs account for ~75% of the asset size of the all the PSBs. The overall performance of the bottom 8 PSBs remains a significant concern with an average return on assets at a meagre 0.18% and average return on equity at just 4.57%. Additionally, the cumulative market cap of the bottom 8 PSBs is just ~20% of top 4 banks market cap.

Over a period of last 3 years, the government of India has already poured in approximately Rs. 3 lac crores for recapitalization of the PSBs. Given the introduction of new-age technologies in the last decade, and the enormous competition from new-age banks and non-banking finance companies (NBFCs), these smaller PSBs could become a big drag on the exchequer for capital support and for depositor protection.

In 2014, the RBI had set up a Committee under the chairmanship of Dr. PJ Nayak to look into the state of PSBs and to make recommendations with regard to their future. Given the lower productivity, steep erosion in asset quality and demonstrated uncompetitiveness of public sector banks over varying time periods (as evidenced by inferior financial parameters, accelerating stressed assets and declining market share), the Committee had also reconfirmed that the recapitalisation of these banks will impose significant fiscal costs. If the governance of these banks continues as at present, it will impede fiscal consolidation, affect fiscal stability, and eventually impinge on their solvency. Consequently, the Committee had recommended two options to the Government: either to privatize these banks and allow their future solvency to be subject to market competition, including through mergers; or to design a radically new governance structure for these banks which would better ensure their ability to compete successfully, in order that repeated claims for capital support from the Government, unconnected with market returns, are avoided.

In my view, given that banking is a strategic sector, the government should retain a controlling stake in the top 4 PSBs. However, for the balance 8 PSBs which are much smaller but fiscally risky, the government should consider reducing its ownership and bring in another strong strategic owner. The strategic local or global partner should be invited to put in significant capital in these PSBs and even take a controlling stake.

The key issues in executing this will be to ensure security of funds for the existing depositors, protection of pension for employees, and recovery of bad assets. To mitigate these, the strategic buyer should be required to put in substantial capital to maintain a high level of capital adequacy and liquidity after accounting for asset write-offs. Additionally, adequate provision for managing the existing employees and pension liability should be maintained. The strategic buyer should be allowed to buy at least 51 to 75% stake in the bank through primary infusion. The requirement of open offer will have to be waived as capital will be required to go into the bank. Government should retain some stake along with the public shareholders who could benefit by the stock re-rating due to future efficiencies.

Finally, since the strategic buyer will be required to contribute significant capital immediately and on an ongoing basis, I would suggest that anyone with deep pocket in India or a strong global financial services player could be allowed to participate in the process, of course post the fit and proper check. Today's proposed recommendations of RBI, if implemented, could ensure that there are enough suitors for to bring in long-term capital from new sources into these PSBs.

Sunil Sanghai
Founder & CEO
NovaDhruva Capital Pvt. Ltd

https://economictimes.indiatimes.com/markets/stocks/news/how-rbi-panels-proposals-can-add-value-to-weak-psu-banks/articleshow/79337063.cms

NovaDhruva