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Indian Government's Bold Banking Reforms: Timely Implementation Key to Success

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Summary

The Indian government announced a slew of reforms to bolster the financial sector in this year's budget. The measures are those which were being considered for a while but no decisions had emerged till now. With a progressive roadmap laid out, it is now time to ensure early implementation in order to support the medium term growth of the economy. A healthy banking sector is critical to economic growth and it is imperative that the government backs up these policy decisions with resolute, wholehearted and timely execution.

Introduction

Fourteen public sector banks (PSB) celebrated their golden jubilee of nationalisation in July 2019. Just half a century after their nationalisation, the government is now seeking to privatise some of these banks. It is worth examining how the journey has come a full circle.

Nationalisation was proposed to prevent the concentration of wealth in private hands and mobilise more resources for economic development. With nationalisation came government and political interference. Further, in 1972, priority sector lending was mandated such that 40 per cent of each bank's credit portfolio was to be for designated sectors. In the early 1990s, prudential norms and greater functional autonomy were introduced to overcome weaknesses that had crept into the system and lend greater strength to the PSB set up. Development finance institutions (DFIs) were set up to provide long tenor loans for industry and infrastructure, as the domestic capital markets had not been developed enough. Later, in the 1990s, private banks were given licenses to lend competition and greater professionalism.

At the turn of the millennium, riding on the wave of an expanding global economy and a benign global sentiment, banks in India grew their loan books at a rapid rate. India had broken out of the 'Hindu rate of growth' syndrome. As a consequence of the reform measures taking root, in 2004, the 'India Shining' story was being talked about. The country had clocked eight to nine per cent growth. It was felt that the time was ripe to amend the Banking Regulation Act in order to draw down government shareholding in PSBs. Foreign direct investment in the insurance sector was in the works. The mood was so upbeat that early elections were announced in 2004. It was felt that DFIs were passé as the model had outlived its utility and banks could undertake lending of all hues. Thus, ICICI was converted into a bank and IDBI demerged, setting up the IDBI bank.

Soon, the euphoria of a rapidly expanding growth began to dissipate. Lending to infrastructure projects had turned sticky. Due to time and cost overruns, largely on account of delayed statutory clearances, banks started seeing stress on their loan books. Added to it, the external environment turned adverse with the financial meltdown.

In the light of the deteriorating health of banks, in January 2014, the Reserve Bank of India (RBI) set up a committee to review the governance of the board of banks under the chairmanship of P J Nayak, former chairman of Axis Bank. The committee submitted its recommendations in May 2014. It recommended, inter alia, a three phase process to empower the boards of PSBs. In Phase 1, the committee proposed the setting up of a Bank Investment Company (BIC) as an intermediate holding company for these banks. The process suggested first appointing a Banks Board Bureau (BBB) to advice on the selection of top management. The BBB was to have a three-year tenure or for a period till powers were passed on to the BIC, whichever was shorter. However, by then, the National Democratic Alliance government had assumed charge and, being cognisant of the situation, held a *Gyan Sangam* (bankers retreat) of heads of PSBs and financial institutions in January 2015. The prime minister himself presided over the deliberations. This was followed by the Indradhanush Plan which was to, inter alia, address issues of capital adequacy, senior appointments and governance in PSBs. It supported the creation of the BBB. Whilst these initial moves were in the right direction it was most unfortunate that they missed the elephant in the room, which was recognising and taking decisive steps to resolve the stress on the balance sheet of the banks.

Private sector banks have taken more resolute action to resolve the stressed accounts by either transferring sticky accounts to asset reconstruction companies (ARCs) or taking a haircut and settling the account. They have then proceeded to capital raising. On the other hand, PSBs could not effectively address the non-performing assets (NPA) problem and, despite substantial equity being injected, viz ₹3,18,997 crore (S$63.19 billion) in the last five years, continue to carry stressed accounts on their books thereby impeding their capacity to enhance lending. There have been additional responsibilities on these banks with the implementation of the *Pradhan Mantri Jan-Dhan Yojna* (financial inclusion programme), the *Pradhan Mantri Mudra Yojana* (micro-credit scheme) and fulfilling the priority sector lending targets. As a consequence of all these factors, the share of PSBs in credit advanced dipped to 59.80per cent in 2020 from 74.28 per cent in 2015, while private banks' share has increased to 36.04 per cent from 21.26 per cent in the same period.[1]

The journey of public sector banking in India has been recounted for India to devise a road map for the future keeping, the previous faults in close focus. History is a great teacher and India needs to learn from past mistakes. The government has made some bold, progressive and challenging announcements pertaining to the financial sector in the current year's budget. These are significant structural reform measures far beyond the business of capital infusion that the government seemed to be mired in. These are very welcome steps. The government has proposed to privatise two PSBs, besides the IDBI bank and one life

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[1] Manojit Saha, 'In just five years, private banks have narrowed public sector's huge lead in loans & deposits', *The Print*, 24 November 2020. https://theprint.in/economy/in-just-5-years-private-banks-have-narrowed-public-sectors-huge-lead-in-loans-deposits/550570/.

insurance company. A DFI is to be set up to enable long-term funding of about ₹5 trillion (S$99.78 billion) in five years. The government also proposes to set up an ARC or bad bank. This paper proceeds to examine the merits of each of these announcements and ascertain whether the mere announcement or setting up these institutions, is a panacea for the economy.

Bad Bank

The debate for setting up a bad bank has been raging for almost a decade now. The government has done well in biting the bullet. A bad bank takes over the stressed accounts of commercial banks and attempts to sell them at the best price that can be obtained. There are about ₹9 trillion (S$179.61 billion) worth of NPAs that PSBs carry.[2] The bulk of these could be transferred to enable the commercial banks to continue with their regular activity. An ARC for PSBs can be successful only if the following factors are addressed. Firstly, is the bad bank a public sector or private sector entity? If it is in the public sector, all inefficiencies associated with the sector will burden it. The professional capability available for this kind of activity in the sector is also suspect. If the institution hires such professionals from the market, the compensation package may become a sticking point. Decision making in this sector is either slow or dogged by fear of subsequent investigation. How is this aspect proposed to be handled? There is also the attendant issue of capitalising such a bank especially in the light of the huge volume of stressed assets that may be transferred to it. The more important factor is that after shedding their stressed assets the PSBs should not start lending indiscriminately and get themselves into a mess yet again. Hence, attendant governance and culture issues need to be simultaneously put in place.

On the other hand, the bad bank could be set up in the private sector with banks/financial institutions capitalising it. It would certainly not suffer from the inadequacies highlighted above. However, we need to be cognisant of the fact that India already has 28 functioning ARCs. What is the value of the assets that they have resolved and what is the appetite for such assets in the country? Further, valuation of the assets that are to be transferred to the bad bank in the private sector will become a stumbling block. Hence, the requisite set of decisions to ensure the efficacy of a bad bank needs to be put in place before the institution is created. It is important to study the experiences of Indonesia, Spain and maybe even the Trouble Asset Relief Program of the United States, which bought up securities and sold them when the market improved. It should not be a convenient vehicle merely too kick the can down the road, without addressing the structural weaknesses of PSBs.

Development Financial Institutions

In her budget speech the Finance Minister, Nirmala Sitharaman, announced that "a professionally managed DFI is necessary to act as a provider, enabler and catalyst for infrastructure financing." The DFI is to have a portfolio of at least Rs 5 trillion (S$99.78 billion) in three years. This will be DFI 2.0 season for India. A DFI at this stage would indeed be a very effective institution as there is no dearth of long tenor money from pension funds,

[2] Ahita Paul, 'Examining the rise of Non-Performing Assets in India', PRS Legislative Research, 13 September 2018. https://www.prsindia.org/content/examining-rise-non-performing-assets-india.

insurance companies and provident funds who may experience comfort in lending on sovereign guarantee.

Earlier, visualising the reduced utility of DFIs, institutions such as IFCI, IDBI and ICICI were converted into banks to enable them to access public deposits. If media reports are to be believed, the Indian Infrastructure Finance Company Ltd, a wholly owned government company is to be subsumed in the new DFI. Now, if this happens what is the guarantee that the DFI so created will not function in the same mode as the existing PSBs? To obviate such maladies, it has to be ensured that the newly created institutions do not suffer from 'directed lending' or cronyism that PSBs have a history of. The basic issue would be to determine the risk appetite of these institutions which, in a government controlled set up, may become a casualty. It is undeniable that a DFI at the present juncture, when infrastructure funding is of top priority, is essential. However, the model so set up must be made to deliver efficiently. This requires that the government, at the initial stage itself, lay down a comprehensive and well-structured road map weaving within it the risk and policy framework which can be operated by experienced professionals recruited from the private sector.

Privatisation

After the reform budget of 1991, the term 'privatisation' had begun to wield iconic proportions. Some institutions were indeed privatised. A successful disinvestment was that of two hotels belonging to Hotel Corporation of India, an Air India subsidiary. However, after 22 years it seems a special Central Bureau of Investigation court has ordered registering of cases against the-then minister and officers.[3] These are the events which limit aggressive reformist moves. One such failed attempt was that though the government had announced the privatisation of IDBI bank in 2014, the entire move got stymied in asset valuation problems. So, the announcement turned out to be a non-starter. In the present scenario, pursuant to the budget announcement to privatise two PSBs, tabling amendments to the two Acts which introduced nationalisation in 1970 and 1980 would be a welcome step to facilitate the process. Considering the rapid rate at which the new generation private banks have been able to capture business and succeed in instilling confidence of their professional culture among the retail and business community, it makes ample sense to allow some PSBs to be run by private groups. Possibly with privatisation in mind, the government had not consolidated about half-a-dozen banks. These should be good candidates for privatisation. It may be argued that they may not fetch a good value but then government will have to recapitalise them if they continue to be in the public sector fold. Hence, either which way, they are of no great value to the state.

The RBI has recently, after addressing issues of 'fit and proper' criteria, taken some well-considered initiatives in the cases of Lakshmi Vilas Bank (LVB) and Catholic Syrian Bank. These takeovers will not only infuse the much-needed foreign capital but world class professional management culture of the variety that DBS bank can provide to LVB. However,

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[3] Sharat Kumar, 'CBI court orders FIR against Arun Shourie for sale of Laxmi Vilas Palace in 2002, tells authorities to seize hotel', *India Today*, 17 September 2020. https://www.indiatoday.in/india/story/cbi-court-order-fir-against-arun-shourie-for-sale-of-laxmi-vilas-palace-in-2004-orders-authorities-to-seize-hotel-1722796-2020-09-17.

for strategic safeguards, government seems keen to continue retaining a stake in four to five large public sector banks. These banks can meet government directions with the others being privatised in order to avail twin advantages of gain in their efficiency and be a lesser drag on government funding for capital enhancement.

Bank Investment Company

The Nayak committee recommended the setting up of a BIC. Whilst the government took the first step of constituting the BBB in 2015, the present budget makes no mention of a BIC. Even if the government were to consolidate banks and have controlling stakes in only a handful, it makes ample sense to constitute a BIC with private participation. The government could initially hold 51 per cent and subject to its proving to be successful, draw down its stake holding to below 50 per cent. The advantage would be that the banks could be professionally run with no fear of government or political interference. Such an entity will be able to attract professional talent from the private sector. An impetus will be given to the reform momentum if the government were to signal its disassociation from management of PSBs and allowing them to be professionally run and access capital from the market. A clear roadmap in this direction would provide a consistent policy approach which would serve as a guide to investors seeking to invest in these financial institutions.

Conclusion

The issue is not merely of structuring institutions since we have enough and more of them in the public sector. The challenge is to make them function effectively. And this can happen only if government adopts an arm's length approach, ensures they are professionally managed and permit decision making on commercial considerations rather at governmental levels. The Indian economy is presently poised at such an inflexion point that we have no option but to ensure the success of these reform measures. It is thus the timely execution of these decisions which is most critical if the benefits of the reform measures are to be realised.

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