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Calling PSU banks to account

The government must move away from the mindset of 'owner as sovereign' to 'owner as investor' to make these institutions healthy again

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No economy can be strong without a strong banking system. The Indian banking system is weaker than most are willing to admit. And it has a lot to do with the challenges of our public sector undertaking (PSU) banks that still account for over 70 per cent of the assets of the system. PSU banks have had a chequered history, buffeted as they have been by the pressures that come from government ownership. It is useful to remind ourselves briefly of this history.

The State Bank of India came into being in 1955 as a result of the nationalisation of the Imperial Bank, which was pursued with the goal of eliminating the anti-agriculture bias of the banking system and making banking services more accessible to the masses. This was followed, in pursuit of the same objectives, by the nationalisation of 14 private banks in 1969 and another six in 1980, and the progressive introduction of other regulations intended to direct credit to "priority sectors" at subsidised costs.

The nationalisation of banks did succeed in dramatically increasing the number of bank branches per capita, in mobilising deposits from the masses and raising the share of agriculture in total credit outstanding. But it also seriously undermined the health of PSU banks and hence of the banking system more generally[1]. By 1992, the return on assets (RoA) of PSU banks had turned negative and their gross non-performing assets (NPAs) were running at 23 per cent of their outstanding advances.

Following the recommendations of the Narasimham Committee, the government pumped in about ₹20,000 crore in tier-I equity to shore up the balance sheets of PSU banks between 1993 and 1998. But even this amount was insufficient for PSU banks to meet with the minimum regulatory capital requirements imposed by the Reserve Bank of India. The government was left with little choice but to also allow PSU banks to raise tier-I equity directly from capital markets by diluting the government's ownership. That infusion of capital was critical in helping the PSU banks finally overcome the burden of accumulated NPAs and support the revival of the last credit cycle.

Now, fast forward to 2014. History is repeating itself. The same pressures that contributed to the declining profitability and deteriorating asset quality of PSU banks the last time around have built up. The last three years of sluggish growth have been difficult for all banks, but PSU banks have fared particularly badly, compared to private banks. Burdened with fuzzy mandates, government control and operational inflexibility, PSU banks have been losing market share and facing declining profitability. Their RoAs have collapsed to under 0.4 per cent of assets, and stressed loans assets (gross non-performing plus restructured loans) are now kissing 12 per cent of loans outstanding, even as the bar for minimum regulatory capital has now been raised even higher thanks to Basel III. PSU banks have become vulnerable and undercapitalised yet again. They pose a risk to the entire banking system.

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As was the case in the 1990s, PSU banks need an extraordinary equity infusion to be nursed back to good health. Without such an infusion they will not be able to support future credit growth as the investment cycle turns. How much capital these banks actually need will be a function of asset quality, regulatory requirements and internal accruals. According to the P J Nayak Committee[2], if PSU banks need to grow their loan books at a modest 16 per cent, and if 30 per cent of their restructured assets become non-performing, then an additional ₹3.1 lakh crore ($50 billion) of equity capital will be required beyond their projected internal accruals over the next four years to ensure that these banks are Basel-III compliant.

In his Budget speech, the finance minister's estimate of the Basel III-related capital requirements of PSU banks was ₹2.4 lakh crore ($40 billion), but that did not include any capital for additional provisions. No matter how you look at it, it is safe to assume that PSU banks will need ₹2-3 lakh crore of additional equity capital in the near future. The government does not have the requisite fiscal resources to shoulder this burden. So this capital will not come from budgetary contributions. Indeed, the government's expectation seems to be that the banks will be able to raise all the necessary equity capital[3] from the markets without diluting the government's ownership share to below 51 per cent. But is this realistic?

The total market capitalisation of PSU banks at today's equity prices is about ₹4 lakh crore and the weighted average government ownership is about 62.5 per cent. Raising even ₹2 lakh crore would dilute the government's ownership share to under 42 per cent. Admittedly, the valuation of PSU banks is quite beaten down at this moment. As the economy improves, market fears about the asset quality of PSU banks will recede and their market valuations will improve, or so goes the argument of the optimists. However, even if the value of PSU banks were to double from current levels, a ₹2 lakh-crore capital raise would still require the government to dilute its ownership to under 51 per cent.

The conclusion is clear. If the government is serious about the economy's healthy recovery, it must ensure that PSU banks are restored to health sooner rather than later. As in the 1990s, this will involve raising equity through the dilution of government ownership — budgetary contributions on this scale are infeasible. But unlike then, this time around, it will be very hard for the government to keep its ownership above 51 per cent. This has fundamental implications for the governance of PSU banks. It means that the government must get comfortable moving away from the mindset of "owner as sovereign" to one of "owner as investor". This will require debate, careful preparation and artful execution.

The initial indications are that this will not be an easy journey for this government. If media reports are to be believed, the government's immediate interest seems to be on how to get PSU banks to make a big push in financial inclusion. A scheme is reportedly being prepared, the goal of which will be to ensure that every family in the country has at least two bank accounts and access to a ₹5,000-overdraft facility. On the face of it, this smacks of the old-style approach of using PSU banks for wider social objectives without regard to profitability. There is no doubt that financial inclusion is an important objective, but to achieve it we must devise strategies that rely less on target-setting and more on facilitating the adoption of technologies and partnerships that can significantly drive down the costs of delivering financial services.

Meanwhile, the government's immediate priority must be to address the very significant capital requirements of PSU banks. The P J Nayak Committee Report has some sensible suggestions on this critical matter. I hope that they will get the expeditious and serious attention they deserve.

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1 Bank profits were also squeezed because of the very high level of pre-emptions in the form of SLRs and CRRs at that time

2 Report of the Committee to Review Governance of the Boards of Banks in India, May 2014

3 Very little can be raised in the form of Basel compliant non-equity instruments