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Privatisation not a panacea for PSU banks

The market can become more supportive of PSU banks provided the government improves their management and governance

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Finance Minister Arun Jaitley is reported to have said that he wants public sector undertaking (PSU) banks to "retain their public sector character". What does he mean? Presumably, he means that he wants the government to retain its ability to use these banks in pursuit of social, political and development objectives that he believes will not be met if these banks were privately run. This is why banks were nationalised in the first place and this is why, 45 years on, the government is still reluctant to let go of its control over banks. Take the Jan Dhan Yojana (JDY), an initiative that is being implemented in "mission mode". It is reported that 20 million new bank accounts were opened even before the scheme was formally launched by the prime minister on August 28.

Mobilisation of administrative resources at this speed and scale could not have been possible if the government had to rely on just private sector banks. Control over PSU banks is what is allowing the government to drive this scheme. But we also know that control has its downside. Government influence can, and has, been abused. It can, and has, eroded the profitability, asset quality and talent pool of these banks. Even the JDY has been designed to deliver on important social goals, so little thought has been given to cost recovery for the participating banks. Whatever the commercial consequences of government control, ownership must surely be backed up with capital.

The dilemma that Jaitley faces is that while he does not want to relinquish control over PSU banks, he does not have the resources to keep them adequately capitalised — he must raise equity funding from private investors. As pointed out in my last article, PSU banks need ₹2-3 lakh crore of incremental equity over the next four years just to support modest credit growth of 15 per cent a year*. Currently, it will not be possible to raise the capital that these banks really need without diluting the government's direct ownership stake to below 50 per cent. There are several scenarios that could unfold.

There is the "do nothing" scenario in which PSU banks are left to cobble together whatever funds the markets are willing to give them. This will be a decidedly poor outcome for it will leave PSU banks severely under-capitalised. Given that more than two thirds of bank loans outstanding are from PSU banks, this course of inaction will erode our financial system's capacity to service the credit demands of a rebounding economy. Indeed, it may jeopardise the economic recovery.

Then there is the "buy more time" scenario in which the government forces insurance companies under its control, notably the Life Insurance Corporation (LIC), to bridge the gap in the equity funding requirements. But beyond a point IRDA, the insurance regulator, will surely prevent LIC from increasing its already substantial exposure to PSU banks. The numbers are too large for LIC to plug the likely funding gap.

The most sensible and, therefore, the most difficult, course of action will be for government to first launch a series of measures to improve the market's confidence in the functioning of PSU banks. The purists will argue that the only way to win the sustained confidence of the markets will be for government to privatise PSU banks. I do not believe that privatisation is a panacea for our PSU banks. It may work for a couple of the smaller PSU banks, but for the rest, it will likely create its own set of problems. I think the market could become suitably supportive even of government-controlled PSU banks, provided these banks stay committed to a certain minimum standard of commercial discipline. How is this to be done?

The government must change its mindset from 'owner as sovereign' to 'owner as investor' in terms of how it engages with the financial system. This implies recognising that retaining control does not require retaining majority ownership

Improve management: Hiring the right people for the job and giving them room to run is half the battle. Getting this right for PSU banks will mean adopting familiar recommendations including: setting up an independent panel of professionals to make transparent, merit-based selections to senior management positions through open competition; fixing a minimum tenure of three to five years for seniormost management positions; and delinking the compensation of PSU bank senior management from government comparators[1].

Improve governance: This will include steps such as: allowing the panel of professionals to also select the non-government outside directors to the boards of PSU banks; bifurcating the position of chairman and CEO and making the former a non-executive position to add another layer of governance; allowing PSU bank boards to function as normal boards with responsibility for strategy formulation, performance targets, succession planning and compensation setting; improving the transparency and quality of disclosures on PSU banks' non-commercial activities; and *inter alia* finding a solution for getting these banks out from under the debilitating oversight of the Central Vigilance Commission (CVC)[2].

Change mindsets: The government must change its mindset from "owner as sovereign" to "owner as investor" in terms of how it engages with the financial system. This implies recognising that retaining control does not require retaining majority ownership. And it will require a shift from using administrative fiat and sanction to using indirect mechanisms and incentives for driving policy outcomes. As far as PSU banks are concerned, the government could allow its ownership share to fall below 50 per cent and drive policy objectives through priority sector-type regulations administered by the Reserve Bank of India rather than through directives issued to bank management. In the case of the JDY, for example, the scheme could be re-crafted to rely less on top-down targets for opening bank accounts and more on providing incentives to all banks, public and private, for stepping up their outreach.

If the government still felt the need to intervene more directly in the allocation of credit it could still rely on the array of existing majority government-owned development finance institutions (DFIs) including the Power Finance Corporation, Rural Electrification Corporation, Industrial Finance Corporation of India, India Infrastructure Finance Company Ltd, National Bank for Agriculture and Rural Development and Small Industries Development Bank of India that together account for a substantial eight per cent of our financial system's advances in three areas of national priority — infrastructure, agriculture and inclusion and SMEs without undermining the governance of the wider financial landscape[3].

This government has the opportunity to significantly modernise our financial system, so that it is prepared for the challenge of the next couple of decades. Unless we act strategically now, we risk drifting into a messy growth-constraining quagmire.

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**'Minimum government, maximum governance' in public sector banks (August 27)*

1 As of now the compensation of PSU bank CMDs is capped not to exceed the compensation of a Secretary to the Government of India

2 There is plenty of evidence to suggest that the threat of CVC action impedes normal risk taking by public sector bankers and it is not particularly effective in curbing unethical behaviour

3 The operations of these DFIs could be made more focused and effective by combining them into one large DFI along the lines of BNDES in Brazil or into three DFIs each focused on one area of strategic priority.