Lessons from a fraud

The Punjab National Bank-Nirav Modi scandal has, once again, given rise to questions about public sector banking in India. The mixing of the business of banking with government is fraught with difficulties. Public ownership effectively reduces the RBI's powers to punish managements and boards of banks when they fail to perform their key role of managing risk. Rules of hiring and salary, political pressures, lack of accountability and the implicit sovereign guarantee of PSBs create the wrong incentives.

While the blame-game is on for l'affaire Nirav Modi, India needs to address fundamental questions about ownership of banks and the difficulties it creates. This is not surprising given the public support for PSU banks. Public sector ownership comes with an implicit sovereign guarantee.

For instance, depositor angst about the Financial Resolution and Deposit Insurance (FRDI) bill has been mainly because it has brought into the public debate the fact that all deposits are not guaranteed. Most depositors are not aware of the Rs 1 lakh limit of deposit insurance. The realisation that deposits above one lakh may not be safe if a bank fails, even if the bank is owned by government, is creating huge discomfort. Whether a bank is involved in fraud, as allegedly in the case of the PNB, or whether it has made bad judgements about business loans, depositors have been looking towards public ownership rather than the competence of the bank management for keeping their savings safe.

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Given that there are few avenues for safe financial savings, this is to be expected. On the one hand, India forces banks to hold government bonds through the Statutory Liquidity Ratio. On the other, it does not allow households to lend to the government through small savings schemes like the Public Provident Fund and National Savings Schemes beyond income tax rebates. Nor can households purchase risk-free government bonds through the stock market. Households which have low-risk appetite go through the public sector banking system to find avenues for their financial savings. The lack of other instruments in the financial sector, therefore, creates political pressure for public ownership of banks.

The PNB-Nirav Modi fraud highlights the failure of operational risk management and auditing systems. Regardless of whether it was inefficiency or fraud, what is the accountability of the management and the board of the bank? If the PNB was privately owned, would the impact of such a fraud have been only on the two officials arrested or directly involved?

It is reported that the RBI has asked the PNB to pay other banks who gave credit based on the PNB's guarantee. If the PNB pays up and suffers losses, would it be the taxpayer who will fill in for these losses through further re-capitalisation of the bank?

How many times in the past have taxpayers paid the PNB and other public sector banks that were falling short? CAG Report No. 28 of 2017 titled "Performance Audit Union Government Recapitalisation of Public Sector Banks" says that GOI, as the majority shareholder, has infused capital of Rs 1,18,724 crore from 2008-09 to 2016-17 in PSBs for meeting their capital adequacy requirements. The government has announced that it is infusing another Rs 2.11 lakh crore into PSU banks. At the same time, bad loans in the banking sector are above 10 per cent of outstanding loans. According to the RBI's Financial Stability Report, while NPAs are rising for both public and private sector banks, those for public sector banks could rise to as much as 14.6 per cent by March 2018.

What is the way forward? The answer may not lie in the over-simplified solution that public sector banks should be privatised. That would be part of the solution, but along with that, other reforms

are needed.

First, there is a need to address the requirements of a large and increasing number of investors who should get greater access to mechanisms to lend to government. This may not even mean lower returns. Considering that today the government 10-year bond yield at above 7 per cent is higher than the fixed deposit rate offered by most banks, some could choose to invest in bonds directly through the stock market. This needs a reform of the bonds market.

Second, small savings schemes should be reformed. Direct lending to small savings schemes can be expanded beyond the tax rebate caps. Interest rates can be linked to government bond yields. Third, to address concerns about private banks the deposit insurance cap could be raised; Rs 5 lakh would cover 98 per cent deposits.

Fourth, if the government decides that PSBs should offer risk-free deposits above the cap on deposit insurance they should be allowed to invest only in government bonds, or, do "narrow banking". Then the implicit sovereign guarantee could effectively turn into explicit sovereign guarantee. The business of giving loans, making decisions, figuring out risk management systems, hiring competent staff, provisioning for bad loans, creating mechanisms for accountability and punishing management when systems fail can be left to private banks. Today the taxpayer pays when PSBs fail to perform these functions properly. Narrow banking by PSBs can take this burden away from the taxpayer.

The reforms of 1991 changed the way business works in India. They allowed the private sector to set up production and import without needing licences. They fundamentally took government out of the role of determining how and what should be produced. However, what they failed to do was to take the government out of the role of financing production and trade. By maintaining a largely bank dominated financial system and keeping it public sector dominated, India tried to run a market economy on one leg. The other leg, of finance, that should have supported the market economy, has been dragging the economy down. More than 25 years after liberalisation, finance is increasingly emerging as the binding constraint which emphasises the pressing need for fundamental reform.

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