Bankers, not bureaucrats, should run India’s banks

Indian banks are being hit with one disaster after another. They are already dealing with a bad-loan problem that’s close to a crisis—and which caused India’s largest bank to declare a quarterly loss for the first time since the beginning of the millennium. Some of the loans that have gone bad—such as those to the flamboyant liquor magnate Vijay Mallya—already had terrible optics and were being investigated by various regulators as well as the police. The latest fraud allegation is of eye-popping scale: Punjab National Bank (PNB) has reportedly admitted that a well-connected jewellery czar connived with bank employees to fraudulently acquire credit guarantees worth over $1.8 billion. That’s eight times the bank’s annual earnings.

The New Delhi bureaucrat who runs India’s banking sector says this is an “isolated” incident. But few people will buy that. Indians already by and large believe that Indian banks are in the pockets of the country’s business elite. The banks’ lending is slanted that way and there have been multiple accusations by politicians that banks provide retail money laundering services for India’s 1%. Even during Indian banks’ finest hour, when they struggled to deal with an entire country being forced to line up at their nearest branch to exchange old notes for new thanks to the government’s decision to withdraw most existing currency overnight, there were persistent complaints that bank employees were letting the rich break the rules.

So what’s new, you ask? Isn’t the entire world convinced that finance is a game rigged for the rich? There’s a very special twist in India, however: Our financial sector, like China’s, is dominated by the state. Punjab National Bank is one of the state-owned banks that have an outsize impact on lending here. In fact, it’s the second-largest state bank. Overall, government bureaucrats in New Delhi control 70% of the banking sector, ostensibly on behalf of “the people.”

India’s socialist rulers nationalized the banks in 1969 precisely because they thought they were set up to favour the rich; it’s long been clear that state ownership has only made the problem worse. It is no coincidence that most of these outsize loans and egregious frauds were made to those with solid political connections of one kind or another. Mallya, for example, entered the upper house of India’s parliament in 2010 with the backing of the ruling Bharatiya Janata Party (BJP).

This particular billion-dollar fraud, according to the management of Punjab National Bank, only involved a few employees. But what’s worth noting is that these employees found risk management systems and existing regulations incredibly easy to subvert—and got employees of other Indian banks to play along. Who put such easily bypassed systems in place? And why have they been allowed to persist?

Punjab National Bank itself got into trouble following a very similar fraud just five years ago—again, it was a jewellery company that took advantage of letters of guarantee. Perhaps jewellery—given the vast sums that have to be moved across borders constantly—is particularly susceptible to fraud. It’s also a clannish and close-knit industry, and the families that rule it have managed to build up close relationships with their bankers over decades. But that’s no excuse: You’re supposed to have mechanisms in place that would more carefully scrutinize precisely such businesses and their transactions.

It’s hard not to conclude that the poor systems and management that enable bad lending and outright fraught are just another consequence of the lack of accountability inherent in state control. Punjab National Bank will hardly have to endure the market’s penalties for bad behaviour and bad decisions; the government has already promised to recapitalize its struggling banks.

There are two lessons to take from this. The first is that you can’t fix India’s banking sector without effort. The government first delayed dealing with non-performing assets and even now is avoiding the real costs of a bank bailout. It has also refused even to consider the only real long-term solution to the crisis—privatization. Without bank governance reform, loan crises and fraud will keep on recurring, and Indian taxpayers will keep on shelling out cash. It’s not surprising that even the deputy governor of India’s central bank has openly called for banks to be reprivatied.

The second lesson, however, is applicable everywhere. Don’t assume that fraud and chumminess with big business in finance can be solved by more government control. India’s experience is clear: It only makes things worse. For that matter, ask a Chinese entrepreneur—quietly—who she thinks the country’s state-controlled banking system is set up to favour. You think you can impose morality on finance by getting more bureaucrats into the system? It hasn’t worked for governments, why should it work for banks? **Bloomberg**

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