Banking reforms package needs more punch

If well-begun is half done, then the recapitalisation programme will indeed go a long way in putting state-owned lenders on the path to recovery. Yet, as one digs deeper, the overwhelming feeling, especially with the sketchy details released so far, is that the government could have gone much further to truly reform public sector banking.

The Rs2.11 trillion recapitalisation programme is truly unprecedented for its sheer size. The government has said that this package will be tied to reforms and performance. Yet, the equity infusion that has been announced is across the board. All state-owned lenders, barring one, are beneficiaries of the capital injection. Indeed, weaker banks, which are under the so-called prompt corrective action (PCA), are going to absorb 60% of the first tranche of funds.

One could well argue that the government doesn't have much choice. It couldn't leave the PCA banks to starve for capital, especially when it has had to fight rumours of such banks closing and reassure depositors. In that sense, the capital injection is a good step because it will help banks clean up their balance sheets.

It will allow lenders to cut down on net non-performing assets and improve their capital ratios, thus enabling them to get out of PCA. However, it appears doubtful whether this first tranche is enough to boost credit growth after setting aside funds for bad loans, regulatory requirement and the planned transition to the new accounting system from 1 April.

Be that as it may, this across-the-board capital infusion perpetuates the old system of banks getting free capital with no incentives to use it wisely and manage their risk well. Indeed, more efficient banks feel penalized despite conducting their business well while the laggards still get capital.

Yes, some reforms have been announced. But they appear all too familiar. Homilies like responsible banking, consumer responsiveness and risk management have been mouthed by earlier finance ministers and Reserve Bank of India officials. Banks do have performance management systems. Many of them have already been selling non-core assets. Many lenders have moved their stressed assets to separate verticals to expedite recovery, to cite a few examples.

The steps outlined in the finance ministry presentation are qualitative for the most part. That banks have to take at least 10% exposure in consortium loans is the one big detail that has emerged.

The key question is how exactly the government is going to tie future infusions to reforms. Its track record isn't exactly sparkling in this regard. In a three-part series published earlier this month, *Mint's* Tamal Bandopadhyay and Achintan Bhattacharya showed how the **department of financial services (DFS) was lax in ensuring efficient capital allocation to banks**. Not only was there wide variation and discretion in the terms of memoranda of understanding signed with banks (the tool to ensure efficiency in state-owned banks), there was ad hocism in monitoring as well, they concluded.

Where the government could have gone a step ahead is to overhaul public sector banking structurally. While it has increased surveillance (read steps like specialized monitoring agencies to red-flag breach of covenants for loans above Rs250 crore), it should allow the banks more autonomy. Public sector banks have to suffer interference from the government and the bureaucracy. Sometimes, they are forced to do things—like extend loans to crony capitalists—when it is in clear conflict with business objectives.

Once bank balance sheets are cleaned up, it is time the government give up ownership of some banks. While some public sector banks may be needed for some financial inclusion objectives, do we need so many state-owned lenders? The government could make a start by whittling down its stake in some PSU banks. As early as 2000-01, the then BJP government's Yashwant Sinha had proposed bringing down government stake to 33%.

Another key reform for state-owned banks would be to ensure that state-owned bankers have the right incentive structures in place. Banks should be given the flexibility to hire the right talent—especially specialists in areas such as project management and IT—professionalize their boards and offer attractive compensation packages, as former RBI governor Raghuram Rajan noted in his 16 August 2016 speech.

To give the government the benefit of the doubt, perhaps the details of these reforms will emerge in the future. But till they are announced, the well-begun recapitalisation and reforms programme will remain only half done.

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