Banking reforms must complement bank recapitalisation plan

The gargantuan non-performing assets (NPAs) have massively dented the net worth of India’s public sector banks. While the need for quickly restoring equilibrium in their balance sheets is compelling, there are many constraints. Recognizing the catalytic role of PSU banks in supporting growth and employment, the government has moved on two mutually reinforcing tracks: introduction of the insolvency and bankruptcy code to help public sector banks sanitize their balance sheets in a time-bound manner and a massive recapitalisation of Rs2.11 trillion over the next two years via recapitalisation bonds (64%), budgetary support (8.5%) and mobilization from the market (27.5%).

Although PSU bank recapitalisation dates to the 1990s, it became vigorous 2010-11 onwards. While up to 2009-10, the cumulative recapitalisation amounted to Rs230 billion, during 2010-11 to 2016-17, it was Rs1,081 billion. Initially, recapitalisation was aimed at mitigating temporary problems encountered by a few weak public sector banks, but later, it degenerated into a tradition, even including the stronger banks of the lot.

As the major owner, the government is free to recapitalise, but the crux of the issue is, at what cost, for how long, and whether recapitalisation alone is enough.

The government is finding it increasingly difficult to recapitalize public sector banks due to the compulsion to adhere to the stringent budgetary deficit benchmarks. In 2015-16, recapitalisation of Rs250 billion eroded 1.4% of total expenditure and 3.4% of direct taxes. In 2016-17, though the recapitalisation amount remained unchanged, the two ratios came down due to higher total expenditure and direct taxes. As a proportion of the gross domestic product (GDP) and gross fiscal deficit, it accounted for 0.2% and 4.7%, respectively, in 2016-17, same as in the preceding year. The cumulative recapitalisation, during 2010-11 to 2016-17, constituted 0.99%, 2.72% and 3.12%, respectively, of total expenditure, direct taxes and gross fiscal deficit (see chart above).

Autonomous and continuous recapitalisation generates several forms of perverse incentives. As seen in the past, bankers become overly aggressive and lackadaisical toward debt recovery, and tend to escalate provisions and contingencies to be adjusted against the fresh capital. Further, in “different-banks-same-pay” situations, employees in the loss-making, but recapitalized, banks become unenthusiastic while those in profit-making, but not recapitalized, suffer heartburn. It also implies cross-subsidization: dividend-paying PSU banks subsidizing the non-dividend paying. Ultimately, systemic efficiency suffers.

It is debatable whether public sector banks, post-recapitalisation, would augment credit deployment. Credit offtake is strongly a function of overall economic environment and policies. Besides availability of other competing sources of funds, it also depends upon the evolving credit culture and bankers’ propensity to take risk—both badly vitiated today. Therefore, increased financial strength via bank recapitalisation may be necessary but not sufficient for credit expansion.

Similarly, capital mobilization from the market in the post-recapitalisation period would depend on the bank’s track record on several parameters other than the refurbished net worth, including, notably, its capability to withstand stress as well as valuation, in the medium-term.

The uninterrupted process of bank recapitalisation, not being adequately matched by expected improvement in the recapitalised banks’ performance, is testimony to short-termism as also lack of follow-up reforms—systemic or bank-specific—to tackle the problems which are, in fact, proving to be much more deep-rooted than earlier thought. The major banking reforms are discussed below.

Consolidation: India still needs public sector banks, but not so many. The banking structure, which was outlined by the Narasimham Committee-I, i.e., (a) Three or four large “international” banks, (b) Eight to 10 “national” banks, (c) “Regional” banks and (d) “Rural” banks, holds relevance for any fresh endeavour.

Going forward, if some PSU banks cannot mobilize the required resources for their profitable growth, they should be either privatized or merged rather than continuing as zombies. In such circumstances, besides merger of accounts, systems and procedures, the review of the business models of the merged entity as well as physical and emotional integration of human resources and addressing cross-cultural issues in the human resource- (HR-) mix assume utmost importance.

Autonomy for banks: For a durable remedy to NPAs, PSU banks must be given adequate functional autonomy and operational flexibility. While eliminating “dual control” is difficult to come by, bureaucratic and political interference must be consciously minimized. Though greater freedom comes with increased surveillance by supervisors and law-enforcing machinery, it should not be so intrusive that bankers euthanize their risk-taking propensity.

Modern HR management: The public sector banks’ approach to the entire HR process needs overhauling and made bank-specific. The individual banks need to take care of their recruitment. The current collective bargaining should be replaced by the “different-bank-different-pay” model and link the remuneration to the individual bank’s “ability to pay”. Motivational aspects like variable pay, employee stock ownership plan (ESOP), etc. need to be introduced forthwith. Re-skilling the existing staff, along with direct recruitment of specialists, is needed to address the talent issue, especially in domains like forex, treasury, IT, data and research, and HR.

Digitalization challenge: Digitalization of the payment systems is inescapable, but only a handful of PSBs are truly active in National Electronic Funds Transfer (NEFT), point of sale (POS) ownership and card transactions space. The major considerations for PSU banks include: cost of acquisition and maintenance of the systems, their scalability, interoperability and adaptability, cybersecurity, and resilience against technological obsolescence. All these necessitate massive capital investments on a regular basis. Against the current deplorable financial condition of public sector banks, combined with the recapitalisation money targeted at “repairing” the balance sheets, they will have to explore the sharing of payment systems, collaboration with financially sound and technologically resilient fin-tech companies and hiving off the payment systems to separate subsidiaries and subsequently, corporatizing these suitably.

Recapitalisation alone cannot be the panacea. It is extremely crucial that the banking reforms are properly sequenced and executed in time. Certainly, the need of the hour is another high-powered committee.

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