To fix the rot in public sector banks, start with the boards

The Rs12,700 crore fraud at Punjab National Bank (PNB) has reopened the debate on privatization of public sector banks. That debate will take years to resolve as multiple stakeholders are involved. The interests of bank employees and taxpayers, the political messaging of privatization, and the government's own interests as the owner will have to be factored in.

This debate should not distract from the more immediate problem: public sector banks need to put their houses in order; systems and processes need to be put in place to prevent such frauds.

Thus, the discussion should be around the separation of ownership and professional management. It should be about ways to strengthen the board and management of public sector banks and build capacity to address risks. While public sector banks may serve social mandates, the government should not see them as an extension of itself; such banks should not see themselves as agents of the state, but as for-profit listed companies. The government can fulfil these social mandates by paying an adequate price, former Reserve Bank of India (RBI) governor Raghuram Rajan said.

When the subject of public sector bank autonomy crops up, the discussion revolves around government interference in lending. Apart from supporting financial inclusion projects and government bond-buying mandate, PSU bankers often have to extend loans—often said to be against their good judgement—because of pressure from bureaucrats and ministers. That is a credit risk, and the first thing that needs to addressed. It has nothing to do with a couple of employees committing a fraud in some branch which is an operational risk. But a strong board will play a role in not only introducing best practices in risk management, but ensuring that these are adhered to.

That brings us to the board then. State-owned banks are regulated in a different way from private banks. The roles of their boards also are different. Key executive appointments in PSU banks are recommended by the Bank Board Bureau and then approved by the appointment committee of the cabinet. The board of a public sector bank doesn't have the power to fire the CEO for poor performance or failure in oversight. If such a fraud had occurred in a private sector bank, the central bank would be well within its powers to remove the board. But in a PSU bank, the power rests with the government itself. While the board may ensure the government's bidding is done, it is powerless to give directions to management and hold it accountable. No wonder then there seems to be a sameness in PSU bank boards.

Separating ownership from management should start with the government saying that while it will have its nominee directors to safeguard its interest and provide direction, boards should be free to set their own vision and mission. They should be free to hire and fire top executives, and roll out human resource management, governance and compensation strategies as they see fit.

Instead of doing this, the knee-jerk reaction seems to be ordering a probe into non-performing loans over Rs50 crore. It will create an aura of fear in bankers about vigilance authorities second-guessing business decisions they had taken. It will be enough to stymie credit growth which has improved to 11% and was expected to rise further on the back of the rebound in economic growth.

Ultimately, this is also about the government having to resolve the conflicts between its role as a owner versus the entity responsible for financial stability. As an owner, it wants to promote financial inclusion, ensure banks keep on buying its bonds and lend to farmers and priority sector etc. That's all fine and it can still drive these decisions. However, for financial stability, it needs to ensure that PSU banks are well run and don't bring the system to the cusp of contagion, at the same time ensuring that taxpayers don’t pick up the burden.

The PNB fraud is a call to action for the government to do the right thing and ensure that the scope for such frauds is minimised forever. This fraud has delivered a message about the rot that has crept in over the years. The government can choose to shoot the messenger or go about the tougher task of reforming the entire public sector banking edifice.

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