1. The Roadmap for Real Banking Reforms

Context:

- The move to merge 10 public sector banks (PSBs) into four large banks has been touted as a banking sector reform.

Background:

- Merging Banks were Narasimham Committee recommendations
- These were forward-looking and are still relevant.
- But if we examine the recommendations to see which of these have been effectively implemented, a pattern emerges.

Explanation:

- There are two ways in which the state could look at the banking sector, there is a **public purpose to be achieved**, and on the other, **there is profitability.**
- There is need to prioritize these, or else results would be half hearted and confused.
- If the objectives of the state are clear, there would be clarity on the instrumentality that is to be used.

Public Interest Motive:

- Nationalization of banks in 1969 and again in 1980 achieved a larger public purpose.
- **Similar Approach**
  - The same is applicable to the setting up of **Development Financial Institutions (DFIs)** in the 1950 and 60s and the establishment of Regional Rural Banks (RRBs) in 1975. This approach looked at banking (and financial services) as a public service, structured within the commercial frame.
  - The concerns were largely pertaining to institutional access to services—particularly, credit to the poor and for public investments required to boost economic development.
  - It did not really matter if these institutions made losses. They would be recapitalized once in a while to keep them going.
- The nationalization of banks bridged the rural-urban divide to an extent by accelerating the opening up of bank branches in unbanked areas.
- RRBs bridged the regional divide by taking a decentralized approach and setting up institutional access in regions other than southern and western India which were well-banked.

- **DFIs helped the industrial sector to develop roots**.
- Nationalization of banks gave the comfort of sovereign backing to the banks (remember there was no Basel norms then), and it was possible for the banking sector to grow fast, without being bogged down by profit maximization considerations.
- The takeover of banking by the state gave it scale and spread. The control of banking also helped in portfolio allocation to sectors that were underserved—agriculture and tiny, micro and small enterprises. This allocation was done through directed credit and administered interest rates which was a pure public purpose initiative.

Crux of the Matter:

- After 1991 economic reforms, there was a fundamental change in the way these institutions were seen as the government's policy moved to become more market facing (while not giving up the public purpose agenda).
- Banks and DFIs were redefined as market facing institutions.
- The reforms suggested by the Narasimham Committee were to make them completely market facing, seen purely through the prism of commercial viability.
- **Explanation**
  - The history of reform from 1991 onward, we find that all those reform measures that are market facing but do not have a public purpose implication have been implemented.
  - However, the state has kept the banks under operational control because it continues to use them for implementing its public purpose activities.
  - It is instructive to look at the Narasimham recommendations, which fell under three broad heads, in some detail.

A) Structural Reforms

- Autonomy for DFIs and banks; boards to be made autonomous; chairman and managing directors to have a fixed tenure; officers to be recruited autonomously with pay structures defined by the respective bank boards; an end to the duality of control, with regulatory control exercised only through the Reserve Bank of India (RBI) and no government intervention, irrespective of ownership.
- Have 3-4 national banks including State Bank of India, 8-10 universal banks, and a slew of local banks with regional footprint and each commercial bank will also need to have a rural bank as a subsidiary.

- **Criticism**
    - These recommendations were never implemented in the spirit that they were made and in the sequence that it was supposed to be done.
    - While the state was ambivalent about ownership and shedding its share, it was (and is) not fully convinced in letting go off operational control because it continues to serve a public purpose (like Jan Dhan accounts).
    - The reform idea of autonomy, independence, and consolidation (in that order) was to signal that if there were any public purpose requirements, they had to be achieved through a non-discriminatory regulatory intervention that was ownership neutral.
    - Autonomy would allow these institutions to strategize and hopefully consolidate based on synergies and value creation. The state has lost the spirit of these recommendations completely.

B) Prudential Recommendations

- The committee suggested that Statutory Liquidity Ratio (SLR) should be seen as a prudential requirement and not as an instrument for financing the exchequer, and Cash Reserve Ratio (CRR) should be a monetary policy instrument and not a secondary expansion tool of the state.
- The public purpose of deficit financing through banks was removed with the abolition of automatic remonetization and the passing of the Fiscal Responsibility and Budgetary Management (FRBM) Act, 2003.
- Therefore, SLR and CRR became prudential requirements without any implication for the state's budgetary management. Other prudential suggestions, from capital adequacy to improving accounting standards, were also implemented by and large, perhaps because there was no significant implication on public purpose.

C) Operational Recommendation

- The abolition of branch licencing; deregulation of interest rates; special tribunals for the recovery of non-performing assets (NPAs); and the promotion of asset reconstruction companies (ARC).
- The branch licencing norms were indeed abolished. When it was seen that adequate branches were not being opened in rural areas, it was changed, but was done in a way which encouraged a level playing field for all banks by including the private sector banks.

- Interest rates were fully deregulated except for agriculture, where a perceived public purpose was being served.
- The other recommendations on NPAs were implemented, first through the SARFAESI Act, 2002, and then later through the Insolvency and Bankruptcy Code. ARCs were also set up.
- Priority sector lending was to be redefined and restricted to 10% (as against 40%) of the bank credit.
- The credit was also to be directed only to small and marginal farmers and tiny, micro and small enterprises. This was serving a larger public purpose, but was not implemented. However, since this is applicable irrespective of ownership, it should not be seen as a reform measure in public sector banking per se.
- The above instances illustrate that the **state is unwilling to let go off operational control, especially when the pretext is a larger public purpose.**
- The interventions over the past two decades have often come via the operational route rather than as policy or regulatory measures.
- At the same time, the state believes that since the vehicles used for these interventions are commercial organizations, they ought to be subjected to the market discipline of profitability and valuation.
- Herein lies the **dichotomy: they are commercial structures but carry a load of non-viable public purposes objectives.**

Issue with Consolidation

- In this context, consolidating banks and calling it “reforms" is a joke. The spirit of the reforms would be met if these institutions are completely made market facing.
- The intervention of the state for its public purpose objective should be through the policy and regulatory instrumentality and must be ownership neutral.
- In the case of RRBs, they continue to serve a larger public purpose. Their balance sheet would need periodic recapitalization and has to be dealt with on the basis of the merits of the public purpose they are addressing.
- The approach of consolidation of RRBs and listing them while continuing to hold on to public purpose objectives is a mindless exercise. The state would never let go of the public (and non-viable) functions that these banks perform.
- The state hopes that as the picture becomes bigger, the warts will disappear. No, they won’t.

- The mindless consolidation of PSBs is also not reform. It just destroys the enterprise value, as we have seen in the market response to the merger announcements.
- The decision to merge should have been a market facing decision, made through a process of discovery of synergies, brand potential, physical outreach, technology platforms, human resources, and unique strengths that mutually reinforce value creation.
- This is a professional exercise, to be carried out autonomously. But now its being carried out by people in administration who neither have the time nor the expertise to engage with value discovery and being implemented without much choice.
- Instead of solving a problem, this makes the problem bigger. Reform is based on one key word: “autonomy".
- The approach to reform, and the sequencing of reform, have been very well laid out in the recommendations of the PJ Nayak Committee.
- However, the state picks and chooses clauses without trying to understand the spirit in which the recommendations were made. Here is a way forward to think afresh on reforming India’s baking system.

Way Forward:

- The opening up of banking to the private sector—both in the case of universal banks and niche banks—was a fundamental market facing reform. Continue to keep the licencing on tap.
- PSBs should continue to serve a public purpose, but only through regulatory interventions that are ownership neutral.
- All regulatory control should be via RBI and the respective bank boards, not via the ministry, arbitrary circulars or the government fiat.
- Repeal the bank nationalization (PJ Nayak Committee recommendation); bring them under the Companies Act; apply fit-and-proper norms as applied to private sector banks. In the interim, there could also be an “autonomous" Banks Board Bureau.
- But the faster it is abolished after it has served a temporary purpose, the better.
- The representation of the government on the board may be restricted to one member (Narasimham recommendation), representing the investment concern of the state. This ideally should be an expert from the investment community and not an officer of a government department.

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