Banking Distress-The Road Ahead

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While the government has taken recent steps to alleviate the distress in the banking sector, these steps still leave scope for significant improvements on the governance of public sector banks (PSBs). Governance changes are essential to avoid repeated drain of taxpayers money to recapitalize the PSBs.

At its core, the issues with PSBs have to do with the umbilical cord that connects the PSBs to the government, and thereby to politicians and even more importantly, to bureaucrats. Political influence, which the current government has been conscious to avoid, usually catches the attention. But the damage done by the directives from bureaucrats are often less visible. These problems stem from banking being a specialized activity. Top bureaucrats are beyond doubt extremely smart people with unmatched levels of commitment to the public cause. However, we must remember that they are not experts in banking. For such non-experts to give directives to public sector banks' chairmen, who have spent 30-35 years in banks, cannot be efficient.

PSBs are clones of each other

Ideally, one wants a State Bank of India to have a different DNA vis-à-vis a Punjab National Bank or a Canara Bank. Such differentiation among the PSBs creates enough diversification among the public sector banks and thereby reduces systemic risk in the economy. If these banks are not clones of each other, a macroeconomic shock may adversely affect say a Canara Bank but not a Punjab National Bank because it's sufficiently different from Canara Bank in terms of the sectors it specializes in. If PSBs are not clones of each other, a macroeconomic shock would not lead to all PSBs facing stress. That's what happens in other economies when the banks are not so homogenous. If you take the earlier cycle of NPAs that happened in the mid-1990s in India and now, whenever there is a downturn in the economy, not a single PSU bank escapes the distress caused by the downturn; every PSB gets affected by the downturn. In contrast, such secular stress does not necessarily manifest with private sector banks: Kotak Mahindra Bank and HDFC bank, which differentiate themselves by focusing primarily on lending to the retail sector, did not get affected as badly by this cycle of distress. Their differentiated strategy primarily enabled these banks to escape the bloodbath. Such a differentiated strategy has yet to surface among the PSBs. In fact, the PSBs are so identical to each other that one has to step outside a branch of a PSB and read the board outside to find out which PSB one is dealing with.

One has to ask the question… what is the malaise that leads to such cloning? The malaise has to do with bureaucrats handling the banks. As in the current instance, except for the distinction among banks recommended for prompt corrective action and the ones that have not been recommended for the same, the directives are identically applicable to all the PSBs. As part of the research for the P J Nayak Committee report, we had looked at the kind of orders that are given to PSBs. Every order that goes from the Financial Services Secretary is addressed to all PSBs without exception. It may be the implementation of a core banking software or asset liability management norms. The same direction is given to all the banks. Over the several decades after bank nationalization, such uniform directives issued to all the PSBs led to the homogenization of PSBs. Ideally, it is the management of the bank and its boards that are best placed to understand the DNA of the bank and implement directives that maintain and enhance the distinct competitive advantage of the bank. If at all bureaucrats assume this responsibility, they should make the effort to understand the DNA and the character of each of these banks and then tailor the directives for each bank. But, such customization of directives has been historically absent and continues to be conspicuous by its absence. As a result, we continue to have 75 percent of the banking sector behaving economically like one humungous bank. That's what creates an enormous amount of systematic risk in the banking system. Therefore, the current set of directives do little to correct this key lacuna.

The Management Selection Process

The second issue pertains to process of selecting the bank's senior management, including the bank chairmen, as well as the board members. Across the world, when it comes to professionals, particularly at the very high-end, peers select peers. In the private sector, the Nominations and Remunerations Committee of the board of a bank recruit the CEO, other senior management and members of the board. In such top-level recruitment, it is extremely important is to understand the CEO's strategic foresight, his/her human capital and leadership skills. How does the current process, even after the constitution of the Bank Boards Bureau (BBB) work?

These selections happen based on a short interview and the mandatory CVC, CBI process that assesses the integrity of the person. But these are definitely not adequate to judge the caliber of a CEO. If we still get some good people as Chairman of PSBs, it is despite the process and not because of it. Take the recent case of SBI. Just 2-3 days before the previous Chairperson was to retire, the new Chairman was appointed. Till that time, nobody at SBI knew who is going to be the next Chairman. As a result, it is unlikely that there would have been a well-coordinated handover, which takes time and effort especially in as complex a business as banking.

Even at the Indian School of Business where I teach, when appointing faculty, we have a full-day recruitment process where a new PhD scholar presents research over a 90-minute seminar, after which he or she interacts with each member of the senior faculty, one-on-one for about 45 minutes. You get diverse and independent judgements, after which we vote on that person and then decide on whether to recruit. That's how recruitment happens in top investment banking or consulting firms. For a senior role you end up meeting all the partners, spend a day, and then the decision is made. A similar process of selection where peers select peers would ensure that the various qualitative aspects of a leader are also assessed.

Disempowered Boards

The boards in a lot of the public sector banks are non-functional. As part of the Nayak Committee's report, we had looked into the kind of issues that are tabled at board meetings. In a bank, the two key aspects that should be discussed at a board meeting are the bank's strategy and its risk. Those two are like the accelerator and the brake in a bank. If one goes through the minutes of the board meetings of the PSBs, what one see is PSB boards do not discuss matters relating to risk and indulge primarily in box-ticking. This itself stems from the absence of risk-experts on banks boards. The poor structure of PSB boards gets reflected in into sub-optimal level of board-level oversight on management, which then leads to poor performance.

Going forward

Some solutions are more long-term, and others are short-to-medium term. The governance issue due to the umbilical cord, those are things that should be fixed immediately. The Indradhanush set of reforms that were promised two years back, they spoke of many of the suggestions that were made in the Nayak Committee report. They've still not be implemented in spirit. We had suggested the creation of the BBB with full powers relating to recruitment, leading up to the creation of a bank holding company, where the government's stakes are transferred. The bank holding company was suggested to create an additional layer between bureaucrats and politicians, on the one hand, and PSB management, on the other hand. If you have a BBB without banking sector experts being made responsible for the key appointments, or if you have a bank holding company where real power is not vested, then we would get business as usual. We had made it very clear that the BBB and the BHC should be populated with senior professional bankers of repute and impeccable integrity so that they became vehicles through which the PSB boards and PSB management make the key organizational, HR and commercial decisions. While commercial decisions have been delegated, the current directives clearly suggest that the organizational and HR decisions still continue to be taken by the Finance ministry. If organizational and governance aspects that created the cloning among PSBs are not removed, the same set of issues are likely to get repeated.