Public Bank Privatisation in a Post-truth World

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The Narendra Modi government appears to have decided to privatise public sector banks (PSBs). Preparations are underway with arguments being marshalled that "there is no alternative" to privatisation. Noises of this kind have emanated often from the Reserve Bank of India (RBI) and government spokespersons, but opposition from the unions and democratic forces inside and outside Parliament have made them just that—noises. Creeping disinvestment was the answer, but control has remained with the state. But now the advocates are getting pushy. While the governor of the RBI and the finance minister have made addressing the problem of weak banks and dealing with non-performing assets (NPAs) the main economic challenges facing the country, the recently appointed deputy governor of the RBI, Viral Acharya, appears to have taken on the task of laying out the road map to reprivatisation of public banks, the time for which has possibly finally come.

Usual Argument

The conventional argument for privatisation is well known. This is that bad decision-making, environmental factors and the absence of due diligence have resulted in an accumulation of NPAs on the books of the PSBs to an extent where they would have fallen by the wayside because of the sheer burden of writing off those losses. The only reason they have not, it is argued, is state support. And with the fiscal crunch, the government is no more in a position to provide similar support, or even the larger support that is now needed. So, mobilising capital from the "market" through sale of new equity that dilutes the government's shareholding is supposedly the only solution.

The fact of the matter is that public banks have survived not because of the support they got from the government. One presumes that support would mean financial assistance to make up for the capital losses that provisioning to write off bad debt would involve. In practice, budgetary support for recapitalisation, of ₹50,000 crore over 2015–16 and 2016–17, was far short of the ₹5 lakh crore of gross NPAs on the books of banks at the end of March 2016, most of which was with the PSBs.

But that is not all. A study by the research department of the State Bank of India has found that over the period 2005–06 to 2016–17, while capital infusion into the PSBs was ₹1.29 lakh crore, the dividend paid out by the PSBs was ₹75,000 crore and the cumulative income tax paid was around ₹1.5 lakh crore. More has flowed from the PSBs to the exchequer than from the latter to the public banks. The PSBs have remained in operation despite that, yet the perception is that NPAs in public banks are a drain on the exchequer and could abort the fiscal reform effort of the central government.

For the last few years, the emphasis has been on selling a part of the NPAs to asset reconstruction corporations (ARCs) at a heavy discount. However, the discounts demanded have been such that the PSBs have not found this route attractive enough, so that actual sale has been far short of expectations. The experience with private ARCs has been a disappointment; it is really asset sale and raising capital from the market that constitute non-government sources of finance to address the problem. But the problem at hand militates against this solution. Given the large NPAs on the books of banks, even when not violating the target of retaining at least 51% of equity, new issues of equity through public offerings may be difficult to push through at a price that is acceptable and non-controversial. So, alternative ways of mobilising capital need to be devised.

A recent ordinance of the government has found a convenient way to get rid of toxic assets in the short run. This is to "persuade" cash-rich public sector companies to acquire these assets in an auction on the grounds that as the environment improves, the borrowers holding these assets would be able to service their loans and the holders of the assets can profit. However, given the nature of these assets and the pressure on banks to take them off their own books, it is unlikely that the public sector units concerned would gain anything at all. They would have to bear the burden of the write-off, assuming the government can persuade them to buy into these worthless assets. This way of funding the removal of bad assets from the banks' books not only takes the exercise "off-budget," but it also conceals the implicit transfer from the government to the large private sector borrowers who are responsible for much of these loans. This is nothing but a subsidy to large firms belonging to business groups, some of whom have even violated the law.

Case for Privatisation

It is in this context that Deputy Governor Acharya's case for reprivatisation has to be examined. His take is that PSBs have not just performed badly, but by sheer virtue of being public, have managed to attract a disproportionate share of deposits, including bulk deposits. As he put it in an interview to *BloombergQuint*, "Once you have India, Maharashtra or a state's name in the name of the bank, the depositor knows it implicitly that the bank is very, very safe."[1] So even public banks with a bad balance sheet and a poor profit record attract large deposits. This helps them survive since they have the resources to lend to healthy projects and sectors that deliver returns, even when much of their money is locked up in NPAs and unhealthy sectors. Helping them out further by violating fiscal discipline and making transfers from the budget would, in this view, only amount to making a bad situation worse.

The tendency, for deposits to migrate to the PSBs has, in Acharya's view, two consequences for private players in the banking sector. First, it keeps the private sector small, since the volume of business undertaken by private banks is limited by their small deposit base. Second, private banks cannot risk lending to sectors where risks may be higher or profits lower because they cannot hedge adequately against potential losses in these sectors by investing in both these sectors and those in which profits are more certain and perhaps larger. This is, in his view, unfortunate because of the positive role that private banks can play in driving credit in the economy.

Acharya's real problem is not the NPAs of banks, but the failure of the private sector to grow despite liberalisation in the banking space. "You look at the last 25 years of private sector growth, the private banking sector growth is flat," he says. "Indian private banking hasn't raised its market share beyond 25%. In fact, it shrunk after the 2007–08 crisis because the depositors, especially the corporates, flew back to State Bank of India and other public sector banks." So the problem is private banking growth, and the constraint is the sheer existence of a public banking sector, since despite poor performance mere public ownership is enough to face the competition from a dynamic private sector.

From here it is a short step to measures that will resolve the problem by shrinking the public sector and expanding the private sector. To quote Acharya again, what

> research shows is that there are banks in the private sector like HDFC Bank, Kotak … which are so well capitalised that they actually have balance sheet capacity … to take over the *healthy parts of the activities that the public sector banks are engaging in* (emphasis added). Clearly, public sector banks have a branch network and franchise that would be very valuable even to private sector banks.

So, "the right creative destruction," he argues, is that even if the provisions on floors to public shareholding cannot be changed easily, "we need to find the minimum level of transfer of assets, branches, franchise that is possible, from unhealthy parts of the banking sector (*read public banks*) to the healthy (*or private*) parts of the banking sector." In his view,

> why this is important is that we need to wean the banking sector of the implicit government guarantees and subsidies that public sector banks enjoy. We need to allow the private sector to grow if they have been healthy. I am not saying we have to make a mission out of the private sector to grow. But if they are performing well and public sector is not, private sector banks should be rewarded for doing this.

In sum, the strategy is to separate the healthy parts of public banks and sell them to private banks so that the latter can grow and the former can shrink. There is no need to create a bad bank to absorb the bad assets of the public banks. The surgical action of separating the healthy and unhealthy part of the public bank concerned, leaves behind a bad bank. Nor is there any need to dilute shareholding in the public banks to mobilise resources to write off loss assets. The money obtained from the sale of the healthy parts would, it is hoped, be adequate to finance the write-offs. The NPA problem moves towards resolution and the "goal" of expanding private banking would be achieved. There could not be a more happy ending, for Acharya. What is left unsaid is that the government would now be holding on to a "bank" that is of little value, since its best assets have been sold to write off its bad assets. But, how private shareholders, who had acquired some of the bank equity through past public offers and disinvestment efforts, can be persuaded to go along with this strategy is unclear.

Default Interests

The main problem, however, is that this whole analysis, even if not consciously devious in intent, is ahistorical. It fails to see why public banking came into existence in the first place, and why nationalisation proved unavoidable. It does not take into account how past policy was shaped by what private banks did and did not do. And it is not based on an understanding of what led to a return of bad assets on the books of banks, after they had been cleaned up in the immediate aftermath of liberalisation. Nationalisation was unavoidable because, despite repeated efforts of the government, private promoters of banks who put in little by way of equity, diverted public savings to projects in which the promoters had a direct or indirect interest. Agriculture and the small-scale sector were starved of credit. In an effort to cut costs at the expense of inclusion, privately owned banks limited their branching and restricted their activities to cities. Finally, with exposure to a few projects that interested the promoters, many banks were vulnerable and fragile. So growth, inclusion and stability pushed the government to take over the Imperial Bank of India in the 1950s and a host of other commercial banks in 1969 and after.

Much was achieved after that. If public banks are in dire straits today, it is because, with the closure of development banking in the country, they have been called upon to finance investments by the private sector in capital-intensive industry and infrastructure (such as steel and power generation and distribution, and transportation and communication). With those projects performing badly, the PSBs are being maligned so as to build a case to use them as instruments to write off the large loans on which big private sector operators have defaulted.

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NOTE

1 All quotations from Menaka Doshi, "Does India Need a Bad Bank to Clean Up the Bad Loan Mess?" *BloombergQuint*, 6 October 2016, https://www.bloombergquint.com/business/2016/10/06/does-india-need-a-bad-bank-to-unchoke-growth.