Business Today

SENSEX	33484.14	NIFTY	10270.10	US$	₹64.92	GOLD	₹30459
132.57 ▲	0.40%	27.45 ▲	0.27%	0 =		-106 ▼	-0.35%

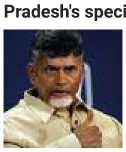
The Overhaul Blueprint

Steps that government, regulators and banks need to take to make the banking system more competitive, efficient and less fraud-prone.

Anand Adhikari New Delhi Print Edition: March 25, 2018

WE RECOMMEND

Demand for Andhra Pradesh's special



status could lead to economic rejig in Southern states

Winning streak: Redmi Note 5, Redmi Note 5 Pro review

State Bank of India (SBI), the countrys largest bank with assets of close to Rs 27 lakh crore , is more than three times the size of the second largest bank, HDFC Bank. This shows a very skewed banking system.

The market capitalisation of HDFC Bank, at Rs 4.95 lakh crore is almost equal to that of all the public sector banks (PSBs) put together, including SBI. This raises a serious issue of capital efficiency and performance of PSBs.

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the package of PSB honchos of equal size or bigger. The uneven compensation package acts as a disincentive for PSB staffers.

Such puzzling statistics from the Indian banking industry are endless, raising questions which defy easy answers. Indeed, domestic banks - particularly the PSBs - have made news for all the wrong reasons recently. NPAs, poor credit standards, bad governance, excessive interference from the political class, etc.

THE TO-DO LIST

1. Reduce the burden of funding companies by creating new sources of raising capital; for instance, bond markets need to be made more vibrant
2. Address governance issues
3. End CEO musical chairs at government banks
4. Reform human resources practices
5. Fill cracks in risk management architecture
6. Adopt technology, encourage collaboration with fintech players
7. Push the Financial Resolution Bill for bankruptcy situations

The massive scam at Punjab National Bank by diamantaire Nirav Modi has put the spotlight once again on banks. Coming close on the heels of the Vijay Mallya episode, it showed how the system could be abused with impunity. Worse, these are not stray examples. Government records show that there were as many as 8,622 frauds at PSBs in two years - between 2014/15 and 2016/17 - often in collusion with staffers. And, surprisingly, private sector banks too have been at the receiving end - they had over 4,000 frauds in the same period.

Still, the private sector has not been in a mess like the PSBs in terms of asset quality. Some analysts criticise them for focusing more on the lucrative working capital and short duration term loans in corporate banking, staying away from long term project loans and core sectors.

Meanwhile, both PSBs and the private sector grapple with ownership issues. While government ownership has hamstrung PSBs, several private sector banks are foreign owned. Uday Kotak, Vice Chairman of Kotak Bank, recently asserted that four out of five private banks are majority owned by foreign investors. In addition, foreign banks, which have been given the freedom to set up subsidiaries in India, have shown no interest in converting from the current branch based model.

Clearly, there is lot that needs to be fixed to have a strong, efficient and a safer banking system. We take a closer look at what needs to be done to set the house in order.

Rewrite Banking Laws

A.K. Khandelwal, Member, Banks Board Bureau, and Former CMD, Bank of Baroda

The dated banking laws are actually burdening the banks. Former RBI Governor Y. V. Reddy recently talked about reducing the statutory liquidity ratio from 20 per cent to global levels as soon as possible. "We cannot have a globally competitive economy with an over-burdened banking system," said Reddy. The government has to create new avenues for its borrowing programme rather than burdening banks. The mandatory priority sector requirement of 40 per cent of net advances should also be reduced as an alternative institutional framework has opened up with Small Finance Banks and MFIs. Many question the governments aggressive push for low ticket Mudra loans and also Jan Dhan accounts. Some analysts feel the sheer scale of the agenda is a problem (30 crore Jan Dhan accounts and Rs 4.6 lakh crore under Mudra in just three years). It upsets the banking system that runs on commercial terms, points out a banker. "The banking system is look upon by the owners as an instrument of social and economic change, which was a very good thought post nationalisation. But today it has been overburdened by the social agenda. Different governments have contributed to it," says Anil Khandelwal, Member of Banks Board Bureau.

Address Structural Issues

The uneven size of the banking players is also an issue. Today, SBI owns almost 25 per cent of the banking assets. There are only three large private sector banks. "The big boys crush everybody else. For example, HDFC Bank has elbowed out competition in the car loan business. Nobody dares to enter this segment," complains the CEO of a small bank. PSBs are already lagging behind in all aspects, from products to

PSBs and private players. "An investment holding company structure for PSBs makes sense. The one down subsidiaries (the PSBs) will have more flexibility. This will actually create flexibility on external talent augmenting internal talent, access to best technology and vendors," suggests Kumar of BCG. Khandelwal suggests that some of the perennially non performing PSBs should be put on notice now. There are calls for complete privatisation by some but there is also a strong case for PSBs as they inspire confidence amongst a large number of people in the semi-urban and rural areas. Many suggest consolidation is the answer based on market forces. "A merger works only if you are willing to make structural changes. In addition, you need a sharper focus on customer segments as well as product segment," says Kumar of BCG.

any merger should be market driven where the boards of the two banks take a call based on the synergies, business fit and also cultural integration.

Reduce Funding Burden On Banks

The government and the Reserve Bank of India have to fix the issue of heavy reliance on the banking sector for credit. The burden automatically falls on the PSBs, which are largely corporate banks by choice. Private banks are cherry picking less risky working capital loans and short duration term loans.

The private banks are efficient but have a minuscule 15 per cent share in deposits and advances. Its just not big enough to meet the economy's credit needs especially in the core and infrastructure sectors. The Union Budget has a novel idea of mandatory bond raising by corporates to meet at least a quarter of their funding requirements. "The bond issuance means more disclosures and also public scrutiny of data by external agencies and researchers. This will bring in more checks and balances," says Rajesh Mokashi, MD & CEO of Care Ratings. Such a framework for borrowing also means lesser chance of a fraud or a scam. The new Insolvency and Bankruptcy Code (IBC) should also be strengthened for boosting the bond market. "IBC will now facilitate investor interest even in lower rated issuers (such as single A or even BBB rated paper) to approach the bond market. The investor comfort in the lower rated bond increases as the code allows filing of bankruptcy by even small creditors with minimum of Rs 1 lakh default," says Mokashi. IBC is seen by many as a step towards boosting the bond market in the longer run.

The government should also be encouraging mutual fund and insurance players as they are gradually emerging as big players bond issuances.

Address PSB Governance Issues

"The fish rots from the head down," says a former chairman of a PSB. There are structural weaknesses in the corporate governance structures of PSBs. The government has taken one good step of splitting the post of Chairman and Managing Director. But a lot needs to be done. "First task is to improve and reform the boards. We should have board members from areas like risk management, technology, human resources, strategic management, accounting," says Khandelwal. There are actually a large number of bank CEOs and former RBI Governors and Deputy Governors whose services should be used by the banks. There is an urgent need for an investment holding concept for PSBs for overseeing appointments, capital requirement, etc. The Banks Board Bureau (BBB) was a precursor for setting up an investment holding company but that is now not in sight. In fact, the future of BBB looks uncertain. It was set up three years ago under Vinod Rai, former Comptroller & Auditor General, and was tasked with the selection of CEOs for PSBs. Despite BBBs recommendations coming on time, there have been delays in announcing successors.

End CEO Musical Chairs

Amit Kumar, Partner & Director, BCG

executive directors (EDs) or CEOs. SBI, the countrys largest bank, is the only PSB where the chairman comes from within. For example, Union Bank of Indias CEO &MD Raj Kiran Rai is from the Oriental Bank of Commerce. Two of the executive directors too are outsiders - Vinod Kathuria is from Punjab National Bank and Atul Kumar Goel is from Allahabad Bank. Many suggest that the EDs, MD and CEO should come from the bank as they know the bank well. Since the tenures at the top are short, it is very difficult for outsiders to get a hang of the issues and make an impact. "People should be groomed right from the manager level," says a PSB board member.

The Need For HR Reforms

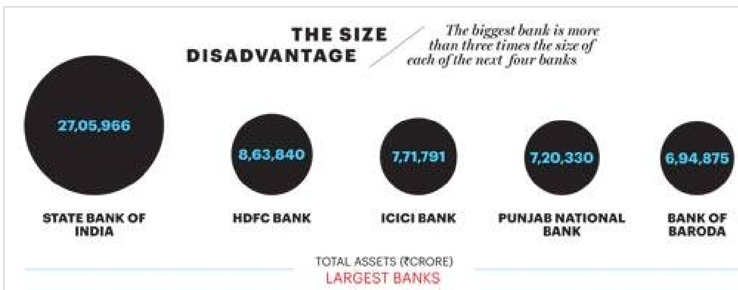
There is a need for training and re-skilling given the digital transformation in banking globally. The current performance management system of PSBs is completely defunct. There is a need for building specialisation in banking right from the entry level. Today, banks need specialists in risk management, treasury, credit, technology, etc. with decades of experience. Private banks are increasingly hiring people from engineering colleges. The old system of rotation or transfer on promotion at PSBs just won't work. These initiatives should be driven by the board and the CEOs. SBI recently took the lead and set 90 per cent of its workforce a target. Earlier only 37 per cent of the supervisory roles had targets. This was the biggest transformation for the bank two years ago. A good HR system will create quicker decision making, build specialisation and encourage meritocracy. "In most banks, HR is still about postings, transfers and promotions and developmental strategy has been a missing gap," says Khandelwal, who headed a committee on HR issues of PSBs in the past. Most of the current problems are an outcome of poor planning and attention to critical functions. "Each bank has to work out a five year human capital adequacy plan," says Khandelwal.

Repair Risk Management

The Kingfisher and Punjab National Bank scams show that the whole approach of government or the regulator to risk management is 'event led' than being 'process led'. "We have seen technology related issues over the last 12-18 months where customer data has been compromised. It shows that bad loans in financial services is part of a bigger problem. It is equally a reflection of our casual approach to risk management," says Tarun Bhatia, MD at Kroll, a global risk consultancy.

Manish Sinha, MD, Dun & Bradstreet, says that banks have to access every bit of data that is available in the market. "They compliance and internal audit to protect themselves," says Sinha.

For credit risk, the management needs to build safeguards to continuously monitor the client. For example, ICICI Bank has a crawler engine, which searches the web for information about their corporate banking client. This information goes straight to the relationship manager to act. The direct outcome of a weak credit system is the instances of fraud. The auditors of Nirav Modi's Firestar International had raised concerns two years ago over the inadequate internal control systems in both the parent company as well as in subsidiaries. It went unnoticed.



Adopt Technology

Fintechs and differentiated banking models like payments bank and small finance banks are already out to erode the business of banks. Banking is no longer a restricted area. The bank licenses are now available on tap. The future disruption will come from fintechs where the banks and their boards have to apply their minds.

There is also a new wave of financial services aggregators in the market. For instance, an Ola or an Uber kind of a business model where a fintech aggregates the financial products (personal loan, card loan or a credit card) of almost all the players across banks, mutual funds and insurance companies. PSBs should utilise that model by tying up with these online aggregators as a distributor of their products. It will enable them to reach out to young customers. In an aggregator kind of a model, the most efficient banks would survive. The key would be competition in the market in terms of interest rate - it directly depends upon the cost of funds, operational costs, risks and margin. The banks have to be well entrenched to raise low cost deposits especially CASA (current account and savings account), use digitisation to reduce costs or make use of fintechs to save costs, manage risk better as there are huge compliance costs and also protect its margin.

Need For FRDI

the bankruptcy of financial institutions. Today, banks are exposed to all kind of risks from cyber security attacks to operational and reputational risks. The compliance costs are going to be very high as regulators are imposing high penalties for any regulatory misstep. Given the government finances, banks have to manage their house or get restructured under the FRDI. The global financial meltdown has already demonstrated the pitfalls for banks. A banking crisis puts the burden on the government.

Overhaul The Government System

In a fast changing and complex banking system, the government, or the Ministry of Finance, also has to pull up its socks. "This is a time that a certain degree of specialisation for banking is required even within the Ministry Of Finance. Continuity of Secretary of Department of Financial Services (DFS) is required. Their tenures are also short," says Khandelwal. "The organisational structure of DFS has to undergo change. They need specialists in areas like risk, HR, technology, etc." adds Khandelwal. Also, there is an issue of government directors not being able to give time to the boards. Many board positions lie vacant for months together. Many CEO posts too are not filled quickly because of the delay by the government. For instance, the post of Deputy Governor at the Reserve Bank of India has been vacant since the retirement of S. S. Mundra in Julylast year.

The need of the hour, then, is to build a strong banking system. It's important that lessons are learnt from the failures of the past.

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Tags: State Bank Of India | SBI | HDFC Bank | Private Bank | PSB Domestic Banks | PSB | NPA | Punjab National Bank | Nirav Modi | Vijay Mallya | Uday Kotak | Kotak Bank | Foreign Bank | RBI Governor Economy | Small Finance Banks | Bankruptcy | RBI Governor | Banks Board Bureau | H

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