ILLUSTRATION BY AJAY MOHANTY

The way forward for state-run banks

A more formulaic approach will work better for them, and this has been part of the organisational DNA of the best PSBs in the past

Public sector banks (PSBs) are demoralised. They fear the Central Bureau of Investigation (CBI), Central Vigilance Commission (CVC), Comptroller and Auditor General (CAG), and Central Information Commission (CIC). They are short of equity capital. Their corporate credit business is beset with problems. In this article, we offer strategies for the big questions. What should PSBs do with borrowers who have defaulted? How should they make corporate credit decisions?

In the long run, India should privatise the PSBs. But this will not happen anytime soon. A large private banking system has a pre-requisite: State capacity in banking regulation. The one thing worse than a PSB is a poorly regulated private bank. When policymakers embark on building the RBI, this is a project that will take five to 10 years, assuming good capabilities at the ministry of finance and at the RBI. Until that project is completed, privatisation is not advisable even if it were politically feasible.

SNAKES & LADDERS

AJAY SHAH

Three things need to be kept in mind when we look at our predicament.

First, while PSBs face a shortfall in equity capital, they are backed by the government. There have been no runs on PSBs; customers trust them as much as they trust the government of India. PSBs get vast subsidies — cheap debt from consumers — as a consequence of this trust. This gives time and room to manoeuvre.

Second, the organisational capabilities of PSBs are highly heterogeneous. SBI is a well-run bank that is better than most private banks. And, there are truly badly-run PSBs. The assets to market capitalisation ratio, which is a market-based leverage ratio, ranges from 12 times for SBI to 71 times for Corporation Bank or United Bank of India. We need to keep this heterogeneity in mind when envisioning solutions.

Third, while there is a lot of focus on PSBs' outstanding corporate credit, this overall number is shaped by a flow of repayments that come in and a flow of new credit that goes out. Decisions are being made about new disbursements all the time. The corporate credit business of PSBs should not freeze up to the point where no new credit decisions are made. A quarter of listed non-financial firms are in distress with an interest cover ratio of 1.5, but the top quarter of listed non-financial firms are in great shape with an interest cover ratio of 13. PSBs should be happy to lend to firms where the objective accounting data shows good health.

Let us now turn to the big questions that demand action. What to do with borrowers who have defaulted? What to do with borrowers who have not defaulted? How to make credit decisions, going forward?

With borrowers who have defaulted, the lender needs to make the right moves in the Committee of Creditors, which is formed through the Insolvency and Bankruptcy Code (IBC) immediately after the default. PSBs are hobbled by fears of enforcement agencies and often have poor internal management procedures. For example, in one recent case, the representative of a PSB voted in favour of a resolution plan at the Committee of Creditors, but later the organisation reneged on this decision. This derailed the timelines of the IBC process.

The solution lies in detailed work on modifying the procedures of the CVC, CBI and CAG so as to support sound processes at a capable PSB. The solution for a PSB with low capabilities is to sell off defaulted loans, through an open auction. This will also require removing the special status of asset reconstruction companies (ARCs), so that any financial investor is able to bid for these assets on an equal footing. A very wide pool of private equity funds, distressed asset funds, etc should be in the fray competing for buying these bonds/loans. This will improve the value realisation for PSBs, compared with the tiny pool of capital with ARCs.

What about the corporate book where no defaults have taken place? What would work for PSBs is to hold the better loans and sell off the weaker ones. This should be done through a low-discretion mechanism. Rules should be established, based on accounting data about firms, through which borrowers are classified into strong vs. weak. The basic idea is simple: Weak firms have high leverage and low profitability, with cutoffs that vary based on the capabilities of the bank.

There is a long tradition of thorough and objective credit analysis, based on accounting data, at the best PSU banks. The RBI and ministry of finance can support this process by giving greater legitimacy to good process designs, as has been done through many expert committees in the past. The hard thing for the department of financial services and RBI will be to differentiate between banks that have high organisational capabilities and those that do not.

Finally, how should PSBs give out incremental gross credit? A low-discretion mechanism needs to be evolved, where facts about borrowing firms are used to give loans to stronger firms. When the borrower drops below a certain threshold, the PSBs should sell off the loan.

PSBs will be around for a while. We have to make them work better. They find it hard to make decisions based on judgement and discretion. A more formulaic approach will work better for them, and this has actually been part of the organisational DNA of the best PSBs in the past. PSBs should utilise objective facts from the accounting data about borrowers to classify borrowers into high vs. low credit risk. PSBs with low organisational capabilities should exit the corporate credit business for high-risk borrowers.

The business of giving credit to weak borrowers, and participation in the IBC process, is one that is feasible for sound PSBs, and for non-bank players. We should create non-discretionary rules through which these weak borrowers are identified. We should remove the special status of ARCs, and create a large unified pool of private funds which own bonds or loans to weak firms, and dominate the IBC process.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi