Corporate Governance and NPAs of PSBs

A series of recent cases, starting with the United Bank of India, Syndicate Bank, Dena, Oriental Bank of Commerce, the increasing level of non-performing assets, etc. have brought into sharp focus the need to improve corporate governance and skill levels in public sector banks. Earlier, the Nayak Committee had given a Report on the functioning of the boards, and made important recommendations.

After reading the Report, I was reminded of good old C. Northcote Parkinson who propounded his law that work expands to fill up the time available for its completion, back in 1950s. One example he quotes is of a board meeting. The principal item on the agenda was sanction for an atomic power station at a cost of £ ….bn. A presentation was made about the technology, safety measures, why the cost seemed high, etc. Since no board member had the knowledge to question the points made in the presentation, the proposal was approved in five minutes. The next item on the agenda was the construction of a new cycle shed for the staff: this was one item on which every board member thought that he was competent to comment, contribute to a wise decision – and earn his fees. The discussion went on for an hour and finally it was decided to call more data and postpone the matter to the next meeting!

More seriously, one of the recommendations of the Nayak Committee is to separate the posts of Chairman and Managing Director. It did not work very well in State Bank of India in the 1960s/70s when the late Shri R.K.Talwar was the Chairman and T.R.Varadachari, the Managing Director. While functioning, Talwar continued to act as his own Managing Director, leaving no role for TRV, himself an extremely able executive. Later, during the emergency, Talwar was sacked for refusing to favour a client close to The Family, and TRV became the Chairman. Given his frustrations, I have often wondered about his role in Delhi during the emergency. The point is that the proper working of the model very much depends on the personalities of the two executives.

The PSB Chief Executives surely learnt their own lesson from the incident: it does not pay to annoy Delhi, and that surely is responsible for a portion of the bad debts. The populist agricultural debt write-off policies have also vitiated the credit culture of borrowers.

Many commentators and reports in the media suggest that corruption could as well be a contributing factor to the level of bad debts. This apart, one of the issues highlighted is the wide disparity between the compensation levels in the private and public sector banks. There is no denying the disparity; the question is whether this leads to a greater propensity to be corrupt. This would be true if the law of diminishing returns, one of the cornerstones of economic theory, applies equally to financial assets. There is enough empirical evidence to suggest that it does not. Consider the insider trading cases in the US: did the hedge fund managers or the former head of McKinsey, each worth hundreds of millions of dollars, need the extra 10/20 million? Consider also the cases of tax evasion: surely it is the rich, who can well afford to pay their taxes without hurting their standards of living, who indulge in tax evasion and money laundering transactions? Clearly, greed is the driving force and the utility of ever more money does not seem to depend on how much you have – or are earning.

Is privatization of banks the solution as some argue? This will help in mitigating political influence in credit decisions. The other side is that bank privatisation is not a panacea: just recall what happened in 2008 despite the vaunted risk management skills of the US/UK banks. The financial crisis led to the largest drop in global output since the depression era 1930s, and the system had to be rescued by a huge commitment of tax payer resources. (Some of the rescued banks in UK are still under government ownership). The cost of bailing out the richer 30% had to be borne by the poorer 70% through unemployment, stagnant incomes for those still employed, negative to low/zero growth which still continues.

The point is that there are no easy solutions to the problem of poor corporate governance in PSBs, and the level of NPAs it is reflected in. This may well require a significant investment in the selection and the skill levels of Board members, and greater specialization of management and executives. Many seem to think that stricter adherence to lending “norms” is the key. But, by their very nature, all norms are quantitative and procedural. I often wonder whether it does not encourage a culture of “box ticking”, with little exercise of judgment, so essential to better credit decisions. Again, credit committees, consortium loans, the feudal culture (“boss knows best”) in PSBs, they all vitiate accountability: when everybody is responsible, nobody really is?

The problem of NPAs has another dimension also: the largest exposures are in the iron and steel, and infrastructure sectors, hit by closure of mines under court orders, regulatory hassles, an uneconomic exchange rate, and growth slowdown. (Bhushan Steel seems to have fooled rating companies also.) The prevailing atmosphere, the forensic audits, etc. may only make bankers more reluctant to take credit decisions, and this will surely not help growth.

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