Public Policy and Banking

Public policy can be defined as ‘courses of action, regulatory measures, laws and funding priorities concerning a given topic promulgated by the governmental entity or its representatives.‘

Banks undertake the two most important functions in an economy of providing payments services for the retail and wholesale markets and channeling savings into investment for ensuring economic activity and growth. Banks are highly leveraged entities using public funds; they have the ability to create credit, they provide all types of financial services; hence their operations are very much within the purview of public policy. Banks are regulated the world over on account of their vital role in the economy. The global crisis underlined the potential role of banks to destabilize the entire financial system and global economy. The public policy implications of banking got reiterated and heavily underscored as sovereigns had to bail out banks and extend deposit insurance to all deposits for a while. All this has led to re-regulation under the aegis of the Basle committee and the G20. Financial stability has become a paramount objective of banking regulation in addition to depositor and consumer protection.

Equally, banks are seen as powerful institutions to facilitate economic growth and that too, inclusive growth. Hence in many jurisdictions, especially in emerging market economies, the role of public policy is not only confined to micro and macro prudential regulations, but also extends to matters concerning the access to finance. Thus financial inclusion as a policy objective has gained popularity and globally, the G20 has a separate work stream on the subject. The fact that the crisis has also made developed markets view public policy in finance not only as a prudential tool but also as one of stimulating growth, especially in the small business sector, is illustrated by the Bank of England Funding for lending Scheme which has recently been focused on the supply of credit to small businesses.

In this talk, I would like to focus on public policy and the banking system in India.

First, I will review the various ways in which public policy impinges on the banking system in India. Second, I will can try and assess the impact –both positive and negative - of such policy, and finally look at issues that need addressing to better achieve the objectives of public policy.

How has public policy impinged on banking in India over time?

1. The first period can be taken from independence to pre-nationalization. The public policy objectives were nation building in a political framework of democratic socialism and planned development through a mixed economy. From 1949 to 1969, till the nationalization of major banks, the focus of public policy in banking in India was on prudential regulation. Several legal changes were made in the Banking Regulation Act to enable RBI to consolidate the banking system, weed out weak units and facilitate both voluntary and compulsory amalgamation. This was also the period, in the aftermath of the Palai Central Bank crisis, which saw the birth of deposit insurance as an instrument of public policy to protect small depositors. India was one of the first countries in the world to introduce deposit insurance.
2. In 1969, public policy considerations led to the nationalisation of major banks in 1969 and to that extent, public policy and banking became even more linked in India. Even in the period prior to nationalisation, the merger of the Imperial Banks to set up the State Bank of India with specific mandate to open branches in rural areas and for government treasury operations, clearly incorporated a public policy objective. In the early period, the losses on such remote branches were provided subvention through the bank retaining the dividend due to RBI as owner. Nationalisation sought to delink the hold of large industry over banking and the nationalised banks were a critical part of the public policy to assist what were termed as the ‘‘hitherto neglected sectors of the economy” – the rural areas, agriculture, small scale industries and self employed businesses. The mandated priority sector lending policy was evolved in this period. The development financial institutions like UTI, IDBI, IFCI, EXIM, ICICI, NABARD and NHB were set up during this period to provide long term and specialized funding to the various sectors seen as critical for development.
3. Public policy also envisaged a significant role for the government in the economy. The fiscal deficits were largely taken care of through borrowing from the Reserve Bank of India and the banking system at administered interest rates. This began to impinge on monetary policy and crowding out of private sector credit. SLR and CRR started creeping up from the mid-70s and in 1991, pre-empted incremental reserve requirements reached an astonishing ratio of 63.5 per cent! The difference in the interest rates at which government borrowed and private sector borrowed was as high as 8 to 10 percent right up to the mid nineties.
4. The mid-80s saw public policy impinging on banking in a different way through loan melas. Several subsidy-cum-credit schemes were launched and loans were distributed to beneficiaries identified by the government officials.
5. The period subsequent to the BOP crisis of 1991 was one of reform in all sectors. This period saw a shift in public policy from a command economy to one of increasing competition and bringing in

market based policies to improve efficiency and productivity. In banking, this implied a sea change. All measures were taken to strengthen the banking system through internationally comparable prudential policies and market based pricing of assets and liabilities, including auction of government debt. Reserve requirements were reduced. New banks were allowed entry. Government shareholding in nationalised banks was reduced to a minimum of 51 per cent and public sector banks were listed on the exchanges. Deepening and widening of financial markets and gradual opening of the external account for current and capital transactions marked this period roughly up to 2004. During this period, there was evidence of greater operational autonomy to the management in public sector banks. The capital markets were reformed and regulatory structure evolved.

6. The more recent period since 2004-05 has witnessed public policy re-emphasise inclusive banking and financial inclusion. With the changes in technology, the vision of all adults having bank accounts was seen as becoming a reality and the public policy objective of electronic transfer of benefits provide the impetus. Public policy encouraged further opening of the capital account for inflows and the boom in this period, fuelled by capital inflows and high growth, saw the balance sheets of banks doubling in three to four years.
7. Post crisis, Government of India through the Ministry of Finance took an active role in ensuring that the public sector banks provided sufficient credit for productive activities despite increasing uncertainties in the global outlook. The surge in provision of liquidity by RBI combined with public policy considerations in ensuring the economy did not slow down resulted in significant growth in infrastructure financing by the banking system. Projects like JNNURM and encouragement of restructuring of loans ensured that the economy post crisis could still grow at a reasonable rate. Subsequently, on account of various external and internal factors that are well known, the slowing down of the economy brought to surface various stresses in the banking system which reflected the slack underwriting standards in the boom period, the chasing of top line growth by banks in period of excess liquidity and the sector saw a surge in CDR cases in the last three years. The geographical spread of banking outreach through branches and BC outlets in this period has been remarkable although the business model for financial inclusion is yet to emerge.

I would like to next examine what the positives and negatives of public policy impact on banking.

In a speech given in 2002, Dr Reddy who was then DG recounted ten achievements of public policy in the financial sector since 1991. These were

- the development of multi-institutional structure in the financial system including diversification of ownership of public sector banks
- greater flexibility to banks to lend based on genuine credit decisions through reduction in pre-emptions and deregulating interest rates

- ensuring that credit flow for priority sectors was met based on commercial terms and in a non-micro regulated manner
- greater efficiency through competition in the banking system
- Preserving the branch network of the banking system to ensure that banking services continue to reach the remote corners of the country.
- prudential standards on par with international best standards.
- Greater transparency in terms of disclosure of accounts by banks and data/ information disseminated by the central bank.
- move away from micro-regulation to macro-management leaving it to Boards to set policy and guidelines
- initiatives to develop financial markets in a gradual manner and integrate them cautiously.
- Stability in interest rates, exchange rates and reined in inflationary expectations to a reasonable level.

To assess the impact of public policy on banking in India, one would have to make cross country comparisons on various parameters that would indicate to what extent the financial system has efficiently contributed to growth and welfare. Ideally such parameters would include an assessment of whether the different sectors /segments of the economy have been credit constrained, whether the system has conserved capital while providing credit, whether there is sufficient cushion to withstand shocks, whether the cost of intermediation is internationally comparable, whether the needs of the relatively underserved segments of society are being met even though at the cost of higher margins and lower profitability, whether consumers feel fairly dealt with by the banking system, whether regional imbalances are countered to a certain extent by the operations of banks in different regions and so on. I cannot admit to having attempted to do this.

Nevertheless, I would venture the following thoughts

- Public policy has ensured a well diversified financial system with coexistence of government and private banks with varying degrees of State ownership and governance structures that contribute to overall stability. This was apparent when, in the aftermath of the crisis, when there was some flight of deposits from some private sector banks to public sector banks and lending from foreign banks and private sector banks slowed while public sector banks maintained their lending to ensure that the economy did not get into a spiraling downturn. The existence of all India development financial institutions like SIDBI, NHB and EXIM bank could also help in ensuring countercyclical lending to the sectors where credit from commercial banks tended to contract.

- Public policy has encouraged more competition by allowing the entry of private sector banks and foreign banks in an increasingly level playing field. The entry of private sector banks has provided the much-needed competition to both the foreign banks and the public sector banks and created incentives for greater efficiency. With the increased private shareholding and listing of public sector banks, such incentives are enhanced as both segments of banking have to compete for capital in the same markets.
- Public policy requirements of branch banking in rural and unbanked areas and flow of credit to priority sectors are applicable to all categories of banks ensuring well-balanced growth and contribute to social stability as well as overall economic and financial stability.
- Public policy has facilitated financial inclusion through distribution of government payments and benefits through bank accounts making it potentially viable for banks to increase their penetration in the country and exploit opportunities for growth of economy and business.
- Public policy and the concomitant fiscal deficits have implied that the SLR requirements could not be brought down as much as intended. This however proved to be a useful liquidity buffer when dealing with the impact of the crisis.

At the same time there are areas where public policy intervention in banking has some downside. I will touch upon a few

- Mandated CRR/SLR requirement has increased cost of intermediation by almost 70 bps. This apart, volatility in yields leads to undue volatility in balance sheet valuation. The high share of securities that are not marked to market inhibits a more deep and liquid government securities market and interest rate derivatives markets

- Today PSL norms are uniform for all categories of Indian banks. Meeting the direct agriculture target of 13.5 per cent when agricultural GDP is just 15 per cent is a huge challenge. In fact, given that housing loans and education loans are part of the PSL, credit to the MSE sector is much less compared to its share in the economy.

- Public policy has had impact on governance in public sector banks. The process of selection of directors on the Boards of the banks in several cases implies that the Board has insufficient expertise to provide the necessary guidance and direction.

- The system of top management appointments in public sector banks has resulted in a situation where the leadership is not sustained and results in short termism. With the frequent changes in incumbency at the CMD and ED levels, continuity of strategy and cohesive execution of such

strategy is compromised. Pressure on top line growth brings in significant asset quality problems in subsequent periods. Inadequate professionalism and governance in credit decisions is one of the reasons why the stressed assets in PSBs are higher. The volatility in the reported NPLs and provisions especially when there is a change in incumbency at the top level also underscore why the market valuations are so much lower than the book value.

- At one stage, there was a conscious attempt towards greater autonomy and move away from micro regulation to macro management as was pointed out above. However of late micro management seems to be creeping back and the autonomy of the Board and the top management is being eroded. It is more appropriate that the ownership role is exercised through a competent Board in the interest of better governance

I would like to conclude by raising some issues that need addressing if we want to achieve the pubic policy objective of an efficient and sound banking system that adequately meeting the needs of both economic growth and inclusivity.

- There is urgent need to have a relook at the present system of selection of the top level in PSBs to ensure effective and positive leadership. There is a need to have out –of- the box thinking to get the right leaders for these banks. One option as has been tried in many countries is to have lateral hire for the top positions (from within and from outside the PSB system) with clear term of five years subject to annual performance targets and reviews combined with reasonable incentives and autonomy.

- There is urgent need to have a re-look at the system for nominating directors on Boards of public sector banks including those representing private shareholders. It would be worthwhile to pursue the idea of a roster of highly competent and experienced persons from public and private sector who can be vetted for "fit and proper" and from whom Government and Boards can make their selection. Persons with finance, HR and IT expertise are a must on any Board.

- While on the subject of public sector banks, it is important to understand that the playing field is far from level. There is a lot of debate on micro –management. As owners the focus has to be on enhancing governance, risk management practices, transparency and efficiency of operations. In areas where autonomy was given, transgressions in some cases, have led to correctives in form of micro-management. A re-look at all operational areas including HR may be needed to see how further autonomy could be given to the Bank Boards and the senior management with sufficient safeguards through internal control.

- On accountability, there is need for all the concerned authorities together to address the question of how bona fide business decisions taken following laid down policies and procedures are not challenged as assured by the FM in his speech at BANCON

- There are activities that PSBs have to do that may not be expected from the private sector. For example electronic benefits scheme (EBT) is one of them. While banks may not look upon this as a commercial proposition, their costs need to be covered adequately for undertaking these activities on behalf of government and this is something that is relevant at the State and Centre level.

- Infrastructure financing is another area where misgivings are expressed that public policy overrides prudence. Public sector banks are required to support this vital sector. At the same time , there is a need to ensure that such lending is based on sound appraisal and that all covenants are included as necessary to result in asset creation and generation of cash flows sufficient to service the debt. Let us take the example of part of the restructuring of the dues of the SEBs to central power sector utilities in the first few years of this century. If I recollect the amount was about Rs 50000 crore. Even at that time, it was clear that unless SEBs had a proper tariff policy and efficiency benchmarks, there would be serious implications if they took on additional liabilities or commitments without such reform. Nevertheless over the last eight years or so banks have increased their exposure to independent power producers supplying power to the SEBs with no fundamental reform in the tariff structure. This has again led to the stalemate that needed a fresh restructuring this time for thrice the amount! If all banks act together and put forth their requirements, there is no way the desired conditions cannot be met, as credit is the most powerful regulator. This also tempts me to highlight the point that in some large private sector exposures that have gone bad recently, if banks had exchanged credit information much before the exposures exploded or did not chase the accounts with the objective of boosting the top line, many a write off may have been averted.

- Let me take another example where public policy need not and should not run counter to banks long term interest. Subsidy linked credit schemes are condemned on grounds that they tend to get misused. In all schemes, the choice of the borrower and the scheme is left to the banks. The whole point of anti poverty schemes being routed through banks is to take advantage of the natural prudence of banks and ability to make an assessment of the bankability of the activity financed which can result in tangible income generation. This role cannot be taken away from bankers and if exercised without fear or pressure will go a long way in ensuring the proper use of subsidies and make non-viable schemes viable and increase the scope for good business for banks. Equally , there is need to review the types of subsidies to see whether these are consistent with activities in which

the poor are largely engaged for both investment and production credit in agriculture and allied activities.

- Public policy perception is that banks cannot and normatively should not charge higher rates of interest to smaller borrowers. There is a clamour for zero interest rates to farmers. On the other hand, we do not mind the poor and disadvantaged borrowing from moneylenders at 36 to 60 per cent or from the SHGs and MFIs at 26 per cent. If mainstream banks especially PSBs charge higher rates (even 18 per cent is considered high!) there will be outcry in public that banks are usurious and that they give loans to rich at lower rates than these usurious rates to the poor. Unless interest rates cover cost of funds risk premia and transaction cost, it will be nigh impossible to achieve the objectives of meeting the credit demand for all productive activities in all segments of society which is the public policy objective. There has to be much better sensitization of public policy on what can be considered reasonable interest rates if banks in India have to do scaled-up inclusive banking.

- Support to farmers for increasing their incomes can be through non agricultural activities as well and through support for forward and backward linkages and not necessarily through higher loans to individual farmers. There is a need to have a re-look at the definition and targets in a realistic manner having regard to the changing nature of the sectors.

- Consumer protection is very much a part of public policy and in all likelihood, there will be an independent regulator for this in the near future. This is an area where much more needs to be done. Some of the important issues that have arisen are (i) Products should be simple to understand and should be sold to the segment for which these are designed. There could be basic plain vanilla products for the relatively uninformed. (ii) Mis-selling should be dealt with very sternly, misleading advertisements are to be avoided, product bundling should be avoided, incentive structures should be aligned to control mis-selling. (iii)There is need for better disclosures, transparency and non-discriminatory policies in pricing. (iv) There is need for customer education and banks should spend certain percentage of their profit/revenue on it.

In conclusion, while public policy in banking has continued to give importance to retaining dominant state ownership in banking, there is an urgent need to look at matter relating to governance and management in these banks if they have to be strong self sustaining and competitive. There is also a need to look at the pricing and allocation of credit in the interest of mass and inclusive banking.