Sardar Patel Institute of Economic and Social Research, Ahmedabad

PROFESSOR D.T. LAKDAWALA MEMORIAL LECTURE
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Future of Public Sector Banking

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Dear Professor Alagh, Director Niti Mehta and friends,

I am grateful to Sardar Patel Institute, in particular, Professor Alagh and Professor Niti Mehta, for giving me the honour and privilege of delivering Professor D.T. Lakdawala Memorial Lecture. I have known Professor Alagh since 1970 and we have been in touch since then. He combines scholarship, commitment to development and personal warmth. This did not change even when he was a Minister in the Union Government. Naturally, personal invitation from him to me, to visit Ahmedabad is of special significance to me. Dr. Niti Mehta made a visit possible and, indeed, valuable by inviting me to deliver the Prestigious D.T. Lakdawala Memorial Lecture in honour of the founder-director of the Institute.

Professor Lakdawala served the society in several capacities – as a teacher, researcher, a public intellectual, and sometimes in a fiduciary capacity. He influenced policies and also steered institutions like Centre for Monitoring Indian Economy (CMIE).

One of Professor Lakdawala's contributions to public policy happens to be his association with both - Planning Commission, then developmental temple of India,

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and the Reserve Bank of India, the continuing guardian of financial stability in India. In operational terms, both the dimensions – development and finance – overlap in the functioning of banks, especially public sector banks. It so happens that in India there is an intense controversy now about the stress in banking sector, in general, and in the public sector banking, in particular. For these reasons, I chose the subject 'Future of Public Sector Banking'.

I will start my presentation with a brief account of the past and lessons from the past. I will then attempt on appreciation of the present – the features of the stress in banking; especially the NPA problem. I will refer to the immediate challenges of recapitalisation, in particular, its funding. I will conclude with a possible policy framework for the future of public sector banks.

The Past

State Bank of India was a result of nationalisation of Imperial Bank of India in 1955, whose ownership rested with Reserve Bank of India and not Government of India till 2008. Further, there were several banks in the Princely States, which were also taken over and became subsidiaries of State Bank of India in due course. In a way, therefore, public sector banking in India pre-dates the nationalisation of banks in 1969.

Public sector banks, meaning government owned banks, as we understand now, started in 1969, with the nationalisation of banks. The choice at that time in 1969 was between social control over private banking industry and the nationalisation. A choice was made in favour of public ownership. Why and how was it made? I will reproduce extracts from the History of Reserve Bank of India.

"According to most oral accounts, Mrs. Gandhi did not consult Governor Jha, knowing fully well that he was a strong advocate of social control and not in favour of nationalization. It has been recounted by some persons who held senior positions in the government then that when Mrs. Gandhi called Jha to go over to New Delhi on 17 July, he went with a comprehensive note in support of social control. She is said to have told him that he could keep the note he was carrying on her table and go to the next room and help in drafting the legislation on nationalization of banks. (However, this view was not shared by left-wing economists of the day.)"

"A day before the announcement on 19 July, she informed I.G. Patel, Secretary, Economic Affairs, that she had taken the decision to nationalize banks on 'political' considerations and that he should prepare a speech within the next 72 hours."

"But the main force driving nationalization was fully comprehended by everyone as being political, rather than economic. Indira Gandhi had won the struggle for supremacy within the Congress party and managed to wrest control, and finally.

(History of Reserve Bank of India, Volume 3, 1967-98, pages 37-39).

The nationalisation of banks changed balances in a fundamental manner. Union Government had till then no official functionaries in the States for initiating or implementing its programmes. The Union Government acquired a country wide presence of its functionaries, albeit indirect. Second, the private sector had to depend on the Union Government owned banks for funding of their activities since

financial intermediation in formal sector was mostly confined to banks. Third, the Reserve Bank of India's command over monetary policy, especially transmission and regulation of bank was diluted. Fourth, large financial resources became available for the Government, which could be used without Parliamentary oversight. The banking system in India, thus, became a useful means to launch many Prime Minister's country-wide programmes.

I submit that the origin of public sector banking was political; it was through an ordinance; its evolution has been political and its future will, perhaps, be determined on political economy considerations.

Just as there were debates in 1969 as to whether we should have social control or nationalise, we now have a debate between privatisation or recapitalisation, or recapitalisation followed by privatisation. Still, it will be political decision, but one with enormous economic consequences as at the time of nationalisation in 1969 and later in 1980.

2017 is vastly different from 1969. The balance between Union and States has been changing. The balance between State and market is different now. Private Sector is more nimble than ever before. Private sector is used even for a sovereign function like issue of Passports. People are demanding more choices than before. India is an integral and important component of global economy and, indeed, global finance. Finance is more complex now, and goes beyond banking.

The context of banking in India is also different now. We are already in a mix of public and private sector banks. We are in a world of public sector banks

having a mix of public and private ownership. We are in a world where empirical evidence for comparing their performance is available – though subject to multiple interpretations. More important, we are in a new world where foreign investors have strong presence both in private sector banks and in public sector banks. So, for policy makers, the choice is more difficult and processes, more complex than in 1969. The degrees of freedom available for arbitrary decisions by Government are circumscribed by dynamics of financial markets.

Recognising that the context is different now, let us explore how public sector banking evolved from 1969.

In the first phase, after nationalisation through an ordinance, lot of good was done in terms of expansion of bank branches, employment and access to banks. At the same time, banks' money, actually depositors' money was available for Governments to use for developmental purpose and this was outside Government budget process.

The "good use" phase was followed by a second phase of 'questionable use' when the government started using banking to disburse loans through grants out of depositor's money in the garb of loan melas through loans, which were mostly not repaid.

In the third phase, by nationalising larger banks in 1980, private sector banks were told that "if you grow, you are dead." This stifled growth of private sector banking for about two decades.

Since then, the quality of services by our banks was a matter of concern due to lack of competition to and among public sector banks.

Qualitatively, both public and private sector banking stalled during this period, while in the rest of the world finance and banking was racing ahead.

The government, the public sector banks, and the RBI became part of a big joint family (Hindu Undivided Family) where no one kept proper accounts of what they were doing with each other; and what they were doing with the rest of the economy. The belief was that they were all serving people.

Over the years, the public sector banks attracted hundreds and thousands of young bright educated middle class and built a pan Indian progressive middle class. It also built powerful trade union.

In the absence of proper accounts, the financial health of banks was not evident. The expenditure and cost of subsidies was not evident. The public sector banks were used for managing the stress in the government, such as, external short-term borrowings or providing temporary accommodation to Indian Oil Company. Underlying problems of the government were, to some extent, shifted to public sector banks and hidden there. This is part of the reasons for eruption of balance of payments crisis in 1991.

Narasimham Committee was appointed in 1991 to give recommendations for reform of financial sector, as a whole. In 1993, another Narasimham Committee was appointed to give recommendations on banking sector reforms. Together, these recommendations formed the foundation for the reforms since then.

As part of reform that commenced in 1991, RBI wanted banks to refine presentation of their accounts as per global accounting norms and start following global best practices. These included classification of assets as those performing and non-performing. The pricing of credit has to be on the basis of assessed risk and not merely end use. When we carried out a scrutiny of accounts of banks, we realised that the capital held was inadequate. So, the government had to recapitalise the banks if we were to move towards the global best practices. The recapitalisation was technically fiscal-deficit neutral and was financed through exchange of bonds with the concerned banks.

The reform period also saw a new paradigm in the system regarding ownership, regulation and competition. First, the banking industry was open to private owned banks enhancing competition. Public sector banks were encouraged to compete with each other. Second, public sector banks became banks with mixed ownership, but with majority ownership and control by government through statutory provisions. Third, prudential regulation and supervision by RBI was oriented to global best practices.

Though the recommendations of the Committee were accepted by all the political formations, some were not acted upon. An important recommendation was that the dual control of public sector banks, namely, by the government and RBI should be ended. Another recommendation relate to consolidation of public sector banks. These have not happened.

By 2003, there was a political consensus to bring in foreign banks to improve the systems, but a roadmap for their enhanced presence was announced. Public

sector banking was in limbo with policy inactions. Around this time, growth in India picked up but we also went in the direction of financial inclusion. That gave an opportunity for banking in general, and public sector banks in particular, to enhance their relevance. Public sector banking did expand with a missionary zeal. The banks, in particular public sector banks, had to divide their attention between financial inclusion and commercial activities. In addition to social obligation, the government pushed the public sector banks to lend to more risky activities as part of development obligation. During this period, the high rate of growth also resulted in unprecedented growth in credit. The RBI tried to restrain high growth of credit, in particular, financing of real estate. During this phase, anti-public sector banking mood was subdued.

Global financial crisis struck in 2008. There was mild panic in India, briefly and public sector banks became attractive relative to private sector ones, though briefly. Globally, there was some rethinking about the cost of private sector banking relative to public sector. Perhaps, after the global crisis the hidden costs of private sector banks became evident at a global level.

The post crisis era is significant for our banking industry in India. The banks benefitted from fiscal stimulus, monetary stimulus and regulatory forbearance including increasing exposure limits to corporates, groups and industries. In retrospect, perhaps, they were more than needed and, were continued for longer period than necessary. Banks had also been encouraged to lend to infrastructure which was not the core competence of the banks, apart from creating asset and liability mismatch in terms of duration. In the process, the focus on their strength,

provision of working capital could have been diluted. Everyone was happy till the problems in these accounts had to come to the open.

The current crisis or stress is a reflection of possibly several factors. First, easy post-crisis macro and regulatory policies since 2009; second the delayed recognition of the problem both by banks and the regulator; third, the impact of slow-down in growth of GDP; and fourth, the arguable factor is high credit growth in 2004-06 despite high interest rates and regulatory counter-cyclical measures.

In brief, we have two problems on hand now; (1) accumulated operational problems for banking in general and public sector banks in particular, which require surgical strike, especially injection of capital to meet capital adequacy, and (2) structural problems that encompass ownership, regulation and competition demanding fundamental and prolonged actions.

There is an important difference between the banking issues in 1990s and now. At that time we did not have a viable private sector banking. Further, government had to pay for the "sins" of what may be described as "populist banking". Now, it is evident that the non-performing assets are mainly on account of large business houses. Particularly galling is their ostentatious living while landing banks into trouble. For these reasons, the dominant mood now is not in favour of giving the benefit of doubt to public sector banking, nor is it hopeful of a future that would be different from the past, as far as public sector banks are concerned. In the process, lakhs of educated, skilled and talented middle class working in public sector feel that they are being accused for no fault of theirs and their life time careers are in jeopardy.

The private sector banking is also under stress but that calls for action by regulator or in macro-economic environment. There is no demand for fiscal support in respect of private sector banks.

<u>Lessons</u>

What are the lessons from the past leading to the present? There are two sources for lessons, namely, the rest of the world and our experience.

First, in 1980s and 1990s, globally banking industry was expanding and flourishing and financial sector was zooming and getting diversified. We missed out partly because we took anti-private sector banking stand in 1983; and partly there was no effective competition to or in public sector till 1990.

Second, finance industry has become diversified globally and we cannot consider banking system in isolation now in India. Banks versus non-banks is a burning issue. But, development in financial sector is impacted by the dominant presence of public sector.

Third, excessive financialisation or extreme deregulation results in a crisis as it happened in the global crisis. But, underdeveloped financial sector not only retards growth domestically but makes the country vulnerable because of globalised finance. So, the cleanup and reform of our banking cannot ignore the global and market perceptions of what we are doing.

The experience with public sector banking within India gives some pointers to what is desirable and what is feasible.

First, political economy considerations have a consensus in favour of continuing with public ownership and control of banks.

Second, there is a blame-game between owner, regulator, the management and the large borrowers, but the tax payer is ending up paying for the losses.

Third, all evils cannot be put at the door of public sector banking. Only the difference in levels of performance between public and private can be attributed to governance in public sector. Across the board, banking problems are essentially a reflection on the regulator or macro policies.

But, the fact remains that tax payers pay for the inefficiencies of public sector banking, unless the RBI fails in ensuring stability in private sector.

Fourth, the cost of public sector banking is evident in and quantifiable, but the benefits are not quantifiable.

Fifth, the public sector banking in India is, in fact, a joint sector banking, with joint ownership. At the same time, the public sector banks are not limited liability entities where capital adequacy is critical for the regulator. In a way, it is not clear whether the joint ownership model has worked very well.

Sixth, the public sector banks are established under a statute and hence they are not entities with limited liability. Substantially, capital adequacy is a technical requirement prescribed by the regulator for all market participants and not a compulsion to retain public confidence in public sector banks.

Seventh, experiments by governments under several political formations with improving governance have not yielded results so far.

Eighth, whenever capital infusion was undertaken, the conditions imposed at that time could not be enforced. There are inherent limitations to enforcing conditions while injecting equity except through the Board.

Ninth, it is possible that contribution of public sector banks in the form of direct and indirect taxes, relative to their share of business, is more than that of the private sector. In assessing fiscal implications, the returns on capital is important, but tax contribution may not be irrelevant.

Finally, efficiency in public sector banking has been improving in India, but not to the extent the private sector has been able to achieve. We must also recognise that overall technical efficiency of private sector has been increasing rapidly relative to public sector, but unless well regulated, the private sector has incentives to shift their losses to public policy.

Present

What is the present state of affairs? Let me pose some questions and explore brief answers.

First, is there a banking crisis? No, there is no crisis but only stress. Typically, banking crisis means loss of confidence in the system, especially among the depositors, or a stress in external sector of crisis that drains liquidity. In fact, India has the luxury of time and freedom to handle the current stress in banking without a crisis looming large.

So, experience of other countries in handling banking crisis, like 'bad banks' may be less relevant to us.

Second, how much of it is a banking problem and how much of it is public sector banking? In regard to former, the equity holder bears the burden unless there is extraordinary crisis. In the latter, the tax payer bears the burden. Logically, corrective actions to address problems of public sector banking should not be extended to the banking industry as a whole. For example, NPA of private sector banks are essentially a matter between banks and the regulator. There are differences in consequences of failure of private and public sector banks, despite intense externalities in banking system.

Third, who is taking the risks? When a public sector bank lends to a company in public-private partnership, especially Special Purpose Vehicles for infrastructure, a disproportionate part of risk rests with public sector. For example, in an airport, the government must ensure the service; is part equity holder and through public sector banking, lender also. There is concentration of risks in such cases.

Fourth, what is the major source of problem now at a micro level? The related party transactions are the most important sources of one segment of a corporate group being profitable and not others where stakes are higher for public sector.

Fifth, there are multiple sources of stress such as macro policies (excessive stimulus) or industry specific business cycles or, regulatory failures or fraud. These

are matters of facts and, to some extent, conjecture. Currently, it appears that there is a convergence of all these. But, the solutions to each of these are different, but inter-related.

Sixth, is there a stress in borrower's balance sheet? Obviously, yes in respect of the entities that borrowed from public sector banks. Stress in banking is often an expression or reflection of stress in its borrowers' balance sheets. Perhaps, the problem is, as the old saying goes, "there are sick industries but not sick industrialists." Mechanisms like BIFR which were designed to facilitate restructuring and early resolution, have been misused, and became counter-productive. However, there is an impression that private sector banks have greater manouverability and incentives to negotiate and effect compromises when the balance sheets of corporates are under stress.

Seventh, there is unanimity that (a) there is an issue of capital adequacy which has to be addressed immediately and equally; (b) a more fundamental problem of "misusing" public money in "public sector banks". The misuse has to be stopped by mending or ending public sector. The question now is: does experience indicate for future the mending route or ending route? Or, is there a third way?

Finally, since 2014, a series of actions have been taken to improve the eco-system in which banking operates. One example is, Insolvency and Bankruptcy code. The fundamental changes in law and institutions in the ecosystem, though yet to be tested, point to a new regime in financial sector – a better than before regime, in alignment with modern finance and global best practice. This is the most appropriate time to chart the future of public sector banking that has been ailing

and losing its share in business while drawing upon tax payer's money and apparently serving the broader public interest as defined by government.

NPA Problem:

Let me start with NPA, the root of current stress. What is an NPA? Technically, it means that borrower is not paying interest or principal due to a bank beyond a reasonable grace period. It is important for any regulator of banks to make sure that banks have adequate capital to honour commitment to the depositors. In good times in the economy, NPAs look very small, and in bad times they look very bad in relation to the advances.

How do we define an NPA? The regulator defines it; and in doing so, can be liberal or rigid, and can also vary from time to time. There are generally accepted principles of identifying NPAs, but not universal or binding. Data on NPAs over time are not strictly comparable, if definitions are changed.

The risk of an NPA arises when lending takes place but it materialises when debt is not serviced. So, the seed for NPAs is often, in a way, planted when lending takes place, and so all lending NPAs cannot be eliminated; but they have to be contained at a reasonably low level.

NPA involves a default, which may be for genuine reasons or due to misunderstanding or fraud. A distinction is made between wilful defaulter and other defaulters. In the case of corporate entity who is a defaulter, the Directors on board are declared as defaulters. As Secretary, Banking in 1995-96, I found my name in the list of wilful defaulters of RBI. I was put on the board of AP Scooters

because it was sick and I was to solve the problem. But, I was identified with defaulters. Technically, the unit had assets but could not be monetised for procedural reasons.

The system has to allow flexibility to genuine risk takers, and deny it to those who may cheat. How to distinguish? Fundamentally, borrower knows more about his business and controls cash flow. The lender can never beat the borrower in having relevant information. It is difficult for the regulator to distinguish between genuine risk taker and a fraudster till after the event. A practical way is to give incentives that promote prompt servicing of debt.

Punishment may be necessary, but that tool has limitations. It is difficult to identify the cheating, and more important the cheat. It takes a lot of cost, time and energy of the society to go through the process of imposing punishment – both for the prosecutor and the defendant. So, we should search for an optimal mix of good incentives but cost effective punishment to the errant.

NPA may arise due to default for genuine problems faced by the borrower but he or she remains a defaulter. There is nothing unusual about default and, in fact, interest charged depends on the risk involved in the business that is financed. So, risk of non-servicing in some cases is built into the system. It has been so since ancient days when trade across seas invited higher interest rates than domestic trade.

Briefly stated, all defaulters are not cheats. Also, all defaulters are not a matter of equal concern for public policy except as a signal, but are relevant to regulator of banks and the banks themselves.

The most striking aspect of the current situation is the large divergence between the bank's classification and subsequent classification by RBI on a detailed scrutiny. Perhaps, the auditors who audited banks had a one-way bias, and they have incentives to do that. Auditors, in some ways, are the extended arms of the regulator, RBI. They are authorised, franchised and licensed by Government. Naturally, RBI depends on their classification of assets of banks. Banks themselves depend on the auditor's statements for the state of borrowing company. Have we asked the question: whether Government or RBI, who are using the auditors, and in some cases, Company Secretaries, as their extended arm, assessed their performance with the integrity and reliability that is expected from them. In brief, an unexplored area is the role of auditors / Company Secretaries in blurring the distinction between genuine transactions and fraudulent transactions, perhaps contributing to NPAs.

In the current context, we should distinguish between underlying cause of NPAs in general and those which are of special relevance to the current bout of high NPAs. They may be exogenous factors, like economic cycle; industry cycle; policy paralysis; judicial activism, etc. There may be policy failures like using banking system for multiple ends, and interference in conduct of business, or directing banks to fund infrastructure though they d not have expertise in it. There may be regulatory failures such as excessive exposure to specific industries, or relaxed

limits on group exposure, over-leverage of corporates, delayed recognition of NPA and corruption. There may be cases of simple fraud by the borrower.

In brief, current NPAs may reflect more fraud than before but it cannot be the case that all NPAs have suddenly become fraud now.

Several options were considered to address the NPA problem, sometimes on a standalone basis and sometimes in conjunction with other measures to solve the underlying issues that result in demand for capital infusion. Consolidation was an option, but that by itself does not increase capital or address weaknesses common to all banks being considered for consolidation. A bad loans bank was suggested but recourse was taken to this method in other countries to meet exogenous shock to banking system but not due to endogenous stress. Diluting the shareholding of government was proposed but that assumes private shareholders will be willing to buy at this juncture at a reasonable price. A combination of further regulatory forbearance and removal of constraints such as SLR or CRR was proposed. But, such moves could have eroded the confidence of markets in banking system and, in any case, may provide marginal relief to all – including private sector banks. Finally, there seems to have been a consensus in favour of recapitalisation as the necessary first step while considering all other options to reduce chances of recurring of such problems in banking system.

Recapitalisation:

It must be recognised that recapitalisation now is vastly different from the one undertaken in 1990s. There is private shareholding in Public Sector banking

now; the bond and equity markets are significant and we have globalised financial markets.

Recapitalisation involves injecting additional equity. This can be done by existing shareholders and/or new ones. In view of the importance of public sector banks, government has decided to recapitalise, presumably without prejudice to other proposals such as consolidation and reduction in government stake that may be considered in future.

Two issues remain: whether all banks should be recapitalised; and if not, what should be the criteria? Here, there are trade-offs involving past performance; current situation or need and future prospects. The difficulties in enforceability of conditional injection of capital in the prevalent institutional framework must be recognised. Perhaps, across the board injection of capital, with some discretion about the extent of such injection in each bank, is a practical way forward.

The option preferred now seems to be a significant reliance on issue of bonds to fund the injection of equity. Bond financing should normally imply increase in fiscal deficit, but it can be interpreted to define in a manner that it does not. Whatever manner it is defined, it adds to the fiscal burden in terms of payment of interest in future. This burden could potentially be compensated by returns on equity injected.

Monetary implications would depend on the revival of activity consequent upon injection of equity and the design of bonds. The design of bonds will have to consider its overlap with monetary management, maturity, interest rate (floating or

fixed) lock-in, tradability, SLR status, eligibility of LAF, etc. Broadly, more the conditions or restrictions, higher would be the interest cost but with less distortions in bond markets and less complications in monetary management. But, the design of bonds should allow an integration of these bonds into the debt market in near future to avoid fragmentation of markets.

Another important issue in the design of recapitalisation is the relative burdens and benefits of government as a majority owner and of private shareholders, of which LIC and Foreign Institutional Investors appear to be prominent. Ideally capital should be injected through rights issue. But it is a time consuming and involves cost, relative to preferential allotment – with pricing as per SEBI guidelines. However, since in many cases preferential share may exceed 5 per cent, open offer may have to be made by government. Some special dispensation by SEBI seems inevitable. Similarly, bond issuance will also require special dispensation in some way or the other. This may include non-SLR and non LAF status and multiple lock in periods to minimise distortions in liquidity management by RBI. Such special dispensation would be facilitated if the operations are by government but not by any special entity treated for the purpose.

It may be desirable to keep the option of divestment of shares or purchase of shares on a continuing basis within the legally permissible limits, whenever the market conditions permit. In other words, government should have the flexibility to withdraw from ownership if fiscal needs demand within the legal framework. This would give the first signal for non ideological but purpose oriented and fiscally prudent approach to the extent of investments in public sector banks.

There are proposals to use the reserves of Reserve Bank of India for recapitalising public sector banks. It would mean that a regulator is being asked to fund the capital needs of the regulated – a strange proposition. To avoid this, there is a proposal that Government could take special dividends from RBI out of its reserves in 'excess' of its needs, and then inject capital.

RBI is one hundred percent owned by Government. It has a claim and a right over RBI's surpluses of income over expenditure, year after year. A fresh assessment of accumulated reserves is different.

A contentious issue is the determination of "excess" or the adequacy of internal reserves in the balance sheet of RBI. For this purpose, it is useful to understand the unique nature of RBI balance sheet. Usually, a good performance of a unit is reflected in high profits, and some of it can be taken to reserves. In the case of Reserve Bank of India, profits may arise not because of the good performance of the Reserve Bank of India, but not so good performance of Government of India. Professor Manmohan Singh had once commented that the profits of RBI are often a reflection of the profligacy of the Government. By funding the needs of the Government through monetisation, RBI makes profit. Secondly, the use of reserves may not necessarily reflect the preference of Reserve Bank of India. In fact, when there are excess capital flows and sterilisation is undertaken, there are losses to the RBI. Sometimes, the reserves may be called in for this purpose. Thirdly, a more telling example relates to our own experience in 2007. When the rupee appreciates, then the value of our foreign assets in rupee terms goes down. Drawing upon one type of reserve or more, becomes necessary.

It may also be necessary to recognise that the international comparisons of adequacy of reserves are misleading because the call on the reserves of a central bank depends not only on the composition of its balance sheet and accounting practices, but also on the macro-economic as well as financial sector conditions. Adequacy of capital of a central bank is highly country specific.

Further, we must appreciate that globally there is significant attention paid to the issue of adequacy of reserves keeping in view the increasing risks that the central banks are exposed to in conditions of stress in financial sector.

For example, a country that needs to build up safety valves in the form of forex reserves has different needs from one whose currency is fully convertible.

I recall a somewhat similar demand (though the proposal under consideration relates to internal reserves of the RBI) for use of forex reserves that was made when I was Governor. The demand was on the ground that we had "excess" forex reserves, and that they should be used for good purpose. Dr. I.G. Patel made a comment on this, and I quote:

"Take one current example. The proposal to use foreign exchange reserves to accelerate infrastructure development has received much public attention in India recently. Anyone who knows anything knows that the reference to foreign exchange reserves in this connection is only a red herring. It is to draw attention away from the real purpose: which is to indulge in greater deficit financing and even to monetize a part of the deficit in violation of solemn undertakings given to Parliament. If you say so openly, you will be shot down in no time. But if you

bring in foreign exchange reserves which are useless and earn nothing and suggest using them for worthwhile purposes, you may hoodwink some people and get by. I have no doubt the proponents of the idea also know this−they are too intelligent not to know what you and I and everyone in the economic profession know. But politicians have to square the circle here and if they can get by, by diverting attention to something irrelevant, why not? They can always say the violation of past commitments is only temporary and once in a while and not a precedent for the future. All politicians always say that, for example, when they introduce amnesty schemes for laundering ill-gotten money which somehow crop up after every election. A former Governor can get by saying all these things openly. But a sitting Governor cannot. Nor can he keep quiet. If he has friends in the government, he can tell them what he thinks and hope it will reach the right ears. He can encourage think-tanks to debate the issue and create public opinion. In this case, perhaps, he can even afford just to sit back and smile. The issue may well die of its own infirmity." (from page # 92).

(*"Of Economics, Policy and Development – An Intellectual Journey by I.G. Patel",* edited by Deena Khatkhate and Y.V. Reddy, Oxford University Press, 2012.)

Above all, the current proposal to use of reserves of RBI in some ways involves a reversal in the approach of the government to the balance sheet of the RBI. The matter was eloquently summed up by the respected statesman Mr. Jaswant Singh in 2003, in response to my proposal on the following lines.

"The issue is whether the cost of adding to the forex reserves should be shown in the balance sheet of the government or the RBI. The government is

already in the red. The Reserve Bank is not. If the government bears the cost, it will add to the fiscal deficit. If the Reserve Bank bears it, its balance sheet could turn from surplus, which we give to the government in any case, into deficit. We can have both the RBI and government balance sheets showing deficit, or only the government's, which is already in the red. It is good to make a central bank balance sheet a healthy one. It can serve the government better.'

Jaswant Singh said, 'I will do nothing, in any way, that undermines our central bank. I want our central bank to be strong. It should command respect. We will approve your proposal.'

(Y.V. Reddy, '*Advice & Dissent – My Life in Public Service',* Harper Collins Publishers India, 2017, pages 350-351).

Future:

From the review of the past, it is clear that at a political economy level, public sector banks are very useful. At a technical level, the benefits of public ownership are not quantifiable while the costs are obvious – injection of capital.

The future of public sector banking has been, formally and officially uncertain since Narasimham Committee's recommendations. The only major step was induction of private shareholding in public sector banks in 1990s, and injection of capital from time to time. Public sector banking was, by all accounts used or misused, in a variety of ways depending on the "eye of the beholder". They had to serve social objectives dictated by Government while being urged to be commercially viable. They continue to face uncertainties in the backdrop of

declining share in market. There is merit in reducing the uncertainty at this critical juncture.

An outline of a fiscal approach to the future of public sector banking was given by the Fourteenth Finance Commission.

Relevant extracts read as follows:

The public sector financial institutions occupy a special position, by virtue of their critical role in the financial system and the economy.

In our view, there is scope and need to further lower the fiscal costs of re-capitalisation by restricting it to select and better performing public sector banks, instead of an across-the-board policy of covering all of them, in view of the competing demands on available budgetary resources. The non-performing public sector banks may be advised to manage their asset portfolio and growth in tune with the available capital. This will promote competitiveness amongst these banks and act as a hard budget constraint on them. This approach requires a view to be taken on, as well as an assessment of, the number of public sector banks that can cater to the desirable share of the public sector banking system in India, in order to serve the social objectives.

A fiscal view requires full understanding of the fiscal implications of options available. First, in injecting capital based on borrowings, it is necessary to make an estimate of whether the government will get a return of equity that exceeds the cost of borrowing. In addition, the alternative use of the borrowing within the fiscal deficit parameter has to be explored. Second, if the expected receipts from sale of

shares are more than the net present value of the future cash flows in government ownership, there is fiscal gain. Third, it is reasonable to expect that the private sector takes into account the scope for improved performance under private ownership while bidding for ownership. Fourthly, the idea that fiscal gains can be obtained by restructuring does not take into account the non-transparent cost incurred by the government in restructuring, and the loss of freedom to the buyer for similar restructuring. Finally, the actual timing is a matter of tactics and should not be dictated by temporary movements in the stock market conditions.

A purely fiscal approach may not be adequate to chart future course of action. More may be needed.

There are strong arguments in favour of continued public ownership of banks. The arguments broadly are on the following lines:

First, globally public ownership is associated with rapid growth.

Second, the parameters used for comparison between public and private, namely, profitability, are inappropriate and show the former in a bad light.

Third, comparisons do not take into account the fact that private sector banks have globally induced the financial instability. Enormous costs have been incurred for their bail-out by the governments.

Fourth, in the case of PSBs, the cost for tax payer is transparent.

Fifth, inefficiencies, if any, are on account of deficiency in governance and not ownership. So, the way forward is reform and not privatisation.

Finally, not all PSBs are inefficient.

There are equally strong arguments against public ownership.

Firstly, it is conceded that PSBs performance will depend on the governance. Experience so far shows that such governance is associated with ownership. The unlimited liability for such banks gives no incentive for good performance.

Secondly, bail-out of private sector banks was in many cases due to weaknesses in macro policies or regulation, and not entirely due to private ownership.

Thirdly, the cost to the tax payer in respect of public ownership is quantifiable but the benefits claimed are not quantifiable and subject to assumptions in favour of the government ownership.

On balance, a pragmatic view will be contextual to India. A view has to be taken in the totality of experience with governance, regulation, and public and private ownership. In the Indian context, the choice is not between public sector or private sector. Both already exist. Nationalisation of private sector banks is, perhaps, not on the table. Share of public sector bank is coming down. So, one issue is whether we should inject more capital from government to support them.

Second issue is whether support to public sector should be minimal to survive or to grow also.

Third issue is whether injection of capital is of a magnitude that is meant to reverse the trend of reduction in PSBs share in the system or maintain or allow the downward trend or to accelerate the trend, by keeping the option to privatise.

Fourth, it is possible to keep all options open and proceed depending on the performance of PSBs as a whole or only those who perform well.

Let me share my tentative thoughts.

I feel that a minimum share of public sector banking in our system should be maintained for several reasons.

First, large sections of population still feel more at ease with PSBs. They complain of the service quality but prefer it. They are small segment of financial world but large segment of population. In fact, there are some segments of credit markets where public sector dominates and private sector is reluctant to penetrate.

Second, Government needs some presence, not necessarily overriding or costly presence for implementing its programmes that need to penetrate into vast sections of population in remote areas.

Third, having experienced the excesses of private finance, there is need for countervailing forces to the private finance.

Fourth, the presence of public sector facilitates reliable information to the regulator.

In brief, right question to be asked is: what should be the minimum share of public sector banking that is essential for strategic reasons, and how to maintain that level in future, ideally in a fiscally neutral manner.

There are three stages for future of Public Sector banking. First, giving life line to all existing PSBs to survive, coupled with fundamental legal changes that facilitate improved governance and dynamic management of portfolio of investment in PSBs. Second, to right size the presence by reforming all and privatising some. Third, to protect and maintain a minimum share for PSBs in the banking system, as a whole, in public interest.

Should the future of public sector banking be confined to those owned by Union Government? There have been demands from some State-Governments to obtain licence to promote banking companies, and requests have not been entertained by RBI so far. If there can be a Gujarat Model or Tamil Nadu model of development, is there a reason why a Gujarat or Rajasthan or Telengana model of banking should not be encouraged? Economies of states are large enough to sustain such banks. Are we promoting yardstick competition and diversifying risks of public sector banking by allowing sort of local areas banks to be incorporated by states? Perhaps, worth pondering.

Conclusion

The birth and evolution of public sector banking has been intensely political. It continues to have enormous economic consequences. The future of public sector banking will also be governed by political considerations. But this time, with mixed ownership of public sector banking and mix of public sector and private sector banks; in a globalised market economy, there are bound to be more of economics than politics.

Let us keep our fingers crossed.

Thank you,