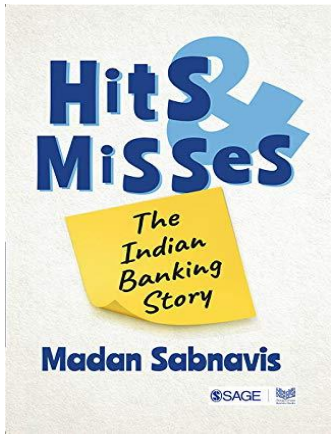
Guest blog/Book extract

'Hits & Misses: The Indian Banking Story'

Madan Sabnavis

In this guest blog Madan Sabnavis quotes extracts from his just published book 'Hits & Misses: The Indian Banking Story' and highlights the trends since financial sector reforms were introduced. It also raises debate on certain issues in governance in banking which goes beyond what we read in the media.

The alleged irregularities witnessed in case of some of the big cases such as PNB, Yes Bank, ICICI Bank, PMC and so on are well known. But the broader issue is often lost as there is focus on persons involved in such deviances rather than the structures which engender them. An extract is given below from the book for reference.



"At the level of governance, the challenges are more acute because while the RBI can compel banks to be more transparent in sharing information, getting people to behave well is always tough. The issue of interconnected lending has to be dealt with more severity. Written statements need to be taken from the top management (which may be defined by the RBI) so that the lending decisions do not involve any such relationship. Taking a written declaration would make a difference in the way in which bankers behave. In fact, if there is interconnected lending, it should be stated upfront that there is an interest along with a justification that the project is a viable one. This would throw the onus on the top management to justify such loans.

The process of giving loans has to be through committees that are defined in a manner such that the top person does not have any say in the decisions. This is hard to crack because even when the CEO steps out of the Committee, the very fact that there is an inclination to garner business would mean that the others down the line would support such decisions. To bring in some discipline out here, the RBI should

release a list of top 100 large companies that are facing high risk where the size of the company or loan can be stated as a threshold for which credit committees would have to provide a detailed explanation for disbursing the loan. This would be referred to in case of any enquiry in future if things go wrong."

Governance is not just about government interference with Public Sector Banks (PSBs). The selection of the CEO as well as the Board members is with the government and even the Banks Board Bureau (BBB) which selects directors is appointed by the government. Can there be an open mind anywhere given that everything is decided at the top. Arguably one can justify the same as the government is the owner. But then governance standards get diluted. Private banks are not very different even though there is a camouflage of there being diversified shareholding pattern. The CEO often is powerful enough to drive the agenda. A relevant extract is given below.

"Let us look at PSBs first. They are owned by the government and will probably continue to be presently structured as there is an inherent incentive to keep them this way for reasons explained in other chapters of this book. The board members are selected by the government and hence would-be bureaucrats, retired bankers, academicians, industry experts and so on. While they follow the processes of independent directors and executive and non-executive directors on the board, they are still appointed by the government. Next, the top management is again selected by the government and there is a Banking Board Bureau (BBB) in place which appoints senior management of PSBs. But the members of the Bureau are again selected by the government. Hence the structures are such that the owner has control over both the board and management. It is but natural that there would be a tendency for congruence between the two with the owners having the upper hand, which in this case is the government. All departments of the government work in a set up where the top man is always right and as political superiors have the power, their word becomes binding informally on everyone. Hence there tends to be a spirit of over-obedient behaviour rather than one of equals which makes such governance structures fragile.

Even when phone banking has stopped bankers, it still has challenges as several so-called recommendations made by the government are orders to banks to execute them. Let us see how this plays out. The government calls all heads of PSBs to Delhi and they are told to lower interest rates. While owners have such a right, it is not in the spirit of corporate governance as commercial judgments should be left to the entity. Second, orders are given to lend to SMEs with threat of increments being held up. This does not give a choice to bankers who become slave to the fancies of

the owners. Third, bankers are told to open 'Jan Dhan' accounts which does not hold for private banks. These are examples where governance norms are violated."

How about private banks? Is it any different? The extract below describes this scenario.

"Most of the private banks have a very esteemed Board of Directors and the composition of the top management, including the MD and CEO, are very good names with excellent credentials which include qualification that can be from the top-rated management institutes and iced with foreign degrees. This structure was not questioned ever except a couple of years back when the NPA issue surfaced. In fact, most of these heads were recognized for their brilliance, dynamism and ethics by various outfits which bestowed awards. They also tended to be involved in all the decisions and policy-making committees of the government and RBI and had far greater representation than the PSBs due to the reverence which went with the term 'new private bank'."

An interesting outcome of this dominance is that the tenure of the CEO gets extended. Often the CEO of a private bank becomes larger than life which the Board would not touch. Care is taken to ensure there is no second hierarchy and hence the position at the top is cemented. There are arguments on both sides and the book strikes a balance here. But clearly the argument that if the CEO has done everything right in one or two decades cannot be a justification for settling with status quo. This is a sticky issue in the realm of governance as such appointments have the acquiescence of the regulator. an extract on this issue is given below.

"The fact that the senior management has been with the CEO for a long time only reinforces the argument that new ideas will never come in and hence there will be limited progress. Hence while such banks have done very well continuously, the question is would they have done better in terms of approach and strategy had the management team changed over the period of say a decade or two decades? There is no definite answer here but the question is relevant."

While the rules of governance are played in the technical sense, the extended tenure goes with the compensation. The beauty of heading a bank is that one can aggressively lend and improve the topline and profit and hence market valuation in the short term. This goes with high rewards which include stocks. But when the NPA cycle starts, one could be out of the frame and hence the past-

pay remains untouched. It is against this background that the RBI has spoken of the claw back action. A related extract is given below.

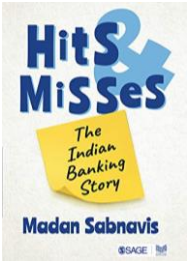
"The private bankers are not normally answerable to anyone but the Board and in the absence of what looks like major financial impropriety, are generally insulated against failure. High NPAs can lead to the non-extension of contract but rarely goes with the investigative agencies gunning for them. Therefore in terms of risk, private bankers have automatic insurance. By the time the backlash is experienced, the management would have changed and there is nothing that can be done. An example here is that in the period post financial crisis several bankers rode the wave of aggressively lending to large infra projects and steel. The benefits came in immediately and the CEOs showcased their success. Subsequently, they left after their term/extended term and the management changed alongside. The bubble of infra lending burst and the bank/s was left holding an adverse portfolio which today is called poor judgment in retrospect. In such cases, the incumbent CEO faces the crisis, while the one responsible for this upsurge is forgotten."

The book brings to the fore these issues and provokes debate. This can lead to better governance structures in banks - if taken in the right spirit.

Madan Sabnavis is the Chief Economist with CARE Ratings and the author of four books. The other three are 'Macroeconomics Demystified", "Eco Quirks" and "Economics of India: How to fool all people for all times". Author of over 2000 articles over the last 32 years, Madan is a post-graduate from Delhi School of Economics and a graduate in Economics (Honours) from St Stephen's College, Delhi University.

Email: ***Madan.Sabnavis@careratings.com*** **or** ***madan.sabnavis@gmail.com***

Twitter: ***@madan_sabnavis***



You can use the following link to buy the book: https://www.amazon.in/Hits-Misses-Indian-Banking-Story-ebook/dp/B08NHL58HM/ref=sr_1_1?dchild=1&keywords=sabnavis&qid=1608810707&sr=8-1

Disclaimer

This document has been authored by Madan Sabnavis. The views expressed in the document are personal to the author and do not necessarily reflect the opinion of IiAS. IiAS shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. This document is provided for assistance only and is not intended to be and must not be taken as the basis for any voting or investment decision and/or legal opinion/advice. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of the individual resolutions referred to in this document (including the merits and risks involved). The discussions or views expressed may not be suitable for all investors. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. IiAS reserves the right to make modifications and alterations to this statement as may be required from time to time. However, IiAS is under no obligation to update or keep the information current. Nevertheless, IiAS is committed to providing independent and transparent recommendation to its client and would be happy to provide any information in response to specific client queries. Neither IiAS nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. The disclosures of interest statements incorporated in this document are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report.

Confidentiality

Other Disclosures

IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024) dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions of about 750 listed Indian companies (https://www.iiasadvisory.com/iias-coverage-list). Our products and services include voting advisory reports, standardized services under the Indian Corporate Governance Scorecard, and databases (www.iiasadrian.com and www.iiascompayre.com). There are no significant or material orders passed against the company by any of the Regulators or Courts/Tribunals.

This article contains excerpts of the book, 'Hits and Misses: The Indian Banking Story' and is a commentary on the general trends and developments witnessed in the securities market.

About IiAS

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for about 800 companies that account for over 95% of market capitalization.

IiAS provides bespoke research, valuation advisory services and assists institutions in their engagement with company managements and their boards.

IiAS has equity participation by Aditya Birla Sunlife AMC, Axis Bank, Fitch Group Inc., HDFC, ICICI Prudential Life Insurance, Kotak Mahindra Bank, RBL Bank Limited, Tata Investment Corporation, UTI Asset Management Company Limited and Yes Bank.

IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024).