Why India Should Privatize Its Banks

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Late last week Viral Acharya, a deputy governor of the Reserve Bank of India (RBI), said: "Perhaps re-privatising some of the nationalised banks is an idea whose time has come ... this would reduce the overall money government needs to inject as bank capital."

Regular readers of the Diary would know that we have said several times in the pastthat public sector banks should be privatised and the government should get out of the banking business, which it is clearly inept at.

Of course, the question is why has Acharya used the term re-privatising rather than privatising. Indira Gandhi nationalised 14 private banks on July 19, 1969. These banks had deposits of Rs 50 crore or more and among them accounted for 90 per cent of the banking business in the country. The funny thing is that at the time this happened, the then RBI governor LK Jha had no clue about it.

As TCA Srinivasa Raghavan writes in *Dialogue of the Deaf-The Government and the RBI: "Volume three of RBI's official history says that on July 17 she* [Indira Gandhi] *asked LK Jha, the RBI governor to come over to Delhi. Jha thought he was being asked to discuss social control and he took with him a comprehensive note on the subject. When he offered it to Mrs Gandhi she told him 'that he could keep the note on her table and go to the next room and help in drafting the legislation on nationalising the banks*.'"

In 1980, six other private banks were nationalised. This time the recommendation came from the then RBI governor, IG Patel.

Now getting back to what Acharya said, re-privatising is something we have advocated in the past. And it makes sense at multiple levels. We now have nearly two decades of evidence that suggests that the new generation private sector banks which were first set up in the mid-1990s, are much more efficiently run than their public-sector counterparts. Yes, there have been cases like the Global Trust Bank, but on the whole private banks are better run than their public sector counterparts. Even the old generation private sector banks, which are very small, are reasonably well run.

Take the case of the bad loans situation that currently plagues the Indian banking sector in general and the public sector banks in particular. As on December 31, 2016, the total bad loans of the public sector banks(gross non-performing assets (NPAs)) had stood at around Rs 6.46 lakh crore.

For the private sector banks, the same number stood at Rs 86,124 crore. Of this, two banks, ICICI Bank and Axis Bank, accounted for bad loans of Rs 58,184 crore. Of course, given that public sector banks give out more loans, it is not surprising that their bad loans are more.

The total loans of public sector banks are 2.9 times the total loans of private sector banks. But their bad loans are 7.5 times that of private banks. If both these set of banks were equally well run, then the two ratios just referred to, wouldn't have been different.

Between 2013-2014 and 2015-2016, the total net profit made by the public sector banks stood at Rs 56,567 crore and that of private banks stood at Rs 1,13,801 crore. This, even though public sector banks are significantly bigger than India's private banks.

These data points tell us that India's public sector banks are inefficiently run. And this inefficiency has cost the government a lot of money over the years. Between 2009 and March 2017, the government has had to invest close to Rs 1.5 lakh crore in these banks to keep recapitalising their capital, in order to keep them going.

Indeed, this is a lot of money and could have gone towards other worthy causes. The basic problem with public sector banks is political meddling. Every government has its favourite set of industrialists and this ultimately leads to the public sector banks and in the process the taxpayer, picking up the bill for this politician-businessman nexus.

As Acharya writes in a paper titled *Is State Ownership in the Indian Banking Sector Desirable?: "One, state ownership creates severe moral hazard of directing bank lending for politically expedient goals and of bailouts when such lending goes bad. Second, state ownership restricts the ability of state-owned banks from raising arm's length capital against state's stake, strangling their growth and keeping these banks-and certainly their private capital base-smaller than it need be*."

What does this mean in simple English? The economist Alan Blinder in his book *After the Music Stopped* writes that the "*central idea behind moral hazard is that people who are well insured against some risk are less likely to take pains (and incur costs) to avoid it.*" Hence, managers of government owned banks know that if loans given to businessmen close to politicians go bad, the government will ultimately pick up the tab by recapitalising the public sector bank to an adequate extent. Hence, they go easy on giving loans to borrowers who are likely to default. Of course, there is always the threat of transfers, which works very well. This has happened for years at end.

Secondly, given that the government has to continue owning a certain proportion of shareholding in these banks, the banks cannot raise as much capital as they require. They have to continue to be dependent on the government for capital. And the government of course does not have an unlimited amount of cash. This limits the ability of the government owned banks to raise as much capital as they may require at any point of time.

So, what are the actual chances of the government re-privatising some of the public sector banks, as suggested by Acharya? Zero. While Acharya, I and others, might think that the basic problem with public sector banks is government ownership, politicians don't think so. This comes from the belief that if you own banks then you can direct lending to areas that you want to. But this as we have seen comes with its own set of costs.