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# Keynote Address by Shri G Padmanabhan, Non-Executive Chairman, Bank of India at CAFRAL's Executive Development Program, December 11-12, 2017, Mumbai

# Governance, Strategy and Risk Culture in PSBs – Some reflections & Way Forward*

Good morning. I am delighted to be here to share my thoughts about financial sector issues that keeps everyone on their toes and has led to, by own admission, insomnia to the RBI Deputy Governor. The sector as many say is a study in contrast, on one side supporting one of the fastest growing economies and on the other grappling with what McKinsey calls a set of "new realities" that are testing its strength and resilience. Let me start by asking the question to myself, now that I am on the other side of equation having to vacate my mindset of a central banker and in-doctrine that of a commercial banker, what in my view are the two focus areas of banks from the view point of income or profits? Why do I say income and profits? Because to me that is the core. If I have that I can get over any situation. I would say good quality credit portfolio and good quality technology adoption. To be balanced, let me also ask myself the question, what are the problem areas which could negate all the income or profits and put pressure on the bank balance sheet? My answer remains the same, bad loan book and poor technology implementation. Lest I am misunderstood, I am not suggesting that it is possible given a set of circumstances for the banks to avoid stress and NPA. That is a part and parcel of banking. But it is possible to be more professional and more proactive - what more do I want to achieve it? A good and professional staff who are compensated based on performance and who can work without fear and favour. Favour me with necessary governance reforms in terms of ability of the Board to function professionally with the right set of professionals inducted as Board members, then the turnaround would be even quicker. I shall return to these issues a little later. But as of now to facilitate this turn around, given the balance sheets that we run, a decisive and adequate bank recapitalisation is a necessary critical intervention. Deputy Governor, Dr. Viral Acharya quotes a recent study from the Bank for International Settlements to conclude that bank capitalisation has a strong effect on bank loan supply: a one percentage point increase in a bank's equity-to-total assets ratio is associated with a 0.6 percentage point increase in its yearly loan growth. He argues that if a banking system remains systematically under-capitalised and new lending is not kept under a tight supervisory watch, then the economy can suffer significantly from a credit misallocation problem, now commonly known as 'loan ever-greening' or 'zombie lending'. In particular, under-capitalised banks have an incentive to roll over loans from financially struggling existing borrowers so as to avoid having to declare these outstanding loans as non-performing. I am not certain these observations are entirely valid to India as the issue is not limited to one bank but several banks. Further, these issues always existed to some degree in the system, the so called "divergence" which is being considered as a four letter word by the analysts. I also contest the arm chair view of some who argue that it is the public sector banks which are more saddled with the mess because of their lackadaisical attitude or complicity with the borrowers. To me the fault lies in the governance which I shall return to.

## A PEEP INTO THE PAST

2. Let me begin at the very beginning. The public sector bank origination itself. 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. In a way, therefore, public sector banking in India pre-dates the nationalisation of banks in 1969. A reference to History of RBI indicates that nationalisation was very much a political decision. RBI was clearly in favour of social control rather than nationalisation which was brushed aside by then Prime Minister Indira Gandhi. Thus, 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. (Therefore simple solutions to present problems like bringing government holding below 51% is economically logical but perhaps politically untenable).

3. 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 or capitalisation followed by consolidation. The context now, however, is different; we already have 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. More important, we are in a new world of market economy, and India is a major economy in global context. So, for policy makers, the choice is more difficult and processes, more complex than in 1969. The degrees of freedom available for arbitrary decisions are circumscribed by dynamics of financial markets.

4. What followed nationalisation makes interesting reading. 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 "misuse" when the government started using banking to disburse loans out of depositors' money in the garb of loan melas; virtually grants as these were invariably 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.

5. Dr Reddy observes that 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. But what really happened was in the absence of accountability and accounting 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.

6. The two Narasimham Committees and the recommendations that followed formed the foundation for the banking reforms since then. However, two important recommendations relating to public sector banks relating to ending of dual control over banks by government and the RBI and consolidation of banks were not implemented. After a quarter century we are again debating on the same issue as a panacea for all the ills. But, RBI proceeded with reforms and regulations, and licensing new private sector banks. In this atmosphere, private sector banking started expanding and some of them have become efficient and world class. Global financial crisis led to 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, increasing the attractiveness of public sector entities to some extent.

7. 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 forbearance of the regulator; third, the impact of slow-down in growth of GDP; fourth, the arguable factor is high credit growth in 2004-06 despite high interest rates and regulatory counter-cyclical measures and finally Indian banks being forced to enter long term financing without either expertise or balance sheet support. Given the history of delays in infrastructure project completion in this country, this was surely a disaster waiting to happen.

8. At the same time, one must appreciate that there is an important difference between 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. 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 public sector banks are concerned.

9. Let me now turn to the second part of my talk. Given the above realities, what could be done to improve strategy, governance and risk culture in public sector banks. What are the big issues that need to be addressed if we are to become professional and competitive.

**NPA PROBLEM**

10. Let me start with NPA, the root of current stress. As I said in the beginning, this issue is neither new nor one of its kind. This time around the sheer magnitude of the problem seems to bewilder many. Whatever you do, we need to admit that the borrower knows more about his business and controls cash flow. The lender can never beat the borrower in having relevant information. But our system of consortium seems to incentivise this behaviour. Hence we need to revisit the norms of consortium lending. Another aspect of the current situation is the large divergence between the bank's classification and subsequent classification by RBI on a detailed scrutiny. This is also not new. May be the quantum but not the divergence. What about the role of supervisors? It cannot be the case that the

divergence being pointed out now were not pointed out earlier – if so what was being done about it – was their supervisory forbearance in addition to regulatory forbearance?

11. While several concerted measures are on to solve the present situation including the much hyped NCLT process, one needs to wait for outcomes to declare victory. But going forward what needs to change? To me what differentiates a public sector from a private sector bank in dealing with problems credits is the ability to cut loss and move forward. How do we strategise for that? In other words, the credit portfolio has to be in today's scenario treated like a treasury portfolio where once the price starts moving against you there is definite cut loss strategy. Yes some of them could be wrong decisions in retrospect but then to my mind we are bankers and not astrologers and bank portfolios whether in the trading or banking book will have to be dynamically managed. This is how private and foreign banks handle these issues. Can public sector banks be given the same freedom? Unless we are freed from the threat of future scrutiny with the advantage of a 20/20 vision by any one and every one, I am afraid we will continue to lag in this respect. It pains me to see stocks of banks one tenth of our size being traded at higher prices because "apparently" their balance sheets are healthier. Let me rest this point by quoting from Dr Rajan's, Prahalad Memorial lecture, "CK Prahalad believed Indian business was capable of scaling world heights and so do I. But there are no easy paths to the top. Jugaad or "working around" difficulties by hook or by crook is a thoroughly Indian way of coping but it is predicated on a difficult or impossible business environment. And it encourages an attitude of short cuts and evasions, none of which help final product quality or sustainable economic growth. While we should respect the entrepreneurial abilities of our business people in difficult environments, it is better for us to change the environment for the better." We need to take a cue from this and change the way we approach issues. And the authorities should facilitate this.

## HUMAN RESOURCE MANAGEMENT CHALLENGE

12. The biggest asset of any service industry, like banking, is its People. And this is where the biggest challenge is emerging out, especially for the Public Sector Banks (PSBs) and old Private Sector Banks. According to one recent estimate by McKinsey, PSBs are going to see natural attrition to the

tune of around 7 lakh employees in the coming years. This is going to be the biggest challenge for us considering not only the scale of recruitment but also ensuring proper skill-match.

13. Banks will have to recruit the right kind of people in the right numbers, and at the same time, will also have to develop the skills and capacities of their existing staff to meet the needs of the changing time. Apart from specialised expert skills in specific areas where banks may have to recruit from the market, it is clear that there will be a huge gap in these and other skills for the system as a whole. Hence, emphasis should be on the re-skilling of the existing staff looking at their strengths and competencies for meeting the gaps in various areas of the banks businesses. E learning to my mind is the way forward and we are going to adopt this in a big way.

14. Some critical questions that come to my mind in this area particularly as far as the public sector banks are concerned are: How to achieve specialisation without coterisiation? Is the answer to specialisation or capacity building specialised recruitment? If so how do were ensure their career path? How to work towards outcomes rather than just following practices? How to differentiate between acts of commission and omission? Between expected risk taking and vigilance?

15. In the case of Public Sector Banks, Performance Management System (PMS) is also a big challenge. A good PMS has to be the backbone of any organisation, as it is performance that helps it to grow, develop and strive for excellence. It has to be the only system that ensures that human capital is properly utilised and encouraged to achieve business results. But is it the case today? Let us learn to accept that each one of us is unique. Each one of us has certain abilities. Every single one of you has something you are good at. Every single one of you has something to offer. And you have a responsibility to yourself to discover what that is. It is equally important for the HR to be able to spot this. Can we say this is happening? You have to accept what I call the new normal that those who succeed are not always the best, and are in no way more gifted than the rest. But the selection process needs to ensure that such events are exceptions and not the rule. But banks face a new challenge if they do not have a credible process. Their best get poached and you are left with the mediocre. Please remember the best of treasury managers today in the Indian system were incubated by the public sector banks. We have to ask the question why we could not retain them? Because the system on some convoluted logic did not allow them to pursue their interest. I disagree that money was the reason. It is often not so.

16. In June 2010, an MoF-appointed committee on “HR issues of public sector banks” laid out far

reaching recommendations for public sector banks related to their compensation, performance management, capability building and talent practices. The report also laid out several key recommendations—encouraging the outsourcing of non-core activities, providing freedom to banks to increase variable compensation, providing ESOPs, offering leeway on individual wage negotiations, encouraging direct and lateral recruitments, creating a common fungible leadership pool at GM levels, and listing several other recommendations on performance management and capability building for public sector banks. However, progress is muted and a lot is left to be desired on the implementation.

## ADDRESSING GOVERNANCE ISSUES AND EMPOWERING BOARDS

17. A few welcome reforms have happened in boards of public sector banks. For instance, roles of Chairman and MD have been segregated in many banks. Recruitment process for selection of MDs and EDs has been made more independent and rigorous. Fresh experienced professionals from private sector have been inducted to boards to lend expertise and diversity of the boards. As a result of these changes, the quality of board deliberations and strategic focus have gone up, in general, across boards.

18. However, the boards of public sector banks feel significantly handicapped. Three particular aspects impact PSB boards. First, there is a general feeling among bank board members that there is direct intervention by the government in the management of banks and many KRAs / KPIs of banks are set by the government without prior consultation with the boards. Second, the government as majority shareholder supersedes the board in appointment and rotation of the MDs and EDs; decisions relating to selection and rotation of EDs and MDs is done without any prior consultation with the board. Third, boards do not have much power to enforce CEO and management performance accountability, as the executive management team is perceived to be more accountable to the government than the boards. These factors impair board governance and impact performance of banks.

19. Therefore, the following recommendations need to be implemented to improve both accountability and governance, which will in turn improve performance:

- Boards to have freedom to set bank KRAs; any government mandated KRAs to be set in consultation with bank boards.
- Appointments and/or rotation of MDs and EDs of the banks to be taken in consultation with the respective boards.
- Boards to have the power to drive management accountability, and have the flexibility to link pay-for-performance for bank's management team.

## BUILDING LEADERSHIP CAPABILITY AND ATTRACTING TALENT

20. Public sector banks are facing a significant leadership void. These banks, without exception, face significant challenges on manpower planning, succession planning and capability building. Manpower planning needs urgent attention in public sector banks as 70–95 percent of its senior management is due to retire by 2020. This is much less of an issue for private banks where the comparable statistic is 10–40 percent retirements in the next three years. Compounding the retirement challenge in public sector banks is the fact that approximately 40 percent of bank employees felt that the mechanism to groom future leaders is not well-defined and needs attention. A rigorous succession planning mechanism therefore becomes very important in the current context.

21. It is argued by many that lateral recruitments can fill leadership void in the public sector banks, a view that I don't entirely subscribe to. Proponents of this suggestion point out that there is very limited lateral recruitments in public sector banks, less than 10 percent at large public sector banks and even lower in smaller public sector banks, in contrast to nearly 70 percent in private banks. PSBs are also not doing too well in communicating a stronger value proposition to attract talent.

22. Given the severity of the situation, there is an urgent need to both attract outside talent, and develop and differentiate in-house talent, and fast track the high performers to fill the leadership gap. Accordingly, following key recommendations have been made to DFS by the Chairmen forum:

- PSBs should have freedom to set compensation across all scales.

- PSBs should also have the freedom to offer higher variable compensation to high performers, including offering of ESOPs.
- Lateral hiring should be encouraged at all levels. Banks should have freedom to do direct campus-hiring to meet specific skill requirements and also to attract high potential talent from institutes of high repute.
- Banks should not be bound by rigid job rotation/transfer guidelines; freedom required to develop specialist cadre of Rural and Semi-Urban focused officers, as also to develop specialist cadre in Treasury, Digital and Credit etc.
- Banks should have the freedom to identify high performing / high potential star talent and invest significantly and differentially in training/capability building for this cohort to take on leadership roles on accelerated basis.

## REORGANISATION, RESTRUCTURING AND REENGINEERING.

23. After the implementation of a Core Banking Solution (CBS), the next most critical challenge for the PSBs is to usher in 'Business Process Re-engineering' and 'Change Management' in a comprehensive manner in order for them to be able to reap optimum benefits out of CBS. We need to address the following critical issues. We have data but do we have information? We all have CBS but have we improved MIS? How can we transform data into information? I also have a strong view that technology adoption has another big casuality. People have stopped thinking. Most of us do not try to understand the whys of whatever we are doing. We need to develop this inquisitiveness to also ensure that we do not waste time doing useless things. As Peter Drucker said, 'there is nothing so useless as doing efficiently that which should not be done at all'. Further, this can lead to out of the box or innovative thinking. Such people end up as winners in this world. But it needs to be admitted that PSBs are drowned in processes so much that agility in technology adoption is totally absent in PSBs. We need to change this if we are to become competitive. Agility in technology adoption is critical for another reason. One area which remains largely untapped for many public sector banks is harnessing alternate business channels. This offers huge opportunity but also warrants a robust IT infrastructure.

24. Agility across the organisation will have far reaching implications in the transformation journey. Agility can be defined as the ability of an organisation to renew itself, adapt, change quickly to

succeed in a rapidly changing and turbulent environment. According Mckenzie, this calls for changes in three core areas, organisational structure (how resources are distributed), Governance (how decisions are made) and Processes (how things get done and performance get monitored). They suggest the following shifts in Indian banks:

(i)flexible resource allocation rather than fixed roles

(ii) Defining end to end accountabilities rather than functional boundaries

(iii) Rapid iteration and experimentation rather than standard product development cycle

(iv) Real time knowledge and information sharing

(v) Hands on governance

(vi) Standardised ways of working or putting in place SOPs across the organisation

(vii) Cohesive community rather than soloed departments

25. At the same time let me say, particularly in public sector bank context that move for agility involving large scale use of technology without the required process changes and re-skilling of employees has the potential danger of increasing the cost of operations rather than reducing it. For transformation to take place in the true sense, banks would, therefore, have to undertake a holistic review of their business processes and work flows, which have been in vogue for nearly a century. This will inevitably involve some labour practice issues. We have to face them and solve them.

## CHALLENGES FROM 'NON-BANKERS' AND NEW COMPETITORS

26. Today as a part of strategy every bank wants to go retail. I have often wondered whether we are creating another bubble in that sector? Further the whole business model and monitoring needs a total revamp if we are to remain efficient. Do we have the DNA? Second maximum disruption from non-banks is coming in the retail sector. For long, banks were comfortable that competition to them was only from similar entities and that the Reserve Bank of India was ensuring that only the least number entered to compete with them. But as it happens in any business, technological innovation and the regulator's delay in waking up to developments have allowed a new set of companies to play the role of financial intermediary with a different name.

27. As a new breed of digital consumer has emerged, so has a new breed of competitor. These competitors are differentiated by the ability to turn big data into meaningful customer insights. In addition, as the banking industry value chain continues to fragment, more competitors are ready to take on traditional banks especially on the payment services, offering discrete financial services without becoming full-fledged banks.

28.. An often ignored competitive threat is disintermediation, which could take the form of Peer-to-Peer (P2P) services, the use of capital markets, third party product offerings (like prepaid cards) or a complete vacating of banking services overall. With the new non-bank entrants, we need to quickly decide our strategy. Do we compete or cooperate?

## TREASURY AS A PROFIT CENTRE

29. At a time when credit growth is under stress, treasury operations need to support the bank more. How many of us consider Treasury as a true profit centre? How many of us do have a truly qualitative Transfer Pricing mechanism? How many of us adopt activity based approach to balance sheet management? I tried to implement NBG wise balance sheet approach without success? There are two issues here. One, the traditional conservatism and second lack of skill sets. The first issue can be resolved if the Board is willing to adequately empower the treasury and accept that all deals cannot be profitable. But this was a simple first step. But many of us lack skilled staff to run all products. For instance, I don't have skill sets to run an options book or provide end to end solutions to our corporates who often approach private sector banks to manage their risk. Most of us depend on regulator to keep interest rate move unidirectionally to make money in fixed income markets. Compare that with private bank treasury. The recent changes implemented by the Reserve Bank in hedging rules for corporates, in my view, opens more opportunities for the treasury. To my mind this move, presuming it is the first step towards easing hedging requirements would certainly have implications for the future of NDF markets and bring the market on shore.

## RECAPITALISATION AND CONSOLIDATION

30. 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.

31. 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.

32. 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.

33. The related issue, at least the way Government is looking at, is the issue of consolidation. It involves strategy and should therefore involve the Boards of Banks.

34. Let me now conclude. What I have tried to do is to collate the issues in one place for ease of reference. I do not claim that any of these are my original thoughts. All I have tried to do is to put together views of various experts whose views matter and lace it with some of my own views. The important message I have tried to convey is that notwithstanding the fact that we live in difficult times, it is still possible to contribute to income and profits if we get our act together.

35. Thank you for a patient hearing.

*Keynote address by G Padmanabhan, Chairman, Bank of India, at Executive Development Programme organised by CAFRAL at Taj Lands End, Mumbai on December 11, 2017. The speaker thanks Ms Usha Thorat, Mr Salim Gangadharan and Mr S Venkitachalam for their comments on the draft.

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