VERMA COMMITTEE REPORT ON WEAK BANKS

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"Free Enterprise was born with man and shall survive as long as man survives".

— **A. D. Shroff**
1899-1965
Founder-President
Forum of Free Enterprise

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INDIAN BANKING is on the threshold of a major revolution — as epoch making as the one of Bank Nationalisation in July 1969. Three factors are forcing the pace of this process. First, two reports of the Narasimham Committees, 1991 and 1998, have already helped to initiate the tasks of restructuring — milestones are clear; what is needed is a definite time-table for implementation. Second, banking and finance, the world over, have almost become transnational. Changes which were unthinkable, say 10 years ago, are taking place in various countries, developed and developing. Our financial institutions are getting increasingly exposed to powerful pressures of globalisation. Third, and the most important is the Verma Working Group Report which has forcefully brought to the fore the problems of Indian banking. Apart from the three weak banks — Indian Bank, UCO Bank and United Bank of India — the health of many other banks is also not satisfactory. Indian banking system is, to a considerable extent, fragile and any major adverse development, national or international, can create the same type of problems as experienced by South-East Asian

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countries two years ago. The Verma Group has rang the alarm bell loud and clear and has also warned that the time is running out and a series of measures are urgently needed for survival as well as growth of Indian banks, particularly those in the public sector which constitute nearly 85 per cent of Indian banking.

To start with, let us understand the yardsticks used for assessing weak banks. According to the Narasimham Committee Report, a weak bank would be one —

(a) where accumulated losses and the net NPAs exceeded the net worth of the bank, or

(b) whose operating profits less the income on recapitalisation bonds — capital infusion made by the Government — has been negative for three consecutive years.

The stress is mainly on solvency and profit-earning capacity. The Verma Group has added further seven specific tests for a greater degree of certainty. They fall in three specific areas, namely, (a) solvency, (b) earning capacity and (c) profitability.

Solvency

(i) capital adequacy ratio

(ii) coverage ratio

Earning Capacity

(iii) Return on assets

(iv) Net interest margin

Profitability

(v) Ratio of operating profit to average working funds

(vi) Ratio of cost to income

(vii) Ratio of staff cost to net interest income (NII) + all other income

A word about the coverage ratio. It is defined as:

$$\frac{\text{Equity Capital + Loan Loss provisions — NPAS}}{\text{Total Assets}}$$

Judged by this set of parameters, 27 public sector banks present a somewhat uneasy picture as at the end of March 1999.

Obviously, three weak banks in the order of priority are : Indian Bank, UCO Bank, and United Bank of India

Six banks are potentially weak (non-compliance of 5-6 ratios out of 7). They are :

Allahabad Bank, Indian Overseas Bank, Union Bank of India, Central Bank of India, Punjab and Sindh Bank and Vijaya Bank.

Nine banks fall in category of fairly good (non compliance of 3-4 ratios). They are :

Andhra Bank, State Bank of Bikaner and Jaipur, Bank of India, State Bank of India, Bank of Maharashtra, State Bank of Mysore, Dena Bank, State Bank of Travancore and Syndicate Bank.

Seven banks can be considered good (non-compliance of only 1-2 ratios). They are :

Bank of Baroda, State Bank of Hyderabad, Canara Bank, State Bank of Indore, Punjab National Bank, State Bank of Saurashtra and Corporation Bank.

The above methodology of measuring weakness should not be used for only one year but at least for three years to get a clear and steady picture. The group has made use of two years. Even if one uses different tests, like the CAMEL rating, the overall picture remains more or less the

same. In the CAMEL rating system, there are five tests - Capital adequacy, Asset quality, Management, Earning capacity and Liquidity.

After presenting a broad scenario of the health of the public sector banks, the Report proceeds to outline in detail a restructuring strategy for the three weak banks. It has examined but found unsuitable other methods used abroad, namely, merger or closure, change in ownership - domestic or foreign and narrow banking. Although the restructuring strategy is primarily aimed at the weak banks, other banks must examine their individual position and work out strategies of their own so that the entire banking system emerges within a definite period much stronger as also more efficient and competitive.

After examining in depth the causes of weakness of Indian banks, and drawing heavily on the experiences of banks in other countries, developed and developing, a restructuring strategy is worked out. What are its essential ingredients and how to operationalise it such that it bears desired fruits? First and foremost, the restructuring strategy has to be comprehensive, covering operational, organisational, financial and systemic aspects. It is going to be an extensive, expensive and one time exercise, leaving no room whatsoever for half-hearted and halting measures or gradualism.

The core principles include manageable costs, the least possible burden on the public exchequer, losses to be shared by all concerned, strong internal governance, effective monitoring and timely course correction and ease of implementation. It is necessary to remember that while

deciding the precise modalities of restructuring, alternative options and sequencing should be worked out in the context of the prevailing socio-economic environment.

Operational restructuring involves (a) basic changes in the mode of operations, resulting in diversification of sources of income and their steady growth, (b) adoption of modern technology, (c) solving the problem of high NPAs and (d) drastic reduction in the cost of operations.

Organisational restructuring is aimed at improved governance of the banks and enhancement in management involvement and efficiency. Financial restructuring implies injecting capital by the Government with necessary conditionalities. And finally, systemic restructuring provides for, *inter alia,* legal changes and institution building for supporting the restructuring process.

A well conceived Business Plan should take care of growth and diversification of business, steadily increasing the flow of income and reduction in costs. They should catch up fast with IT to provide prompt, efficient and cost effective services to customers. As the three banks under close scrutiny could neither have resources nor skills required for setting up the IT, it is suggested that they should have common networking and processing facilities. Such common facilities could be outsourced from an existing reputed company. The service provider could also be invited to follow a 'Build, Own, Operate Transfer (BOOT) model. The total cost for this is estimated at Rs. 300 crores which may come by way of assistance from Government or from multilateral lending institution.

The most critical part of the restructuring plan relates to the reduction of NPAs. Neither BIFR nor Debt Recovery

Tribunals (DRTs) have helped much. The Narasimham Committee recommended way back in 1991 the setting up of an Asset Reconstruction Fund (ARF) and again reiterated the same recommendation in 1998. But so far no action has followed. The Verma Group has once again recommended the same proposal with some modifications. It has recommended the three structure - the Financial Restructuring Authority (FRA) at the top, followed by the Asset Reconstruction Fund (ARF) and the Asset Management Company (AMC).

In our situation, it thought desirable to develop a structure which will combine the advantages of Government ownership and private enterprise and initiative. The broad structure thus recommended is a government owned ARF managed by an independent private sector AMC. The principal objective of the ARF will be to buy impaired loans from the weak banks and to recover or sell them after some reconstruction or in an 'as is where is' condition. The management of the ARF would be entrusted to an independent AMC, a private sector entity, which will employ and avail of the services of top class professionals. The AMC could be compensated for the services it provides in the form of service commission on the value of assets managed coupled with incentives for recoveries if they are higher than an agreed bench mark. AMC may require the initial capital of Rs. 15 crores — 49 per cent to be held by the government and the remaining 51 per cent by the private sector, including institutions like SBI, LIC, GIC, UTI, IDBI, etc. The responsibility of recovering loans which become NPAs after the notified date will remain totally with the banks concerned. Therefore the life of ARF is visualised not more than seven years.

The payment in respect of assets purchased from weak banks may be made by the ARF by issuing special bonds for the purpose bearing a suitable rate of interest. It may also be guaranteed by the Government to improve its liquidity. The bonds may be issued to weak banks with an initial lock-in period of at least two years. These bonds as also those which will be issued for raising funds against the security of assets purchased by the ARF may have maturity of five years. ARF may be required to acquire assets of the face value of about Rs. 3000 crores. The capital needed by the ARF would be in the region of Rs. 1000 crores.

The ARF may be set up by the 'FRA' set up under a Special Act of Parliament. The FRA would have wide ranging powers. It would oversee the health of weak banks on a continuing basis. It will design and monitor restructuring strategies and ensure implementation. It would protect the ARF against obstructive enforcement of its rights against them. It is recommended that Reserve Bank of India (RBI) sets up a Special Wing for regulating and supervising weak banks. This will help the FRA to co-ordinate with RBI many aspects of the restructuring programme and its effective implementations.

Cost reduction is another critical aspect of restructuring. The cost of operations of the weak banks is clearly unsustainable and is threatening the long term viability and survival of these banks. It must be remembered that non-staff costs are less critical than staff costs. This is true in varying degrees for other banks also. The Group has estimated that nearly one third of the staff in these banks is redundant. Therefore, it has advocated a reduction of

staff strength of the order of 25 per cent to start with. This step is considered absolutely unaviodable. These banks can follow the Voluntary Retirement Scheme (VRS) as is being practised by industry and other establishments. The total cost of the VRS is estimated between Rs. 1100 and Rs. 1200 crores. If the VRS does not lead to the needed reduction in the banks operating costs, there will be no alternative left but to resort to an across the board wage cut of the order which will result in a similar reduction in costs. It is with this urgency in mind that the Group has suggested keeping the VRS open for a limited period of six months.

The three banks have not factored the wage revision that is to become effective from November 1997. No provision in respect of the increase (12-25 per cent) has been made. It is suggested to place a cap on the staff expenses of the three banks and also a freeze on the future wage increase, including the one presently under consideration. All these measures relating to staff have evoked a sharp reaction and protest from the Unions. This question will be considered in the concluding part.

As regards the financial restructuring, the Government has infused capital in the three banks upto Rs. 6,740 crores; for the public sector banks as a whole over Rs. 20,000 crores. A minimum of Rs. 3,000 crores further capital will be required to bring their capital adequacy ratio upto 9 per cent - one per cent above the prescribed one. A portion of the additional capital requirement would need to be provided in cash in the form of either preference capital or long term subordinated debt. On this, the banks should have an obligation of giving a return.

Thus, the overall cost of restructuring the three banks over the next three years is estimated to be of the order of Rs. 5,500 crores. The purpose-wise break-up of the required amount is as follows :

Technology upgradation	Rs. 300-400 crores
VRS	Rs. 1100-1200 crores
NPA buyout	Rs. 1000 crores
Capital adequacy	Rs. 3000 crores

The biggest hurdle in tackling the problem of NPAs is the old and archaic framework of the legal system with a bias in favour of borrowers. All attempts made to improve the system have not succeeded. Special bodies like BIFR and DRTs have not helped much. The laws regarding foreclosures and bankruptcies need urgent revision. Equally important is the need to reform court procedures. Some of the Asian countries following the recent financial crisis have made necessary changes in their legal system without any delay and they provide models for us, including the system in China. The entire legal framework for effecting recovery of bank dues is being examined by an Expert Group constituted by the Government of India under the Chairmanship of Mr. T. R. Andhyarujina, Former Solicitor General of India. The Expert Group will also address the lacunae observed in the functioning of the DRTs. It is hoped that the Expert Group realising the urgency would make its report available without much delay and the action on its recommendations would follow promptly.

So far, I have faithfully given the broad summary of the Report. Before I make some specific comments, let me say that this is one of the best reports I have seen on

banking problems — clear and precise, an appropriate blue-print for action. The Group deserves high appreciation for both, to bring the banking problems to the fore and giving the studied solutions. It is also a matter of satisfaction that both the Prime Minister and the Finance Minister have accepted the need to give a high priority to the financial sector reforms. Now that the Report is in the hands of the Finance Ministry and RBI, they should come out with a specific scheme of implementation - timing, sequencing the steps required to be taken and creation of necessary institutional support. The authorities should urge the banks also to draw up their own restructuring strategies so that they can become more efficient and competitive.

The scheme of implementation requires first and foremost the political will which can help build up a fairly good consensus on the broad strategy of restructuring. It has to be driven home that inaction or delay may result in a much heavy sacrifice later. It should along with Indian Banks Association (IBA) impress upon the trade unions to take a constructive view of the report and come out with positive suggestions. Once the Government takes a decision on the implementation strategy, the Finance Minister can convene a meeting of RBI, bankers and trade unions to understand different points of view and create congenial climate. His second round could be with political parties. This will help make the smooth passage of the Bill on the FRA. Equally urgent is the Andhyarujina Expert Group Report. The Group, if possible, should start giving the report in parts as it is the legal system which is at the root of NPA problem.

The problem of overstaffing and over-unionisation in Indian Banking is too well-known to be recounted here. That is

one of the major factors behind the near absence of technology in banking. The Government also treated banks as easy avenues for offering employment opportunities to the educated unemployed. The changed times should be recognised. It is time to recognise one unit one union rather than one industry one union. The IBA has to take the lead and open purposeful dialogues with the unions. If other Asian countries could find solutions, there is no reason why we cannot hammer out an agreed formula on the basis of some give and take.

Again at the root of the present malaise is the 'inadequte' leadership in Indian Banking. The growth of banking and development of leadership have been inverse proportion. Partly the Government is responsible and partly the bankers. Top level transfers from one bank to another, short tenures and the failure to build up the line of succession have all stunted the growth of bank leaders. It should be remembered that a banker is not only a leader in his own bank or for the banking industry but also for the business as a whole. If India can provide top bankers outside to major international banks, there is no reason why they cannot grow in our own institutions? Many of the problems Indian banking is facing today will be overcome at the bank or industry level, if the right type of leadership is allowed to develop. As in the U.K. or the USA bringing a few top ranking industry leaders to banking is worthwhile consideration.

If the restructuring strategy is properly devised and implemented, it will then set a stage for further and far reaching reforms. As all over the world, it will encourage the process of mergers and privatisation. The Government

can then hope to recover or more than recover the capital it has infused in Indian banks. If the Verma Group Report is implemented fully in next three years, the shape of Indian banking will start changing. The present names and the numbers may not remain and the map of Indian banking may be totally redrawn. SBI has already taken the lead and proposed to merge all subsidiaries into one entity and raise American Depository Receipts (ADRs) worth $1.2 billion to strengthen its capital. Among the financial institutions, ICICi has already taken such a lead. Let us hope this process of strengthening the Indian financial sector gets accelerated momentum so that this vital sector of our economy becomes an integral part of world banking and finance. Let us further hope that this sector would throw up leaders equal to thōse anywhere in the world. We have the ability, what we require is strong will.

The views expressed in this booklet are not necessarily those of the Forum of Free Enterprise.

"People must come to accept private enterprise not as a necessary evil, but as an affirmative good".

— Eugene Black

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