Regulate, Don't Privatise

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(I)

There seems to be a never ending procession of skeletons tumbling out of the rotten cupboards of the PNB-Nirav Modi scam. The size of the cupboard seems to be increasing with every passing day, drawing into its ever widening spiral of fraud more and more Public Sector Banks (PSBs). The script also looks much familiar- use high connections to get huge loans from PSBs without any collateral, use the money for profiteering by cheating through innovative Ponzi mechanism or laundering, park the profit outside the country and keep the travel papers ready to flee to the safety of a foreign land just when the scam is about to break with cyclonic fury. Then a familiar old pattern follows - stock markets go into tumble, raids are made on empty cages from where the bird has flown away with the feed, left-out assets are attached, probes are launched, fiery speeches are made inside and outside Parliament and accusations flow thick and fast, while the bank that takes the hit meekly provides for the loss at the cost of public exchequer. Then everything is back to business as usual; probes lose their steam, names of the high and mighty involved in the scam are never revealed, recovery from the seized assets gets entangled in legal complications and new fraud entrepreneurs enter the field using the same old rules of the game, while the short arm of Indian law never reaches the fraudsters who continue to wallow in luxury in the foreign shores enjoying the fruits of their ill-gotten wealth. Just to reckon the cost to the public exchequer, between 2008 and 2017, the government has infused capital of Rs 1.19 lakh crore into the PSBs, with another Rs 2.11 lakh crore being on the pipeline to recapitalise them to tide over their NPA crisis.

The scam whose magnitude has now swelled to Rs 14000 crore and is still counting, has exposed several serious chinks in the armour of our banking and financial system, 70 percent of which is controlled by the PSBs in which we trust our life's savings. It has exposed not only the absolute lack of internal control in them, but brought into question the accountability of the banking regulator RBI which is now scurrying for cover and inventing excuses. Hundreds of fictitious LoUs issued without any security and orchestrated through the global SWIFT system bypassing the Banks Core Banking System to remain undetected for seven years only through the machinations of some middle level managers is like a phantom story, except that it isn't true. We shall never find out the real life characters hiding comfortably in the shadow of Gokuldas Shettys, now that Nirav Modi is gone forever, like Vijay Mallya. But why blame the RBI alone, the bank's own Board of Directors, the Ministry of Finance, the Ministry of Financial Services, the Bank Board Bureau, the Internal and External Auditors of the Bank, and the Central Vigilance Commission (CVC) - all these agencies were supposed to exercise effective oversight, but none smelled a whiff of what was going on underneath their noses for seven long years. Now each is blaming the others. The Finance ministry remains blissfully clueless about the affair, and in what looks like a joke, the PNB, was also given

an award for excellence in vigilance by the CVC in 2017. As the Nobel Laureate Joseph E. Stiglitz had said, "We have banks that are not only too big to fail, but too big to be held accountable."

It is pointless to dwell on how Nirav Modi Mehul Choski duo had used the LoUs in a superb Ponzi scheme to defraud their naive and trusting bankers and fooled them. Public anger is giving way to demands for privatisation of PSBs. The demands are indeed justified as the Government has no business to be in business that it cannot manage. But privatisation may not be the answer, because the issue is regulation rather than ownership. Besides, there is absolutely no political appetite for privatisation of PSBs. An overwhelming majority of Indians would trust their money into the PSBs rather than private banks on the mistaken belief that their money is safer with the former, and no government, irrespective of the political dispensation, would dare push for privatisation and alienate the voters. Privatisation of PSBs is a no brainer. All that the Government can hope to achieve is offloading of their stakes in PSBs, and more mergers to achieve better economics of scale.

Nationalisation of banks indeed had altered the banking scenario in the country, even though the situation may not be the same today. Just before nationalisation in June 1969, there were only 1,833 rural and 3,342 semi-urban bank branches; by March 1991, the numbers had grown to 35,206 and 11,344 respectively and the total number of branches increased from 8,262 to 60,220. The non-urban areas were practically unbanked before nationalisation, and massive expansion in bank branches took banking to rural areas. It would never have been possible without nationalisation of banks, which also channelled 40% of the lendable funds to what the government had defined as the priority sector, comprising agriculture, SSI, MSME, housing and educational loans etc. The ratio of priority sector credit to total credit rose from 14% to 37.7% between 1969 and 1991, which is significant because a vast majority of Indian people still derive their livelihood from these 'priority sectors', which were practically excluded from bank credit by private banks before nationalisation. It certainly loosened the vice like grip of private moneylenders in the rural areas, if not eliminating them altogether. PSBs helped the poorest of the poor through their Differential Rate of Interest loans, extended loans to thousands of women's self-help groups and funded rural infrastructure through the Rural Infrastructure Development Fund. Without the PSBs, financial inclusion and opening of 31 crore Jan Dhan Accounts would have remained a fantasy.

Banks cannot be the agents of change, they can only play a supportive role. Nationalisation could have become a game changer if it was backed up by appropriate policies and programmes; unfortunately the government strategy remained short sighted. The social welfare-model was given prominence over capital and employment creation which alone could have addressed the problems in the long term. Rural scenario thus remained unchanged. Once politicians got unfettered control over the PSBs, cronyism, corruption and interference became the order of the day, when we actually needed a renewed focus on management, strengthening of regulatory institutions and ensuring public scrutiny. After liberalisation, the PSBs were made to compete with private sector including foreign banks and chase quick profits which could only come from corporate loans. But the management still remained captive to the politician-bureaucrat nexus, which forced it to give loans to industries and people regardless of their viability. The result was the NPA crisis and ballooning of defaulting loans. The strategy went completely berserk.

It is not that scams are absent in the private sector, but given that 70% of the banking scenario in the country is dominated by the PSBs, naturally the law of probability would work against the PSBs. PSBs in

India lost at least 227.43 billion (Rs 22,743 crore) owing to fraudulent banking activities between 2012 and 2016, according to an IIM-Bangalore study. Government informed Parliament recently that 25,600 cases of banking fraud worth Rs 1.79 billion were reported till December 21 2017. According to data released by the apex bank for the first nine months of FY17, approximately 455 cases of fraud transactions - each of Rs 1,00,000 or above - were detected at ICICI Bank; 429 at State Bank of India, 244 at Standard Chartered Bank and 237 at HDFC Bank. Most of these frauds were perpetrated through the collusion of bank employees themselves, indicating loose internal controls.

Banking scams have also been surfacing with astonishing frequency since a long time involving almost all PSBS. Side by side bad loans have been increasing alarmingly - between 2013 and 2017, their amount has quadrupled from Rs 28,417 crore to over Rs 1.1 lakh crore. While some of this would be due to interest being added, the quantum of the increase is too large to be accounted by interest alone. "Wilful default" - defaults despite the borrowers' paying capacity – has also been rising. The cumulative total of more than 50 companies or groups each with over Rs 250 crore of "wilful default" works out to about Rs 48,000 crore, 80% of which are due to PSBs alone. RBI data shows that between April 2013 and December, 2016 all commercial banks, including private ones, lost Rs 66,066 crore to 17,504 frauds, in which there were, 2,084 cases (12%) involving insiders. Still, as history has shown, a scam has nothing to do with ownership. Lehman Brothers, Royal Bank of Scotland or Merrill Lynch were not controlled by their governments, yet collapsed due to scams. The elephant in the room is a strict and effective regulatory mechanism we have never cared to establish.

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It is not my case that PSBs should not be privatised, but that the regulatory system that covers private banks as well as PSBs in India should be made reliable, effective and unfailing, with multiple checks inserted to cover all identified risks. I believe that the existing laws and rules are more or less adequate and may only need a little reengineering to strengthen oversight. Audit of banks is one essential instrument of this oversight.

Banks typically are subjected to four kinds of audits: statutory audit, which is basically an audit of the bank's financial statements by auditors appointed by the RBI; internal audit conducted by the bank itself, a concurrent audit of transactions by internal or external auditors; and inspection done by the RBI. Under the concurrent audit system, each bank branch is audited by not one but two teams of auditors, it is a part of the banks early warning system to detect frauds and irregularities. None of these mechanisms, not even concurrent audits nor internal audit, could detect the scam that was going on for 7 long years. What is their accountability?

RBI itself is audited under section 50 of the RBI Act 1934, by auditors appointed by the Central Government. Though section 51 of the Act enables the Government to appoint the CAG of India as auditor of the RBI, the provision has never even been invoked. The Government clearly wants the CAG to be away from the audit of the RBI for reasons best known to itself. Even the PSBs, though they qualify as government companies having majority stake-holding by the Government, are out of the ambit of CAG's audit, a fact which is not mostly unknown, even to knowledgeable commentators.

CAG has the authority to audit government companies under section 19 of the CAG'S (Duties, Powers and Conditions of Service) Act, which mandates the CAG to conduct audit of Government Companies in accordance with the provisions of the Companies Act. Section 143 of the Companies Act 2013 empowers the CAG to appoint the statutory auditor and direct him in auditing the accounts of the Government Company. CAG also has the authority to conduct a supplementary audit over and above the statutory audit conducted by the statutory auditor appointed by him, and report the results thereof to the Parliament or state legislature, as the case may be. It may be mentioned that CAG has the power to penalize the statutory auditor if he fails in his duties as auditors, a power which he exercises judiciously and regularly. The appointment of auditors is made following a robust and transparent process and there has rarely been any complaint against the objectivity of the process. It is partly to the credit of the robustness of the CAG's oversight that even in an age when scams erupt with astonishing regularity in almost every entity under the control of the government, no major scam of the public sector companies has as yet shocked us into numbness like the way the PNB scam has.

PSBs are governed by the Banking Regulation Act, 1949 and Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970. The Banking Regulation Act, 1949 gives wide powers to the RBI to control advances by banking companies and to issue directions thereon (section 21), appoint auditors or order special audit of banks if necessary (section 30), inspect banks (section 35), remove managerial and other staff, appoint additional Directors, supersede the Board of Directors and override other laws in this regard, including imposition of punishments for certain activities (section 36). If despite this statutory provisions, RBI complains of inadequate powers, it means that it has been taking its powers and responsibilities rather casually. It should probably draw some lessons from Mr. T N Seshan and Mr Vinod Rai who made their institutions immensely power even within the existing framework of laws.

PSBs are audited by auditors appointed by the RBI under Section 10 of The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 which provides that auditors will be appointed by the Central Government with the approval of the RBI and will submit their report to the central Government which will be placed in Parliament. RBI sometimes picks the auditors from the panels prepared by the CAG, but unlike the Government Companies, CAG exercises no power of direction or supplementary audit of their reports, neither does he review their performance or penalizes those violating the auditing standards. RBI has now delegated the powers to appoint auditors to the Board of Directors of individual banks, and the process of their appointment is shrouded in opaqueness, in which the possibility of conflict of interest in the appointment process cannot be ruled out.

Further many PSBs have huge number of branches. As branch is the pivot in respect of sanction of loans and their disbursement, security or collateral, documentation and recovery. Since most of these transactions are handled at the branch level, their audit naturally assumes extreme importance. There are multiple statutory auditors of a bank, how the work distributed among them remains a grey area which leads to lot of dilution and diffusion of responsibility and hence laxity in audit. The principal statutory auditors often fails to take into cognizance the poor internal controls existing within a branch.

Statutory auditors are chartered accountants, and are bound by the rules and ethical standards of the Institute of Chartered Accountants of India (ICAI) which is a self-regulatory body established the Parliament, and that, probably is its biggest flaw. ICAI includes government representatives as part of its

oversight who often lack the acumen that is required in understanding accounting and auditing to be able to exercise effective oversight; it also creates unmitigated conflicts of interest.

One argument proffered against the CAG audit of PSBs is that CAG may not have the necessary expertise for audit of PSBs or RBI. But the expertise is not required under the existing regime, as these audits are kept outside the CAG's purview. Once CAG is given the responsibility for auditing these, it is only a matter of time before the necessary expertise is acquired and inculcated.

CAG conducts three kinds of audit, compliance audit where he checks compliance to rules, regulations and procedures; financial audit which is basically an audit of financial statements and disclosure requirements, and performance audit, which is focused on performance, where he may question the rationale for giving a loan. If the government wants to protect the autonomy of the banks, CAG may be debarred from conducting performance audit of the banks. But he will still be able to see that the disclosure requirements are fully met, that rules are complied with and that risks have been adequately covered. PSBs will then unquestionably benefit from CAG's expertise in appointment, regulation and supplementary audit. But there has to be other mechanisms as well.

In the aftermath of the Enron scandal, governments realised the need for creating a non-government entity to regulate the audit profession. Before this, the audit profession was self-regulated even in the US. This led to the creation of the Public Company Accounting Oversight Board (PCAOB), a private-sector, non-profit corporation created by the Sarbanes–Oxley Act of 2002 to oversee the audits of public companies and other issuers in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. The conflict of interest in self-regulatory bodies was recognised, inhibiting their ability to protect of interests of investors. All PCAOB rules and standards require approval by the US Securities and Exchange Commission (SEC). Through the PCAOB, for the first time, US public companies were subjected to external and independent oversight instead of self-regulation. PCAOB discharges four primary functions in exercising the oversight of auditors: registration, inspection, standard setting and enforcement, and is a member of the International Forum of Independent Audit Regulators (IFIAR). These actions helped to strengthen the quality of auditing in the US.

We also need to shakeup the audit profession, as suggested by Krishnamurthy Subramanian, first, by creating a National Financial Reporting Authority (NFRA) and then activating a mechanism for IFIAR. We have a Quality Review Board (QRB), set up under Section 28A of the Chartered Accountants Act, 1949 which is mandated to conduct independent audit quality reviews. QRB is not yet a member of IFIAR for which it needs to demonstrate its independence. The IFIAR membership consists of 52 independent audit regulators from around the world, besides observers like Basel Committee on Banking Supervision, European Commission, Financial Stability Board, International Association of Insurance Supervisors, International Organization of Securities Commissions, Public Interest Oversight Board, and the World Bank.

Once we align ourselves with such and other international organisations, and allow the CAG access to RBI and PSB accounts, much of the malaise afflicting the banking sector can be effectively addressed. Privatisation of banks is a knee-jerk reaction and if we privatise without strengthening their regulation, the PSBs will continue to be mired into such scandals.