Economists' Statement on Bank Scams

The scale of the recent bank scams and the potential losses faced by banks holding non-performing loans given to some large companies and individuals, has shocked all of us. However, we are concerned to note that this has become an excuse to demand the privatisation of publicly held banks. While it is true that the current scam involves Punjab National Bank, the second largest public sector bank, the basic cause is very clearly the inadequate and faulty regulation and monitoring of the banking sector. This affects all banks, regardless of ownership. But in a curious turn, fraud that was led by and benefited private players pursuing super-profits at any cost is being made the reason for handing control of the nation's savings to the private sector.

Poorly regulated private banks are even more prone to scams and failure, as the financial sector is rife with information asymmetries and market imperfections. Private profit orientation generates incentives for managements to exploit loopholes in rules and engage in risky behaviour, as shown by US and European bank behaviour leading to the Great Financial Crisis of 2008-09. The bailouts they then require tend to be even more expensive for the public exchequer, because bank runs have to be prevented.

It is worth noting that even a scam as large as the present one has not led to a widespread run on PNB and other banks. This is because of the state guarantee that still generates trust in the public banking system.

In India, before the nationalisation of banks in 1969, there was an average of 35 private bank failures every year. This came down drastically after most of the sector came under public control. After the liberalising reforms of the 1990s, the collapse of the private Global Trust Bank, Times Bank and Centurion Bank (among others) resulted in mergers, with the losses being borne by public sector banks. At present, several private banks also face large NPAs, often with the same companies that are defaulting on public banks. Some private banks have also been found guilty of providing unsecured loans and ever-greening of loans – both practices that PNB is now accused of. In fact, because of the opacity of banking practices, public banks are actually easier to regulate than private banks. As a first step to address the problem of NPAs, the Finance Minister should immediately require all banks to publish their lists of wilful defaulters.

Public sector banks in India have played a critical role in financial inclusion, a project that is still far from complete. After nationalisation, there was an increase in rural bank branches and accounts, and an increase in credit to sectors that were ignored earlier, such as agriculture and small-scale enterprises. Even now, private banks continue to avoid these activities and focus only on higher value borrowers and lenders, thereby excluding the poor.

At this juncture, it is critical to focus on effective regulation and supervision of all banks, and to make the regulatory process stricter as well as more transparent and accountable. Using this crisis to privatise public banks will only make matters much worse.

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