Finance Commission and bank recapitalisation

The Financial Stability Report (FSR) released by RBI recently has once again underlined the vulnerability of the Indian public sector banks (PSBs). They have been under a severe balance sheet crisis even before the pandemic, and the crisis created by the pandemic, and the moratorium offered, will explode when the chickens come to roost. According to the FSR, under a baseline scenario, the gross non-performing assets would go up from 11.3% in March 2020 to 15.2% in March 2021, and to 16.3% under a very severe stress scenario. The CRAR is estimated to deteriorate from 14.6% in March to 13.3% in the baseline scenario, and to 11.8% under a very severe stress scenario. The volume of recapitalisation required is humongous.

There is an expectation that the government will yet again take an easy solution of bailing out weak banks through recapitalisation instead of taking up serious reform alternatives. The issue of stressed assets of the banks has continued for long, time and again the government has been giving oxygen support to the critically Ill patient, and neither the banks nor the government has seen any urgency in reforming the governance structure. Lasting reform would entail addressing the difficult issue of the role of the government owning and running commercial banks itself. It is in this context that the discussions between the Fifteenth Finance Commission (FFC), the department of financial services in the ministry of Finance and RBI raise concerns. Is it the intention of the Commission to make provision for the recapitalisation of the banks by reducing the tax deviation to the states?

The core question in this context is the role of the Finance Commission in the recapitalisation of banks. The basic task of the Commission is to address the matters specified under Article 280 (3 a, b, bb, and c) which relate to tax devolution, giving grants in aid of revenues, and measures needed to augment the consolidated funds of the states to supplement the resources of rural and urban local bodies. There has been a significant expansion in the mandate given to the Finance Commissions in their TOR over the years, and these have been issued under Article 280 (34), which is “any other matter referred to the Commission in the interest of sound finance”. The expanded TORs include the review of deficit and debt levels, and recommending a sound fiscal roadmap for sound management, up-gradation in the standards of administration, prevention and mitigation of disasters, the impact of GST including the compensation payments, introducing measurable performance-based incentives for the states in a number of areas. Recapitalisation of public sector banks or the issue of resolving their stressed assets is not a part of the TOR. However, the Commission’s interest in this may be to consider the recapitalisation requirement as a genuine liability of the Union government while assessing central finances. According to the constitutional assignment, item 38 in the Union List relates to RBI and item 45 relates to banking. However, if recapitalisation requirement is taken as a genuine expenditure commitment of the Centre, the resources available for distribution will be severely constrained, and the Commission may have to reduce the share of the states in tax devolution from the 41% recommended in the report for the year 2020-21. This will severely constrain the states’ finances and efforts to revive the economy post-pandemic.

The genuine question, which the Commission must consider, is not whether or not the issue of bank recapitalisation comes within its ambit, but the larger issue of the role of the government itself. The important questions that need to be answered are, is there a case for government ownership of the banks on the grounds of market failure? If there is, what is the nature of the failure and does it warrant ownership? On the first question, there is a case for governance intervention on the ground of market failure due to asymmetric information. However, that does not warrant government ownership. Ownership of banks by the government alters the structure of incentives and accountability and hampers effective regulation and supervision as has often been pointed out. Several committees have made far-reaching recommendations in this regard. The Narasimham committee in 1998 recommended that government ownership and management, and autonomy do not go hand in hand, and recommended a review of functions of boards and enabling them to adopt a professional corporate strategy. The Nayak Committee has gone a step further and recommended dilution of government ownership to 25%. Privatising the ownership of the banks will change the structure of incentives and accountability, enabling more effective supervision and regulation, and subject them to market discipline. Despite these recommendations, the successive governments have continued to soft- pedal the issue. The PSBs, on their part, have been busy fighting one emergency after another, be it demonetisation or merger. They do not have any incentive to take risks and perform better as the government pumps in money from time to time. Should the states be penalised by reducing their share of taxes in the divisible pool because the Union government failed to reform the PSBs? Reducing the states’ share in the divisible pool of taxes on the grounds that the Union government requires fiscal space to recapitalise PSBs is tantamount to penalising them for the mistakes committed by the Union government.

As it is, the Union government which drafts the presidential TOR includes many tasks for the Commission to perform within its short tenure. However, the Commission’s main focus should be to address the main issues mentioned in Article 280 (3 a, b, bb, and c). The tenure of the Commission is a short tenure, and out of this, substantial time is being spent for finding the place, establishing the office and getting the staff to start functioning. The Finance Commission is not a tax reforms commission, not an expenditure reforms commission, nor is it a public enterprise reform or banking reform commission. The Constitution envisaged it to be an impartial adjudicator of finances to resolve vertical and horizontal imbalances arising from the assignments, and in doing so, impart fiscal discipline in both the Union and states towards calibrating sustainable fiscal policy. Hopefully, the Commission will stick to these basic tasks.