GS-III: The current crisis at PMC Bank serves the country a warning.

News

The crisis unfolding at PMC Bank is a tip of the iceberg of larger, unresolved problems in India’s banking sector.

Roots of the cause:

- The roots of the crisis in the banking sector go back to the unresolved problem of non-performing assets (NPAs).
- These are magnified in the case of cooperative banks due to lax governance and a dicey business model.

Other problems with the cooperative sector:

- Bad loans and poor governance.
- The business model offers depositors high-interest rates and lends money to borrowers of dubious credentials at low interests.
- It can easily run into difficulty due to the resultant wafer-thin profit margins.
- Poor regulatory response – it has so far been symptomatic and shows little understanding of the underlying disease.

Way ahead for cooperative banks:

- Fundamentally reformed governance so that a crisis such as this one does not occur in the future.
- The long-run health of the banking sector requires short-run transitional costs. This dichotomy between long-run and short-run cost—is at the root of many deferred or unfinished reforms.
- Rationalizing taxes is a good start. But it cannot serve as a fix to the sort of problems that we are seeing at PMC Bank and other troubled banks.

Conclusion:

The fundamental political economy problem is that public sector banks serve multiple masters and, as a consequence, loan decisions are not always based on economic and financial logic.