SHIVAJI UNIVERSITY
Kolhapur

Keeping Banks Safe

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Vice Chancellor Shinde, Mrs. Usha Thorat, Dr. Yashwant Thorat, Prof Shirke and friends,

I am thankful to the Vice Chancellor for giving me the opportunity to be with you, share my thoughts and listen to you during interaction.

In consultation with the organisers, I have selected the subject **"Keeping Banks Safe"** for five reasons. First, there are reliable reports of several wealthy individuals massively defaulting on their dues to banks. After all bankers lend depositors money. Second, some people in our country are currently having concerns about the safety of their deposits in the banks. Third, I am somewhat familiar with the subject, having been both in Government of India as Secretary Banking and in Reserve Bank of India. Fourth, Kolhapur has produced two central bankers, and I worked with both of them in the Reserve Bank of India for several years. In particular, Mrs. Usha Thorat worked on this very subject very closely at a critical time.

Hence, she can correct me or supplement me on the subject. Fifth, the subject is of great interest for the future of our financial sector and the welfare of the people of our country.

Before I go into the subject, I would like to pay tribute to a great son of Kolhapur, namely, General Thorat. He served our country with admirable distinction. India paid a heavy price for ignoring his warnings about China in 1960. This talk is dedicated to him. Equally I would like to pay my respects to his father, Dr P C Patil who reflects the truth that education makes the man – one of the firsts to have become a matriculate, a graduate and to complete his PhD when he was well into service.

The title of the subject has been carefully chosen. 'Keeping Banks Safe' means that they are safe for depositors now, but we have to make sure that they continue to be safe.

I made enquiries about banking experience in this area in regard to urban cooperative banks. Out of 64 banks eight banks were wound up and DICGC paid out Rs. 126 crore. Seven got merged. Yet there was no lack of trust in the banking system as a whole

It is true that there is no 100 per cent guarantee that all money of all depositors will always be safe in the bank. At the same time, almost everybody has been protected and most banks are mostly safe.

What explains this almost safe or almost always safe, but not one hundred percent safe phenomenon?

If depositors are guaranteed 100 per cent protection, the bankers may become reckless. The depositors also may not be very vigilant. RBI always tries to say that we do not bail out banks, but when banks are in real difficulties, RBI ensures that the depositors' interests are safeguarded. There is a legal backing for this system. The Reserve Bank of India can give temporary support as a lender of last resort. It has power to merge a weak bank with other banks in the interest of depositors. In case a bank is forced to wind up, some protection is granted to small depositors through the Deposit Insurance and Credit Guarantee Corporation.

How is this policy of almost guaranteed safety working in practice? It ahs been working exceptionally well in our country. Sometimes special effort was needed and that was forthcoming. I will illustrate with the work that RBI officers, including Usha, have tried to accomplish.

<u>What we did together</u>:

The Reserve Bank of India has been very particular about ensuring adequate trust in the banking system. Banks can do business only if they have depositors. Depositors will put money in the bank only if they have trust. That is why the Banking Regulation Act under which the RBI functions gave highest importance to the interests of the depositors and empowers Reserve Bank of India accordingly.

Interests of depositors are adversely affected when borrowers do not pay principal and interest as scheduled or if non-performing assets are large. Banks make loans out of depositor’s money and there are bound to be some loans where their judgment has gone wrong or circumstances have made them NPA.

Data of NPAs is available only from 1996-97 (See table below). The Non Performing Assets in 1996-97 were 17.8 per cent of gross advances and 9.2 per cent of Net Advances. These ratios are much higher than what is prevailing today at 11.7 per cent and 6.9 per cent in 2016-17. They were brought down to 9.4 per cent and 4.5 per cent in 2002-03, still higher than in 2015-16. A lot of improvement in the financial health of the banks had taken place by the time I joined as Governor in September, 2003. Yet, the NPAs were high, higher than in 2015-16. There were weak banks; and some public sector banks needed capital injection. These issues were addressed quietly, gradually and systematically. As a result, the NPAs were down to 2.0 percent and 0.9 percent in 2008-09. How did we do it?

GROSS AND NET NPAs OF SCHEDULED COMMERCIAL BANKS

Scheduled Commercial Banks

Year (End-March)	Non-Performing Assets	
	Gross	Net
	As Percentage of Gross Advances	As Percentage of Net Advances
2016-17	9.3	5.3
2015-16	7.5	4.4
2014-15	4.3	2.4
2013-14	3.8	2.1
2012-13	3.2	1.7
2011-12	3.1	1.3
2010-11	2.5	1.1
2009-10	2.4	1.1
2008-09	2.3	1.1
2007-08	2.3	1.0
2006-07	2.5	1.0
2005-06	3.3	1.2
2004-05	5.2	2.0
2003-04	7.2	2.8
2002-03	8.8	4.0
2001-02	10.4	5.5
2000-01	11.4	6.2
1999-00	12.7	6.8
1998-99	14.7	7.6
1997-98	14.4	7.3
1996-97	15.7	8.1

A combination of strategies worked- gradual tightening of rules in accordance with global standards, better accounting and auditing standards, and recapitalisation by the Government through the bond route where required. Of course overall growth in credit also made the ratios go down. One initiative we took related to disclosures of penalties levied by RBI on banks for irregularities or violations committed. Previously RBI was not disclosing the penalties that it imposed on the banks for the irregularities committed by the banks. We took a stand that the depositors have a right to know if the RBI imposes penalties on the banks, though some aspects of the individual parties concerned may be protected for privacy considerations. We also argued that the banks also will behave more responsibly if they have the fear of penalties being disclosed. We finally succeeded in having a balance between disclosure of the faults in banks and also ensuring of the trust. This is most clearly illustrated in the urban cooperative banks with which many of you are familiar. Penalty disclosure has had a hugely beneficial impact by dis-incentivising risky behavior.

We noticed that some of the private sector banks were not adequately capitalised, which means, they did not have enough capital to take care of the depositors' interests in case their borrowers failed to service the loans. We did not announce their weaknesses, but we took action on several fronts. How did we do that?

We made sure that they got merged with other banks or brought in adequate capital. We also prescribed guidelines for fit and proper criteria for ownership of more than 5 per cent. Similar fir and proper standards were imposed on the directors of the Boards as Mrs. Thorat recalled in her remarks.

We were very keen about prompt preventive corrective actions and we reinforced the monthly monitoring system of the banks. Sometimes, some banks become weak, but our efforts were to push them and get them stronger without necessarily creating panic.

We in RBI faced a real challenge in the case of one bank, that is, Global Trust Bank. In September 2003, we knew that it was vulnerable because many hidden things came to light. We wanted to avoid panic and so we gave an assurance that the very bad picture presented for that particular year was not a reflection of the problems during the year, but it was an accumulation of problems over the period. This was to avoid panic, even though it might have given an impression that we were giving the bank a good health certificate. The public questioned us , as to why we could not have warned them earlier. That would have certainly triggered a run on the bank with larger losses being incurred by the depositors. However, we made our own plans to take actions, and finally merged the bank with a public sector bank. The shareholders suffered and complained, but we were very clear that the interest of the depositors is foremost and no depositor lost any money. The criminal actions followed. There was perfect coordination between Government and RBI. The whole process did not result in any panic, except for two days of uncertainty.

Banking system contains public sector banks also. We wanted to introduce good governance practice in public sector banks also, but the power to do so rested with the government. Therefore, while the same regulation viz. having adequate capital, liquidity, exposure norms etc applied equally to public and private sector banks, the regulation relating to management and governance was entirely with the government. Our attempts to try and persuade the Government to use similar criteria for selection of Board directors did not succeed.

We had a more complicated problem with regard to Urban Cooperative Banks. Some of them were insolvent. It means they did not have enough capital to discharge their liabilities to depositors. We, therefore, had to work with the state governments to resolve the problems. Together, we identified those which are bad and need to be eliminated; those which are not so bad and need to be helped, and those which are good and need to be supported. This system improved the confidence in Urban Cooperative Banks. Government of Maharashtra was slow to accept the MOU regime but eventually did. In the process, a few Urban Cooperative Banks in the State had to be wound up. A few remained, accepting deposits, though they were not solvent. Overall, many urban cooperative banks which were under stress in 2004 survived. They remain robust till today. Deposits continue to be safe. In all this, Mrs. Thorat played a crucial role. I can take the credit of not stopping her or interfering with her.

Rural Cooperative Banks system is also important. Here Yashwant Thorat took a lot of interest and he can tell you all that he did. Yashwant is totally committed to rural development and he became head of NABARD. Yashwant Thorat with full support from government and full cooperation from RBI, injected significant capital from the budget of Government of India. Some improvements took place. The depositors' interest continued to be protected.

Doubts about Safety

Global financial crisis struck in September 2008.

The crisis was managed well, but in the process banking system was also affected. In some ways, today's problems are traceable to global financial crisis ten years ago and how we managed it.

We are now facing accumulated problems, not something that came up suddenly. The problem looks big because it is accumulated and not revealed for several years after the global financial crisis.

Why have the doubts about trust in banks arisen in the recent months? There are six sources of discomfort. They are (a) mounting non-performing assets not due to lending to agriculture or social banking but defaults by the very rich and very powerful; (b) inadequate capital to make up for non performing assets in discharging liabilities of banks; (c) a proposal to change law relating to resolving issues of problem banks by making depositors share the burden of insolvency; (d) the large criminal frauds committed in select banks; (e) the investigations launched and raids conducted on some Board members and CEO; and (f) the impression that RBI has been taking severe actions simultaneously in a determined manner to address accumulated problems possibly causing some disruption in some quarters.

Non Performing Assets

Systemic data on NPAs is available only from 1996-97. Non Performing Assets as a percentage of Gross Advances as well as Net Advances now is lower than what it was between 1996-97 and 2001-02. But by 2008-09, they were brought down through several measures when global financial crisis struck India also. But our banking system remained unaffected at that time. But, by 2013-14, the NPAs shot up. What happened?

Several policy actions were taken by Government and RBI in response to the global financial crisis. The banks benefitted from fiscal stimulus, monetary stimulus and regulatory forbearance including higher exposure limits to corporates, groups and industries. In retrospect, perhaps, the extra-ordinary measures taken were more than needed and, were continued for longer period than necessary. Banks had also been encouraged to lend to infrastructure, which was not the core competence of the banks, apart from creating asset and liability mismatch. Disclosures of real position were delayed. So, the accumulated problems came to the open in 2013-14 and in subsequent years.

How does this affect depositors? It affects the depositors if bank does not have enough money to pay the depositors, that is, when the capital is not adequate.

Capital Adequacy

What is the position now? From all accounts, the private sector banks have adequate capital to meet the requirements of depositor's safety. But, there is inadequate capital with public sector banks to meet the obligations of the banks to the depositors. However, it is not a problem for the safety of deposits because the owner is government. Sovereign cannot be insolvent. So, while technically capital is inadequate, in reality they are safe.

People know this instinctively and, therefore, do not rush to withdraw deposits. The uncertainty and delay in Government's injecting of capital as required by the RBI is a source of discomfort, no doubt.

In any case, the tax payer has to pay for high NPAs since Government as owner has to bear the burden.

Proposal to bail-in

There was a proposal in 2017 to amend the law relating to resolution of banks and financial institutions. The objective was to equate the bank depositor on par with other creditors. This caused nationwide concern, and rightly so. Fortunately, the law has been deferred or dropped. In any case, private sector banks are adequately capitalised and, therefore, there is no issue now. Yet the proposal has itself created a panic, and some withdrawal of deposits took place. To an extent, some permanent damage has been done to the trust in safety of bank deposits.

<u>Bank Frauds</u>;

A big fraud has come to light in the recent months involving thousands of crores in regard to one particular bank. It is clear that it is a fraud. The focus of all institutions should be to punish those who indulged in fraud and benefitted most from the fraud. It is a crime and investigation of the crime should be the top most priority.

Who should be worried most about the fraud? The owner of the bank who stands to lose most. The owner is the Government. The owner should be worried about what the Directors it nominated in the Board, were doing. The owner should be worried about the Managers it appointed. The owner should be worried about the system of monitoring and control of its own investment. That should be the focus of the owner.

Who pays for the losses due to the fraud? The tax-payers. The tax payers who have entrusted their money to the Government owned banks should be asking the government to explain why as the custodian of their money it failed to prevent the fraud.

Is RBI responsible? Though its main responsibility is financial system stability and the depositors' protection – it cannot escape responsibility for maintaining the trust of the public in the banking system. The fraud is of such a magnitude that it affects the credibility of RBI in ensuring the trust of people in banking. To this extent, it has to review its own regulatory and supervisory practices.

Raids and Investigations

Recently, large scale operations have been taken up by CBI. To my knowledge, a magnitude of the actions in recent months is unprecedented. Most of them are based on conspiracy and implied loss to Government than bad motive or pecuniary gains. Raids and investigations may be intended to (a) punish the guilty, and (b) act as a deterrent. Whether the really guilty have been booked; whether they will be punished finally; and whether they act as a deterrent are questions that remain. But, what is certain is that there is loss of confidence in the integrity of the banking system. It is not clear whether this by itself enhances the trust and whether there is anything on the anvil to show that the future system will be different. But, depositors are safe, no doubt.

RBI's reputation

Despite criticisms in some segments of media, RBI is held high in peoples esteem. Recently, government has amended laws to acquire powers to direct RBI to act on the issue of recovery of dues to banks. Actions taken by Government and official statements should ideally reinforce confidence in the RBI at this juncture. RBI should be seen to command respect and backing of Government to continue to effect mergers to protect depositors' interest.

Current Status

Bank deposits continue to be as safe as they have ever been , as far as private sector banks are concerned. They have adequate capital.

The public sector banks do not have adequate capital to take care of the depositors' interest, but since the majority ownership is that of the government, the deposits are safe. These are not limited liability companies, but institutions established under the law. However, the depositors are protected with the tax-payers money.

The confidence in the working of the public sector banks is at a historically low level

The foreign banks have been spared of any controversy so far.

The government has shown determination in initiating punitive actions, but there is no confidence that they will end up with any convictions.

An important initiative taken in regard to improvement of the system is the law relating to company insolvency. Some preliminary results are appearing.

There is no doubt that Government and RBI are taking many steps that are required and doing the right things; but together they need to ensure that they bring about non –disruptive changes while maintaining trust in the banking system. This is the need of the hour.

The future of the public sector banking which accounts for a major part of the banking system is uncertain. They are functioning without knowing where they would be..

Way Forward

What is the way forward? On the basis of our experience in the past, we can only make some general guidelines for improvements in the system and reduction in the NPAs.

Firstly, there should be clarity in where we want to go from here. Our experience was that a road map with a vision statement works well when it is non negotiable but the path should be non-disruptive. We should be able to indicate a bright future for banking system to keep banking safe for depositors and, in fact, for all concerned.

Secondly, effectiveness of RBI will be enhanced with demonstrable support from the Government.

Thirdly, there should be clarity on the future of public sector banking towards which we should move. The objective for public ownership of banks should be clarified and simplistic comparisons with the private sector banks avoided.

Fourthly, all punitive actions that are taken do not necessarily or by themselves result in positive outcomes. However, there should be a dual approach of simultaneous punitive action and system improvement.

Fifthly, today there is trust in the urban cooperative banks and these banks in places like Kolhapur do meet the needs of medium and small industry and traders. Each State Government should be encouraged to bring out a white paper to promote urban cooperative banks as institutions that can expand and grow. At this juncture this is critical to overcome the disruptions in the banking system. I hope the RBI will encourage such initiative.

Finally, confidence, coherence, consistency and clarity should be maintained in official pronouncement on banking recognising that banks are special and deposits in banks are very special.