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ADMINISTRATIVE STAFF COLLEGE OF INDIA
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K.L.N. Prasad Memorial Lecture

STATE OF BANKING IN INDIA

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Chairman Shri Padmanabhaiah garu, family of K.L.N. Prasad garu, Director General Khwaja and friends,

I am happy to be here in familiar surrounding and among longstanding friends to give a memorial lecture in honour of Mr. K.L.N. Prasad. Prasad garu had an incredible range of interests and innumerable friends, cutting across diverse backgrounds.

I was introduced to Mr. K L N Prasad forty years ago, in 1978, by M. Narasimham garu in World Bank Headquarters in Washington, D.C. All three of us ended up as neighbours in Road No.12, Banjara Hills Hyderabad.

K L N Prasad garu was a banker, a politician, a promoter of newspaper and an industrialist – with an extra-ordinarily pleasant and friendly

disposition. I have fond memories of my association with K L N Prasad garu, though occasional and brief.

Today, I want to speak on a subject that was close to Mr. K L N Prasad's heart, and of contemporary interest, while being familiar to me. The talk is on "State of Banking in India".

The subject is vast and the issues are complex. There are issues with consequences of immediate concern and there are also others of long term significance. Both are mixed up in the debates on the issues. I will share my thoughts on some of the issues based on my experience.

Is there a banking crisis in India?

Banking crisis is generally associated with macro economic instability especially in the external sector or financial sector. In India, there are no signs of any such instability.

Banking crisis is also associated with loss of trust in the banking system and run on the banks. Barring the recent draft bill on resolution or "bale in", to which I will revert later, there is no evidence of loss of trust in

banking or a tendency to withdraw deposits. True, many banks have the problem of inadequate capital (or capital inadequacy) but it is confined to the public sector banks and not private sector banks. Public sector banks are not limited liability companies but statutory bodies. So, there is no question of insolvency of the sovereign.

In brief, people of our country are right in recognising the problem of capital adequacy in public sector banks, but not worrying about safety of deposits.

Does absence of a crisis mean that there is no serious problem?

The big problem with our banking system is the difference between what the saver gets as a return or interest as a depositor and what borrower has to pay for a loan – the cost of intermediation.

The cost of intermediation through the banking system in India is by all accounts high. However, it can be argued that the resources available for the banks to lend are constrained by the stipulations of statutory liquidity ratio, CRR, priority sector lending stipulations and other social objectives from time to time. In a way, the bank depositors are subsidising the

government's borrowing program through SLR, the building of forex reserves through CRR; and the Government's developmental objectives through priority sector program. In other words, one of the major problems faced by the banking system is exogenous and lies in large pre-emption of resources and policy directed non-commercial operations. At the same time, banks have to compete with others, say, mutual funds, who have no such obligations.

In brief, there is no crisis in banking but banks are over-burdened with policy induced obligations.

(i) The first step for improving our banking system is a commitment to reduce SLR and CRR to global levels as soon as possible. We cannot have a globally competitive economy with an over-burdened banking system.

Who owns our banking system?

The foreign banks account for relatively small part of the banking business in India. From regulators point of view, large presence of foreign

banks, either as subsidiaries or as branches, poses problems of effectiveness. This is not an issue in India now.

What is the extent of foreign share-holding in Indian banking system? The foreign share-holding in the largest private sector banks is well over 70 per cent. In regard to public sector banks, the government and the LIC which is part of the public sector account for bulk of the ownership of the shareholding, and a major part of the rest is with foreigners. Thus, a major part of the private sector share-holding in our banking system is held by the foreigners.

In brief, we do not have one hundred per cent government owned banks. We have public sector banks, with a mixed ownership (public and private), and large private sector only with foreign share holding being part of private share-holding. Our banking system is predominantly owned by government, followed by foreigners and least by Indians. I repeat least by Indians. Share of public sector banking is and will come down, and under current policy, that space will be occupied irrevocably by foreigners owned banks unless there is a change in policy.

Indian incorporated but foreign owned banks are no substitute for Indian owned banks. With the widespread acceptance of proxy advisers by foreign institutional advisers, they operate in tandem. Hence, the diversified ownership as a buffer is a myth. The fit and proper ownership, and not extent of ownership, should be the criterion and it is time we have that in banking in India.

Banking is too important to allow foreign presence freely and WTO commitments of all countries are a testimony to this.

Most countries with large domestic economy have strong presence of domestically owned and managed banks. Why not India?

Indian's profile has the best brains, and best technology for global banks; and it will be a tragedy if Indians cannot own and run our own banking system.

(ii) The current policy of ownership and governance in banking needs to be reviewed urgently to correct the outdated and distorted policies. This should be done before our banking system passes on to foreign owners, irrevocably.

Why is there a stress in banking?

The current stress on banking system is a reflection possibly of several factors. First, easy post-crisis macro and regulatory policies since 2009; second, the delayed recognition of the problem both by banks and the regulator; third, the impact of slow-down in growth of GDP; and fourth, the arguable factor is high credit growth in 2004-06 despite high interest rates and regulatory counter-cyclical measures.

It is well known that our banking system was relatively less stressed by the global financial crisis 2008. Several policy actions were taken by Government and RBI in response to the crisis. The banks benefitted from fiscal stimulus, monetary stimulus and regulatory forbearance including increasing 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 in

terms of duration. In the process, the focus on their core strength, namely, provision of working capital could have been diluted.

In brief, the major source of current stress is large NPAs, predominantly post-crisis excesses.

<u>What is NPA Problem and how to solve it?</u>

What is an NPA? Technically, it means that borrower is not paying interest or principal due to a bank beyond a reasonable grace period. When the borrower does not service the loan, a bank's capacity to honour the obligations to depositors is in doubt. The regulator prescribes capital to be set aside to face the contingency of default. It is important for any regulator of banks to make sure that banks have adequate capital to honour commitment to the depositors.

How do we define an NPA? There are generally accepted principles of identifying NPAs, but not universal or binding. The regulator defines the NPA in detail, and in do so, may be liberal or rigid and vary over time. Data on NPAs over time are not strictly comparable if definitions are changed.

The risk of an NPA arises the moment lending takes place but it materialises as and when debt is not serviced. So, the seed for NPAs is often, in a way, planted when lending takes place, and so all lending NPAs cannot be eliminated; but they have to be contained at a reasonably low level.

There is nothing unusual about default and, in fact, interest charged depends on the risk involved in the business that is financed. So, risk of non-servicing in some cases is built into the system through the rate of interest. NPA may arise due to default for genuine problems faced by the borrower.

Briefly stated, all defaulters are not cheats. But the chances of default increase if the incentives to repay are not in place. If the judicial system is weak or prone to chronic delays, even those who have ability to service the debt may not do so.

We should distinguish between underlying cause of NPAs in general and those which are of special relevance to the current bout of high NPAs. They may be exogenous factors, like economic cycle; industry cycle; policy

paralysis; judicial activism, etc. There may be policy failures like using banking system for multiple ends, and interference in conduct of business, or directing banks to fund infrastructure though they d not have expertise in it. There may be regulatory failures such as excessive exposure to specific industries, or relaxed limits on group exposure, over-leverage of corporates, delayed recognition of NPA and corruption. There may be cases of simple fraud by the borrower.

The most striking aspect of the current situation is the large divergence between the bank's classification and subsequent classification by RBI on a detailed scrutiny. Auditors, in some ways, are technically the extended arms of the regulator, RBI. They are authorised, franchised and licensed by Government. Naturally, RBI depends on their classification of assets of banks. Banks themselves depend on the auditor's statements for the state of borrowing company. Have we asked the question: whether Government or RBI, who are using the auditors, and in some cases, Company Secretaries, as their extended arm, assessed their performance with the integrity and reliability that is expected from them.

An unexplored area is the role of auditors / Company Secretaries in blurring the distinction between genuine transactions and fraudulent transactions, perhaps, contributing to NPAs.

The economy and the tax payer are paying a heavy price for high NPAs, and there are multiple causes.

(iii) A high level internal enquiry within the RBI should be undertaken to fix the responsibility for excesses in NPAs in recent years and, more important, to suggest and adopt measures to improve the system as a whole.

What are the options to de-stress the Public Sector Banks?

Several options are being considered to address the NPA problem of Public Sector Banks, sometimes on a standalone basis and, sometimes in conjunction with other measures to solve the underlying issues that result in demand for capital infusion.

Consolidation of banks in public sector is an option, but that by itself does not increase capital or address weaknesses common to all banks being

considered for consolidation. If the problem is governance, how does consolidation help?

A bad loans bank was suggested but recourse was taken to this method in other countries to meet exogenous shock to banking system but not due to endogenous stress.

A combination of further regulatory forbearance and removal of constraints such as SLR or CRR was proposed. But, the former only buys time – like changing the measure of sickness. The latter should be done in any case, but the scope is limited in the short-run due to government borrowing program; the sterilisation of capital flows and the recent liquidity overhang due to demonetisation.

In brief, there seems to have been a consensus in favour of recapitalisation as the necessary first step while considering all other options to reduce chances of recurrence of such problems in banking system.

The preferred option now seems to be a significant reliance on issue of bonds to fund the injection of equity – with more equity to weaker banks. Bond financing should normally imply increase in fiscal deficit, but it can be

interpreted to define in a manner that it does not. Whatever manner it is defined, it adds to the fiscal burden in terms of payment of interest in future. This burden could potentially be compensated by returns on equity injected. Current approach appears to inject more capital to weaker banks since their needs are more.

The Fourteenth Finance Commission had something to say on this.

"In our view, there is scope and need to further lower the fiscal costs of re-capitalisation by restricting it to select and better performing public sector banks, instead of an across-the-board policy of covering all of them, in view of the competing demands on available budgetary resources. The non-performing public sector banks may be advised to manage their asset portfolio and growth in tune with the available capital. This will promote competitiveness amongst these banks and act as a hard budget constraint on them. This approach requires a view to be taken on, as well as an assessment of, the number of public sector banks that can cater to the desirable share of the public sector banking system in India, in order to serve the social objectives."

The Fourteenth Finance Commission also recommended (Number 107), a broader view of the whole problem of keeping or putting tax-payers money in public sector financial entities.

"We recommend that a Financial Sector Public Enterprises Committee be appointed to examine and recommend parameters for appropriate future fiscal support to financial sector public enterprises, recognizing the regulatory needs, the multiplicity of units in each activity and the performance and functioning of the DFIs."

In brief, it is necessary to make explicit the stand of the Government on these important recommendations.

(iv) In view of the large amounts of public money involved, the government may put in public domain action taken on Fourteenth Finance Commission's recommendation for improving the financial system with economical use of tax payer's money.

Why not privatise Public Sector Banks?

To understand the scope and limits to Privatisation of public sector banks, we need to go back to the nationalisation of banks in 1969.

The nationalisation of banks changed balances in a fundamental manner. Union Government had till then no official functionaries in the States for initiating or implementing its programmes. The Union Government acquired a country wide presence of its functionaries, albeit indirect. Second, the private sector had to depend on the Union Government owned banks for funding of their activities since financial intermediation in formal sector was mostly confined to banks. Third, the Reserve Bank of India's command over monetary policy, especially transmission and regulation of bank was diluted. Fourth, large financial resources became available for the Government, which could be used without Parliamentary oversight. The banking system in India, thus, became a useful means to launch many Prime Minister's country-wide programmes, even though they were in the jurisdiction of states.

The reform of 1991 brought about another role for public sector banks. They became critical for public-private partnership, but they also became the bridge between politics and business.

Just as there were debates in 1969 as to whether we should have social control or nationalise, we now have a debate between privatisation or recapitalisation, or recapitalisation followed by privatisation. Still, it will be political decision, but one with enormous economic consequences as at the time of nationalisation in 1969 and later in 1980.

The origin of public sector banking was political; it was through an ordinance; its evolution has been political and its future will, perhaps, be determined on political economy considerations.

2017 is vastly different from 1969. The balance between Union and States has been changing. The balance between State and market is different now. Private Sector is more nimble than ever before. Private sector is used even for a sovereign function like issue of Passports. People are demanding more choices than before. India is an integral and important

component of global economy and, indeed, global finance. Finance is more complex now, and goes beyond banking.

The context of banking in India is also different now. We are already in a mix of public and private sector banks. We are in a world of public sector banks having a mix of public and private ownership. We are in a world where empirical evidence for comparing their performance is available – though subject to multiple interpretations. More important, we are in a new world where foreign investors have strong presence both in private sector banks and in public sector banks. So, for policy makers, the choice is more difficult and, processes more complex than in 1969. The degrees of freedom available for arbitrary decisions by Government are circumscribed by dynamics of financial markets.

In brief, the future of public sector banks is unclear to them; and this itself undermines their efficiency, and also efficiency in the banking system, as a whole.

(v) A White paper on the future of Public Sector banking may be placed before the Parliament at the earliest in view of their criticality for

efficiency in financial sector as a whole, to be able to serve a globally competitive economy.

Are bank deposits fully protected or perceived to be fully protected?

Lack of capital adequacy did not erode the trust of people especially depositors in our banking system. But introduction of a bill to "bail in" all financial intermediaries has created a panic in recent weeks. Government sources clarify that the proposal does not in any way dillute the existing position. People do not give credence to this interpretation. In my view, people are right.

Bank Deposits in India are protected only up to one lakh, strictly as per law. In practice, people believe that bank deposits in India are fully protected. Why?

As mentioned, banking crisis arises when the trust of the people in the banking system as a whole is eroded. That has not happened in India so far mainly because of the policies of RBI and the law that enables it to do so.

In India, banks have a special place. There are large number of savers who put their money out of total trust in the banking system. The RBI has been practicing what may be called "constructive ambiguity" in assuring a sense of safety of all depositors – including those that are not covered by Deposit Insurance, though there has been no legal or formal commitment by Government or RBI to do so. The RBI does not assure a bail-out, or legally guarantee safety of all deposits but somehow manages the situation on a case by case basis, giving full comfort to the community of depositors that their deposits are generally safe under the watch and authority of RBI.

The proposal now is to have an arrangement for resolving the problems of all financial intermediaries when they are in trouble, by a new institution to be set up. In other words, banks will be treated like other financial institutions and bank depositors will be treated like other stake-holders in all financial institutions. It implies special responsibility of RBI and the powers to RBI to take such measures as are necessary to protect the depositors' interest stand eliminated and, in any case, totally diluted.

Despite assurances to the contrary, the current proposal for bail-in may really be a "bail-out" for other stakeholders relative to bank depositors who had a pride of place in the current dispensation under BR Act. Under the proposals, bank depositors are in the queue along with many others and subject to decisions by authorities dealing with many other institutions and claimants.

This approach has not stood test of time in other countries. In fact, half of G20 countries have not even considered this approach so far.

The current proposal is, therefore, trying to find a risky and untried solution where no problem exists and in the process, problem of trust in banking has been created.

The fear of the depositors that their protection is substantively diluted by the proposed legislative change is, therefore, fully justified. Fortunately, the matter is being deliberated, and hopefully the proposal will be dropped.

(vi) In brief, the current approach of treating Banks as special and bank depositors as special must be continued, and an assurance to this effect may be extended by the Government.

Why not use the excess reserves of Reserve Bank of India for recapitalisation?

Several suggestions have been made to use the accumulated reserves on the balance sheet of RBI to fund recapitalisation of banks. This proposal is difficult to justify for several reasons.

Let us start with the problem that the proposal seeks to solve.

RBI is the regulator of banks. The regulator feels that the banks are not having adequate capital. The regulator is asking the owner of the banks to bring money and put in the capital to protect the interests of the depositors. This proposal to use the reserves of RBI implies that we are asking the regulator of the banks to put its own money into the banks because the regulated is not having enough funds. It is somewhat, if not exactly, like asking the Court to pay the penalty since the convicted does not want to pay the fine for a crime committed.

A simple and straight forward approach would be for the Government as the owner of RBI to take the surplus of income over expenditure in any

given year, after finalisation of accounts as per law, from the RBI into the budget and do whatever it likes, including putting the money into the banks.

There are reports that the Government is planning to take money out of the accumulated reserves for recapitalising. This can be questioned simply because any accretion to reserves has happened in past, after application of mind by the Board, in consultation with Government, year after year. Accumulated reserves are meant to serve the contingent needs of the RBI and not the current needs of the Government of the day.

There has also been a suggestion that interim dividend will be provided to the Government. This means that both the fiscal needs and cash management considerations of Government will influence the determination of surplus and timing of transfer of such surplus to Government. For the reasons I stated, this is not a desirable approach.

There has obviously been an unfortunate disagreement about the adequacy of reserves of RBI, resulting in changes in the formula for transfer of reserves that was in force since 1998, till 2014. NO doubt, there is a case for review of the arrangement by RBI taking account of recent developments

in global concerns on risks to central bank balance sheets and in our economy.

(vii) In view of global developments and emerging Indian economy, there is a case for RBI to internally review the current policy of annual transfer of surplus after determining the needs for addition to reserves and adopt a new policy after due consultation with Government.

CONCLUSION

Friends, I have a reputation for analysing issues on money and finance, and taking the audience to a higher level of confusion. It has been said that "Dr. Reddy needs no introduction. He needs only a conclusion."

In a departure from my usual style, I have given seven specific recommendations.

Thank you, friends, for provoking me to think and encouraging me to be candid.

Thank you.