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STATE OF BANKS

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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. There is no evidence of serious loss of trust in banking or a tendency to withdraw deposits.

Why is there no serious loss of trust despite serious problem of capital adequacy?

The problem of inadequate capital (or capital inadequacy) is confined to the public sector banks and not private sector banks. Public sector banks are not limited 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 seriously worry about safety of deposits.

How did we get here?

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.

Where are we? Large NPA's with inadequate capital; constrained credit growth; a package of punishments, structural changes, legal changes, cumulatively creating uncertainties in the absence of coherence or design for change.

<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 in Public Sector banks.

What is the biggest problem in banking?

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, banks are over-burdened with policy induced obligations such as CRR, SLR, priority sector.

Recent Frauds

A big fraud has come to light in the recent months involving thousand 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. There is a witch hunting going on for blaming different people on their roles for a fraud committed by one bank. Is the lack of focus an accident?

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 the Directors whom 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 loses due to the fraud. The tax-payers. The tax payers who have entrusted their money to the Government 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 question its own regulatory and supervisory practices. The argument that it does not have enough powers over public sector banks is more general and cannot be an explanation for this particular instance.

Suddenly, there are some other issues relating to private sector banks which come to the open as part of this fraud. The losses in respect of private sector banks are borne by the private shareholders and to that extent it does not have the same level of public interest as that of the public sector banks. Is there any reason why private sector bank's activities are brought into the debate at this stage? Is diffusion and diversion from a focus on the fraud an accident?

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.