THE INDIA FORUM
A JOURNAL-MAGAZINE ON CONTEMPORARY ISSUES

February 3, 2021

Indian Banking Reforms

Talking Tokyo, Looking London?

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With most of India's attempts to reform its financial sector rolled back post demonetisation, the country could soon be facing a possible solvency crisis amongst state-run banks. The government must quickly return to its early reforming zeal.

The banking system in India was in stress much before Covid-19 hit us. There are two aspects to the stress. One is historical, related to how the banking system was managed as an extension of the state, and the resulting exuberance in lending during the high growth period of the early 2000s. The second is contemporary: an outcome of how the so-called 'reforms' have been carried out by the current union government. In the Union Budget for 2021-22 there is once again a claim to giving a new push with a couple of initiatives on public sector banks.

Making sense of the mess is complicated. It is not just the twin balance sheet problem of a stressed economy and a stressed banking system, but it is more than that.

Usually, in a bank a liquidity crisis manifests itself only if there is a loss of faith leading to a run on the bank. There is hardly any physicality to the transactions in the financial sector. Most of the transactions happen through transfers and there is no logistics involved – except for the handling of currency at the terminal level. Therefore, unless the bank itself chooses to recognise the stress, it may not be visible to the outside world. Depositors do not do detailed due diligence while parking their funds in the bank as there is an implicit trust both in the liquidity and solvency of a banking institution.

On the other hand, the real sector businesses have better early warning systems in the form of excessive inventory and unrecovered receivables, both resulting in a cash flow problem. If at that stage these firms were to borrow, there is greater scrutiny by lenders. So, the stressful situation in such a firm will most likely manifest itself in a liquidity crisis.

There is always a big question as to whether the financial sector lags the real sector or leads the real sector. When we look at the pronouncements of annual credit plans, outlays, and central bank monetary policy statements, we tend to believe that the financial sector leads the real sector economy, by pump-priming investment towards a virtuous cycle of growth, prosperity and development.

However, when there is a downturn, the virtuous cycle turns vicious. The lag of the stress in the real sector permeates to the financial sector in terms of defaults, bad debts, and write offs. This results in a weak balance sheet of the financial sector firms, and severely restricts the ability to lead a recovery. The financial sector firms need to be adequately capitalized. While it appears like a cliché, we are in unprecedented times and face a heavily unpredictable future.

Reforms—The earnest steps

Even under the current political regime, it is important to break up the banking story into two phases. The best time marker would be 8 November 2016, the day the prime minister announced the withdrawal of specified bank notes amounting to 86% of the currency in circulation— demonetisation or *notebandi,* as it came to be known.

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The pre-demonetisation phase saw two major initiatives, showing great earnestness but policy duality. The government was signalling an effort to get independent governance and professional management at the state-controlled banks, to make them more market-facing. At the same time, it was imposing social targets on the banks through an aggressive agenda of carrying out financial inclusion with the PMJDY programme and lending MUDRA loans. This duality could have been sorted out in the medium term if the state had remained on course.

First, the reforms. It appeared that the government was well on its way to insulating the banking system from government interference and providing public-sector banks with greater operational autonomy. The earnestness of banking reform could be seen with the interest that the prime minister personally took in trying to address the challenges in this sector. Strategies and reforms were discussed in depth at two national meetings of public sector bank chiefs, called the Gyan Sangam. This was followed up by project Indradhanush, which converted some of the ideas of Gyan Sangam into actionable points of governance reform based on a well-articulated seven-pillar-framework. On the 80th anniversary of the Reserve Bank of India (RBI), the prime minister talked about coordination with the central bank and its governor and of convergence between the union government and RBI on managing the economy and the banking system.

Apart from the meetings, there was action. The 2014 report of the Nayak Committee (Report of the Committee to Review the Governance of Boards of Banks in India) was pulled out and reforms on its recommended lines were initiated. A Bank Boards Bureau was formed as a first step to provide insulation in appointments of chief executive officers (CEOs) of state-controlled banks. The position of the chairman and the CEO was bifurcated. In two big banks — Bank of Baroda and Canara Bank — a CEO was inducted from the private sector, until-then unheard of in the state-controlled banking sector. There were broader changes being initiated too, like the passing of the Insolvency and Bankruptcy Code (IBC) to quickly resolve the issue of non-performing assets (NPAs) and to hold promoters and people controlling the business accountable for losses and bad debts.

> Financial inclusion seemed to be the only issue on which the state was furthering its developmental agenda, while all the other efforts were prudential and market-facing.

The exception to the tendency of granting operational autonomy to banks was the launch of the Prime Minister's Jan Dhan Yojana (PMJDY) programme, which mandated the banks to rapidly open at least one account for every household in the country. While the scheme was intended to enhance financial inclusion by leveraging connectivity and the spread of banking outlets, this initiative would not have resulted in immediate business or enhanced viability. However, financial inclusion seemed to be the only issue on which the state was furthering its developmental agenda, while all the other efforts were prudential and market-facing.

Doubts along the road

All this while, there has been a cat and mouse game between the regulator and the bankers on how stressed assets and potential losses are recognized. In essence, the question was: do we push bad news about banks under the carpet and pretend that all is well, or do we take it on the chin?

It started with an advisory from the RBI in 2011 to have an automated system for identifying bad loans. A computer would generate a list of NPAs through due-date tags, without providing for discretion through human intervention. It culminated in an Asset Quality Review (AQR) of banks in 2015. Based on the review, the framework of recognising bad loans was tightened and eventually led to considering even a day's delay in repayment being treated as a default. Alongside came the Insolvency and Bankruptcy Code (IBC), which provided a forum for the resolution of such non-performing and stressed assets.

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Soon, the piled-up NPAs started getting recognised and tagged. The principle of conservative accounting required that the income that was recognised on these assets (the accrued interest) be de-recognised and the loan itself be adequately provided for — a method for recognition of the potential losses till it manifested itself. Both measures resulted in lower profits for banks due to historical ills.

This would have been bearable if the economy was doing well. These losses would have been absorbed by an expanding economy. Vibrant commerce would have presented opportunities for the banking system to make advances and earn from a growing balance sheet. The accumulated sins of the past could be washed out.

However, there were two disruptions in the banking system, even before the contagion hit us.

The turning point

The 2016 demonetisation programme not only removed cash from the economy, it also almost crippled the banking system. Banks had to grapple with the immense logistics of replacing currency, moving the focus away from growing their business. Shortly afterwards the

economy was hit by the hasty implementation of the Goods and Services Tax, with all its legislative confusion and correction. The GST disproportionately affected the large informal and semi-formal sectors. The economy's balance sheet was thus under stress due to significant shocks to liquidity, resulting in solvency problems. The banks' balance sheets were under stress due to existing bad loans and the escalation in new NPAs.

> Banks were suffering because of inappropriate policy interventions, while the economy was also going through its own crisis largely created by government policies.

It was around this time that massive frauds in the banking and financial system were detected. Some scams were big in terms of impact: Vijay Mallya, Nirav Modi, Mehul Choksi, the Sandesaras, the Guptas of South Africa, and the Wadhwans. Others were big in terms of news value: the investigation and shaming of Chanda Kochhar of ICICI Bank; Archana Bhargava of United Bank of India; Usha Ananthasubramanian of PNB and Allahabad Bank; KV Brahmaji Rao of PNB; Ravindra Marathe, Rajendra Gupta, and Sushil Muhnot of Bank of Maharashtra; and SK Jain of Syndicate Bank.

The flow of bad news was continuous. Three banks were in trouble: PMC Bank, located in Mumbai, that brought under scrutiny the urban co-operative bank network; Yes Bank that was initially put under a moratorium and eventually bailed out with a change in management; and Lakshmi Vilas Bank that was merged with a foreign bank, DBS of Singapore. Two large non-banking financing companies (NBFCs) went into trouble: Dewan Housing and IL&FS.

There were issues of inadequate checks and balances and regulatory action at these institutions. The CEOs and senior officials of banks came under scrutiny and some of them were perceived to be victimised through firings and arrests. Punitive action was imposed on public sector banks. All of this led to doubts about the willingness of the banks to take positions that would grow the credit book. Hence, the ecosystem in which the financial institutions were operating was also not doing well. It did not help that the NBFC sector was so intricately involved with the banking system.

While the increased level of stringency showed the piled-up bad assets, the economic situation after demonetisation created incremental bad assets at a rapid rate. Like the twin balance sheet problem, there was a twin policy problem, where the banks were suffering because of inappropriate policy interventions, while the economy was also going through a crisis largely created by government policies.

Pretension is better than cure

Not only did reforms get inadequate attention, but the government's steps in the months after demonetisation were also regressive from the perspective of growth. From earlier taking pro-active measures at reform, it moved towards non-action. Measures packaged as reforms did not address basic issues.

The attempt to pass the Financial Resolution and Deposit Insurance Bill in 2017 attempted to introduce a 'bail-in' clause, that in case of a bank failure, deposits would be frozen and used as resources to resolve the crisis. This created a scare. While the bill was eventually withdrawn, the fear of such legislation remained.

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Amidst the downturn in the economy, the government continued its 'reforms' by merging public sector banks. The logic of the mergers and the basis for choosing the partners was not clear. Bank of Baroda was merged with Vijaya Bank and Dena Bank; Punjab National Bank with Oriental Bank of Commerce and United Bank of India; Canara Bank with Syndicate Bank; Indian Bank with Allahabad Bank; and Union Bank of India with Andhra Bank and Corporation Bank.

The mergers were all done with aggressive timelines and did not pause even when there were severe negative events in the ecosystem. The larger banks should have been addressing issues of credit and the economy. In the event, they were busy looking at matters of software compatibility, integration of human resources, rationalising branch networks, and rebranding.

Shaky foundations

We are now standing on these shaky foundations. Every earnest reform measure introduced before demonetisation has been reversed. A significant part of the state-owned banking sector is suffering from low morale amidst restructuring and a pileup of bad assets. Negative growth hit the economy much before the banking system could recover from the multiple cuts that had been inflicted on it.

The stringent recognition of NPAs has been rolled back. In 2020-21 India had an officially declared moratorium for six months, which means that it will take some time before the real losses hit the books. While the assets side at this time looks healthy because of the moratorium, the eventual recognition of NPAs would reduce profitability and increase the leverage of the banks. The gross NPA figure, that was at 7.5% in September 2020, is expected to slip to 13.5% by September 2021, as per the baseline estimate of the Financial Stability Report (FSR) of the RBI. The report further states that "the fuller impact of the deterioration in the macroeconomic environment on banks asset quality, capital adequacy and profitability may unfold gradually" (31).

> Under the guise of providing better dispensation for the micro, small, and medium enterprises [...] measures taken by the government to undermine the debt resolution process makes it a rollback.

The IBC procedures were themselves very slow pre-pandemic and their effectiveness was being questioned. The relief package post Covid-19 gives more time to report cases under the IBC and also extends the time permitted for resolution. The pressure to dilute the norms came from two fronts, delaying the recognition of bad loans and delaying initiating the bankruptcy process. Both were under the guise of providing better dispensation for the micro, small, and medium enterprises.

An RBI order of 2018, which required that even a day's delay in repayment should see the loan treated as NPA, was struck down by the Supreme Court in 2019. This resulted in a new order that considerably diluted the process. Recent books by former RBI governor Urjit Patel (2020) and former deputy governor Viral Acharya (2020) both confirm that there was immense pressure on the central bank in this regard. (The pressure was a significant reason for both of them to quit their positions much before their terms ended.) These measures taken by the government to undermine the debt resolution process makes it a rollback to status quo ante.

Solvency risk

Soon after Covid-19 was declared a pandemic and a lockdown was imposed, the response of the RBI was to pump in liquidity. It was possibly the right thing to do at that time, given that the moratorium would put a stress on banks' liquidity. However, hindsight tells us that the banking system is now stuffed with liquidity.

> The banking sector thus seems to be in a paradoxical situation of abundant liquidity (largely reflected in savings) but with inadequate capital [...] This is a crisis that could be unprecedented.

Credit offtake has been tepid, with the new accounts falling by a fourth and the growth in the new loans seen predominantly in agriculture and personal loans. There was no offtake of credit for industry and services sector (both showing negative growth). Overall, the year on year (YoY) growth in credit was at 5.7% at end March 2020 and at 5.0% at end September 2020. Deposits grew at around 10% for all quarters ending with a 10.3% YoY growth in September 2020. There has been no significant increase in the offtake of credit after September 2020 and it would take a while for growth to revive.

These indicate a broad loss of faith in economic activity picking up. When the recovery does pick up, the banking sector will see a cascading pileup of NPAs. It will also face liquidity stresses. Savings would move towards mutual funds and equity even as demand for bank credit increases, both resulting in cash outflows. The overhang of NPAs will stress inflows.

The banking sector thus seems to be in a paradoxical situation of abundant liquidity (largely reflected in savings) but with inadequate capital. While at this time there is no liquidity risk, there is every danger of a solvency risk.

This is a crisis that could be unprecedented. The interconnectedness within the banking sector and across NBFCs (where half of the borrowing is from banks) and the inter-sectoral exposure to asset management companies will all play out. We may not be adequately prepared to handle the incremental stress that will pan out on the financial system.

Where are we headed? Where should we be headed?

Is there a way out? What could be an appropriate policy response at this time?

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The budget for 2021-22 has proposed setting up what was earlier called a 'bad bank' to suck out the NPAs from the banks. A bad bank would allow other banks to continue operations, with possibly no significant need for capitalisation. The capital requirement of a bad bank — which would be a non-banking finance company —may be far less given that it is buying the NPAs at deep discounts. While this is an interesting intervention, it only moves the NPAs from one entity to the other, possibly to an entity that has a zeal for recovering the loans. A bad bank would be effective in dealing with wilful defaults where criminality can be established, and the personal assets of the promoters and key management personnel can be attached. But this zeal would not help deal with the challenges a stressed economy.

The FSR indicates that while the overall banking system can take the stress of deterioration of the macro-economic situation, there could be individual banks that may have to watch out. During the AQR exercise and under the PCA, several public sector banks were put under a credit moratorium. The situation has since exacerbated.

The question then is: should the policy approach be that some bank failures will be allowed? If not, does the state have the ability to pump in more capital to maintain the solvency of the banking system owned by it? Would this be used as an opportunity to open up the space for the new players (both foreign banks and industrial houses) to pump capital into stressed banks? These are important questions.

> If the government wants to help the banking sector, its focus should be more on the reviving the real economy.

This may be the time to ease capital adequacy norms, signal implicit sovereign backing to the banks, and allow space for each of the banks to clean up. This means a rewind to the Gyan Sangam and Indradhanush frameworks, with a strong IBC in place. At the same time, it may make sense to roll back Basel capital adequacy norms by one notch, for a specific and reasonable period so that there is no need for a capital outflow from the exchequer.

Many commentators indicate that we should never waste a bad crisis for good reform. We need to look at what would be the reform path as we go forward. If we were to read the tea leaves from the action of the government on reform in labour laws and the farm laws, we know the direction in which it is headed.

If the government wants to help the banking sector, its focus should be more on reviving the real economy and not on the banking and the financial sector. If the finance minister can take adequate fiscal measures, the RBI is quite capable of managing the banking sector's stability.

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