Resolving India’s banking crisis

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MAY 11, 2019 00:15 IST

Acceleration in economic growth is not possible without addressing the problem of non-performing assets

The government that assumes office after the general election will have to crack a serious and unresolved problem: India’s **banking** sector. To do so, it needs clarity on how the problem arose in the first place. Only then can it discard simplistic and ideologically-driven solutions in favour of those that can be effective.

Non-performing assets (NPAs) at commercial banks amounted to □10.3 trillion, or 11.2% of advances, in March 2018. Public sector banks (PSBs) accounted for □8.9 trillion, or 86%, of the total NPAs. The ratio of gross NPA to advances in PSBs was 14.6%. These are levels typically associated with a banking crisis. In 2007-08, NPAs totalled □566 billion (a little over half a trillion), or 2.26% of gross advances. The increase in NPAs since then has been staggering. How did this come about?

Origin of the crisis

The answer lies partly in the credit boom of the years 2004-05 to 2008-09. In that period, commercial credit (or what is called 'non-food credit') doubled. It was a period in which the world economy as well as the Indian economy were booming. Indian firms borrowed furiously in order to avail of the growth opportunities they saw coming. Most of the investment went into infrastructure and related areas — telecom, power, roads, aviation, steel. Businessmen were overcome with exuberance, partly rational and partly irrational. They believed, as many others did, that India had entered an era of 9% growth.

Thereafter, as the Economic Survey of 2016-17 notes, many things began to go wrong. Thanks to problems in acquiring land and getting environmental clearances, several projects got stalled. Their costs soared. At the same time, with the onset of the global financial crisis in 2007-08 and the slowdown in growth after 2011-12, revenues fell well short of forecasts. Financing costs rose as policy rates were tightened in India in response to the crisis. The depreciation of the rupee meant higher outflows for companies that had borrowed in foreign currency. This combination of adverse factors made it difficult for companies to service their loans to Indian banks.

Tightening norms

The year 2014-15 marked a watershed. The Reserve Bank of India (RBI), acting in the belief that NPAs were being under-stated, introduced tougher norms for NPA recognition under an Asset Quality Review. NPAs in 2015-16 almost doubled over the previous year as a result. It is not as if bad decisions had suddenly happened. It's just that the cumulative bad decisions of the past were now coming to be more accurately captured.

Higher NPAs mean higher provisions on the part of banks. Provisions rose to a level where banks, especially PSBs, started making losses. Their capital got eroded as a result. Capital from the government was slow in coming and it was barely adequate to meet regulatory norms for minimum capital. Without adequate capital, bank credit cannot grow. Even as the numerator in the ratio of gross NPAs/advances rose sharply, growth in the denominator fell. Both these movements caused the ratio to shoot up to a crisis level. Once NPAs happen, it is important to effect to resolve them quickly. Otherwise, the interest on dues causes NPAs to rise relentlessly.

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This, in brief, is the story of the NPA problem. Since the problem is more concentrated in PSBs, some have argued that public ownership must be the problem. Public ownership of banks, according to them, is beset with corruption and incompetence (reflected in poor appraisal of credit risk). The solution, therefore, is to privatise the PSBs, at least the weaker ones.

There are problems with this formulation. There are wide variations within each ownership category. In 2018, the State Bank of India's (SBI's) gross NPA/gross advances ratio was 10.9%. This was not much higher than that of the second largest private bank, ICICI Bank, 9.9%. The ratio at a foreign bank, Standard Chartered Bank, 11.7%, was higher than that of SBI. Moreover, private and foreign banks were part of consortia that are now exposed to some of the largest NPAs.

The explanation lies elsewhere. PSBs had a higher exposure to the five most affected sectors — mining, iron and steel, textiles, infrastructure and aviation. These sectors accounted for 29% of advances and 53% of stressed advances at PSBs in December 2014. (The RBI's Financial Stability Report does not provide similar data for the period thereafter.) For private sector banks, the comparable figures were 13.9% and 34.1%. Our rough calculations show that PSBs accounted for 86% of advances in these five sectors. By an interesting coincidence, this number is exactly the same as the PSBs' share in total NPAs.

As mentioned earlier, infrastructure projects were impacted by the global financial crisis and environmental and land acquisition issues. In addition, mining and telecom were impacted by adverse court judgments. Steel was impacted by dumping from China. Thus, the sectors to which PSBs were heavily exposed were impacted by factors beyond the control of bank management.

Plans to prevent such crises

Wholesale privatisation of PSBs is thus not the answer to a complex problem. We need a broad set of actions, some immediate and others over the medium-term and aimed at preventing the recurrence of such crises.

One immediate action that is required is resolving the NPAs. Banks have to accept losses on loans (or 'haircuts'). They should be able to do so without any fear of harassment by the investigative agencies. The Indian Banks' Association has set up a six-member panel to oversee resolution plans of lead lenders. To expedite resolution, more such panels may be required. An alternative is to set up a Loan Resolution Authority, if necessary through an Act of Parliament. Second, the government must infuse at one go whatever additional capital is needed to recapitalise banks — providing such capital in multiple instalments is not helpful.

Over the medium term, the RBI needs to develop better mechanisms for monitoring macro-prudential indicators. It especially needs to look out for credit bubbles. True, it's not easy to tell a bubble when one is building up. Perhaps, a simple indicator would be a rate of credit growth that is way out of line with the trend rate of growth of credit or with the broad growth rate of the economy.

Actions needs to be taken to strengthen the functioning of banks in general and, more particularly, PSBs. Governance at PSBs, meaning the functioning of PSB boards, can certainly improve. One important lesson from the past decade's experience with NPAs is that management of concentration risk — that is, excessive exposure to any business group, sector, geography, etc. — is too important to be left entirely to bank boards. The RBI has drawn this lesson to some extent. Effective April 1, 2019, the limit for exposure to any business group has been reduced from 40% of total capital to 25% of tier I capital (which consists of equity and quasi-equity instruments). The limit for a single borrower will be 20% of tier 1 capital (instead of 20% of total capital).

Risk management

Other aspects of concentration risk remain to be addressed. Overall risk management at PSBs needs to be taken to a higher level. This certainly requires strengthening of PSB boards. We need to induct more high-quality professionals on PSB boards and compensate them better.

Succession planning at PSBs also needs to improve. Despite the constitution of the Banks Board Bureau to advise on selection of top management, the appointment of Managing Directors and Executive Directors continues to be plagued by long delays. This must end.

The task of accelerating economic growth is urgent. This is not possible without finding a solution to the problems that confront the banking system. There is ample scope for improving performance within the framework of public ownership. It can be done. What is needed is a steely focus on the part of the government.

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The authors are grateful to Siddharth Purohit for data support