The banking Ordinance seems like action taken. But it skirts real solutions to the ongoing crisis

Don't Blow Up in Our Face

Ajay Chhibber

India's banking crisis has been on a slow burn for the last three years. But just like with a slow-fuse Diwali firecracker, the blast will inevitably come. Unfortunately, the more the delay, the bigger the blast will be.

Experience world over shows that banking crises end up always costing more if strong upfront actions are not taken. The latest banking Ordinance gives the appearance of action. But it will delay the inevitable resolution, ending up in a much bigger bill for the Indian economy.

The crisis was not created during the Narendra Modi government's tenure. The UPA government can take the credit for it, exacerbated further by the global economic crisis of 2007-08. But what the Modi government can be accused of is not addressing the issue seriously.

Lend Me Your Fears

Gross non-performing assets (NPAs) have been growing steadily since the global economic crisis as pressure has come on banks to classify properly. In March 2014, the revealed gross NPAs were ₹2.73 lakh crore, almost ₹3 lakh crore by March 2015, and crossed ₹4 lakh crore by December 2015.

Some three years since the Modi government came to power, NPAs are estimated to be ₹6.80 lakh crore. They could be as high as ₹12 lakh crore — about 8% of GDP — if stressed loans are added to the revealed NPAs.

With growing NPAs, the banking sector too has reduced lending sharply. Bank loan growth that averaged around 18% growth a year during 2011-14 fell to under 12% in 2014-15, stayed at about 10% in 2016, and is now running at 5% in 2017. Some of the recent drop can be attributed to demonetisation. But much of the earlier drop is due to the growing bad loan problem.

The real side effect of the banking sector crisis is a sharp drop in private investment, especially corporate investment, which has fallen by around 7% of GDP, hurting growth, which, in turn, has further reduced demand for credit. Despite being flush with liquidity after demonetisation, the banking sector has no borrowers and no great desire to lend either.

Falling real credit growth has resulted in a drop in investment. This has led to a drop in GDP growth by about 1%. With a GDP in 2016-17 of around ₹150 lakh crore, delays in resolving banking sector problems costs the economy about ₹1.5 lakh crore a year in lost economic output. A delay of five years would cost almost ₹7.5 lakh crore, in addition to the hole in the banking system estimated to be around ₹12 lakh crore.

GoI waved its hands at the problem. It initially set up the Indradhanush scheme and tried to bring in more professional management to banks. It then set up a Public Sector Bank Bureau, which had no real powers or money to deal with the issue. It set aside piddling amounts — only ₹10,000 crore in Budget 2016-17 — to deal with the problem.

The new banking sector 'Ordinance' allows the RBI to push banks to take stronger actions. Along with the new bankruptcy law, it may help resolve some of the bad loans, especially in cases where coordination among multiple lenders is needed to take tough decisions on 'haircuts'. But it is unlikely to make a major dent on the growing NPA problem.

The real and quick solution to the NPA problem was already proposed in the Economic Survey as the Public Sector Asset Rehabilitation Agency (PARA). But such an approach requires upfront funding of around at least ₹9-10 lakh crore to transfer the assets and fill the hole in the public sector banks (PSBs). The survey proposed that this be financed either by issuing government bonds or by transferring government securities from RBI, increasing its equity holdings.

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Don't let these booms bust the economy

The Aim is Bond

Both options pose risks. Government bonds of that magnitude would need to be absorbed by the market, drying up liquidity for new lending. In the second case, it would pose substantial risks to the RBI's balance-sheet. Borrowing from the International Monetary Fund (IMF) would be another option. But this would be politically damaging, as it would need to accept tough IMF conditionalities.

Injecting new money will not be enough if the same banking management and structure remain intact. Some PSBs should be merged with others after their balance-sheets have been. Others should be privatised.

By posing it as a twin balance-sheet problem, a case is being made by some to use taxpayer funds to save corporates. The corporate borrowers should be fully penalised for the bad loans to the maximum extent possible. The cleaned-up banking system will then look for new lenders and not go back to the cycle of putting more good money to the same wilful defaulters.

Some tough decisions are needed. Allowing the problem to persist until after the 2019 elections will add at least another ₹3 lakh crore in costs of foregone GDP and probably another ₹2-3 lakh crore in additional NPAs. Time to stop delaying the inevitable.

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