ILLUSTRATION BY AJAY MOHANTY

Worst-case scenario for the banking crisis

A long crisis with a lack of sound short-term, long-term actions can result in sluggish growth in India, similar to that in Japan

Our banking crisis is one of the biggest challenges faced by macro/finance policy in many decades. With banking crises, every day of "extend and pretend" drives up the cost. How will the story unfold in the absence of a strategy for the short term and the long term? We would get a mild "Japanisation" of the economy. Every firm should take steps to reduce exposure to the stressed part of the economy.

We have had one previous experience with a banking crisis. In the mid-1990s, there was an investment boom. Banks did not know how to think about credit risk, and the Reserve Bank of India (RBI) did not know how to regulate banks. By the late 1990s, the world became a more difficult place, and we got a banking crisis. This haunted Yashwant Sinha's time as finance minister. And yet, with hindsight, the numbers involved there were small compared with what we face today.

SNAKES & LADDERS

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Estimates for the hole in Indian banking range from five to 10 per cent of the gross domestic product or GDP. Perhaps five large banks are in reasonably good shape; perhaps 50 large banks (both public and private) are under varying degrees of stress. Things were easier in the late 1990s. In that banking crisis, shotgun marriages were arranged for private banks that got into trouble. For example, Oriental Bank of Commerce was forced to take Global Trust Bank, thus socialising the loss. This time, such shotgun marriages are harder to arrange, as public sector banks (PSBs) are under extreme stress, and private banks would sue.

Last time, the team of Mr Sinha, Jaswant Singh, S Narayan, Bimal Jalan, Jaimini Bhagwati, P Chidambaram, U K Sinha, M Damodaran and K P Krishnan systematically chipped away at forming a strategy and solving problems. Short-term solutions were found (eg split the loss in UTI 50:50 between unitholders and taxpayers) but long-term policy reform was also obtained. For example, the UTI Act was repealed, it was broken into a good UTI (UTI Mutual Fund) and a bad UTI (SUUTI). The good UTI was privatised and sold to a foreign company. This is the scale on which we have to play today.

Let's think the unthinkable. What if we continue to flounder? What if banks continue to hide bad news with the support of RBI, and a short-term and long-term strategy for attacking the problem is not crafted?

The first milestone is where private persons roll their eyes at the claims of RBI and banks. As an example, Jaypee Group has a lot of debt, which RBI and banks have classified as standard, but information about defaults has been leaking out owing to accounting disclosures. If these assets are sold on the market, they are likely to command less than face value. When RBI and banks claim they are valued at par, this elicits mistrust.

The fundamental property of insolvency is that the hole in the balance sheet becomes bigger with the passage of time. The essence of good thinking is to nip things in the bud, to ferret out bad news, to take strong action at a very early stage. This approach defines sound regulation and supervision. This requires RBI reform, which has not begun.

Failures of regulation and supervision give insolvent banks, which must be taken out at an early stage. This requires a new institution called the Resolution Corporation (RC). Financial Sector Legislative Reforms Commission (FSLRC) headed by B N Srikrishna has drafted this law. In August 2015, the Ministry of Finance Task Force led by M Damodaran finished the planning for setting up the RC. Under perfect execution of this project plan, we are two years away from having the RC in the fray. Execution could be less than perfect; for example, 11 months have elapsed and the execution has not begun.

In the unthinkable scenario, there will be no progress on RBI reform and setting up the RC. In this case, the size of the hole will worsen and it will become increasingly obvious that banks are insolvent. With private banks, "extend and pretend" is limited by runs on banks: at some point, depositors lose confidence and walk away. With PSBs, however, the liability of the exchequer is unlimited and "extend and pretend" can on go for a long time. The Comptroller and Auditor General and finance ministry must worry about the contingent liabilities that are being placed on the exchequer. The dominant issue in medium-term fiscal planning is the size of payments that are going to arise owing to the banking crisis.

"Extend and pretend" cannot get too brazen, so RBI and banks have to gradually recognise some of the problems despite the best attempts at obfuscation. This will put pressure on equity capital of banks and choke off bank credit growth.

A long, slow banking crisis, with a lack of sound short-term and long-term actions, has been seen before: in Japan and China. These failures are the source of sluggish Japanese growth in the last 25 years. In the unthinkable scenario, we will get such Japanisation. But our version will be milder, as India's bank credit to GDP ratio is small. We are a market dominated financial system, so the drag on Indian growth will be smaller as compared with what happened in Japan and China. RBI's failures got us into this mess, but these also gave us a small banking system, which limits the damage.

What should private firms do? Chief executive officers and chief financial officers should look at their business environment, and identify firms that are vulnerable to the lack of bank credit. Customers who use more bank financing will face difficulties. Every large firm creates an ecosystem of small firms who use bank financing; this ecosystem will need nurturing. As Indian finance works poorly, large non-financial firms should become financial intermediaries: raise capital from the equity and bond markets, and give debt into their ecosystem. Special effort is required to do big corporate bond issues, which have a chance to become liquid in India's faulty bond market. This will require building trust with global corporate bond investors.

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