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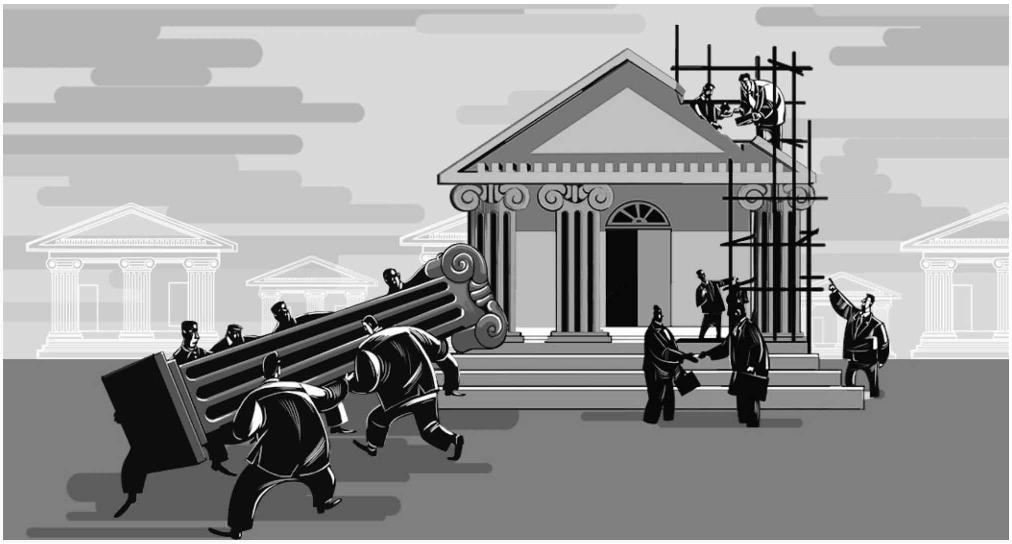

Strategy to deal with the banking crisis

Healthy firms need more financing while RBI needs reforms

SNAKES & LADDERS

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The dust is now settling on demonetisation and the Budget. It is time for a fresh sense of the points of pain in the economy. The defining issue is stagnant investment. Malfunctioning government, balance sheet difficulties and problems with profitability are holding back firms. The banks have balance sheet stress. The behaviour of enforcement agencies may snarl up the private sector. The quick fixes have failed; there is now no alternative to deeper reforms.

Various solutions are being proposed for the banking crisis. Merging PSU banks does not change anything. A big PSU bad bank is the politically attractive choice, but that does not solve the deeper problem. It would make sense to remove barriers to non-bank finance, so as to support the economy at a time when bank credit will not grow, and simultaneously undertake RBI reforms.

The problems of banks in India have long been the subject of a cover-up. But the bad news is increasingly slipping out. There is now an increasing sense that we can count the sound banks on our fingers, and the rest of Indian banking is either bankrupt or has inadequate equity capital.

Some people like the idea of merging PSU banks. But if we merge two sick banks, we get a bigger sick bank. If we merge a sick bank into SBI, we are grabbing a chunk of SBI's equity capital. India will benefit from putting SBI's equity capital to work through SBI's management capabilities, rather than using it to pay for the rescue of a failed bank.

There is also the matter of public shareholders. Company law and Sebi regulations are making it increasingly difficult for promoters to abuse the interests of public shareholders. How will we justify, to the public shareholder of SBI, that this was the best use of his money?

In the private sector, mergers can create value as there are scale economies. As an example, if two banks have 100 employees each, of which 10+10 are IT staff, the merged bank may be able to get by with only 15 IT staff, which makes it possible to eliminate five positions. This kind of restructuring is infeasible in the public sector.

The biggest issue is the long game. The journey of other PSUs is instructive. The end outcome was privatisation for VSNL, CMC, and UTI, and irrelevance for MTNL, BSNL and Air India. To the extent that we are able to privatise some PSU banks in the future, that is a better outcome. Privatisation is easier for small firms. From this point of view, it is better to keep a PSU bank small.

Some people like the idea of making a big PSU bad bank. The bad assets in Indian banking are probably worth 30 per cent of par value. But the big PSU bad bank will buy up NPAs at the full par value. It will be bankrupt from inception. The Ministry of Finance will use taxpayer resources to fill this hole over the coming 10 years.

The big bad PSU bank dumps a large cost upon the taxpayer. Nobody knows how big the problem is. If we assume that the loss is 70 per cent and the NPAs are ₹10 lakh crore, taxpayers are going to be asked to pay ₹7 lakh crore. For a comparison of an alternative use of taxpayer money, a dense metro system for Mumbai costs ₹5 lakh crore. The taxpayer does not have a seat on the table and is unable to protest against the bad bank. The Indian Budget process does not work effectively and is often unable to shoot down bad ideas.

Other than the taxpayer, everyone else loves the big bad PSU bank.

RBI likes this as all sins are forgiven, no RBI reforms are undertaken. The taxpayer pays to clean up Indian banking once again, and RBI can gear up to give us the next banking crisis.

The banks like this for the same reason. All sins are forgiven, and banks can gear up to give us the next banking crisis.

The incumbent promoters of India like this. Their bad companies are not put through the bankruptcy process: Instead, they get to deal with a sleepy PSU bad bank for the next decade. They get back to dealing with a banking system that favours incumbents.

The bad bank is a bad use of taxpayer money. It removes the pressure to reform, and exacerbates India's fiscal stress. We should solve problems at the root cause, instead of asking taxpayers to pay for the losses associated with repeated banking crises.

What is the way forward? A two-pronged strategy is required.

The first element is to address the financing problems of the Indian economy. Private sector bank credit is growing slowly, and a disproportionate fraction of this is going to bankrupt firms, thus choking bank credit access to healthy companies. The magnitudes involved are, however, smaller than those seen in banking crises elsewhere in the world, as private sector credit in India is only around 50 per cent of GDP.

We need to bring more financing to healthy firms. For this, four non-bank channels of financing need to be opened up. They are capital account liberalisation, NBFCs, the bond market and distressed asset funds (ARCs). All four areas have been choked by mistakes in regulation. Financial sector reforms can reverse these mistakes.

The second element of the strategy is RBI reform. Why are we getting a banking crisis every decade? Why are banks underpricing credit, and then running into trouble when a certain proportion of NPAs inevitably surface? Because of technical failures of bank regulation and supervision at RBI.

There are problems in the working of the RBI board, the process through which regulations are made, the process through which licensing and investigations are done, and the quasi-judicial process through which punishments are awarded. RBI has agreed to implement the "FSLRC Handbook" which solves all these, but has not followed through with the implementation. The role and function of RBI requires reform, so as to focus RBI upon its two deliverables: Price stability, and soundness of banks.

The second element (RBI reforms) is a five-year process. This will give us a destination where India is able to safely have a banking system. Open entry for private and foreign banks will then be possible. The first element (opening up to non-bank channels) can yield results in 2017 itself.

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