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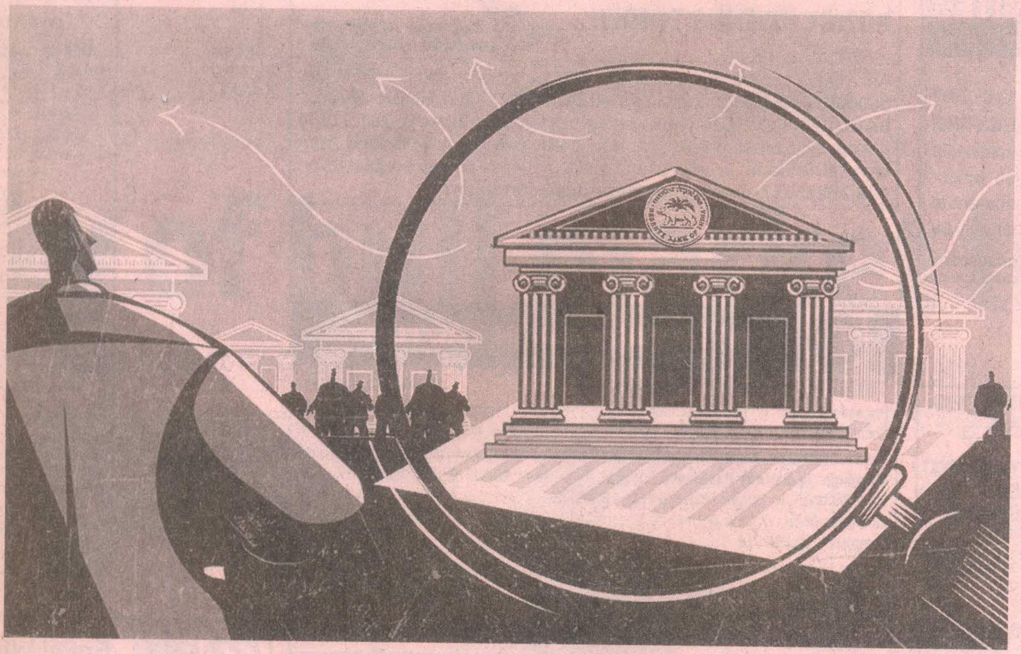

Does the ordinance solve the banking crisis?

The biggest threat in banking regulation is the pressure within the RBI to hide bad news at banks, as faltering banks reflect poorly upon bank regulation by the regulator

SNAKES & LADDERS

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Bureaucracies are prone to failure. Clarity of purpose and accountability are essential for obtaining performance. The decisions that are required when dealing with a bad loan require energy and profit-motivated thinking. It is hard to do this in PSU banks, and it is harder to do this at the RBI. We know how to build the RBI to do monetary economics and banking regulation. We do not know how to build the RBI to make commercial decisions. It is unreasonable to ask the RBI to get into the driver's seat when dealing with bad assets.

The bureaucracies in banks have fumbled on dealing with NPAs. In response, we want to give overriding powers to the bureaucracy at the RBI. We should pause and ask: Why do we believe the bureaucracy at the RBI will make the right decisions?

Dealing with an NPA is not a simple matter. The debtholders have to sit across the table and negotiate about a possible restructuring. They have to evaluate what recoveries can be obtained if the Insolvency and Bankruptcy Code (IBC) is invoked. They have to stoke the pipeline of private equity funds and strategic buyers who might toss in a bid if the IBC is invoked. They have to form a rational sense of the NPV (net present value) that can be realised by going down the IBC route, and settle for a deal offered by the borrower if the cash offered is higher. If there is no deal, then the IBC has to be invoked, and decisions have to be taken between the multiple offers on hand.

This work is entirely in the domain of profit-motivated commercial decision-making based on a speculative view of the future. What bids will arise through the IBC route? How much money will be obtained and when? How trustworthy is the shiny new IBC machinery? How much of a discount do we accept, when comparing an offer of hard cash today, in exchange for the uncertainties of the IBC?

All over the world, banks tend to be bureaucracies and fare poorly at this kind of work. Banks in India are particularly bad at this, as RBI regulations have converted banks into bureaucracies that blindly follow micro-managing regulations. The ability to look into the future, form speculative views, and manage risk is largely absent in the Indian banking system. This problem is, of course, the worst at PSU banks, which are the least thinking bureaucracies, through the twin influence of the RBI and ministry of finance.

The right place for this work is a private equity fund. A private equity fund is fully private, is not hindered by regulation, is able to make sound decisions quickly owing to the absence of bureaucracy, and has strong financial incentives for the decision makers. The right way forward is for banks to sell bad assets to private equity funds.

The wrong place for this work is the RBI. The RBI is a bureaucracy, more so than PSU banks. How will commercial decisions get taken in such an environment? How will speculative views about the future be formed? How will the choice between two risky paths be taken? Who will be blamed when things go wrong?

The basic rhythm of a regulator is the three process manuals that govern the legislative, executive, and quasi-judicial branches. In its legislative function, the RBI must operate a process manual that governs how regulations are written. In its executive process, it must operate a process manual that gives out licences, conducts investigations, and detects wrong-doing. In its quasi-judicial function, the RBI must operate fair procedures through which an independent mind will hear both sides and write a reasoned order that will stand the test of appeal at the Securities Appellate Tribunal and then the Supreme Court. These three processes are surrounded by board governance, and the loops of reporting and accountability.

Building these five components are a tall demand upon the organisation. We have a huge task in front of us, in building an RBI that will have five sound process manuals and live by them. But at least, in these five areas, we have a body of knowledge and international experience on how this is to be done. The draft Indian Financial Code has the blueprint of five process manuals. We have the broad picture on what has to be done, and now confront the complex management of change management, of the RBI reforms that get us there.

Even in the most ambitious plans for RBI reform, there is no plan to make commercial decisions inside a regulator. We don't know how it can be done. There is no body of knowledge or international experience that guides us on how this is to be done. There is no document like the Indian Financial Code which has the blueprint for how to do it.

The biggest threat in banking regulation is the pressure within the RBI to hide bad news at banks, as faltering banks reflect poorly upon bank regulation by the regulator. This problem will be exacerbated if the RBI has made commercial decisions about NPAs.

It is unfair to place these new burdens upon the RBI. The RBI has its hands full, learning how to do inflation targeting and regulate banks. There is not a time to increase the burden upon the RBI's top management, particularly when the increased work (making commercial decisions about NPAs) will make it more difficult to learn how to do banking regulation.

Sound policy requires thinking through gritty management questions in public administration. We should not just wave our hands in the air and say "let's have the RBI do it". We should think more about incentives, skills, process manuals and conflicts of interest. State capacity in India has, too often, been damaged by making mistakes on the mandate of agencies. The RBI's emergence as a capable central bank and banking regulator is hampered by the unlikely combination of functions which has been placed within it. The additional role will be performed poorly and will hamper the core business of building a sound RBI.

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