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The long winter in banking

The silver lining lies in the fact that India is a market-dominated financial system with a fairly small role for banking

Indian banking is limping. We often get calls for decisive action that will quickly solve the problem. However, we are reaping the consequences of decades of policy mistakes. The best policy reforms will solve problems slowly. Under perfect conditions, we are in for a long winter in bank lending. The rest of fiscal and financial policy should be designed around this foundation. Luckily, India has a small banking system, and the drag upon the economy is limited.

Banking is the business of borrowing from the public and then lending this capital. The price in lending has to account for a certain proportion of failed loans, which are an inevitable part of life. Bank managers like to hide bad news as this overstates profits and avoids scrutiny of their lending decisions. Sound banking regulation ensures that bad loans surface rapidly and that banks fully recognise the associated losses.

We in India have had unsound banking regulation. Regulation has collaborated with bank managers in hiding bad news. In this environment, banks have systematically mispriced credit: They have charged too little for loans.

Out of ₹100 of corporate credit, suppose ₹10 goes bad and yields recoveries of ₹5.5. This loss of ₹4.5 has to be paid for by profitable lending to the ₹90. This cost alone requires an interest premium of 5 percentage points. Banks in India are used to the idea of never facing up to bad debt and have been charging too little for their loans. This has given chronically poor returns on equity even in good times, a great thirst for capital-for-growth even in good times, and collapses of capital adequacy in bad times. The root cause of this is faulty banking regulation, which gives banks the comfort of thinking loans that go bad can be hidden away for many years.

SNAKES & LADDERS

AJAY SHAH

The biggest achievement of bankruptcy reform is that it has become hard to hide bad news. Once the Insolvency and Bankruptcy Board of India (IBBI) imposes adequate transparency on the credit market, the names of defaulters and recovery rates will be part of our standard corporate databases. This will make it hard for banks to claim the deadbeats are standard assets. The RBI needs to do more on provisioning: There is too much optimism in the 50 per cent markdown that the RBI requires once the National Company Law Tribunal proceedings begin. Assuming that the IBBI and RBI do their work, going forward, we will have achieved a disruption of the long-established misbehaviour of banks. This will be a historic milestone for Indian finance. For the first time in India's history, banks will be under pressure to learn how to do banking.

A similar story is unfolding on individual bankruptcy. In the past, we had loan waivers from time to time. These used taxpayers' money to bail out banks faced with stressed loans. Once the IBC (Insolvency and Bankruptcy Code) personal insolvency falls into place, episodic loan waivers will be replaced by a quiet every day operation of IBC personal insolvency, which includes debt write-offs for the poor through the "fresh start" mechanism. This will be a healthy way to build the ecosystem for individual credit. But it will shift the burden of bad loans from taxpayers to banks. Once again, banks will be under pressure to learn how to do banking.

Indian banking thus has many hoops to jump. The RBI has to improve its processes, and learn how to do banking regulation and supervision. Banks have to learn how to do banking. There is a large capital shortfall, which needs to be gradually addressed. These are not small events; they are once-in-a-lifetime developments for the country.

There are calls for quick decisive action, for the use of a "big bazooka" of public money, to quickly solve the banking crisis. Taxpayer money is precious, and we should not kick the can down the road. We should be more gentle in our expectations. What we are faced with is a difficult problem and there will be no quick answer. It may take five to ten years, depending on the quality of the team that the Ministry of Finance is able to deploy for the task.

In the long historical evidence, bank credit to the private sector has grown by roughly 10 per cent in real terms per year. At the 4 per cent inflation target, this translates into 14 per cent nominal annual growth. We should plan for a long winter in banking, where such values will not be obtained for a long time. Relative to GDP, banking must shrink. A large banking system is a luxury for countries that are able to create state capacity in banking regulation and supervision.

The silver lining lies in the fact that India is a market-dominated financial system with a fairly small role for banking. Non-food credit by banks to all private persons is at ₹79 trillion (November 10) while the market capitalisation of the CMIE Cospi index (December 8, just 2,477 liquid companies) was ₹146 trillion (₹1 trillion = ₹1 lakh crore). Compared to countries like China or Japan, which experienced deep banking crises while having large banking systems, the situation here is much better.

We should reconcile ourselves to this long winter, and look for optimal public policy initiatives. Improving entry barriers in banking is not too useful until RBI reforms are completed; else the new banks will fail like the old banks did, and we will get a bigger failed banking system. The key levers are in non-bank finance. Market-based financing — the equity market and the bond market — is the way forward. This requires strengthening the Securities and Exchange Board of India and exchanges, liberalising the equity market, and undertaking the fundamental changes required (Public Debt Management Agency) for the bond market to take root. The fintech revolution can get credit out to small firms and individuals, but this requires financial regulatory process reforms, and it will require financing from the bond market. Capital account liberalisation, and domestic insurance and pension reforms will foster resourcing in the equity and the bond markets.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi