ILLUSTRATION BY AJAY MOHANTY

First, build a capable RBI

We should block the nominal growth of banking until we get to a minimum level of capabilities at the regulator

A certain minimal state capacity in bank regulation and supervision is required, and we are repeatedly discovering this is absent. Some people see this as a question of public versus private banking. Private banks in India also have major difficulties with non-performing assets (NPAs), which suggests that the common factor of banking regulation is the root cause. Our first port of call has got to be building a capable RBI. The one thing worse than a badly regulated public sector bank is a badly regulated private bank. We need to execute a slow decline in the size of the banking system, while the RBI develops capabilities.

The problem

In the Punjab National Bank (PNB) crisis, we discover that SWIFT messages were sent out, giving guarantees to private persons, which were not reckoned in the main accounting system of the bank. When supervisors walk into a bank, this is one of the first things they should be asking. What's the list of guarantees that were given through SWIFT? Are they represented in the accounts? For a random sample of these, can you prove that the due process of risk management was followed? These are elementary things that bank supervisors do.

There are numerous other elements of the PNB story which would have been caught by elementary capabilities in banking supervision: Utilising the weekly reports that the RBI gets from banks on forex activities, rules that mandate regular transfers of people in sensitive positions, etc.

In a similar fashion, the NPA crisis would have been precluded if regulators had done elementary things. Banking supervision for commercial loans is not hard. It requires a rule whereby faltering assets are detected and rapidly marked down to zero. This would ensure that a false portrayal of bank soundness would not happen. When the bank sees that the internal value of the asset is zero, it would apply commercial considerations in recoveries. When recoveries come in, they would go straight to the bottom line and come back to the equity capital of the bank.

None of this is rocket science. But we have very poor state capacity at the RBI, and so these elementary things don't get done. In the Indian state, we see persons working in their own self-interest, and failing to deliver on the objectives of the organisations that they represent. The railways is shaped by the interests of the railways bureaucracy, education is shaped by the interests of the education bureaucracy, defence is shaped by the interests of the uniformed ones, and the RBI is shaped by the interests of the RBI bureaucracy.

SNAKES & LADDERS

AJAY SHAH

This is not about PSU banks

There is a wave of criticism of public sector banks. But the problem is one of supervision and not ownership. If the RBI had done the right things in supervision, these mistakes would not have happened in banks, public or private. Private banks such as ICICI Bank and Axis Bank also have tremendous NPA problems. As an example, when the government announced recapitalisation of public sector banks, the shares of ICICI Bank went up by 9 per cent. Why? Public money would now be used by public sector banks to rescue defaulters, and these same defaulters have borrowed from ICICI Bank.

Public sector banks are easier to regulate. The top management of these bank is given low-powered incentives of a fixed salary and no shares. Their top management is fundamentally deferential to the RBI. In contrast, senior managers of private banks are unruly. They have high-powered incentives with high salaries, bonuses, stock ownership, and stock options. They will tenaciously look for and exploit loopholes in rules. Regulating private persons requires greater state capacity.

For this reason, the right sequencing is to first build state capacity in banking regulation. Only after this is well in place should public sector banks be privatised.

Road map to RBI capacity

What does it take to obtain a high-performance RBI? There are four ingredients. The first is clarity of purpose: The RBI must be about the pursuit of sound money and sound banking. We have begun on the former with inflation targeting, and not begun on the latter. There are myriad other objectives which are inducing failure on all fronts.

The second is the role of the board. At present, the RBI board meets for coffee and is ignored by the organisation. The board must control the organisation design, resource allocation, and process manuals, and hold heads of departments accountable.

The third are detailed procedures to be followed for the legislative, executive, and judicial functions. At present, the RBI staff have full discretion in how these things are done. This has given a bias in favour of arbitrary power and low competence. What is required is detailed procedural law that gives rule of law, fair play, and competence.

Reporting and accountability come fourth. At present, the RBI is a remarkably opaque organisation. It is the largest and most complex financial wing of the Indian state, but there are only four pages of financial disclosure, and it is not audited by the Comptroller and Auditor General. Copious high-quality reporting will generate accountability.

These four ingredients have been designed with great thoroughness in the draft Indian Financial Code (IFC). This is the key milestone in the journey to a capable RBI.

Finally, it takes two hands to clap. For the RBI to achieve high performance, its parent department (the department of economic affairs) also needs to develop institutional capabilities and perform the roles envisaged of it in the IFC.

While this is not done

This is a long-range project. We'd have to enact the IFC, and then spend many years building capabilities at the RBI. It would take five to 10 years to get through. What is to be done in the meantime?

In the meantime, we should see a large banking system as a threat. A country that does not know how to run the ATC (air-traffic control) should not have airlines. In a country that does not know how to regulate banks, we should systematically reduce the size of banking relative to GDP. We should foster non-bank financing, and block the nominal growth of banking until we get to a minimum level of capabilities at the RBI.

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