

When the supervisor slept

PNB, ICICI could have averted malpractices if banking system had a mechanism that sounded timely red alerts



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THE MATTER PERTAINING to the ICICI Bank's CEO Chanda Kochhar goes beyond the question of propriety. It follows close on the heels of the Punjab National Bank-Nirav Modi fraud case. While the first case occurred in a government-owned bank, the second incident brought focus onto a private bank. In both cases, investigative agencies like the CBI and the ED have stepped in. The common missing factor is the bank supervisor.

Banking is a non-transparent business. Depositors do not know how their money is being invested. Loans are normally given on the basis of the bank management's judgement. The management assesses the health of a company and its business plans and on the basis of that, decides whether to give the company a loan or not. Bank depositors, the ones whose money is being lent out, do not have information about the company. Regulation and supervision of banks have the objective of protecting bank consumers, reducing the risk of bank failure and limiting the systemic risk arising from the bank's operations to the financial system as a whole. The supervisor examines the books of a bank with these objectives in mind. The supervisor is not, and should not be, involved in each loan decision. However, the principles based on which loans are given, the integrity of the management, the bank's audit system, its IT systems and its risk assessment models do come under the bank regulator's purview.

Speed is critical in ensuring that regulation meets its objectives. The pertinent question is: Does the supervisor catch loans getting stressed and becoming non-performing in time for the top managers or the board to be held responsible for their incompetence or complicity?

Evidence does not seem to suggest that banking supervision in India has, so far, been timely. In an earlier article ('Extend and pretend,' IE, October 31, 2017), I argued that the RBI has failed to spot stressed assets in time and created a huge burden for the tax payer. The banking supervisor had allowed banks to hide bad news and permitted them to continue ever-greening loans; this led to rising

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NPAs. In December 2017, gross NPAs in the Indian banking sector stood at Rs 8.4 lakh crore. This crisis alone brought a recapitalisation bill of Rs 2.11 trillion to the taxpayer. The NPA figures and the recapitalisation needed are likely to grow.

The PNB-Nirav Modi case and the ICICI conflict of interest case suggest further weaknesses in bank supervision. The PNB fraud will cost more than Rs 14,000 crore. If the lack of integration between the CBS (Core Banking Solution) and SWIFT (Society for Worldwide Interbank Financial Telecommunication) allowed PNB officials to cheat, there could be more such cases hiding in other banks.

The ICICI case revolves around a loan given to Videocon from whose promoter an immediate family member of Kochhar may have benefited. The CEO was part of the committee that made the decision to give the loan. The loan was one in which there could have been a possible conflict of interest. It subsequently turned into a non-performing one. This does raise questions about the people involved and their ethics. But the episode also shows in poor light the systems which are meant to ensure that possible conflicts of interest are brought to the attention of the banking supervisor.

An important element of the story is the speed with which a malpractice is caught by the banking supervisors. Again, there is a parallel between the ICICI and the PNB case. In the PNB (and other public sector banks) there was a lack of integration between the CBS and the SWIFT system through which money was transferred abroad for Nirav Modi. The bank supervisor appeared to have been inadequately apprised of the magnitude of the damage that this lacuna could bring upon the bank. It did not promptly see the problem when it occurred and that allowed the beneficiaries to milk the system for many years before they were brought to book. In the ICICI case, recognition of the Videocon loan as a bad asset took a long time. Both cases appear to have festered for many years before the CBI or the ED stepped in. What

steps did the RBI take in the two years since the allegations were made?

In the ICICI case, the bank involved is designated by the RBI as a Systemically Important Bank. This means that if the bank gets into trouble, the entire financial system of the country could be jeopardised. This also means that this bank would have received heightened supervision by the banking regulator. Risk-based supervision implies that the RBI has a special framework for Systemically Important Banks and supervisors watch the bank more carefully. In many jurisdictions, dedicated supervisory teams are assigned to each systemically important financial firm.

The common thread in these cases is banking regulation and supervision. One key question is whether the oversight system for regulation and supervision of banks is adequate. Does the supervisor have red alerts going off when there are possible conflicts of interest? Is there a risk-based system of supervision in place? This is similar to the PNB fraud where the question was: Does the supervisor have red alerts going off for banks where the Core Banking and the SWIFT systems do not talk to each other? The RBI knew that this created risks and officials spoke about it in seminars, but what matters is whether banks in which there is no integration face greater supervisory scrutiny?

The immediate effect of the ICICI case will be to put an end to the demand for privatisation of public sector banks. That is not a bad outcome because to see the problem of the bad performance of Indian banks as one related only to public ownership of banks is a partial view. While ownership is a very important reason for the ills of Indian banking, the lack of adequate regulation and supervision are equally important. We first need to develop our regulatory and supervisory capability before privatising public sector banks or unleashing a large number of small banks onto the system.

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