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Why RBI should be given more powers and age old banking laws be fixed to avoid scams like PNB

BY [SALONI SHUKLA](#), ET BUREAU | UPDATED: MAR 21, 2018, 09.12 PM IST

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What should have been a trigger to initiate the long overdue reform in the banking industry, is turning into a slugfest. Public spat between the [Reserve Bank of India](#) and the finance ministry in fixing the blame over the Rs 13,000-crore [Punjab National Bank](#) scam involving diamantaire [Nirav Modi](#) and Mehul Choksi is exposing the fault lines running beneath the complicated Indian banking system. Indian banking is like the poor countryside where the latest model of Mercedes Benz and a pile of garbage co-exist. Some of the most sophisticated transactions are executed, but as the [PNB](#) scandal shows, it also lacks some elementary risk management systems.

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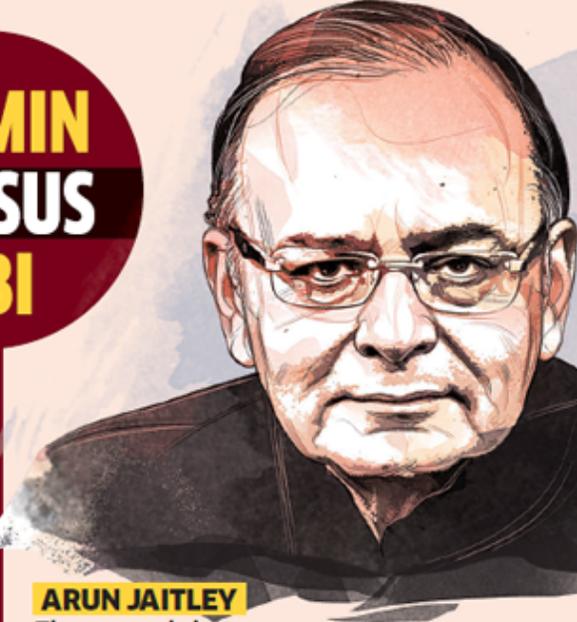
At the heart of the debate is whether the [RBI](#) should have identified and plugged the gap with its powers to supervise, inspect and direct banks, or the regulator’s hands are tied when it comes to having its way with banks that are owned by the state.

The banking industry is plagued by the same menace that is holding back the nation on other fronts too – many overlapping laws that make regulation difficult and help the smart one escape.

“It’s a unique situation that in the banking industry we have multiple acts,” says Saurabh Tripathi, partner at Boston Consulting Group. “If you read these acts, they say that the boards of the public sector banks have no real power. While the government says that consolidation of PSU banks will be led by its boards, the act actually says that the boards will do nothing if they don’t have prior approval from the central government. And that is very clearly written.” There are at least four different Acts that govern Indian banks – the

Banking Regulation Act of 1949; public sector banks are regulated by the government under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970; the Bank Nationalisation Act, 1980; and the State Bank of India Act, 1955.





URJIT PATEL
RBI Governor

- RBI cannot remove directors & management at PSBs as Section 36AA(1) of the BR Act is not applicable to PSBs
- Section 36ACA(1) of the BR Act that provides for supersession of a bank board is not applicable to PSBs
- Section 10B(6) of the BR Act that provides for removal of CMD of a banking company not applicable to PSBs
- RBI cannot force a merger in the case of PSBs as per Section 45 of the BR Act.
- RBI cannot revoke the licence of a PSB under Section 22(4) of the BR Act
- RBI cannot trigger liquidation of PSBs as per Section 39 of the BR Act

ARUN JAITLEY
Finance minister

- RBI has enough powers under Banking Regulation (BR) Act to regulate PSBs
- FinMin draws up a list of 13 provisions in BR Act that empower RBI
- Section 36 of the Act allows it to order changes in management
- Section 30 allows it to call for special audit
- BR Act empowers RBI to appoint its officers to banks, inspect any bank & its books and examine a director or officer on oath
- Govt claims BR Act restrains it from acting against PSBs to ensure their autonomy
- Finmin can't inspect a bank or give directions as per Section 8 of the Banking Companies Acquisition Act, without consulting the RBI

(From finmin sources)

The Amalgamation Moves

Acquirer	Target Bank	Year	Reason
ICICI Bank	Bank of Rajasthan	2010	RBI forced merger
HDFC Bank	Centurion Bank of Punjab	2008	Merger after troubled times
Federal Bank	Ganesh Bank of Kurandwad	2006	RBI forced merger



IDBI Bank	United Western Bank	2006	RBI forced merger
Centurion Bank of Punjab	Lord Krishna Bank	2006	RBI forced merger
ICICI Bank	Sangli Bank	2006	RBI forced merger
OBC	Global Trust Bank	2004	RBI forced merger



THE PNB FRAUD

India's second biggest state-run lender in February admitted publicly that jeweller Nirav Modi and his uncle duped it to the tune of Rs13,000 crore through misuse of an instrument called the Letters of Undertaking, or LoUs.

These LoUs are an implicit guarantee provided by a bank on behalf of its customer – in this case Modi and Choksi – that in case of a default the bank would make good the losses. Such guarantees are sanctioned when the customer provides security for the amount equivalent to the LoUs.

Between 2011 and 2017, PNB's Brady House branch in Mumbai, a stone's throw away from the RBI headquarters, issued LoUs without any collateral and rolled over the loan amount since Modi and Choksi did not pay. It came to light when a staffer Gokulnath Shetty, who has since been arrested, retired and a replacement found out the violations of rules. The bank said the fraud could not be detected because of its basic banking system and the one used for international transactions – Swift – were not integrated. As it acquired political colour, finance minister Arun Jaitley indicated the regulator should share the blame.

"We must always remember that regulators have a very important function. They ultimately decide the rules of the game and they have to have a third eye kept perpetually open and turned towards the sector. But unfortunately, in (the) Indian system, we politicians are accountable, the regulators are not," Jaitley had said last month. The blame game intensified with PNB accusing other banks of lax standards, the government pointing fingers at the RBI, and Governor Urjit Patel now saying it did not have enough powers to whip erring state-run banks, which are shielded by the government.

"This legislative reality has in effect led to a deep fissure in the landscape of banking regulatory terrain: a system of dual regulation, by the finance ministry in addition to RBI," said Governor Patel.

BARKING UP THE WRONG TREE

The regulatory discrepancy between the private sector and public-sector banks is well known in the industry circles and many have been

pointing it out for decades, including the first Narasimham Committee in the 1990s. But it has fallen on deaf ears. Public sector banks had implied guarantee from the government and its appointments are made by the government and the RBI rarely intervened, though it was also a part of the board of directors. But it is slowly withdrawing citing conflict of interest.

It is no secret that many appointments to the banks' board and even to the top management were partly political. But to show that the PNB fraud is a failure of the RBI and the regulator citing lack of powers to contain it may be misplaced.

“To suggest that the PNB fraud points to major regulatory failure is incorrect,” says TT Ram Mohan, professor of finance at the Indian Institute of Management, Ahmedabad. “The procedure is for the bank to report the fraud once it has happened and then the RBI comes in to see what the inadequacies or failures were. It's little too much to expect the RBI to uncover frauds that is the responsibility of the bank management and the internal and external auditors.”

But at the same time, the regulator pointing to lack of powers on this occasion doesn't cut much ice since it is more to do with inspection and supervisory powers, where it enjoys absolute freedom.

“In terms of supervision, it has powers,” says C Rangarajan, former governor at RBI. “So far as supervision is concerned, there are enough powers. But to take action against the public sector banks, consultations with the government is needed because government is the owner of the PSU banks.” The question of effecting management changes and overruling boards do not arise at all. Did RBI ever go to the government seeking changes in a particular bank? “I don't find any instance in my memory when RBI recommended the removal of a chairman or an executive director of a state-run bank and the government said no,” says DK Mittal, former secretary at the Department of Financial Services, Ministry of Finance. “Or RBI said these two banks should merge and the government said no. I think unless RBI makes these recommendations, the intention of the government will have to be tested on that ground.”

THE WAY AHEAD

Given that the fraud has become a tool for political parties to throw muck at each other, a reasonable debate about the issue and how to prevent its recurrence and improve the system may be difficult.

Although the PNB issue doesn't involve the absence of power or interplay of various legislation leading to let the fraud going undetected, it throws open an opportunity to revisit various laws that govern one industry.

Just like one set of rules govern companies in aviation, mutual funds, refining and telecom, the banking industry needs a uniform set of

laws across the spectrum, be it private or state-owned. “RBI should have full authority over any kind of banks and ownership should not have any kind of impact,” says former secretary Mittal. “We don’t see this regulatory differentiation in the mutual fund industry where some PSUs have set up such companies.”

The current sparring does not involve more powers to a regulator, or the government ceding control over some business units, but it is about a level playing field. “When it came to resolution of bad debt, the government asked the RBI to take charge, so you might as well give them equal powers to govern public sector banks,” says Tripathi of BCG. “It’s not like they are asking for more powers, it will just be identical with the powers they have in governing private banks.”

Over to Minister Jaitley now. Should foreign portfolio investment.

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