

Why RBI is right on bank reforms

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Reserve Bank of India Governor Urjit Patel sounds a bit self-serving when he quotes the IMF and World Bank's FSAP report as saying the central bank had made substantial progress in 'strengthening banking supervision', but that it was constrained by not having adequate powers to, say, "remove PSB (PSU Banks) directors or management who are appointed by the government of

India (GoI)” and having “limited legal authority to hold PSB Boards accountable regarding strategic direction.” While elaborating on this, Patel says the power of superseding a bank board does not apply to PSU banks. In the context of the Punjab National Bank scam, while not actually naming it, Patel says [RBI](#) had identified “the exact source of operational hazard”—the SWIFT system—and had issued “precise instructions via three circulars in 2016 to enable banks to eliminate the hazard”. He then goes on to say, “clearly, the internal processes at the bank failed”. What Patel is ignoring here is that, as a regulator, it is not enough for RBI to identify the danger, it has to ensure the loopholes are plugged. After all, that is why RBI has annual inspections. Indeed, if Patel were to get the powers he talks of, and could remove bank managements, how would that ensure the SWIFT loopholes were plugged?

Where Patel and his predecessor [Raghuram Rajan](#) have to be congratulated though, is that while banks were merrily ever-greening dubious loans, RBI inspections never uncovered this in the past. It was only after Rajan’s insistence on the Asset Quality Review (AQR) that the extent was forced into the open, and now, RBI is forcing PSU banks to report, and recognise, the “divergence” in their estimates of bad loans and that of RBI. RBI has now come up with even stricter guidelines on early recognition of stressed assets. Patel is on stronger grounds when, while saying no regulator can stop all frauds from happening, he argues that private sector banks do better because “the real deterrence arises from market and regulatory discipline, and their confluence”. If a PNB-type scam happens in a private bank, it reduces its ability to raise fresh capital—especially if RBI imposes Prompt Corrective Action (PCA) restrictions on it—and this ensures “there are incentives to invest in governance”.

In contrast, when a PSU bank is placed under PCA, this matters less to it since government ownership means the bank can never fail; naturally, the need to invest in governance structures is less urgent. Also, given how PSU banks are rapidly losing market share (an 8 percentage point fall in the last four years alone in the loan market) and are facing a much sharper fall in terms of value (from 43%, the share of PSU banks in overall banking market capitalisation is down to 23%), the government—and the Opposition parties—would do well to pay attention to this.