View: India's banking system requires stronger watchdog

BY BLOOMBERG | UPDATED: APR 21, 2018, 06.33 AM IST

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To many economists, the solution to India's bad-loan crisis appears as obvious as the problem: Privatize state-owned banks, which have racked up billions more in soured loans and performed much worse than their private-sector counterparts. Yet, unless the government first strengthens its ability to supervise all banks, public and private, selling some of them off will be slim guarantee against another crisis.

One can understand the urge to privatize. A long-mooted bankruptcy law finally passed last year allows any single creditor to initiate the bankruptcy process. This has disrupted the earlier cozy system, whereby banks hid the full extent of their soured loans and the Reserve Bank of India, which oversees the sector, looked the other way.

As bad loans tumbled out of the closet, it quickly became clear that banks didn't have nearly enough equity capital. The government has proposed a $32 billion recapitalization package. Saddled with this enormous bill, taxpayers rightly want some assurance that their money isn't going to waste.

Propping up bloated and inefficient state lenders would seem to ensure a repeat of the current crisis. As long as the government dominates the banking sector, politicians will continue to interfere with lending decisions. Boards will be stacked with indifferent yes-men and yes-women. Managers will face little pressure to improve.

The recent $2 bn scandal at Punjab National Bank -- the second-biggest state lender -- has focused voter anger. A politically wellconnected jewelry magnate, Nirav Modi, allegedly bribed PNB officials to provide him letters of credit overseas. The accused officials were reportedly able to hide their activities by taking advantage of the bank's poorly integrated IT systems and lax oversight.

In recent weeks, though, the performance of two of India's biggest and most respected private banks has called this easy narrative into question. Bad loans have surged at both ICICI Bank Ltd. and Axis Bank Ltd. to 7.82 percent and 5.28 percent respectively. Worse, questions have been raised about ICICI CEO Chanda Kochhar, whose husband allegedly benefited from a business relationship with one of the bank's biggest borrowers. (All three figures have denied any wrongdoing.) Skeptics of privatization have been quick to point out that cutting ties to the state is no guarantee of good management.

That's true. It's equally true that the common factor across both sets of bad-loan crises has been the striking ineffectiveness of external supervision. Either knowingly or unknowingly, the RBI allowed both private and state-owned banks to build up dangerously large amounts of stressed assets. Officials may have reasoned that banks didn't have the resources to provision for bad loans. In that case, however, they shouldn't have allowed those banks to expand their books.

RBI officials have spoken about the need for banks to reconcile information across multiple IT systems, which might have prevented the alleged Nirav Modi scam. Yet those exhortations haven't been translated into regulations, enforcement or sanctions against non-compliant banks. In the ICICI case, the RBI is reported to have looked into the allegations about Kochhar's husband in 2016. It flagged some issues for investigative agencies to pursue, but found no wrongdoing.

At a minimum, the RBI's supervisory capacity needs strengthening -- including better training, more specialization and longer tenures for officials, among other measures that the bank itself has recommended. In today's increasingly complex financial world, supervisors also need to have processes in place to evaluate bank corporate governance and clearly set out expectations for boards.

But that alone isn't likely to be adequate; greater checks and balances need to be built into the system. The government is looking to create a resolution corporation, similar to the U.S. Federal Deposit Insurance Corporation, which would partner with the RBI in handling failing banks. As currently envisioned, the corporation could only get involved at later stages, once a bank is classified as troubled. Instead, it should be able to look over the central bank's shoulder in evaluating all banks, including those considered at low or moderate risk. Otherwise there's a chance that danger will be identified too late, when financial firms are in serious trouble and can no longer be sold as running concerns.

Other reforms are needed as well to improve financial regulations and increase competition in the sector. And, yes, state-owned banks should ultimately be sold off. If those banks aren't to run into the same problems under new owners, though, the government must ensure that the officials charged with overseeing them have the incentive and the resources needed to do so effectively. This is a devilishly complex problem. Any easy answer is probably the wrong one.

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