

Raghuram Rajan's AQR for PSBs wasn't a pragmatic move

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Banking dynamics were changing during Rajan's Governorship, so were policies of regulator. The Note reads like a list of reaction function, not a research-based, policy-driven strategy.

The Note to the Parliamentary Committee by [Raghuram Rajan](#), the former Governor of the Reserve Bank of India ([RBI](#)), reported widely in the media, makes interesting reading on the story of non-performing assets (NPAs). The Note (PN) needs

analysis and closer examination because not all public sector banks (PSBs) had slipped into high NPAs. Also, in following with the findings of the great financial crisis, the role of credit rating agencies, evaluators, valuers, legal experts, auditors and chartered accountants should have also been questioned, and not just PSBs.

In an emerging country, banking is an important source of financial resources. The banking system in India has evolved over the years, and especially since 1991. The system is complex, with PSBs, old and new private sector banks, foreign banks, small banks, payments banks, and cooperative banks competing with non-banking financial companies to mobilise financial resources. To regulate and supervise such a complicated banking network, all by RBI, is itself a challenge. Further, PSBs are also regulated by the central government, and cooperative banks by state governments. In addition, in a vast country like India with 22 major languages and 720 dialects, banking is indeed unique. Banks, by virtue of their business, serve as advisers to individuals and small businesses.

In India, PSBs, laden with social objectives, have played a very prominent role in infrastructure, agriculture, and micro, small and medium enterprises. It can be argued that the financing role of PSBs in the phase of global crisis substituted government support, which otherwise could have escalated the gross fiscal deficit. Further, in extending banking to the rural areas, and to the masses, it is PSBs that have outperformed private and foreign banks—clearly demonstrated in the success of the Pradhan Mantri Jan-Dhan Yojana (PMJDY).

It is ironic that banking theoreticians, academicians, practitioners and scholars in India have yet not formulated specific parameters for PSBs and enthusiastically apply generalised Basel norms, which are mainly designed for private sector banks. On the basis of generalised parameters, PSBs are pronounced as sick, vulnerable and corrupt institutions. The recent instances in private sector banks substantiate the view that this is a banking phenomenon, and not just prevalent in PSBs.

Interestingly, in the US, historically, the Federal Reserve was created to address the issue of regular failure of banks—those banks in character were mainly private. The Glass-Steagall Act of 1933 (in the US) would make informative reading for sceptics,

as also the Vickers Report (the UK, 2013) and the Dodd-Frank Act (the US, 2010). It is interesting to note that banks in the US are far behind India in implementing Basel norms.

There was a need for making a rigorous and granular study of the health of the banking system before pronouncing that the complete banking system was infected. After all, there are various reasons for rising NPAs, ranging from genuine frauds, mal-intentions and malfeasance to factual errors in evaluation of the project, and assessing and projecting cash flows.

The continuous critique of PSBs and then leading them into the Asset Quality Review, at a time when not only domestically but even globally NPAs were very large, was definitely not a pragmatic strategy.

Following the style of the PN of medical analogy, it is like asking a wounded patient to do a treadmill heart test. Obviously, the results would be sickening, given that overall economic growth was sagging.

Historically, banks worldwide and in India have suffered the most economic shocks and take time to recover, as banks are intricately connected with the economy through the cycle of deposits and credit advances. The incessant thrashing of PSBs, especially in the public domain, which account for nearly 75% of banking, damaged public confidence and also the morale of bankers, leading to scare-in-banking during those years. Consequently, following negative sentiments, investment and economic growth slowed down. An experienced doctor waits for vital statistics to stabilise before starting the surgery.

The banking sector reforms are a continuous process and the regulator has to be alert. A few banks which were showing strains of rising NPAs should have been addressed on a case-by-case basis. A corrective approach could have been tested in those banks on a pilot basis. The need for capacity building in PSBs with training on assessing and mitigating risks, in view of the unfolding of the great recession, should have been considered. The governance issues were the most important, but were ignored despite the PJ Nayak Committee recommendations in May 2014. And research from RBI and CAFRAL (Centre for Advanced Financial Research and Learning) waned during this period.

The other pertinent issues, too, like extending banking to unbanked individuals and involving intensive use of information technology—as nearly 50% of Indians did not have a bank account even by 2013—were relegated, but inflation targeting was prioritised. In a developing country, enjoying an enormous demographic dividend, pursuit of inflation targeting when there is a clear case of trade-off between growth and inflation, operating Phillips curve, was probably not the correct strategy. Moreover, many countries and economists had recorded obsession with inflation targeting since 1991 at the cost of other variables as the cause of missing the Minsky moment leading to the great global recession. Similarly, in the midst of a difficult situation, the debate on the independence of a central bank was unwarranted, especially when such a concept had itself been questioned in the case of Bank of England and Federal Reserve.

The PN, historical, reads like an event report. As the dynamics of banking were changing in those three years of Rajan's Governorship, so were the policies of the regulator. In brief, the PN reads like a list of reaction function and not like a well-thought-of research-based policy-driven strategy that was being implemented. It is pertinent to ask as to who suffered from this learning-on-the-job assignment? In general, the resident taxpayers, many of whom were innocent and even did not have a bank account, and whose per capita income is less than one-hundredth of US professors and who don't even have the luxury of social security.

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