

Banks' NPA and RBI: Are regulators responsible for the (non) performance of the regulated?

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This does not sound right.

The high-pitched proxy debate between the government and the Reserve Bank of India (RBI) has touched on one unrelated, but very important issue—it is the contention that RBI allowed banks to lend indiscriminately during 2008-14, which sowed the seeds for the non-performing asset (NPA) problem. As is the case in any crisis-like situation, one has the advantage of hindsight when making such an evaluation.

The fundamental question is, whether or not it is the duty of the regulator of any market to get involved in commercial decisions of the regulated? It is necessary to address this issue because once this responsibility is taken on, then it would also be responsible for the performance of the entity and its shareholders. This does not sound right.

A banking regulator lays down the rules of the game, and ensures that everyone follows them. There is an ongoing supervisory process that is topped with periodic audits. There are, hence, stringent norms on capital adequacy where RBI has always clearly been ahead of the curve of both Basel II and Basel III. Similarly, the norms for recognising income and asset quality are clearly spelt out, and the compliance ensured. Within this framework, banks have to take their decisions. There are several rules in place on lending practices, such as concentration, groups, etc. If one plays within these rules, the regulator should be agnostic to how the regulated function.

The same holds in the capital markets, where the rules are laid down on how business should proceed. But, at the end of the day, if the market crashes for some reason and players make losses, the regulator is not responsible as every player is supposed to take their own calls on stock price movements. The

regulator only ensures compliance with rules and fair play, and also spreads awareness as individuals are involved.

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In 2008, when the crisis struck, all of us wanted an economic stimulus, which was provided through both the fiscal and monetary routes. The government spent more money, while RBI became accommodative. Ironically, even today, with the so-called liquidity conundrum, the call is on RBI to provide liquidity! The decibel levels at the time of the Lehman crisis were even higher as there was a fear of the economy slipping into a recession. When the central bank intervenes, it announces measures to provide liquidity to banks or makes loans cheaper by changing the policy rate, hoping that the pass-through channel is efficient. But it does not force banks to lend and 'nudging' is often the tone assumed. Banks ultimately take their call on lending to their customers based on their individual risk appetite.

Now, in this phase, everyone assumed with hubris that India was the second-fastest growing major economy in the world, and that the way was only forward. Every investment bank, economist, stock analyst, etc, assumed with confidence that India would grow at over 10% per annum, which became the groupthink. At that stage, there were no naysayers. All white papers of the government and reports from the western world painted the same picture as growth prospects for India were decoupled from the rest of the world. The same confidence level permeated the banking sector, where it was assumed that all sectors would grow—especially infrastructure—which led to over-lending in a way. And, interestingly, no one objected to this futuristic vision.

It was the same story about the Lehman saga. When securitisation caught on in the United States, it was considered by all to be a marvel in financial engineering, when one dollar lent could be churned multiple times and the holders of debt instruments were different from the originator. No one expected this edifice to collapse. The absence of regulation was noteworthy out here, which was followed by a more coherent framework. But, in our case, the regulatory framework was always in place.

The problem really was that there were unusual circumstances that were triggered by a series of irregularities in the earlier political regime, and which brought projects to a standstill, leading to the creation of NPAs. At this time, in the collective wisdom, it was argued that these assets were not NPAs, but viable, as they were affected by extraneous factors such as non-availability of coal or power, etc, and were rechristened as restructured assets. As the corporate debt restructuring cell consisted of bankers, there was a perverse incentive to classify more NPAs under this heading. Few criticised this move at that time. This carried on for almost five years, before the asset quality recognition norms came in.

While the camouflage of restructured assets could be a debatable issue in terms of the central bank permitting the same, a question that can be posed is, what would have been the reaction if this was not allowed? Probably the same as is being witnessed today of unnecessarily penalising banks—which is being said about the prompt corrective action (PCA) framework. At that time, emotions were high that the so-called scams were responsible for this malaise. The same kind of umbrage would have been expressed in case such a drastic

step was taken, as is being done today for curbing the lending activity of the 11 banks under PCA.

Therefore, it would be necessary to frame the rules for the regulator of any market. It has to be separated from the commercial considerations of the regulated entities. Banks take decisions based on their perceptions of the real sector. The real sector, i.e. industry, behaves in a whimsical way, which is often cyclical. But there is a difference between failure in the real sector and the financial sector. If a steel company fails in terms of losses, then the shareholders bear the cost.

However, this failure spills over to the financial sector, which is the intermediary, and which cannot fail as it receives sustenance from the public—like deposit holders or insurance policy holders—and not the shareholders. This is why it becomes a serious issue.

It cannot be argued that the regulator should dictate the activities of the regulated. If that is done, then it becomes responsible for the performance of the regulated, which should not be the case. No regulator ever tells the regulated to be indiscriminate while lending or investing. The so-called incorrect decisions are based on subjective judgements of bankers, which will always get exposed in these episodes of downturns.

In addition, it must be accepted that economic cycles are a reality and there will be even sharper amplitudes in the future. Any failure or collapse will hurt, and cannot be painless.

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