Source : www.indianexpress.com Date : 2020-08-07

BANK AND THE COVID PAIN

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

An irony of history is that Prime Minister Indira Gandhi's speech to the nation at 8.30 pm on July 19, 1969, announcing "bank nationalisation is being done to allocate credit to farmers, small enterprises and the self-employed" was drafted by I G Patel. But by 1979, the then RBI Governor Patel wisely reflected: "Credit is not a gift or a subsidy and it has to be repaid. Otherwise any credit expansion, no matter how worthy the recipient or cause, will only waste scarce national resources that a poor country cannot afford. To encourage anybody to incur debt which cannot be repaid or to encourage wilful non-repayment, would be to mock the very concept of development and elimination of poverty." COVID creates deep pain but we must resist consistently choosing borrowers over lenders and persist with our multi-year five-pillar strategy to sustainably raise our Credit to GDP ratio from 50 per cent to 100 per cent.

A modern economy grows by lending and a modern state is a welfare state. But fiscal constraints or natural disasters often create temptations to disguise spending as lending. COVID's pain is breeding unreasonable requests like interest waivers, endless moratorium extensions, blanket one-time restructurings, fudging accounting, reducing capital adequacy, 24-month IBC suspension, etc. It's also breeding an academic blame game that insists the problem pertains to personalities, not structure. The last 50 years suggest that the Diet Coke approach to banking — taste without the calories — doesn't work in raising the financial inclusion of migrants, self-employed, and MSMEs. And the last 20 years have given three lessons: Giving loans is easier than getting them back (corporate credit growing from Rs 18 lakh crore in 2008 to Rs 54 lakh crore in 2014 created a Rs 12 lakh crore bad loan problem); breaking the thermometer doesn't help the fever (disallowing accounting fudging and restructuring would have saved Rs 7 lakh crore because banks would have run out of capital) and government banks need more than capital (their risk-weighted assets are lower than two years ago despite a Rs 2 lakh crore capital infusion). History recommends patiently balancing financial inclusion and stability by persisting with our five-pillar strategy:

Bank competition: India had 82 banks in 1924, 97 in 1947, and has 95 scheduled commercial banks today. Socialism is essentially capitalism without competition — our bank drought represents the zero-sum mentality of socialism. Raising credit availability and lowering its price needs competition-driven innovation. Capital should be chasing Indian banking given its high net interest margins, high market cap to book value ratios, and massive addressable market. Yet, the RBI's on-tap licencing has few applications pending. We need many more banks.

Private bank governance: Private banks are only 30 per cent of deposits but 80 per cent of bank market capitalisation, 77 per cent of incremental deposits, and 77 per cent incremental loans. Private banks are a special species — society does not allow anybody else 20 times leverage, but this makes privatised gains and socialised losses possible. Recent accidents suggest problems with public shareholder collective action and the attention, skill, and courage of board directors. Private bank governance must move from a jaagir (perpetual private fiefdom) to amaanat (trustees that hand over in better condition to the next generation).

Government bank governance: Government banks and companies sometimes have the wrong "tone from the top" that says the return on equity and market capitalisation doesn't matter. But as Warren Buffet says, equity markets may be voting machines in the short run but they are weighing machines in the long run. Over 10 years, government companies have sunk from 30 per cent of India's market capitalisation to 6 per cent. Government banks mirror this decline — their 70 per cent bank deposit share translates to only 20 per cent bank market capitalisation

share. Many have irrational employee costs to market capitalisation ratios (Bank of India, 58 per cent, Canara Bank, 77 per cent, and Punjab and Sind Bank, 155 per cent). We need only four government banks with strong governance and no tax access for capital.

RBI's regulation and supervision: Recent accidents in financial institutions reinforce the importance of statutory auditors, ethical conduct, shareholder self-interest, and risk management. But they also suggest a first-principles review that raises the RBI's regulation and supervision game. Zero failure is impossible, but the RBI should boldly re-imagine its current mandate, structure and technology.

Non-bank regulatory space: A regulatory apartheid traditionally existed between banks and non-banks. But progress in payments, MSME lending, and consumer credit suggest that non-banks are important for financial inclusion. They need more regulatory space and supervision.

Progress is underway. Forex reserves are at a high and interest rates at a low. Borrower rate transmission is improving. Our billion digital mobile payments a month target has been reached and replaced by a new target of a billion payments a day. Bank and NBFC accidents have seen orderly resolution. The RBI's bank governance note is open for comments. The RBI has an internal committee to review bank licencing and capital norms. It is creating a new specialised cadre for supervision and creating a college of supervisors. The RBI is raising its supervisory technology investments and revamping early warning models. It is finalising an ambitious five-year vision for HR and technology. RBI has proposed licencing competitors to the NPCI. "Phone" banking and board lobbying in government banks has stopped. The IBC is a world-class bankruptcy law that will soon resume with vigour. Deposit insurance limits have been raised with a risk-based premium framework proposed. And the RBI is calibrating an exit strategy for emergency COVID measures.

Bank nationalisation captured the idealism of the 1967 Hazari Committee (nationalising banks to democratise credit) and the 1955 Avadi Resolution (controlling a myopic private sector). This idealism didn't deliver — our credit to GDP ratio is embarrassing (same as Bangladesh and lower than Iran) and the bad loan problem is unaffordable. God willing, we won't test the RBI's COVID worst-case scenario of 14.7 per cent bad loans but handling the inevitable COVID bank pain needs resisting short-termism. In the long run, we are not all dead.

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