RBI's new NPA rules may hurt but will drain the swamp

It has been commented, after a fashion, that the Reserve Bank of India (RBI)'s new NPA rules are akin to kicking a man while he's down. The banking system is grappling with a Rs10 trillion bad loan problem which is still some way from being sorted despite the new bankruptcy framework. The government extended a lifeline with its Rs2.11 trillion bank recapitalisation plan, but even that may have been yanked away because a bad loan pile-up is anticipated with the introduction of these new norms.

With that the hope of a revival in bank credit growth is blown away, which will also crimp economic growth, goes the argument. But that's taking the short-term view. Yes, slippages will rise and so will provisioning. But in the long term, the central bank will get credit for pressing reset on the banking system.

The new rules will instil a sense of transparency, more investor confidence in the financials of banks and change the way banks do business. There will be greater prudence in lending. Cowboy lending, especially towards larger projects where banks lack the capacity to conduct proper appraisals, could be on their way out. Chief financial officers will read loan covenants more carefully because the tolerance for defaults is being lowered considerably. They will need to ensure loan repayment terms are more realistic.

Banks will also pay better attention to developing risk management frameworks, something the government has been trying to push as part of its banking reforms package along with recapitalisation.

The new norms will also instil some discipline in the corporate sector on honouring debt servicing commitments on time. With the insolvency and bankruptcy code being the cornerstone, there are higher chances of a company getting liquidated, prompting better promoter behaviour.

While bank books might get worse over the next 12 months, in the longer term, the new NPA rules will ensure that the books reflect actual underlying asset quality. There will be no place to hide as the new norms are quite inflexible towards larger loans that come under distress. Banks get six months to resolve such loans else they have to be forwarded to bankruptcy court.

A second reason for greater transparency is the introduction of weekly reporting for defaults over Rs5 crore to RBI's centralized database, CRILC (Central Repository of Information on Large Credits). More information sharing will mean that there is less scope for so-called divergences—the difference between a lender's and RBI's assessment on loans turned bad. Remember, just last week, State Bank of India reported a divergence of Rs23,239 crore at the end of March 2017.

Pushing large NPAs to the bankruptcy courts was the first sign that the tolerance of banks towards large defaulters as we knew it had ended. The current move institutionalizes this intolerance towards default. There is a risk that it may crimp business sentiment as it does not distinguish between genuine and wilful default. But that's a debate for another day. The need of the hour is firefighting.

The new norms reiterate signals emanating from central bank headquarters for some time: we are no longer interested in regulatory forbearance. RBI deputy governor Viral Acharya's comments three weeks earlier about rising bond yields is another example of RBI's intolerance towards regulatory forbearance. It refused to ease the pain of banks who took a hit on their treasury books from rising yields.

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Regulatory forbearance is one reason Indian banks have been burdened with a Rs10 trillion bad loan pile in the first place. Doing away with it is the first step in ridding the economy of a devil that comes back to haunt it every once in a decade or so.

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