Can banking recover?

The bank frauds involving Punjab National Bank (PNB) and the companies associated with businessmen Nirav Modi and Mehul Choksi as well as the Rotomac case couldn't have come at a worse time. The Indian banking system is already reeling under the pressure of growing NPAs, or non-performing assets (less politely known as loans that are not going to be repaid), which will touch nearly 10 lakh crore by March this year. This does not include the 6 lakh crore already written-off. This has already caused a slowdown in disbursal of bank credit, in turn affecting productive investment.

Failure at many levels

What has been revealed so far could be only the tip of the iceberg. The sheer ease with which fraudulent practices have been carried out and the length of time over which they continued suggest that the rot is much deeper. Other banks could have provided large loans without due diligence, which other companies then received without intent to repay; this means that many more loans gone bad could soon surface.

These revelations cannot bode well for the ruling party or for a Prime Minister who had promised to be the nation's "chowkidar" to prevent any such loot. But let us step away from the politics. It is now clear that the scams are fundamentally and overwhelmingly a failure of regulation.

This failure has occurred at many levels. At the level of the bank, it is impossible to believe that only a handful of employees (the current fall guys) have been implicated. Senior management and auditors did not track these problematic transactions for years. The Reserve Bank of India (RBI) did not monitor banks properly and created opacity with new financial instruments. The Finance Ministry failed in its oversight and regulation. And successive Central governments, including the present one, did and have not done anything to address the obvious problems that were festering, and made them even worse.

Using LoUs

The PNB scam relied on the existence of an unusual financial instrument, the letter of undertaking (LoU). This is a bank guarantee that enables a bank's customer to raise short-term credit from another Indian bank's foreign branch. It has to be another Indian bank, because the LoU as a form of underwriting other borrowing does not exist in other countries and is not even recognised by foreign banks. It was created by the RBI as an additional incentive to importers who could then avail of cheaper credit abroad, even though import credits already exist.

These LoUs — which are equivalent to providing credit and should be recorded as contingent liabilities — were not so recorded. When loans are not repaid — in this case vast amounts borrowed from other banks based on these LoUs were apparently siphoned off to shell companies controlled by the Modi-Choksi combine — the buck stops with the issuing bank. What was intended to be trade credit was misused, with no record and monitoring of the spending from those loans. There is talk of sums in excess of 20,000 crore being involved in this case as these businessmen were alleged to be so influential that they were even able to game the SWIFT system for foreign exchange transactions.

This case involves pure criminal fraud, but there is a thin line between fraud and the many large defaults that plague the system. Commercial bank lending is massively skewed: according to the

RBI, in March 2016, 11,643 borrowers accounted for 38% of all bank loans; large corporate borrowers had the overwhelming share (84%) of bad loans. Just 12 large outstanding NPA accounted for as much as 250,000 crore.

All you need to know about Nirav Modi and the $1.77-billion PNB fraud

The issue of crony capitalism that was much criticised during the United Progressive Alliance government is alive and well under this government. Finance is one of the many ways in which concessions and advantages are distributed. Some favoured companies are not declared wilful defaulters even when the government's own investigating agencies find that they are diverting funds. Those declared as wilful defaulters are neither punished nor prevented from leaving the country. In fact their names are not even made public, so they can continue to access loans from other banks. Some insolvent companies are made to sell their assets which are then purchased at throwaway prices by relatives or associates of the defaulting owners. Despite claims to the contrary, shell companies held by influential people continue to enable the siphoning of assets and money laundering in various forms.

Privatisation no answer

Many analysts within and outside government have responded to these scams by pointing the finger at public sector banks, claiming that they are more vulnerable to influence peddling and crony capitalism. The current mess has also become an excuse to demand the privatisation of state-held banks. This completely misses the point since privatisation would actually make things much worse for Indian banking.

The key issue is one of poor regulation, and not ownership. Indeed, the reason why the current scam has not led to a widespread run on the PNB and other banks is precisely because of the sovereign guarantee that, despite everything, still generates trust in the public banking system.

Poorly regulated private banks are even more prone to scams and failure as the financial sector is rife with information asymmetries and market imperfections. Private profit orientation generates incentives for managements to exploit loopholes in the rules and engage in risky behaviour, as examples by U.S. and European bank behaviour leading to the great financial crisis of 2008-09 show. The bailouts they then require tend to be even more expensive for the public exchequer because bank runs have to be prevented.

In India, in the decade before the nationalisation of banks in 1969, there was an average of more than 35 private bank failures every year. After the liberalising reforms of the 1990s, the collapse of the private Global Trust Bank and Centurion Bank (among others) resulted in mergers, with the losses being borne by public sector banks. Private banks such as Axis and ICICI also face large NPAs, often with the same companies that are defaulting on public banks. Kotak Mahindra Bank and several others have been found guilty of providing unsecured loans and ever-greening, practices that the PNB is now accused of. In fact, because of the opacity of banking practices, public banks are actually easier to regulate.

So why has banking regulation in India failed to this extent? It is not only mala fide intent and corruption but also an overall approach to economic policy. The RBI may have been too occupied in counting old currency notes and dealing with the other damaging consequences of demonetisation to pay enough attention to its real job — of bank regulation. But more significantly, this government, like the previous one, has created incentives for all banks to privilege large high-profile corporate borrowers and be relatively lax on their repayment in the mistaken belief that this would encourage sustained income growth. This context makes it easy for some players to game the system.

Recovering from this will require stricter adherence to sound banking rules and more transparency and accountability from both public and private players. But most of all, these would apply to the regulators themselves and the government that frames all this.

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