The fight to the finish against banking frauds

The cleansing of the Indian banking system now seems to have reached an advanced stage. After the recent issuance of a new framework for the resolution of stressed assets by the Reserve Bank of India (RBI), the government is working on reducing the possibility of bank frauds. Although the Nirav Modi case has garnered public attention because of its sheer scale, it is not the only instance of Indian banks' vulnerabilities being exposed, especially in the public sector. Several other cases, such as those involving the promoter of Rotomac Pens and top executives of Simbhaoli Sugars, have also surfaced in recent weeks. RBI data, obtained by Reuters through the right to information, shows that public sector banks (PSBs) reported 8,670 cases of "loan fraud" involving Rs61,260 crore over the last five financial years up to March 2017. The amount will go up significantly once the recent frauds are added.

The government has done well by not letting this crisis go to waste. For instance, it has asked PSBs to inspect all bad loan accounts above Rs50 crore. It has also given them 15 days to address technological and operational risks. It will be worth watching how banks that have neglected such risks so far put their house in order. It has also directed PSBs to rationalize overseas operations and proposed a new law against fugitive economic offenders. This will give the government the power to confiscate the assets of a fugitive offender, both in India and abroad. It has also decided to set up a regulatory body for auditors. The RBI too has formed an expert committee to look into rising instances of fraud. While at an aggregate level these are steps in the right direction, the government should not lose sight of at least three broad issues in this fight against bank frauds.

First, it should avoid over-regulating or overburdening the banking system. Inspecting all bad loan accounts in excess of Rs50 crore, for instance, could result in excessive fear among bankers, as at some point investigative agencies will also get involved. This could affect the flow of credit in the economy—the last thing India needs at this stage. Action by investigative agencies in some of the cases related to non-performing accounts in recent years is said to have affected bank lending. This is also one of the reasons why bankers in the public sector are hesitant to take a haircut in non-performing accounts and have been forced by the regulator to go to the National Company Law Tribunal in a number of cases. Therefore, it is important that bankers are protected adequately and are able to take commercial decisions.

Second, as the Indian experience has shown, laws by themselves don't act as a deterrent. The government will need to build investigatory and judicial capabilities so that cases are decided in a reasonable time frame. Only time-bound closure of cases will deter fraudsters. India will also need to build institutional capabilities to be able to negotiate with foreign authorities in order to bring back fugitives and prosecute them under Indian laws.

Third, PSBs need urgent governance reforms. The Punjab National Bank fraud is the consequence of a complete collapse of governance. Governance in PSBs needs an overhaul and government interference in appointments should be minimized. In this context, the P.J. Nayak committee (2014) rightly noted: "Government officers and regulators may not possess the skills to appoint the top management of commercial banks. Banking is a very specialised activity, and top management needs to combine strategic foresight with a good commercial knowledge of sectors to lend to, prudent risk management and human resource skills." The outcome of establishing the Banks Board Bureau has also not been as desired. Therefore, the government needs to revisit the way appointments are made in PSBs, starting with the board. Only a professional board will be in a position to take the right decisions. It is important for banks to continuously improve operational efficiency by making the right investments in technology and human resources. This is a good time to initiate reforms as the government is in the process of recapitalizing PSBs.

The shock of frauds and subsequent regulatory action can affect the flow and cost of credit in the short run. However, things should stabilize in the medium term as the RBI’s revised framework makes it mandatory to report stressed accounts above Rs5 crore on a weekly basis. This will enable real-time tracking and reduce the chances of future frauds. Indian banks will emerge stronger after the short-term pain of cleansing the system.

Will the steps taken by the government help reduce bank frauds? Tell us at views@livemint.com

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