Source : www.thehindu.com Date : 2019-03-26

DELAYING BAD NEWS: ON PROPOSED BANKING REFORMS

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

For now, Indian banks burdened by sour loans will not have to admit the true size of their likely losses. On Friday, the Reserve Bank of India postponed the implementation of the Indian Accounting Standards (Ind AS) norms for banks indefinitely, citing the need for amendments to be made by the government to the relevant banking laws. The RBI had initially planned to implement the norms starting April 1, 2018 in order to bring Indian accounting standards in line with international standards, but the Centre's delay in enacting the necessary amendments had given breathing space for banks for another year. It is believed that the adoption of the accounting standard could cause significant credit losses to banks, which will be forced to prematurely recognise losses on their loans and build up the necessary underlying capital required to overcome the impact of such losses. Under the proposed norms, financial institutions like banks will have to calculate expected credit losses (ECL) on their loans during each reporting period and make necessary adjustments to their profit-and-loss account even before a borrower may default on a certain loan. This is in contrast to the present accounting norms wherein banks incur credit losses in their books only after outstanding loans have been in a state of default over a certain number of days as stated in the rules laid down by the RBI.

Given the losses they would likely have to incur, it is understandable why banks would try to avoid adopting the accounting norms for as long as possible. So the delay in the implementation of the Ind AS norms is not surprising at all. Further, to adjust to the new norms, banks will have to improve their ability to forecast future credit losses with precision. Until this happens, bank earnings could experience volatility. The Central government, which has been trying to bail out public sector banks without carrying out the structural reforms required to clean up balance sheets, might also prefer to delay the enactment of the legislation. For the new norms will cause more outstanding loans to be added to the huge existing pile of bad loans and cause further headaches to the government. According to estimates made by India Ratings & Research, public sector banks would have to make additional provision of over a trillion rupees if the norms are adopted right away. The Centre may not be able to foot the bill, and may instead prefer to help public sector banks to hide the true size of their bad loans. This does not bode well for the health of the banking system as banks that do not recognise their problems might not resolve them.

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