Source : www.thehindu.com Date : 2020-03-13

SHOULD DISTRESSED PRIVATE BANKS BE SAVED BY PSBS?

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

*A day after the government imposed a moratorium on the financially troubled Yes Bank last week, the Reserve Bank of India announced a draft restructuring plan that entails the State Bank of India acquiring a 49% stake in the private lender. In a discussion moderated by **Suresh Seshadri**, T.T. Ram Mohan and Ananth Narayan examine whether the proposed bailout is warranted and what lies ahead for the wider financial sector. Edited excerpts:*

T.T. Ram Mohan: It's not the best option certainly. I think the first option should always be to have a private investor come in and infuse his capital into the private bank. The RBI did give some time to the Yes Bank management to work out such an arrangement but evidently that did not succeed.

The next option then, the straightforward option, would have been for the government to simply nationalise Yes Bank. And as you know, that's exactly what happened during the global financial crisis with innumerable private banks all over the world.

But here the government is facing severe fiscal constraints. And also, it is finding it very difficult to infuse money into its own public sector banks. That perhaps explains the reluctance of the government to nationalise Yes Bank. So, what we have is really something that should be the very last resort, which is getting a public sector institution, a public sector bank, SBI, to lead the rescue.

Ananth Narayan: It's never pleasant or elegant to see something like this… intervention by the government. But let's face it, this is an issue of financial stability. Yes Bank was not a small bank. The total balance sheet size was close to 3.5 lakh crore, lots of depositors, lots of businesses. And one thing which the Financial Stability Report of the RBI does kind of enumerate is the level of inter-connectedness within the financial services ecosystem. While after the global financial crisis, the idea was always to have no bank which is too big to fail, the reality is the inter-connectedness between banks themselves, banks and the rest of the financial sector ecosystem, including mutual funds, insurance companies, non-banking finance companies (NBFCs), etc. And then the inter-connectedness of the financial sector with the real economy is so deep, that you know, what is good in theory would rarely be good in practice. So, I don't dispute that what the government has done, which is stepping in to try and resolve the Yes Bank crisis, is the right approach. We can argue about what could have been the best approach. In the past, banks such as Global Trust Bank have been subsumed within existing banks, rather than trying a half-way measure as we are doing right now. So we can argue about the right way of doing this and the right modalities of doing this. But some kind of intervention was definitely required.

I will only also add, this isn't over. While Yes Bank was an immediate problem, which obviously had to be resolved and I'm sure will be resolved, the larger trust deficit in the financial services ecosystem remains. And much work needs to be done beyond this.

Podcast | Should distressed private banks be bailed out by PSBs?

T.T. Ram Mohan: Whenever you have a failure like this, there is a presumption that the regulator has not been up to the job. This is something that will have to be looked into. I think the

Finance Minister has already asked the RBI to fix accountability for whatever has happened. But it's not clear to me in what way the regulator can be said to have failed in this particular case. Because they did move in to oust the founder from the bank, sometime in 2018. So that step was taken. Whether any step could have been taken prior to that, I think it's a matter of guesswork. But what I will say is that the conditions in the financial sector deteriorated significantly post September 2018, when we had the collapse of IL&FS, which is a non bank. And my own view is that that was a serious lapse on the part of the government not stepping in to rescue IL&FS. Because the shocks arising from the failure of IL&FS, the erosion of confidence, and the flight of funds from the NBFC sector, all that we are still sort of experiencing. So, in some sense, it's not a regulatory failure, or if there's a regulatory failure, it's the failure of the RBI to persuade the government to step in, in the case of IL&FS.

Ananth Narayan: It's never good for a bank to have to step in and practically as a last resort have to rescue another bank. I'm sure given the choice, the SBI management would have probably rather not gotten themselves involved in a Yes Bank rescue. But as the chairman and managing director of SBI himself said, when the country's interests come to the forefront, people have very little choice.

Things are a little fragile for the overall financial services ecosystem. As per the Financial Stability Report, public sector banks have 12.7% of gross non-performing assets (NPAs) as of September 2019. That number could actually be higher if you were to include or remove the kind of forbearance available on some sectors like small and medium-sized enterprises [SMEs] and real estate. Plus, as of September, loans to NBFCs such as DHFL [Dewan Housing Finance Corporation] were actually counted as current. So, accounting for all of that, that number is probably higher, and it's higher than the rest of the ecosystem. Plus, over the last few years, the government has had to infuse 3.5 lakh crore of equity into public sector banks. So, the overall banking system is kind of fragile at this point in time, and it's clearly burdened with things like NPAs and loans.

I wouldn't call this particular Yes Bank episode a question as to whether public sector banks are better governed or private sector banks are. I think the reality is that every element of the financial services ecosystem requires governance reforms. Governance is a cross bank and cross institutional issue. It's not limited to public sector banks or private sector banks or NBFCs; it's across the board.

T.T. Ram Mohan: The criticism, up to this point, has been that the PCA framework is far too stringent. And as you know, there's been tremendous pressure on the RBI to get the banks which were under PCA, public sector banks and I think one or two private banks, to get some of the public sector banks out of the framework. Now, if people are arguing the framework is not stringent enough, then that's an altogether new point that they're making. In the case of Yes Bank, it did not qualify for inclusion under PCA using the metrics which are applicable and now what people are saying is that the RBI should have looked at something like the rate of growth of assets or the rate of growth of the loan book. And that when there is this kind of aggressive growth, the regulator should be watching very closely. Now that is strictly hindsight. Because part of the reason for a very rapid growth in the loan book of private banks is that the public sector banks have been fairly comatose, there has not been much lending as corporate lending, at least in the last few years, growth has been very tepid. And that space has been taken up by private banks. And the second thing is that a bank like Yes Bank starting off on a low base, high rate of growth would not be an issue. Now, after the event, if we were saying that they were growing at 30-35%, and the regulators should have done something about it, and that the PCA framework should accommodate something like that. Well, I think it's a bit of a stretch. I would say that matters such as this would fall within the domain of the risk management committee of the board of the bank.

Ananth Narayan: From what I can see of the RBI circulars, Basel III regulations, as well as the information memorandum relating to these particular AT1 bonds, I think what the RBI has proposed is perfectly legally valid. I understand it's being challenged in a court of law and you will probably know the result soon enough, but it does seem absolutely within the letter and spirit of the law, whatever has been proposed by the RBI. In fact, one of the information memorandum that I saw for a particular AT1 bond of Yes Bank, specifically says that if Section 45 of the Banking Regulation Act is invoked by the RBI, the bond will necessarily see a full write-down, a permanent write-down of 100%. So, given those kind of conditions, I'm really not sure if bondholders can really contest this. I'll tell you something, which still is kind of a question mark; any person studying corporate finance is taught that equity is the riskiest instrument, and that subsequent instruments are senior to equity in terms of the risk hierarchy. Having a situation where equity holders are still salvaging something... at a time when AT1bonds are being written down completely is quirky and is something which raises questions. So, at the very least, the people who are subscribing to these AT1 bonds the way they've been defined and designed, should have been questioning as to whether these are really senior to equity in terms of risk and should be probably questioned even now as to why those investments really happened.

To your broader question on what the ramifications will be: Look, there's no question that AT1 investments going forward will be repriced, which means that investors will take a lot more of a hard look at those papers before putting their money into it. In a way, that's not bad news at all. Frankly, AT1 markets in India were probably being mispriced. There were also instances of mis-selling by some bank relationship managers of AT1 papers to high-net-worth or even middle-net-worth kind of individuals, which is gross mis-selling, in my view. So, while it will be difficult for banks to raise money from AT1 going forward, it's not a bad outcome in entirety, I think it will be better risk managed, better risk priced, better designed, and there'll be more checks and balances to ensure that mis-selling doesn't happen.

One last bit. I'm glad that at least so far, the tier-two bonds and the infrastructure bonds and other senior secured bonds of Yes Bank are not being touched. We don't know what the final solution will look like. But at the current situation, while we can question as to whether that's the right outcome for the specific case of Yes Bank, I think it's the right outcome for the ecosystem as a whole. The last thing you wanted was a broader question mark about the applicability of other senior secured instruments as well, beyond the AT1.

T.T. Ram Mohan: The systemically important banks are banks which are tracked more carefully and which are also subject to higher capital requirements under Basel III. But that is not to say that banks which are relatively smaller in size, such as Yes Bank, do not pose systemic risk and therefore, should not be rescued. In practice, the threshold for a bank to be considered large enough to constitute a risk to the system is much lower. So characterising a bank as systemically important has more to do with tracking particular banks more carefully. That does not mean that there is no case for a rescue with banks of a much lower size. Even a bank with a size of about 2,00,000 crore, if it were to fail today, would need to be rescued. And that way it does constitute a systemic risk.

Ananth Narayan: This is a risk that a lot of us have been flagging for a while now, that there is a trust deficit in the financial services ecosystem which is linked to several stresses on corporate and SME balance sheets at this point in time. As per the Financial Stability Report of the RBI, as of September, the gross NPAs of the banking system was 9.3% of advances. And there are analysts who say that if you include the forbearance available to SMEs and to some real estate assets, besides the fact that some NBFCs were not classified as non-performing in September, even though they subsequently have [become] non-performing like DHFL, the actual number could be higher than 9.3%. The problem really is for NBFCs where the official number for gross NPAs, as of September, was 6.3% of advances. That number doesn't make sense. NBFCs typically lend to sectors which are riskier than banks. And it does feel like the real number could be much, much higher and mind you, no asset quality review has happened for NBFCs as yet.

Now, the whole edifice of a financial services ecosystem is trust — if people don't trust the numbers, which are being put out for the asset quality, clearly that has implications for financing, that has implications for the ability and the willingness of people to actually lend and put out money. And this is something which has to be addressed. Eventually to restore trust, I think we have no choice but to actually make a clean breast of where we are in terms of the true asset quality. Which is, where all the ramifications of the stressed sectors including real estate, construction, power, telecom, airline and shipping, maybe even several public sector enterprise loans, will come to the fore. So, alongside that disclosure, if you don't want the system to actually go through a lot of strain, you obviously require a solution as well. Now, while we have a very good Insolvency and Bankruptcy Code and the NCLT [National Company Law Tribunal] process, I don't think it's geared to handle the overhang of stock that we have right now of NPAs. We already have more than 2,000 cases pending at the NCLT courts. So we probably require a one-time solution as well to go along with this actual disclosure of the real state of affairs. Absent these two things, and of course, the larger reforms… it is possible that this overall financial services ecosystem remains in a bit of a comatose condition for a long time and that's terrible news for us. We need our financial system to be able to fund growth; at the moment, that's not the case at all.

T.T. Ram Mohan: I agree the conditions are very challenging, and not just the adverse global conditions. At the moment the stresses within our own financial system have got considerably exacerbated consequent to the Yes Bank episode. We have to see what happens to the attempted rescue. The details of the rescue plan are evolving, even as we speak. It's not clear what the precise rescue plan is going to be. And so we have to wait and watch and see whether any attempted rescue of Yes Bank has a reasonable chance of success. That is a crucial factor.

But irrespective of how that problem is resolved, the damage to confidence caused by the moratorium, one month moratorium, and the cap on withdrawal of deposits of 50,000 cannot be overstated. And I think that is duly reflected in the hammering that several private bank stocks have received over the last few days. It's also not helpful that the Maharashtra government has made it very clear that none of the State government's accounts or the accounts of the civic and other bodies under the State government will be left lying with private banks hereafter. Now, I shudder to think of what the implications would be if other State governments were to imitate the State government of Maharashtra, which is highly likely. So we need some cool heads at this point and there has to be coordination between the Central government, the State governments and the RBI to bring about some calm in the sector.

The rescue plan for Yes Bank is a starting point. But there are various other things that need to be done. And let me say that the impending bailout package for telecom is one of the many imponderables in the scenario. But my guess is that whatever plan is announced is going to prove quite stressful for the banking sector.

Ananth Narayan is Professor of Finance at SP Jain Institute of Management and Research; T.T. Ram Mohan is a professor at IIM Ahmedabad.

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