Extend and pretend

The problem of rising non-performing assets of banks has been simmering beneath the surface for many years. Until now, it was possible to sweep bad news under the carpet. But the pressure arising from bad loans going through the bankruptcy mechanism has made it difficult to continue the game of extend-and-pretend. Recapitalisation of banks is, however, not a reform. It uses taxpayer money to cover up the failure of institutions. To prevent a recurrence of such failure, it is important to reform not just governance, but also regulatory oversight.

The problem of hidden bad assets is pervasive across the entire banking system. Both public and private sector banks are part of the story. If one bank had been undertaking fraudulent accounting practices and hiding problems, it could have been blamed, and its management punished, as in the case of Satyam and the conviction of Ramalinga Raju. If the problem was limited to public sector banks, we would have found solutions in their governance. Private banks have also been hiding bad assets. The present NPA crisis appears to be as much a failing of the banking regulator. For many years, despite its unquestioned powers to regulate, supervise and inspect banks, the regulator did not take action against banks that were hiding their bad assets. Instead, it proposed one loan restrucuturing scheme after another. None of the schemes, like CDR, SDR, S4A succeeded and stressed assets grew in number and value. It is only now, when credit growth has collapsed, that solving the problem cannot be postponed further and the regulator has become strict.

There has been a lot of discussion about restructuring public sector banks. However, this misses the point that private sector banks are also in a similar situation. The question to ask is: Why did the banking regulator fail to take action against banks that were hiding bad loans? The RBI is a regulator that interferes with bank operations more than any other banking regulator in the world. Given its policy of giving hardly any new bank licences, the RBI has only a small number of bank books to examine. So why did it fail in this core function?

A charitable explanation could be that its staff is of poor quality. It is ill-equipped to inspect bank books. Why did the RBI not see the problems, like late payment of interest and principal, evergreening of loans, mechanisms that banks created to keep bad loans from been classified as such until 2015? Many regulators, particularly abroad and some in India like SEBI, hire practitioners from the industry to be part of supervision teams. Is it that the RBI does not have adequate lateral entry and depends on people who have not been on the other side, and thus keeps getting outsmarted?

A second, less charitable explanation could be that bank inspection did reveal the bad asset problems. But the inspectors kept quiet. Finance Minister Arun Jaitley has said the problem was hidden under the carpet till 2015. In other words, the regulator knew that there were bad assets, but did not press upon banks to declare them non-performing. The regulator did not take action when banks continued to extend-and-pretend. Loans were not declared NPAs despite non-payment of interest or principal. Bank inspectors looked the other way when banks gave additional loans to defaulting clients to service these loans. If this was the problem, should there not be a question about why the regulator behaved in this manner? A bad loan is a rapidly depreciating asset. The RBI was the only authority with oversight over banks, and allowing extend-and-pretend increased the cost to the taxpayer of recapitalising banks. Who was responsible, who is accountable?

Whatever the correct explanation - incompetence, complicity or the attempt to hide its own inadequacy - there is no question that the banking regulator, by failing to do its job, has burdened the taxpayer with higher costs. The cost of solving the NPA problem has grown every year that the

RBI has hidden it, and the burden on the taxpayer has increased.

The RBI has an annual spend of Rs 13,000 crore at present. It is the only regulator that is not subject to a CAG audit. In the name of independence, the RBI has become unaccountable. All institutions that spend public money need to be accountable, and one that fails in its job cannot be excused for any reason. A mistake as big as one requiring Rs 2.11 trillion of taxpayer money should be followed by an analysis of the failure of the government agency explicitly tasked with preventing this very situation.

In view of the earlier PSB recapitalisations and bank regulatory failures in the past, the Financial Sector Legislative Reforms Commission (FSLRC) had proposed changes to the governance, regulation making, supervision, inspection and data collection in all regulators, including the RBI. The FSLRC also proposed a resolution corporation with powers to inspect banks. While the Financial Resolution and Deposit Insurance Bill that aims to create a resolution corporation for banks has been tabled in Parliament, it does not give it the power to inspect banks and thus to create checks and balances to the RBI's power. Without additional supervision, and without checks and balances, the RBI will continue to be the only supervisor of banks. The resolution corporation will step in only after the RBI declares a bank has failed.

Regulatory failure across the world has led to changes in regulatory regimes, in laws and in institutions. Creating checks and balances is a necessary element of the reform process. Independence and accountability are two sides of the same coin. Regulators must have both.

In conclusion, in the discussions about the reform that should accompany recapitalisation, it is important to remember that it is not enough to reform public sector banks. The problem of hiding NPAs is also present in private sector banks. The failures of banking regulation must be addressed and checks and balances created.

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