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THE CURRENT CRISIS AT PMC BANK SERVES THE COUNTRY A WARNING

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

It is symptomatic of a broader malaise in our banking sector that requires fundamental reforms of governance to address

The crisis unfolding at PMC Bank is but the tip of the iceberg of larger, unresolved problems in India’s banking sector. The roots of the crisis in the banking sector, writ large, go back to the unresolved problem of non-performing assets (NPAs), which were magnified in the case of cooperative banks due to lax governance and a dicey business model.

Unfortunately, the Reserve Bank of India’s (RBI’s) approach seems to be to bolt the barn door after the horse has escaped. And, by imposing severe withdrawal restrictions on depositors (recently relaxed)—inevitable when problems have been allowed to fester—those who suffer are largely the poor folk enticed by the higher deposit rates that cooperative banks offer.

What is more, the problems at PMC are only the latest and most publicized in the cooperative sector, which has been beset by bad loans and poor governance for donkey’s years. A business model in which you offer depositors high interest rates, and lend money to borrowers of often dubious

credentials at low interests, can easily run into difficulty due to the resultant wafer-thin profit margins, especially when such banks are used as piggy banks for well-connected politicians and others.

Unfortunately, the regulatory response thus far has been symptomatic, with little that shows an understanding of the underlying disease. What is needed at cooperative banks is fundamentally reformed governance so that a crisis such as the one that has befallen PMC—with an extraordinary 70% of the loan book represented by one business group with close ties to the bank—does not occur in the future. It is but a more extreme version of the malaise in public sector banks more generally, in which NPAs have built up because borrowers with political connections received loans they should never have got in the first place.

Former RBI governor Urjit Patel understood that painful medicine had to be administered and that this would be the only way out to cleanse the banking sector and jump start the investment cycle, at least on the supply side of the credit situation. Unfortunately, RBI under his successor appears not to have stuck to the path laid out by Patel, but has hewn closer to the government’s position of laxer regulation, especially under the Prompt Corrective Action (PCA) framework. This amounts to little more than kicking the can down the road, and putting off the day of reckoning.

There is a classic political economy dilemma here: the long-run health of the banking sector requires short-run transitional costs, as banks do the heavy lifting of cleaning up their loan books. This dichotomy—between long-run gain and short-run cost—is at the root of many deferred or unfinished reforms, and one of the main reasons that reforms only occur at a time of crisis, when kicking the can down the road is no longer a viable option.

The other interesting element in the public reaction to the PMC Bank crisis is the direct appeal by many frustrated depositors to Prime Minister Narendra Modi to solve the problem, ubiquitous on social media. Some of the videos doing the rounds document absolutely distraught, impoverished depositors literally begging and pleading with the Prime Minister to help them out. One cannot possibly imagine such a response in advanced economies, where the reaction of a disgruntled public would more likely be of anger at the failure of politicians and regulators, rather than one of entreaty.

This is a reminder, if any were needed, of the still somewhat feudal relationship between the ruler and the ruled that appears to characterize Indian democracy. What exactly do these folks expect the Prime Minister to do to help their respective personal situations?

The crisis at PMC and, more broadly, unresolved issues in the banking sector as well as other spheres of the economy seem to suggest that the government does not have a coherent and well thought-out overarching strategy for economic policy, including toward the unfinished economic reforms agenda. Rather, policy seems reactive rather than forward-looking.

Thus, the corporate tax cuts—which I support—are presented by those close to the government and its acolytes as a magic bullet, with an insouciance and complacency when it comes to other pressing reforms, including of labour laws, and other critical failures such as of infrastructure.

While rationalizing taxes is a good start, it cannot serve as a fix to the sort of problems that we are seeing at PMC Bank and other troubled banks. Those can only be handled through a more stringent regulatory process and, more fundamentally, legislative reform that overhauls the governance of cooperative banks as well as of the larger public banking sector. The fundamental political economy problem is that public sector banks serve multiple masters and, as a consequence, loan decisions are not always based on economic and financial logic. This bedevils cooperative banks as well.

The PMC crisis should be a warning to the government: get serious on economic reforms. Time is running out.

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