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FORGET LEHMAN BROTHERS, INDIA IS STILL IN A FINANCIAL CRISIS

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

The world of economic and financial crises is full of ironies and misplaced priorities. It has been a decade this 15 September since Lehman Brothers shut down, felled by avarice and obduracy. In recalling the event, 10 years later, the predominant zeitgeist seems more celebratory than commemorative. There is a general feeling of having successfully exorcized the Lehman ghost and all the evils that it portended. Nothing could be further from the truth.

A recent banking round-table conducted by *Mint* highlighted the myriad risks that bedevil the Indian banking system. Another Op-Ed in this newspaper by Philip Turner, former deputy head of Bank for International Settlements, warns of gathering dark clouds brought about by impending interest rate risks. Many otherwise and calm heads have warned about additional risks lurking in the shadows.

The banking system's overhang of bad loans is another full-blown crisis in India that stymies growth and shows no signs of an early resolution. Popularly referred to as non-performing assets, or NPAs, these are loans for which borrowers have stopped repaying (or are unable to pay) interest and principal. The corpus of bad loans just keeps growing and is proving to be a drag on economic growth. It is acting as a constraint on fresh loans not just for the large corporates but also for the crucial small and medium sector which forms the economy's backbone.

The June quarter data for gross domestic product (GDP) underlines the damage. Gross fixed capital formation, an indicator of investment demand in the economy, has slowed down quarter on quarter. Private sector investment has been negligent and bulk of the investment in the economy is originating at the government end. The Indian economy is growing on the strength of consumption, which—in the absence of investment in infrastructure and additional capacity creation—is inflationary in nature. In short, it's déjà vu time all over again.

In the midst of all this, a note submitted by former Reserve Bank of India (RBI) governor Raghuram Rajan to the parliamentary estimates committee on non-performing assets (NPAs) makes for an interesting reading. It does not tread new ground but does provide a brief historical sketch of the reasons behind the bulging NPA pool. Read in conjunction with a report on the banking sector from the parliamentary standing committee on finance, a few points emerge clearly.

One, the standing committee's observations and recommendations betray a sharp divide between the legislative and central bank. The committee questions RBI's penchant for excessive prudence, especially its logic for not only agreeing to adhere to Basel-III but insisting on Basel-III-plus norms. The committee argues that Basel-III-plus is disproportionate, especially for the nine banks brought under prompt corrective action which do not have any international operations. The committee argues that RBI's Basel-III-plus stipulations need to be reviewed for freeing up lendable capital.

This point becomes pertinent when viewed in the backdrop of accelerated NPA provisioning and its consequent effect on capital impairment, which has deterred banks from extending fresh loans. Adherence to Basel-III-plus is likely to put further strain, given the government's inadequate recapitalization programme.

At the *Mint* roundtable, former RBI deputy governor S.S. Mundra also expressed some disquiet over India readily accepting global regulatory changes post Lehman, despite these rules being designed for the developed markets with questionable relevance to India. This needs to be balanced with RBI's argument to the standing committee that, apart from the need to be seen as a timely implementer of globally accepted banking regulation norms, Basel-III-plus allows for development of a resilient banking system which can support the real economy in times good and bad.

The second point arises from Raghuram Rajan's note which makes it abundantly clear how many corporate borrowers have gamed the system, both in obtaining loans as well in the resolution process. His note observes: "Unscrupulous promoters who inflated the cost of capital equipment through over-invoicing were rarely checked…Too many bankers put yet more money for additional 'balancing' equipment, even though the initial project was heavily underwater, and the promoter's intent suspect. Finally, too many loans were made to well-connected promoters who have a history of defaulting on their loans."

Rajan also highlights how numerous Indian promoters have systematically undermined the debt recovery process, whether under the earlier process of debt recovery tribunals or the Sarfaesi Act. Unfortunately, the same malaise seems to have infected even the insolvency and bankruptcy code, which was hailed as the best solution for quick resolution of NPAs. Instead, as cautioned by Rajan, Indian businessmen have found ways to either destabilize the process or attempted to take back their companies at steep discounts.

A corporate bond market is the ideal solution for freeing banks and businesses from this eternal cycle of bank loans and NPAs. The idea remains still-born despite numerous committees recommending it; every time the idea pops up, another committee is promptly set up. The fortunes of the market are currently hostage to an inter-regulator turf battle. There are no easy solutions for NPAs; at least not till April 2019.

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