Overdraft: Saving the Indian Saver

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Overdraft: Saving the Indian Saver is a well-written, concise book which engulfs major concerns of the level playing field between government-owned banks (GBs) and private banks (PBs), powers of the Reserve Bank of India (RBI) as a regulator and the impossible ‘trilemma’. The sovereign (state) and the regulator (the RBI) face the trilemma. The three aspects of the ‘trilemma’ are (a) dominant ownership of government in the banking sector, (b) independent regulation and (c) adhere to public debt targets. The author is of the view that all three cannot concomitantly be sustained, and one must give way. Hence, privatization of banks may be an option, but there is no incentive for the government to make it happen. Urjit Patel’s book is compelling and is immensely valuable, and a nice read for students, academicians and practitioners. Being a member of the banking system for quite some time, the author could see the non-pragmatic approach of the banks, the regulator and the policy-maker. He has elaborated in this context what should be done to probably solve the impossible ‘trilemma’. This indeed is a unique contribution of the book.

The book begins with a grave concern about the ‘banking sector-fiscalization’ and an impossible ‘trilemma’. Mr Urjit Patel opines that the Indian banking system has reached a dead end where there is a dominant government sector (which indicates the GBs), a limited fiscal space (which indicates that government cannot spend money which is extremely high as compared to its income) and independent regulation. The author opines that such a situation is an impossible ‘trilemma’ and cannot coexist, and one of these trilemmas has to give way. He focuses on how the Indian political economy and the government, year after year, declare ‘credit budgets’ on behalf of banks instead of curtailing government expenditure. He opines that although such abnormal situations continued over a period that seems normal, the financial burden on the national balance sheet snowballs and takes the form of an inexorable problem. He says that the ‘almost dying’ capital stock must be put to work towards investment, and working capital and government has a vital role to play in two ways. First, the channelization may happen through government

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and PBs, and second, social lending requirements and statutory restrictions may be put in place.

The second chapter focuses on all the major stakeholders who contributed to the accumulation of the economy. These stakeholders include the government (policymakers), the regulator (the RBI), the banks (lenders), the corporations (borrowers) and the financial media. The government missed macroeconomic risk management by forcing higher credits to sensitive sectors such as real estate and construction. Although it received significant dividends from the GBs, it did not question the status of risk management in such banks. Audit committees did not have the full members, and seats were vacant due to the talent/domain knowledge gap. This acted as a hindrance in carrying out the fiduciary responsibilities of such banks.

The regulator failed to challenge the assumptions for lending activities such as much rigorous stress-test scenarios at the bank level, sensitivity levels on demand assumptions and sector risks. The asymmetry of information exists between the regulator and the lender, and it makes the regulator always too late for real-time monitoring. The delay affected the timely increase of sector risk weights to ensure the protection of lenders by increasing capital requirements. Evergreening of loans were allowed still in 2015, which allowed banks to hide their asset quality and at the same time allowed the borrower to avoid default. The regulator seemed to have increased the exposure limit for high-risk sectors like infrastructure projects. Even the governments three vigilance agencies (Central Vigilance Commission, Comptroller and Auditor General of India and Central Bureau of Investigation) could not provide real-time monitoring.

The banks acted merely as an efficient intermediator between savers and borrowers and did not take ownership of macroeconomic management. The banks applied little risk analysis in segregating bad loans from good loans, did not apply due diligence, skepticism, concern for exposure concentration and dynamic assessment over the loan cycle. The deafening silence of the business associations and the largest corporations (borrowers) over non-performing assets (NPA) is also a reason for such a long delay in identifying NPAs. The financial media has faulted in bestowing awards to banks that have been fined by sector regulators for transgressions. The author opines that the reputation of abiding by regulations should matter, and giving such awards to the wrongdoers may indicate condoning of wrongful actions. Costless verification can be made from disclosures to the stock market before bestowing such awards in the future.

In the third chapter, a comparison is carried out between the government banks and the PBs. The author opines that periodic sector-wise salary adjustments for employees of GBs is not at all linked with bank profitability and productivity, as the difference in compensation between profit-earning banks and loss-making banks is minimum. With these stark NPAs, the perception that government banks are safer would go away. The return on assets and returns on equity both seem negative for government banks whereas positive for PBs. Foreign institution investments seem to be much higher for PBs when compared to government banks. Government banks seem to do poorly when compared to PBs and equity markets.

On the contrary, PBs seem to do better than the equity markets and the GBs. To make matters worse for GBs, it appears that NPA ratios seem to be three times for GBs when compared with PBs. Frauds seem to happen more in GBs when compared to PBs.

In the fourth chapter, the book talks about the 9 Rs, for dealing with the crucial problem of NPAs. The first 4 Rs are recognize the reality, record, report and recovery. In order to get a feel of the size and nature of the NPAs, the RBI established the Central Repository of Information on Large Credits (CRLIC) in May 2014 to collect, process, store and disseminate data on all borrowers’ credit exposure, including Special Mention Accounts (SMA 0, 1 and 2) with aggregate fund-based and non-fund-based exposure of ₹50 million or more. This credit information is shared with all commercial banks. This analysis provided a borrower-wise and bank-wise first-level information dashboard for regulators and policymakers, which helped gauge how large and deep the problem was. CRLIC report provided dynamic real-time information that decreased information asymmetry between lenders and gaming by wily borrowers.

Asset Quality Review (AQR) of banks was carried out by the regulator in the second half of 2015, which helped all the stakeholders to know about the actual asset quality because banks were hiding problematic assets. After the exercise, there was a threefold increase in the NPAs of government banks and a twofold increase in the NPAs of PBs. Although there was a jump in stressed assets for PBs, their ratio of stressed assets to gross advances was appreciably lower. Their levels of regulatory capital were much higher. So AQR helped both policymakers and the regulators to catch up to reality. Efforts were exerted for timely restructuring of viable accounts and recovery or sale of unviable accounts. At this juncture, the constitution of the Joint Lenders’ Forum (JLF) was thought of. The JLF could refer resolution plan and one-time settlement proposals to the Overseeing Committee (OC). Due to the non-availability of the Insolvency and Bankruptcy Code (IBC), stop-gap mechanisms such as the strategic debt restructuring and scheme for sustainable structuring of stressed assets were adopted.

The fifth chapter introduces the 5th R, which focuses on resolution, including a series of temporal reforms such as the DRT Act of 1993, the SARFAESI of 2002 and...
the IBC of 2016. As per the IBC, defaulter of ₹10 million or more, even by a day, can be referred to the National Company Law Tribunal (NCLT). IBC offers a single window, time-bound (within 180 days), non-court route for credit resolution, increasing creditor rights. IBC provided that the defaulter could lose the firm to potential bidders in the event of a default. Hence, this would incentivize firms to borrow sensibly and avoid defaults. The threat of liquidation should provide sufficient incentive for creditors to arrive quickly at a resolution. Market discipline is not present in GBs since they know they will be backed up by the regulator, who strives to protect depositors’ interests. Banks that fear losing deposit base and incur the wrath of shareholders would timely recognize all possible losses. The inaction of banks against large defaults and poor coordination amongst banks is failing the impact of IBC.

The sixth chapter elaborates the 6th R, which reinforces resolution. Since empowered lenders failed to manage incipient risks and recover assets through IBC, the regulator had to step in. RBI invoked sections 35 AA and 35 AB of Banking Regulation (Amendment) Act, 2017 and issue directions to banks to initiate insolvency resolution process in case of default as per provisions of the IBC. The RBI also advised banks to put in place a board-approved dynamic policy for making provisions at a higher rate than the regulatory minimum, based on the risk and stress of various sectors. OC was reconstituted with an increase in scope and membership. The Internal Advisory Committee (IAC), a subcommittee of the central board of the RBI, recommended loan classification based on quantum, materiality and age of the NPA. RBI established a separate Enforcement Directorate to address the gap in the implementation of IBC, specific violations and breaches.

The 7th R is recapitalization which is discussed in detail in seventh chapter. A two-year recapitalization plan for GBs was rolled out. Banking sector recapitalization could take several forms: direct cash infusion by government and public financial institutions, issuance budget-neutral recap bonds by the government, raising capital (equity, sub-debt) from the market, realization of capital gains on investment (as a promoter by the government) and divestment of equity holdings in joint ventures, special purpose vehicles and asset management companies, subscription by GBs and financial institutions to each other’s Tier-II capital (like Japanese banks) and so on. Around ₹1.9 trillion was injected by the principal owner in GBs in 2017–2018 and 2018–2019. Similarly, the Life Insurance Corporation of India injected ₹2.1 trillion in GBs in 2018. So the aggregate infusion from 2010–2011 to 2018–2019 stands at about ₹3.1 trillion.

But the long shadow of moral hazard only gets broader as government’s general insurance companies now are short of capital and in the queue for recapitalization. Capital for more capital support by the principal owner (that is the government) is a function of the fiscal space. We could get the idea of the fiscal space by the difference in general government debt to GDP and target debt to GDP. Empirical evidence shows that general government debt to GDP is much higher than the target debt to GDP. There is no indication of effort in reducing general government debt to GDP from 2014–2015 through 2018–2019. Hence, further huge capital infusion by the principal owner, without destabilizing the economy, may be difficult.

The 8th R, corroborated in the eighth chapter, is reset and ring fence to cement the change. This R focuses on doing away with the resolution process based on asset classification of lenders, which existed in the immediate pre-IBC era. Now immediately on default, the accounts were to be classified as SMAs and the resolution process should start within a day of default. If the default issues of large borrowers were not resolved within six months, then these cases were to be referred to NCLT for recovery/liquidation. The revised framework excluded micro, small and medium enterprises with exposures up to ₹250 million. The defaulting promoters face the risk of losing control over their firms, and IBC incentivizes them to borrow judiciously and manage business risks to avoid default at any cost. Strengthening the credit culture at loan origination, continuous monitoring, default, asset quality recognition and swift resolution has shown a fall in NPA slippages. Ring fencing the problem through prompt correcting action, which involved specific regulatory action for banks to prevent further decline from the steady states. The regulator would keep a close watch on the prudent risk-tolerance thresholds and financial parameters, including the basic one of profitability. Limits on expensive deposits, reducing costs, discouraging expansion based in a risk-weighted asset basis and limiting high-risk exposures were other measures that could be imposed.

The ninth chapter talks about how reforms were weakened through lobbying. The author is of the view that judicious lending should be exercised by banks. He highlights how five loss-making banks were ‘graduated’ out of the PCA to augment credit growth. MSME loans saw extensions and augmentation at the same time. The regulator has to raise lending and monitoring standards rather than offer a loan bonanza. The RBI and the government were at loggerheads when the government thought that the deterrence effect (that is ‘future defaulters beware, you may lose your business’) is achieved and hence follow up action after default seems unwarranted. The author is of the view that if no action is taken within a reasonable timeframe, we will go back to the DRT and SARFAESI era.

The outcomes and implications of Rs are discussed in the tenth chapter. Indian lending model seems to
have become opaquer. While IBC gained modest traction, progress is slow as high-profile cases took 800 days. The cases seem to toggle amongst the NCLT, the NCLAT and the Supreme Court. There is no equity infusion from markets for the GBs, and they underreport NPAs that culminated in huge fines. The interconnectedness of GBs, PBs, NBFCs and mutual funds has brought more complexity. The AQR exercise for all these are mandatory. For PBs, strong regulation and market discipline will act as adequate guardrails.

The ninth R, discussed in the eleventh chapter, is a reform that seems to have disappeared as per the author. The author is of the opinion that the RBI does not have any authority on removing the directors and management of the GBs nor can it force or trigger any merger or liquidation. The RBI cannot revoke the license for the GBs as it can do for the PBs. Although RBI has been in the regulatory position for maintaining overall financial stability, the non-availability and exercisability of these powers has resulted in it being ineffective in dealing with frauds. Further, the duality of the managing director and the chairman of banks lead to serious corporate governance issue.

The twelfth chapter covers aspects of agricultural credit. Indian agriculture has perennially seen low investment, archaic irrigation practices, dependence on monsoons, low levels of technology, lack of property rights, fragmentation of land holdings and no initial net worth of farmers, which forces them to the vicious cycle of indebtedness with high frequency. Loans have been given over a period of time in the form of priority sector lending, subvention schemes of various types, loan waivers, various schemes to landless farmers, various government schemes. However, it has not resulted in an increase in average output over time. Moreover, the author opines that there may be an inflationary trend due to huge spending by the government in the form of loan waivers.

The thirteenth chapter discusses preventive vigilance. There are three kinds of vigilance: preventive vigilance, detective vigilance and punitive vigilance. Preventive vigilance is aimed at preventing the occurrence of a lapse of a rule; detective vigilance involves identification and verification of the occurrence of a lapse, and punitive vigilance is to take steps to deter such action in future. Preventive vigilance takes centre stage and conceptually will work best for PSUs.

The author focuses on five key issues on regulation and policies in the fourteenth chapter. The first is the globalization and adherence to global standards and rules. He focuses that our financial system should embrace global norms of risk recognition, capital and accounting standards; adopt a fiscal policy based on budget or expenditure rule and market-based exchange rate regimes. The second aspect that he focuses is that regulation should be more anticipatory and data-based rather than ad hoc. Regulation should be aimed to address information asymmetry between key stakeholders, which deters herd behaviour. The third aspect is that there should be forward-looking instead of backward-looking. Fourth, the author spoke on the ‘too big to fail’ argument of systemically important banks and financial institutions. Since they become systemically important, they get cheaper funds and hence their risk-taking soars. Going by their actions, their competitors also do the same, leading to an economy-wide vulnerable position. Finally, the author talks of global macroeconomic prudence and the current inadequacy of global financial safety nets and discriminatory central banks’ swap lines.

The fifteenth chapter explains how economists can help in policy framing and regulations. Economists can make both direct and indirect contribution in helping the policymakers. One is to be the part of the committee/body that deals with the issue at hand, and another is through their thought-provoking research. Spectacular reforms like the amendment to the RBI Act call for a specific mandate for the RBI to maintain price stability while keeping in mind the objective of growth. The amendment also incorporates the relinquishing of the monetary policy decision by the RBI governor to a six-member monetary policy committee. Economists also help to gain insights from unavailable official statistics through survey-based research as well.

The concluding chapter enumerates that GBs are allowed to boost preferred sectors, leading to equity infusion from the government. This adds to fiscal deficit and sovereign liabilities. Excessive credit growth during good times is immediately followed by repayment problems. Instead of ascertaining true asset quality, banks have been soft on borrowers. COVID-19 and low-interest coverage ratio will add to greater bad debts in future.

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