

Indian Banks: A Time to Reform?¹

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Abstract

This paper examines what holds Indian banking back and suggests a variety of implementable reforms that could allow banking activity to grow significantly without the periodic boom-bust cycles it has been subject to. Apart from regulatory and market reforms, we propose reforms to bank governance and ownership, especially for public sector banks. With the current enormous strains on government finances, there may be a window of opportunity in which these reforms may be possible since the status quo is untenable.

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India's credit market outcomes are full of paradoxes. The country's credit to GDP ratio remains low, even by the standards of emerging markets, at less than 60%. One might conjecture that the lack of credit penetration in India implies that banks are not lending "down the quality curve" and instead cream-skimming to lend to relatively high-quality borrowers. Yet the country's banking system has among the highest gross non-performing assets (GNPA) to total assets ratio globally, amassed mostly from loans to large industrial firms in brick-and-mortar sectors such as infrastructure, power, and steel, among others. The GNPA ratio stood at 8.5% even pre-COVID for the banking sector as a whole, 11.3% for public sector banks (PSBs) and 4.2% for private sector banks; the Reserve Bank of India's Financial Stability Report estimates the post-COVID stress scenario to result in an aggregate GNPA ratio in the range of 12.5-14.7%, with some analysts suggesting it might be even higher.

Furthermore, recoveries from defaulted loans are meager. Bank loan recoveries have historically been as low as 25-30%, having improved somewhat in recent resolutions under the Insolvency and Bankruptcy Code (IBC) to 40-45% -- one should note, though that these are early days still for the IBC, and these numbers may reflect easy resolutions. Even so, they remain way short of the global average and low even compared to several other emerging markets. Interestingly, default rates on small-ticket loans provided by micro-credit institutions tend to be substantially lower while recovery rates are higher.

A vast body of literature in economics finds that increased access to finance supports growth. Yet, sectors in India experiencing significant credit growth have routinely experienced subsequent growth slowdowns as rapid credit booms have been followed quickly by busts. Indeed, the subsequent resolution of distressed sectors, and the restoration of lenders to health, takes a long time. For instance, the boom-bust cycle of credit growth that preceded and continued through the global financial crisis lasted for about eight years from 2005 to 2013, yet its resolution is not yet in its decisive end game even in mid-2020.⁴ In the last five years, the historically stable category of micro-, small- and medium-sized enterprises (MSMEs) has experienced a boom in credit supply, at least by official numbers; were it not for delays in recognition of losses on MSME loans, it would be clear that this boom has also gone bust with a painfully long resolution stage likely in years to come. Unsurprisingly, a recent study by Harsh Vardhan and Rajeswari Sengupta suggests

⁴ Rohit Azad, Prasenjit Bose and Zico Dasgupta, "Riskless Capitalism in India: Bank Credit and Economic Activity", *Economic and Political Weekly*, Aug 5 2017, Vol LII No 31.

that increases in measured productivity of Indian banking sector (due to an expansion in lending) are soon followed by sharp drops and a rise in non-performing assets.⁵

Whichever way one sees it, banking in India seems more a manifestation of the boom-and-bust cycle view of credit rather than credit growth leading to sustained economic growth. While non-bank finance seemed to be growing well as a substitute for bank-based finance, notably through housing finance, asset-backed finance, and market finance (bonds and commercial paper), it has come under much stress too in the past five years and shown similar signs of a boom-and-bust cycle. Inevitably, stabilization of non-bank finance has been achieved in part through indirect central bank support via the banking system.

In essence, there is no escaping the hard task of making India's banking sector robust in terms of improved standards for loan underwriting, monitoring and recovery, along with a better capacity to manage risks. Increasing the loss-absorption capacity in the form of greater bank capital is desirable but will not be sufficient in itself. At any rate, the government will be severely fiscally constrained post pandemic. Since 2010, close to INR 4 trillion has been injected to recapitalize public sector banks. The additional opportunity cost of this sum (as measured by returns from investment in the aggregate stock market or an index of private sector banks) has been estimated to be INR 2.5-3.5 trillion. With the consolidated – central plus state – government deficit to GDP ratio likely to cross double digits this year (some estimates suggest 15%) due to the impact of COVID, and India's sovereign debt to GDP likely to reach historic highs, it seems imperative to consider alternatives, and at a minimum, reduce the inefficiency.

In this paper, we start by exploring why banking has become more difficult in India over the past few decades; we focus especially on challenges faced by public sector banks where issues of poor loan underwriting standards and resolution appear systemic compared to the relatively idiosyncratic governance issues that have arisen in private banks. We then discuss institutional complexities as well as deep incentive problems that have made bad debt resolution in India an exercise in “kicking the can down the road” with no end in sight; we offer some possible ways to deal with the legacy bad debt problem as well as to improve loan performance going forward.

Key to it all is improving the performance of public sector banks. We discuss how their management can be improved without a change of ownership as well as how ownership of public

⁵ “Are more productive banks always better”, Rajeswari Sengupta and Harsh Vardhan, working paper, IGIDR, August 2020.

sector banks might change. We also suggest ways through which banks can make better loans and monitor them, as well as, over time, better manage their market risks. A not-mutually-exclusive alternative is to increase the variety of banking structures in the country, an approach that seems to be delivering well. Our recommendations are summarized below, in the temporal sequence that they might be carried out:

I. **Dealing with Bad Loans:**

- a. **Out-of-court restructuring frameworks** can be designed for time-bound negotiations between creditors of a stressed firm, failing which National Company Law Tribunal (NCLT) filing should apply; the two need to work in tandem as the Insolvency and Bankruptcy Court's (IBC) procedural threat serves as the fall-back, facilitating meaningful negotiation out of court.
- b. **Development of an online platform for distressed loan sales** to provide real-time transparency in loan sales. Banks could be nudged to sell loans, and average prices for each class of loans could serve as objective "marks" for recording bank recoveries and losses, as well as guiding write-downs.
- c. **Private asset management and national asset management "bad banks"** should be encouraged in parallel to the online platform for distressed loan sales. Private players could aggregate and recover on loans in sectors where government intervention isn't necessary. The national public sector "bad bank" could serve as a vehicle to aggregate loans, create management teams for distressed firms, and possibly buy and hold distressed assets in a sector like power till demand returns. It could provide fall-back prices for loans sold by PSBs.

II. **Improving the Performance of Public Sector Banks:**

- a. **Operational independence for boards and management**, a proposal made by a large number of banking reforms committees over the past three decades, needs to be embraced by creating a holding company structure for government stakes. The holding company should make professional and diverse board appointments to each bank, and these directors should be empowered to guide the bank towards its

objectives; this way, government can maintain an arm's length from the management of PSBs.

- b. **Payment by the government to banks for achieving its mandated goals** (such as reimbursing costs for maintaining branches in remote areas or opening bank accounts for all); these payments should be available to all banks so that both private banks and public sector banks compete to deliver on mandates.
- c. **Winding down Department of Financial Services in the Ministry of Finance** is essential, both as an affirmative signal of the intent to grant bank boards and management independence and as a commitment not to engage in “mission creep” when compulsions arise to use banks for serving costly social or political objectives.
- d. **Incentive structures for management** need to be strengthened with longer terms for senior management, better assessment of performance, performance-based promotions and extensions, as well as some reliance on lateral hiring, which would also bring in state-of-the-art banking ideas and practices.

III. **Alternatives for Ownership Structure of Public Sector Banks:**

- a. **State-linked banks** can be a first step in altering the ownership structure of some PSBs, where the government brings down its stakes to below 50%, creating distance from operations of banks, and improving governance along the way (using some of the measures described in II).
- b. **Re-privatization** of select PSBs can then be undertaken as part of a carefully calibrated strategy, bringing in private investors who have both financial expertise as well as technological expertise; corporate houses must be kept from acquiring significant stakes, given their natural conflicts of interest.
- c. **Automatic dilutions** can be deployed as another intermediate step to re-privatization, whereby the government commits upfront to letting the bank board dilute the government's stake through raising of fresh capital whenever the government is unable to inject the capital required to meet regulatory requirements.

IV. **Making Better Loans:**

- a. **Create better capital structures for project finance**, for instance, in the form of greater promoter equity and eventual loan sales to long-term investors, even while government alters the real conditions under which these loans are made.
- b. **Smooth expected provisioning of loan losses** can be incorporated in bank regulation with the adoption of IFRS (International Financial Reporting Standards) / Ind AS as accounting standard for banks, with loan provisioning front-loaded rather than mostly back-loaded. Banks would then have incentives to recover on loans by resolving them rather than ever-greening.
- c. **Transition from asset-based lending to (also) cash-flow based lending.** Banks could rely more on loan covenants for large borrowers, tied to liquidity and leverage ratios (instead of lending purely against assets). This would set up “trip wire” points for enhancing loan collateralization, rather than requiring it from the beginning; in case of small borrowers, reliance on GST invoices and utility payment bills, among other cashflow information, can facilitate such a transition.
- d. **Transparency around frauds and group exposures** would improve market discipline and public enforcement, creating deterrence in egregious asset-stripping, cash-flow siphoning, and related-party transactions; group exposure limits, both at the bank level and the system level, need to be implemented, given increasing risk concentration in several key groups.

V. **Strengthening Risk Management at banks:**

- a. **Complete external benchmarking of loans** to market-based floating rates for *all* variable rate loan categories in order to create an automatic pass-through of monetary policy to the stock of legacy loans; this would create natural interest-rate sensitivity on bank balance-sheets that they can manage with greater use of interest-rate derivatives.
- b. **Time-bound transition to greater mark-to-market of treasury positions**, in order to move banks away from “lazy lending”, where investments in government bonds become a one-sided bet with downside risks managed by regulatory

forbearance; such transition would also increase the demand for interest-rate risk management by banks.

- c. **Index National Small Savings Fund (NSSF) rates to average contemporaneous bank deposit rates** to remove the fiscal overhang on transmission of monetary policy, and allow bank deposit rates to move more in line with interest-rate impulses; this would in turn enable a better pass-through of monetary policy to the real economy.

VI. **Creating Greater Variety in Banking Structures:**

- a. **On-tap licensing for banks** can be kept open at all times – with an annual invitation for applications – to create more vibrant banking with entry of better players, especially allowing high-performing micro-credit institutions to become small finance banks, and similarly, high-performing small finance banks to become universal banks. Conversely, poorly performing universal banks can be relegated to small finance bank status.
- b. **Promoting greater entry of non-bank players**, especially in the area of capital markets and newer forms of lending such as FinTech, building on the success in digital payments.
- c. **Encouraging development of wholesale banks** that rely on market financing, as a way to provide greater financing for long-term infrastructure projects without expanding the size of deposit insurance.

Our proposals, taken together, will move the needle significantly on Indian banking. They are not, however, revolutionary. Many of them have been heard in various guises before, starting perhaps with the first Narasimham Committee (1991), continuing to the P.J. Nayak Committee (2014), and through many speeches of regulators. There are strong interests against change, which is why many would-be reformers are cynical, and either have given up, or recommend revolutionary change that has little chance of being implemented. We are more optimistic that a middle road is achievable, given that the greatest stumbling block has been the government, the bureaucracy, and the interests within it. With the enormous strains on government finances from the slow growth pre-COVID and the subsequent effects of the pandemic, the country has to transform the banking

sector from being a drain on government resources and an impediment to growth to becoming an engine of growth. This will not happen through incremental reforms. The status quo is fiscally untenable. This is why we believe with the right political motivation, much can be accomplished that was impeded in the past. Given the importance of the banking (more generally, the financial) sector, though, reforms have to be on many fronts, closely monitored, and recalibrated to developments. What follows in this paper is an outline of a possible path.

1. Why is Banking More Difficult Today?

The degree of competition in the Indian banking sector over the past fifty years is best seen as the product of two “grand bargains.”

The first was between successive governments and the banks, whereby banks got privileged access to low-cost demand and time deposits (with some restrictions on rates that could be paid), to the central bank’s liquidity facilities, as well as some protection from competition, in return for accepting obligations such as financing the government (through the Statutory Liquidity Ratio or SLR), helping in monetary transmission (through maintaining the Cash Reserve Ratio or CRR), opening branches in unbanked areas, and making loans to the priority sector. While the privileges in this bargain are common to banking in most countries, the obligations were specific to India though they arise in some degree in other countries too.

The second grand bargain was between the public sector banks (PSBs) and the government, whereby these banks undertook special services and risks for the government, including providing coveted secure salaried employment to the middle class, and were compensated in part by the government standing behind the public sector banks.

As India has evolved from a mostly nationalized and bank-dominated economy to a more decentralized and market-financed economy, both these bargains have come under pressure – from development, competition, as well as the strained fiscal resources of the government.

Today, the investment needs of the economy, especially long-term investment in areas like infrastructure, have multiplied. With the government’s uneven past record in undertaking such investments, private entrepreneurs have taken them up. To create space for financing these investments, the government has been forced to pre-empt less of the banking system’s assets. But private investment is risky. Banks have to be more careful on both upfront project evaluation and monitoring over the course of the project. While banks have financed a considerable number of

large projects in the past two decades, loan losses have become huge. Ideally, more of these losses should have been absorbed by risk-absorbing financing from corporate bond markets and from equity markets. It seems, however, that many of corporate India's risks still end up on bank balance sheets, especially public sector ones. Indeed, because the strongest corporate borrowers can access domestic and international markets rather than relying on banks, the expansion of, and competition from, these markets has led to a further deterioration in the average quality of bank balance sheets.

Deposit financing is also no longer as cheap as in the past, as households have alternatives such as financial markets (direct holdings of equities and bonds, as well as indirect holdings via mutual funds), housing, and durable goods for investing their increasingly scarce savings. As households become more sophisticated, they are unwilling to leave a lot of money in low-interest-bearing accounts, especially as quick-access retail credit and new payments technologies make the liquidity offered by such accounts less valuable.

The first grand bargain – cheap deposits in return for financing the government – is therefore being threatened from both sides. Deposits are no longer cheap, while the government cannot pre-empt financing if we are to have a modern private-enterprise-led economy.

Public sector banks are, if anything, in a worse risk position than private sector banks, which is why the second bargain is also under threat. As low-risk enterprises migrate to financing from the markets, these banks are left both with very large risky infrastructure projects and with lending to medium, small, and micro enterprises (MSME). The alternative to taking these risks is to plunge into highly competitive retail lending where private banks have a strong presence.

With no easy lending options, and the country's critical need for infrastructure unmet, public sector banks initially chose to lend considerable amounts to large projects, especially in infrastructure. Many of the projects being financed today, however, require sophisticated project evaluation skills and careful design of the project's capital structure, recognizing that sometimes the greatest impediment to project success is government action (or inaction). Successful lending requires the lender to act to secure his position at the first sign of trouble, otherwise the slow banker ends up providing the loss cover for more agile bankers, or for unscrupulous promoters. To survive in the competitive business of project lending, public sector banks need to have significant assessment and monitoring capabilities they did not need in the past.

In the past, PSBs also had the best talent. But past hiring freezes have decimated their middle-management ranks, and private banks and multinationals have also poached talented

personnel from PSBs. New entry-level hiring is constrained by court requirements that hiring be done through open exams, which makes it hard for PSBs to attract candidates from elite educational institutions, who have little desire to sit for yet another exam. PSBs need to be able to recruit laterally, while retaining the talent they have, but to do so they need to be able to promise employees adequate compensation, responsibility, as well as the freedom of action. Unfortunately, employee actions in public sector banks are constrained by government rules and second-guessed by vigilance authorities, even while pay is limited. It has been hard therefore for public sector banks to compete for talent. If, in addition, these banks have to fulfill government mandates to further the ostensible public interest, their performance suffers further – as for instance in the recent push into MSME lending under the Mudra scheme. This makes it hard for them to raise capital. With the government strapped for funds, its ability to support the capital needs of public sector banks as part of the second grand bargain has been eroded.

Ironically, however, with inadequate support from the government, undercapitalized public sector banks tend to revert to financing the government rather than taking risks on new corporate or retail lending. Such “lazy lending” (a term coined by Dr. Rakesh Mohan) is a serious impediment to the growth of productive parts of the economy, even if it keeps the banks relatively safe on paper.⁶ Finally, the lack of profitability at PSBs has also affected their ability to service their core deposit franchise well, so they are slowly but steadily losing deposit share to private banks.

We cannot go backwards to revive the two bargains – that means reversing development and bottling the genie of competition, neither of which would be desirable for the economy even if feasible. Instead, the best approach may be to develop the financial sector by increasing efficiency, competition, and variety. Key to the transformation are public sector banks. They cannot keep veering from bouts of crazy lending – where they make losses and deplete capital – to lazy lending – where they lend to the government but not to the private sector – and back. Their limited current capabilities have to be seen as the central impediment to Indian banking’s progress, and it has to change if India is to have any hope of high rates of growth. Before that, however, the balance sheets of many public sector banks (and some private banks) have to be restored to health.

⁶ Of course, a bank that simply borrows from depositors to invest in government bonds cannot earn enough to pay its employees and other fixed costs over the long run, so lazy banking is unsustainable as a strategy. This is in part reflected in the rather low market-to-book ratios of public sector banks, presently only around 0.6 on average, reflecting both weak growth potential (numerator) and inflated book values (denominator).

2. Dealing with the problem of bad debt.

Even before the pandemic, the Indian banking system was dealing with high levels of non-performing loans. These will only increase post-pandemic. What should be done about them? The first step needs to be an honest recognition of loan losses.

Why recognize bad loans?

There are two diametrically opposite approaches to loan stress. One is to apply band aids to keep the loan current, and hope that time and growth will set the project or firm back on track – these include making new loans to allow the borrower to make payments on old loans (also called “ever-greening”). Sometimes this works. But most of the time, the low growth that precipitated the stress persists. Ever-greening grows. Facing larger and potentially unpayable debt, the promoter loses interest, does little to fix existing problems, often engages in asset-stripping or cashflow diversion, and the firm goes into further losses. The firm then technically becomes a zombie – neither dead nor alive. From the bank’s side, such problem loans consume much of management’s attention as well as new credit. Lending to finance healthy new investment or consumption by healthy borrowers suffers.

The problem spreads. One way that industries adjust to low demand is when some of the failing corporations in that industry close, allowing supply to fall, capacity utilization to improve, and prices to rise. However, if zombies are kept alive by banks that are unwilling to let them close, even healthy firms in the industry lose pricing power, start generating large losses, become stressed, and stop investing. Ever-greening, as Japan experienced in the 1990s and several Eurozone countries witnessed after the global financial crisis, can bring down growth rates in the entire economy as firms stop investing and bank lending is largely devoted to propping up distressed firms.⁷

An alternative approach is to try to put the stressed firm back on track rather than simply applying band aids. This may require deep surgery. Existing loans may have to be written down because of the changed circumstances since they were sanctioned. If loans are written down, if the promoter brings in more equity, and if other stakeholders such as the tariff authorities or the local government chip in, the firm may have a strong chance of revival, and the promoter will be

⁷ The academic literature providing this evidence is now extensive. Some of the key references for Japanese and European experience are contained in “The Unfinished Agenda: Restoring Public Sector Bank Health in India”, by Viral V Acharya, in *Quest for Restoring Financial Stability in India*, SAGE India Publishing, July 2020, Pages 27-42.

incentivized to try his utmost to put it back on track. Paradoxical as it may seem, a bank can recover more through an effective restructuring, even if it writes down the face value of its loans – indeed, that is precisely why banks participate willingly in such efforts across the world.

But to do deep surgery such as reducing loan interest rates, converting some portion of the loans to equity, and writing down loans (all these are collectively termed “restructuring”), the bank has to recognize it has a problem – it has to classify the asset as a Non-Performing Asset (NPA), which technically in India and many parts of the world is any loan where payments are at least 90 days overdue. Think therefore of the NPA classification as an anesthetic that allows the bank to perform extensive necessary surgery to set the firm back on its feet. If the bank wants to pretend that everything is all right with the loan, it can only apply band aids such as extending the term of the loan – for any more drastic action would require NPA classification.

Loan classification is merely good accounting – it reflects what the true value of the loan might be – as well as good economics for it allows the bank to preserve loan value best going forward. It is accompanied by provisioning, which ensures the bank sets aside a buffer to absorb likely losses. If the losses do not materialize, the bank can write back past provisioning to profits. If the losses do materialize, the bank does not have to suddenly declare a big loss, it can offset the losses against the prudential provisions it has made. This way the bank’s balance sheet represents a true and fair picture of the bank’s health, as a bank balance sheet is meant to. Provisioning also means that the bank’s owner (which is the government in the cases of PSBs) sees less profit, and less accretion via retained earnings to the bank’s capital, but if provisioning is steady, the owner is not surprised as the losses are recognized.

In India, as elsewhere, there are strong incentives for bank management to avoid provisioning. It implies an immediate hit to profits, and management invariably prefers that their successor takes the hit. The problem is doubly intensified in the case of public sector banks, since the government’s budget takes a hit from provisioning by PSBs (lower inflows of bank dividends to government revenues or higher required outflows to replenish bank capital). The short horizons of both bank management and finance ministry officials invariably imply there is pressure on the regulator to forbear and waive provisioning norms.

Of course, the day of reckoning is only postponed if the regulator waives provisioning requirements and turns a blind eye to ever-greening or zombie lending. Unless conditions in the industry improve suddenly and dramatically, the bank’s balance sheet presents a distorted picture

of health – the bank’s true capital is much lower than the accounting numbers suggest; worse, keeping zombies alive reduces the chance that industry conditions will improve as even healthy firms lose pricing power and do not find making investments attractive. The bank may even be tempted to make more injudicious loans based on the make-believe accounting capital it has. Moreover, when the losses are finally recognized, the owner has to set aside large and unexpected amounts to recapitalize the banks – if the owner is the government, it has typically not budgeted for it, and is made to pay for the profligacy of its predecessors.

Timely provisioning also gives bankers the incentive to deal with the root cause problem at an early stage. Furthermore, since there may be no additional hit to income when the banker actually writes down the loan, bankers are able and willing to restructure loans where necessary. Consider the extreme where a loan has been provisioned fully (100%). A bank’s incentive is now to realize as high a value in recovery from the loan and as early as possible since the entire amount recovered would accrue to the bank’s earnings. This is an important and positive incentive effect of an “accelerated” provisioning requirement for banks in helping resolve bad loans. With forbearance in the form of delayed provisioning, not only does the firm’s condition deteriorate, but the banker has to take a large loss when he eventually restructures the loan. So instead the banker holds off, under-provisioning mounts, and what was meant to be temporary regulatory forbearance inevitably creates banker demand for more, near-permanent forbearance.

Other impediments to dealing with distress

Even distressed corporations welcome forbearance, in part because of the stigma associated with being declared a non-performing asset (NPA). In India, the stigma has very real consequences. Indian bankers are particularly reluctant to make further loans to a firm whose loans have been declared NPA. This, even though the Reserve Bank has no regulation prohibiting such lending. Indeed, a firm may need working capital to continue operations, so a bank may be able to enhance the value of its previous loans to the firm (even if they have become NPAs) by making a secured working capital loan to the firm. Public sector bankers, however, claim they might be hauled up by the investigative authorities (the proverbial 3 Cs or Central Bureau of Investigation, Central Vigilance Commission, and the Comptroller and Auditor General) if they make such a loan. Indeed, the whole process of recognition and restructuring of bad loans, which is essential to deal with inevitable mistakes or bad luck that accompany any lending, is fraught with fear. Bankers don’t want to recognize a loan that has gone bad and they don’t want to lend to a distressed

borrower. Any of these actions may attract an inquiry by external agencies who second guess their professional actions; Why did you make this loan? Why did you lend to a distressed firm?

The problem is not just in provisioning or new lending. It may be particularly acute when it comes to writing down loans to a distressed firm. In developed countries, such write downs are deemed successful if the firm recovers, and is able to repay the written down amounts fully. Yet, from the investigative agency's perspective, such success is evidence that the bank wrote off too much – after all, could it not have gotten back more by writing down less? Of course, the agency does not consider the possibility that a more modest write-down may have left the firm too indebted to flourish again.⁸ Business decisions should not be evaluated with the benefit of hindsight, but it is hard for an investigating officer to avoid this error.

Private sector bankers sometimes take advantage of the fears of public sector bankers have of being associated with distress. They have sometimes gotten PSB-dominated banker consortiums to pay the private bank's loans off, knowing the consortium is reluctant to pull the plug on a distressed borrower. Indeed, because there is a variety of incentives within a consortium of bankers, it is hard to get them to agree to a course of action with the borrower. Some (typically fully-secured private bankers) want to be tough, others lenient, and any coordinated movement towards resolution is difficult.

The National Company Law Tribunal

The National Company Law Tribunal (NCLT) offers a way for the responsibility for restructuring to be taken out of the hands of the bankers. Essentially, the NCLT appoints an insolvency resolution professional who conducts an auction for the distressed firm and its assets, and pays the proceeds to claimants. Since the tribunal conducts the auction, bankers are off the hook in deciding how much of a write-down they must take.

There are still concerns, though. First, bankruptcy through the NCLT requires a change in management, since the original promoter is precluded from bidding for the firm. This requirement was necessary in the past because otherwise there is a strong incentive for the failed incumbent promoter to scare away other bidders (literally!) and buy back his company on the cheap, thus defrauding creditors. However, this requirement makes the NCLT a poor mechanism to deal with

⁸ Not considering this possibility reflects a view of provisioning and write-offs that is a purely accounting one, rather than an economic one.

borrowers whose firms are stressed through no fault of theirs – which is more likely to be true in case of stressed loans arising from the pandemic.

Second, the NCLT has limited capacity. It already has a large backlog of cases, some of which have dragged on for much longer than the targeted duration for bankruptcy. It cannot possibly handle the volume of distress that will have to be dealt with post-pandemic without a significant expansion of the number of its judges and benches. Unfortunately, the quantum of trained personnel that is needed may simply not exist.

Third, bankers still have to push the firm into bankruptcy court. Many of the reasons why bankers were reluctant earlier to deal with distress still apply.

One important (but not adequately understood) advantage of the NCLT is that it takes into its fold *all* creditors of the borrower while resolving default. While the Reserve Bank of India (RBI) and the Indian Banks' Association (IBA) have sought to coordinate creditors through arrangements such as inter-creditor agreements, these are binding on banks only. Non-bank creditors such as insurance companies and debt mutual funds and their respective regulators are not party to such arrangements. Given the increasing role of such non-bank creditors in the financing of large corporations (through commercial paper (CPs) and non-convertible debentures (NCDs)), there is a good rationale to keep NCLT open as a viable option for restructuring, even during the current pandemic, with possibly tight controls on eligibility of borrowers.

A reasonable option might be for post-COVID NCLT cases to allow the original borrower to retain control, with the restructuring agreed with all creditors further blessed by the court. Another alternative might be to allow the original borrower to also bid in the NCLT-run auction. In either case, it should be up to a super-majority of creditors to approve such exceptions (from the norm that original promoters are not allowed to bid), and they would do so only if the borrower is likely to be co-operative.

Ideally though, there should be greater use of out-of-court restructuring and the NCLT should be used to stamp the out-of-court restructuring with legal finality. Only if an out-of-court restructuring could not be agreed upon between the creditors and the borrower would the firm be forced into a bankruptcy auction. The shadow of bankruptcy would then improve the ease and quality of the negotiation out of bankruptcy, as it does in other countries. But this requires bankers, especially public sector bankers, to be able to negotiate.

Improving Negotiation in Distress

Clearly, a first step in dealing effectively with distress is to get distress to be seen as a normal commercial occurrence, not *prima facie* evidence of banker malfeasance. Numerous successive Indian governments have indicated they will move towards reining in the investigative agencies, but even if temporarily reined in, public sector bankers fear these will be unleashed whenever politically convenient. Moreover, some loans are undoubtedly tainted by poor diligence or even corruption. We will discuss possible remedies shortly when we turn to public sector banks.

Second, for the shadow of bankruptcy to keep out-of-court loan renegotiations honest, it is important that they be time-bound, and the NCLT proceedings be invoked automatically after a pre-specified number of days. Indeed, the longer distress drags on, the more it slows the economy. Corporate and financial sector distress should be dealt with quickly, far quicker than India has managed so far. Collection delays have resulted in the loan contract in India, especially for large promoters, being less of a debt contract and more like equity (as noted by N S Vishwanathan, former Deputy Governor of the RBI⁹), with none of the upside traditionally accruing to equity.

And third, for out-of-court loan renegotiations to work out, some mechanism to coordinate banks with non-bank creditors seems important, which may require a joint initiative of the respective regulators of banks, mutual funds, insurance companies and pension funds.

Bad Banks

Whenever the issue of distress comes up in India, discussion automatically moves to setting up a “bad bank”, a new entity which will take bad loans off bank balance sheets and resolve them. Yet these proposals rarely describe how the bad bank will resolve existing problems. Some caution is warranted – India’s primary experience with a bad bank is when IDBI Bank transferred bad loans worth over Rs 9000 crores in 2004 to a wholly-owned special purpose vehicle. Neither did IDBI recover substantial amounts via its bad bank (especially factoring in the delay in the recovery) nor did IDBI Bank’s lending record improve. In part, the bad bank is no solution if it simply transfers bad loans from one government-owned entity to another without changing the incentives to make bad loans at the seller or improving the ability to collect at the buyer.

⁹ “It is not business as usual for lenders and borrowers”, Speech by [N S Vishwanathan](#), Lecture at the National Institute of Bank Management, Pune, 18 April 2018.

Some questions about the functioning of an independent bad bank arise immediately. Consider some: First, what price will the distressed loan be sold for to the bad bank? Second, will the bad bank be able to write down the loans it buys? Third, will a successful bad bank trigger a political backlash? The answers differ depending on whether the bad bank is set up under public sector ownership or private sector ownership.

If set up as a public sector firm, investigative agencies may not quibble about the price at which bad loans are sold by public sector banks to the bad bank. After all, loans are moving from one arm of the government to another, the gains and losses stay within the government. However, if the bad bank is to benefit from buying all loans to a firm made by a consortium and negotiating one-on-one with the promoter, it will have to buy from private banks too. The price matters here, since the bad bank's officers could get into trouble (with the investigative agencies since it is a public sector firm) if it is deemed to have paid too much. Some "reference" prices would thus help.

Even if the public sector bad bank buys a significant fraction of the consortium's loans, though, its troubles are not over. It has to negotiate how much it will write them down, which exposes it again to the capricious attentions of the investigative agencies, especially if the firm recovers after the write-down. Corporate revival may, in the eyes of the untutored investigator, be a sign that the bad bank wrote down too much. Again, reference prices could alleviate the issue.

Do these problems go away if the bad bank is in the private sector? Not necessarily, since we already have a number of bad banks, called Asset Reconstruction Companies, and they have had only modest success. In part, public sector banks worry about the price they will sell loans at (especially since this involves recognizing a loss immediately, with possible recompense only later when the loan is partially repaid). Moreover, while the private bad bank may not have qualms in writing down loans, it (and sellers) may be subject to political scrutiny if it turns out to be successful – were loans sold to it at too low a price?

To mitigate pricing concerns and worries about the extent to which a public sector bad bank could write down the face value of the loans it buys, it might be useful to create a more liquid market for distressed loan sales. This can make secondary market prices of loans transparent, which allows them to be used as reference prices in other similar transactions. This could also be a benchmark for expected recovery from resolution. At present, attempts to sell loans by Indian banks feature individual banks soliciting bids that are never publicly revealed – other than the ultimate decision to sell or not. In essence, there isn't a transparent secondary loan market.

To aid the development of such a market, loan contracts (ideally standardized ones) would need to be codified into a data registry; a Public Credit Registry (PCR) being presently implemented by the RBI could be a natural place for hosting such a contract registry. Piggy-backed on the registry, an online platform can be developed to attract bids. Financial-sector-wide, possibly even real-sector-wise, transparency can be provided on bids received and eventual bids accepted and declined. Besides giving banks a market-based mechanism to determine loan sale prices and reducing their aversion to clear loans from books, the history of bids received can be analyzed by both buyers and sellers for improving pricing in future transactions. The resolution of South East Asian crisis in late 90's in South Korea led to the development of Korean Asset Management Company (KAMCO) that has now evolved into performing such a function as a public utility.¹⁰

Banks may need a regulatory nudge so that they sell loans, and jump-start price discovery in the market. Private sector banks could take the lead here, and they will have sufficient stock of saleable loans given the likely large amount of post-pandemic distress. Public sector banks could follow using the marks private banks establish. Large loans may be sold (even between banks) partly for cash and partly for participation rights in recovery proceeds (so as to share recovery risk between the loan seller and the bad bank) while smaller loans might be sold entirely for cash. In order that participation certificates not be an end-run around capital requirements, it is important that the provisioning requirements against them be adequate. At any rate, as the market develops, there will be more certainty on recovery values and therefore on reasonable loan sale prices, as well as write-downs. It is important for the authorities to create such a mechanism now. Fortunately, price discovery can improve quickly based on the large volume of distressed loans that have to be transacted.

If the problems of pricing and write-downs can be resolved, more viable public sector and private sector “bad banks” could emerge that primarily perform the function of aggregating loans and managing the underlying assets. Rather than trying to get a consortium to agree on every aspect of a restructuring, it may be easier for the consortium to sell out collectively to a bad bank. The officials of the bad bank can then negotiate directly with the borrower.

In some situations – for instance, when there are few bids in bankruptcy auction – the value on loans is better realized if the bad bank takes over the borrower and places the firm under new

¹⁰ “Bad Bank Best Practices: Lessons from KAMCO (Korean Asset Management Company/Bad Bank for the Indian Context”, Raunaq Pungaliya, CAFRAL, 2018.

top management. This could be done if it wins the bid for the assets in the bankruptcy auction. Each bad bank can have in-house management teams focused on a few specific sectors. These teams can be led by top managers who have retired or are recruited from the industry, and the teams can be parachuted into companies to replace the promoter and her top aides. The team can be compensated in part by an equity share that will grow with the extent of the turnaround. In effect, the bad bank takes on the *management of real assets*, replacing top existing managers at the promoter. This puts the bad bank in the role of a private equity manager, a necessary role in the face of widespread distress. Of course, the bad bank will find it advantageous to exercise management rights only when the original promoter is not an effective manager, and when other experienced industry players are unable to pay a reasonable price for the firm.

Finally, given the excess capacity in some sectors (such as power), there may be assets that have little value today but are likely to be more valuable as the economy grows (e.g., power consumption would naturally rise over time). Rather than trying to operate power plants in the face of inadequate demand, or liquidate them piecemeal, a better option might be to “mothball” them till demand is adequate to reopen them. Private entities may find it hard to mothball assets due to their high costs of long-term capital. Either existing government entities (such as the National Thermal Power Corporation) could perform this function or alternately a finitely-lived, professionally-managed national asset management bad bank could be set up for warehousing and resolution/sale of these assets (along the lines of the Resolution Trust Corporation in the United States after the Savings and Loans Crisis or the *Danaharta* in case of Malaysia after the South East Asian Crisis). It is unclear how these assets will be valued – so such transactions may initially be easier between public sector banks and public sector bad banks.

An alternative to setting up a national asset management bad bank for mothballing purposes is for the government to provide guarantees to private players who buy the distressed asset. However, what the private players pay banks to buy their loans would depend in turn on the cost of guarantees charged to private players. Such a government-guaranteed private arrangement may, however, be attractive if underlying assets are likely to be better managed in the mothballing stage by private players than by government-appointed asset managers.

Of course, while legacy bad loans are being cleared up, the authorities need to prevent yet another build up. While some private banks in India have been managed very poorly, even fraudulently, PSBs have more of a systemic problem. We now turn to this.

3. Improving Public Sector Bank Management without Ownership Change.

There are well-managed public sector banks and poorly-managed private banks across the world, and even in India today. So re-privatization is not necessarily a panacea to improving the competitiveness of the public sector. But even without privatizing, a change in governance, management, operational and compensation flexibility, and risk management, are almost surely needed in India to improve the functioning of most PSBs. This will enable healthier parts of the economy to receive more credit at reasonable interest rates.

Interference and Intervention

Start with governance. Clearly, post-nationalization, Indian governments have been reluctant to give public sector banks independence. The intent of nationalization was to make public sector banks fulfil non-commercial mandates such as equalizing access to finance across regions and sectors in the economy, and reducing the stranglehold that certain private houses seemed to have over borrowing. Regardless of the debatable success the public sector banks have had in delivering on these mandates, the downside has been government interference in the operations of the banks and intervention in their strategy. At the first *Gyan Sangam* in 2015, Prime Minister Modi suggested government interference was inappropriate, but government intervention was needed to further public objectives.¹¹ Unfortunately, neither has been good for the banks. Interference, including appointing favored candidates to management, expanding lending just before elections, or directing banks to lend to favored borrowers is obviously harmful, but so is intervention in setting mandates. The mandates are rarely transparent, and their cost is disguised to the tax payer. The collateral consequence is that the government uses these mandates to hold on to the banks, opening the door to problematic interference.

Instead, perhaps a better approach would be to pay for the mandates (such as reimbursing costs for maintaining branches in remote areas or opening bank accounts for all) so that both private banks and public sector banks compete to deliver on them. This will distance the public sector banks a little from the government. While public sector banks may be given a slightly different set of objectives than private banks (for example, they may put more weight on financial inclusion), their boards should have operational independence on how to achieve the objectives.

¹¹ <https://www.moneylife.in/article/old-gyan-about-public-sector-banks/40194.html>

Public sector bank boards are still not adequately professionalized, and the government rather than a more independent body still decides board appointments, with the inevitable politicization. Despite the government retaining the power to appoint, senior management and board positions at PSBs have remained vacant for months.

Far better would be to appoint strong bank boards with independent professional directors representing all segments of society. They should be empowered to take all bank-related governance decisions, including appointing the CEO and proposing the slate of candidates for private shareholder directors (subject to shareholder approval). These boards should be focused on governance – overall strategy and the means by which decisions are reached – be competitively remunerated, and be held responsible for meeting measurable aspects of the objectives, including profitability. They should not, however, be engaged in specific executive decisions. For instance, too many boards are dragged into approving specific loans even though board members have little commercial banking experience – they should monitor the process of loan making, and be able to judge outcomes (and hence loan officer performance) independently without being implicated in them.¹²

A holding company (an expansion and revitalization of the current Bank Board Bureau) could be created to hold government PSB shares. Its job would be to appoint government directors, who would vote the government's stake (after ascertaining the government's views). If the government's stake falls below 50 percent, these directors would clearly be forced to build coalitions with other shareholders if they want to push for some decisions.

If all these changes are made to governance, there will really be no need for a Department of Financial Services (DFS) in the Ministry of Finance. Today, its job is to assert the government's will over public sector banks and seek to affect bank regulation via the RBI Board seat carved out for the DFS Secretary in 2012. A key marker of whether PSB bank boards have sufficient independence is whether the department is eliminated, and its officials redeployed more productively elsewhere.

¹² A collateral risk of underpaying board directors and engaging them in specific executive decisions such as individual loan sanctioning is that vacancies may attract a number of directors who don't care about remuneration but benefit from influencing executive decisions.

Turning to PSB management, a number of eminently practicable reform suggestions have been made, some of which have been partially implemented – breaking up the position of Chairman and CEO (except for State Bank of India) and increasing the length of PSB CEO tenures.

One important reform is to move steadily to pay top management like bankers rather than as bureaucrats. Bureaucrats measure rank by salary. The heavens would fall if the ranking secretary in the Department of Financial Services was paid less than public sector bankers! Hence top bankers are paid poorly relative to their private sector counterparts, with little tied to performance, and the 3 Cs used to ineffectively keep them in line while they make decisions worth multiple thousands of crores. This needs to change, especially because more outside talent is needed in top management in PSBs – there is a talent deficit in internal PSB candidates in coming years because of a hiatus in recruitment in the past. At the same time, if the health of the public sector banks recovers, there will be plenty of opportunities for internal PSB promotees to expand their responsibilities.

Relatedly, the incentive structure for bankers should be worked out so that they evaluate, design, and monitor projects carefully, and get significant rewards if these work out. This means that even while loan committees may take the final loan decision, some senior banker ought to put her name on the proposal, taking responsibility for recommending the loan. Information technology systems within banks should be able to pull up overall performance records of loans recommended by individual bankers easily.

As for the problem of investigation by the 3 Cs, it should be possible for the government to offer public sector bankers various safe harbors, including triggering investigation by agencies only if an officer has a consistent record of decisions inimical to the bank (across multiple loans), and even so, only if the bank's empowered board authorizes it. Moreover, bank boards should have a range of available punishments (in addition to the rewards discussed above) for management decisions, including docking bonuses, suspension, and termination for cause, before criminal investigations are invoked. Put differently, corruption at public sector banks can only be dealt with if management is rewarded (and punished) for measurable performance. This requires a move away from the current reward and punishment systems, which are more applicable to the bureaucracy – no surprises because that is where it comes from.

Risk management processes also still need substantial improvement in PSBs. Risk management compliance is still not adequate in Indian banks, and cyber risk needs greater

attention. Government support may be the “original sin” that makes these banks less concerned about managing risk. Therefore, we turn next to the issue of ownership of PSBs.

4. What forms can PSBs ownership change take?

Some commentators argue it is impossible for the government to distance itself effectively from public sector banks or to improve PSB management through the kinds of steps we have suggested above. The only way to cut the umbilical cord connecting the two is to ensure the government has to share governance with private shareholders. A government holding below 50 percent will ensure that banks are free from public sector norms such as those pertaining to procurement, recruiting, pay, and oversight by the 3 Cs, which will give them greater ability to compete with the private sector.¹³ Some experimentation is certainly warranted to test this view.

State linked banks

The government ownership could be allowed to slide below 50 percent with suitable amendments to the Nationalization Act – as once suggested by NDA Finance Minister, Yashwant Sinha. PSBs could become state-linked banks rather than state-owned. A board obligated to work in the interests of all shareholders, rather than just the government, could improve governance.

Worker unions will have to be convinced. Their incentives are skewed by the fact that pay, benefits, and job security for a large number of public sector employees at grades below management exceeds that available in private banks (with the reverse at top management levels). Clearly, workers will worry that their packages will be rationalized down to meet that of the competition. There are ways this fear can be alleviated without overly tying the hands of bank management, including through credible promises of re-training, some protections given to existing pay and benefits, and the offer of reasonably attractive voluntary retirement schemes. Ultimately, though, the most convincing argument will have to be that the status quo is untenable, and the government simply does not have funds to keep plugging holes in bank balance sheets. This also implies the easiest candidates for state-linkage might be mid-sized, modestly performing banks. If these turn out successful for all stakeholders, it will pave the way for further such actions.

¹³ An alternative is that public sector banks are kept under-capitalized in the RBI’s Prompt Corrective Action (PCA) framework and prevented from undertaking excessive risks. While this is a possible option, it would not rule out lazy lending and attendant interest-rate risk building up on their balance-sheets; it also does not rule out the possibility that as and when further risks materialize, the burden falls ultimately on the taxpayers. Hence, options to alter ownership structure must be considered even if some banks are required to be kept under the PCA.

For some banks, such transition of PSBs to state-linked banks may be a natural step towards full re-privatization. Privatization should, however, be viewed as a process planned in advance rather than a one-off action.¹⁴ It is important that the entity to be privatized has a strong board that can take over once the government sells down its stake – that will also ensure it gets a good price. So one sequence might be for the bank holding company or the BBB to create an empowered board, and for the government to sell its stake below 50 percent, but still exercise some oversight through its directors while steadily selling the government stake down further. A couple of strong financial sector investors with significant equity stakes in the bank might add to the necessary governance. It might be especially valuable if these investors have financial sophistication (a foreign financial firm or a domestic private bank) and technology sophistication (a fintech firm or a technology focused private equity investor).

(Re-)Privatization

A final step for some banks would be full privatization, leaving the government with only a small stake. This may be necessary if the experiment with state linkage is not fully successful, or if it is and yet the government wants to redeploy funds where the need is greater. Two pitfalls to be avoided are (1) privatizing a bank without an adequate governance structure in place, and (2) selling a bank to a corporate house. The first is obvious since Indian banks are rarely allowed to fail. The second is more controversial, but is enshrined in RBI rules on new bank licenses. The experience in other countries with allowing corporations to own banks is that it increases the possibility of self-dealing within the group – the bank is used to make risky loans to failing group entities, and the bill is paid by the tax payer when the bank is eventually bailed out. A second rationale for avoiding the combination of banking and industry in the same group is that Indian industry is already highly concentrated. To allow more concentration by selling banks to industry groups is not sensible.

There is nothing wrong with independent banks with no dominant promoter, governed by strong professional independent boards that ensure their own continuity – some of India’s

¹⁴ During the South East Asian crisis, as government costs for bailing out banking sectors grew large for affected countries, several state-owned banks and non-bank financial firms were privatized or had government stakes divested below majority. Such divestments were, however, made under significant duress and some stakes were sold at steep discounts to aggressive private equity investors who often “flipped” the acquired stakes at better valuations rather than built long-term presence for active management and governance (see Viral V Acharya, Hyun-Song Shin and Tanju Yorulmazer, “Fire-sale FDI”, 2011, *Korean Economic Review*, 27(2), 163-202). Such risks from forced one-off privatization actions can be avoided with a phased plan towards privatization.

successful private banks have this structure. This is what we should strive for with full bank privatizations. One possibility could be that the government itself commits to an *automatic dilution* mechanism. In particular, if government does not inject the required capital into a bank to meet regulatory capital standards, it must automatically allow the bank's board to sell required equity stakes in open market at prevailing market conditions. This would in essence be a phased divestment plan that could eventually also lead to re-privatization; it also frees the bureaucracy from valuation considerations as the dilution rule would apply automatically once a decision not to inject required capital in a specific PSB has been made.

5. Making Better Loans

Bank underwriting, monitoring and risk management practices need to improve across the system, both in private banks and public sector banks.

Better project conditions and financing

The difficulty in lending to any “green field” project in India is that land acquisition is problematic, and even if it is successful, myriad further permissions are needed from various authorities for the project to commence. If the associated risks of delay are not contained, it is not surprising that many of these projects become commercially unviable. A significant fraction of the loan losses from project lending in India stem from government failure, not bank failure. The environment for doing business needs significant improvement.

At the same time, these risks will not fall overnight. What this then means is that greenfield projects have to be financed with significantly more buffers in the form of promoter equity, the more so the more the land/permissions that are yet to be obtained. Government will have to do more upfront so as to make projects viable, but the rest will have to be made up by careful design of project capital structures.

Banks have the leeway to raise long-term bonds to finance projects – the key for really long-term projects is for lending to be structured so that once the project construction is over and the infrastructure project is operational, the loans can be sold to longer term players such as pension funds and insurance companies. Such a loan sales market needs further development, transparency, and support, along with the distressed loan sale market discussed earlier.

Relatedly, banks have to develop their own project evaluation units, and not be dependent on one or two organizations like SBI Caps or IDBI that have their own weaknesses. Overreliance

on one or two assessors leads to increased aggregate risk if too many banks rely on them. Furthermore, banks should monitor construction closely, so that promoter practices such as over-invoicing capital goods purchases or selling goods (that are not paid for) to a related party abroad are stopped. Within-bank monitoring also needs to be enhanced, through automation of processes, setting of compliance norms, and monitoring the adherence to them.

Smooth expected loss provisioning and improve incentives to monitor

To ensure that banks are not tardy on provisioning, provisioning should be automatically done in anticipation, *i.e.*, in line with expected credit losses (ECL), rather than provisioning after losses have materialized; as explained earlier, delayed provisioning not only provides banks little incentive to engage in resolution and recovery, it also makes provisioning standards subject to repeated negotiation for regulatory forbearances.¹⁵ It is desirable that India switch to IFRS / Ind AS accounting standards – private banks have already prepared for it but implementation by public sector banks requires a legislative amendment. IFRS / Ind AS requires banks to provision for loan losses in anticipation and this would bring bank regulation in India in line with global standards.

There is, of course, some subjectivity in determining expected credit losses.¹⁶ Under-capitalized banks will have the incentive to understate losses, which can be addressed in part by supervisory oversight and by requiring a “floor” on the level of provisioning. Regardless, the adoption of IFRS / Ind AS will be a big improvement on current practice; it would shift the supervisory timeline of dealing with under-provisioning from after loan defaults have occurred to prior to their occurrence. Basel capital standards have allowed the transition “cost” of additional capital in switching to IFRS / Ind AS to be spread over a five-year horizon, softening the immediate impact from adoption. A few banks might face upfront losses in spite of the transitioning arrangement, but that hole might be affordable over the medium term given the likely gains from better accounting and provisioning of anticipated loan losses. At any rate, a post-pandemic reset in the banking system should include a time line to move to IFRS / Ind AS accounting.¹⁷

¹⁵ While the provisioning coverage of non-performing assets has improved substantially for Indian banks from 41% in 2016 to 70% in 1Q2021, back-loaded provisioning on future non-performing assets due to COVID runs the risk of another cycle of regulatory forbearances that is associated with inefficient credit outcomes in the form of lazy and/or zombie lending.

¹⁶ External or internal credit ratings are subjective, and the mapping from these to expected losses is based on models, which feature some subjective model parameters as also subjective modelling.

¹⁷ A possible next step in the reforms could be the adoption of macroeconomic stress tests in determining bank capital requirements. Such tests are already conducted by the RBI’s Financial Stability Unit and aggregate results published in its Financial Stability Report. Greater use of stress tests in regulatory and supervisory processes might

Another measure that can be considered is to shift banks from a mostly “asset-based” lending culture to more “cash-flow based” lending. As countries grow richer, the intangible portion of firm assets such as brand names and intellectual property increases. Often, the most important assets – its workers – are not owned by the firm. Consequently, loan contracts in more advanced economies have covenants that are linked to leverage and cash-flow (liquidity) conditions of borrowers. These covenants when tripped by a borrower allow banks to decide in advance of a default whether to renew the loan, alter the terms (shorten maturity, increase interest rate, require extra collateral, etc.), or refuse the rollover. This way, the bank loan contract does not rely exclusively on assets (if any) against which the original lending was provided, but adjusts sensitively to the cash flows of the borrower. These provide advance signals, even if imperfect ones, on firm credit quality, and can be used by lenders to protect loan value dynamically against the risk of loss in default. On the one hand, such covenants would create incentives in banks to monitor and build in automatic risk management. On the other hand, by creating risks to borrowers earlier than the point of default, they would improve borrower discipline in making timely repayments and maintaining prudent balance-sheets.

Indeed, such cash-flow based lending is the essence of micro-finance where borrower reputations develop over time starting with small and short-term loans, and its adoption at public sector banks could improve their underwriting standards and increase the share of consumer loans relative to commercial and industrial loans.¹⁸

Dealing with Frauds and Group Lending

It is worrisome that only a handful of large fraud account cases have been closed with the perpetrators brought to book. Unfortunately, the apparent lack of punishment encourages further fraud. In part, fraud cases are hard to solve because the trail is cold by the time the case is reported. Currently, fraud cases stagnate on average for at least 2-3 years as NPAs before being reported by banks. When fraud is detected, bankers should be incentivized to report them quickly – the RBI now levies monetary penalties on banks that delay inordinately. Specialized financial fraud units

also help focus the attention of bank management and boards on potential downside risks embedded in loan portfolios.

¹⁸ Presently, bank loans in India do not feature much use of such covenants; market finance instruments such as bonds do. One reason could be gold-plating at the time of loan origination which means there is not much additional security that can be pledged once risks materialize; another could be that without a well-functioning NCLT or out-of-court restructuring mechanism as a deterrence, bank’s negotiating power is weakened when covenants are tripped.

at the investigative agencies should then take up the trail quickly, and desist from focusing only on the banker (one reason for the delay in reporting). A list of frauds – which is already reported to the RBI – as well as progress in resolving them, should be made public and updated periodically. Private sector analysts also need to be encouraged to undertake forensic accounting to catch accounting fraud early, and they should be protected from legal harassment.¹⁹

Finally, complex corporate structures allow certain promoters to run extremely large conglomerates on thin slivers of equity. Not only does this create systemic risk in the banking system, it also leads to concentration of corporate power and a complex maze of related party transactions between financial and real subsidiaries of the group that are often the veil behind which frauds are perpetrated. The RBI has set aggregate group lending limits, but these have not been enforced yet because private industry claims the economic environment is weak. While it is understandable that groups may find it difficult to shrink their borrowing in difficult times, there is no reason that highly indebted groups should be allowed to expand their footprint significantly by using bank money to bid on new projects. While such lending should be discouraged immediately, group lending norms should be enforced as the economy recovers. Indeed, aggregate permissible system exposures should be linked to the aggregate debt equity ratio for the group (including non-bank borrowing and foreign borrowing). Over-leveraging by specific promoters or groups needs to be limited if the Indian banking system's health is to be restored.

6. Managing Banking System Risk Better

A variety of market risks, including interest rate risk and commodity price risk need better management, not just at public sector banks but also private banks (and in fact, also non-bank financial companies and mutual funds). We focus here on interest rate risk, but the concerns are more widely applicable.

Lazy Banking and Interest Rate Risk

Banks have historically not managed the interest rate risk in their sizeable government bond holdings. In part, this may be because no banker was ever fired for making losses on his holdings of government bonds. In part, this has been justified by the hope that inflation expectations or interest rates would decline. The preference for government securities – the world

¹⁹ <https://www.wsj.com/articles/india-analyst-is-jailed-after-negative-report-1418359350>

over – is further increased because banks require no additional capital for such holdings, a boon for undercapitalized banks. In India, public sector bankers lead the demand from the regulator to (i) alter the accounting treatment of bond holdings (protracted recognition of losses, increase in the held-to-maturity category of bonds, etc.) with the intention of postponing the recognition of treasury losses when interest rates rise; and, (ii) press for open market purchases of government bonds by the RBI that transfer interest rate risk to the central bank balance-sheet. Private sector bankers, clearly, lose nothing from supporting these demands.

The key point is that in one way or the other, investing in government bonds – a form of lazy lending for under-capitalized banks seeking to make quick gains – is a strategy whose risks are not managed by banks. In particular, there is little, if any, use of interest rate derivatives to contain the risks. Overall, there is a parallel here to outcomes in real sector lending where once underwritten, loans are subject to little monitoring and resolution, and ultimately, the onus is on the RBI to provide relief in loan loss recognition and on the government to recapitalize when losses are recognized. While there are notable exceptions to this behavior even among public sector bankers, it is far too common for the health of the banking system to be robust. The implication of this “heads I win, tails the taxpayer loses” is that with interest rate risk not priced well by a significant portion of the banking system, market discipline to contain fiscal deficits is substantially weakened.

A possible way out is to phase out the Statutory Liquidity Ratio (SLR) requirements given their overlap with Liquidity Coverage Ratio (LCR) requirements, and adopt mark-to-market accounting on a greater proportion of the Treasury portfolio of banks, so that interest-rate fluctuations pass through more regularly to the profit-and-loss statement in an economic value sense. The resulting variation induced in bank quarterly earnings would provide a powerful motive to bank treasuries to manage the interest rate risk. If IFRS / Ind AS was to be adopted as the accounting standard, then banks would have the option to select once and for all the size of their held-to-maturity (HTM) portfolio, any alteration to which would require the entire HTM portfolio to be marked to market in future. This would also reduce the presently asymmetric nature of interest-rate bet embedded in bank purchases of government bonds.

The argument that interest-rate derivatives markets are not well-developed in India is simply a “chicken-and-egg” problem that will be resolved once there is adequate demand for interest rate risk management by public sector banks. With the adoption of complete mark-to-

market accounting and induced interest-rate risk management by banks in normal times, regulatory forbearance in postponing recognition of treasury losses would be substantially reduced.

Monetary Policy Pass Through

An implication of lazy lending is that as the RBI embarks on an accommodative cycle, the pass-through of monetary policy is largely limited to government bond markets as public sector banks take their asymmetric interest-rate bets. In contrast, corporate bond yields and lending rates may not come down as fast; corporate bond yields have lower interest-rate sensitivity than government bonds, and won't generate as quick gains to bank treasury earnings if interest rates are cut further. Worse, banks do not pass on the benefit of interest rate cuts to existing borrowers as competition amongst banks is for purchasing government bonds rather than capturing loan shares with competitive terms.

Indeed, even though the RBI has tweaked the various formulae for determining how bank lending rates should float with deposit rates, their determination is still largely within the control of individual banks, which then makes bank lending less competitive. An effective solution to all of this is to require that bank loans be indexed to floating interest-rate benchmarks (such as 3-month or 1-year Treasury bill rates or commercial paper yields) determined using market prices by Financial Benchmarks India Limited (FBIL) so that existing borrowers experience an automatic pass-through from monetary policy. An alternative is to simply have the loans be linked directly to the central bank's policy repo rate.

The RBI has adopted such an *external benchmark* approach for new retail and micro- and small-enterprise loans, allowing banks to choose the specific benchmark (the preference to date being the policy repo rate). The RBI is yet to require external benchmark for medium-sized enterprise and corporate loans, where banks continue to employ an *internal benchmark* that is ostensibly based on their cost of funds but also allows for several discretionary inputs that are hard for supervisors to vet carefully in real time. In a declining interest rate cycle, the slow adjustment of the *internal benchmark* approach affords banks excess profits on legacy loans, and thereby steers credit allocation away from new loans. This problem too would be mitigated if banks managed interest rate risk better, and passed on declining rates to their borrowers, even if their cost of funds did not decline as fast.

Rates on Government Small Savings Schemes

Of course, banks are not entirely to blame for poor transmission. Another impediment in having banks be market-sensitive is that the high administered rates being offered by the government on National Small Savings Funds (NSSF) do not allow bank deposit rates of banks to come down rapidly. Even though NSSF yields are now linked to the government bond yield curve based on maturity of the investment, they provide a substantial premium to savers over bank deposit rates. The pass-through of the lower yield curve is often delayed to help the government garner resources to deal with its fiscal pressures. NSSF proceeds are now used widely, ranging from Air India to Food Corporation of India. Most recently, these funds have been proposed as a possibly way to bridge the state deficits. It is perhaps time to revise the formula for the NSSF rates a step further and index them directly to an aggregate of bank deposit rates and without any time lag in such indexing. This would help remove an important fiscal overhang on monetary policy pass-through to deposit rates, and, in turn, to lending rates for the real economy.

Finally, it is conceivable that credit risk could also be managed by banks in a more active manner during the life of loans, through reliance on credit derivatives such as loan guarantees and credit default swaps. Natural players for providing such credit risk protection and transfer would be insurance companies and hedge funds. The rules governing such credit risk transfer markets need to be set taking on board *all* market regulators besides the RBI to ensure that there is a demand for *both* hedging and speculating in these markets. A similar need for inter-regulatory coordination has arisen in the context of corporate bond repo markets where mutual funds and insurance companies need to be brought on board as active players – in addition to banks and bond issuers – so as to improve the funding liquidity of bond positions. While these markets (and the sophistication of new entrants into them) need to be monitored carefully, they could help banks manage and price credit risks.

7. Creating More Variety in the Banking System

There are, of course, a number of areas of success in the Indian financial system. For instance, the Universal Payments Interface (UPI) bridge has facilitated a large number of payment transactions, even while ensuring access to the infrastructure to all, whether private or public corporation. This is increasingly seen as a model around the world, where there is a growing concern over the monopolization of the digital payment infrastructure by large private

platforms.²⁰ Easy payments can be a building block to much lower transaction costs in banking and thus greater financial inclusion.

Existing players as well as new players will have to contemplate the integration of fintech into their operational practices. The creation of the payment bank license was a first step in including non-financial firms in the financial system. While this experiment is still work in progress, regulators have to consider a measured expansion of the financial system to include non-financial players and new technologies, using regulatory “sandboxes” for calibrated experimentation.

Given India’s low credit to GDP ratio, and its varied needs, the on-tap licensing that was initiated a few years ago need to be operationalized; interest in applying could be enhanced by organizing a coordinated annual applying and licensing process. Since granting universal bank licenses to new players can be fraught with significant governance risks, an attractive approach might be to persist with the path of differentiated banking licenses adopted over the past decade.

For instance, it may be the easiest to allow micro-credit institutions to obtain small finance bank licenses. Micro-credit institutions would benefit from access to retail deposits. The most successful of these banks will grow to larger sizes and can then be considered for universal bank licenses. Conversely, poorly performing universal banks can be relegated to small finance bank status. Indeed, even some of the smaller PSBs that remain state-linked and are not easy to re-privatize in the short run can be effectively specialized to be small finance banks, serving the role of financial inclusion rather than being highly risky universal banks.

If specialized small finance banks can make more than their quota of priority sector loans, and can sell their excess performance through priority sector lending certificates operationalized by the RBI, it will have two important positive effects. It will make “small” banking more profitable. It will also allow the entry and expansion of wholesale banks, including foreign banks, who operate through a limited branching structure, and focus on large loans, cross-border loans, and capital market operations. The presence of foreign banks might also help

²⁰ See, for instance, the G30 Report on Digital Currencies and Stablecoins: Risks, Opportunities and Challenges Ahead. <https://group30.org/publications/detail/4761>

develop capital markets such as corporate bonds and interest-rate derivatives, given their greater experience in managing market risks.

Some of our larger banks may over time find it desirable to float wholesale bank subsidiaries that provide long-term development or infrastructure finance and rely on wholesale financing rather than a retail deposit base. Given the past mixed experience of IFCI and IDBI, the government should resist entering this space again.

8. A Timeline for Reforms

These reforms will have to be sequenced. Dealing with distress is most immediate, but the creation of empowered public sector boards is also possible now – the Department of Financial Services simply has to hand over power to the Bank Board Bureau, which would further delegate the power of appointment of all top management and non-government directors to the reconstituted boards of the banks. The process of changing legislation governing nationalized banks, and subsequently selling government stakes below 50 percent, will follow, once the boards start exercising their augmented powers effectively.

Market reforms that require more upfront capital (such as IFRS / Ind AS provisioning) should be placed on the agenda once India recovers from the pandemic. However, long-overdue reforms to traditional sectors (power, real estate, telecom, etc.) and improving the ease of doing business and making investments (land, labour, judicial and contract enforcement reforms) would improve the real sector's capacity to generate cash flows that also contribute to the underlying ease of credit intermediation; these reforms should not be delayed at all.

9. Conclusion: Is any of this possible?

While we have put together a variety of suggestions, many of these have been discussed in the past. Many concern public sector banks and their governance. Is there any reason to be more confident they will be implemented now?

One salutary warning should be the NDA government's still-born effort to reform public sector banks. Following the PJ Nayak Committee report of 2014, the government brought a variety of key players together to a *Gyan Sangam* in early 2015, which recommended the setting

up of a Bank Board Bureau to make public sector bank appointments, and the creation of strong empowered bank boards that would allow banks to have differentiated strategies (one lament heard there was that every public sector bank branch looked similar, no matter which bank it belonged to and no matter where it was located). These ideas were supported by the Prime Minister.

Yet five years later, it appears that little has changed. The government still appoints bank CEOs; instead of the earlier practice of appointing a nomination committee dominated by government bureaucrats and regulators (with a couple of academics and retired bankers to ensure an outside opinion), that same committee is lodged within the Bank Board Bureau. The final decision as well as allocation of selected CEOs to banks is still with the government. The Department of Financial Services still appoints bank board members and decides on important strategies such as mergers. The failure of the *Gyan Sangam* suggests that any change has to have steady political support (rather than a one-off ceremony) and will have to be forced on a bureaucracy, notably the Department of Financial Services in the Finance Ministry, that has little incentive to change. Yet it is probably unfair to blame just the bureaucracy – the government in power has little incentive to loosen its grip on public sector banks. Why?

The government obtains enormous power from directing bank lending. Sometimes this power is exercised to advance public goals such as financial inclusion or infrastructure finance, sometimes it is used to offer patronage to, or exercise control over, industrialists. The government also has potential access to an enormous amount of sensitive information through its state ownership – for instance, the identity of purchasers of electoral bonds is known only to the State Bank of India.²¹ The government can oblige party members by appointing favorites to positions in public sector banks, including on their boards – and once there, some of these appointees use their influence to direct bank loans to favored parties. Parliamentarians of all parties are not immune to the lure of public sector banks – the banks are often asked to arrange the logistics for their fact-finding committee meetings in enjoyable locales across the country. And Finance Ministry bureaucrats are reluctant to let go of the power that allows a young joint secretary to order the chairpersons of national banks around.

²¹ <https://carnegieendowment.org/2019/11/25/electoral-bonds-safeguards-of-indian-democracy-are-crumbling-pub-80428>

We have already discussed the reluctance of unions to see any change in the public sector character of banks. The tax payer may occasionally get angered by the size of loan losses and fraud in public sector banks. However, reports of malfeasance at private banks, whether strategically timed by vested interests or otherwise, tend to diffuse the already weak incentives for the tax payer to press for change at public sector banks – even though the losses and fraud-affected accounts at public sector banks dwarf those at private banks. Moreover, the ordinary citizen is worried about the possibility that privatization leads to a greater concentration of economic power. So who of any consequence is for change?

The reality is few are. Nevertheless, change is necessary, and perhaps it may be forced by the pandemic. For the costs of the system, as reflected in the huge loan losses it generates, may soon be greater than what the government can afford to pay. With government deficits and debt levels reaching enormous levels, there simply are not enough budgetary resources to recapitalize banks. An encumbered, under-capitalized public sector banking system will not lend well, which will be a huge tax on growth, as it has been for the last six years. More worrisome, without reform the banks will cumulate further losses. Status quo is simply not an option.

At the same time, poorly structured reforms may not help. For instance, rapid re-privatization of a public sector bank without firming up an independent governance structure for the privatized bank may exacerbate problems rather than solve them.

It is important that the government use the urgency of the moment to draw key players together to develop a reasonable reform path; it should be comprehensive and not just a one-off “tick-the-box” exercise dealing with a thin sliver of issues. It should then reach a consensus with concerned players such as unions and political parties, and then embark on the reforms. To do any less at this important juncture would be a severe blow to the country’s aspirations.