Banking in next decade: Resolve first before planning…

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When talking of the future of banking in the next decade, one needs to be pragmatic in understanding the situation as it is today and have the critical issues addressed before talking of a theoretical structure which has been articulated several times by management consultants and government committees. The fact is that the banking sector is in an ideological mess, where we need to accept that there are fundamental problems that have to be answered before talking of the future. Or else, the same fundamental issues will keep popping up again leading to the same set of discussions.

The malaise as has been seen over the last year or so is not just in the public sector banks which are the easy punching bags, but also, private banks and the regulatory system which include successive governments which lived in denial and allowed the situation to reach this state. In short, there are signs of a banking crisis which has been accepted though not in so explicit terms which has not fortunately exploded to cause fissures in the real economy.

In the global context there have been major financial crises starting from 1987, when there was the stock market crash which did not affect India due to the absence of globalization. The 1997 Asian crises which again had as its cornerstone crony capitalism and lending shook the Indian economy without bruising it and the crisis was more on the forex front. The 2007 crisis was quite global and we remained smug that we were not affected because we were prudent. But, this very cause i.e. reckless lending called NINJA loans in the housing space which was blown up by the use of financial derivatives such as CDS, CDOs, etc. in a way entered our system in a different form. Lending to high profile projects became pandemic as all banks wanted a share of the pie and hence, lent to mega projects. This was part of the fiscal and monetary stimulus which we were proud of. GDP growth escalated and with a big touch of hubris we claimed that our growth was de-coupled from the world and India can drive the world economy along with China. There was never a counter argument here.

Alongside, there were several political controversies which led to projects getting stalled for several reasons and while the usual blame game started, it was always directed to the government. At this time as the quality of assets took a hit, we did not accept this development and started restructuring assets in the name of CDR, where the justification was that projects failed because of extraneous circumstances and, hence, need to be restructured. The fact that the lenders were a part of the CDR cell meant that entry into the club was easier and we managed to keep kicking the can. Then, one fine day the regulator insisted on recognizing all these assets as being bad and in the last 2 years things have gone from bad to worse as the timeline which should have been met got pushed forward continuously. The latest RBI FSR does indicate that March 2019 may be a more realistic timeline until which we can see more such recognition.

In this milieu, the PSBs have become the favourite whipping boys. The reason is that they have been lending to most of these infra or heavy funded

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companies which have gone bad. As heads of banks change, there are more revelations made with the previous regimes being blamed for the build-up of an adverse asset portfolio. Sleuths from various investigative agencies are on to the backs of even retired Chiefs making banking a dangerous game. As there are no easy solutions, talks of mergers, privatization, closing down banks, restricting activity (prompt corrective action rule) etc. are being espoused regularly. In between, the IBC has raised hope with a resolution process being in place. Given the legacy issues in most cases, the value of the asset has fallen over this time period – which could be a decade for some cases. Therefore, recovery rates are lower.

It is against this background that conjectures can be made or suggestions provided which need to be taken up with urgency in the next decade.

Broadly speaking, the agenda for the next decade can be in two parts with no specific time lines as the second part should be taken on after the first is completed. The first is in the area of ideology and structure which should be taken up; and the sooner there is consensus the better it would be for the system.

Four related issues that have to be taken up together can go with the 4P acronym – Political Agenda, Privatization, Priority Sector Lending and Power Structures. All the four are inter-related and hence, need discussion and resolution. The first is political agenda. Politics must be separated from banking which is a commercial venture undertaken by entities that happen to be owned by the government. As long as there is interference in any form, banks would always be subservient to the government in power. Governments often run their political agendas based on largesse which is provided through the banking system. This could be the old loan melas which now comes in terms of targets being set for agriculture lending or SME lending through MUDRA. Why should banks be told what to do once the 40% norm of priority sector is laid down by the RBI? And if one sifts through data, it will invariably be the PSBs which are forced to do such lending which results in concentration – the latest is MUDRA loans. In fact more recently a Minister of State has warned bankers that if SME lending targets are not met, increments would not be provided by the system. In such a situation how can one expect lending to follow the best practices?

Next, loan waivers announced by government vitiate the concept of credit risk evaluation as bankers are now not sure whether it makes sense to be judicious when lending. The quality of credit evaluation slips when the environment is driven by such agendas. Third, PSBs Chiefs have always been called by the FM regularly and told to lower interest rates. Shouldn't such decisions be left to the bankers? Such instructions are another reason for bankers to push credit and lower the interest rate which leads to adverse selection of assets. The ostensible reason is the pressure put by corporate bodies on the government to get cheaper finance. While it is legitimate, the decision should be left to the banks which finally become responsible for the quality of the portfolio. Last, special schemes like say the Jan Dhan have been virtually forced on the PSBs where they account for more than 90% of the accounts. Why should this be done?

Now, related to the political economy is the issue of privatization. When PSBs are owned by the government it becomes their duty to support them and there should be no second thoughts. If the government wants to move out, it should be clear that the banks must be privatized. It is arguable whether privatization is the answer as private banks have also not fared too well when they do the kind of lending that PSBs do. Those which have done well have focused on retail lending where there is lower probability of delinquency. Also the idea of privatization should be to go below 50% to make sense or else it sounds like a feeble attempt to get resources for meeting fiscal

targets. This is a tough call to take and if it cannot be done, then the capital infusion has to be through the Budget and there is no other option. The recap bonds concept though a legitimate way of capitalizing banks is not a long term option. The attempt to get public sector FIs to buy PSBs is a hotchpotch as is the idea of merging two PSBs. In case of the former the only beneficiary is the government as the bank would run with similar governance structures. In case of the latter, it is a way of camouflaging a weak balance sheet with a stronger one and does not address the issue.

Therefore, while it is still not clear whether private banks do better than public in terms of governance, the idea of privatization has to be with conviction and not one where the goals is to push the problem below the carpet.

The third P is Priority Sector Lending where the stipulation is just too high. In fact, if we go back to the Narasimham Committee Report, almost all the recommendations have been met except the one on Priority Sector Lending which has remained un-touched. This is associated with the political agendas and hence has never been altered. In fact, all other avenues like MUDRA or affordable housing are also pushed into this 40% which comes in the way of running any commercial venture. While no banker would admit this is a drag, the fact that no bank exceeds this limit is evidence that it is being done because it is mandatory. The same funds could earn higher returns in case they were lent elsewhere.

The last P pertains to Power which is related to governance structures. When it comes to PSBs, it goes back to the political agenda which drives such selection. This appears to be the bane of all public sector organizations where the selection of the management process makes it subservient to the government. This has to change. The Banks Board Bureau was a good idea which has not quite been allowed to do what it was supposed to do. The entire system of governance has to change internally in banks where hierarchies need to be reassessed and a proper reward system put in place. All this has been articulated several times and unless we change the system, it will just be years before the next crisis (which can never be eschewed in this dynamic and globalized world) pop up the same issues. Given the controversies in some private banks, the operating process for lending should be articulated by statue to ensure that the rules are followed.

While none of these points are new, it should be reiterated that unless the superstructure exists in a near perfect form, only then can the banking infrastructure work the way it has to or else there will always be conflicts that have to be addressed. The big question is: Are we willing to do this major housekeeping exercise?

The second part of the agenda for banks is to do introspection and get into the CLAP mode – Capital, Lending, Asset Quality and Profits. It cannot be debated that the Indian economy is definitely poised to grow at a high rate of above 8% on a continuous basis for an extended period of time given the spare capacity that is there in terms of satiating the needs of a population where income will increase and providing finance for infrastructure which remains quite abysmal even today. With the Basel III norms being more stringent with the focus on liquidity, banks will have to gear up to continuously keep their capital ticking which can be through fresh issuances or profit plough back. This is something which has to be monitored on an annual basis so that barriers to growth are not reached. So far Indian banks have been well capitalized and not encountered a problem with the exception of some PSBs which have had challenges with the provisioning eroding their net worth. Here, the PSBs have to be told clearly what the options are from the beginning.

On lending banks need to be cautious when interpreting economic signals. In the period post financial crisis of 2007, no one expected that the economy would fall into deep stagnation as projections

were overly optimistic with everyone talking of double digit growth. This led to adverse selection of projects as everyone assumed that growth will be exponential. Here, banks need to have the right skill sets to evaluate credit risk, which should be stringent and subject to regular audit to ensure that excessive risk is not taken. The risk management departments have to take a very professional view here. Also the lending has to be aligned with the overall ability of the bank to assess and disburse such loans like tenures, skills for assessment and so on.

Asset quality will always be the variable to watch out for as banking involves risk and howsoever prudent one can be a credit risk evaluation, there would always be cycles when they would be humped up. This is where banks need to recognize them immediately and look for resolution as per the latest RBI Resolution Guidelines. Taking these cases to the IBC as per timelines would be prudent for the bank, as the recovery tends to be higher too when the asset is functional. Separate departments should be there for monitoring NPAs which should be in regular conversation with the clients informing them of the action to be taken. More importantly, there should be no relaxation of norms for such recognition as such flexibility is always used to justify other sectors too. For example, there is talk of providing a dispensation for power projects, and once an exception is made, can be extended to others too.

Last, banks should work towards meeting pre-determined profit goals which should be on par with global standards. Ideally they should be working with lower interest rate spreads which is not the case today. The ultimate goal would be to attain a ROA of 1%.

The next decade will also be important for banks because, several actions taken in the last couple of years would be indicative of how the existing commercial banks have to respond to the changing circumstances. First we have already seen the entry of some payments and small banks which are niche banks that are into specific areas. They would be competing or complementing banks on deposit raising and lending to SMEs. Their business models are different as payments banks are generally driven by technology and would be competing with banks for the wallet of people in the hinterland. Small banks would be looking at SMEs and the issue is really whether they will go to the un-banked or compete with existing banks. Depending on how these banks perform, commercial banks will have to be prepared to change their models.

Second, NBFCs are becoming more important and have leveraged the opportunity posed by the present challenging situation in the banking space. While they would prefer to become banks, their operations could compete with banks especially if banks move away from high volume term lending and look more closely at the retail space.

Third, RBI and SEBI have given a big push to the corporate bond market as it is believed that this market is best suited for meeting requirements of long term finance. Therefore, the large exposure norms brought in by RBI which will force companies with bank exposures of over ₹ 10,000 cr. in April 2019 to move to the bond market could mean some loss of business though, one is still not sure how this would be enforced. Similarly, the government announcement to let insurance companies and provident funds to invest in 'A' rated paper can make companies move to the bond market as the cost is lower than in banks. Presently, the restriction of AA rated paper keeps several companies out of the bond market and they perforce come to banks to borrow funds. SEBI's proposed norms of prodding large companies (with long term loans of above ₹100 cr.) to borrow 25% of requirements form the bond market would provide some relief to banks, but also, lower their quality of portfolio as this holds for AA rated companies.

Fourth, the further advent of technology through digital transactions and artificial intelligence would

be something banks have to be prepared for. The concept of branches, ATMs and even staff would have to be re-evaluated so that one is prepared for such changes. This will be something which banks have to contend with as modes like peer-to-peer lending or crowd funding are being spoken of and can be a reality tomorrow.

For sure, the next decade will be exciting for the banking system. But we need to get the ideology right to reduce the pain of contradictions which we have not been willing to resolve so far. Banking is highly controlled from above and also blamed for sub-performance which is not the way the business should be run.