Research Paper

EPRA International Journal of Economic and Business Review-Peer Reviewed Journal
Volume - 11, Issue - 1, January 2023 | e-ISSN: 2347 - 9671| p- ISSN: 2349 – 0187

SJIF Impact Factor: 8.302 || ISI Value: 1.433 || Journal DOI URL: https://doi.org/10.36713/epra2012

PRUDENTIAL BANKING REGULATIONS

A Critical Review of Indian Banking Regulatory Framework

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DOI No: 10.36713/epra12261 Article DOI: https://doi.org/10.36713/epra12261

ABSTRACT

Several Financial Institution Reforms have been undertaken in India in the recent past, specifically targeting some endogenous weaknesses inherent in Indian Banking Regulatory Framework. Several other reforms, however still await implementation that can potentially enable India's financial institutions to cushion the long-term blow inflicted by the Covid pandemic. This paper reviews several prudential banking regulations that can potentially benefit Public Sector Banks in India – The 9R's , Dealing with Bad Loans, Alternative ownership structure for PSB's, among others.

INTRODUCTION

RBI's Financial Stability Report published in January 2021 estimated that the post-COVID stress scenario will result in an aggregate GNPA ratio for the Scheduled Commercial Banks to be around 13.5 per cent by September 2021 under the baseline scenario and may even deteriorate and escalate to 14.8 per cent under the severe stress scenario. In these uncertain and crippling economic times, it is important to critically and constructively gauge at the health of the banking system of the county, delve deeper into the root cause of the prolonged stress and analyse the numerous possible resolutions that can be implemented to reverse the pessimistic trend.

India's banking system has the highest gross non-performing assets (GNPA) to total assets ratio among the BRICS economies and has the second worst GNPA to total assets ratio (10.3% as on September 2019) among large economics according to IMF data. It ranked India 33rd among 137 nations with bad NPA ratios. In this context, a critical review of the potential prudential banking regulations that could help de-escalate the risks faced by Indian banks is of utmost importance. The same is attempted in this paper.

The first wave of "*Twin Balance Sheet Crisis*", followed by the second wave of challenges from the "*Four Balance Sheet Crisis*"

As the world economy slowed down in the aftermath of the Global Financial Crisis in 2008, various infrastructure projects that started during India's investment boom of the mid-2000s began to go sour. This led to an onset of the first wave of Twin Balance Sheet Crisis in India, encompassing Banks and Infrastructure companies. India's exports were growing at their fastest rate since Independence just as the GFC hit and global trade growth collapsed. Further, prior to the GFC, confidence in the future was soaring high, riding on the back of glaring export performance of the country. Hence investment, particularly in the infrastructure sector reached an unprecedented 38% of GDP. This investment boom was financed by an extraordinary expansion of credit by the banking sector. Both Investment as well as Exports which had thus far propelled rapid growth in the Indian economy began to show signs of distress contributing to the Twin Balance Sheet problems. As the Advanced Economies rallied to reign in the GFC, it increased the relative interest rates domestically and led to the depreciation of Indian Rupee vis-à-vis

the US Dollar, all of which led toa downgrade in the financial projections of the profitability of firms especially those in the infrastructure sector. Profits consequently collapsed, and the firms found it difficult to service their debts borrowed during the boom prior to the GFC (Felman & Subramanian, 2019). With the mounting of the corporate Debt, the NPAs of the Banks increased reaching double digits. India was now saddled with the first wave of Twin Balance Sheet Crisis.

However, the economy also experienced huge windfall gains in the form of falling International Crude Oil Prices, a Credit Boom extended by the NBFC sector and a (largely Hidden) Fiscal Stimulus (Felman & Subramanian, 2019) which enabled the realization of reasonably good economic growth despite the predicament of the Twin Balance Sheet Problem. The NBFC Credit Boom however was withdrawn in the late 2018 and with that, all major engines of growth, this time also including consumption, sputtered, causing growth to collapse. It was this collapse in growth that ushered in the second wave of stress in the Indian banking framework with India now facing a Four Balance Sheet challenge (Banks, Infrastructure Companies from the first wave and Real Estate, NBFCs from the second wave) (Felman & Subramanian, 2019).

Just like the current Four Balance Sheet Crisis, the governments resolution of the banking sectors challenges has come in two phases. In the first phase of the resolution of the first wave of Twin Balance Sheet Crisis, Capital to the tune of Rs 2.8 lakh crores was injected into the Public Sector Banks. This was a successful effort as it led to an increase in the Common Equity Tier 1 ratios of the PSBs to 10%, above the regulatory minimum of 8%. As a result of these capital injections, the PSBs have successfully been able to write-off NPA exposure worth Rs 7.2 lakh crores since 2014 and simultaneously reduce their NPA ratios from 11.5% in 2017-18 (peak) to 9.5% of Banks assets in 2020, approximately equal to Rs. 9.2 lakh crores.

According to Felman & Subramanian (2019), even these ratios are an under-estimation of the gravity of the NPA's in public sector banks. A sum of Rs 2.5 lakh crores is additionally being negotiated as "Inter-Creditor Agreements", a euphemism for "Stressed Assets".

The RBI itself has come up with several "Restructuring Schemes" such as Strategic Debt Restructuring (SDR) Mechanism, Scheme for Sustainable Structuring of Stressed Assets (S4A), etc to resolve the "Bad Loan" burden on the Indian banking sector. The Insolvency and Bankruptcy Code (IBC) was then legislated in 2016 to initiate a "prompt resolution based on Commercial Criterion". Unfortunately, the pace of the resolution through IBC has itself been inadequate, with the completion of cases taking 409 days on an average as opposed to the judicially mandated 270 days' time-frame. The pace of the progress of resolution is even slower in the case of Large Debtors which account for the bulk of the Bad Loan Burden in PSBs. By the end of 2020, IBC channelled resolutions were successful in recovering only Rs 83,000 crores of the Rs 2 lakh crore worth Bad Loans referred to it by RBI (a huge hair-cut had to be tolerated by PSBs). Even this small fraction of NPA resolution is deemed by economists as an overstatement of the prospects of the success of IBC mechanism because most of these bankruptcies processed by the IBC have been relatively straightforward cases, such as steel producers caught in the downturns in global steel prices, simultaneously as China aggressively dumps its steel in the Indian markets (*Electrosteel* with a recovery rate of 38%, *Bhushan Steel* with a recovery rate of 62%, *Monnet Ispat* with a recovery rate of 25%, *Jyoti Structures* with a recovery rate of only 17%, *Alok Industries* with a recovery rate of 77% and *Essar* with a recovery rate of 54% - source : IBBI report). The largest portion of the stressed assets belong to independent power producers and their resolution is a long way in the recovery process.

The second wave of the Twin Balance Sheet Crisis started when the stress could not be contained merely as a legacy problem of banks and infrastructure companies, The NBFCs (on the lender's side) and real estate conglomerates (on the borrower's side) are the two new sectors plagued by the balance sheet crisis. The demonetization exercise flushed the banking network (including mutual funds) with considerable amounts of cash, as close to 99% of the currency was returned to the banks. Much of these funds were lent out to the NBFCs. By December 2017, Credit acceleration was visible, largely driven by the lending spree of NBFC's. A significantly large part of the NBFC lending was channelled to the real estate sector (emerging middle class, higher income earnings and aggressive launching of new housing projects).

Historically, the real estate sector was primarily funded by banks, but the trend reversed after demonetization when majority of their incremental lending was financed by the NBFCs. By 2018-19, nearly half of the real estate loans outstanding (amounting to about Rs 5 lakh crores) was obtained from NBFCs. NBFCs believed that real estate developers would be able to complete projects timely, sell their inventories and repay back their outstanding debts. This premise however could not materialize as demands for flats remained sluggish for a long time.

Mutual Funds (were themselves heavily invested in NBFCs) were quick to recognize that the probability of NBFCs being paid back in the short-run was weak at best and hence within the span of one year itself (between August 2018 and August 2019) reduced their own exposure to the NBFCs by 1/3rd (Credit Suisse Report). The collapse of the IL&FS (caught in a funding squeeze) in September 2018, sent shockwaves through the financial system. This unexpected event prompted the regulatory agencies to reassess their outlook of the NBFC sector itself. However, the recapitalization of the public banks became increasingly inadequate to cope up with stress from the untimely arrival of the second wave of Twin Balance Sheet Crisis, on top of the unresolved stress from the first Twin Balance Sheet problem (Felman & Subramanian, 2019).

Regulation of the Indian Banking Network: a critical review addressing the endogenous weaknesses of the existing regulatory framework

The size and Nature of the NPA problem necessitated commensurate measures from both RBI as well as government to signal their intent and commitment in resolving the NPA crisis. The challenge began to be addressed squarely in a coherent manner in mid-2014, with a regulatory, legal and institutional thrust, the first phase of which was completed in 2016. The establishment of the Central Repository of Information on large Credits (CRILC) by the RBI in May 2014 filled a crucial breach in addressing information asymmetry regarding NPAs at the system level by facilitating collection of data on credit exposures across the banking system. The Asset Quality Review (AQR) exercise was initiated in the second half of 2015 because banks were hiding problem assets. There was a threefold increase in disclosed NPAs for PSBs from the 2013-14 level and for Private sector banks, there was a doubling in reported NPAs (Patel, 2020). PSBs had to raise capital from markets to shore up capital ratios and initiate a buffer for higher provisioning. In this manner, the AQR was a form of catch-up to reality. This was followed by the various restructuring schemes initiated by RBI.

This was the series of steps taken by Regulatory agencies up until 2016. Broadly these have been termed as ***the 4Rs*** by former RBI governor Urjit Patel. According to Patel (2020), the first R, ***RECOGNIZE*** was achieved with the institution of CRILC, the second R, ***RECORD*** started with the AQR, the third R, ***REPORT*** was a follow up of AQR and the fourth R, ***RECOVERY*** started under RBI's various restructuring schemes such as SDR Mechanism, S4A scheme, and many more. However, a complete overhaul of the financial infrastructure of the economy would require a total of ***9Rs.***

For the fifth R, ***RESOLUTION***, Patel (2020) recommended "housing" stressed assets above a certain ticket size in a special purpose vehicle, to sanitize the banking sectors balance sheet in one fell swoop, thereby freeing banks to make a new start for lending (Bad Bank). The Insolvency and Bankruptcy Code (IBC) was enacted in 2016 as a watershed towards strengthening India's Financial architecture. It empowered the creditors to take the necessary action upon failure to pay. But this envisaged self-correction did not transpire. Inaction by banks against large defaulters undermined the credibility of a major legal and institutional reform designed to improve the allocative efficiency of the economy. The fifth R failed largely due to severe agency and aggravated moral hazard problem of not solving the NPAs when the Banking sector was majorly government owned. There was unconstrained discretion in the decision to invoking IBC or not, rather than a binding rule for large defaults.

For the sixth R, ***REINFORCED RESOLUTION,*** the thrust came from amendment of a key legislation "The Banking Resolution (Amendment) Act 2017, which empowered the RBI to issue directions to banking companies to initiate an insolvency resolution process in respect of a default under the provisions of IBC.

The seventh R, ***RECAPITALIZATION,*** initially was in the form of direct equity infusion from the budget, but in 2017 and 2018 Recapitalization Bonds were issued to PSBs and the money was used by the government to buy equity in the same banks. Much of this capital was used for bridging regulatory shortfall and provisioning for ageing impaired loans. However, the capacity for further capitalization is a function of the fiscal space. But given the FRBM roadmap suggest that there is hardly any elbow room.

The eighth R, ***RESET AND RING-FENCE,*** was initiated with the RBI's 12th February, 2018 circular which instructed the banks to "timely recognize the problem assets and initiate restructuring, failing which NCLT-based resolution had to be used". The final Ring- fencing was done by an important macro-prudential instrument, the "Prompt Corrective Action" under which specific regulatory actions are taken by the RBI if banks underperform on key operational variables. 11 PSBs were placed under PCA framework and were discouraged from expanding on a risk-weighted asset basis.

The ninth R, ***REFORM***, was aimed at restoring the faith in PSBs. To help facilitate credit growth, 5 PSBs were brought out of PCA. Unfortunately, the ninth R could not succeed in its end goal and somewhere lost sight of its vision to reform the banking culture, in the constant tug-of-war between the defaulters approaching the Supreme Court and

the resultant judicial overreach shown by the Supreme Court which ultimately diluted the RBIs power.

This means that the regulatory reform is still impending, posing a constant risk on the pocket of the exchequer. But numerous recommendations have been put forth by economists and bankers to support the spine of the Indian Banking Infrastructure i.e the Public Sector Banks.

Some of these recommendations are shared below.

1) DEALING WITH BAD LOANS

An honest “Recognition” and “Acceptance” of a “Loan-gone-Bad” is avoided by banks as they keep applying band-aids to keep the loans current under the naive assumption that with time, as growth picks up and demand in the concerned sector is revived, firms will eventually be in a position to service their past debt obligations. This phenomenon is referred to as “Evergreening of loans”. However, as situations persist on remaining pessimistic and borrowers go into deeper losses, promoters often loose interest and incentive to fix the existing predicaments and instead engage in “asset-stripping” or “cash-flow diversion” effectively rendering the firm a “zombie” neither fully dead not fully functional (Acharya & Rajan, 2020).

From the point of view of the concerned industry, a failing corporation is often a blessing in disguise as it allows supply to be curbed, prises to rise and a full capacity utilization of the incumbent firms of the industry. But the insistence of the banks in keeping the zombie alive by evergreening their debt obligations hampers the expansion plans of other industries in that sector, their investments suffer and healthy borrowers themselves come under undue stress through no fault of theirs. Instead, it is required that the exiting loans be “written down” in the event of changed circumstances since the sanction of the loans. Banks should recognize and classify Assets as NPAs.

“Prudential Provisioning” (setting aside a buffer to absorb likely losses) must accompany the NPA classifications. The exercise of provisioning however means that banks will sees less profit, and less accretion via retained earnings to the bank’s capital (Acharya & Rajan, 2020).

To deal with the problem of Bad-Loans, Rajan & Acharya (2020) recommended designing a framework for time-bound negotiations between creditors of a stressed firm, failing which National Company Law Tribunal (NCLT) filing should apply. NCLT takes the responsibility of restructuring out of the hands of bankers (primarily administrators in the case of PSBs) and appoints an “Insolvency Resolution Professional” to auction the assets of distressed firms. The NCLT must work in coordination with Insolvency and Bankruptcy Courts facilitating meaningful negotiations out of court.

Simultaneously an online platform for distressed loan sale to provide transparency to the process should be functionalized. Parallel to the online platform, “Bad Banks” an independent entity which will take bad loans off the balance sheets of banks and resolve them. Bad Banks, conceptualized as National Asset Management or Private Asset Management players could serve as a vehicle to aggregate loans, create management teams for distressed firms, and for sensitive and vulnerable sectors like power sector, could possibly buy and hold distressed assets till demand returns. It could provide fall-back prices for loans sold by PSBs (Acharya & Rajan, 2020).

2) IMPROVING THE PERFORMANCE OF PUBLIC SECTOR BANKS

Sine a greater segment of NPAs in the Indian economy are under the umbrella of the PSBs, improving the Performance of PSBs gains prominence. A large number of Banking Reform Committees over the years have proposed “Operational Independence” for boards and managements of PSBs. A holding company (on lines of a Bank Boards Bureau) should be created to make professional and diverse board appointments to each bank (these directors should be empowered to guide the bank towards its Objectives). It will allow the government to maintain an arm’s length from the management of PSBs.

Creation of an Incentive structure for both Private as well as PSBs (for instance reimbursing costs, relaxation in reserve requirements, etc) to achieve government mandated goals (largely in public interest – Priority Sector Lending, Kisan Credit Card, Jan-Dhan-Aadhar Yojana, rural branch expansions) will be instrumental in improving performance of banks.

Granting independence to bank boards and management is essential and an effective winding down of the Department of Financial Services in the Ministry of Finance will be a signal of the intent to grant the banks with this independence. This will ensure that PSBs are not unduly exploited for serving costly social or political objectives.

3) ALTERNATIVE FOR OWNERSHIP STRUCTURE OF PUBLIC SECTOR BANKS

To improve governance structures, the government needs to create distance from the operations of banks, and this can be achieved if government is able to bring down its take in PSBs to below 50%. This alteration in the ownership structure of some PSBs

will be the first step in the creation of an alternative structure of "State-linked Banks" as opposed to 'State-owned Banks". A calibrated strategy to Reprivatize select PSBs can also bring in the much needed financial as well as technological expertise. But as an intermediate step to the final stage of re-privatization, "Automatic Dilution" can be adopted 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 ((Acharya & Rajan, 2020).

4) MAKING BETTER LOANS

It is recommended that "Automatic Provisioning" can be adopted in banks in the country, under which provisioning is done in anticipation (i.e in line with Expected Credit Losses) rather than after losses have materialized. This will ensure that regulatory forbearance is not held hostage to repeated negotiations. Adoption of Anticipated Provisioning will bring bank regulations in India in line with global standards. It is desirable that India switches to International Financial Reporting Standards for banks which recommend "front-loaded" loan provisioning rather than "back-loaded" loan provisioning, thereby incentivising banks to prioritize loan recovery and resolution over evergreening. A large segment of private banks in the country have already made the switch to anticipated provisioning, but implementation by public sector banks requires a legislative amendment which is still impending.

Acharya & Rajan (2020) have suggested that shifting the culture of lending in Indian banks from "asset-based" lending to "cash-flow (liquidity)" based lending. In several advanced economies loan contracts are linked to liquidity conditions of borrowers. It allows the 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. These act as advanced signals (though imperfect) to characterize quality of firm credit and can potentially enable lenders to dynamically protect loan value against the risk of loss in the event of a default. 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.

5) STRENGTHENING RISK MANAGEMENT AT BANKS

In India, investing in government bonds is considered "lazy-lending" (banks require no additional capital for such holdings – a boon for under-capitalized banks). But the risks associated with such investments are not managed well by banks. Interest rate derivatives are not used to contain risks. Interest rate risk is not priced well by a significant portion of the banking system which substantially weakens the market discipline to contain fiscal deficits.
Any downside risk associated with investment in government bonds is managed by regulatory forbearance making such investments effectively a one-sided bet.

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 (Acharya & Rajan, 2020). Interest-rate derivatives markets are not well-developed in India and 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 (Acharya & Rajan, 2020).

To create an automatic pass-through of monetary policy to the stock of legacy loan, Acharya & Rajan (2020) recommend "Complete External Benchmarking" of loans to market-based floating rates for all variable rate loan categories. This would create natural interest-rate sensitivity on bank balance-sheets that they can manage with greater use of interest-rate derivatives. Acharya & Rajan (2020) also recommend Indexing of National Small Savings Fund (NSSF) rates to average contemporaneous bank deposit rates. This would enable a better pass-through of monetary policy to the real economy, remove the fiscal overhang on transmission of monetary policy, and allow bank deposit rates to move more in line with interest-rate impulses

6) CREATING GREATER VARIETY IN BANKING STRUCTURES

Operationalization of On-tap licensing for banks can be revived with an annual invitation for applicants, to create more vibrant banking with entry of better players, especially allowing high-performing micro-credit institutions to become eligible as a small finance banks, and high-performing small finance banks to become eligible candidates for universal banks. Conversely, the existence of poorly performing universal banks can be relegated to the status of small finance bank.

In the area of capital markets and newer forms of lending such as FinTech, entry of non-bank players needs to be promoted, building on the success in digital payments. Simultaneously, development of wholesale banks needs to be encouraged, that will rely on market financing as a way to provide greater financing for long-term infrastructure projects without expanding the size of deposit insurance.

CONCLUSION

In the regulatory, enforcement and legal landscape around loan recoveries in India, all stakeholders seem to be aware about the preordained inability of government policies to stay the course. Episodic concerns about policy uncertainty seem to be recurring more often than desirable. Investment policy and regulatory integrity requires staying the course to be credible accepted by bankers and borrowers alike.

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