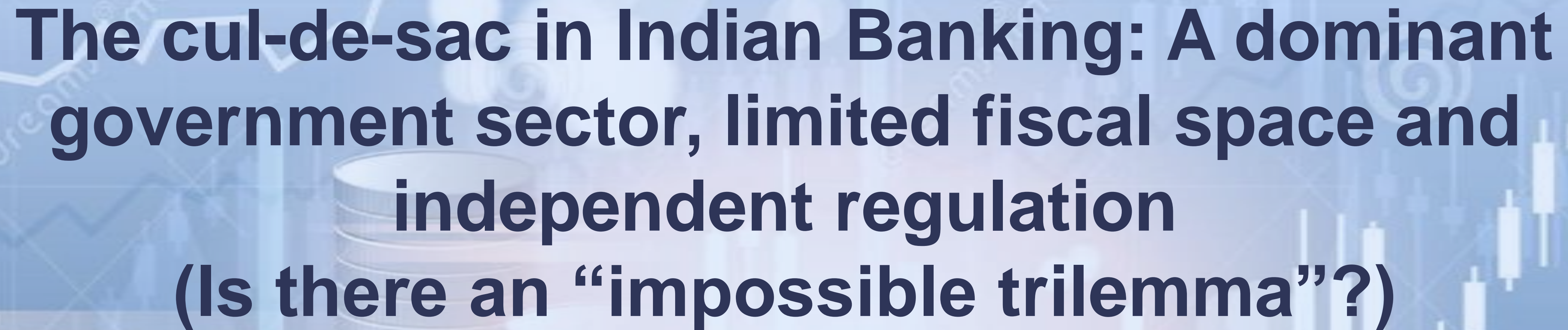
The cul-de-sac in Indian Banking: A dominant government sector, limited fiscal space and independent regulation
(Is there an “impossible trilemma”?)



(Session VI Keynote: Financial Sector)

Urjit R. Patel

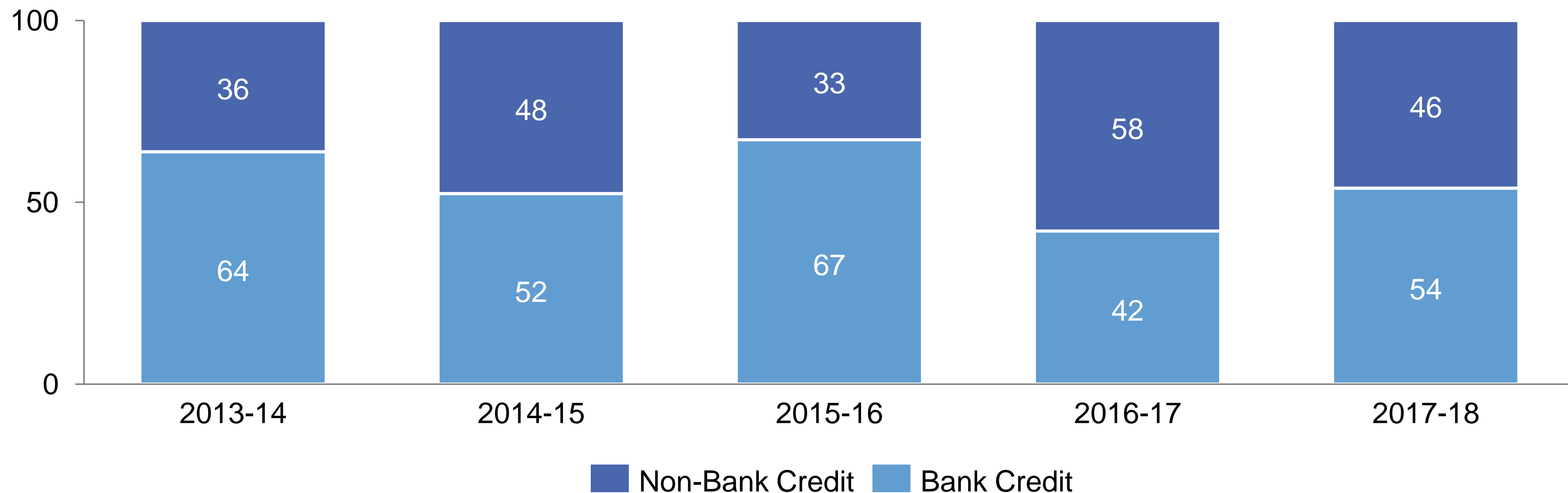
19th Annual Conference on Indian Economic Policy
Stanford, June 3-4 2019

Broadly the presentation is about…

- **The banking sector in India:** Evolution, market shares and performance.
- **Proximate problem of NPAs:** Sharp rise, causes, potential for sector instability.
  - "A tale of 2 sectors": contrast between government-owned banks (GBs) and private banks (PBs).
- **How did we get here?**
- **Response:** 8-R approach.
- **Outcomes & Implications.**
- **Deeper problems abound:** Quadruple challenge of Indian banking:
  - (quasi-) fiscal/pump priming role of GBs; *aggravated* form of moral hazard (AMH), that is, hazard beyond standard/familiar "too-big-to-fail" etc. considerations – concomitant blunting of incentives, with risk management and accountability as primary casualties; high cost and HR management.
- **Concluding observations (I, II, III).**

Indian funding model is bank-led; hence, banking sector health has to be a priority area.

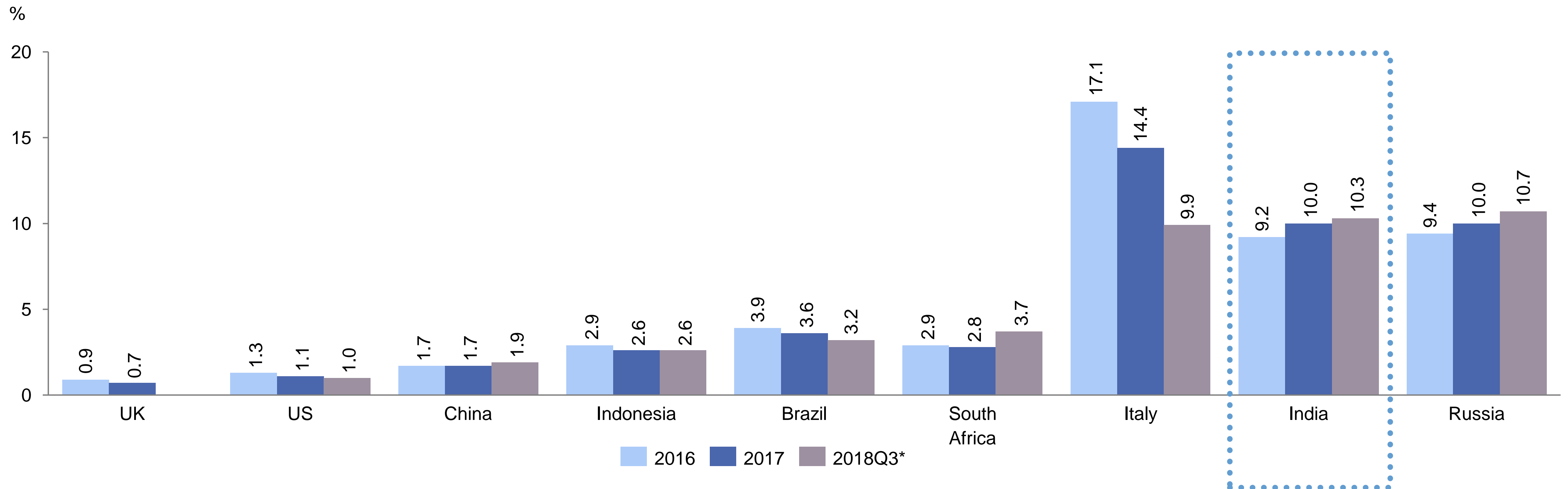
The dominance of bank-led funding is slowly changing, but, expected to remain important, plus there is interconnectedness between banks & non-banks; complexity.



Notes: 1.Data pertains to flow of resources to commercial sector. 2. Bank credit pertains to non-food credit. 3 Non-bank credit includes domestic sources of funding such as public issues by non-financial entities, systemically important non-deposit taking NBFCs, net credit by housing finance companies etc.
Source: RBI, SEBI, NSE, Merchant Banks, LIC and NHB.

In recent years, NPAs in India have been one of the highest amongst major economies; inducing a negative risk perception. It could be that the funding model is gradually/grudgingly becoming more discerning now…

Gross NPA Ratio



*: For Italy and China, data pertain to 2018 Q2. For UK, neither 2018 Q2 nor Q3 numbers were available.
Note: Q2 and Q3 refer to calendar year quarters ending in June and September, respectively.
Source: Financial Soundness Indicators (FSI), IMF

…even as there has been intermittent concern over sector health.

2015	2016	2017	2018

Public sector banks dominate banking system, says RBI

Public sector banks (PSBs) had a 73.2-per cent and 73.9-per cent market share in credits and deposits respectively as of March-end 2014, according to the report.

Mail Today Bureau
New Delhi, May 11, 2015 | UPDATED 09:52 IST

Private banks outshine PSBs in profit share in 2014-15

Our Bureau | Mumbai | Updated on January 22, 2018 | Published on December 23, 2015

The return on assets of public sector lenders also showed significant decline: RBI report

More funds for PSU Banks: FinMin lays out Rs 70K-crore capital infusion plan

PSBs' extra fund needs pegged at Rs 180K cr by 2019.

RBI initiates prompt correction action against Indian Overseas Bank

3 min read . Updated: 06 Oct 2015, 01:16 AM IST
Vishwanath Nair, Anup Roy

Move comes to improve internal controls and consolidate the business activities of the lender

Public sector banks post net loss of Rs 17,993 crore in last fiscal: MoS Finance

According to the data presented in Lok Sabha by Minister of State for Finance, Santosh Gangwar, in reply to a query, the 28 public sector banks reported a collective net loss of Rs 17,993 crore in 2015-16.

PTI | Updated: Dec 02, 2016, 06.13 PM IST

Save

Health concerns of Indian public sector banks

Once a tag of wilful defaulter is imposed on a borrower, very quick action is warranted

BY BIJOY BHUSHAN BHATTACHARYYA
8 min read
PUBLISHED: Jun 20, 2016

Public sector banks condition worsens;

By: FE Bureau | Published: June 29, 2016 6:13 AM

Stressed assets – non-performing assets and restructured loans – of public sector banks (PSBs) rose 40 basis points (bps) to 14.5% in March 2016 from 14.1% in September 2015, the Reserve Bank of India (RBI) said in its financial stability report (FSR) on Tuesday.

NPAs of public sector banks tripled since June 2014

The gross NPAs of India's public sector banks more than tripled between June 30, 2014 and the end of December 2017, the Reserve Bank of India said in response to an RTI query sent by India Today TV.

Last Updated : May 17, 2017 08:15 PM IST | Source: Moneycontrol.com

3 years of Modi: Banking sector reforms announced;

In an attempt to help banks, especially public sector banks (PSBs) recognise the ashes of high level of non-performing assets (NPAs) and rise like a phoenix, in December 2015, the Reserve Bank of India under the leadership of former Governor Raghuram Rajan, asked banks to set aside a pool of funds in the form of provisioning towards sub-standard assets. This further dented the banks' balance sheets.

MACRO

Master plan to reform public sector banks

But is it structural change or just papering over the cracks?

By ASHISH GUPTA, Apr 25, 2018 | 6 min read

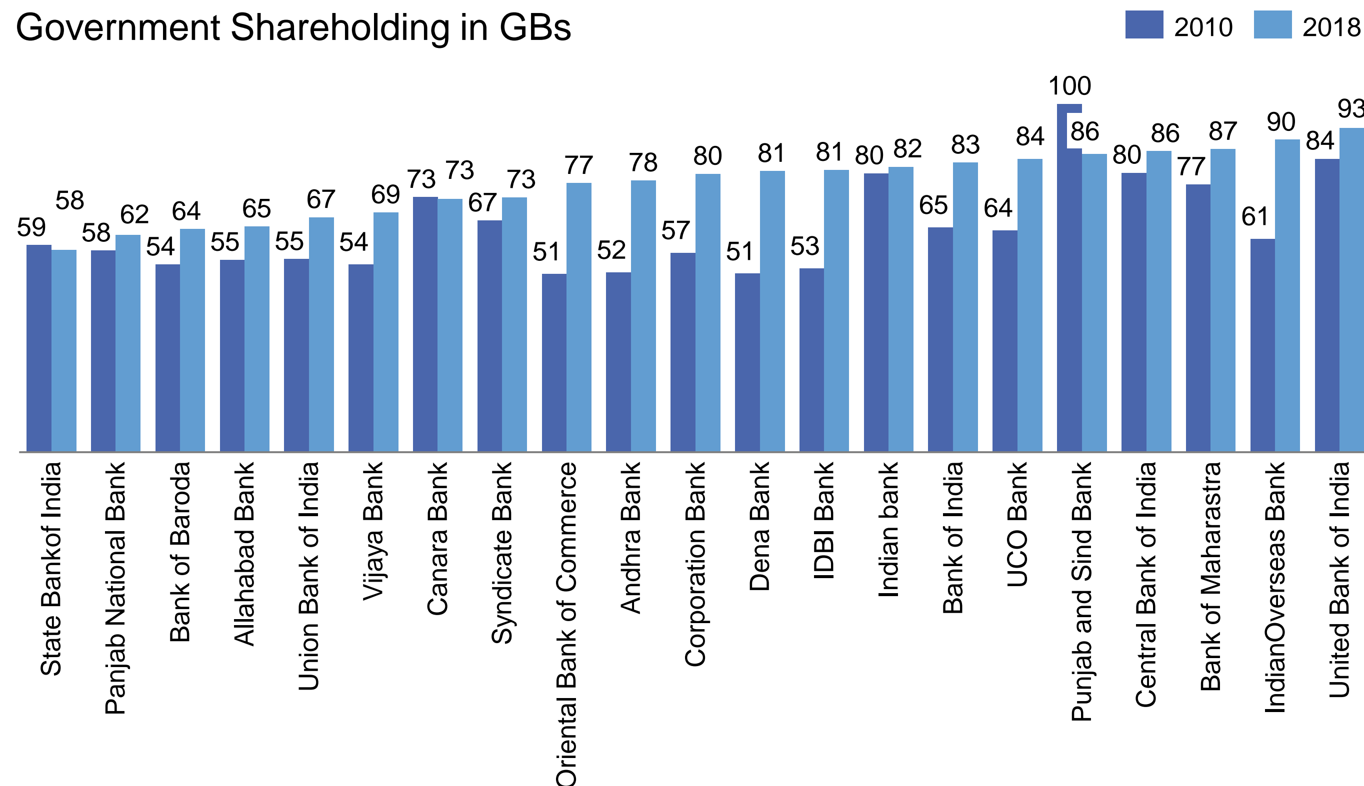
Govt withdraws FRDI bill in Parliament following backlash

1 min read . Updated: 07 Aug 2018, 11:47 PM IST
Remya Nair

The FRDI Bill has been withdrawn over concerns of a bail-in clause that aimed to resolve a failing bank and insurance cover on bank deposits

Majority of large universal commercial banks are government owned for diverse (legacy?) reasons.

Govt. owns majority share in 21 banks; has large holdings in GBs which have further increased in last 10 years…

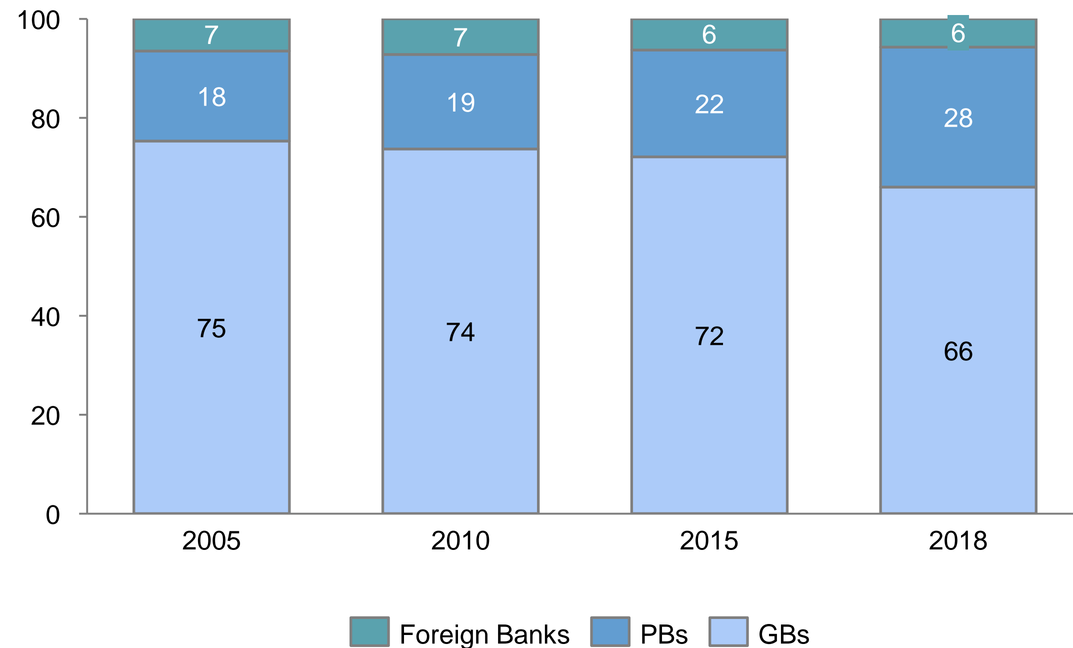


…driven mostly by the need for govt. participation to drive policy & for social objectives.

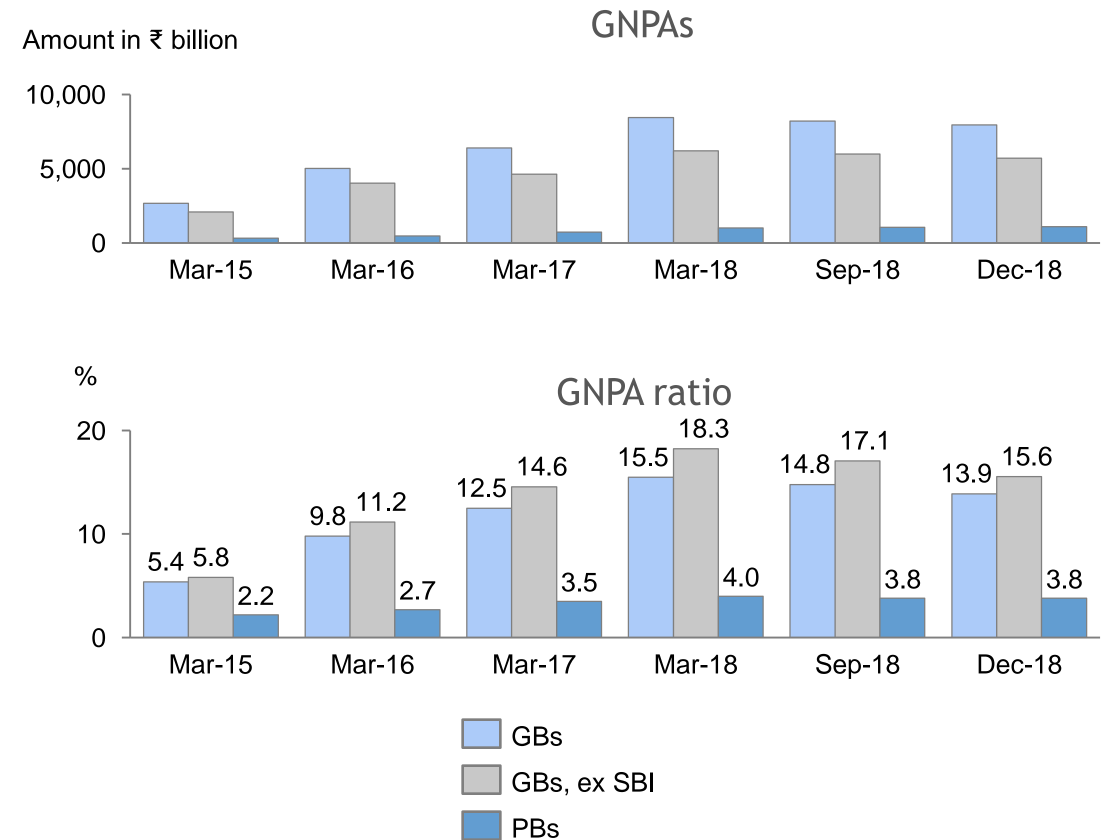
- Budget usually has announcement of “credit budgets” (e.g., for agriculture), on behalf of banks.
- “Quasi fiscal” reasons, most recently the Mudra scheme for MSMEs (also 59-minute loan approval programme launched in late 2018).
- Universal bank account coverage achieved in 2015.
- Employment in GBs (about 0.85 million employees).

The NPA issue has largely been driven by GBs.

Although GBs are losing share to PBs, former still account for around 2/3rd of total assets.

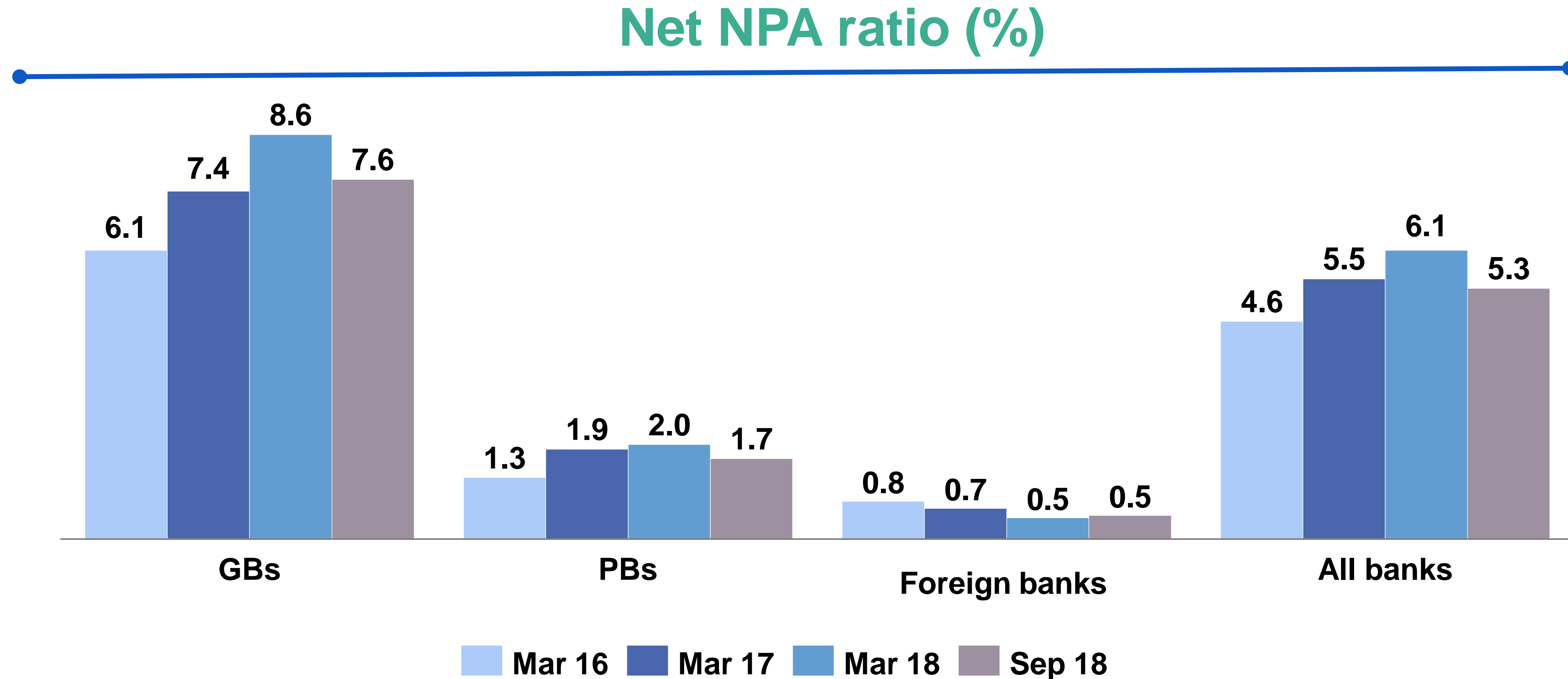


GNPAs & GNPA ratio much higher for GBs (GNPA ratio for GBs > 3x of PBs) – even more stark for GBs-SBI.



Source: Statistical Tables Relating to Banks in India, RBI

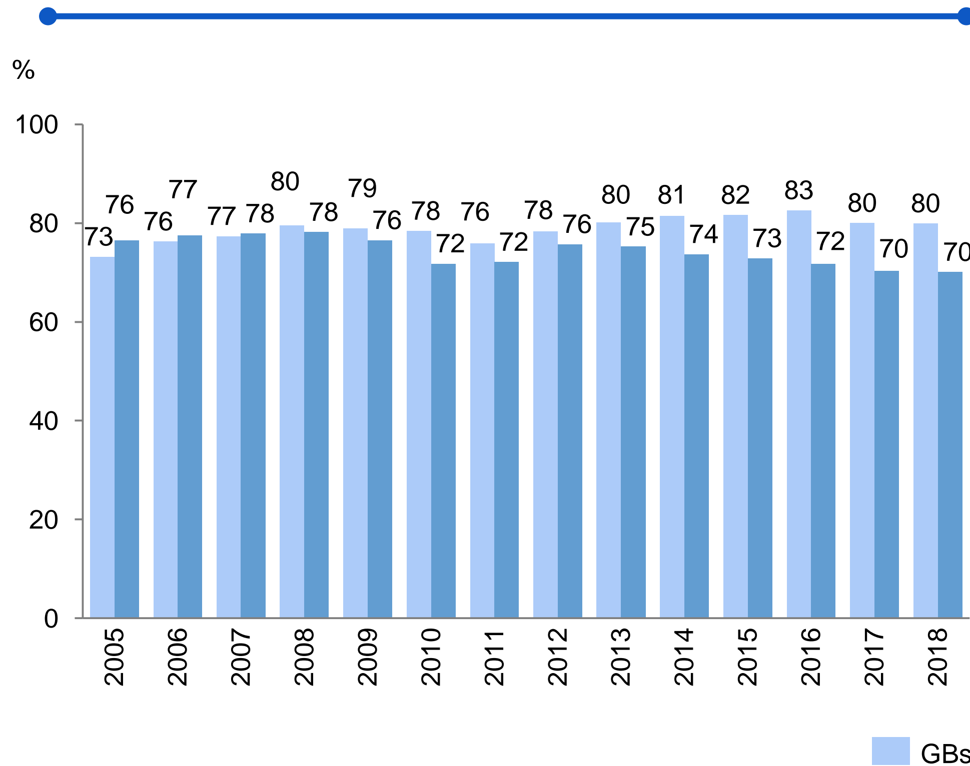
There is a significant divergence in the performance of PBs and GBs in terms of operations & financial indicators (“ A tale of 2 sectors”).



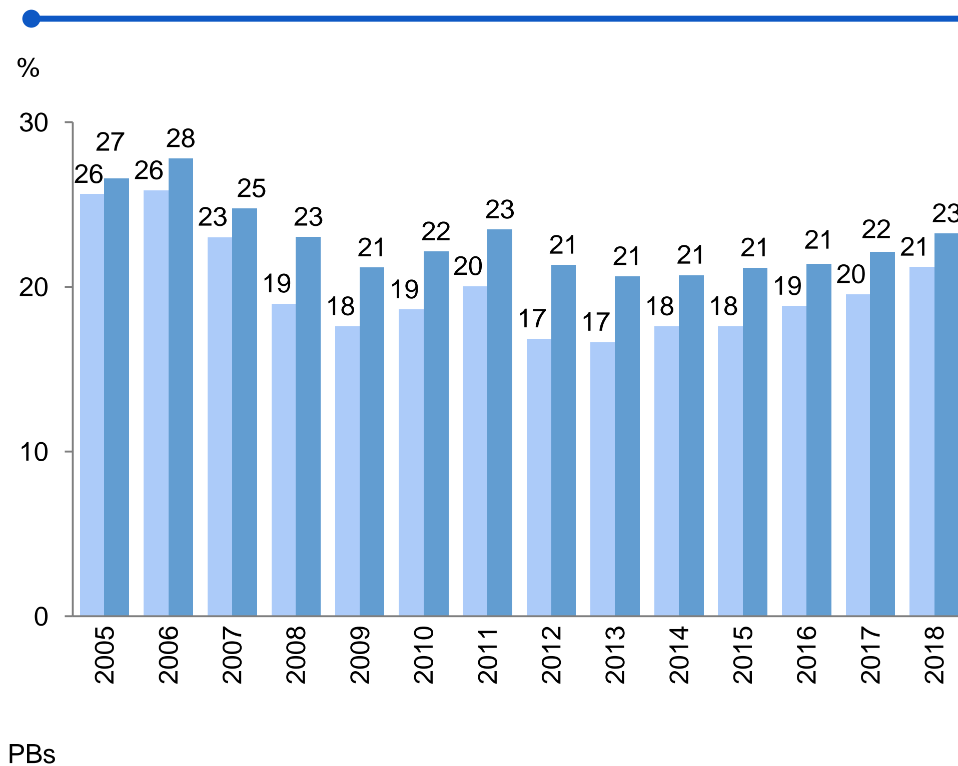
GBs have high ratio of non-operating expenses to earnings compared to PBs. High cost structure of GBs is borne by economy; may be impinging transmission of policy rate changes.

(lower opex/earnings but higher total exp/earnings)

Total expenses to earnings ratio



Operating expenses to earnings ratio



Employment
GBs: 0.85 mn
PBs: 0.39 mn

Cost/employee
GBs: Rs 1.19 mn
PBs: Rs 0.74 mn

Rev/employee
GBs: Rs 4.2 mn
PBs: Rs 5.5 mn

NOTE: All numbers except employment are for top 3 GBs (SBI, BoB, PNB) and top 3 PBs (HDFC, ICICI, Axis), for FY18
Source: Audited Annual Accounts of Banks; Capitaline.

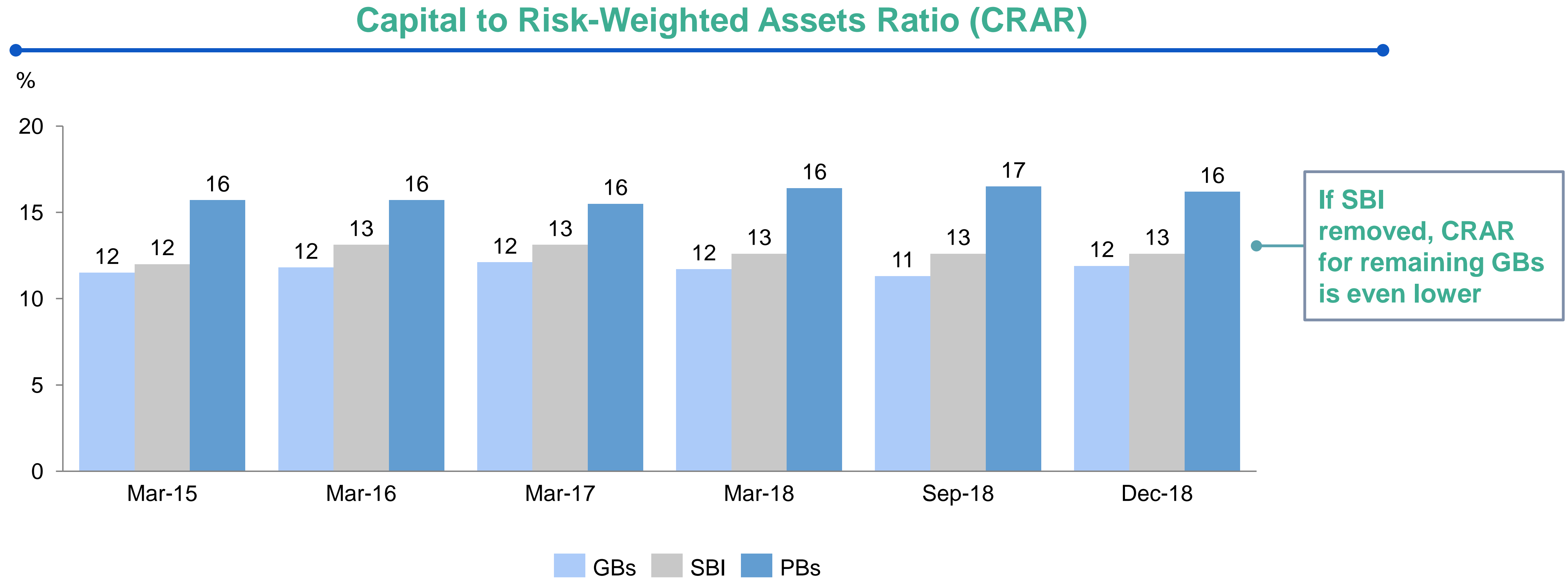
Further, GBs also marred by higher incidence of frauds owing to poor operational risk management/internal audit.

- As many as 90 per cent of frauds occurred in GBs while share of PBs is about 10 per cent.
- Most frauds are related to advances/loans.
- Quantum has quadrupled in the five years since 2013/14.

"....[T]here is the third kind of problem with PSB lending — pervasive corruption from branches to regional offices in sanctioning and writing off a vast number of smaller loans."
Business Standard, March 4th 2019.

Source: RBI Financial Stability Report, December 2018; https://www.businesstoday.in/sectors/banks/bank-frauds-rise-over-72pc-to-rs-41167-crore-in-2017-18-says-rbi-report/story/305552.html

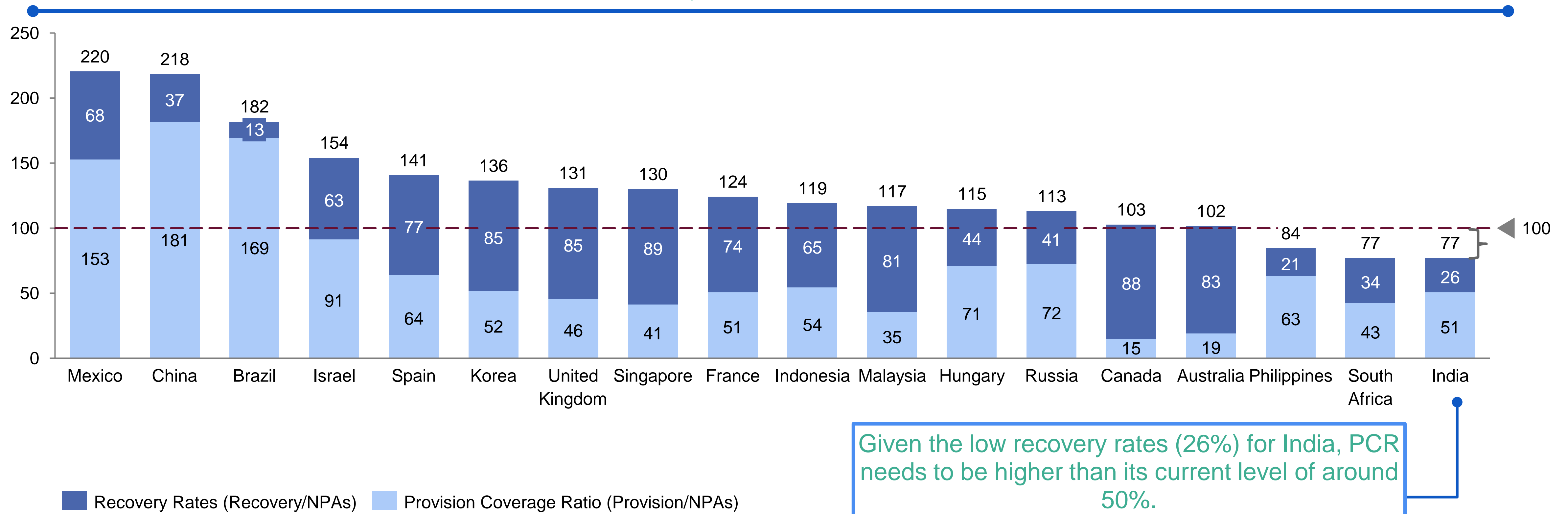
Private banks also have a much higher CRAR vis-à-vis GBs – indicates more robust balance sheet of PBs.



Source: Off-site surveillance returns, Financial Stability Report 2018.

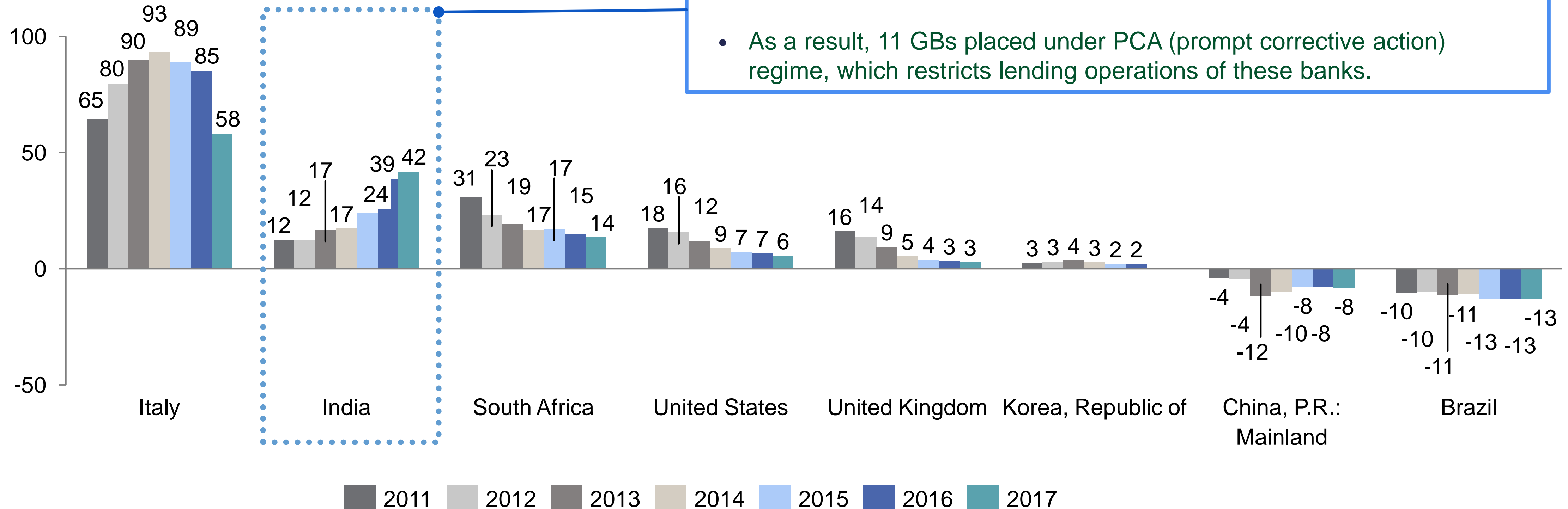
Present level of bank capital masks the future expected capital write-offs.

Provision Coverage Ratio for Indian banks is much lower, despite the loss given default being considerably higher in India



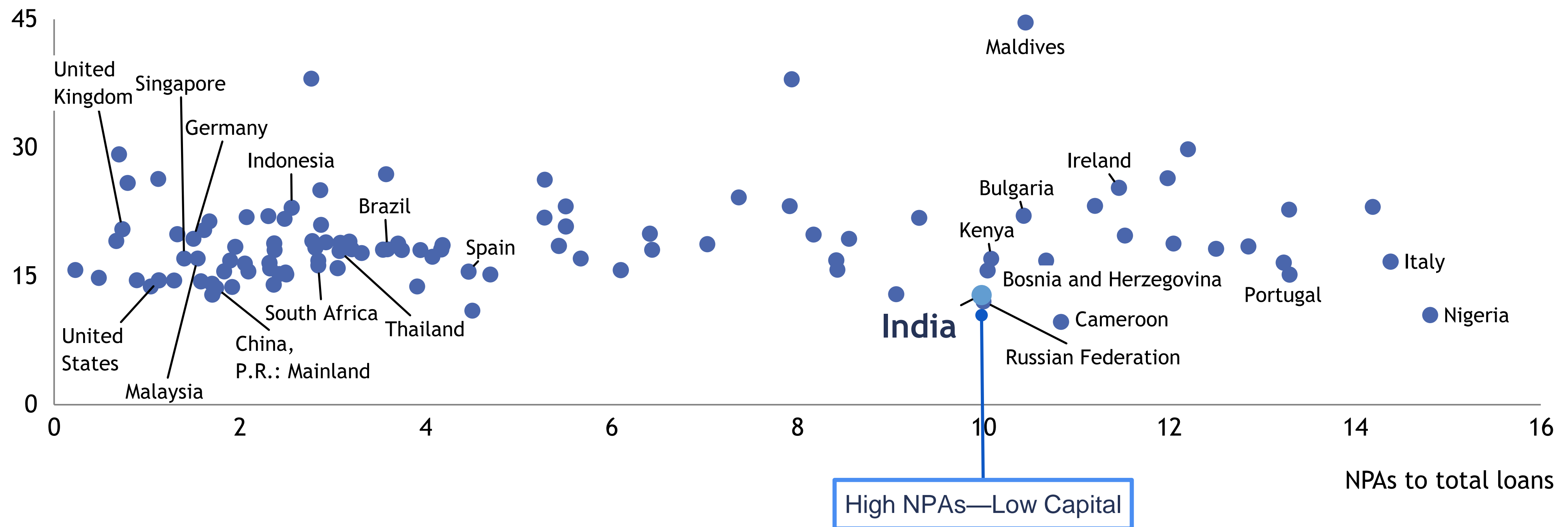
Source: IMF Financial Stability Indicators

High net NPAs compared to other countries – implies that current headline capital adequacy is, in effect, overstated.



Source: IMF Financial Stability Indicators

In Indian banks, capital is low relative to NPAs compared to global standards.



Source: IMF Financial Stability Report

How did we get here? | Plenty of blame to go around! Prior to 2014 all stakeholders failed to play their role adequately.

1. Banks

2. Regulator

3. Government

1

Banks' risk management policies & over-lending.

- Applied very little risk analysis & management in sifting good from bad assets; liberal concentration ratios; ignored leverage.
- On average, board-level fire walls did not fulfil remit adequately.
- Failed to maintain balanced credit lending growth: Non-food credit growth over FY07-12 was ~20% vs. real GDP growth rate of around 7%.

2

Regulator should have acted earlier.

- **Supervisor's role is to ensure that stringent risk management processes/requirements are adhered to**.
  - Failed to acknowledge & rectify GBs inability to:
  - identify poor performing assets; and
  - restructure & react quickly to improve recovery or cut losses (e.g., iron & steel companies, airlines, generators, real estate, etc.).

- **Regulator failed in gauging when extant assumptions were getting stretched & needed revision:**
  - Challenge assumptions through, e.g., more rigorous stress test scenarios at bank level, as well as sensitivity analysis on (demand) assumptions, and sector (policy) risks.
  - Object to the scale of exposures (sector and project) to slow down expansion and/or tighten the lending norms; take away the "punch bowl" from the "credit-binge party".
  - Instead, allowed greater flexibility (e.g. company/group/NBFC exposure norms as % of banks' net owned funds were adjusted upwards).

3

Government did not fully play its role as principal shareholder and manager of economy's health.

- Principal (dominant) owner didn't question risk controls in GBs even as it was receiving significant dividends.
- Encouraged GBs to help pump prime economy for higher growth (in the realm of political/electoral credit cycles over the last decade), under the guise of "capital deepening", "sensitive" sectors etc.!
- Number of GBs did not have senior management in place, and governance suffered.

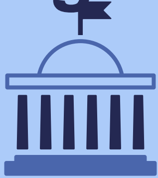
Summary | Regulatory/policy response to the crisis was the “8 R’s”.

Step 1 (4 R’s)				Step 2 (5th R)	Step 3 (6th R and 7th R)		Step 4 (8th R – AWOL)
Led to stark increase in NPAs as banks recognised issue.				Failed largely due to agency & moral hazard problems of not resolving NPAs when sector is majorly govt.-owned.	Aimed to legally enforce 5th R and Recapitalisation commitment.		Aimed at restoring faith in GBs.
Recognise (by banks, regulator, government). Information aggregation under **CRILC** started in June 2014.	**Record** (started in 2014-2015). Under-take AQR.	**Report** (started in 2015-2016).	**Recovery** under RBI’s restructu-ring schemes (“alphabet soup”) 2015/16.	**Resolution** under IBC 2016. RBI establishes **Enforcement Department**, distinct from Supervision and Regulation, in April 2017; an attempt to break the institutional “Stockholm Syndrome”.	**Reinforced** regulation by RBI. New statutory powers/Feb 12th circular for defaults; got rid off alphabet soup of “extend and pretend”. June 2017 onwards.	**Recapitalisation** 2015-2019; large quantum in 2018 and 2019.	**Reform**: • Virtually missing. • Banks put under PCA guard rails but commitment to PCA cut short. • Routinely, senior positions in GBs have been vacant; board seats were unfilled. • Dual regulation of GBs by RBI and government not addressed.
3/4 ✓	✓	✓	✕	1/2✓	1/2✓	1/2✓	✕

1st 4R Outcome | Stark increase in reported NPAs in both private and public banks

- The size and nature of the NPA problem necessitated concomitant measures to signal intent and commitment of the government and the RBI to meet the challenge squarely.
- RBI established the Central Repository of Information on Large Credits (CRILC) in 2014:
  - To collect, store and disseminate data on all borrowers' credit exposures including Special Mention Accounts with aggregate exposure of Rs. 50 million and above.
- AQR of banks undertaken by RBI:
  - ~3x increase in Gross NPAs for GBs.
  - ~2x increase in Gross NPAs for PBs.
- Accounts at some banks had to be restated.
- PBs had to raise capital from markets to shore up CARs and create buffer for higher provisioning; they have done this relatively easily.
- **Plus Enforcement Action by RBI:** Large fines/strictures on bank management imposed in the last 3 years for under-reporting NPAs, regulatory violations more generally.

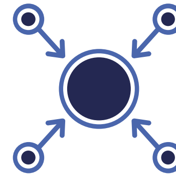
5th R – Indian Bankruptcy Code (IBC) introduced by Government to strengthen legal framework…



Lack of a comprehensive legal framework led to easy gaming by defaulters:

- India had multiple laws that governed various facets of a corporate rescue and/or insolvency process, without having a comprehensive legal framework that envisages a holistic process applicable to troubled or defaulting companies.

…focused on 3 elements



- A single window (but in practice, perhaps, has morphed into a 3-tier one);
- Time-bound process for resolution of an asset; and
- An explicit emphasis on promotion of entrepreneurship, maximisation of value of assets, and balancing the interests of all stakeholders (including operational creditors).

Belated response did not work in the area of resolution…

- Banks were not forthcoming with required action in respect of large stressed accounts.
- Part of the inertia was due to the typical (and severe) agency and (*aggravated*) moral hazard problems of not resolving NPAs when the banking sector is majorly government - owned.
- Question mark over banking sector stability periodically reared its head.

…leading to a need to address 2 key shortcomings in the earlier framework

- Absence of a hard-coded, time-bound period for resolution; and
- Agency and coordination failures at banks and Joint Lenders Forums (JLF) in pushing through viable restructuring plans, or, failing that file for liquidation.
- In effect, inaction against large defaulters was undermining credibility of IBC 2016.

Further response was 6th R | legally reinforce RBI's regulatory powers in 2017…

- Market failure necessitated statutory backing for Reserve Bank to direct reference of cases under the IBC.
- Therefore, the Banking Regulation (Amendment) Ordinance, 2017 was put in place to empower RBI to instruct banks to initiate insolvency proceedings under IBC in respect of a default.

- Regulator (on the recommendation of a board sub-committee) directed banks to file for resolution/ liquidation of 41 of the largest defaulting corporations ≈ Rs. 5 trillion (approximately 45 percent of NPAs) between June & September 2017. (For around 2 years, banks had not been able to do much about these large "restructured standard assets" – an oxymoron, if ever there was one – despite broad leeway granted by regulator).
- Proposed Financial Resolution and Deposit Insurance (FRDI) legislation had to be withdrawn again, due to doubts that were raised on banking sector stability in social media and elsewhere (depositor bail-in provision was used as a handle by detractors).

…followed by 7th R (recapitalisation) |

A 2-year Rs. 2.1 trillion recapitalisation plan over 18 months for GBs (initiated in September 2017). (Aggregate recap since 2010/11 of Rs. 3.1 trillion.)

Recapitalisation can be in the form of:

Direct cash infusion by government and public financial institutions.

Budget neutral recap bonds.

Raising of capital from the market.

Divestment by GBs of equity holding in JVs, SPVs, AMCs.

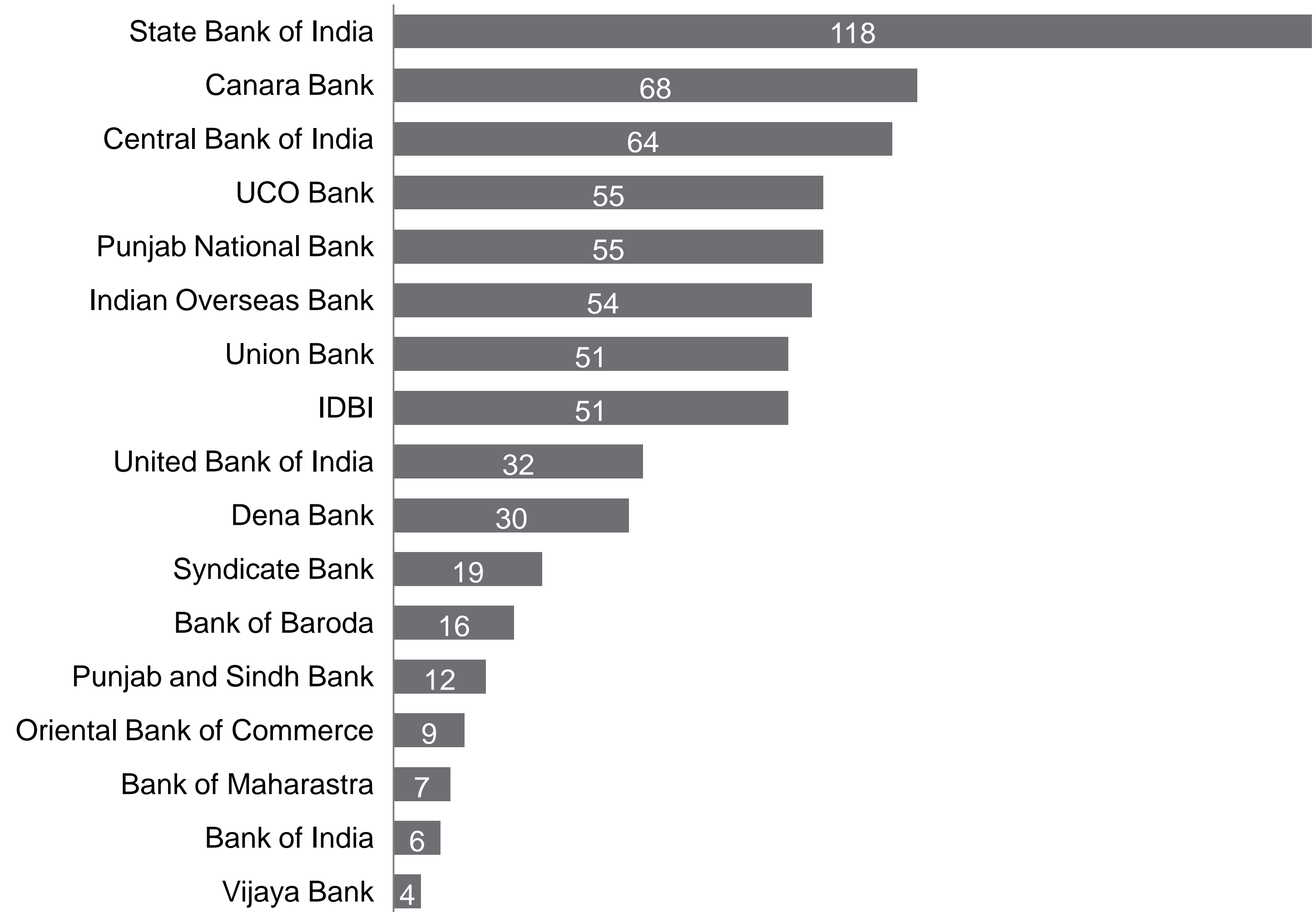
Focus over last couple of years has been recapitalisation…

Bank Name	FY 18	FY 19	Total
IDBI Bank	125	216[1]	341
Bank of India	92	147	240
Punjab National Bank	55	142	196
Corporation bank	22	116	138
Allahabad bank	15	117	132
UCO Bank	65	64	129
Central bank of India	52	66	117
Indian Overseas Bank	47	60	107
Oriental Bank of Commerce	36	67	103
State Bank of India	88	0	88
Union Bank of India	45	41	86
Bank of Maharashtra	32	47	79
United bank of India	26	50	76
Andhra Bank	19	53	72
Syndicate Bank	28	40	68
Bank of Baroda	54	0	54
Canara Bank	49	0	49
Dena Bank	30	0	30
Vijaya Bank	13	0	13
Punjab & Sind Bank	8	0	8
Indian Bank	0	0	0
TOTAL	900	1,226[1]	2,126

1. This 216.24 bn infused by LIC of India
Note: All figures in the above table are in Rs. billions.
Source: ICRA research.

- Around Rs. 1.9 trillion has been infused by principal owner into GBs over the last two years.
- LIC of India's investment of Rs. 216.2 billion into IDBI Bank in 2018 took the total funds pumped into GBs in two years to Rs. 2.1 trillion.
- In the first round (early 2018), even SBI required support.
- Biggest beneficiary of the last round of capital support – Corporation Bank (Rs.90.9 billion) & Allahabad Bank (Rs. 69 billion).
- Bank of Baroda, State Bank of India, Canara Bank, Vijaya Bank & Indian Bank did not receive additional capital from the government in the latest round.

…which may continue given likely additional capital requirement.



…Has to come from retained profits, markets and govt. fiscal measures.

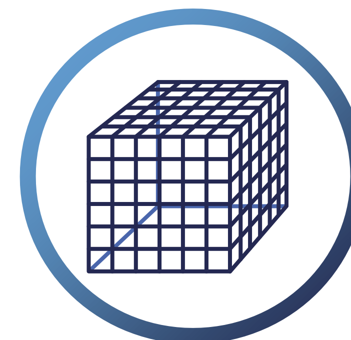
Note: Figures for Allahabad Bank, Indian Bank, Andhra Bank and Corporation Bank were not available.
Source: ICRA research.

6th & 7th Rs provided opportunity for the regulator with 2 further complementary steps…

1. **Nudge GBs to be proactive in dealing with problem assets on a timely basis.**

February 2018 regulations to *nudge* banks for timely <u>rule-based</u> recognition of problem assets and initiate time-bound restructuring, failing which NCLT-based resolution/insolvency. (Reset “power” between borrower and lender?)

2. **Work towards a blue print to set aside concerns over sector stability.**



RBI’s PCA framework implemented to help with the convalescence of weak GBs and to mitigate likelihood of a further escalation of the problem and b/s stress.

1 February 2018 regulations released by RBI…

A measure, under guidance of a board sub-committee to, *inter alia*, put in place a rule-based steady-state process (in steps over a timeline) after the reference of 41 large defaulters (individual exposure of Rs. 30 billion and above).

- Removed discretion on what constitutes default, which, *ipso facto*, pushes lenders to initiate restructuring/resolution.
- It further required that if accounts of the defaulting large borrowers were not resolved within 180 days from the date on which its installment fell due, they had no choice but to refer these accounts for resolution under the NCLT-based Insolvency & Bankruptcy Code.
    - Above was a steady-state process initiated after the first 41 large (mature) defaulting cases were referenced.
- The RBI scrapped all the past restructuring mechanisms (the "alphabet soup"), which pre-dated the IBC – logically, no longer required.

"I was in the banking industry for 36 years, but I don't remember a single circular being as powerful as the one issued on February 12, 2018..." - ***Former chairman & managing director of a GB.***

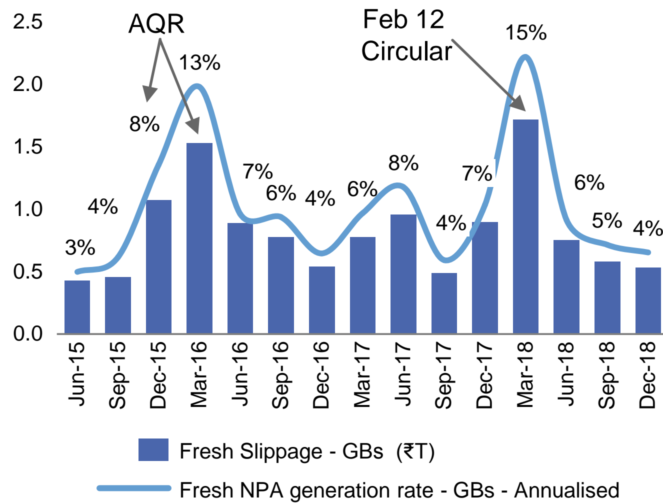
2 …and PCA framework implemented by RBI

Meanwhile, to help with convalescence of GBs and to prevent a further expansion of the problem, 11 badly performing GBs were placed under PCA (which imposes lending restrictions on sectors with high risk weights & prevents them from expanding on a RWA basis, among other curbs). Preservation of capital is a key objective.

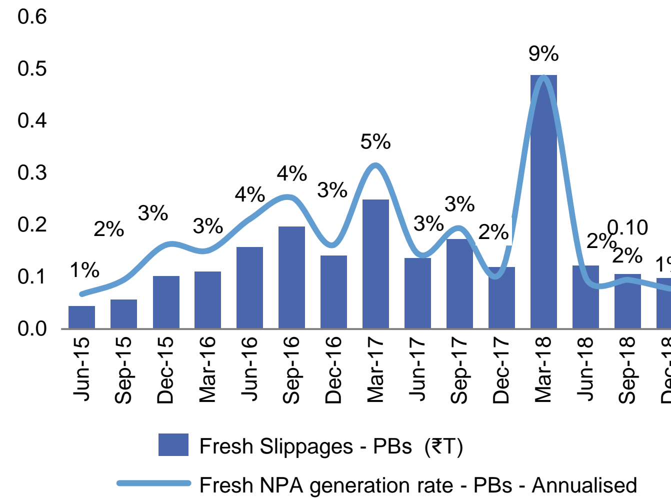
1

…Leading to fall in NPA slippages…possible evidence of borrowers concern of instantly being flagged as defaulters (deterrence effect?).

Trend in fresh slippages - GBs

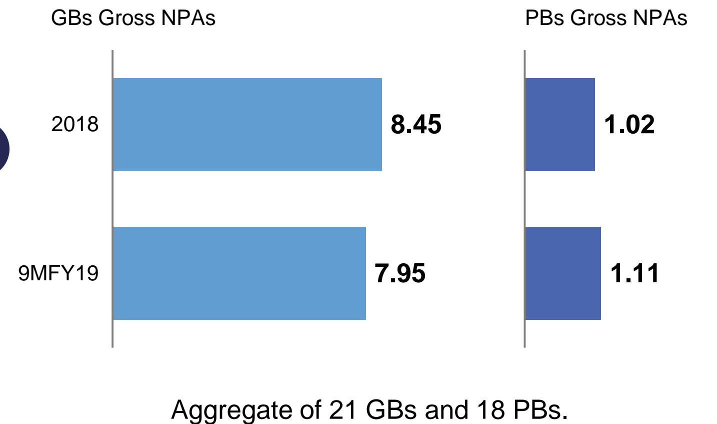


Trend in fresh slippages - PBs



Gross non-performing assets decline in FY2019

However, decline in FY19 modest vs. Mar'18 data (Rs. trn).



Aggregate of 21 GBs and 18 PBs.

"

It is a very good circular, and no major dilution is needed. It set a clear cut boundary line, and gave full freedom to banks- ***Indian Banks' Association (IBA).***

"

The streamlining of the NPA resolution process affords simplicity, timeliness and credibility, so is a long-term positive for the banking sector- ***press release by CRISIL Ratings.***

Note: E= Estimates
Source: RBI Financial Stability Report, ICRA Research, Press release

Significant increase in closure rate and modest increase in CIRP admissions noticed after issuance of February 2018 regulations

Table: Status of Corporate Insolvency Resolution Process (CIRP)

Quarter	CIRPs at the beginning of the Quarter	Admitted	Closure by				CIRPs at the end of the Quarter
			Appeal/ Review/ Settled	Withdrawal under Section 12A	Approval of Resolution Plan*	Commencement of Liquidation	
Jan - Mar, 2017	0	37	1	0	0	0	36
Apr - Jun, 2017	36	129	8	0	0	0	157
July - Sept, 2017	157	232	18	0	2	8	361
Oct - Dec, 2017	361	147	38	0	7	24	439
Jan - Mar, 2018	439	195	20	0	11	59	544
Apr - Jun, 2018	544	246	20	1	14	51	704
Jul - Sept, 2018	704	238	29	27	32	86	768
Oct - Dec, 2018	768	275	7	36	14	77	909
Jan - Mar, 2019	909	359	11	27	14	73	1143
Total		1858	152	91	94	378	1143

Quarter of introduction of February circular

Out of the first set of 12 large accounts for whom resolution was initiated by banks in 2017, as directed by RBI, 3 resolved, 2 headed for liquidation.

Source: IBBI Newsletter, Jan - March 2019

1 However, the regulation was struck down

Perceived to be credit negative for the banking sector.

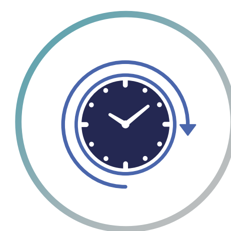
- The circular was deemed ‘ultra vires’ (or beyond the legal ambit) vis-a-vis Section 35 AA, under which the RBI issued the circular.
- This will likely have implications (and only time will tell):

RBI's remit

Decision has raised questions on the RBI's remit to issue directions to banks after empowered by legislation.

Uncertain future

Issues of ever-greening the NPA problem may emerge again. Banks may drag their feet on decision making, viz., delayed negotiations/taking haircuts for timely resolution could come back to haunt the sector.



Slow asset resolution

Effectively a case by case approach for reference under the IBC and which may require permission of the government. (Key catalyst has been removed?)

… and the same has been acknowledged by rating agencies like Moody's.

This (Supreme Court's verdict on February circular) is credit negative for Indian banks as it will weaken stressed loan recognition and resolution for large borrowers, and delay the resolution process of some existing large non-performing loans (NPLs)." ***Moody's Investors Service (post SC verdict)***

2

11 GBs placed under PCA in recent years; f/w relaxed to graduate loss-making banks out of the framework in early-2019. Further forbearance for MSME loans at the same time.

Out of the 11 GBs, 5 have moved out of PCA.

Out of the PCA framework

- Bank of India
- Bank of Maharashtra
- Oriental Bank of Commerce
- Allahabad Bank
- Corporation Bank

- Dena Bank (merged into Bank of Baroda)

Still under PCA framework

- United Bank of India
- UCO Bank
- Central Bank of India
- Indian Overseas Bank
- IDBI Bank

Outcomes of the 7Rs | Shrinking autonomy of GBs and prolonged fiscal commitment from the government to the banking sector; regulator undermined (I).

- Concerns over financial stability were put to rest to a considerable extent.
- Modest decline in GNPAs (December 2018) since March 2018, but still higher compared to March 2017. (Likely further progress may have been made up to end-March 2019.)
- Limited resolution of major/large corporate defaulters.
  - Only a few large corporate defaults resolved.
  - Signs of gaming visible? Avg. resolution time of around 350 days (going up to > 600 days for some cases).
- India's second and third largest GBs, BoB & PNB, have reported loss in the latest quarter.
- Some reports (to be treated with caution) indicate that provisioning for NPAs (for GBs) may aggregate Rs. 500 bn in the last quarter of 2018/19.
- Government’s priorities in terms of lending to sensitive sectors (MSME, agriculture etc.) and bailing out systemic sectors like power generation perceived to be undermined by RBI’s initiatives on default definition and GBs placed under PCA framework.

Outcomes of the 7Rs | …(II)

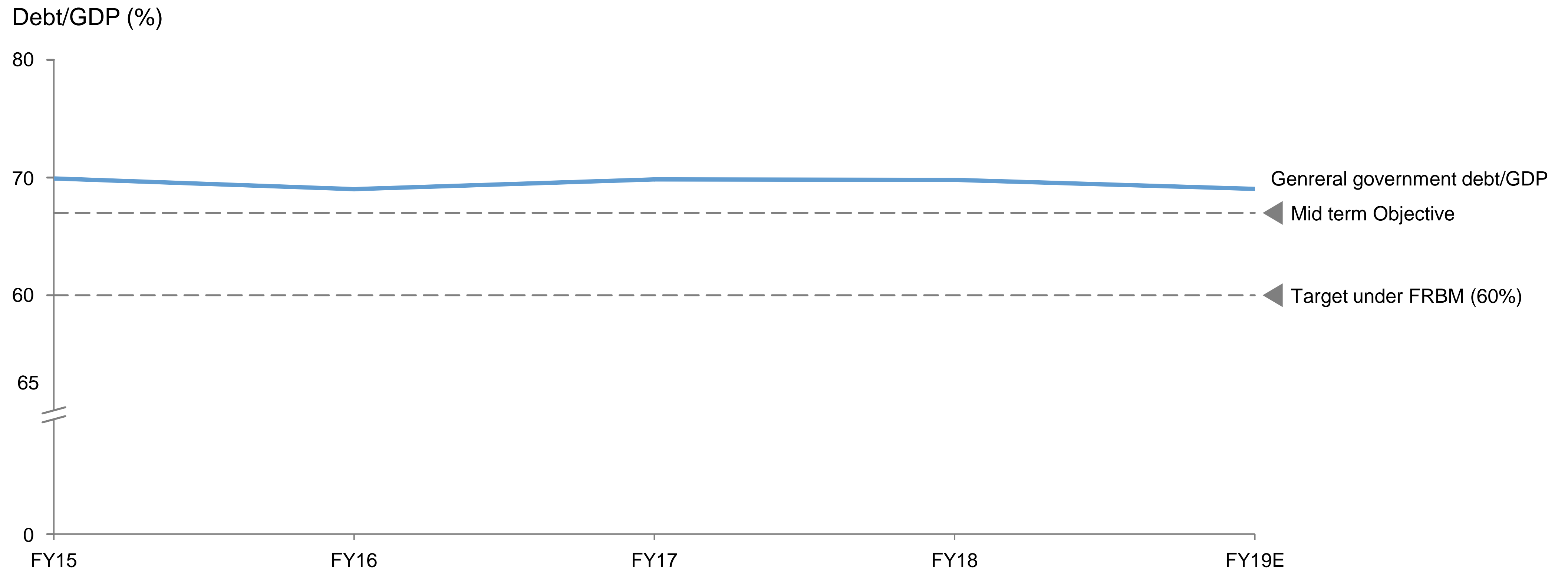
- Limited ability/desire to raise capital from market thereby leading to increased govt. stake in most GBs.
  - Little equity capital raised from market (non govt./non-LIC).
  - Even SBI received recap funding from govt. in 2018.
  - SEBI rule of at least a 15% free float for listed entities has been ignored.

- Virtually no divestment of JVs, SPVs, AMCs despite Indian equity markets overall remaining quite buoyant.

- Appetite for selling significant stakes even when post-stake sale government will continue to be the majority owner has been negligible thus far.

- Consolidation/ownership change among GBs.
  - Merger of 3 GBs (usually erodes value of the entity that takes over the weaker ones).
  - One highly problematic GB taken over by LIC.

Constraints | Capacity for recap by principal owner is a function of the fiscal “space”. How much is available? One candidate metric is the difference between the current general government debt/GDP ratio and targets/objectives.



Source: https://www.indiabudget.gov.in/ub2019-20/frbm/frbm2.pdf; Statista.
Compared to EM peers, India’s general govt.-GDP ratio is markedly higher.

Implications I

Banking Sector

It is possible that episodic high risk perceptions for the banking/financial sector as a whole will persist *inter alia* due to:
(i) government fiscal constraint; intermittent/"start-stop" approach may continue. Market perception is that the principal owner is one step behind regarding capital infusion into its banks due to fiscal constraints.

(ii) interconnectedness/complexity within/between intermediary categories, viz., GBs, PBs, NBFCs, MFs.

- AQR for NBFCs/HFCs is inevitable with attendant consequences for confidence.

Setting aside of February 2018 regulation – Time will tell whether "extend & pretend" will make a comeback.

GBs:

- Periodic bailout by government and LIC will be necessary.
- Share in banking sector to erode further - not a bad thing in itself from efficiency perspectives (say, of capital deployed).
- Limited likelihood of branch rationalisation on account of (self imposed) red lines (no HR right sizing to increase productivity, no significant stake sale, or, even in JVs, other assets etc.)

PBs:

- Strong regulation and market discipline on PBs to continue.
- Likely to remain out of trouble – able to raise capital from markets.

Implications II

Regulator – RBI

Forbearance (past, and future?):

- Dilute asset recognition norms for sectors, viz., MSMEs (continuously since 2016 for some categories), power generators through (“wing and a prayer”) restructuring etc. (MSME NPA ratio is 8.7-11.5 percent.)
- Delay IndAs/IFRS accounting standards; postpone prompt recognition of losses on holding of government securities. Capital conservation buffer (CCB) requirement postponed by a year to March 2020.
- Revise mandatory CRAR, which is commensurate with extant risks (credit rating “inflation” in India); as it is, the provision coverage ratio is inadequate compared to average recoveries of NPAs through resolution/liquidation.
- Relax/ignore PCA guard rails.
- Attenuate IBC?

Concluding observations (I)…

- Some headway has been made in addressing the NPA challenge and repair of banks' b/s.
    - A coherent policy "scaffolding" has been constructed over 2014-2018.

- Government and regulator face a trilemma: Not possible to (i) have dominance of GBs in the banking sector; (ii) retain independent regulation; and (iii) adhere to public debt-GDP targets. All 3 are not feasible on a durable basis.
    - After fiscal dominance over monetary policy, are we looking at fiscal dominance over banking regulation?

- Temptation to deploy GBs for catalysing aggregate demand:
    - Culmination is a vicious cycle: as the government's headroom for running (even) higher fiscal deficits is (virtually) exhausted, GBs are nudged to (over-)lend to pump prime the economy/boost preferred sectors. But this leads to higher NPAs over time, which requires equity infusion from the government, and this eventually adds to the fiscal deficit and sovereign liabilities (e.g., on account of recap bonds) in due course, anyway.

Concluding observations (II)…

- Regulatory forbearance has played a complementary role to help matters along in this regard.

- Size of government’s credit enhancement/guarantee obligations have also increased.

- Decline in share of GBs in the banking sector should not be resisted (market mechanism is working).

- Tax payer has to decide how much of government revenues are earmarked to infuse capital into GBs – this will determine GBs market share.

- Government has to assess whether return on its equity investment in GBs is value for money since its shareholding in GBs continues to increase. Ditto for LIC.

Concluding observations (III)

- Regulatory forbearance to continue and important reforms (IFRS, mark-to-market, FRDI legislation, capital conservation buffer etc.) held up against the “touch stone” of implications for GBs.
  - Two-tier structure of regulation could (explicitly) emerge, one for GBs and one for PBs.
- Process for executing the IBC has thrown up a worrying number of exceptions.
- Recent developments underscore importance of the passage of the FRDI bill to deal with failing institutions.
- AQR for NBFCs, as also borrower categories like MSMEs, may get delayed further.
- Temptation to reset “back to the past” should be eschewed. Episodic concerns for stability? Possible if there is foot dragging, or, worse, back peddling, and the concomitant delays.
  - Short cuts/sweeping the problem under the carpet is unlikely to work; will only delay unlocking of capital, and come in the way of financing future investment efficiently.