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Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

India's Bad Debt Problem

Notwithstanding a host of accomplishments, the biggest promise by India's Prime Minister Narendra Modi during his electoral campaign for the high office – reviving investment and creating jobs – remains unfulfilled. Obstructing this is the bad debt problem of the Indian banks which have defied resolution to reach crisis proportions. Earlier in May 2017, the government amended the law to invest the Reserve Bank of India with extraordinary powers to direct the process of resolving this crisis. This step has raised a number of concerns even as the prospects of its success are uncertain. A resolution of the problem of bad debts will lead to the next big challenge – of recapitalising the public sector banks. The government will then face limited options. Whether it will finally settle for privatising the public sector banks remains a tantalising question.

Duvvuri Subbarao[1]

Earlier in May 2017, the Indian government promulgated an ordinance[2] amending the Banking Regulation Act as the latest effort to resolve the bad debt problem plaguing the country's banking sector. The ordinance contains three measures:

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1 Dr Duvvuri Subbarao is Distinguished Visiting Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He is a former Governor of the Reserve Bank of India and a former Finance Secretary to the Government of India. He can be contacted at subbarao@gmail.com. The author bears full responsibility for the facts cited and opinions expressed in this paper.

2 An ordinance is legislation that is passed by the executive branch of the government when the parliament is not in session. An ordinance has to be approved by the parliament at its next session, and at any rate before six months from the date of promulgation. In the absence of such parliamentary approval, the ordinance will

i. The government can authorise the RBI to issue directions to banks to initiate insolvency proceedings against defaulters under the bankruptcy code;

ii. The RBI, on its own, can issue directions to banks for the resolution of stressed assets; and

iii. The RBI may set up oversight committees to advise banks on the resolution of stressed assets.

This legislative initiative, anticipated for some time now, was widely hailed, since the bad loan problem of banks has reached crisis proportions and has ballooned to pose, by far, the biggest threat to the country's growth prospects.

Unfulfilled Campaign Promise

The Narendra Modi government came into office in May 2014 on a campaign platform of reviving investment in the economy which had declined steeply during the tenure of the outgoing United Progressive Alliance (UPA-II) government. This was seen as a top priority not only because investment today expands the productive capacity of tomorrow thereby laying the foundations for sustainable growth, but also because it is key to job creation. The government has accomplished quite a lot over the last three years it has been in office but this most important campaign promise remains unfulfilled. The reason for this is what has come to be called the 'twin balance sheet' problem – banks being unable or unwilling to lend because of accumulated bad debts; and corporates, the potential investors, being unable or unwilling to borrow because of overleveraged balance sheets. The ordinance signifies the urgency the government attaches to breaking this lethal impasse.

This paper outlines the background to the bad loan problem, and evaluates the issues thrown up by this policy initiative and the prospects for its success.

cease to be operative at the end of six months. The Indian Constitution provides for this recourse to enable the government to address urgent policy issues.

Size of the Bad Debt Problem

According to the RBI's Financial Stability Report of December 2016, the gross non-performing advances ratio of banks increased to 9.1 per cent in September 2016 from 7.8 per cent in March 2016, pushing the overall stressed advances ratio to 12.3 per cent from 11.5 per cent. Many analysts believe that the figures reported by individual banks subsequent to the RBI Report suggest a much more alarming picture, with total stressed assets topping, perhaps, Rs10 trillion (S$214.9 billion), in an economy with a gross domestic product of Rs150 trillion (S$3.2 trillion).

Although private banks, too, have a sizeable non-performing advances (NPA) problem, much of the malaise is overwhelmingly concentrated in the public sector banks which account for as much as 70 per cent of the banking sector by way of assets. RBI Deputy Governor Viral Acharya said that up to one-sixth of public sector banks' gross advances could possibly be impaired (non-performing, restructured or written-off), and that for banks in the worst shape, the share of assets under stress may have exceeded 20 per cent.[3]

In its Global Financial Stability Report released in April 2017, the International Monetary Fund highlighted two points about India's bad debt problem:[4]

i. The Indian corporate sector is now among the most heavily indebted in the world in terms of the ability of its cash flows to service its bank loans; and

ii. The Indian banking sector is worse-off than that of other emerging economies, in terms of how little capital that the banks have set aside to provide for non-performing loans, extended primarily to the corporates.

Genesis of Bad Debt

A problem as large and complex as this has no simple or single cause. The popular notion – that banks colluded with large borrowers to extend loans beyond their project requirements,

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3 https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1035
4 http://www.imf.org/en/publications/gfsr/issues/2017/03/30/global-financial-stability-report-april-2017

thus enabling the promoters to ‘steal’ the money – is catchy but misleading. Undeniably, there was some of that, either because of the banks’ own volition or under pressure from the government, but the problem was mainly caused by a host of other factors – the irrational exuberance during the high growth phase of 2003-2010 which fuelled an investment overdrive in core sectors; the large forays into infrastructure investment which was an uncharted territory both for the lenders and the borrowers; and cost and time overruns caused by the policy environment during the UPA-II tenure. Crony capitalism, where it is detected, should be ruthlessly penalised, but to approach the task of bad debt resolution as a morality play risks diverting attention away from the crux of the problem.

Efforts So Far to Resolve the Bad Debt Problem

As the banking regulator, the RBI, has been grappling with the bad debt problem for some time now through a series of schemes, each new initiative based on learning from the experience of the earlier ones. Its efforts met with limited success for a variety of reasons, the most important being that India has not had a statutory insolvency regime, a hallmark of mature economies, until recently. There are legal options for banks to seize and sell the assets of the defaulting borrowers or change the management but the processes got bogged down by intractable problems and skewed incentives.

To start with, there was what the government’s Economic Survey called ‘the coordination problem’ among the lenders. Typically, the defaulting corporates had borrowed from a consortium of banks which were later unable to reach agreements on resolution because the sacrifices each of them had to make varied depending on their exposure to the defaulter. Even where they reached an agreement to sell the assets, they were unprepared to take the deep haircuts required to complete the sales, fearing the damage it would inflict on the bank’s balance sheet. On the other side of the deal, the Asset Reconstruction Companies were unwilling to buy at the prices offered by banks, this resulting in a classic market failure. Resolution through the Debt Recovery Tribunals typically takes years while the bad debt keeps getting compounded with each passing day. And to top it all, senior managements of public sector banks, governed by the government’s anti-corruption regulations, were scared of taking bold decisions for the fear of having to face vigilance inquiries which would haunt them even into their retirement.

A standard solution to the bad debt problem, with a fairly credible record of success in several countries in the past, is to establish a 'bad bank' to which the impaired assets would be transferred. This will enable a cleaning up of the banks at one-go which can then be recapitalised so that they can get back into the basic business of lending. Meanwhile the 'bad bank' would focus on resolving the assets with undivided attention and specialised expertise.

The government's Economic Survey made a strong recommendation to this effect. Acharya had also endorsed a variant of the option.[5] However, the government remained unpersuaded. Although it did not clearly indicate the reasons for its reluctance to go along this route, the government's reservations could be due to the huge capital required to establish a 'bad bank' of the size warranted by the huge proportions of the NPAs which the government in turn could not fork out, given its own fiscal compulsions or possibly also because of an apprehension that the government's direct involvement in the nitty-gritty of bad debt resolution could expose it to allegations of crony capitalism.

Implications of the NPA Ordinance

It is too early to say how the implementation of the provisions of the ordinance will unfold and how effective they might be.

The expectation is that the RBI will first give strict timelines for banks to resolve the cases by and amongst themselves. In the event this step fails, it would assume greater control of the process and direct specific action including a recourse to the insolvency procedure. The RBI might also establish committees as provided for in the ordinance to 'advise' the banks on the resolution package, in some sense giving a reassurance to the bankers about protection from vigilance action.

Reportedly, about 50 corporates account for the bulk of the bad debts and, in that sense, the task is quite circumscribed.

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5 https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1035

Is this the Best Possible Solution?

By all accounts, the ‘NPA’ ordinance is not a totally benign option; indeed it has raised a number of questions.

Is it appropriate for the RBI, which is also the regulator of banks, to directly get involved in the executive decisions of the regulated institutions? Will that not compromise the RBI’s regulatory authority which is effective only if it remains at arm’s length? What is the RBI’s comparative advantage or proven expertise in directing business decisions? What is the basis for presuming that the RBI staff will not succumb to corruption just like the bank staff? Conversely, will not the direct involvement in business decisions vitiate the RBI’s hard-earned reputation for integrity and professionalism?

In the absence of any prior experience with this sort of an experiment, it is difficult to make a judgement call at this stage on any of these issues. However, given the size and urgency of the problem and the lack of other viable alternatives, this seems to be the least-bad option under the circumstances. The government could have assuaged the concerns on conflict of interest by inserting a sunset clause in the amendment to the effect that these provisions would lapse, say after one year, thereby making it clear that this is an extraordinary one-time measure to resolve an unusual challenge.

The disquiet about the conflict of interest is understandable but a bigger worry should be about the prospects of success. If this unusual and unconventional measure does not produce results, it will dent the credibility of the RBI and erode confidence in India’s growth prospects.

Recapitalising Banks

The resolution of bad debts is, in fact, the first of a two-step challenge. When a loan account is resolved – by restructuring, change of management, sale of assets or through the insolvency process – the bank will be required to recognise substantial losses which will erode its capital base. The bank can get back into business only if it is recapitalised. It is difficult to put a figure on the capital gap that the resolution might result in but it is likely to be substantial.

Compounding the problem is that this recapitalisation requirement will come on top of the additional capital that banks are obliged to bring by March 2019 to meet the 'Basel III'[6] norms.

The recapitalisation challenge raises a number of big-ticket policy issues. How will the government meet its share of the recapitalisation burden, given its obligations under fiscal responsibility? Will the government consider some financial engineering options to meet the recapitalisation burden, such as raising money from the market without giving up its controlling stake in the public sector banks? What is the likelihood that it might succeed in such endeavours? Will the watchdogs, particularly the rating agencies, not penalise the government, viewing such financial engineering as a contingent fiscal liability or even as infringement of fiscal responsibility?

The questions continue. Will the government try to earn some breathing space by engineering a consolidation of public sector banks – merging strong banks with weak banks? Will such inorganic marriages work? Indeed, should the capital base of the relatively strong banks be used to promote their own business or should it be wasted to rescue weaker banks?

Of course the biggest question of all is this – will the government bite the bullet and persuade itself to privatise the public sector banks, thus bringing the curtain down on one of the biggest policy initiatives of socialist India?

Conclusion

The bad loan problem is a huge challenge for the Modi government. However, the silver lining is that it gives an opportunity to the government to demonstrate its competence, commitment and reform credentials.

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6 'Basel III' is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; improve risk management and governance; and strengthen banks' transparency and disclosures. See http://www.bis.org/bcbs/basel3.htm. Accessed on 23 May 2017.