mintessay

A tale of three banks: what next for our banking system?

Its woes will continue unless there are fundamental changes, ranging from stopping behest lending prompted by the government, to making the appointment of independent directors sacrosanct

DEEPAK NAYYAR
is emeritus professor of economics, Jawaharlal Nehru University, New Delhi. He served as chief economic adviser, government of India, from 1989-91, and as vice-chancellor, University of Delhi, from 2000-05.

Banks are in the news with banner headlines. It would seem that the rot runs deep. Punjab National Bank (PNB) experienced a mega-fraud of Rs12,500 crore which surfaced in mid-February. It has raised many questions. But there are few answers. The managing director and chief executive officer of ICICI Bank is in the eye of a storm. There are allegations of nepotism and impropriety, if not a quid pro quo, in a bad loan to Videocon. The managing director of Axis Bank, who had been reappointed as managing director and CEO for a fourth term of three years, has to step down in eight months, evidently because of serious questions raised by the Reserve Bank of India (RBI). Given the systemic flaws in regulation and governance, these instances might just be the tip of an iceberg.

The PNB story is bizarre. Its Brady House branch in Mumbai issued letters of undertaking (LoUs), without any collateral, to Nirav Modi, a billionaire diamond jewellery designer. Modi then used these as guarantees to borrow from overseas branches of Indian banks to finance imports. This process started in 2011 and continued undetected until 2018. It ended by sheer accident when a person from the Modi firm, who did not realize that the colluding official had just retired, was stupid enough to ask for a fresh LoU without any cash margin, claiming that this had never been asked for in the past.

The explanations are hard to accept at face value. The same mid-level bank officials prepared, checked and authorized messages fed into the SWIFT messaging system for international transactions, committing millions of dollars on behalf of PNB without this information ever being integrated into its core banking system. Were these grave systemic errors ever noticed by internal audit or the statutory auditors over a period of seven years? Is anyone accountable for this lapse, which cost PNB almost $2 billion?

The outcome, to begin with, was a blame game. The finance minister stated that politicians are held accountable while regulators are not. The governor of RBI said that the Banking Regulation Act, which does not allow the RBI to intervene effectively in public sector banks, is the culprit. Where are we two months later? A few mid-level PNB officials have been suspended. The managing director of PNB says that the worst is over, the situation is under control, and all should be well in six months. Of course, the ultimate burden will be on depositors and shareholders. Does anyone care?

For many, the solution to this problem is to privatize public sector banks. But private sector banks are no different. Bad loans, in the form of non-performing assets (NPAs), which cease to generate income, are mounting. There are serious lapses in governance. The stories of ICICI Bank and Axis Bank provide confirmation.

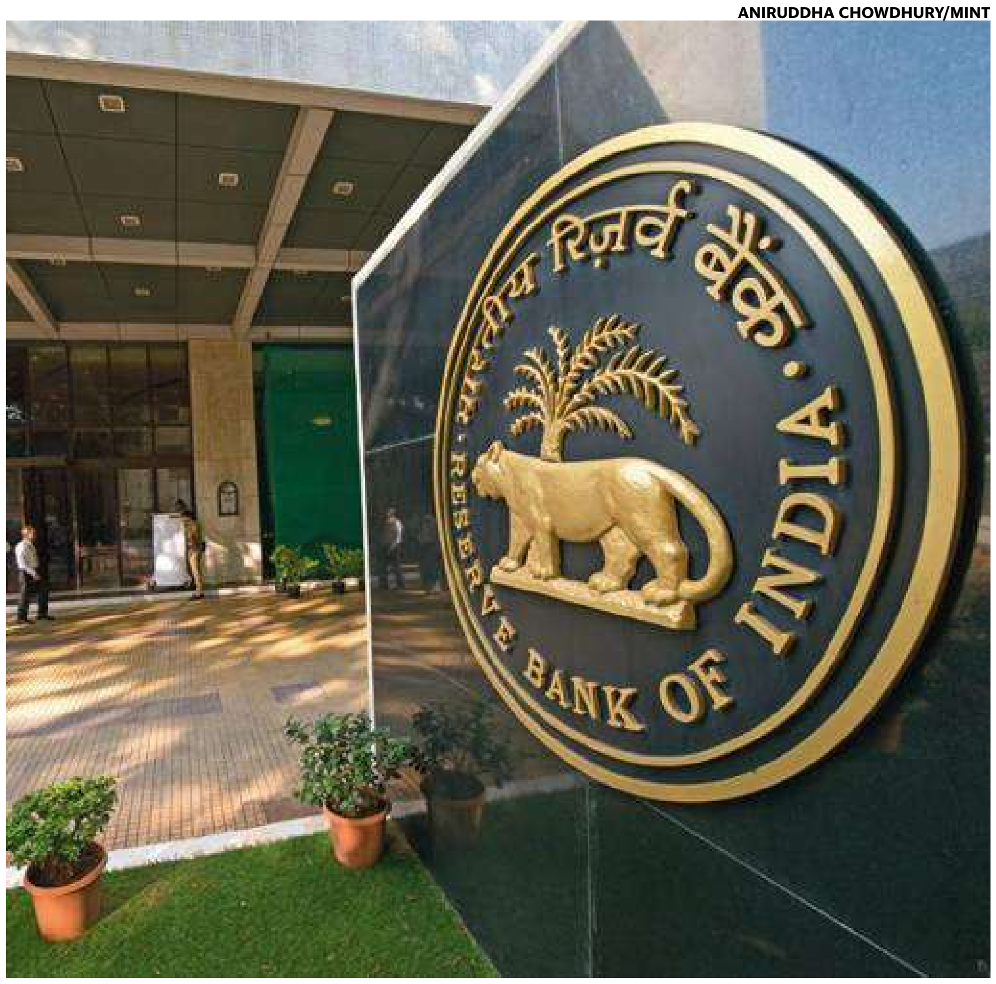
For ICICI Bank, gross NPAs as a proportion of total assets have risen from 2.6% in March 2010 to 5.8% in March 2017 and 7.8% in December 2017. And there are probably concealed NPAs not reflected in these figures. Corporate governance is also under question. It has been alleged that ICICI Bank CEO Chanda Kochhar served on a committee that granted a loan of Rs3,250 crore to Videocon in 2012, even though its chairman, Venugopal Dhoot, had been a business partner of her husband Deepak Kochhar. This web of transactions is now being investigated, which alone can establish whether or not there was any quid pro quo. Even so, it is clear that Chanda Kochhar served on the committee that sanctioned the loan to Videocon although she should have withdrawn from the committee in conformity with the conflict-of-interest principle. Yet, in their first response, the ICICI bank board and its chairman strongly defended the CEO, denying allegations of impropriety or nepotism. However, as shareholders, mostly foreign institutional investors, are now voicing concerns, and there are newspaper reports that a divided board is rethinking the matter.

For Axis Bank, gross NPAs as a proportion of total assets have risen from 0.7% in March 2010 to 3.9% in March 2017 and 5.3% in December 2017. But that is not all. It is reported that, on the basis of its income recognition and asset classification norms, the RBI discovered that there was a large divergence between the NPAs reported by Axis Bank and RBI's assessment: as much as Rs9,480 crore in 2015-16 and Rs5,630 crore in 2016-17. It led the RBI to impose a penalty on Axis Bank for non-compliance. Yet, the board recommended a fourth three-year term for the CEO, Shikha Sharma, starting June. This was obviously not approved. It has been reported that RBI wrote to the chairman asking the board to reconsider its recommendation on the reappointment of the CEO, citing performance of the bank and deteriorating asset quality as reasons. The Axis Bank board has just announced that, at Sharma's request, her term as CEO was being renewed only until December.

The situation is grim. The financial stability reports of RBI show that, for all commercial banks, gross NPAs as a proportion of total assets were 9.6% in March 2017, 10.2% in September 2017 and 10.8% in March 2018, as compared with 11.4%, 13.5% and 14.5%, respectively, for public sector banks. The share of private sector banks in total gross NPAs of all banks is around one-fourth, so their problem is real. These NPAs erode profitability insofar as provisioning for bad loans in balance sheets constitutes expenditure in annual accounts, thereby reducing profits. It dissuades banks from lending to firms so that bad borrowers drive out good borrowers. It imparts fragility to the financial sector. Ultimately, such outcomes impose a burden on people as depositors and citizens as taxpayers.

In such situations, banks do need an infusion of equity capital. The government announced a recapitalization of public sector banks by Rs2.11 trillion in October 2017 driven by two factors. The first was regulatory compulsion, as Tier I or core capital of banks (equity plus reserves) must conform to global standards embodied in Basel III norms by April 2019. The second was economic necessity, as provisioning for NPAs constrains lending ability of banks, or violates capital adequacy norms, while credit is the lifeblood of a market economy. This was necessary but cannot be sufficient. Recapitalization will help reduce or eliminate stocks of toxic assets held by banks. However, it can do nothing to stop the flow of toxic assets if the practice of bad loans continues. It can be stopped only through effective regulation, better governance, and genuine accountability.

ANIRUDDHA CHOWDHURY/MINT



Where accountability is diluted, essential corrective action is not implemented, it creates what economists call 'moral hazard'

For private sector commercial banks, RBI is the regulator and the supervisor. The board recommends, while RBI approves, the appointment of CEOs, directors, and independent directors. The RBI is also responsible for their supervision. For public sector banks, under the Banking Regulation Act, government as the owner decides on the appointment of CEOs, directors and independent directors. The role of the RBI is in effect limited to supervision. Corporate governance in all banks—public or private—is the responsibility of their board of directors, audit committee, nomination and remuneration committee, independent directors and the statutory auditors.

The PNB fraud began life in 2011 and was discovered in 2018. It is clear that the government bears primary responsibility as the owner-cum-regulator. It is just as clear that there was a supervisory failure from RBI. In addition, there was a serious lapse in corporate governance by the board of directors, audit committee and independent directors of PNB. It would seem that the regulator, supervisor and management were all asleep at the wheel. Does accountability end with the few middle-level officials who have been suspended? Surely not. The CEO and the board must be accountable.

ICICI Bank has a serious bad loans problem that has accumulated over a decade. Its CEO, who has been named in a web of transactions that are under investigation, has, for sure, violated the conflict-of-interest principle. There is an obvious lapse in corporate governance. It is reported that the RBI has not approved the board decision to pay Chanda Kochhar a bonus of Rs2.2 crore for 2016-17. But the RBI has not yet stepped in as regulator or supervisor. The board of directors, including members of the audit committee and independent directors, responsible for corporate governance, has so far simply defended the CEO.

Axis Bank also has the same problem of mounting bad loans. The magnitude of non-performing assets has been underestimated for two consecutive years, thus concealing bad loans. In this case, the RBI has possibly acted as regulator and supervisor. Reports say that the RBI did not approve the board decision to pay Sharma a bonus of Rs1.35 crore for 2016-17. Earlier this month, it was reported that the RBI asked the chairman and the board to review the reappointment of Sharma as CEO. The board has complied. Yet, the board of directors, including the audit committee and independent directors, are primarily responsible for corporate governance.

In such situations, where accountability is diluted, essential corrective action is not implemented. It creates what economists call a "moral hazard" because negligent bankers who do not pay any price for their sins could repeat their errant behaviour.

Indeed, such incidents will recur unless there are fundamental changes. As I have written in an earlier column (*https://goo.gl/HJC96j*), "Behest lending prompted by government must stop. Inept lending and corrupt practices by banks must stop. Banks must exercise due diligence in their lending operations." The process of appointing independent directors must be sacrosanct with no manipulation for patronage or cronies. The RBI must ensure that there are no regulatory or supervisory failures. The government must not interfere in public sector banks except to invoke accountability as the owner. Boards of directors must ensure good governance in the management of commercial banks. And those who fail in their tasks must be held accountable. The future of our banking system depends on this.

Comments are welcome at views@livemint.com