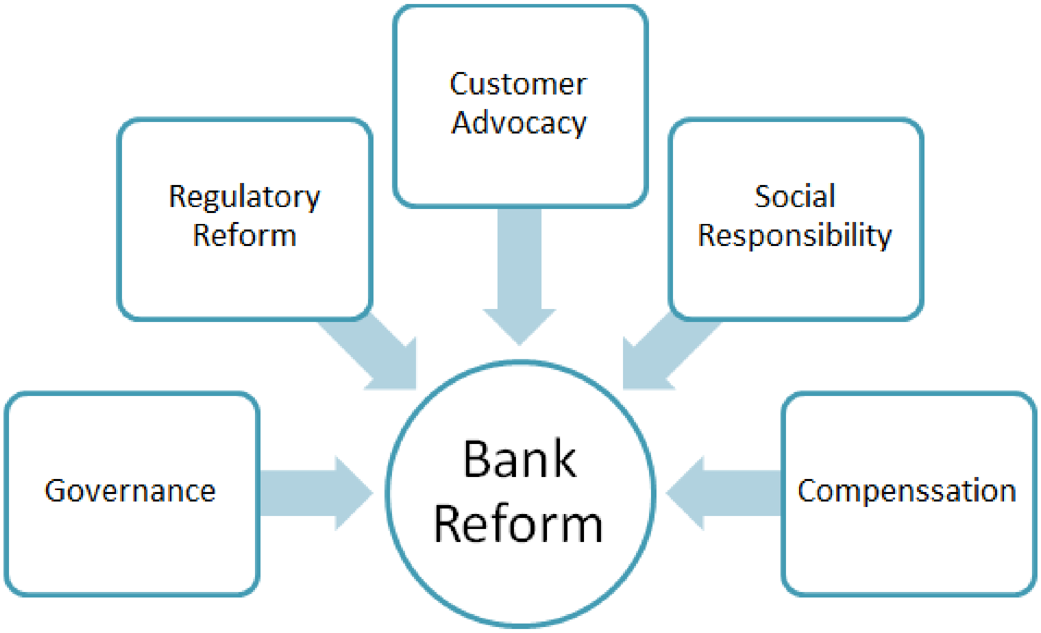
The next big step in banking reforms



The overall performance of the financial system depended on the functioning of the public sector bankswhich accounted for more than two-thirds of banking business.
The standards of governance depended on the manner in which the government exercises its powers under the legislative provisions by which several banks were nationalised. The RBI's oversight of public sector banks was focused on prudential regulation.
The asset quality review, initiated by the Reserve Bank of India (RBI) in December 2015, prompted banks to take steps to recognise all nonperforming assets and ensure appropriately provisioned balance sheets by March 2017.

RBI as an independent statutory body requires more autonomy and more insulated from day to day politics. While Finance ministry takes care of Fiscal policy its RBI in charge of monetary policy.
For a stable micro and macroeconomics its very much important that Fiscal and monetary policy are in sync with development goal of overall economy.
The Banks reforms committee advocates greater liberty for all banks in general. Licensing of branches and automated teller machines by the Reserve bank of India (RBI) should cease and these should become tradable between banks.
They include greater autonomy for public sector banks (PSBs), unshackling them from the fetters of a multitude of "public sector" administrative regulators, allowing proportional representation of various stockholders—public and private—in truly empowered PSB boards.

- There are 21 PSBs in the country which constitutes 70% of the banking sector. According to RBI financial stability report the banking system's gross bad loan ratio was 9.6% in March 2017.

- The recapitalisation and reform agenda is sharply focused on strengthening PSBs, increasing lending to MSMEs and making it easier for MSMEs and retail customers to transact as well as significantly increasing access to banking services. Asking public sector banks to become more MSME-friendly is an important step, given the footprint and role of small enterprises.

Banking reforms committee Recommendations:

- The recommendations of the Banking reforms committee for the financial sector reforms, that were recently put up for public comment, seek to fundamentally alter the landscape of the Indian banking sector.

Broad impact on India's banks if these suggestions are implemented:

First, the banking sector would become largely "ownership neutral". PSBs, domestic private sector banks and foreign banks would become largely indistinguishable in their operations and business models. Further, the distinction between banks and non-banking financial companies (NBFCs) would become far less watertight and areas of competition will be determined by the functions rather than forms of the competing institutions.

As the financial sector develops in India, the traditional boundaries between banks and NBFCs become fuzzy. Banks now sell insurance and mutual funds and provide portfolio and corporate treasury advisory services while NBFCs accept term deposits and provide loans.

To avoid perverse incentives and regulatory arbitrage, it is important that institutions serving essentially the same function face the same set of regulations whether they have a banking licence or not.

For instance, secured creditors such as banks and NBFCs should have the same status with regard to the SRFAESI Act or debt recovery tribunals, which is not currently the case.

Regulations should deal with functions, not historical labelling of institutions. This is true not just for banks and NBFCs but across and within various sectors of the Indian financial landscape.

But what about the social responsibilities of PSBs? Will this not be a banking sector solely targeted for the urban rich? Will banks any longer open branches in remote rural areas to aid financial inclusion? Will the government and RBI be able to achieve their distributional policies through banks?

From the government's perspective then, inclusion of banks is better served by setting appropriate norms and providing incentives at the policy level, without distinguishing between public and private banks. Both are equally likely to promote inclusion if and only if they find it in their best interests to do so.

In recent years, private banks have actually directed a greater share of their lending to priority sectors than PSBs though the composition of priority lending may be different.

Historically, bank nationalization has led to more credit to agriculture, villages and public sector undertakings but not to the small scale sector or thrust areas identified in recent five-year plans.

In terms of the credit quality of priority sector lending, PSBs have fared relatively poorly.

Uniform and detailed priority sector lending norms are likely to yield similar lending patterns on the ground regardless of whether the lender is a private or a public bank. Allowing banks to trade priority sector lending credit would ensure that priority sector lending is allocated to banks according to their capabilities in this area.

The core principles guiding these recommendations include

- Regulations based on function, rather than form; and
- The separation between policymaking and bank management.

Eliminating NPAs needs structural reforms in two areas-

- The management of PSBs and
- The way cases of bank frauds are handled by investigating agencies.

Economic Survey: Banking Reforms Must Follow Resolution And Recapitalisation:

While the admission of large stressed assets under the Insolvency and Bankruptcy Code and the recapitalisation package for public sector banks will help address India's twin balance sheet problem, more will need to be done in the new financial year, said Arvind Subramanian, chief economic adviser, in his Economic Survey for 2017-18.

The IBC, according to the survey, has provided a resolution mechanism for the bad loan problem. The government's recapitalisation package for public sector banks, which account for most of the banking system's troubled assets, has taken care of the recapitalisation aspect of the banking system's turnaround.

Now, the government would need to focus on the fourth 'R' of the twin balance sheet problem. The TBS actions, noteworthy for cracking the long-standing "exit" problem, need complementary reforms to shrink unviable banks and allow greater private sector participation.

Reform Agenda

- Banks have been asked to tie up with specialized monitoring agencies for credit exposure above Rs250 crore. Proper due diligence has also been suggested while sanctioning loans. They have also been asked to scrutinize balance sheets, ensure strict mechanism and ring-fence while giving loans.
- Banks have been asked to create a separate stressed asset management vertical to focus on recovery of loans.

- India still needs public sector banks, but not so many. If some PSBs cannot mobilize the required resources for their profitable growth, they should be merged.
- PSBs will have to revamp their lending practices, especially in advancing loans to big businesses, monetize non-core assets, rationalize overseas branches, embrace technology and move to recover loans that have turned bad. The strategy is to provide a lifeline to banks struggling under the legacy of bad loans so that they can once again resume commercial lending—and revive the investment cycle in the economy.

Conclusion:

It is the right time to take the necessary action in revising the rules and regulations concerning the functioning of banks, their boards and CEOs.

Rather than getting obsessed with moral issues, a practical way would be to strengthen the regulatory framework and review it every two years based on the banks' response.

Policymakers should set suitable incentives and allow independent banks to pursue efficiency in that setting, not meddle in their functioning through action-specific regulations. Therein lies the essence of second generation reforms in Indian banking.

The rot in the Indian banking system is deep but it can be treated. Unless the measures suggested are implemented effectively, the banking system would continue to burn cash for the politicians, bureaucrats, and businessmen. And the people of India, including the poorest of the poor would continue to pay the price.

Banks' operational risk management, risk culture, internal control frameworks and external audit function should typically play a central role in preventing fraud.