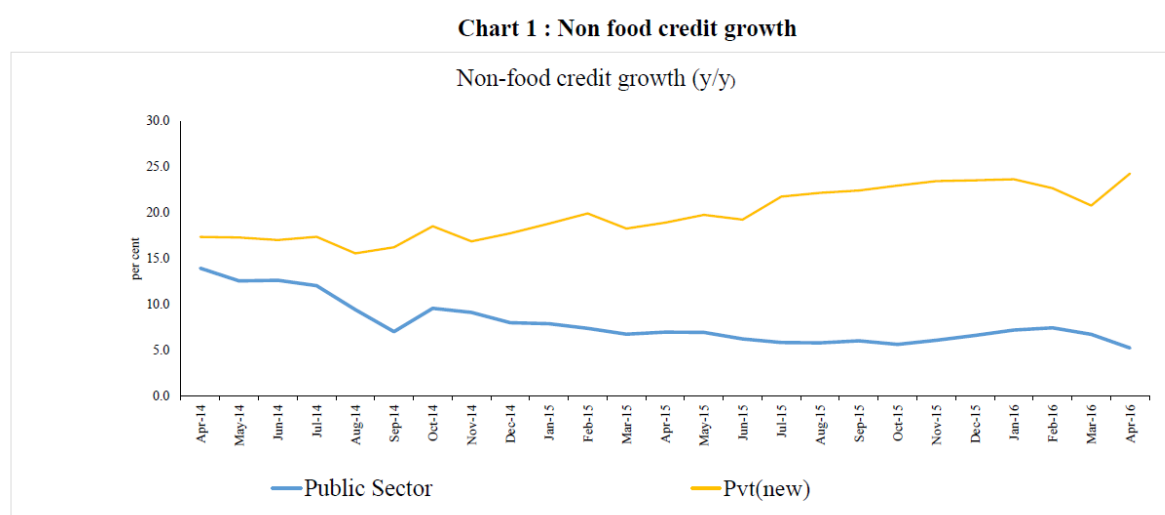


Resolving Stress in the Banking System¹

Thank you very much for inviting me to give this talk. Ordinarily, in a city like Bengaluru, we would talk about startups. Today, however, I want to talk about the resolution of financial distress. I will argue that the slowdown in credit growth has been largely because of stress in the public sector banking and not because of high interest rates. As such, what is required is a clean-up of the balance sheets of public sector banks, which is what is underway and needs to be taken to its logical conclusion. Specifically, I will describe what we have been doing in India to change the culture surrounding the loan contract. To start, let us look at public sector credit growth compared with the growth in credit by the new private banks.

Public Sector Lending vs Private Sector Lending

As chart 1 (Credit in India) shows, public sector bank non-food credit growth has been falling relative to credit growth from the new private sector banks (Axis, HDFC, ICICI, and IndusInd) since early 2014. This is reflected not only in credit to industry (Chart 2), but also in micro and small enterprise credit (Chart 3).² The relative slowdown in credit growth, albeit not so dramatic, is also seen in agriculture (Chart 4), though growth is picking up once again. Whenever one sees a slowdown in lending, one could conclude there is no demand for credit – firms are not investing. But what we see here is a slowdown in lending by public sector banks vis a vis private sector banks. Why is that?



¹ Speech by Dr. Raghuram G. Rajan, Governor, Reserve Bank of India, at ASSOCHAM – Interactive Meet with Industry & Trade, June 22, 2016, Bengaluru.

² In Chart 2, the latest negative growth April number may be an aberration because of UDAY bonds being transferred from bank loan books to investments)

Chart 2 : Credit to Industry

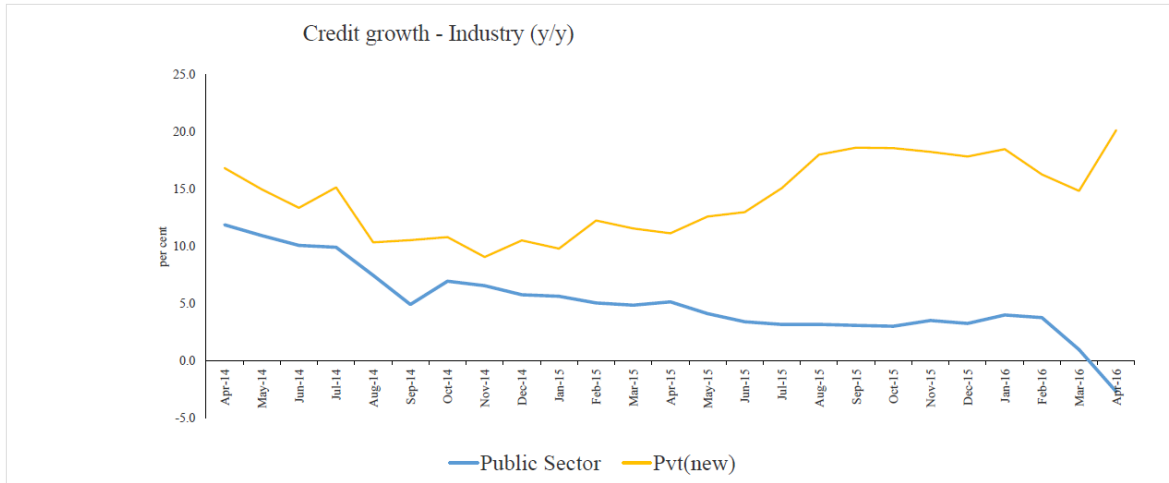


Chart 3 : Credit to Micro and Small Enterprise

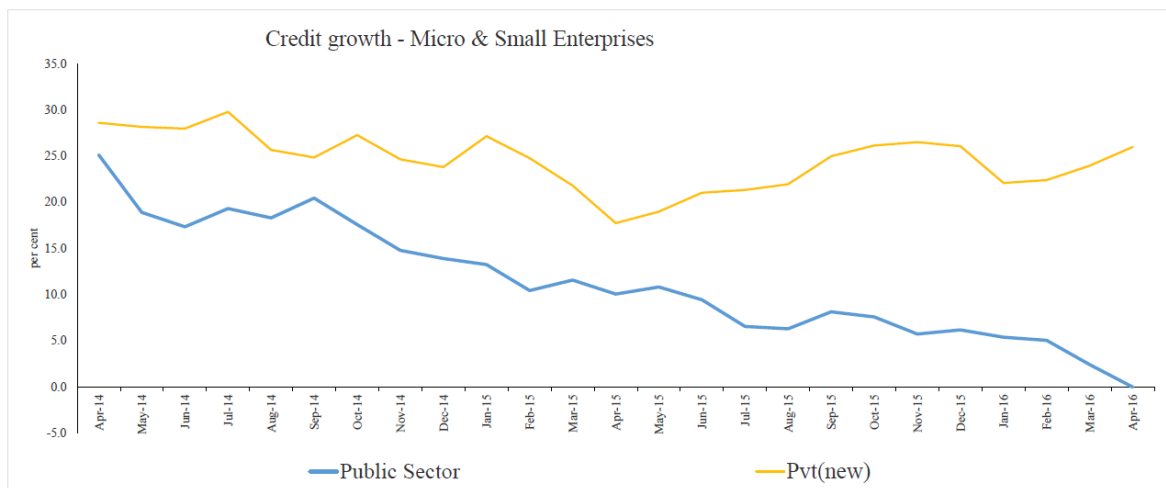
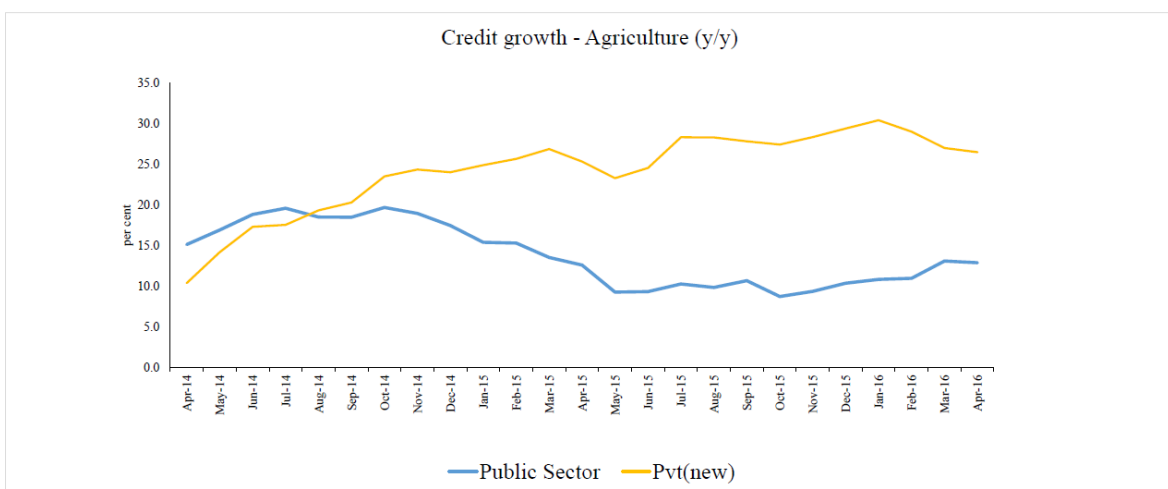


Chart 4 : Credit to Agriculture



The immediate conclusion one should draw is that this is something affecting credit supply from the public sector banks specifically, perhaps it is the lack of bank capital. Yet if we look at personal loan growth (Chart 5), and specifically housing loans (Chart 6), public sector bank loan growth approaches private sector bank growth. The lack of capital therefore cannot be the culprit. Rather than an across-the-board shrinkage of public sector lending, there seems to be a shrinkage in certain areas of high credit exposure, specifically in loans to industry and to small enterprises. The more appropriate conclusion then is that public sector banks were shrinking exposure to infrastructure and industry risk right from early 2014 because of mounting distress on their past loans. Private sector banks, many of which did not have these past exposures, were more willing to service the mounting demand from both their traditional borrowers, as well as some of those corporates denied by the public sector banks. Given, however, that public sector banks are much bigger than private sector banks, private sector banks cannot substitute fully for the slowdown in public sector bank credit. We absolutely need to get public sector banks back into lending to industry and infrastructure, else credit and growth will suffer as the economy picks up.

Chart 5 : Personal Loans

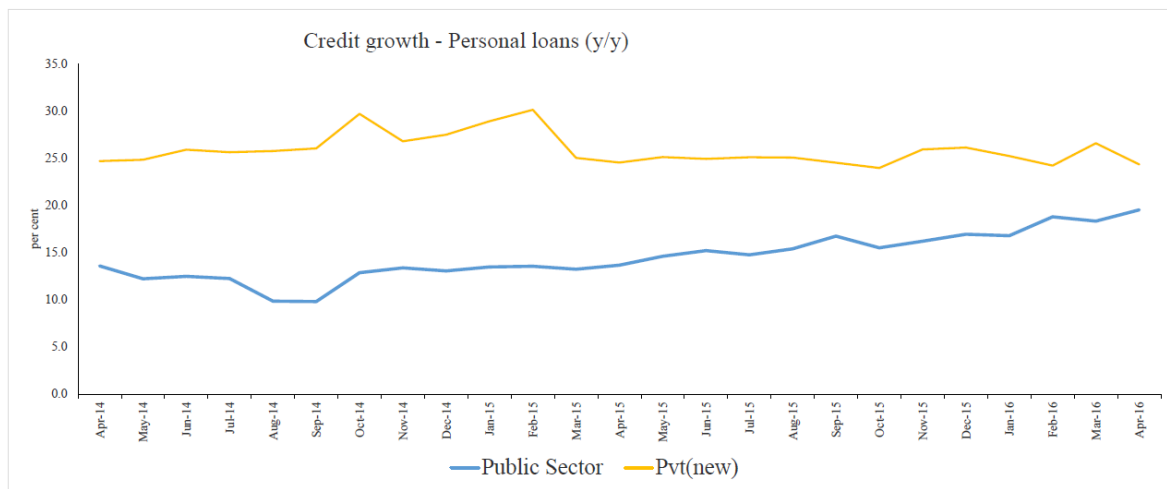
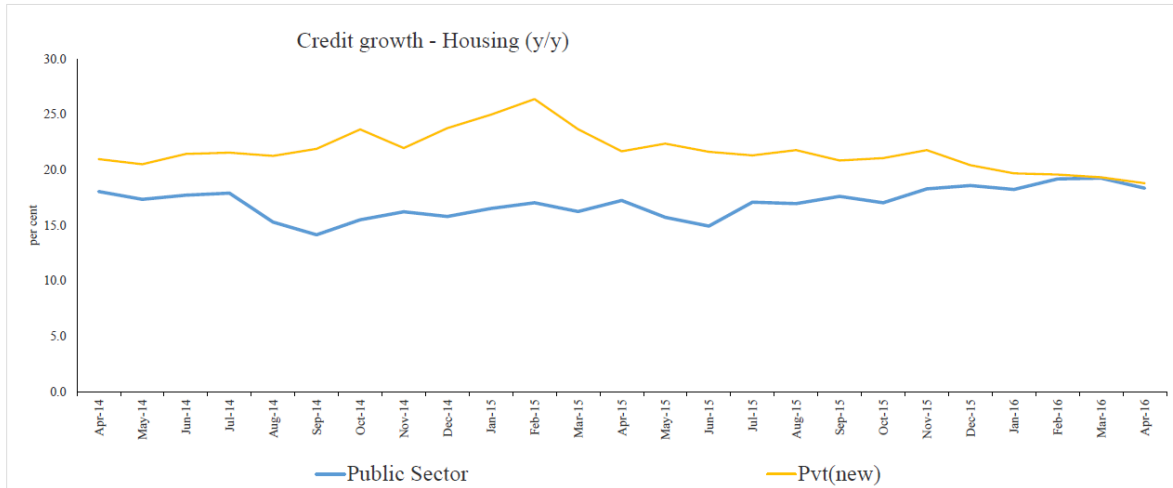


Chart 6 : Housing Loans



These charts refute another argument made by those who do not look at the evidence – that stress in the corporate world is because of high interest rates. Interest rates set by private banks are usually equal or higher than rates set by public sector banks. Yet their credit growth does not seem to have suffered. The logical conclusion therefore must be that it is not the level of interest rates that is the problem. Instead, stress is because of the loans already on PSB balance sheets, and their unwillingness to lend more to those sectors to which they have high exposure.

There are two sources of distressed loans – the fundamentals of the borrower not being good, and the ability of the lender to collect being weak. Both are at work in the current distress.

The Sources of Lending Distress: Bad Fundamentals

Why have bad loans been made? A number of these loans were made in 2007-2008. Economic growth was strong and the possibilities limitless. Deposit growth in public sector banks was rapid, and a number of infrastructure projects such as power plants had been completed on time and within budget. It is at such times that banks make mistakes. They extrapolate past growth and performance to the future. So they are willing to accept higher leverage in projects, and less promoter equity. Indeed, sometimes banks signed up to lend based on project reports by the promoter's investment bank, without doing their own due diligence. One promoter told me about how he was pursued then by banks waving checkbooks, asking him to name the amount he wanted. This is the historic phenomenon of irrational exuberance, common across countries at such a phase in the cycle.

The problem is that growth does not always take place as expected. The years of strong global growth before the global financial crisis were followed by a slowdown, which

extended even to India, showing how much more integrated we had become with the world. Strong demand projections for various projects were shown to be increasingly unrealistic as domestic demand slowed down. Moreover, a variety of governance problems coupled with the fear of investigation slowed down bureaucratic decision making in Delhi, and permissions for infrastructure projects became hard to get. Project cost overruns escalated for stalled projects and they became increasingly unable to service debt.

I am not saying that there was no malfeasance – the country’s investigative agencies are looking into some cases such as those where undue influence was used in getting loans, or where actual fraud has been committed by diverting funds out of a company, either through over-invoicing imports sourced via a promoter-owned subsidiary abroad or exporting to related shell companies abroad and then claiming they defaulted. I am saying that, typically, there were factors other than malfeasance at play, and a number of genuine committed entrepreneurs are in trouble, as are banks that made reasonable business decisions given what they knew then.

The Sources of Lending Distress: Poor Monitoring and Collection

The truth is, even sensible lending will entail default. A banker who lends with the intent of never experiencing a default is probably over-conservative and will lend to too few projects, thus hurting growth. But sensible lending means careful assessment up front of project prospects, which I have argued may have been marred by irrational exuberance or excessive dependence on evaluations by others. Deficiencies in evaluation can be somewhat compensated for by careful post-lending monitoring, including careful documentation and perfection of collateral, as well as ensuring assets backing promoter guarantees are registered and tracked. Unfortunately, too many projects were left weakly monitored, even as costs increased. Banks may have expected the lead bank to exercise adequate due diligence, but this did not always happen. Moreover, as a project went into distress, private banks were sometimes more agile in securing their positions with additional collateral from the promoter, or getting repaid, even while public sector banks continued supporting projects with fresh loans. Promoters astutely stopped infusing equity, and sometimes even stopped putting in effort, knowing the project was unlikely to repay given the debt overhang.

The process for collection, despite laws like SARFAESI intended to speed up secured debt collection, has been prolonged and costly, especially when banks face large, well-connected promoters. The government has proposed reforms to the judicial process, including speeding up the functioning of the Debt Recovery Tribunals, which should make it easier for banks to collect, but those legislative reforms are before Parliament. Knowing that banks

would find it hard to collect, some promoters encouraged them to “double-up” by expanding the scale of the project, even though the initial scale was unable to service debt. Of course, the unscrupulous among the promoters continued to divert money from the expanded lending, increasing the size of the problem on bank balance sheets.

The inefficient loan recovery system then gives promoters tremendous power over lenders. Not only can they play one lender off against another by threatening to divert payments to the favored bank, they can also refuse to pay unless the lender brings in more money, especially if the lender fears the loan becoming a Non-Performing Asset. Sometimes promoters can offer miserly one-time settlements (OTS) knowing that the system will ensure the banks can collect even secured loans only after years. Effectively, loans in such a system become implicit equity, with a tough promoter enjoying the upside in good times, and forcing banks to absorb losses in bad times, even while he holds on to his equity.

Cleaning Up the Banks: Principles

The world over, there are three cardinal rules when faced with incipient distress.

1) Viability does not depend on the debt outstanding, but on economic value. Debt may have to be written down to correspond to what is viable.

Because of changed circumstances, demand may be lower and project cash flows may be significantly lower than projected earlier. The project has economic value when completed – in the sense that operating cash flows are positive, but much less than the interest on the debt it carries. If the debt is not written down, the project continues as an NPA, even while the promoter, knowing it cannot repay, loses interest. If neglected, the project may stop generating any cash flows and the assets may depreciate rapidly.

2) Complete projects that are viable, even if it requires additional funds infusion.

Stalled projects do not get any better over time. If there are small investments needed to complete the project, and the promoter has no funds, it may still make sense to lend to it, even while writing down the overall debt. Essentially, the new loan makes it possible to generate operating cash flows to service some debt, even if not all the outstanding debt.

3) Don't throw good money after bad money simply because there is an unreliable promise that debt will become serviceable.

This is the opposite of (2). If the project is unviable, doubling its size does not make it any more viable. Promoters that have over-borrowed often propose an increase in scale so that the bank's outstanding debt and new loans will all become serviceable. Perhaps it would be better for the bank to write down its loans to the initial project, rather than going deeper into

the hole because the promoter may incur new cost-overruns as he expands. An incompetent or unreliable promoter will remain so even when scale expands.

Bank Moral Hazard

Unfortunately, the incentives built into the public sector banking system have made it more difficult for public sector bank executives to follow these principles (I should add that some private sector bank executives have also not been immune on occasion). The short tenure of managers means they are unwilling to recognize losses immediately, and more willing to postpone them into the future for their successors to deal with. Such distorted incentives lead to overlending to or “ever-greening” unviable projects. Unfortunately, also, the taint of NPA immediately makes them reluctant to lend to a project even if it is viable, for fear that the investigative agencies will not buy their rationale for lending. The absence of sound and well documented loan evaluation and monitoring practices by banks makes such an outcome more likely. So excessive lending to bad projects and too little lending to viable ones can coexist.

The Regulator’s Dilemma

For regulator who wants the banking system to clean up so it can start lending again, this creates a variety of objectives, which can be somewhat conflicting. First, we want banks to recognize loan distress and disclose it, not paper over it by ever-greening unviable projects. Loan classification is merely good accounting – it reflects what the true value of the loan might be. It is accompanied by provisioning, which ensures the bank sets aside a buffer to absorb likely losses. If the losses do not materialize, the bank can write back provisioning to profits. If the losses do materialize, the bank does not have to suddenly declare a big loss, it can set the losses against the prudential provisions it has made. Thus the bank balance sheet then represents a true and fair picture of the bank’s health, as a bank balance sheet is meant to.

Second, we want them to be realistic about the project’s cash generating capacity, and structure lending and repayment to match that.

Third, we want them to continue lending to viable projects, even if they had to be restructured in the past and are NPAs.

The problem is that any forbearance in labeling loans NPAs on restructuring makes it easier to avoid disclosure and indulge in ever-greening. On the other hand, strict disclosure and classification rules could imply a cessation of lending to even viable projects. There are no clean solutions here given the kind of incentives in the system, and given the absence of

an operational bankruptcy code in India. Therefore, the RBI has had to adopt a pragmatic approach to the clean-up, creating new enabling processes.

The RBI's Approach

Our first task was to make sure that all banks had information on who had lent to a borrower. So we created a large loan database (CRILC) that included all loans over Rs. 5 crore, which we shared with all the banks. The CRILC data included the status of each loan – reflecting whether it was performing, already an NPA or going towards NPA. That database allowed banks to identify early warning signs of distress in a borrower such as habitual late payments to a segment of lenders.

The next step was to coordinate the lenders through a Joint Lenders' Forum (JLF) once such early signals were seen. The JLF was tasked with deciding on an approach for resolution, much as a bankruptcy forum does. Incentives were given to banks for reaching quick decisions. We have also tried to make the forum more effective by reducing the need for everyone to agree, even while giving those who are unconvinced by the joint decision the opportunity to exit.

We also wanted to stop restructuring of unviable projects by banks who want to avoid recognizing losses – so we ended the ability of banks to restructure projects without calling them NPA in April 2015. At the same time, a number of long duration projects such as roads had been structured with overly rapid required repayments, even though cash flows continued to be available decades from now. So we allowed such project payments to be restructured through the 5/25 scheme provided the long dated future cash flows could be reliably established. Of course, there was always the possibility of banks using this scheme to evergreen, so we have monitored how it works in practice, and continue tweaking the scheme where necessary so that it achieves its objectives.

Because promoters were often unable to bring in new funds, and because the judicial system often protects those with equity ownership, together with SEBI we introduced the Strategic Debt Restructuring (SDR) scheme so as to enable banks to displace weak promoters by converting debt to equity. We did not want banks to own projects indefinitely, so we indicated a time-line by which they had to find a new promoter.

All these new tools (including some I do not have the space to describe) effectively created a resolution system that replicated an out-of-court bankruptcy. Banks now had the power to resolve distress, so we could push them to exercise these powers by requiring recognition. This is what the Asset Quality Review, completed in October 2015 and subsequently shared with banks, sought to accomplish. Since then banks have classified

existing distressed loans appropriately, and since March 2016 are looking at their weak-but-not-yet-distressed portfolio for necessary actions. There is a change in culture, and banks have been quite willing to get into the spirit of the AQR. Many have gone significantly beyond our indications in what they have cleaned up by the quarter ending March 2016. Of course, once the banks have properly classified a non-performing loan and provisioned against it, their incentive to evergreen or avoid writing down the debt to appropriate levels is diminished.

Nevertheless, clean-up is ongoing work. The SDR scheme dealt with weak promoters. But some promoters are competent even while their projects are overly indebted. The ‘Scheme for Sustainable Structuring of Stressed Assets’ (S4A) is an optional framework for the resolution of large stressed accounts. The S4A envisages determination of the sustainable debt level for a stressed borrower, and bifurcation of the outstanding debt into sustainable debt and equity/quasi-equity instruments which are expected to provide upside to the lenders when the borrower turns around. Thus capable-but-over-indebted promoters have some incentive to perform, and because the project is not deemed an NPA if adequate provisions are made, public sector banks continue lending to it if necessary.

Most recently, the government is contemplating a fund to lend into distressed situations, with significant participation by third parties, so that new loans can be made to viable distressed projects. Provided decision making is not dominated by banks whose very loans are distressed, this could be an effective vehicle to speed up resolution.

Why So Many Schemes and Why the Constant Tinkering

The sources of borrower distress are many, and we have sought to provide lenders with a menu of options to deal with it, even while limiting their discretion to paper over the problem. Effectively the RBI has been trying to create an entirely new bad loan resolution process in the absence of an effective bankruptcy system. We have had to tinker, since each scheme’s effectiveness, while seemingly obvious when designing, has to be monitored in light of the distorted incentives in the system. As we learn, we have adapted regulation. Our objective is not to be theoretical but to be pragmatic, even while subjecting the system to increasing discipline and transparency.

The good news is that banks are getting into the spirit of the cleanup, and pursuing reluctant promoters to take the necessary steps to rehabilitate projects. Indebted promoters are being forced to sell assets to repay lenders. We will shortly license a number of new Asset Reconstruction Companies (ARCs) to provide a deeper market for stressed assets. We are also working on a framework to enhance efficiency and transparency of price discovery in

sale of stressed assets by banks to ARCs. Bank investors, after initially getting alarmed by the size of the disclosures, have bid up PSB bank shares. To the extent that these are still trading at a fraction of book value, there is still room for upward valuation if the banks can improve the prospects of recovery. The new schemes, as well as the improving economy, should help.

Fraud and Willful default

Even while we make it easier for committed promoters to restructure when they experience bad luck or unforeseen problems, we should reduce the ability of the fraudster or the willful defaulter, who can pay but simply is disinclined to do so, or the fraudster, to get away. This is why it is extremely important that banks do not use the new flexible schemes for promoters who habitually misuse the system (everyone knows who these are) or for fraudsters. The threat of labeling a promoter a willful defaulter could be effective in the former case, and we have coordinated with SEBI to increase penalties for willful defaulters. For fraudsters, quick and effective investigation by the investigative agencies is extremely important. We should send the message that no one can get away, and I am glad that the Prime Minister's Office is pushing prosecution of large frauds. The RBI has set up a fraud monitoring cell to coordinate the early reporting of fraud cases to the investigative agencies. And for those who have diverted money out of their companies, especially into highly visible assets abroad, a stern message sent by bankers sitting together with investigative agencies should help send the message that the alternatives to repayment can be harsh.

Bank Risk Aversion

Bankers often argue that the easiest people to label in a fraud are the bankers themselves, who often could be victims rather than perpetrators. Similarly, they accuse the vigilance authorities of excessive zeal when loans go bad, of immediately suspecting bankers of malfeasance when the bad loan could be an unintended consequence of sensible risk taking. Unfortunately, all too often, such investigations also uncover sloppy due diligence or loan monitoring by bankers. After the fact, it is hard to distinguish sensible risk taking from carelessness or from corruption. While the vigilance authorities continuously attempt to reassure bankers that they are not vigilantes, the bankers themselves know that their own enthusiasm and deficiencies can expose them to unwarranted accusations of corruption.

Certainly, part of the solution is for bankers to pull up their socks. But another part of the solution is to not label a banker based on the outcome of a single loan but instead look for a pattern across loans. A banker who makes an excessive number of bad loans compared to his cohort deserves, at the very least, to be questioned. But the banker who makes the occasional bad loan amidst a lot of good ones probably needs to be rewarded. Such pattern-

based monitoring by bank authorities, with serious punishment through vigilance action only if there is evidence of money changing hands, could control malfeasance while rewarding risk taking. This does require some changes in the current system, including de-emphasizing the committee based approach to loan approval in banks, which appears to diffuse responsibility for loan decisions.

What Responsibility does the RBI have?

Bankers sometimes turn around and accuse regulators of creating the bad loan problem. The truth is bankers, promoters, and circumstances create the bad loan problem. The regulator cannot substitute for the banker's commercial decisions or micromanage them or even investigate them when they are being made. Instead, in most situations, the regulator can at best warn about poor lending practices when they are being undertaken, and demand banks hold adequate risk buffers. The important duty of the regulator is to force timely recognition of NPAs and their disclosure when they happen. Forbearance may be a reasonable but risky regulatory strategy when there is some hope that growth will pick up soon and the system will recover on its own. Everyone – banker, promoter, investors, and government officials – often urge such a strategy because it kicks the problem down the road, hopefully for someone else to deal with. The downside is that when growth does not pick up, the bad loan problem is bigger, and dealing with it is more difficult. It is when the bad loan problem is allowed to accumulate through forbearance or non-recognition that regulators have the difficult task of bringing the system back on track. That is the problem we have had to deal with at the RBI.

As I have shown you, the consequence since early 2014 of the past build-up of stressed loans was a slowdown in public sector bank lending in certain sectors. The cessation of RBI forbearance and the Asset Quality Review in mid 2015 were therefore not responsible for the slowdown. Instead, high distressed exposures in certain sectors were already occupying PSB management attention and holding them back. The only way for them to supply the economy's need for credit, which is essential for higher economic growth, was to clean up and recapitalize.

The silver lining message in the slower credit growth is that banks have not been lending indiscriminately in an attempt to reduce the size of stressed assets in an expanded overall balance sheet, and this bodes well for future slippages. In sum, to the question of what comes first, clean up or growth, I think the answer is unambiguously "Clean up!". Indeed, this is the lesson from every other country that has faced financial stress. It is important,

therefore, that the clean-up proceeds to its conclusion, without any resort to regulatory forbearance once again.

Sometimes, easier monetary policy is proposed as an answer to reducing the bad debt problem. For the heavily indebted promoter, however, easier monetary policy will typically bring no relief. Even with lower policy rates, the bank, which is typically not made whole even if it grabs all the borrower's cash flows, has no incentive to reduce the interest rate the borrower can pay. And few banks are competing for that borrower's business, so there is no competition to force down loan rates. The bottom line is that easier monetary policy is no answer to serious distress, contrary to widespread belief.

What can the Government do?

The government is in the process of speeding up the debt recovery process, and creating a new Bankruptcy system. These are important steps to improve the resolution process. In the near term, however, two actions will pay large dividends.

The first is to improve the governance of public sector banks so that we are not faced with this situation again. The Government, through the Indradhanush initiative, has sent a clear signal that it wants to make sure that public sector banks, once healthy, stay healthy. Breaking up the post of Chairman and Managing Director, strengthening Board and management appointments through the Banks Board Bureau, decentralizing more decisions to the professional board, finding ways to incentivize management, all these will help improve loan evaluation, monitoring and repayment.

The second is to infuse bank capital, with some of the infusion related to stronger performance, so that better banks have more room to grow. Capital infusion into weak banks should ideally accompany an improvement in governance, but given the need for absorbing the losses associated with balance sheet clean up, better that government capital be infused quickly. Governments are sometimes reluctant to infuse bank capital because there are so many more pressing demands for funds. Yet, there are few higher return activities than capitalizing the public sector banks so that they can support credit growth. Finally, the Economic Survey has suggested the RBI should capitalize public sector banks. This seems a non-transparent way of proceeding, getting the banking regulator once again into the business of owning banks, with attendant conflicts of interest.

Better that the RBI pay the government the maximum dividend that it can, retaining just enough surplus buffers that are consistent with good central bank risk management practice. Indeed, this is what we do, and in the last three years, we have paid all our surplus to the government. Separately, the government can infuse capital into the banks. The two

decisions need not be linked. Alternatively, a less effective form of capital, if the government cannot buy bank equity directly with cash, is for it to issue the banks “Government Capitalization Bonds” in exchange for equity. The banks would hold the bonds on their balance sheet. This would tie up part of their balance sheet, but would certainly be capital.

Conclusion

The cleaning up of bank balance sheets, and the restoration of credit growth are vital, related elements in the growth agenda. The government and the RBI are helping our public sector bankers in this difficult but critical task. I know the process is working, so public sector banks will soon be set to finance the enormous needs of this economy once again.