*Issues in Banking Today**

Raghuram G. Rajan

Thank you for inviting me here today. In a country that is growing at above 7 per cent, is brimming with entrepreneurial zeal, has a young population which has grown up with mobile technology, one would think that the banking sector would be buoyant. Yet the recent decline in bank share prices has investors on the edge. Of course, part of the reason is that markets are in turmoil. Some of the greater decline of bank share prices can therefore be explained by the fact that they are seen as a leveraged play on the economy. On bad days, they move down more, on good days they move up more. With markets generally in decline, the decline in bank share prices has been more accentuated.

However, part of the reason is that some bank results, mainly public sector banks, have not been, to put it mildly, pretty. Clearly, an important factor has been the Asset Quality Review (AQR) conducted by the Reserve Bank and its aftermath. So it may be useful to understand the rationale for the AQR, the process, and what I believe will be the outcome.

Dealing with Stressed Loans

Over time, as you know, a number of large projects in the economy have run into difficulty. Reasons, as Mr. Mundra articulated this morning, include poor project evaluation, extensive project delays, poor monitoring and cost overruns, and the effects of global overcapacity on prices and imports. Loans to these projects have become stressed.

There are two polar approaches to loan stress. One is to apply band aids to keep the loan current, and hope that time and growth will set the project back on track. Sometimes this works. But most of the time, the low growth that precipitated the stress persists. The fresh lending intended to keep the original loan current grows. Facing large and potentially unpayable debt, the promoter loses interest, does little to fix existing problems, and the project goes into further losses.

An alternative approach is to try to put the stressed project back on track rather than simply applying band aids. This may require deep surgery. Existing loans may have to be written down somewhat because of the changed circumstances since they were sanctioned. If loans are written down, the promoter brings in more equity, and other stakeholders like the tariff authorities or the local government chip in, the project may have a strong chance of revival, and the promoter will be incentivised to try his utmost to put it back on track.

But to do deep surgery such as restructuring or writing down loans, the bank has to recognise it has a problem – classify the asset as a Non Performing Asset (NPA). Think therefore of the NPA classification as an anesthetic that allows the bank to perform extensive necessary surgery to set the project back on its feet. If the bank wants to pretend that everything is all right with the loan, it can only apply band aids – for any more drastic action would require NPA classification.

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 materialise, the bank can write back provisioning to profits. If the losses do materialise, 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

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sheet is meant to. Of course, we can postpone the day of reckoning with regulatory forbearance. But unless conditions in the industry improve suddenly and dramatically, the bank balance sheets present a distorted picture of health, and the eventual hole becomes bigger.

In 2008-9, after the global financial crisis, the Reserve Bank agreed to forbear on certain kinds of stressed loan restructuring, hoping that this was a temporary need pending stronger growth. Unfortunately, for a variety of reasons, the stress has not been temporary, and growth in these sectors has proved elusive. Therefore, early in the process, the Reserve Bank set about giving banks the tools to deal with stressed loans, including information about the degree of the borrower's collective indebtedness from the system and more effective ways to reduce the project's financial stress such as the Joint Lender's Forum, the Strategic Debt Restructuring mechanism, and the 5/25 mechanism. In a way, the RBI has been trying to create a functioning resolution process in a situation where the existing bankruptcy system functions poorly.

Asset Quality Review

Of course, every new tool can be used to deal with a problem, but also perversely, to avoid it. So after giving banks the tools, the RBI ended forbearance in April 2015, and then started the Asset Quality Review (AQR) to ensure that banks were taking proactive steps to clean up their balance sheets. Working with the banks, our supervisors, led superbly by our head of banking supervision, Ms. Parvathy Vairasundaram, our Executive Director for supervision, Ms. Meena Hemchandra, and, of course, our Deputy Governor, Shri S. S. Mundra, identified loans that were of concern, as well as loans that had potential weaknesses. For the loans that are of concern, the banks are attempting to regularise the loans that can be put back on track, and are classifying those that cannot for deeper surgery – and taking provisions in accordance with the degree of extant stress in the loan. They will also make provisions for loans that have weaknesses. Our intent is to have clean and fully provisioned bank balance sheets by March 2017.

Why not do everything in one go rather than over a period of six quarters? Precisely because a number of these loans can be regularised, or stabilised when weak but regular, through the right collective actions. Sometimes, an NPA classification, even while permitting deeper surgery, prompts risk aversion on the part of bank boards and they stop lending even when the project is viable. We need to overcome this view – we have issued circulars stating that a loan to a project whose other loans are NPA does not automatically become an NPA – but it will take time. Pending the change in attitude, which I think will come as banks turn to unlocking the value in NPAs, we are working with them to sequence the most obvious actions up front. However, the end game is clear to everyone and bounded. We do not envisage a sequence of AQRs.

Having pointed out the contours of the task to be accomplished, our teams are working with the banks to ensure that they are all broadly on the same page in terms of recognition and provisioning, even though each one has flexibility on individual cases. This means that December 2015 quarter results can be compared across banks to get a rough sense of the task each bank has to accomplish. Some banks have expressed an intent to moves faster, so as to put the problem behind them, and we have not held them back. We have not put out any of our final estimates because we believe it is a moving target, with more bank action, promoter response, and growth diminishing the eventual cost. It is important to recall that underlying many of these stressed loans is an economically viable productive asset, not ghost townships.

A lot of work has gone into this review, including many meetings with the Government at every level including the highest. The Government has been fully involved and supportive. We have mapped out a variety of scenarios on possible outcomes. The Finance Minister has indicated he will support the public sector banks with capital infusions as needed. Our estimate is that the Government support that has been indicated will suffice. Our various scenarios also show private sector banks will not want for regulatory capital as a result of this exercise. Finally, the RBI is also working on identifying currently non-recognisable capital that is already on bank balance sheets, such as undervalued assets. The RBI could allow some of these to count as capital as per Basel norms, provided a bank meets minimum common equity standards.

There are some wild claims being made by some financial analysts about the size of the stressed asset problem. This verges on scare-mongering. Our projections are that any breach of minimum core capital requirements by a small minority of public sector banks, in the absence of any recapitalisation, will be small. They will need government equity or preference share infusion since they are typically banks that will find it difficult to raise equity in the markets. A few others will need a top up of their capital to ensure they have a reasonable buffer over and above minimum capital. What the Government has already explicitly committed is, in our view, enough to take care of all reasonable scenarios, and the Government has committed to stand behind its banks to whatever extent needed. The RBI will provide whatever liquidity is needed by any bank that needs it, though we do not foresee liquidity stress.

In sum, while the profitability of some banks may be impaired in the short run, the system, once cleaned, will be able to support economic growth in a sustainable and profitable way. The economic assets of our public sector banks, such as the trust they are held in by the population, their knowledgeable employees, their location and reach, and the low-cost funding they have access to, can then be fully realised.

Why Now?

Why now? Why did we have to pick this period of global market turmoil for banks to start cleaning up? Why not let growth take care of the problem? As I have already said, the process started in April 2015. We knew at that time that the global economy would continue to be weak but not that markets would be in turmoil today. Nevertheless, this simply reinforces our belief that we needed to act when we did.

While growth will help the system, it would likely be significantly impaired if we did not nudge the process of clean up. Non-food credit growth from public sector banks, the more stressed part of the system, grew at only 6.6 per cent over the calendar year 2015. Industrial credit growth for PSBs was only 3.3 per cent while growth in lending to agriculture and allied lending was only 10.4 per cent. The only area of strength was personal loans, where growth was 16.9 per cent. In contrast, non-food credit growth in private sector banks was 20.2 per cent, in agriculture 25.4 per cent, in industry 14.6 per cent, and 23.5 per cent in personal loans. Put differently, in each of these areas except personal loans, loan growth in private sector banks was at least 10 percentage points higher than public sector banks, while loan growth in personal loans was 6.6 percentage points higher.

The most plausible explanation I have is that the stressed balance sheet of public sector banks is occupying management attention and holding them back, and the only way for them to supply the economy's need for credit, which is essential for higher economic growth, is to clean up. 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.

Some citizens are outraged by the size of the losses that will have to eventually be absorbed and want the perpetrators to be brought to justice. Let me emphasise that all NPAs are not because of malfeasance. Indeed, most are not. Loans can go bad even if the promoter has the best intent and banks do the fullest due diligence before sanctioning. Nevertheless, where there is evidence of malfeasance by the promoter, it is extremely important that the full force of the law is brought against him, even while banks make every effort to put the project, and the workers who depend on it, back on track. This is why we have strengthened the fraud detection and monitoring mechanism, and look forward to bank support to make it effective.

The Government is taking direct action to clear bottlenecks and revive stalled stressed projects, and intends to support them with equity infusion through the National Investment and Infrastructure Fund. Private well-funded players are looking to buy assets, and in recent weeks we have seen some promoters sell assets to raise money to pay banks or infuse in projects. All this activity bodes well for the success of the clean up.

Improving Bank Management and Governance

We must also ensure 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. Strengthening Board and management appointments, decentralising more decisions to the professional board, finding ways to incentivise management, all these will help improve loan evaluation, monitoring and repayment. Banks must review their procedures to ensure they can make good credit decisions. The new bankruptcy code, when enacted, will finally give creditors a way of collecting repayment through the judicial process in reasonable time. So my hope and belief is that the next time will be different for public sector banks – they will emerge from this clean up stronger and more capable.

Liquidity

Let me turn to a final issue, unrelated to the AQR, that is, system wide liquidity. The RBI has been infusing plenty of liquidity in the system to offset any seasonal build up in Government balances. Indeed, money market rates have dipped dramatically on some days because of the liquidity infusion. Nevertheless, market participants have complained about shortage.

We invited a number of market participants to the Reserve Bank to discuss their concerns. While we are still trying to understand which of their concerns have merit and can be addressed, we are acting today on one issue that we were cognizant of, the use of SLR bonds to meet Liquidity Coverage Ratio needs. While the circular was in the works, we have expedited its issue because of what we heard from the participants. As of today, we will allow banks to count 3 percentage points more of their SLR holdings towards LCR requirements. A more detailed announcement will be released this evening.

In Conclusion

The market turmoil will pass. The clean-up will get done, and Indian banks will be restored to health. While we should not underplay the dimensions of the task, we should be confident that it is manageable and that the Government and the RBI will do what it takes to make sure that banks are able to support the tremendous growth that lies ahead. Thank you.