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Resolving Stress in the Banking System and Restoring Credit Growth Vital to Growth Agenda: RBI Governor

"The cleaning up of bank balance sheets and the restoration of credit growth are vital and related elements in the growth agenda. The government and the Reserve Bank of India are helping our public sector banks in this difficult but critical task."

The Government's effort in speeding up the debt recovery process and creating a new Bankruptcy system are two important steps towards improving the resolution process; whereas improving governance of public sector banks and infusing bank capital will pay large dividends in the short run. The Reserve Bank at the same time has been trying to create an entirely new bad loan resolution process with pragmatic and not theoretical approach while subjecting the system to increasing discipline and transparency. "The good news is that banks are getting into the spirit of cleanup and are pursuing reluctant promoters to take the necessary steps to rehabilitate projects."

"I know the process is working, so public sector banks will soon be set to finance the enormous needs of this economy once again."

Dr. Raghuram G. Rajan, Governor, Reserve Bank of India said this in his talk on "Resolving Stress in the Banking System" at an interactive meet between industry and trade arranged by ASSOCHAM in Bangalore on June 22, 2016.

The Governor, in his speech, argued with the help of data that the slowdown in credit growth in public sector banks was largely because of stress and not because of high interest rates or lack of capital.

According to him, fundamentals of the borrower not being good and the ability of the lender to collect being weak were the two sources of current distress in the system. Further, irrational exuberance, excessive dependence on evaluations by others and weak monitoring, even as costs increased on the part of the banks and global financial crisis followed by slowdown, with governance problems and fear of investigation slowing down decision making in Delhi that made permissions for infrastructure projects hard to get, contributed to project cost overruns and stalling of projects. This in turn made debt servicing by promoters increasingly difficult. Malfeasance by some borrowed was also at play. Distorted incentives such as short tenures of managers made it possible for excessive lending to bad projects and too little lending to viable ones coexist.

The Governor said that faced with the dilemma of wanting banks to recognise loan distress and disclose it, not paper over it by ever-greening unviable projects, be realistic about the project's cash generating capacity, and structuring lending and repaying to match that and wanting them to continue lending to viable projects, even if they had to be restructured in the past and were NPAs, the Reserve Bank had to adopt a pragmatic approach to the clean-up, creating new enabling processes.

The Reserve Bank's approach to cleaning up the banking system therefore was to introduce several measures, such as, creation of a large loan database (CRILC), coordinating the lenders through a Joint Lenders' Forum (JLF), stopping restructuring of unviable projects by banks which want to avoid recognising losses, introducing the Strategic Debt Restructuring (SDR) scheme so as to enable banks to displace weak promoters by converting debt to equity and formulating the 'Scheme for Sustainable Structuring of Stressed Assets' (S4A) as an optional framework for the resolution of large stressed accounts. The Governor emphasised that the important duty of the regulator was to force timely recognition of non-performing assets (NPAs) and their disclosure when they happened. "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", he said and added that "The cessation of RBI forbearance and the Asset Quality Review in mid-2015 were therefore not responsible for the slowdown." The only way for the banks to supply the economy's need for credit essential for higher economic growth was to clean up and recapitalise, he emphasised.

The suggestion made in the Economic Survey - of the Reserve Bank capitalising public sector banks - was a non-transparent way of proceeding and getting the banking regulator once again to own banks had attendant conflicts of interest, according to the Governor. He would rather the Reserve Bank pay the government the maximum dividend that it could, retaining just enough surplus buffers that were 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", he said. Separately, the government could infuse capital into the banks. Alternatively, a less effective form of capital would be to issue "Government Capitalisation Bonds" in exchange for equity. Holding the bonds on their balance sheet would tie up part of banks' balance sheet, but would certainly be capital.

In conclusion, the Governor said, "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 or for fraudsters."

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