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Fixing the banking system should be a top priority

It will be difficult for the banking system to support high growth, especially in the industrial sector, if the growth in NPAs is not checked

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The deteriorating health of public sector banks has adversely affected their ability to lend. Photo: Mint

The upcoming Union budget will be instrumental in shaping the contours of political and economic reforms during the remaining term of the National Democratic Alliance (NDA) government. Given that it will be the last full budget before the 2019 Lok Sabha election, the government needs to send a strong signal about its willingness to undertake serious reforms.

While there are several important issues that need to be addressed, one that requires immediate attention is the ailing banking sector. A robust and well-capitalized banking sector supports capital formation and economic activity by facilitating intermediation of resources between savers and borrowers. India saves close to 30% of its annual output. Given the importance of the banking sector in the financial system, it has a crucial role to play in channelling these savings to productive investments. The mounting stock of bad loans, which amounts to over Rs7 trillion, suggests that something has gone wrong with the process of financial intermediation in the banking sector and needs to be fixed.

How does the current banking sector landscape look?

The Indian banking sector is dominated by public sector banks (PSBs) with a market share of roughly 70% of total banking assets. There has been little dynamism in the banking sector in recent decades. Since 1991, only 15 licences have been issued to universal banks, a relatively modest number for a fast-growing economy in which the banking system remains an important source of corporate financing.

PSBs remain the biggest contributors to the large and rising stock of non-performing assets (NPAs), with a share of approximately 90% of the total stock. Rising NPAs have put a strain on the health of PSBs, reflected in their declining profitability ratios which turned negative in 2016 for the first time in a decade.

The deteriorating health of PSBs has adversely affected their ability to lend. Even though non-food bank credit growth has recovered, growth of bank credit to the industrial sector remains subdued. Within the industrial sector, credit to medium enterprises continues to decline while growth in credit to large enterprises is barely positive. It will be difficult for the banking system to support high growth, especially in the industrial sector, if the growth in NPAs is not checked.

What needs to be done?

It is certainly promising that the government seems to recognize the urgency for broad-ranging banking reforms, but effective implementation and a multi-pronged approach are essential. As we argue in our recent Brookings Institution report (I. Agarwal and E. Prasad, "A Vision And Action Plan For Financial Sector Development And Reforms In India", Brookings India IMPACT Series Paper No. 012018), recapitalization of PSBs is important, but should be done in tandem with other reforms, including corporate governance reforms to make the incentive structure of the banks consistent with productive allocation of credit; improved financial supervision so that the signs of stress on banks' books can be identified early; development of a vibrant corporate debt market to avoid concentration of credit risk in the banking system; and improved debt recovery mechanisms to ensure efficient and speedy recovery of assets.

India should move towards a more dynamic banking sector that fosters innovation and checks the inefficiencies created by a lack of entry. There can be enormous gains from productive reallocation of capital in the banking sector as inefficient banks are driven o of the system (or merged with other banks) and new banks enter.

The policy of "on-tap" licensing of banks is a promising step in the direction of increasing competition in the banking sector. However, some of the conditions, such as initial capital requirements and priority sector lending targets, seem onerous and may fail to attract individual promoters. So far, only one application has been received by the Reserve Bank of India for "on-tap" banking licence.

There should be a gradual push towards greater private ownership of ailing PSBs. The argument in favour of PSBs is that they can penetrate unbanked areas where private sector banks do not find it profitable to operate. However, with the new guidelines issued by the RBI on banking outlets (no longer restricted to a "brick and mortar" branch), private sector banks should be able to leverage the model of banking correspondents to provide doorstep banking services in rural areas at a reduced cost. Hence, it is time to re-evaluate the benefits of having a banking system dominated by public sector banks and the benefits that greater private ownership can bring.

Another priority is to increase the resilience of the banking sector to losses. It is impossible to eliminate risk completely from any banking system. A sound system should, however, be able to minimize risk by adopting pre-emptive measures, including better risk assessment systems, and cushion losses ex-post by developing better loss management techniques. Lending standards should be strengthened for lending to sensitive sectors and bigger projects. In addition, there should be enough provisions for expected losses.

Banks need to have better mechanisms to evaluate the viability of projects when making lending decisions. To deal with ex-post losses, there should be a vibrant market for stressed assets so that banks are able to sell their NPAs at a fair price. This can be achieved by increasing participation in the market for stressed assets. Greater competition will lead to a competitive bidding process and help in better price discovery, potentially reducing the losses suffered by banks owing to haircuts on sales of stressed assets.

There has been some progress on improving the institutional and regulatory frameworks needed to support a strong banking system, although much more needs to be done. For instance, the Insolvency and Bankruptcy Code has improved the legal landscape and should help in speedier recovery of bad loans. The challenge is to make sure it is implemented effectively.

The clock is ticking and the stakes are high. Without a strong banking system, Prime Minister Narendra Modi's vision of making India a $5 trillion economy by 2025 could remain a pipe dream.

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