

Banking Regulatory Powers Should Be Ownership Neutral

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I speak today to highlight some fundamental fissures that exist in the regulation of banks, in particular, public sector banks (PSBs). It has been slightly over a month since the latest fraud in the Indian banking sector broke news.

Success has many fathers; failures none. Hence, there has been the usual blame game, passing the buck, and a tonne of honking, mostly short-term and knee-jerk reactions. These appear to have prevented the participants in this cacophony from deep reflection and soul searching that can help solve fundamental issues that are the root cause of such frauds and related irregularities in the banking sector, which as I will explain are in fact far too regular.

Let me start with what has been at the heart of some of the immediate reactions – the Reserve Bank’s supervision of banks.

IMF/World Bank FSAP Assessment

In its 2017 Financial Sector Assessment Programme (FSAP) of India, conducted, completed and released prior to this episode, the International Monetary Fund (IMF) and the World Bank (WB), made the following observations:

1. In the publicly released FSSA (Financial System Stability Assessment) report, Para 35, page 17: *The RBI has made substantial progress in strengthening banking supervision: A key achievement was the introduction in 2013 of risk-based supervision through a comprehensive and forward-looking Supervisory Program for Assessment of Risk and Capital (SPARC). The Basel III framework and other international guidance were implemented or are being phased in, including stricter regulations on large exposures. Domestic and cross-border cooperation arrangements are now firmly in place. The AQR [Asset Quality Review] and the strengthening of regulations in 2015 have improved distressed asset recognition. In April 2017, the RBI established a new Enforcement Department and revised its prompt corrective action framework to incorporate more prudent risk-tolerance thresholds.*
2. Further, in its specific comments on Other Regulation, Accounting, and Disclosure (Core Principles or CPs 20, 26–29: Para 60, page 21): *The internal control regulations issued by the RBI are adequate and are supported by the requirements of the SPARC risk-based supervision system. This system provides extensive guidelines for inspection of the internal control and audit function, and prescribes that a bank’s internal controls allow identification and controlling of risks. The Internal Audit Departments in banks are*

required to have appropriate resources and staff with the requisite skills. Tasks can be outsourced, allowing additional expertise to be brought in. The auditors reported that overall experience with the quality of internal audit of banks was satisfactory.

However, the FSAP for India laments at several points the fact that the Reserve Bank's regulatory powers over banks are not neutral to bank ownership:

1. In the Detailed Assessment Report (DAR) on the Basel Core Principles (BCP) on the Effective Banking Supervision, Para 6, Page 7: *Some previously observed weaknesses concerning the independence of the RBI and the inherent conflict of interest when supervising public sector banks (PSBs) remain. The RBI enjoys a large degree of operational autonomy, but amendments to several legal provisions, and formal grounding of RBI independence in the RBI Act, would provide greater legal certainty. The RBI's legal powers to supervise and regulate PSBs are also constrained– it cannot remove PSB directors or management, who are appointed by the government of India (GoI), nor can it force a merger or trigger the liquidation of a PSB; it[RBI] has also limited legal authority to hold PSB Boards accountable regarding strategic direction, risk profiles, assessment of management, and compensation. Legal reforms are thus highly desirable to empower the RBI to fully exercise the same responsibilities for PSBs as now apply to private banks, and to ensure a level playing field in supervisory enforcement.*
2. Specifically, on Corporate Governance (CP 14, Para 50, page 18): *The appropriate rules on fitness and propriety, and banks' internal governance structures, are in place with respect to private and foreign banks. Nevertheless, the influence the RBI may exercise on banks' governance through section 21 BR Act, placement of RBI representatives on banks' Boards, and the RBI's very limited authority under the Banking Acts, as well as the custom to hold the PSB Boards accountable has become problematic. Under the law and according to custom, the RBI cannot hold PSB Boards accountable for assessing and– when necessary– replacing weak and nonperforming senior management and government-appointed Board members.*¹

Let me elaborate.

¹It is to be noted here that the FSAP also mentions in Other Regulation, Accounting, and Disclosure (CPs 20, 26–29, Para 62, page 21): *Currently, the external auditor is not obliged to report immediately to the RBI regulator any issues encountered in the audited bank that are of material interest to the supervisor. This is only permitted after publication of the annual statements. Moreover, regulators need powers to access the auditor's working papers when needed. This is currently not envisaged. The laws and/or regulations should explicitly authorise the external auditor to inform the RBI of any concerns at any time; also, before the annual statements have been finalised and published. The RBI should be given the explicit authority to obtain information at any time from the external auditor.* This point, however, applies both for public and private sector banks.

Banking Regulatory Powers in India are NOT Ownership Neutral

All commercial banks in India are regulated by the RBI under the Banking Regulation (BR) Act of 1949. Additionally, all public sector banks are regulated by the Government of India (GoI) under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970; the Bank Nationalisation Act, 1980; and the State Bank of India Act, 1955. Section 51 of the amended BR Act explicitly states which portions of the BR Act apply to the PSBs, most common thread across the omissions being complete removal or emaciation of RBI powers on corporate governance at PSBs:

1. RBI cannot remove directors and management at PSBs as Section 36AA(1) of the BR Act is not applicable to the PSBs.
2. Section 36ACA(1) of the BR Act that provides for supersession of a Bank Board is also not applicable in the case of PSBs (and regional rural banks or RRBs) as they are not banking companies registered under the Companies Act.
3. Section 10B(6) of the BR Act that provides for removal of the Chairman and Managing Director (MD) of a banking company is also not applicable in the case of PSBs.²
4. RBI cannot force a merger in the case of PSBs as per Section 45 of the BR Act.
5. PSB's banking activity does not require license from RBI under Section 21 of the BR Act; hence, RBI cannot revoke a license under Section 22(4) of the BR Act as it can in the case of private sector banks.
6. RBI cannot trigger liquidation of PSBs as per Section 39 of the BR Act.
7. Furthermore, in a remarkable exception of sorts, in some cases there is duality of Managing Director and the Chairman – they are the same – implying the MD is primarily answerable only to himself or herself.

This legislative reality has in effect led to a deep fissure in the landscape of banking regulatory terrain: a system of dual regulation, by the Finance Ministry in addition to RBI.³ I will now take a few minutes to explain why this fissure or the fault line is bound to lead to tremors such as the most recent fraud.

Temptation to engage in fraud at the level of employee or employees is always present, in banks (or in corporations), be it in public sector or private sector. The question then is whether there is

²The exception to this is IDBI Bank Ltd., for which the Articles of Association (Clause 120) grant the RBI the requisite authority.

³Of course, there are several other (well documented) implications of being public sector banks: board constitution, wherein it is difficult to categorise any director as independent; significant and widening compensation differences with private sector banks, leading to the erosion of specialist skills; external vigilance enforcement through the Central Vigilance Commission (CVC) and Central Bureau of Investigation (CBI); and limited applicability of the Right To Information (RTI) Act.

adequate deterrence faced by employees from undertaking frauds and enough incentives for management to put in place preventive measures to preempt frauds. In case of banks, three potentially powerful mechanisms could induce discipline against frauds:

1. **Investigative/vigilance/legal deterrence:** Criminal investigation of frauds and attached penalties can serve as an effective deterrence if reporting and investigation are expedient and penalties are adequately severe relative to the gains from fraudulent activity.
2. **Market discipline:** Fraudulent activity can be a net loss to the bottom-line; in this case, bank investors would impose deterrence, e.g., uninsured creditors might “run” on the bank inducing liquidity problems, or shareholders might “exit”, effectively raising the cost of capital and inducing solvency questions. In anticipation of such disruptive outcomes that might cause loss of control, management and board members may put in place governance mechanisms to prevent or reduce the incidence of fraud and/or hold larger buffers in the capital structure to bear losses when fraud materialises.
3. **Regulatory discipline:** Banks in most parts of the world, however, have a significant portion of deposit funding that is insured, and since banks serve critical payments and settlements function, they are often too big to fail or too many to fail. Hence, a part of the market discipline is weakened as a tradeoff with financial stability and is substituted by delegation of supervisory and regulatory powers to a banking regulator. Detection and punishment by the regulator then need to be effective to discipline fraud.

How do these mechanisms work in case of private and public sector banks in India?

Investigative and formal enforcement process takes in our country, perhaps for the right reasons, a fair bit of time. Indeed, RBI data on banking frauds suggests that only a handful of cases over the past five years have had closure, and cases of substantive economic significance remain open. As a result, the overall enforcement mechanism – at least until now – is not perceived to be a major deterrent to frauds relative to economic gains from fraud.

It is fair to say that in case of private sector banks, the real deterrence arises from market and regulatory discipline, and their confluence. A private bank CEO’s primary concern is whether s/he will be able to raise capital when the need arises or even whether s/he will still be running the bank the next day. The point is that they could be readily cautioned through their Boards and even replaced by the RBI in case of large or persistent irregularities. Further, a private bank failing to meet bank solvency standards and under RBI’s “prompt corrective action” (PCA) would find it hard to raise capital, whereby it would need to put the house in order at swift notice so it can raise funding from markets and get back to growth path. In turn, there are incentives to invest in governance, so as to limit frauds and regulatory violations, and to respond with alacrity when incidents do arise.

In contrast, the market discipline mechanism for public sector banks is appreciably weaker compared to that at private banks. There is implicitly a stronger perceived sovereign guarantee for all creditors of PSBs, and the principal shareholder – the government – has not so far been interested in fundamentally modifying the ownership structure. From an economic

standpoint, this weakened market discipline should imply that the government would prefer *stronger* regulatory discipline of these banks, not *weaker*. However, as I explained above at length, and perhaps since the original idea behind bank nationalisation was complete government control over credit allocation to the economy, the situation in India is exactly the reverse: RBI's regulatory powers over PSBs are *weaker* than those over the private sector banks.

The BR Act exemptions for PSBs mean that the one agency – the regulatory – that can respond relatively quickly against banking frauds or irregularities cannot take effective action. Hence, for example, MDs at PSBs find it comfortable to tell media that business will be as usual for them under RBI's Prompt Corrective Action framework as even if they do not meet the stipulated restrictions of the framework, the ultimate authority over their tenure is with the government and not with the RBI.

It is not entirely surprising that there has been a recurring theme in report after report on financial sector reforms in the country that has suggested strengthening of PSB governance through improvement in top management and Board member appointments; or, ownership neutrality in banking regulatory powers; or improving market discipline by considering a variety of diverse ownership structures.

Will we let another opportunity to catalyse fundamental reform at PSBs pass by?

It is fully transparent what needs to be done. From the RBI's standpoint, legislative changes to the BR Act that make our banking regulatory powers fully ownership neutral – not piecemeal, but *fully* – is a minimum requirement. It might also be the most readily feasible of these options.⁴

No Banking Regulator Can Catch or Prevent All Frauds

Another point is in order before I move to the broader issue of bank stressed assets and their resolution. There has been a tendency in the pronouncements post revelation of the fraud that RBI supervision team should have caught it. While that can always be said ex post with any fraud, it is simply infeasible for a banking regulator to be in every nook and corner of banking activity to rule out frauds by “being there”. If a regulator could achieve such perfect outcomes, it would effectively imply that the regulator can do anything that banks can do, and by implication, can simply perform the entire banking intermediation activity itself. What is needed is that various mechanisms to deter frauds and other irregularities are in place and have bite so that fraud incidence is low and magnitudes contained. Indeed, frauds have happened at banks in regimes with varied levels of banking regulatory quality and in both public and private banks.

In the specific case at hand, the Reserve Bank had identified, based on cyber risk considerations, the exact source of operational hazard –through which we understand now the fraud had been

⁴The duality of banking regulatory powers exists even in the case of co-operative banks where the RBI has to contend with several powers being vested away from it in hands of state governments. Co-operative banks are typically small and their failures are dealt adequately with through liquidation by the Deposit Insurance and Credit Guarantee Corporation (DICGC) which insures some of their depositors. This duality also needs to be addressed as part of the broader banking sector reforms to improve credit culture and reduce fraudulent lending.

perpetrated. In particular, the RBI had issued precise instructions via three circulars in 2016 to enable banks to eliminate the hazard. It turns out ex post the bank had simply not done so. Clearly, the internal processes at the bank failed in allowing the operational hazard to remain in place in spite of clear instructions to close it. As we have stated in RBI's only press statement on this case to date, this was essentially an operational failure at our second largest public sector bank. The RBI will undertake actions against the bank that it is empowered to but this set is limited under its BR Act powers over PSBs.

Indeed, in a recent interview to the Press Trust of India, March 11 2018, the IMF Deputy Managing Director Tao Zhang has reinforced this point along with others I alluded to above:

“[W]e think the PSB recapitalisation should be part of a broader package of financial reforms to speed up the resolution of NPAs, improve PSB governance, reduce the role of the public sector in the financial system, and enhance bank lending capacity and practices... The experts recommended legal changes to enable the RBI to extend all the powers currently exercised over private sector banks to public sector ones; in particular, regarding Board member dismissals, mergers, and license revocation... Having said that, banks' operational risk management, risk culture, internal control frameworks and external audit function should typically play a central role in preventing fraud.”

Need to Refocus on the Bigger Issue of Stressed Assets Resolution

Let me now turn to an issue of greater magnitude and more significance than the most recent banking fraud. Its magnitude is larger than 8 1/2 lakh crores of stressed assets on bank balance-sheets and its significance stems from several practices in promoter-bank credit relationship that need immediate attention. The RBI's Financial Stability Report of June 2017 (Section VII. Frauds, Para 3.36) clarifies that there is a link between bank frauds and this stressed assets problem:

“One of the emerging risk to the financial sector is increasing trends in frauds in commercial banks and financial institutions. During the last five financial years, frauds have increased substantially both in volume and value terms. During this period, while the volume of frauds has increased by 19.6 per cent from 4235 to 5064, the value (loss incurred) has increased by 72 per cent from Rs. 97.5 billion (Rs. 9,750 crores) to Rs.167.7 billion (Rs. 16,770 crores). Share of frauds in [loan] advances portfolio continued to be high at 86 per cent of the frauds reported during 2016-17 (in terms of amount involved)...In a number of large value frauds, serious gaps in credit underwriting standards were evident. Some of the often seen gaps are liberal cash flow projection at the proposal stage, lack of continuous monitoring of cash flows and cash profits (EBITDA), lack of security perfection and over valuation, gold plating of projects, diversion of funds, double financing and general credit governance issues in banks. Moreover, almost all corporate loan related fraud cases get seasoned for 2 to 3 years as NPAs before they are reported as fraud.”

The broad conclusion that has been universally reached is that enterprises in India have over and over again received excessive credit during loan growth cycles, which is followed soon after with repayment problems. Rather than resolving stressed credit problems swiftly, banks—either

through loan-level “fudges” or refusal to recognise the true asset quality of the credits – have allowed promoters in charge of enterprises to have a soft landing. This soft landing has comprised of even more bank lending so as to keep the accounts artificially in full repayment on past dues, protracted control for promoters over failed assets, and effectively granting them the ability to divert cash and assets, often outside of our jurisdictional reach.

The RBI has been clamping down on the failure to recognise asset quality as non-performing as per its norms by requiring that banks, whose “divergence” exceeds by 15% of the true non-performing assets as per the norms, disclose the divergence. This should restore some market discipline against such practices, especially in the case of private sector banks. However, ultimately there also needs to be a framework in place for time-bound resolution of the underlying stress in assets that limits the discretion of banks to delay the recognition of stress, ever-green “zombie” or living-dead borrowers, and poorly allocate credit.

To this end, I wish to present and clarify the rationale behind RBI’s revised framework for prompt recognition and resolution of stressed assets. The framework that was released last month remains somewhat under-appreciated in terms of its importance. So let me lay it out.

Prompt Recognition and Resolution of Stressed Assets – Revised Framework

1. The Banking Regulation (Amendment) Act, 2017, and the subsequent authorisation given by the Government of India therein, has empowered the Reserve Bank to issue directions to the banks for resolution of stressed assets, including referring assets to the Insolvency and Bankruptcy Code 2016 (IBC). The Reserve Bank has taken steps over the last year in this direction, with a focus on reference to the IBC of certain large value stressed accounts, covering approximately 40% of banking sector’s overall exposure to the stressed assets.
2. The revised framework for resolution of stressed assets released by the Reserve Bank on February 12, 2018 is a step towards taking these initial steps to their natural conclusion and laying down a steady-state approach. The steady-state approach is aimed at ensuring early resolution of stressed assets in a transparent and time-bound manner so that maximum value could be realised by the lenders while also recognising the potential ongoing concern value of stressed assets. As explained below, this approach is a positive step towards strengthening the credit culture in the economy, at both borrowers and banks.
3. Various special schemes for resolution, which were introduced by the RBI in the pre-IBC context, had made the resolution process driven by asset-classification consideration of lenders. In particular, the forbearance that was embedded in the schemes to make it easier for banks to resolve assets became an end in itself with little resolution achieved through deployment of the schemes.
4. The revised framework substitutes for these pre-IBC schemes and does away with forbearance since it delayed resolution. The framework relies instead on the biggest

structural reform in the credit system in the country in several decades, viz., the IBC, as an important part of resolution. By employing the IBC as its lynchpin, the framework is intended rightly to ensure that the resolution plan for stressed assets is dictated also, and in fact, primarily, by asset viability considerations.

5. It must be stressed that the revised framework would allow lenders absolute flexibility to put in place any credible resolution plan, as under the pre-IBC schemes, subject to meeting certain implementation conditions (the conditions being necessary to alleviate concerns relating to ever-greening of unviable assets).
6. In particular, in respect of accounts with aggregate exposure greater than Rs. 2,000 crores, the resolution plan would be required to be implemented within 180 days from the date of default, failing which these would be referred under the IBC. This threshold would be brought down only gradually over a period of two years to enable the IBC infrastructure to install in parallel the required capacity to handle more cases. It must be emphasised that IBC itself is a resolution framework, whereby such accounts will have sufficient time (180 days from the date of default plus up to 270 days under the IBC) for effective resolution.
7. It must also be underscored that under the revised framework:
 - a. Change of ownership is being favoured even prior to the IBC reference as it leads to asset being classified as standard (as under the earlier schemes). The defaulting promoters also risk losing control of the firm under the IBC bidding. Hence, the revised framework will engender incentives for borrowers to not over-borrow and instead to manage better the various business risks that might lead to default.
 - b. There will also be greater incentive for lenders to implement an efficient turnaround plan to get a quicker upgrade in case of restructuring. Further since there is no forbearance for assets classified as NPAs, the revised framework will encourage banks to reduce slippages to NPAs through early recognition of stress and timely action, possibly even before a borrower gets into financial difficulty.

In other words, the IBC along with RBI's revised framework will help break the promoter-bank nexus which has led to crony capitalism and attendant NPA/credit misallocation problem as ever-greening suited some borrowers and some lenders under the earlier framework. In turn, this will prevent the erosion of growth from the emergence of zombie firms and sectors.

8. Finally, the revised framework specifically excludes the revival and rehabilitation of Micro, Small and Medium Enterprises (MSMEs) with exposures of up to Rs. 25 crore, which shall continue to be covered under the earlier norms.

We believe this is precisely the fundamental reform needed in order to strengthen the credit culture at origination, default, asset quality recognition and resolution stages. By so doing, it should weaken in the first place opportunities for engaging in frauds relating to loan advances.

Let me now make some **Concluding Remarks**.

I have chosen to speak today to convey that we at the Reserve Bank of India also feel the anger, hurt and pain at the banking sector frauds and irregularities. In plain simple English, these practices amount to a looting of our country's future by some in the business community, in cahoots with some lenders. As safeguards of your deposits at banks, and starting with the Asset Quality Review of banks announced by the Reserve Bank in 2015 – since ably conducted by our supervisory teams and as acknowledged objectively by experts of reputed multilateral agencies, we are doing all we can to break this unholy nexus.

I see what we have undertaken for cleaning up the credit culture of the country – in particular, the comprehensive regulatory overhaul announced by the Reserve Bank on February 12th for prompt recognition and resolution of NPAs at banks – as the *Mandara* mount or the churning rod in the *Amrit Manthan* or the *Samudra Manthan* of the modern day Indian economy. Until the churn is complete and the nectar of stability safely secured for the country's future, someone must consume the poison that emanates along the way. If we need to face the brickbats and be the *Neelakantha* consuming this poison, we will do so as our duty; we will persist with our endeavours and get better with each trial and tribulation along the way.

I do wish more promoters and banks, individually – or collectively through their industry bodies, would reconsider being on the side of *Devas* rather than *Asuras* in this *Amrit Manthan*.

The owner of our public sector banks – the government – which has provided the IBC, the related ordinances and the bank recapitalisation package to get the churn going, might consider making further, equally important contributions by:

1. Making banking regulatory powers neutral to bank ownership and leveling the playing field between public sector and private sector banks; and,
2. Informing itself about what do with the public sector banking system going forward as part of optimising over the best use of scarce national fiscal resources.

It is an open issue whether centralised government control alone can be effective enough at designing and implementing governance of banking franchise comprising over 2/3rds of the sector's deposits and assets. It would be better instead to restore regulatory and market discipline.

These, and other structural reforms to the banking sector, would enable India to grow sustainably at respectable rates. Thank you.