The Banking Conundrum
Non-performing Assets and Neo-liberal Reform

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Neo-liberal banking reform was launched in the early 1990s to address the low profitability of the public banking system and the large presence of non-performing assets. It set itself the objectives of cleaning out NPAs, recapitalising the banks and modifying banking practices to restore profitability and drastically reduce NPA volumes. This did initially have some effect. However, while the NPA ratio fell between the early 1990s and the mid-2000s, it has risen sharply since then. Moreover, while earlier priority and non-priority loans contributed equally to total NPAs, more recently, large non-priority loans to the corporate sector account for the bulk of NPAs. An analysis of these features reveals that these trends are indicative of the failure of neo-liberal banking reform in India.

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As fiscal year 2017–18 drew to a close, the Government of India decided to bite the bullet and implement a proposal to "resolve" what was being presented as one of the leading challenges then facing the Indian economy: large non-performing assets (NPAs) on the books of the banks, especially the public sector banks (PSBs). The recapitalisation plan, first announced in October 2017, involved infusing ₹2.11 lakh crore of new equity into the PSBs, of which ₹1,35,000 crore would be new money from the government, financed with recapitalisation bonds. Another ₹18,139 crore was the balance due under the ₹70,000 crore Indradhanush plan initiated in August 2015 and funded from the government's budget. The remaining ₹57,861 crore was to be mobilised by the banks from the market. The plan was to clean up the books of the banks to a significant extent, enabling them to adhere to the Reserve Bank of India's (RBI) voluntary decision to get banks to meet Basel III-type capital adequacy norms by 2019.

If corporate borrowers are let off the hook and losses of the banks are recapitalised with resources from the budget, then private losses are clearly being socialised, since their burden is being transferred to those paying direct and indirect taxes today or in the future. This has been under way for some time now. Between 2000–01 and 2014–15, budgetary allocations for recapitalisation of banks totalled ₹81,200 crore. Much of this was provided for in recent years, with as much as ₹58,600 crore (or 72% of the total) announced during just four consecutive years ending 2013–14. However, the government seemed to have lost the appetite for such recapitalisation. Even when it was seen as unavoidable, allocations from the budget for the purpose were short of what was promised, and what was promised was short of what was required. In 2014–15, while ₹11,200 crore was allocated for the purpose in the budget, actual capital infusion into PSBs was just ₹6,990 crore. Then in 2015–16 there was a revival, despite the initial reduction of even the budgetary allocation for the purpose to ₹7,940 crore. In the course of the year, the government announced a four-year Indradhanush plan, under which the PSBs would be provided with new capital worth ₹70,000 crore, with ₹25,000 crore being disbursed that financial year and the next, and ₹10,000 crore in each of the two subsequent years. In its most recent avatar, the recapitalisation exercise is the ₹2.11 lakh crore plan announced in October 2017.

The recent decision to proceed with the recapitalisation plan came after much delay for two reasons. First, over a considerable period, alternatives to recognising bad assets, writing

them off and taking a hit in the form of reduced profits or losses were being quietly sought by all concerned. Second, once the NPAs were recognised, ways to avoid recapitalisation financed by the government were being sought, on the grounds that it would derail the government's successful effort at "fiscal consolidation."

NPA Recognition

The first set of factors delaying NPA recognition was the result of the nature of the NPAs that were accumulated during the years of high growth after 2003–04. These unrecognised NPAs consisted of large loans most often delivered by multiple lenders to relatively big corporate entities or groups. In 2001, as part of the reform, the government put in place a corporate debt restructuring (CDR) mechanism, to enable defaulting firms to devise (in consultation with lenders) turn-around strategies. This effort at revival of large loans that were under threat of default included measures such as extending the maturity of the loan, reducing the interest rate charged, converting a part of the loan into equity, providing additional financing, or some combination of these. Once agreement among creditors, and between them and the debtor, on a turnaround-cum-debt restructuring package could be arrived at, modified rules permitted the credit assets concerned to be identified as "restructured standard assets" and exempted from provisioning.

The process was expected to strengthen firms that were defaulters and allow them to resume normal debt service commitments. It also exempted banks from provisioning against loans that were bad, which would have resulted in losses and eroded capital. If banks had to make provisions for likely losses on such loans at the first sign of them turning non-performing, the impact this would have on their finances would dissuade them from undertaking such lending. So the exemption from provisioning was clearly aimed at encouraging banks not to withdraw, but keep large credits flowing to the corporate sector, especially to capital-intensive projects with long gestation lags, as in infrastructure. Thus, the government with its neoliberal agenda chose to treat restructured loans as "standard assets" and not non-performing ones. Banks were given some leeway when classifying assets, which the RBI later claimed was misused. This brought down actual and potential NPAs, which were initially concealed.

After a significant period of time, when the gap between declared NPAs and the "stressed assets" of banks (or the sum of "restructured standard assets" and NPASs) began to widen, the RBI decided in the second half of 2015 to undertake an asset quality review and impose stricter guidelines for bad loan recognition. The result, soon thereafter, was a sharp spiral in the ratio of gross NPAs to gross advances. Moreover, provisioning for these NPAs sharply reduced profits in some banks and forced losses on others.

It could be argued that these losses are temporary and need not impair the capital base of the banks. Write-offs of NPAs are technical, and if, in time, much of the value of the loans in default can be recovered, the balance sheet of the banks would not be damaged.

Unfortunately, the evidence on recovery has not been comforting. The rate of recovery of NPAs of scheduled commercial banks (SCBs) through various channels (Lok Adalats, Debt Recovery Tribunals and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest [SARFAESI] Act, 2002) had fallen from 22% of amounts involved in cases referred to these channels and being considered by them at the end of March 2013 to 9.8% by end-March 2017.[1] Overall, the experience with loan recovery has been disappointing. Not only has total NPA reduction been stagnant between 2014–15 (₹1,270 billion) and 2015–16 (₹1,280 billion) when the sum of declared NPAs was rising, but much of this reduction has been the result of compromises or write-offs that yield the bank little or nothing. NPA reduction is reported under three heads (actual recoveries, "upgradation" or transformation of NPAs into paying assets, and compromises/write-offs). Write-offs involve a complete loss for the banks.

According to finance ministry figures, the share of write-offs in the NPA reduction of the PSBs rose from an already high 41% in 2014–15 to 46% in 2015–16. PSBs have written off a total of ₹2.46 lakh crore worth of loans over the five years, 2012–13 to 2016–17. The ratio of declared profits to write-offs has fallen sharply. In 2012–13, PSU banks wrote off ₹27,231 crore while declaring combined net profit of ₹45,849 crore. The corresponding figures for 2016–17 were ₹81,683 crore and ₹474 crore.[2]

Part of the reason for this is that the government has been encouraging banks to be lenient when pursuing defaulting firms, unless they are wilful defaulters. Thus, the finance ministry's *Economic Survey 2016-17* argued:

> Cash flows in the large stressed companies have been deteriorating over the past few years, to the point where debt reductions of more than 50 percent will often be needed to restore viability. The only alternative would be to convert debt to equity, take over the companies, and then sell them at a loss. (GoI 2017: 85)

The point implicitly being made here is that it is necessary to help get companies back on their feet even at the expense of bank balance sheets. The finance ministry's claim was that this is necessary because the companies cannot share any blame for their current position. The *Survey* argued:

> Without doubt, there are cases where debt repayment problems have been caused by diversion of funds. But the vast bulk of the problem has been caused by unexpected changes in the economic environment: timetables, exchange rates, and growth rate assumptions going wrong. (GoI 2017: 85)

Such arguments notwithstanding, it is clear that the accumulation of NPAs and the losses resulting from that process are indications of the failure of neo-liberal banking reform in India. The case for such reform, advanced by a spate of official committees set up over the course of the two decades following 1991, was that the social banking heralded by nationalisation was unviable. Public banks were unprofitable or not profitable enough and were accumulating large NPAs because of the policy of directed credit to the priority sector. That is, it was not the failure of the dominantly publicly-owned banking system to achieve the goals of bank nationalisation that occasioned the perceived need for the continuous and sweeping shift in banking

and financial policies that occurred after the July 1991 balance of payments crisis. In fact, bank nationalisation had succeeded in terms of an expansion of the reach and spread of formal banking, increased credit provision on an expanded deposit base, greater focus on underbanked areas and populations, correction of the extreme skew in bank lending in favour of industry and big business (with more credit going to agriculture and small industry and business), greater inclusion of the poor in the provision of financial services and credit, and restructuring of the banking infrastructure through measures such as the creation of regional rural banks and emphasis on social banking practices. Indeed, the aims of bank nationalisation meant that the realisation of these objectives, rather than profits, should be the basis for assessing banking performance. Going by such indices, the performance of the PSBs was outstanding, as they managed to realise within a decade or a little more, what the private banks had failed to deliver even partially in more than two decades

Notwithstanding this history and these goals of social banking, the attempt at policy reversal in the early 1990s focused on the so-called "failure" of nationalisation as reflected in the low profitability of the public banking system, the NPAs resulting from directed credit to the priority sector and the poor level of banking services offered to clients of public banks. Therefore, an important component of banking "reform" was an effort to write off NPAs, recapitalise banks, change banking rules, and modify banking practices that would restore profitability and drastically reduce NPA volumes. The evidence suggests that this was achieved in substantial measure during the first decade and a half of reform (Table 1). But once the credit boom began in the mid-2000s, NPAs returned, though initially concealed, through restructuring.

Table 1: NPA Ratios of Public Sector Banks in India (%)

	Gross NPAs to Advances Ratio	Gross NPAs to Assets Ratio	Net NPAs to Net Advances Ratio	Net NPAs to Asset Ratio
1992–93	23.1	11.8		
1993–94	24.8	10.8		
1994–95	19.5	8.7	10.7	4.0
1995–96	18.0	8.2	8.9	3.6
1996–97	17.8	7.8	9.2	3.6
1997–98	16.0	7.0	8.2	3.3
1998–99	15.9	6.7	7.1	3.1
1999–2000	14.0	6.0	6.9	2.9
2000–01	12.4	5.3	6.3	2.7
2001–02	11.1	4.9	5.8	2.4
2002–03	9.4	4.2	4.5	1.9
2003–04	7.8	3.5	3.1	1.3
2004–05	5.5	2.7	2.0	1.0
2005–06	3.6	2.1	1.3	0.7
2006–07	2.7	1.6	1.1	0.6
2007–08	2.2	1.3	1.0	0.6
2008–09	2.0	1.2	0.9	0.6
2009–10	2.2	1.3	1.1	0.7
2010–11	2.4	1.4	1.1	0.7
2011–12	3.3	2.0	1.5	1.0
2012–13	3.6	2.4	2.0	1.3
2013–14	4.4	2.9	2.6	1.6
2014–15	5.0	3.2	2.9	1.8
2015–16	9.3	6.0	5.7	3.5
2016–17	12.5			

Source: *Handbook of Statistics on the Indian Economy*, Reserve Bank of India, various issues.

In the event the NPA ratio displays a v-shaped tendency in the years after 1991, falling sharply from close to a quarter of gross advances in the early 1990s to 2% in 2008–09 and then rising to around 13% last year (Table 1). But the problem had begun well before 2008–09 and continued thereafter. The lagged spike in the NPA ratio was the result of the RBI's mandate that NPAs that were being kept hidden under the garb of being "restructured standard assets" had to be reclassified, with a deadline of March 2017. The PSBs were the location of much of those NPAs, accounting for 87% of gross NPAs at the end of March 2017. So, whatever occurred was also clearly due to acts of commission or omission of the government, which is known to influence the behaviour of the PSBs.

Macroeconomic Shift

Understanding the determinants and the implications of v-shaped movement in the NPA ratio and the policy responses it calls for, requires placing it in the overall economic context, which reflects the consequences of fiscal and monetary policy reform, on the one hand, and of domestic and external financial liberalisation, on the other. Neo-liberal macroeconomic policy reform is focused on weakening the proactive fiscal policies of the state, that expand tax- or debt-financed state spending, and relying more on the monetary policy levers of managing liquidity and adjusting policy interest rates, which are expected to drive private consumption and investment in the desired direction. In keeping with this perspective, a central feature of post-reform fiscal policy has been the effort to control the fiscal deficit, which was funded in large part by government borrowing from the banking system. That effort has been particularly successful since the adoption of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003. Combined with monetary and banking reform initiatives that reduced the statutory liquidity ratio, which requires banks to invest in specified government securities, from a peak of 38.5% of net demand and time liabilities (NDTL) to 19.5%, this has forced banks to shift focus away from government securities as an avenue for longer term investment.

Simultaneously, post-liberalisation changes made banking extremely important from the point of view of the financing of private economic activity. Prior to liberalisation, the understanding was that banks could provide long-term funding to industry and the housing market only to a limited extent. Being dependent on relatively small depositors who would like to hold their savings in highly liquid deposits, lending to long-term, illiquid projects would result in maturity and liquidity mismatches. So the resulting shortfall in the financing of long-term investment had to be met by creating specialised financial institutions with access to more long-term capital directly from the government or the central bank, or through pre-emption of a part of the resources of commercial banks.

A major change brought about by neo-liberal reform was in the provision of development finance. The turn to and emphasis

on development banking in the immediate aftermath of Indian independence was explained by two features characterising the economy at that point in time: the inadequate accumulation of own capital in the hand of indigenous industrialists; and the absence of a market for long-term finance (such as bond or active equity markets), which firms could access to part finance capital-intensive industrial investment.

Post-independence policy perceived that banks per se could not close the gap for long-term finance, because there are limits to which banks could be called upon to take on the responsibility of financing such investments. Banks attract deposits from many small and medium (besides, of course, large) depositors, who have relatively short savings horizons, would prefer to abjure income and capital risk, and expect their savings to be relatively liquid, so that they can be easily drawn as cash. Lending to industrial investors making lumpy investments, on the other hand requires allocating large sums to single borrowers, with the loans being risky and substantially illiquid. Getting banks to be prime lenders for industrial (and infrastructural) investment, therefore, results in significant maturity, liquidity and risk mismatches, limiting the role that banks can play in financing long-term productive investment. Other sources need to be found.

This was the gap that the state-created or promoted development-banking infrastructure sought to close. That infrastructure was created over a relatively long period of time and was populated with multiple institutions, often with very different mandates. Funds for the development banks came from multiple sources other than the "open market"—the government's budget, the surpluses of the RBI, and bonds subscribed by other financial institutions. Given the reliance on government sources and the implicit sovereign guarantee that the bonds issued by these institutions carried, the cost of capital was relatively low, facilitating relatively lower cost lending for long-term purposes. Therefore, until the 1990s, India was an exemplary instance of the use of development banking as an instrument of late industrialisation.

However, as part of financial liberalisation and based on the recommendations of the Narasimham Committee reports, the all-India development finance institutions, which with budgetary and central bank support and implicit sovereign guarantees were seen as distorting the playing field for commercial banks, were abolished. Some were allowed to atrophy whereas others like the IDBI and the ICICI were allowed to create commercial banks, with which the development banking arms were "reverse merged." The result was that investors in capital intensive projects had to turn to the remaining main source of financing—the commercial banks—for long-term funding.

So liberalisation involved ending the dichotomy between banking and development financing, with banks now being encouraged to foray into term lending of different kinds. The net result was that in the distribution of financial assets among banks and the financial institutions (such as the cooperative banks, the development financial institutions, the nationalised insurance companies and sundry other public institutions), the share of the banks, which had declined from 71% to 61% between 1981 and 2000, rose to 82% by 2012.[3] In this sense too, banking was gaining in prominence rather than shrinking relative to other markets and institutions after liberalisation.

One result of these changes was a transformation of the structure of financing of productive activity, especially industry. Measured as a ratio to gross domestic product (GDP), the importance of financial assistance from the erstwhile development finance sector diminished considerably after 2000, partly because the development finance institutions had become banks, and partly because they had been rendered irrelevant. On the other hand, the capital market did not emerge as a substitute for these institutions, with the new capital issues market virtually absent, except for periods of an engineered speculative boom as in the early 1990s. The two main sources of external finance for industry seem to have been the banks or the private placement market, with the latter being the target of foreign investors looking for high and/or quick returns. In sum, banks continued to dominate the financing business in India.

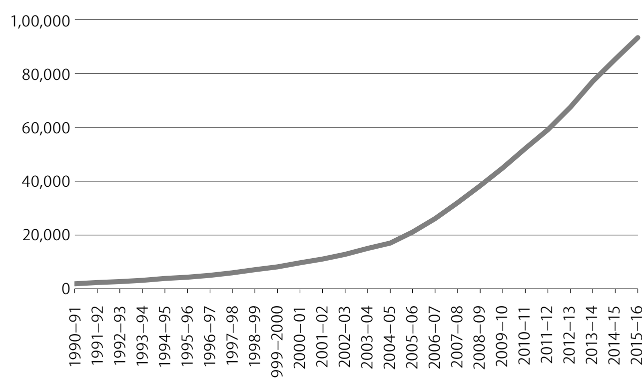
The demand for financing of private capital-intensive projects was strengthened by the widening infrastructure gap that resulted from the self-imposed restrictions on public investment stemming from fiscal conservatism. The government declared that given its fiscal "constraints," crucial infrastructure investment had to be undertaken either through the private sector or through public–private partnerships. Since the private players in such "partnerships" typically relied not on their internal resources but on funds borrowed from PSBs, this placed the onus of finding the finance for such projects partly on the government, which owned these banks. So, it was natural that the banks would be under pressure to lend to projects varying from roads and ports to power and steel.

Consequences of External Liberalisation

Coincidentally, the effects of those shifts became operative when there was another change triggered inter alia by reform, with large flow of foreign capital into India after 2003. Liberalisation did from the start increase inflows into the country, but large capital flows, which were substantially in the form of portfolio capital, were a later development. Until 1993–94, total net inflows amounted to less than a billion US dollars annually. Subsequently, foreign investment flows rose sharply to $4.2 billion in 1993–94 and averaged about $6 billion during the second half of the 1990s. Then, there were even more significant changes. During the first decade of this century such inflows rose to $15.7 billion in 2003–04, and then to $70.1 billion in 2009–10, despite a fall in the crisis year 2008–09. Thereafter, after averaging around $64 billion during 2000–13, the figure fell because of the "taper tantrum" in 2013–14.[4] But flows bounced back to $73.6 billion in 2014–15, before falling to $35 billion the next year. In sum, despite high volatility, the trend has been one of a sharp increase after 2003.

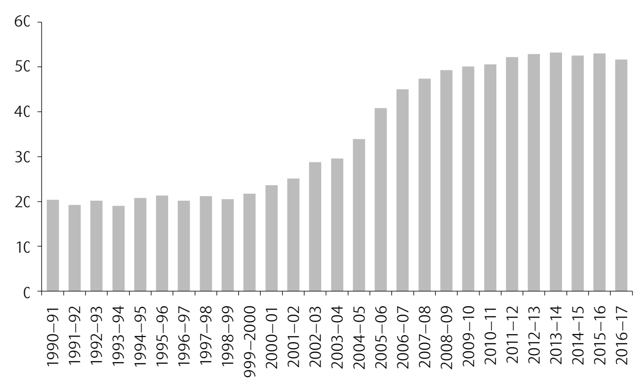
This increase would not have been possible without the relaxation of sectoral ceilings on foreign shareholding and the substantial liberalisation of rules governing investments and repatriation of profits and capital from India. But liberalisation began rather early in the 1990s, whereas the boom in foreign

Figure 1: Aggregate Deposits of Scheduled Commercial Banks (₹ billion)



Source: *Basic Statistical Returns of Commericial Banks in India*, Reserve Bank of India, various issues.

Figure 2: Ratio of Outstanding Scheduled Bank Credit to GDP (%)



Source: *Basic Statistical Returns of Commericial Banks in India*, Reserve Bank of India, various issues.

investment flows occurred much later. That change provides reason for distinguishing between two phases in the post-liberalisation years, with 2003–04 as the break.

Obviously, these direct and portfolio flows of foreign capital affect domestic money and asset markets. One counterpart of the capital inflow surge was an increase in the overhang of liquidity in the domestic economy. There was a dramatic expansion of the deposit base of banks from ₹1.93 trillion in 1990–91 to ₹9.6 trillion in 2000–01, ₹52.1 trillion in 2010–11, and ₹107.6 trillion in 2016–17 (Figure 1). Since banks do not have the option of sitting on deposits that they must accept and pay interest on, the surge in the deposit base would have forced banks to seek new avenues for investment and lending. While the "flexibility" offered by financial liberalisation helped in this context, the fact that fiscal reform had after 2003 shrunk the space for parking funds in safe government securities was a source of pressure.

The result was an explosion in credit growth (Figure 2). While the ratio of scheduled bank credit to GDP stood at around 20% through much of the 1980s and 1990s, it rose by two-and-a-half times between 2000–01 and 2011–12, to touch 51%. This increase occurred in a period that includes the high growth years between 2003–04 and 2008–09, which makes the rise in the ratio of credit to GDP even more significant. The credit deposit ratio of SCBs as a group (which had fallen from 60.4% in 1990–91 to 51.7% in 1998–99, despite a substantial increase in the loanable funds base of banks through periodic reductions in the cash reserve ratio (CRR) and statutory liquidity ratio (SLR) by the RBI starting in 1992 rose sharply after 2003–04 to touch 74% in 2006–07 and 78% in 2011–12.

Bank Lending to Industry and Infrastructure

The rapid expansion in credit required an expansion in the universe of borrowers and the level of exposure per borrower, which implied increased risk. There were also significant changes in the sectoral distribution of credit, as banks sought to expand the volume of their lending and their universe of borrowers. Overall, two sets of sectors gained in share. The first comprised of retail advances, covering housing loans, loans for automobile and consumer durable purchases, educational loans, and the like. The share of personal loans increased from slightly more than 9% of total outstanding commercial bank credit at the end of March 1996 to close to a quarter of the total more recently. This was a "natural" diversification, because they were either loans of short-term maturities that could also be easily pooled and securitised, or they were loans that were backed by implicit collateral in terms of the asset whose purchase was financed. In fact, housing loans accounted for a very large share of the total. Moreover, other than for educational loans, the rates of default in the retail sector have hitherto not been too high.

What was less natural was the second direction of change. Despite the huge increase in credit provision, the share of credit going to industry stood at around 40% of total bank credit, not too far below pre-reform levels of about 50%. And long-term loans to corporates, including for infrastructure, accounted for a significant share of this lending. The share of infrastructure lending in the total advances of SCBs to the industrial sector rose sharply, from less than 2% at the end of March 1998 to 16% at the end of March 2004, and as much as 35% at the end of March 2015. So even as the volume of bank lending to industry rose, the importance of lending to capital-intensive sectors and infrastructure within industry has increased hugely. Sectors like steel, power, roads and ports, and telecommunications were the most important beneficiaries. For commercial banks, known to prefer lending for short-term purposes, this turn to lending to infrastructure was a high-risk strategy.

What this suggests is that the increase in corporate demand for large loans from the banks, for reasons discussed earlier, suited the banks as well, since they were under pressure to lend, given the expansion in their deposit base that resulted from the foreign capital inflow-generated overhang of liquidity in the system. Further, since the government was interested in facilitating capital-intensive private investment, especially in infrastructure, it could be presumed that the financing of such projects would be backed by the government in the case of liquidity problems or even default. There appeared to be an implicit sovereign guarantee.

The net effect of these multiple factors was a sharp increase in lending to capital-intensive projects, including those in infrastructure, where maturity and liquidity mismatches were significant. But once this tendency of lending large sums to a

single project or business group began, it did not stop with such projects, but was extended to other areas of corporate lending as well. In practice, the failure of these projects/investments to generate the revenues needed to bear the debt service costs associated with their high debt to equity ratios, led to defaults, even in cases where much effort at restructuring was made.

Thus, underlying the V-shaped movement in the NPA ratio, was a post-2003 credit boom and a structural shift in credit provision.

New NPAs

This obviously had an impact on the nature of the NPAs themselves. While the NPA problems of the 1990s stemmed substantially from bad assets arising in priority or non-priority sector loans to agriculture and small industry, those after 2003 were dominated by bad assets arising from large loans to a relatively few large corporates, including loans for private investment in the infrastructure sector. As Table 2 shows, between 1997 and 2003, the non-priority sector (including public sector) accounted for around a half or a little more of NPAs in the PSBs. Starting 2006, this share began to decline to 38% in 2008, only to rise again to reach earlier levels. One reason for this was the use of the CDR scheme, which allowed banks to restructure large loans subject to default, through means such as extended repayment periods, lowered interest rates, partial conversion to equity, and additional credit.

However, it soon became clear that many of these borrowers were not in a position to restore normalcy of operations, so that defaults continued or resumed, forcing the recognition of the assets concerned as non-performing. After the RBI instituted the asset quality review to reclassify assets and reverse the practice of treating all restructured assets as standard assets, there was a sharp spike in the share of the non-priority sector in total NPAs from 50% in March 2012 to 77% by March 2016. The role of big corporate borrowers in this accumulation of bad assets is striking. As of March 2017, large borrowers (with exposure of ₹50 million or more), which were provided 56% of gross advances, accounted for 87% of the gross NPAs of the SCBs. The corresponding figures for the top 100 borrowers were 15% and 26%. Post liberalisation, Indian banks were sitting on a pile of debt directed at a few large borrowers, a large share of which was bad.

Table 2: Composition of NPAs of PSBs (amount in ₹ billion)

	Priority Sector		Non-priority Sector		Public Sector		Total
	Amount	%	Amount	%	Amount	%	Amount
1995	192.08	50.0	178.61	46.5	13.16	3.4	383.85
1996	191.06	48.3	190.67	48.2	14.11	3.6	395.84
1997	207.76	47.7	213.4	49.0	14.61	3.4	435.77
1998	211.84	46.4	231.07	50.6	13.62	3.0	456.53
1999	226.06	43.7	276.08	53.4	14.96	2.9	517.1
2000	237.15	44.5	285.24	53.5	10.55	2.0	532.94
2001	241.56	45.4	273.07	51.4	17.11	3.2	531.74
2002	251.39	44.5	302.51	53.5	11.16	2.0	565.06
2003	249.38	47.2	267.81	50.7	10.87	2.1	528.06
2004	238.41	47.5	256.98	51.2	6.1	1.2	501.49
2005	215.36	45.2	254.94	53.5	5.92	1.2	476.22
2006	222.36	53.8	182.79	44.2	8.55	2.1	413.7
2007	225.19	58.0	156.03	40.2	7.32	1.9	388.54
2008	248.74	61.5	150.07	37.1	5.74	1.4	404.56
2009	242.01	53.8	205.28	45.6	2.97	0.7	450.26
2010	304.96	50.9	291.14	48.6	3.14	0.5	599.24
2011	401.86	53.8	342.35	45.9	2.43	0.3	746.64
2012	557.8	47.6	588.26	50.2	26.56	2.3	1172.62
2013	672.76	40.9	960.31	58.4	11.55	0.7	1644.61
2014	798.99	35.2	1472.35	64.8	1.3	0.1	2272.64
2015	966.11	34.7	1815.98	65.2	2.59	0.1	2784.68
2016	1258.09	23.3	4141.48	76.7	34.82	0.6	5399.57
2017	1609.42	23.5	5237.91	76.5	154.66	2.3	6847.32

Source: *Statistical Tables Relating to Banks in India*, Table 19, Reserve Bank of India, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications.

The immediate problem this could cause is a loss of depositor confidence resulting in a run on some banks. This, however, was not a danger. In India, inasmuch as banks were dominantly publicly-owned, and though some private banks too were forced to declare a larger volume of bad loans, the bulk of NPAs were on the books of the PSBs. Given the sovereign backing that public ownership implied, there was little or no danger that these NPAs would in any way disrupt the functioning of these banks. In fact, much higher NPA ratios in the late 1980s and early 1990s had no adverse impact. In sum, large-scale recapitalisation was not imperative from a stability point of view.

However, the officially generated fear of insolvency and the argument that meeting Basel guidelines was imperative, was used to make recapitalisation an urgent necessity. The financial community supported this because it backed their case for privatisation of public banks through issue of new equity to ensure recapitalisation. There followed a clamour to revise the requirement that PSBs must have at least 52% government ownership of equity, so that additional equity could be sold to private players. The problem, however, was that private investors were unlikely to buy equity in banks that were burdened with NPAs. So some way of ridding the banks of their NPA burden had to be found before they could be "recapitalised." What followed were a series of experiments such as attempted sale of bad assets to asset reconstruction companies, and segregation of bad assets in a bad bank and selling some good assets and businesses to cover losses. None of them worked, so, the government had to finally lead the recapitalisation exercise.

New Resolution Framework

But recapitalisation does not mean the end of the effort at privatising public banking. What is surprising is that the policy establishment that created the circumstances that led to NPAs, with liberalisation and enforced reliance on public bank funding for capital intensive projects, and postponing the recognition of NPAs by designing the CDR scheme, all of a sudden turned aggressive vis-à-vis these same banks. Once the asset quality review resulted in a spike in NPA ratios and provisioning requirements, a new "prompt corrective action" (PCA) framework was devised, which placed restrictions on banks as a corrective to trends indicative of fragility. The PCA framework specifies values of the capital to risk (weighted) assets ratio (CRAR, ratios of core equity to risk weighted assets), net NPA ratios, return on assets values and leverage ratios, which define three levels of risk thresholds. A bank breaching any of these thresholds is

called upon to take corrective action varying from holding back on dividend payments, to restrictions on branch expansion, increased provisioning, and restrictions on managerial compensation. While these may seem like needed actions, identification of banks as having breached any of these thresholds may set off developments (such as deposit withdrawals) that weaken the bank's position even further.

Soon, banks were pushed to opt for the resolution framework offered by the Insolvency and Bankruptcy Code (IBC) and the National Company Law Tribunal (NCLT). Having long delayed the resolution of the problem of stressed assets in the banking system, the RBI decided to rely on the IBC as an important instrument to address the problem. To do that, the RBI shed its reticence to interfere in the resolution process with support from the government. The latter on its part promulgated the Banking Regulation (Amendment) Ordinance, 2017, now passed by Parliament, which introduced new clauses into the Banking Regulation Act, 1949 permitting the RBI to initiate action requiring banks to launch proceedings to resolve bad assets with specifically identified clients.

The action has multiple components. To start with, large NPAs that have proved difficult to resolve for a long period of time have to be identified. The consortium of banks holding those assets is given a deadline by which the problem should be resolved. For this, agreement in the Joint Lenders' Forum (JLF) of 50% of the members involved and 60% of the value of the loans concerned was adequate. Failing the successful negotiation of a restructuring solution by the stipulated date, the banks were required to move the NCLT for initiation of liquidation proceedings. During those proceedings, the incumbent management was moved out, the creditors were put in control of the process and an insolvency professional appointed to assist the stakeholders, with definite timelines for resolution or liquidation. A resolution plan had to be in place within 180 days of referral to the NCLT (with additional 90-day grace period if needed). If a plan is not agreed upon within the timeline, then the company will go into liquidation.

In a first attempt at implementation of this procedure, the government notified 12 large NPA accounts in June 2017 for which lending banks were required to file insolvency applications. At the end of financial year 2016, the size of debt to the commercial banks of these 12 borrowers varied from ₹3,802 crore to ₹41,843 crore, with seven of them burdened with unserviceable debt of more than ₹10,000 crore. Their combined debt totalled ₹2,26,400 crore. These accounted for as much as a quarter of the total NPAs on the books of the SCBs.

Even while these cases were being directed to the NCLT and the National Company Law Appellate Tribunal (NCLAT), the government had flagged more cases of bad, high value debt, and called for their resolution in six months, failing which, they too would be considered for reference to the NCLT. But the process seems to have accelerated with the RBI reportedly issuing instructions for proceedings to be launched against 40 or more borrowers, whose NPAs are large and chronic.

However, it is becoming clear that the problem is not easily addressed. There are three kinds of difficulties that the process faces.

The first is the opposition of the debtors, who would use every means at their command to prevent liquidation, arguing that their default is not the result of errors or failures of the borrower, but of extraneous circumstances, the burden of which has to be shared by creditors. As noted, the government, which in its official *Economic Surveys* has described the problem as a "twin-deficit" problem (the deficit on the books of borrowers leading to default, on the one hand, and the deficit on the books of the lenders, on the other), is sympathetic to this view, fearing a backlash from business.

The second is the opposition of those with whom the defaulter has liabilities, but who are not included in the JLF. There could also be opposition from other third parties, such as home buyers, as in the case of Jaypee Infratech, who have paid up vast amounts in instalment payments but have not been given possession of the homes they had bought. Defaulting entities owe money not just to the banks but others, including the tax authorities. To the extent that the IBC favours the banks, these "third parties" that would lose out would oppose the resolution. This can delay the process and the results can be messy.

Third, the JLF members themselves who may want assurance that there would be limits on the haircuts they would take if liquidation is initiated. The market value of the assets held by these companies and the strength of the collateral needs to be tested, and as other cases such as Kingfisher Airlines suggest, there is unlikely to be enough to recover a large share of the debt and interest due. In 10 cases of resolution under the IBC reported in the *Economic Survey 2017–18*, the claims of financial creditors were met in full only in one (Prowess International, for which the claim was extremely small). For the rest, the extent of recovery relative to claims varied from 6% to 58%, with only two recovering more than 50%.

Government's Response

This failure to recover money lent to top corporates has been accompanied by an effort to sell off assets to private Asset Reconstruction Corporations (ARCs), which could acquire NPAs at a negotiated discount. They make upfront payments of as low as 5% of the sums due, with the balance covered by security receipts accepted by the banks from the ARCs, which need to be redeemed only when the ARCs manage to sell the assets concerned. Thus, the ARCs were being contracted to recover a small percentage of the total NPA value, with their fee depending on the difference between the acquisition and sale price. The result has been that when the discount on NPAs sold by banks was sought to be lessened, the volume of NPAs sold reduced.

These "failures" only confirm the suspicion that the government's decision to recapitalise banks does not mean a commitment to provide state backing for the PSBs. Rather, the effort to

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clean the books of the banks may be aimed at preparing them for market, since banks burdened with bad debt and/or undercapitalised are unlikely to command a reasonable price for their equity. Once banks are recapitalised, the probability of raising capital from the market by sale of public bank equity at reasonable prices is high.

One problem here is that if the banks concerned are to remain "public" with at least 51% of equity owned by the government, the headroom available for stake sale may be limited because of past disinvestment. Besides private entry, an important component of the transformation of banking engineered by liberalisation was a restructuring of PSB ownership. This meant that it was not just weak PSBs that were made candidates for equity dilution.

Early in the liberalisation era, in December 1993, the State Bank of India, with paid-up capital of ₹200 crore chose to go in for a public issue of shares worth ₹274 crore at par, but sold at a premium of ₹90 per share. The shareholding of the RBI and the Government of India (together) came down to 66.3%, with the remaining 33.7% being held by other entities. That was only the beginning. Out of 26 PSBs (including the 19 nationalised banks, the State Bank Group and IDBI Bank), as many as half that number had no private shareholding even as late as 2002, and only two had private shareholding in the maximum possible 40%–49% range. But in the decade that followed, dilution has been rapid, so much so that as many as 14 banks had private shareholding in the 40%–49% range by end-March 2012. Another 10 fell in the 20%–40% private shareholding range. Private holdings include foreign ownership of equity in 24 out of the 26, with the extent of such ownership varying from 0.1% (State Bank of Mysore) to 17.4% (Punjab National Bank) as at end-March 2012.

Financial Resolution and Deposit Insurance Act

There is other evidence that an important element of the government's approach to dealing with the problem of high NPAs is to try and socialise PSB losses without the intervention of the budget, through the creation of a new debt resolution mechanism and authority. On 10 August 2017 the government tabled a new bill in Parliament, with the aim of using its majority to push through a desperate policy initiative in the form of the Financial Resolution and Deposit Insurance (FRDI) Act. The act seeks to create an ostensibly "independent" FRDI Corporation (FRDIC), which would take over the task of resolution of failing financial firms from the RBI and other regulators. To that end, it is to be armed with special and near draconian powers to implement its mandate, and given control of the deposit insurance framework currently managed by the Deposit Insurance and Credit Guarantee Corporation of India.

As a first step to address the problem, the government promulgated the Banking Regulation (Amendment) Ordinance, 2017, which introduced new clauses into the Banking Regulation Act, 1949. These clauses meant that the government could authorise the RBI to take special action to resolve the bad debt problem. This would involve forcing banks to launch proceedings against identified borrowers to recover their unpaid dues. If no agreement for restructuring could be arrived at between the borrower and its lenders, liquidation proceedings against the borrower were to be launched to recover as much of the loan as possible.

But, as argued earlier, proceedings at the NCLT suggest that this effort can at best be a partial solution, since, among other things, finding assets that can cover the defaulted loans is not easy. Large write-offs are inevitable. So if the government is to wash its hand of the bad debt problem, and the likelihood of debts going bad remaining high even after recapitalisation, other measures of resolution are needed.

The FRDI Act defines the resolution mechanisms being pushed by the government, as an alternative to recapitalisation. At the centre of the new scheme is the creation of a new independent corporation that would take over the task of resolution of bankruptcy in banks, insurance companies, and identified "systemically important financial institutions" (SIFIs). The FRDIC will also take over the task of insuring bank deposits, compensating depositors up to a specified maximum amount (at present ₹1 lakh), in case of bank failure.

As part of its responsibilities, the corporation is to be mandated to classify the financial institutions under its jurisdiction under different categories based on risk of failure, varying from "low" and "moderate" (or in whose case the probability of failure is marginally or well below acceptable levels), to "material" or "imminent" (implying failure probabilities that are above or substantially above acceptable levels), and finally critical (or being on the verge of failure). In cases of financial firms placed under the material or imminent category, the Resolution Corporation is to be given the power to: (i) inspect the books to obtain information on assets and liabilities; (ii) restrict the activities of the firm concerned; (iii) prohibit or limit payments of different kinds; and (iv) require submission of a restoration plan to the regulator and a resolution plan to the FRDIC, if necessary involving a merger or amalgamation. In cases identified as critical, the FRDIC will take over their administration, and proceed to transfer their assets and liabilities through merger or acquisition or to liquidate the firm with permission from the NCLT. To leave no choices open, the law prohibits recourse to the courts to stay the proceedings at the NCLT or seek alternative routes to resolution. Since liquidation involves compensating stakeholders according to their designated seniority, depending on the net assets available, any stakeholder can be called upon to accept a "haircut," including holders of deposits in excess of the maximum specified as insured against loss.

There are many implications of this act. To start with, while the independent FRDIC and the concerned regulator will determine whether a financial firm is to be placed in the material or imminent category, the task of working out an acceptable restoration or renewal plan rests with the firm under scrutiny. So the responsibility of restoring viability is that of the bank, insurance company or SIFI, with the regulation and resolution authority retaining the right to determine whether this has managed to reduce the probability of failure.

Second, since mere categorisation in the material or imminent category will send out a signal, banks so designated can become

the target of a run, as depositors fearing failure would want to move out their deposits. As a result, instead of resolving the problem of vulnerability to failure, the mechanism may precipitate failure.

Third, the restoration and/or resolution plan, to be acceptable, may "force" the financial firm to accept amalgamation or merger. This would have implications for parties that are not responsible for the state of the firm, including officers, employees, creditors, and small shareholders. For example, retrenchment or downgrading of the status of employees may follow merger and amalgamation. And where resolution requires the preferred strategy of "bail-in" of the firm, shareholders, creditors, and if need be, depositors, would be forced to accept a "haircut" or loss. The unstated objective of the exercise is to save the government and the regulator from carrying the costs of a bailout of the failing firm.

Thus, the tabling of the FRDI Bill is a clear declaration by the government that it sees painful resolution or liquidation as a way out of addressing the bad debt problem that currently afflicts the banking sector in particular. It also makes clear that the finance ministry, the central bank, and the government-sponsored regulators will not carry any of the financial burden associated with resolution, but rather would transfer financial and other costs (such as job losses) to the employees, officers and shareholders, and even depositors holding deposits in excess of the insured amount. Since the problem of potential insolvency is at present concentrated in the public banking system, the government is obviously willing to write off capital already invested, but wants to minimise any additional costs. This way, the mechanism of socialising private losses is transferred out of the budget so that its effects are directly borne by the larger "public."

It is in this odd way that the contradictions inherent in neoliberal banking reform are being addressed. It should be obvious that, if the current financial and economic policies are persisted with, bank losses would continue to rise, as the return of NPAs to the books of the PSBs after 2003 makes clear. If that cannot be prevented, the only option is to force banks to restructure when they cross some threshold level of NPAs in their books. The FRDI's hope is that this can be done without knocking on the government's doors. But if experience worldwide is any guide, this would only precipitate a different kind of crisis, forcing the government to step in. The market cannot resolve its own problems.

NOTES

1 Figures from, *Statistical Tables Relating to Banks in India*, Reserve Bank of India, Table 19, https://dbie.rbi.org.in/DBIE/dbie.rbi?site=publications.
2 Figures quoted in Verma (2017).
3 Figures are from *Database of the Indian Economy*, RBI.
4 All figures from the RBI's database at www.rbi.org.in.

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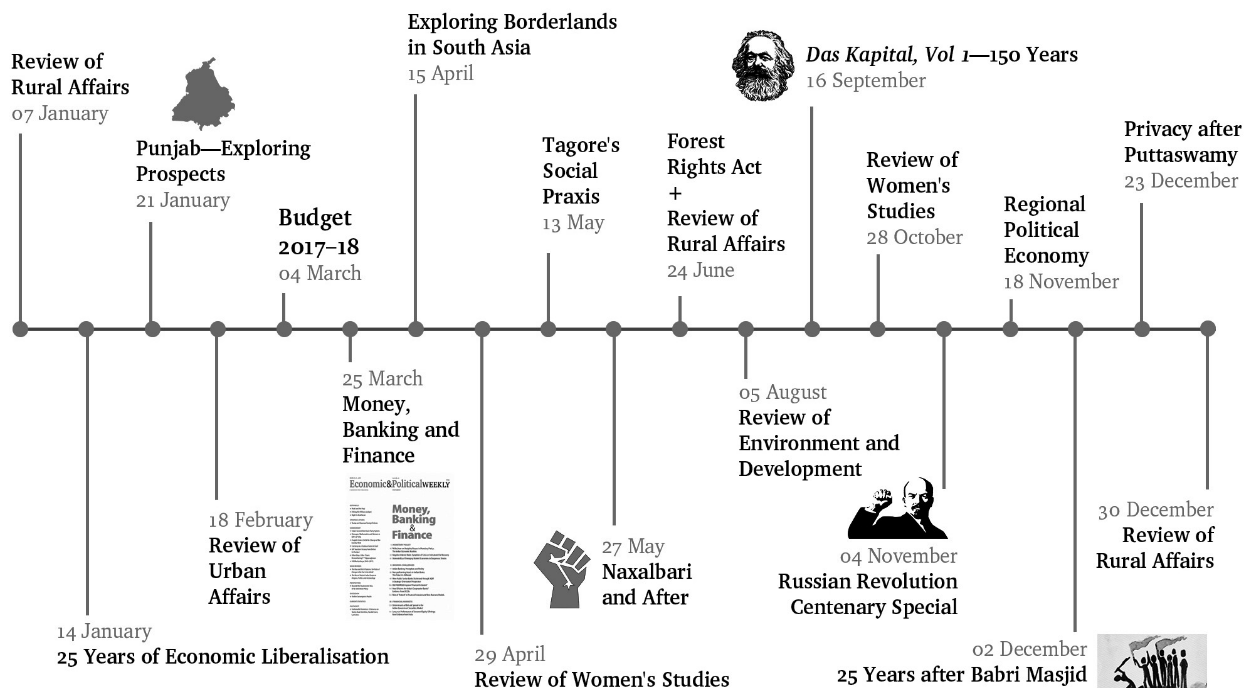

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