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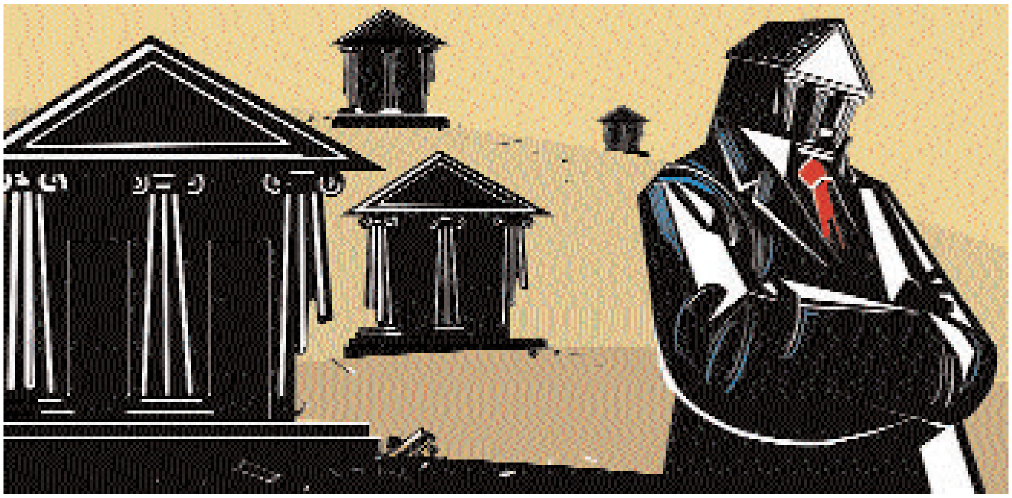

Monumental failures of RBI

India's central bank has failed in regulating the banking system

"RBI has done a commendable job in managing the monetary policy, but as a regulator of the banking system, it has failed the Indian economy." This is what I said publicly to Raghuram Rajan, then Governor of the Reserve Bank of India (RBI), after he delivered a lecture in May 2016. Referring to my paper, "Sub-Prime Infrastructure: Crony Capitalism in Public Sector Banks", I highlighted a potential loss of ₹6 lakh crore facing the banks. Dr Rajan acknowledged the paper and listed the measures taken by RBI to deal with non-performing assets (NPAs), which I thought were belated as well as inadequate, as time has since proven.

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Undoubtedly, the senior management of banks was primarily responsible for these mammoth losses. The Central Government, as owner of these banks, was also a part of the problem. To backstop such failures of the management and owners of banks, RBI was meant to be the last line of defence, in its capacity as the independent statutory regulator, but it simply capitulated. Though it has been claiming success in managing external financial crises in the past, RBI failed to detect in time, leave apart contain, this internal crisis of gigantic proportions.

The fact is that if one single institution is to be held responsible for the sordid state of India's banking sector, it can be none other than RBI in its statutory capacity as the regulator of the banking system. It was RBI's job to lay down effective norms and guidelines, as also to detect serious problems and take timely action against erring banks. In the absence of a vigilant regulator, banks went wayward and lost heavily. They have since moved away from investment lending, which in turn has stunted the growth of incomes and employment.

The government-owned banks will cost the Indian taxpayer no less than ₹6 lakh crore, or about $100 billion. Yet, no one in the government or RBI has been held responsible. Indeed, India is encumbered by an indulgent manner of governance!

The problem did not develop overnight. Way back in 2010, I circulated a discussion paper titled "Sub-prime Highways" to the ministries concerned and some financial institutions, in the naïve belief that after the debacle caused in 2008 by sub-prime housing in the US, the authorities would check the enormous gold-plating highlighted in that paper. Most recipients chose to ignore the paper while some even took offence at what I said. Besides reiterating these concerns at several fora, I wrote yet another paper in 2013 and sent it to the then RBI governor, who replied with a note that did not disagree with my facts, but did not mention any corrective action by RBI.

Consider the loans of several lakh crores of rupees that were given for power and highway projects. Such loans are typically regarded as "limited recourse lending" because banks do not have recourse to any collateral security and rely primarily on anticipated project revenues. In the developed world, such lending is preceded by rigorous scrutiny so as to minimise the risk of default. But Indian banks as well as the RBI failed to adopt the prudent practices associated with such limited recourse lending. So a highway project having an approved capital cost of ₹1,000 crore (to be sustained by a given level of toll revenues) was revised by the concessionaire to, say, ₹1,700 crore by fudging costs as well as revenues. Bloated loans were approved by bank boards that include an RBI official. Even the regulatory inspections of RBI failed to flag this large-scale malfeasance that was certain to result in bad debts.

Take next the case of power projects. Quite aside from the issue of inflated capital costs, the banks did not ensure the existence of a sustainable fuel supply agreement without which a power project could be stillborn. Strangely, several power purchase agreements (PPAs) between power producers and electricity distribution companies (Discoms) wrongly assigned fuel price risks to the private producer, contrary to the practice followed in India and elsewhere. Prudence demanded that projects with such unstable fuel supply arrangements be deemed unbankable, but the banks turned a Nelson's eye to this fundamental flaw that has led, predictably, to bad debts.

The taxpayer will pay over ₹3 lakh crore in the form of government bailouts or other indirect support to meet the losses of banks on account of such irresponsible lending to projects. An equal amount would also be borne by taxpayers to cover the bank loans to Discoms across the country. Virtually all Discoms in India have been making losses year after year. First, they have been buying expensive power on account of inadequate transparency and competition. Second, there is massive theft of electricity. Third, the resultant losses cannot be recovered from consumers for political and economic reasons. However, banks have been continuously lending to these near-bankrupt Discoms in order to fund their ballooning losses. Such lending, with the full knowledge of RBI, must be regarded as irresponsible and contrary to the elementary principles of banking. Interestingly, only government-owned banks were involved in such lending.

Then came the euphemistic scheme called Ujwal DISCOM Assurance Yojana, or UDAY (sunrise!) that transferred the unrecoverable loans of discoms to the respective state governments who will use taxpayers' money for repayment over the next decade. The Central Government has thus protected its banks at the expense of taxpayers, thanks to RBI allowing such loans in the first place.

There was little clarity on the treatment of loans to infrastructure projects as secured lending. It took a detailed proposal from the erstwhile Planning Commission to persuade RBI to revise its "Prudential norms on Advances to Infrastructure Sector", in March 2013, by which time much damage had already been done. Even now, the regulatory framework continues to be inadequate. Clearly, RBI needs to build knowledge and capacity in banking regulation. It has to ensure that the systems and processes followed in banks are secure and efficient. It also needs to exercise vigilant oversight. If not, the taxpayer bears the cost of its failure.

RBI's mindset is best described by the Latin saying "*catus amat pisces, sed non vult tingere plantas*". A cat loves fish, but is unwilling to wet its feet. RBI loves to lord it over the banking system, but does not want to get into the muddy waters of improving and enforcing banking regulation. RBI's abdication coupled with a general lack of institutional capacity has imposed an enormous cost on the economy. RBI needs to descend from its academic ivory tower to the mundane but critically important business of effective governance.

The writer was principal advisor, infrastructure, in the erstwhile Planning Commission