The Sources of Bank Vulnerability

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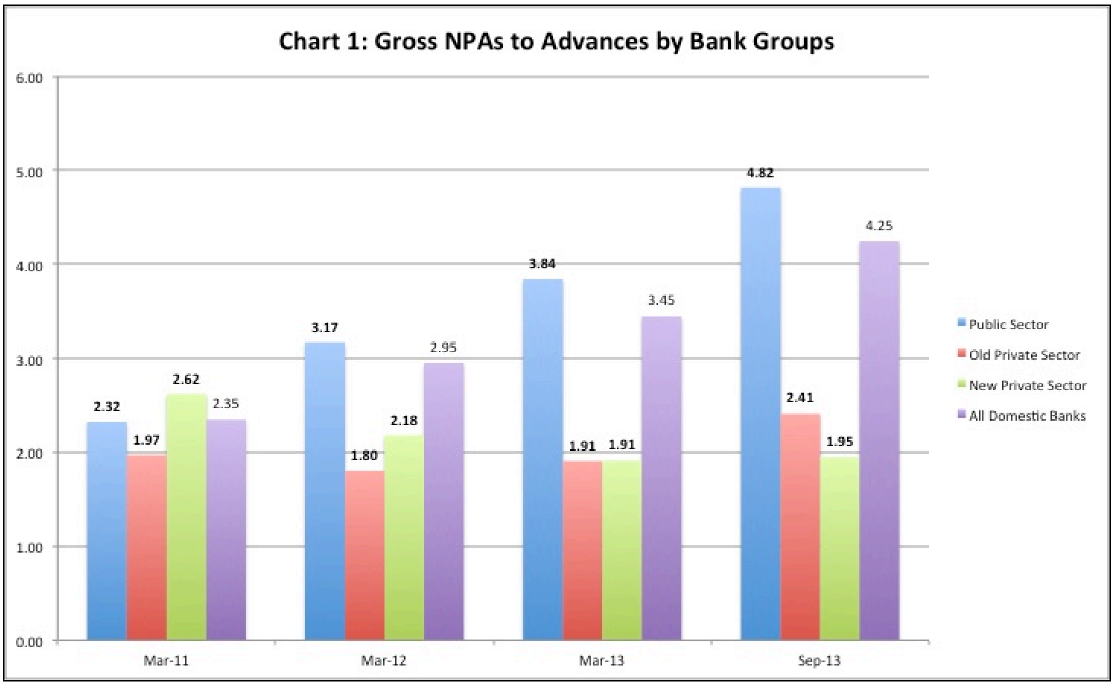
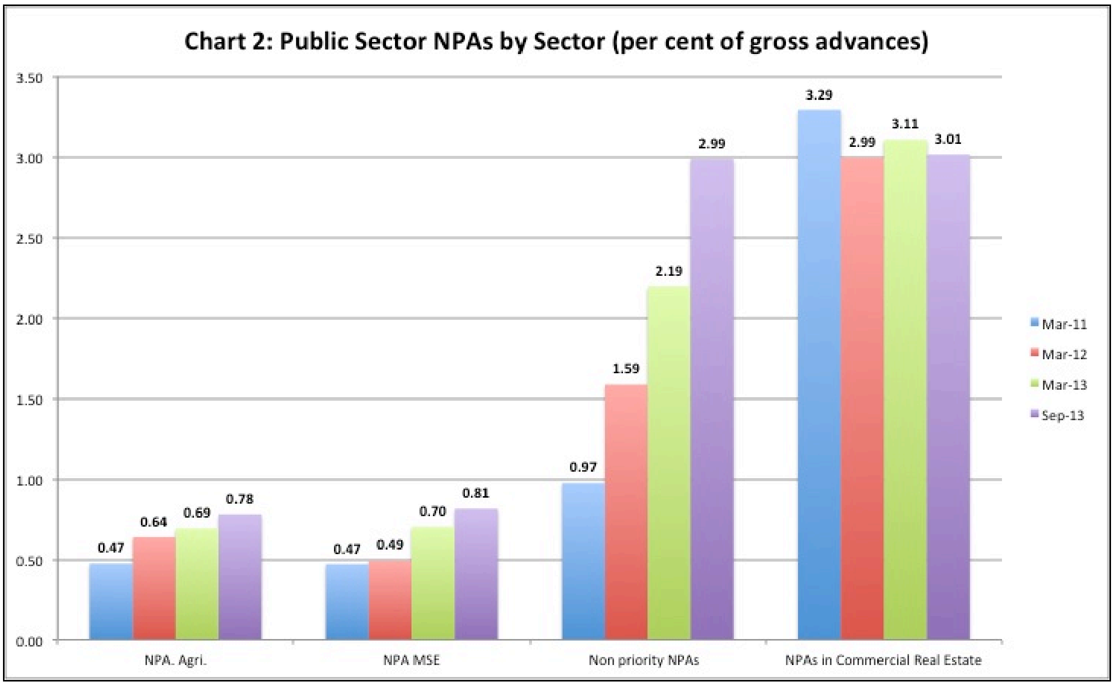
Few deny that Indian banking is currently at its vulnerable worst since the restructuring and recapitalisation that accompanied the financial reform was completed by the middle of the last decade. Voices from within both the Finance Ministry and the Reserve Bank of India have been expressing concern and calling on banks to do more to hold down the share of non-performing loans in total advances and recover as much as possible of the loans that were in default.

This surprises some because "financial reform" was seen as having corrected many of the weaknesses that led to rising NPAs in the banking sector. Reform was based on the principle that pre-liberalisation India was characterised by "financial repression", involving large-scale state control over financial prices and financial activity. Bank resources were pre-empted and directed to sectors considered "priority". This, it was argued, not only capped the rates that bank could charge their customers, but also resulted in larger volumes of non-performing loans because of exposure to weak sectors like agriculture and the small scale sector. The casualty was healthy intermediation, with banks unable to direct resources to the best and highest-yielding projects. The result was low profitability and higher NPAs.



Thus, reform partly involved redefining what constituted priority lending (including in its ambit large, input-supplying firms and certain kinds of loans for personal housing, for example), as well as giving banks greater flexibility and autonomy in deciding what they did with the resources they mobilised. However, the share of credit required to be lent to sectors categorised as priority remained at 40 per cent of total advances.

This led up to the view that the reason why NPAs in the banking system have been on the rise in recent times is the pressure to stick with priority lending. Like a lot else of the "introspective reasoning" that underlies economic argumentation under liberalisation—which leads to wrong assertions such as that markets are efficient and allocate resources best and that deficient or inferior economic outcomes are the result of policy measures such as subsidies to the poor and priority sector lending—this is not based on evidence. That comes through from a number of features of the vulnerability of India's banks revealed in answers to parliamentary questions tabled in the December 2013 session of Parliament.



The first (revealed in answer to parliamentary question no. 283 tabled in the Lok Sabha on December 6, 2013) was that between the periods ending March 2011 and September 2013, the ratio of gross NPAs to gross advances in public sector, old private sector and new private sector banks put together, rose rather sharply from 2.4 per cent to 4.3 per cent (Chart 1). Further, an overwhelmingly high share of the increase in absolute NPAs was on account of NPAs in public sector banks. While the share of the public sector banks in the increase in advances between end-March 2011 and end-September 2013 was 76 per cent, their share in the increase in absolute NPAs was 96 per cent. The ratio of gross NPAs to advances even declined in the case of the new private sector banks. This seems to strengthen the view that it is the state-controlled public sector that is the problem, requiring disinvestment in addition to financial reform to correct it.

Is the use of the public sector banks to deliver more credit to agriculture and the medium and small scale industries or to push priority sector lending in general responsible for this tendency? The evidence says it is not. More than 80 per cent of the increase in the ratio of non-performing assets to advances is on account of NPAs located in the non-priority sector. While there has been some increase in NPAs in advances to agriculture and the MSMEs, these are small in comparison (Chart 2).

Was the problem the flexibility and autonomy given to public sector banks managers under liberalisation that they were unable to handle? Here too the answer seems to be no. One of the notable features of bank lending has been the sharp increase in the share of advances directed to the infrastructural sector. In fact (according to figures from answer to question no 1584 tabled in the Lok Sabha on December 13, 2013), even in the short period between March-end 2011 and September-end 2013 the share of lending to infrastructure in the total advances of public sector, old private sector and new private sector banks put together rose from 13.2 to 15.7 per cent. Moreover, public sector banks account for as much as 86-88 per cent of the advances of the three segments of domestic banking to the infrastructural area.

On the other hand, there is evidence that many infrastructural companies are not delivering the revenues and surpluses that they were expected to yield resulting in defaults in payments of interest and amortisation due on bank credits, leading to debt restructuring and subsequent default. As at the end of March 2013, 23 per cent of all debt restructured under the corporate debt restructuring (CDR) mechanism was to infrastructural projects.

There is no reason why when provided flexibility and autonomy public sector bank managers would use the money of their depositors and rush to lend such large sums to capital intensive projects, loans to which are known to be more risky and more illiquid. The fact is, the idea that financial reform leads to less intervention and increases the flexibility and autonomy of public sector bank managers is a myth. What is worse under liberalisation is that, since the government wants to promote private entry into the infrastructural area, either independently or under the PPP framework, it has been pressurising the public banking system to support that process. The result has been much higher public, when compared to private, bank exposure to infrastructure. This makes high NPAs in the public sector a consequence of the pursuit of the liberalisation agenda by the government rather than the failure of public sector bank managers per se.

It is this rather than priority sector lending that is among the principal factors explaining the growing vulnerability of India's public banking system.

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