Banks as Victims*

C.P. Chandrasekhar

In the outcry against the disastrous demonetisation experiment of the Modi government one aspect that has not been given adequate attention is the damage it has done to the reputation and the balance sheets of the banks. Customers queueing before bank doors and ATMs seem on occasion more forgiving of the government than of the harassed bank employees, who are forced to ration out currency and offer those customers they can accommodate, less than even the maximum withdrawal permitted by the government and the RBI. When new notes are discovered in inexplicable sums in the hands of rogue operators, it is the bank officers and employees who are looked at with scepticism though they are not the only ones who figure in the long chain from the mints through the currency chests to the bank branches and the final holders of currency.

This damage to the reputation of institutions and individuals, which and who have been victims of the engineered cash shortage, is likely to be aggravated by the adverse effects the demonetisation may have for the already damaged profit and loss accounts and balance sheets of the banks. The end-June edition of the Reserve Bank of India's (RBI's) biannual Financial Stability Report, had reported that the gross non-performing assets (GNPAs) of the scheduled commercial banks (SCBs) had risen sharply from 5.1 per cent of gross advances at the end of Mar-2015 to 7.6 per cent at the end of March 2016. Both the level and rapid growth of the volume of bad assets gave cause for concern. According to answers given to two questions in the Lok Sabha in August, while the total gross non-performing assets GNPAs of public sector banks stood at Rs. 4,768 billion at the end of March 2016, the non-performing assets that were reported by them in the second half of financial year 2015-16 alone amounted to Rs. 2,770 billion.This rapid rise was partly the result of an asset quality review mandated by the previous RBI Governor, Raghuram Rajan, which resulted in a recategorisation of a chunk of "restructured standard assets" as NPAs in the books of the banks. Restructured assets are those in whose case default had been postponed by adopting measures such as lowered interest rates and easier terms of repayment. But figures reported by Reuters indicate that stressed assets (or the sum of restructured and bad assets) on the books of the banks had risen from Rs. 8060 billion at the end of December 2015 to Rs. 9220 billion at the end of June 2016. So loans that were bad or near-bad are on the rise.

It is in this background that another consequence of demonetisation for Indian banking must be assessed. This follows from the sharp increase in deposits of the demonetised notes with the banking system On November 28, 2016, the Reserve Bank of India in a press release declared that up to November 27, 2016, demonetised notes worth Rs. 8.45 lakh core had been returned to the banking system. Since then the estimate has been revised to Rs. 11.55 lakh crore, as reported in the Press Conference presenting the Fifth Bi-monthly Monetary Policy Statement 2016-17 held on December 7, 2016. Only a small proportion of this is being withdrawn from the banking system given the ceiling on withdrawals and the shortage of new notes. As of December 10th while banks had received Rs. 12.44 lakh crore in deposits of the demonetised Rs. 500 and Rs. 1000 notes, they had issued only 4.61 lakh crore of the new notes. That was a net accretion of Rs. 7.83 crore in terms of deposits of the old notes that had not been neutralised with issue of new notes. This implies that there is a substantial increase in the deposits held by banks in the short run.

For the banks, the receipt of these deposits is a burden, since they had to pay depositors interest on their deposits which could not be withdrawn at the pace they were being generated because of the ceilings on cash withdrawals. On the other hand, lending or investing against these deposits to earn interest that can cover the cost of deposits was problematic because much of the money would be withdrawn as ceilings on withdrawals are relaxed. Moreover, such lending against large deposits received over a short period of time can not only be risky for a banking system already overburdened with stressed assets but extremely difficult to implement.

Combine all of this with the fact that just handling the absorption of demonetised notes and the distribution of new ones is keeping bank employees and officers overworked, and the result has been a sharp decline in credit growth. According to figures from the Reserve Bank of India, as compared to an average increase in credit of Rs. 30-35,000 crore during the November 11 to November 25 period in the previous two years, the corresponding fortnight in 2016 (which followed demonetisation) saw credit provision falling by Rs. 65,000 crore. If lending shrinks while deposits rise, banks would not be able to recoup the costs of deposits from the returns from lending.

One option was for the banks to park this money in interest earning instruments with the RBI. But this transfer of the interest burden from the banks to the central bank would have adversely affected the operating surpluses of the latter. To prevent this leading to a peculiar situation where the RBI may incur losses, the central bank chose initially to foreclose this option by declaring a 100 per cent incremental cash reserve ratio for the banks. That is, all new deposits coming into the banking system had to be held ether as cash or as non-interest bearing deposits with the central banks. So long as that situation prevailed banks would be incurring losses because they were paying interest on deposits that they could not lend or invest.

Since this absurd situation created by demonetisation could not last, the RBI and the government have chosen to offer an out for the banks and the central bank in the form of an enhanced Market Stabilisation Scheme (MSS). Under the scheme the RBI has been allowed as of December 2 to issue as much as Rs. 6 lakh crore worth of government securities which can be sold to the banks. As and when these securities are sold by the RBI and are held by the banks, the government has to pay interest on these bills. As the deposits are withdrawn from the banking system, easing the burden on the banks, the RBI can reduce the volume of these bills in circulation and reduce the interest bill payable by the central government. Meanwhile, by investing in those securities the banks can earn an interest that can cover the cost of incremental deposits held. By the 10th of December the RBI had exhausted much of this leeway it had got from the Rs. 6 lakh crore ceiling it was subject to on the bonds it can issue under the MSS.

It is true that due to this roundabout scheme under which the government is likely to have to shoulder an additional interest burden in excess of Rs. 9,000 crore this financial year, the losses incurred by the banking system would fall. But losses there will be, the full dimensions of which will only be known as banks begin to release their accounts for the quarter in which the period of implementation of the demonetisation exercise falls. But whatever those losses are, they will damage the profitability of banks and provide another reason why their image would be sullied for no fault of theirs.

Given the nature of the current dispensation in government and the RBI it is likely that this damage to the image of banks inflicted by the government would provide grounds for the government to argue that public sector banks must bring in private capital through equity issue to strengthen their damaged balanced sheets and image. That is, both wittingly and unwittingly the government is providing and will provide reasons why the government share in equity of the public sector banks should be brought below 50 per cent, i.e., why they should be privatised.

That devious argument would only be strengthened by the fact that the economic contraction that the demonetisation is resulting in would reduce government revenues, while schemes such as the MSS necessitated by demonetisation would increase the outgo because of interest payments in the government budget. Since these would raise the fiscal deficit of the government in this and the coming year, it would claim that it does not have the money to recapitalise the banks so as to restore their capital base after they have provided for their enhanced losses post-demonetisation. Privatisation as a route to recapitalisation and meeting the Basel III capital adequacy norms would, therefore, be advocated.

If this line of reasoning does materialise in practice, employees and officers in the banks would face one more challenge—the restructuring of jobs that private owners would demand to reduce (personnel) costs to restore profitability. And since patriotism and commitment to the nation requires everyone to go digital, a case can be made that bits, phones and electronic gadgets can replace human beings to conduct the banking business. This is in keeping with the evidence that while demonetisation does little to curb black money or counterfeiting, it hits the working people who have been called upon to make sacrifices and endure hardships for the greater good of the 'nation', which in this case seems to be the rich earning profits through fraudulent means.

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