

The Future of Indian Finance*

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India's financial landscape appears set for a sea change. Early into its second term, the Modi government, through the Budget speech of its Finance Minister, has signalled the likelihood of a fundamental transformation of Indian finance. There were five indications of this possibility in the Budget speech. The first was that the government has chosen not to do set aside funds for recapitalisation. Banks would need capital not only because past allocations have not been adequate but because of the continued presence of a high level of non-performing assets (NPAs) in their books. The impact on the budget would not have been too adverse, because of the methods used to release funds for recapitalisation. The government sold bonds to the banks and used the money so mobilised to acquire equity in the banks concerned. This meant that the funds used for recapitalisation did not contribute to the fiscal deficit, since the liability in the form of bonds issued was matched by the assets in the form of equity acquired. It is only the interest due on the bonds that tended to show up in future years in the budget. Yet, the government has decided that it would not want to make any additional commitment for recapitalisation. Banks are to be left to their own devices.

Second, the Budget calls on banks to turn to capital markets to raise resources to fund recapitalisation. While this appears a corollary of the decision not to provide state funds for recapitalisation, it is significant for at least one other reason. Creeping disinvestment has already reduced the share of government in total equity in many public sector banks. Mobilising large sums through issue of new shares would reduce the government's stake to less than 50 per cent, which raises the possibility of loss of government control. However, this is a possibility that is unlikely to be immediately realised. Potential investors may not be keen on buying equity of banks burdened with large non-performing assets, unless the price is set at unacceptably low levels. The option is for the government to clean the books of the banks before going to market. But that would defeat the whole purpose of the exercise, which is to end provision of budgetary support for recapitalisation, as well as invite criticism that the government is making unrequited transfers to the private sector.

This would imply that some other mechanism must be found for rendering public sector banks viable. The Insolvency and Bankruptcy Code was seen as a way of resolving the NPA crisis, inasmuch as it sought to put in place a time bound and transparent process of resolution of instances of bad debt, failing which the defaulter was to be taken to liquidation. Much has been made of the success of the IBC in resolving large debt defaults and in raising the recovery rate to more than 40 per cent, which was way higher than achieved through the SARFAESI Act, Debt Tribunals and Lok Adalats. But this so-called success has come after much delay and really reflects the resolution of a few cases, such as in the steel sector, where the assets on offer were valuable in themselves and especially for the players who made the successful bids. The process has not been successful in a majority of cases and that explains the government's desperation to find alternative modes of resolving the crisis. According to rating agency CRISIS: "As on March 31, 2019, there were 1,143 cases outstanding under the IBC of which resolution in 32% of the cases was pending for more than 270 days.... Also, there are a few big-ticket accounts for which resolution has not been

finalised for over 400 days.” Thus, though the IBC process was a step forward relative to previous methods of resolution, it remains inadequate to the task.

The third indication in the Budget speech of coming financial transformation is the decision to extend the disinvestment and privatisation exercise from sale of equity in non-financial public enterprises to that in financial public sector enterprises. In its search for non-debt creating capital receipts that do not contribute to the fiscal deficit the government has set itself a hugely ambitious disinvestment target in Budget 2020-21, of which disinvestment of equity in non-financial enterprises is expected to contribute Rs. 1,20,000 crore and that in financial enterprises an additional RS. 90,000 crore. The Budget speech mentions sale of the government’s remaining stake in IDBI and sale through an IPO of government equity in the Life Insurance Corporation. But if opportunity arises, government equity in public sector banks will also be sold, given the decision to allow significant dilution of government’s stakeholding through sale of additional equity.

The really significant announcement is with respect to LIC. The company is not only profitable and held dominant market share when faced with competition from private players set up in collaboration with international giants, but has been an important instrument for stabilising stock markets, supporting infrastructural investments, and, above all, ensuring stability in the crucial insurance sector which world over is seen as crisis prone when in private hands. That is because insurance is an area where players sell products that are mere “promises to pay” to collect premium incomes that are invested for profit. An institutional framework that does not privilege profit above all is therefore a prerequisite for stability. The decision to privatise LIC therefore would involve a major transformation of the financial sector.

A fourth set of initiatives that the budget advocates are measures aimed at increasing private domestic and foreign investment in markets for government and corporate bonds. The intention clearly to use the bond market, rather than revived development financing institutions, as instruments that can substitute for the role that the public banking sector had come to play in financing private corporate investment, including in infrastructure. Private investors are to be given more scope for investment and induced with risk mitigation schemes like partial credit guarantees. Past experience suggests that this is unlikely to go very far, but this seems to be a part of the financing strategy outside of fiscal policy that the Budget speech elaborates. If the state is not going to guarantee the survival of banks, other institutions need to be found to undertake risky, long-term financing.

All this, still leaves unanswered how the current crisis in banking with persistently high NPA ratios, that threaten the solvency of at least some banks, would be resolved. A fifth element in the Budget speech provides a hint of what could be in store. The government has decided to raise the size of deposits of any single depositor protected with deposit insurance, that would compensate the depositor for losses suffered in case of bank failure, from Rs. 1 lakh to Rs. 5 lakh. This may not appear significant since the Rs. 1 lakh limit had been set more than 25 years back and had not been raised despite the recommendation of a five-fold increase made by the Damodaran Committee in 2011. But there are some unresolved issues here. To start with even Rs. 5 lakh is no large sum, especially for those who have chosen to invest their life’s savings in what they think are a safe avenue. Further, if banks are to bear the insurance premium, they are bound to transfer the cost to the depositors in some form.

So, all depositors would have to bear a cost to take account of the possibility that some banks may fail.

Which brings us to the fundamental question this announcement raises. If the government, by raising the ceiling on the size of deposits insured, is trying to assuage the fears of depositors about losing their money because of the bad debts accumulated by banks, is it also signalling that it is not guaranteeing bank solvency and protection of all the savings of all depositors? This question arises also because of the doubts that were created by the subsequently-withdrawn Financial Resolution and Deposit Insurance (FRDI) Bill that had allowed for the policy of an enforced bail-in as part of the resolution process in which besides shareholders and creditors, depositors would also have to accept a haircut when banks are overburdened with bad debt.

The furore this generated forced the government to temporarily withdraw the bill for redrafting. But a hitherto unreleased official note, accessed by Sucheta Dalal of Moneylife, of the economic affairs department of the Finance Ministry detailing what a revised bill (renamed the Financial Sector Development and Regulation (Resolution) Bill) would contain, suggests that the issue has not been laid to rest. The note reportedly suggests that in a new dispensation the resolution authority should have the “power to terminate contracts, write down debt, modify liabilities or set up bridge institutions”. This could well include a decision to require depositors to take a hair cut. It is also possible that if through such a resolution process the books of a banking institution are cleaned, it could well be taken to liquidation to pay off stakeholders, resulting in its sale to a private player. Privatisation could be the end result of the resolution process, where the government’s commitment to protecting the depositor is restricted to Rs. 5 lakh.

None of this is made fully clear in the Budget speech. But with a government clearly keen on washing its hands of the mess in the public banking system and desperate to mobilise resources by selling any assets that have takers, this could be the direction that policy takes. That would change the character of India’s hitherto state regulated and substantially state-owned financial sector.

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