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Banking Sector

Enhanced regulatory oversight augurs well for the long-term health of the Indian banking system

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ICRA RESEARCH SERVICES

Enhanced regulatory oversight augurs well for the long-term health of the Indian banking system

RBI's focus has been on ensuring system stability with enhanced bank regulation under the scanner

The Reserve Bank of India's (RBI) role in the financial system has been well defined over the years. The RBI has the responsibility of organising sound and healthy commercial banking system and has to ensure an effective co-ordination and control over the volume of credit by using appropriate monetary and credit regulation tools. However, while the RBI's role in the regulation of the economy has usually been the focus, ICRA notes that the institution's focus has increased on maintaining the system's financial stability in general and heightened oversight with respect to bank regulation over the past few years.

Multitude of shocks affecting the banking system have necessitated an expansion of the regulator's oversight

The past few years have seen the banking system affected by various shocks. Starting from the massive scale of asset quality issues, which by far have dwarfed similar shocks at any other time in the history of Indian banking over the past two decades to the emergence of multi-billion dollar worth of frauds, the banking system and also the regulator has been grappling with events the scale and systemic impact of which has been massive and protracted without any easy solutions. Seen in this light, in ICRA's view regulatory oversight had to be expanded beyond a narrow focus on regulatory compliance or bank solvency, towards assessing the riskiness of a bank's operations and its risk mitigation strategies. This meant that the RBI had to focus not only on the operating performance of banks or comment on its riskiness of operations but also had to transcend boundaries with respect to its governance structures. This note attempts to discuss in some degree of detail the regulator's moves and their efficacy.

In ICRA's view, the most important regulatory move initiated by the RBI has been around harmonising the recognition of bad loans across commercial banks. With different asset classification across banks, asset classification and NPA recognition practices were subjective. Hence the first step to solving the problem was to first recognise it and then determine the extent of it. The RBI during April – August 2015 had conducted an inspection of selected banks' balance sheets at random. Such inspections termed as asset quality review (AQR), starting from Q3 FY2016, led to the first wave of elevated levels of bad asset disclosure, a trend which has continued over the next two years. This move also led to better communication from banks to their stakeholders with respect to reporting of vulnerable accounts. In addition, the RBI came up with their own estimation of bad loans for each bank and forced banks to make disclosure of the variance between the banks' own estimation of bad loans and the RBI's estimation.

Reporting of divergencies across banks' standardised problem of loan reporting

RBI's intervention has been necessary to ensure harmonising of asset quality indicators reporting standards to ensure better comparability between banks

As per ICRA's analysis (represented by Exhibit 1), 30 banks have reported material divergence (defined as divergence beyond 15% in reported GNPAs or additional provision requirements because of divergences requiring additional provisions such that it is more than 15% of the reported profits) in their asset quality for March 2017 and 23 banks have reported material divergences in asset quality for March 2016. Further the Exhibit 2 represents that unlike March 2016, where private and public sector banks had almost equal share in reported divergences, the share of public sector banks has been much higher in March 2017. In ICRA's view, the first step towards asset quality improvement for banks was to first recognise the problem and then determine the extent of it. Hence in our view, the RBI's heightened oversight substantially helped create a level playing field for better comparison of banks across asset quality parameters as well as sense the quality of financial reporting as well as corporate governance standards and standing of management quality. While the number of banks reporting divergences has reduced in FY2017, the quantum of divergences in FY2017 was higher than FY2016. Further, the current AQR exercise under progress for FY2018, it remains to be seen whether the banks have proactively recognised stressed accounts, thereby reducing the divergences.

EXHIBIT 1: Divergences in Asset Quality

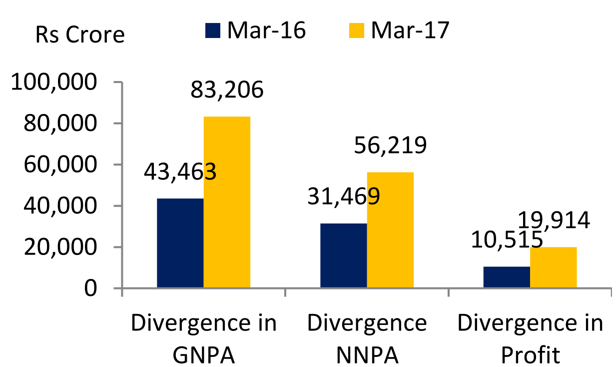
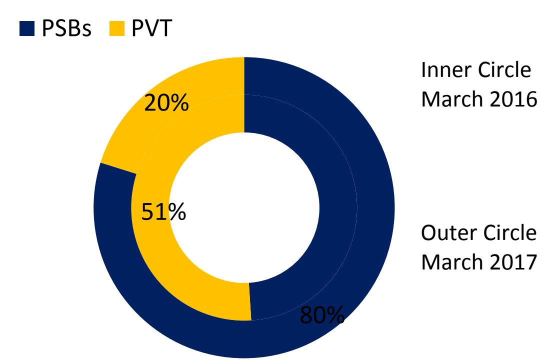


EXHIBIT 2: Share of Divergences in GNPA



Source: Banks and ICRA research;
Data for 23 banks in March 2016 and 30 banks in March 2017 that have reported divergences

February circular deters incentive to defer recognition of bad loans and creates framework for stressed asset resolution

February 12, 2018 RBI circular disincentivises banks to defer recognition of problem loans aiding overall transparency in NPA reporting

Continuing with this theme, the RBI in February 2018 constituted a committee to look into the reasons for high divergence observed in asset classification and provisioning by banks vis-à-vis the RBI's supervisory assessment, and the steps needed to prevent it. In our view, apart from the regulatory disclosures, the banks should be forthcoming for reasons for such divergences for better transparency with various stakeholders.

Also, the RBI in it February 12, 2018 circular enshrined a new framework for stressed assets resolution. The RBI has also tightened the criterion for upgradation of NPA accounts or accounts which get classified as NPAs upon restructuring under the resolution plan approved by JLF. The accounts can be upgraded if the borrower has a demonstrated track record of timely debt repayments and has paid at least 20% of the principal outstanding of sustainable debt portion at the time of implementation resolution plan. This is against the earlier norm for restructured accounts, which was one year from the commencement of the first payment of interest or principal, whichever is later, on the credit facility with the longest period of moratorium under the terms of the restructuring package. In our view, the tightening of the criterion for upgradation of loans, the incentive for banks to defer the recognition of problem loans by creating a ballooning repayment schedule with back-ended amortisation of principal will be discouraged.

The regulator has also tried to ensure a better credit culture by referring large accounts to the bankruptcy court if not resolved within 180 days of occurrence of a default, and this is already yielding reasonable results

Another confidence-building measure has been the regulator's attempt to improve the credit culture in the country and instil discipline in errant borrowers. In the same February 12, 2018 circular, the RBI directed lenders to refer an account with over Rs 2000-crore loans to the bankruptcy court if it is not resolved within 180 days of a default. Also, the various stress resolution schemes such as all the schemes such as the Corporate Debt Restructuring, Sustainable Structuring of Stressed Assets or S4A, Strategic Debt Restructuring, and Flexible Structuring of Existing Long-Term Project Loans stand abolished. The Joint Lenders' Forum, designed to resolve potential bad debts has also been disbanded. The RBI's endeavour has been that early identification of stress would provide lenders sufficient time to put in place the required resolution plan. In ICRA's view, the various stress-related schemes served the purpose of prolonging the problem without adequate resolution, apart from building further uncertainty with respect to the status of the stressed assets. Discontinuance of the same would eventually help in stressed asset resolution.

RBI's greater say in appointments of key managerial positions for banks and adherence to rules

RBI's regulatory oversight includes a better governance structure for the banking system; and working towards appointments for private sector banks

The regulator has also ensured stricter adherence to conditions while granting banking license

RBI's risk-based supervision approach encompassed a closer scrutiny of the top management of banks. In the recent past, the RBI has overruled the extension of the board-approved CEO nominations of two large private sector banks and initiated a probe on the erstwhile MD & CEO of another large private sector bank with respect to allegations of impropriety. Historically, it was perceived that the RBI's approval of the MD / CEOs of banks was more a matter of routine, especially once the respective boards blessed the appointment, hence the recent stance of the regulator represents a marked departure from the earlier stance.

While the exact reasons for the non-extension of tenure of CEOs cannot be determined, what can be envisaged is that the RBI wants a bigger say in the quality of the management teams at the helm of banks to ensure better governance standards. In ICRA's view, such steps from the regulator, in the medium to long term could substantially re-affirm stakeholders' confidence in banks and by logical extension for the financial system in the country.

Also, important to note is the RBI's insistence of strict adherence to the conditions of granting a banking licence. The same has been seen in the RBI's reluctance to grant any leeway to adherence of maximum promoter shareholding for commercial banks. This has been observed in recent examples of another large private sector bank where the RBI stated that the bank's issuance of perpetual non-convertible preference shares "did not meet the promoter holding dilution requirement." In a similar example, in October 2018 a newly publicly-listed private sector ban was barred from opening new branches without the RBI's approval and the salary of its CEO was frozen over its failure to meet shareholding rules by bringing down the promoter shareholding to below 40% from the existing 82%. Also, two small finance banks which got their SFB licences were asked by the regulator to list their banking units separately within three years of commencement of its operations. This is in accordance with the central bank's licensing requirements for small finance banks. Hence in ICRA's view, the RBI is strictly adhering to the licence conditions of the banks.

Further, the RBI has also expressed its desire to exercise similar control on public sector banks (PSBs). Earlier, RBI governor has gone on record arguing for better authority over the PSBs, much of which has been significantly weakened by the provisions of the Banking Regulation Act. For instance, Clause 51 did not allow RBI the powers for the removal of the chairman, directors or even the PSB management. In addition, mergers between PSBs are disallowed by the Act. Also, the RBI regulations need promoters and directors to meet the "fit and proper" criteria on a continuous basis. Hence, while that can be more strictly ensured in private sector banks, it cannot enforce the same with the same vigour in public sector banks since the Government's authority reigns supreme.

Way forward:

In ICRA’s view, this enhanced regulatory oversight would help the system by reduction of excesses, create a cleaner framework for asset quality recognition, substantially improve corporate governance standards and inculcate financial discipline in the borrowers.

While this would create some pain in the short run, in our view all these initiatives are welcome and augur well for the long term financial health of the financial system in India. We also believe that continuous improvements in the disclosure levels from the banks and the regulators will help improve the market efficiency and reduce information asymmetry amongst various market participants.

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