The Twin Balance Sheet Challenge, the 4Rs and Banking Reforms: Government's Response and Way Ahead

Some quick and abbreviated reflections

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Speech delivered at Shri Guru Tegh Bahadur Khalsa College
Delhi University
October 25, 2017

I.INTRODUCTION

Yesterday, the government announced a major initiative—firing a *Brahmastra* as it were—to address the challenges of stressed assets and weak banking balance sheets. This follows on some earlier actions to address the indebtedness problem in the corporate sector. Together, these can be expected to have a significant impact on the economy, boosting credit, growth, and employment.

Today, with your indulgence, I want to step back and talk about the Twin Balance Sheet Challenge afflicting the Indian economy, explain the government's actions and outline the issues that must be addressed in the period ahead.

In the Economic Survey of 2014-15, we first identified the Twin Balance Sheet (TBS) Challenge afflicting the Indian economy. Briefly, the TBS challenge refers on the one hand to: over-indebtedness in the corporate sector which makes them unable and unwilling to borrow, depressing the demand for spending and investment; and on the other hand to stressed bank balance sheets especially in the public sector banks (PSBs) that make them unwilling and unable to supply credit to finance spending by the corporate and household sectors. The TBS clogs the economy, depriving it of demand and the lubrication that oils and feeds that demand.

Research by Carment Reinhart and Ken Rogoff shows that countries that experience the TBS witness prolonged and weak growth. Growth only revives if the TBS challenge is swiftly and decisively addressed. The Japanese experience of the so-called lost decades of the 1990s and 2000s illustrates the consequences of not attacking the TBS challenge decisively.

In Volume 2 of this year's Economic Survey we showed that India has been in the throes of this TBS for nearly 7 years since the global financial crisis. As we provocatively put it, India's growth has been decelerating not because there was inadequate flow of credit but because there had not been a sharper decline in credit or faster deleveraging. This necessary purging of the bad assets in the banking system could then pave the way for a more durable and stable growth revival.

II.The 4 Rs

As we outlined in the Economic Survey of 2015-16, resolving the TBS challenge comprehensively would require 4 R's: *Recognition, Recapitalization, Resolution,* and *Reform.*

Banks must value their assets as far as possible close to true value (*recognition*) as the RBI has been emphasizing; once they do so, their capital position must be safeguarded via infusions of equity (*recapitalization*) as the banks have been demanding; the underlying stressed assets in the corporate sector must be sold or rehabilitated (*resolution*) as the government has been desiring; and future incentives for the private sector and corporates must be set right (*reform*) to avoid a repetition of the problem, as everyone has been clamouring.

<u>A. An Iron Law of Non-Recognition</u>: A word on recognition. Stressed and non-performing assets (NPAs) in the banking system together amounts to roughly 10 lakh crores and we have made major progress in coming to grips with the true extent of the problem thanks to the Asset Quality Review. But a note of caution. I want to advance/hazard a Subramanian Law of Recognition or rather Non-Recognition. The amount of stressed assets always and everywhere is at least 10-20 percent more than what it is always and everywhere claimed to be. I say this not because I am a doom-monger or

that I know something that all of you don't. Rather it is based on not knowing what everyone does not know! So, while we know the magnitude of the underlying problem, it would only be prudent to assume that we have not identified all of it.

B.Resolution: In May 2017 the Government passed an ordinance to promote resolution. The RBI followed up decisively by identifying on June 13, 2017, 12 loan accounts to be taken up under India's new Bankruptcy Law with its tight deadlines and well-specified resolution process. These loans account for about 25% of the current NPAs (not the overall stressed assets) in the banking system. Another 30-40 cases have since been added to the list, and if settlement does not take place, they may also enter the bankruptcy process.

The new bankruptcy law provides a legal framework for taking the difficult decisions that can help resolution. It is to be hoped that these actions will decisively address the TBS challenge. Nevertheless, market participants have pointed out that procedures are still in their infancy, untried even for small cases. It has been argued that even if the system does work well, it might still not lead to resolutions if debtors are able to challenge the procedures in the courts. Policy-makers are closely monitoring the process but only time will tell if some of these challenges will delay or stymie the resolution process. Early and prominent successes will impart confidence in the new bankruptcy process.

Today I want to focus more on the remaining Rs, recapitalization and reform.

C.Why Recapitalization?

Even as the new measures aimed at resolution unfold, it is worth thinking about the longer-term strategic approach about the other Rs in the context of a strategic approach to the banking sector. Burdened by stressed assets and the atmosphere of uncertainty that has existed for some considerable time, banks, especially those in the public sector, have had to focus on their NPAs than on new lending. Data shows that inadequate demand cannot be the full explanation for the credit slowdown because the growth in lending by private sector banks is robust and much greater than for the PSBs.

Rather, the central problem is that public sector banks are in damage limitation mode rather than seeking out new clients and opportunities. An important and simple way of addressing that is to provide banks with the money to clean up their balance sheets so that they have the financial ability and managerial attention span and incentive to refocus on their core activity of lending, finding viable projects.

That is what the government has announced yesterday. The package consists of three parts. Rs18000 crores from the budget, Rs58000 crores that banks would raise from the market over the next two years). All this, however, is not new and can be thought of as the residual resource mobilization under the earlier reform package called *Indradhanush*.

What is new, however, is that the government also committed today to issuing Rs1.35 lakh crores as "recapitalization bonds" over the current and next fiscal year, and using these bonds to recapitalize public sector banks. These bonds—after taking into account the existing provisioning and the recoverable value of the underlying loans—will ensure a healthy capital base for the PSBs, also consistent with international norms and standards.

Details of the mechanics of issuing these recap bonds will be elaborated in the period ahead (will they be marketable, will they count toward SLRs, what will be the coupon etc. etc.). It is likely that the recap bonds will be placed with the banks for which the government will get an equivalent holding of equity in the banks. This will strengthen the capital base of the PSBs and allow them to strengthen and increase their lending.

(i)What are the costs—economic and accounting of recapitalization?

First, the true fiscal cost of issuing the 1.35 lakh crores recapitalization bonds is the interest payment of about Rs. 8000-9000 crores. But cost can be offset by the confidence impact of addressing the critical economic bottleneck, thereby increasing credit supply, private investment and growth. The rest is all accounting.

Second, so what is the accounting? If central government issues the recap bonds, its DEBT will go up. Third, but do recap bonds add to the fiscal DEFICIT? It depends. Under standard international/IMF accounting, recap bonds do NOT increase deficit; they are "below-the-line" financing. But under India's convention, these bonds would add to deficit.

Fourth, IMF convention is economically more intuitive because bonds are a capital transaction, their issuance does not increase directly demand for goods and services and has no inflationary consequence. It is a capital transaction because on the one hand it increases the government's liability but it also increases its assets. The overall or net financial position of the government remains unchanged.

Finally, the accounting is to some extent moot. Of course, there is a cost to recapitalization consisting of the additional interest burden on the recap bonds. But these costs were always there. The government is already liable to banks as owner (for the unrecoverable part of the underlying loans that were made). Issuing bonds merely makes explicit an implicit liability; or rather puts on the books what is a contingent liability.

D. Reform: All the effort invested in the previous Rs will become more effective and have more bite if also accompanied by the fourth-R, Reform. Reform will ensure that the problems that India has faced over the last few years will not recur in the future. Economists often talk about *moral hazard*: the perverse incentives created by government intervention. And the recapitalization announced yesterday will raise the moral hazard question: isn't this a bailout of the bad lending and borrowing decisions of the past. To some extent, moral hazard is unavoidable. In the real world there are no costless actions, policy makers have to balance the perverse incentives created against the necessity of reviving the economy and creating growth and jobs.

But moral hazard must be minimized and that is where reforms come in. The Honorable Finance Minister said yesterday that reforms to accompany the recapitalization would be formulated in the period ahead. In the current circumstances, what are some of the key reforms that will be necessary to make the package announced even more effective, the *uber-Brahmastra* (to mix languages, Sanskrit and German)?

Reforms must be animated by a vision of where we think the banking sector should be in say 5-10 years, financing a double-digit growing economy.

III. ELEMENTS OF FUTURE REFORM

Should recapitalization be discerning?: There is a view that there are too many banks and a few unviable ones. The aim must be to shrink or narrow the scope of the unviable banks as former RBI Governor Y.V. Reddy has argued. In this view, recapitalization must be selective and incentive based, directing it to those banks where the bank for buck in terms of new credit creation will be maximum. Since all banks must maintain a minimum capital adequacy, one possibility would be to recapitalize the unviable banks only to the extent necessary to finance their current balance sheet size while explicitly not providing for their growth.

Excising or just recapitalizing banks? The other question confronting the recapitalization strategy is whether to recapitalize by leaving the stressed loans on banks' balance sheet or taking them off. The latter course would have two benefits. The cleaner the balance sheet the more likely that the private sector will be willing to become owners or equity-holders. Otherwise, there will be far too much uncertainty about the underlying value of the bank which would deter private sector participation. Another reason is simply this: as long as the loans remain on the books, bank management will remain distracted by having to deal with them, taking attention away from the key critical task of finding good projects and increasing credit supply.

Should majority private sector participation be facilitated? A number of commentators have argued that, of course, the key elephant in the room question is majority private sector participation. In an ideal banking world of tomorrow, India needs to have both large public sector and private sector banks, competing domestically and being competitive internationally. In one view, achieving this would require allowing majority private ownership. Such ownership is not a panacea nor will it in and of itself ensure that problems of imprudent lending and moral hazard will not arise. International experience suggests that effective regulation is an absolutely vital pre-condition to a sound and effective banking system, regardless of ownership structures.

Public discussion of private sector ownership has emphasized the benefits that will derive from less political interference and politically-directed lending that public ownership has led to in the past. That is the conventional case for privatization. But there may be other benefits: the freedom to recruit and retain personnel and procure from most efficient sources; avoiding the excessive caution in decision-making that often flows from a variety of constraints imposed by referee institutions, the so-called 4Cs. It is striking how much caution, inertia, and yes even fear that public sector bank managers experience. That must be addressed.

The most important and new observation relating to private ownership stems from India's experience of the TBS challenge. It has become clear now that in India exit is the most difficult challenge. I often say that India has moved from "socialism with limited entry to capitalism without exit." It is very difficult to get out of inefficient and unproductive production whether in agriculture, fertilizer, civil aviation.

But the TBS problem has revealed an exit problem of a unique and perverse sort. We have found that exit is especially difficult when public sector banks lend to private sector companies. Once the bad lending occurs, getting out is difficult for fear of being seen as favouring certain groups—typically the promoters and others--especially in an institutional environment dominated by the 4 Cs.

In the future, one view is that it may be better to have more private-to-private lending and even private-to-public lending. But the public-to-private lending model has proved toxic. We want to be careful before we repeat that experiment again.

IV. CONCLUSION

With the reform package announced yesterday, we have come a long way in decisively addressing the TBS challenge. A lot will depend on steady implementation and the important follow- up reforms. In 2013 India suffered from a Twin Macroeconomic Deficit problem. This then gave way to the Twin Balance Sheet Challenge. It is time to move past both sets of twins.