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EXECUTIVE BRIEFINGS
POLICY AND ECONOMY: THE BANKING REGULATION ORDINANCE

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A difficult journey… will finally start

The recent ordinance issued by the government to amend the Banking Regulation Act 1949, empowers the Reserve Bank of India (RBI) to assume a more decisive role towards a resolution of bad loans that cripple the balance sheets of commercial banks and constrain their ability to lend. The RBI can now effectively force banks to initiate measures on stressed assets as well as invoke insolvency proceedings against irredeemable defaulters. Moreover, it can advise banks on the resolution process, possibly even supervise it, through special committees comprising of its representatives, those of lending institutions and potentially outside experts. Bad loans within the banking system amount to an appalling 9% of gross advances, the highest amongst major emerging markets barring Russia. However, if all at-risk assets were to be counted, the ratio jumps to a shocking 15% according to the Government of India's own Economic Survey 2016-17. Previous clean-up efforts have largely flopped and the ratio of bad loans to gross lending has consistently risen over the years. The Ordinance aims to reverse this trend.

The initiative is opportune for several reasons. Despite recent legislative and regulatory changes intended to strengthen the position of banks, little action has actually been taken against defaulters. Many of these cases will entail large haircuts (a whopping 75% in the case of the 57 biggest cases) in the form of distress sales and settlements. Since such decisions involve a degree of subjectivity, bank officials worry about being exposed to investigative scrutiny at a subsequent date. Moreover, a written down balance sheet with consequential losses would reflect poorly on the record of a CEO and, in a public sector career, he has little incentive to take such a step. A third factor, applicable to large syndicated loans, is the inability of consortium banks to agree on how, or even whether, to initiate penal action against defaulters. The new Ordinance aims to alleviate some of these problems by providing banks with the cover of an RBI mandate and an external oversight committee to guide the resolution process. Some have argued that this will merely shift the investigative glare from bank managers to the central bank and committee officials. However, this would seem an unwarranted concern as such individuals would be alien to the original transacting parties and in any event are fulfilling regulatory obligations, not commercial ones.

A more legitimate concern is the fact that the Ordinance effectively induces intervention by the central bank into the affairs of banking corporations. Although it is meant to limit itself to the issue of bad loan resolution, the fact is this issue is intrinsically linked to basic management and operational practices within a bank. It is hard to say how meddling the RBI will be or where it will draw a line between a curative role versus an intrusive one. However, going by its history of progressive and unobtrusive regulation, one might rightfully expect it to strike a judicious balance.

On a more practical note, a major constraint to the resolution of loan settlements lies just around the corner. This stems from the hopelessly over-burdened and under-resourced judicial system that is expected to arbitrate insolvency cases. The National Company Law Tribunal (NCLT), created in 2016 under the new Companies Act, will not only adjudicate on company law matters but also on cases under the Insolvency and Bankruptcy Code. The Tribunal, moreover, is required to assume all pending proceedings from the high courts, the erstwhile Company Law Tribunal (CLB), the Debt Recovery Tribunal (DRT) and the Board for Industrial and Financial Reconstruction (BIFR). According to a study by Alvarez & Marsal, a consulting firm, this includes 4,000 cases from the CLB, 700 from the

BIFR, 5,200 from various high courts and 15,000 from DRTs – a total of almost 25,000 cases. To handle all of this the NCLT has 11 benches and a grand total of 26 adjudicating members. It is also short of administrative staff and assistants, which impairs its ability to function. Alvarez & Marsal estimates that while an average debt recovery judge in the US clears about 2,895 cases a year, his Indian counterpart is able to manage just 360. At this rate, it will take the NCLT seven years just to clear the backlog of pending and transferred cases, not counting the additional burden that will soon be added when the Banking Regulation Ordinance kicks in. On a positive note though, the Government appears aware of the problem and is currently in the process of increasing the NCLT's strength.

In the final analysis, however, what really matters is whether and to what extent commercial banks are willing to make an earnest effort at debt resolution. The RBI can force them to initiate insolvency proceedings and set up expert committees to guide them, but it is ultimately the banks that have to implement measures and absorb losses. Subsequently, they will need to rebuild their balance sheets through a recapitalisation process, which comes with an entirely distinct set of challenges. A bank with a shrunken capital base can hardly lend. Be that as it may, the ordinance is a decisive start and demonstrative of the government's effort to get to grips with the problem.