Banking Jitters*

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In an unusual and ill-advised move, the Reserve Bank of India issued a brief 'clarification' on October 1st which said: "There are rumours in some locations about certain banks including cooperative banks, resulting in anxiety among the depositors. RBI would like to assure the general public that Indian banking system is safe and stable and there is no need to panic on the basis of such rumours."

That move was unwise because it unnecessarily drew attention to the possibility that recent developments in the banking sector, especially the stringent limits set on withdrawals from the failing Punjab and Maharashtra Cooperative Bank (PMCB), could give depositors in other banks the jitters, and precipitate a run leading to failure elsewhere as well. The public statement was also a mistake since it presumed that the credibility of the RBI was good enough to persuade depositors to refrain from doing what their own better judgement says they should do.

That the self-assessment by India's central bank was overly positive was evident from the extent of violation of rules and norms at the PMCB, and the magnitude of fraud in a game that had played out under the nose of the RBI. That did not speak well of the ability of the institution either to recognise potential failure or do much to stem it when recognised. Moreover, what the PMCB experience makes clear is that when banks do go bust, the RBI is not in a position to protect depositors and find a quick solution in their favour. At the start of the PMCB crisis the RBI limited withdrawals to Rs. 1000 and declared that even though the banking licence of the cooperative institution was not being revoked, restrictions that affected depositors adversely could stay in place for as long as six months.

One excuse for dealing with the problem in this manner was that closure of the bank was not an option because the maximum compensation of Rs. 1 lakh under India's deposit insurance scheme, which had been set more than 25 years back, was woefully inadequate in the current circumstances. What was side-stepped was the fact that this limit had not been raised for so long, despite the recommendation of a five-fold increase made by the Damodaran Committee in 2011, which is one indication of the complete absence of concern for depositors under the current regulatory dispensation.

What explains this failure to raise the ceiling on deposit insurance cover, leaving it at the pathetic level at which it stands? Clearly, the government and the RBI did not think that the option of paying off depositors and closing down failing banks would ever be resorted to. There were two valid reasons for holding such a view in the past. The first was that complete closure of a bank was not considered a viable option since it would unleash depositor anger that can be politically damaging. Hence, the government chose, in emergencies, to rely on enforced mergers of banks to keep deposits in the failing bank active by being absorbed into the viable new entity. This, however, was not an easy policy to implement given the inevitable resistance from the promoters of the profitable bank that had to absorb the failing entity.

But with nationalisation, such resistance was no longer a problem, as state-owned banks could be persuaded to do the job. Thus, when a new private sector bank like Global Trust Bank, considered to be a model of post-liberalisation banking, sank, a

resolution was swift because of its merger with publicly-owned Oriental Bank of Commerce. With an option of that kind in hand, the central bank could take time to try and restore to health any ailing bank, confident that if that effort fails it could still protect depositors with an enforced merger with a healthy public sector bank that could raise no objection.

If the same confidence and swiftness of action are currently absent it is because of changed circumstances. Public sector banks, having been made instruments in the credit-fuelled boom of the 2000s, are now so burdened with bad debt that few are in a position to absorb another entity on the verge of failure and survive themselves. In fact, mergers are being resorted to in order to prevent weak banks from failing in the absence of adequate government support. The basic problem is that, given its own fiscal stance, the government is unwilling to absorb all the bad debts of the failing bank.

In fact, a lenient tax regime and a conservative fiscal stance that precludes enhanced government borrowing also underlie the current predicament of public banks. With the government unable to finance investments in crucial capital-intensive sectors, including infrastructure, the private sector had to be persuaded to take on that responsibility. To facilitate that, public banks and specialised institutions like IL&FS were commandeered to steer finance to willing private players, who saw in this trend a government-guaranteed opportunity. In practice, the strategy did not work, and projects did not take off or proved non-viable, leading to the large defaults that underlie the pile-up of non-performing assets. In short, the current precarious situation that can trigger sequential failures is a direct result of the transformation of public banking associated with the neoliberal agenda pursued since the 1990s.

These deeper roots of the banking crisis suggest that the problem with banks cannot be attributed solely or largely to operational failures or fraud but are the outcome of the policy regime that underlies both the boom of the 2000s and the current bust. The liberalised environment, with its regulatory forbearance and its reliance on market-mediated regulatory tools like risk-weighted capital adequacy ratios, provided the environment that breeds delinquency and fraud. If the role of the banker is to fuel private investment for profit, asking for a cut from that profit may not appear unwarranted.

Ignoring this reality, the confidence of the RBI that it can persuade depositors that they should not succumb to rumours of impending bank failures partly rests on the belief that the PMCB crisis is an aberration or an outlier, and not a symptom of systemic flaws. If that is not true, then the inability of the central bank to deal with such events and protect depositors is even more alarming. Possibly the government and the RBI do believe that they need to change the perception that depositors and their savings must always be protected by the different arms of the state.

That could explain the provisions of the temporarily discarded draft Financial Resolution and Deposit Insurance Bill of 2017, which sought to put in place a mandatory resolution process with ‘bail in’ provisions. Those provisions required all stakeholders, including depositors, besides creditors and equity holders, to share in the costs of resolution by taking a haircut, that in cases like PMCB could amount to 100 per cent. If a bank fails, depositors who risked their money with the bank concerned must also pay a price, the argument went. Resistance to those provisions

and reacting to evidence that depositors were pulling out their deposits out of fear, the government withdrew the bill at the last moment. But given the current challenges it faces, the bill may be revived and passed with a brute majority. Meanwhile, banking jitters must be quelled to ensure that the burden of resolving failed banks does not fall on the government. It is not clear whether a bland and badly worded ‘clarification’ can do the job.

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