Crisis in Indian Public Sector Banks – Failure of Governance and Regulation - A Diagnostic Study

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Abstract:

Banking is lifeline of every economy. It looks like simple thing like collecting money from people and giving credit to people, and retuning the money with interest when depositors wanted it. But banking does many more functions, like financial inclusion, through priority sector lending loans to agriculture, MSMEs , renewable energy, issuing bonds, facilitator in foreign exchange, and many more . At present banking sector in crisis due to many challenges. NPA issue is looming, , willful defaulters like Vijay Malya and others, bank employees collusion with corporates to loot bank, capital to risk adequate ratio dwindling, conflict of interest while sanctioning loans, and many more. But the bigger question is that, what is the root cause of these problems or symptoms? Is it because of failure of governance or failure of Regulation needs a detailed analysis.

After the thorough review the literatures on the titles; i) The Public sector banking crisis in India ii) The Government needs a clear vision for the future of India's Banking Sector" iii) The roots of the current banking crisis iv) The crisis in Indian banking v) Root cause of India's banking crisis: A non-existent corporate bond market vi) What this banking crisis really is, and how govt has missed what matters most and viii) Is India Sliding Into A Banking Crisis? A diagnostic research approach is used in analyzing the presenting the data pertained to Indian public sector banks. Reasons for increasing NPAs, failure of governance and regulation, meeting social obligations, in-effective recruitment system, on on-compatiable interest rates, increased customers expectations, lack of accountability, meeting global requirement both in terms of quality, speed and size, mis-match in bank employees salaries are the major challenges before the public sector banks needs urgent attention and to find the suitable solutions through consolidation of banks among the public sector banks and between public and private sector banks , which is the successful model in western countries.

Amendment in banking Regulation act to give more power to RBI to take decisions to reduce NPA, steps like big private audit firms must audit which public sector banks would not allow now and Independence and autonomy to banks while ensuring compliance, market based salaries to higher professionals, Clearing the balance sheets would ensure sustainability of banking sector. Laws like confiscation of property of fugitives, and extradition treaty with nations like UK and western nations help to repatriate those absconders like Malya, Neerav and Lalith Modi,

This paper also throws a light on the recent developments takes place in the banking sector with particularly in public sector banks and the ways and means to curb NPAs threat also has been analysed. Recent Developments and Ways to Tackle NPA Insolvency and Bankruptcy Code (IBC) **,** Credit Risk Management , Tightening Credit Monitoring , Amendments to Banking Law to give RBI more power , More "Hair-cut" for Banks, Stricter NPA recovery, Corporate Governance Issues**,** Making every employee should come under Accountability, raising capital" to address the problem of NPA**, u**sing unclaimed deposits , **m**onetization of assets held by Banks, **ma**king Cash Reserve Ratio (CRR) attractive**, r**efinancing from the Central Bank , Structural changes to involve private capital and so on.

Key Words: Banking Crisis, NPAs, CRR, MSME's, Governance, Regulation, Willful defaulters

Introduction to the Topic

Banking Crisis in India is a hot topic as many business men looted the banks and escaped to foreign countries, more than dozen industrialists are facing bankruptcy defaults, mounting NPA's and the failure of Governance and Regulation. In the year 2008, sub-mortgage crisis loomed world over, all major economics affected and growth rated declined, inflation doubled, unemployment increased. However its impact was minuscule in India due to strong banking sector. In the past also Asian economic crisis happened due to failure of banking sector in Asian countries. At that time also India immune from crisis due to fortified banking sector. Such a great role banking sector played in India, however recent incidents like Vijay Malya evasion of bank loans, Nirav Modi scam, ICICI loan to Videocon shaken the credentials of banking sector . Is it because of failure of governance or failure of Regulation, to know that issue need detailed analysis.

Objectives of the Paper

The Core Objectives of this research paper are;

1. To know the essence of Banking system in Indian Economy.
2. To diagnoses the multiple causes/challenges for Crisis in Indian Banking Sector with special reference to Public sector Banks.
3. To explore the possibilities to come out from the Crisis

Scope of the Paper

This discussion in this research paper comprises the root causes, effects and ways and means to come out from the present crisis in Indian Banking sector in general and public sector banks in India in particular.

Research Design

The paper is purely based on the exploratory analysis of secondary data available in the different sources of secondary domain such as; web-resources, review of research articles, experts opinion (Delphi approach), articles available in journals and conceptual data from text books. The Collected data has been arranged in a meaningful order and through a diagnostic approach the data has been analysed and interpreted.

Review of Literature

A thorough review of Literature on the said topic of paper is enlisted below;

1. **David Bergeron, Amit Deshpande and Wolfram Hedrich**[1] in their article titled 'The Public sector banking crisis in India: The Government needs a clear vision for the future of India's Banking Sector' opined that, The Reserve Bank of India is trying to bring problems into the open, having conducted an Asset Quality Review and enhancing the reporting of restructured assets. It has also asked banks to initiate forced-bankruptcy proceedings against 12 large defaulters that, between them, account for 25 percent of the banking system's non-performing loans; another 26 defaulters are scheduled to be forced into bankruptcy in December if their restructurings have not been resolved by then. This high level of non-performing loans is eroding the ability of public-sector banks to retain earnings and is thereby damaging their capital positions. Under Basel III, banks must have capital ratios of at least 11.5 percent

[1] David Bergeron • Amit Deshpande • Wolfram Hedrich RISK JOURNAL | VOLUME 7(pp1-4)[David Bergeron is a Mumbai-based partner and Amit Deshpande is a Mumbai-based principal in Oliver Wyman's Financial Services practice. Wolfram Hedrich is the Singapore-based executive director of Marsh & McLennan Companies' Asia Pacific Risk Center.]

by March 2019. Various analyst reports have recently estimated that to meet this standard, the public-sector banks will need to rise between $19 billion and $21 billion (a finding in line with our own estimates from 2016).

2. **Manas Chakravarthy** [2] in his article 'The roots of the current banking crisis' states that, The seeds of every bust are sown during the heydays of a boom. The same goes for financial frauds and embezzlement. As Charles Kindleberger, celebrated author of the classic history of financial crises declared in Manias, Panics and Crashes, "The propensity to swindle grows parallel with the propensity to speculate during a boom... the implosion of an asset price bubble always leads to the discovery of frauds and swindles." The roots of the current crisis in our banks, therefore, lie in the great boom of 2003-08, which was then prolonged in India by a fiscal and monetary stimulus. The following five charts tell the story:
3. **Ajay Chhibber**[3]**,** in his article titled Is India Sliding into a Banking Crisis? Opined that, India must remember that the 1997 Asian financial crisis was exacerbated by tight monetary policy, forced on by IMF conditionality. India may well be quietly sliding into a banking crisis. The revealed non-performing loans (NPLs) are over $50 billion but could be as high as $200 billion — just under 10 per cent of GDP and rising. If the banking problems are handled badly and if the global factors worsen, India could be headed for a full-blown banking crisis, and the rupee could appreciate to 80 against the US dollar or even higher.

4. **Mihir Sharma**[4] in his article **'**What this banking crisis really is, and how govt. has missed what matters most? States that, Government seems intent on abandoning good ideas for dealing with the country's banking crisis and encouraging bad ones. Perhaps that shouldn't be surprising, given that the bureaucrats don't yet seem to have grappled with the real nature of the problem. The latest terrible proposal for dealing with the bad loans weighing down India's state-owned banks, which control more than two-thirds of deposits, is to create a "bad bank" an asset-management company that would take stressed assets off their balance sheets.

5. **Satya N Mohanty** [5] in his article **"**Root cause of India's banking crisis: A non-existent corporate bond market, Both banks and India Inc have incentives to stop the creation of a bond market states that, The Indian banking system's bad loans have reached Rs 10.25 trillion. Gross NPAs have become 10.5 per cent by March 2018, up from 9.5 per cent of March 2017. It is expected that currently stressed loans can deteriorate to NPAs worth Rs 11.5 trillion or 14 per cent of advances during the present financial year.

The net NPA of banks is Rs 4.95 trillion when only two-thirds of the bank assets are reviewed. The number of banks under 'prompt corrective action' are 34 now. This will result in the deterioration of their capital which will impact their loan growth. IBC (insolvency and bankruptcy code) cases will also add to their woes as the banks are likely to take a haircut in each case. They will have to go for higher provisioning, which reduces their headroom for increasing advances

Weak credit loss absorption capacity will force the government to infuse new capital of Rs 60 billion, as some estimate. This will be in addition to Rs 90 billion infused already. The merry-go-round we see so frequently will recur again because the fundamental principles of risk control management and supervision have not been addressed yet. Already plans are afoot to amalgamate small and weak banks. The clamour for independent evaluation within RBI is going up and the chorus for the privatisation of PSBs will only grow louder.

- **Banks contributions in Economy**

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[2]Manas Chakravarty's columns at livemint.com/capitalaccount Manas Chakravarty looks at trends and issues in the financial markets. mint ePaper27 Feb 2018.

[3] Ajay Chhibberis, Visiting Distinguished Professor at the National Institute of Public finance and Policy and Visiting Scholar at the Institute of International Economic Policy, George Washington University 22March, 2016

[4] Mihir Sharma, in Business Standard, published dated 2nd Feb.2018

[5] Satya N Mohanty (June 2018) in his article "Root cause of India's banking crisis" Business Standard, (pp.xi-xii)

Banking is lifeline of any economy. It looks like simple thing like collecting money from people and giving credit to people, and retuning the money with interest when depositors wanted it. But banking does many more functions, like financial inclusion, through priority sector lending loans to agriculture, MSMEs, renewable energy, issuing bonds, facilitator in foreign exchange, and many more. That is why it's cascading impact is huge on many other sectors, after all everything needs money.

India also understood the importance of the sector. To make banking more inclusive and secure and safe , nationalization of banking done at early stage. Although some disadvantages are there but helped in making financial inclusion through banks. Later on India implemented Narasimhan recommendations and allowed private sector to participate and can hold 74% of stake. These innovative steps increased competition and productivity of banks.

▪ Banking Crisis in India: Challenges and Problems

At present banking sector in crisis due to many challenges. NPA issue is looming, around 8 lakhs crore nonperforming assets, willful defaulters like Vijay Malya, bank employees collusion with corporates to loot bank, capital to risk adequate ratio dwindling, conflict of interest while sanctioning loans, and many more. But the bigger question is that, what is the root cause of these problems or symptoms? this has to be critically analysed.

➢ Challenges before Indian Public sector Banks

1. **Banking sector has to fulfill n'number of Social Obligations**

   Banking sector has many social obligations but any govt. must handle with professionalism. However banking sector does many **non banking functions** as they are controlled by govt. Demonetization caused great burden on banking sector. Financial inclusion under Jan Dhan yojana, distribution of scholarships, pensions, selling electrical bonds, distribution of laptops and some institutions applications also available at banks also poses a big challenge for the banks. These extra banking functions along with routine banking activities also increases burden and focus of employees also shifting, not giving full time to banking functions.
2. **Ineffective recruitment system**

   Banks recruitment system also not so effective, except SBI other recruitment tests are not so standard and need to be updated to meet the latest standards and requirement. Training to selected candidates also need to updated with latest frauds.

3. **Adopting Non-Compatible Interest Rates**

   To get deposits banks need to offer compatible interest rates, however rates offered by kisan vikas pages, and other small savings scheme are better banks, so banks are not attracting deposits in large scale, govt keep on recapitalizing banks to meet Basel norms. This is not a good trend. Banks can't offer market interest rate but it should not be less than postal scheme interest rates.

4. **Meeting Customers' Expectations**

   Customers face many problems like waiting in queues, cheque bounces, forgetting passwords, failure of net banking and so on. If banks respond quickly customers show interest to banking, otherwise they simply move to chit business, or invest in relation estate or gold.

5. **Lack of Employees Accountability**

   Here employees believe it is not their money and collude with corporates, corporates believe they are not looting people as govt. recapitalize banks, ultimately tax payers money is using to compensate the scams. If taxpayers money is using for filling scams, will they pay taxes , that is why we have low tax to go ratio 11%.

6. Lower salary and perks packages for the Bank Employees

At the lower level salaries are good in public banking sector , however to attract professionals at the higher level , salaries must be increased , otherwise public sector employees collude with corporates like PNB scam. Raghuram Rajan said his salary as professor is 10 times more than RBI governor, reveal the horrible picture , and SBI chairman salary was hardly below 1 crore, whereas any corporate CEO earns 50 crores p.a minimum.

7. Too much Political Interference in Banking affairs

Political interference is another major reason for crisis in banking. Major higher level appointments done by govt, and many former RBI governors talked about finance minister interference in RBI functioning. Recent SBI loan to Adani group also exposed the same. Nayak committee also written about it , and banks board bureau was established to appoint high level officials, however it was not functioning effectively.

8. Funding Infrastructure projects for longer gestation period

Banks lend for infrastructure projects, this was one of major reason for **NPAs** as these projects gestation period is long, so banks must not fund them, and bond market need to take care of it. And other international mechanisms like World Bank, ADB, AIIB can be given more importance.

9. Increased number of Banking Frauds

Fraud was one of the biggest issues bothering RBI**,** with 86 percent of such cases taking place in the loans and advances portfolio of banks. The central bank had also detected serious gaps in credit underwriting standards in a number of lage-value frauds. These included *accepting liberal cash-flow projections, non-monitoring of cash flows, gold-plating (inflating value) of projects and diversion of funds. Describing loan-fraud incidents as an issue of greater significance than PNB-type of frauds.* (Rs.14,500 crores loss in this year).

10. Mounting Non-Performing Assets (NPAs) in Indian public sector Banks

According to the Reserve Bank of India (RBI), the gross non-performing assets in Indian banks, specifically in public sector banks, are valued at around Rs 400,000 crore, which represents 90% of the total NPA in India, with private sector banks accounting for the remainder.Three key Reasons for the Rise in NPA levels!

- From 2000-2008, the Indian economy was in a boom phase and banks, especially public sector banks, started lending extensively to companies.
- However, with the financial crisis in 2008-09, corporate profits decreased and the Government banned mining projects. The situation became serious with the substantial delay in environmental permits, affecting the infrastructure sector – power, iron, and steel – and resulting in volatility in prices of raw materials and a shortage of supply.
- Another reason is the relaxed lending norms adopted by banks, especially to the big corporate houses, foregoing analysis of their financials and their credit ratings.

▪ Ways and Means to come-out from Crisis

There are some arguments that **public sector banking is a major reason for crisis**; however combination of public and private sector worked out well in western counties also, so instead of focusing on privatization of banking, reforming the public sector would help to resolve the crisis.

1. RBI governor Urjit Patel veiled pitch for PSB privatisation: We at RBI also feel the anger, hurt and pain at the banking sector frauds and irregularities. In a pointed accusation at PNB, Patel said the fraud was essentially an operational failure with the bank disobeying instructions.

2. Even former RBI governor Shri Raghuram Rajan had alerted Govt. on Big defaulters and big number of NPAs originated in 2006-08, , when India's economic growth was strong! and banks lent by relying on project investment reports prepared by a promoters investment banks, rather than doing due diligence on their own.(Article in TOI, dated 11/09/2018)
3. RBI has initiated a clean-up through its new norms on NPAs, which is compared to the mythological Amrit Manthan "Until the churn is complete and the nectar of stability safely secured for the country's future , someone must consume the poison that emanates along the way like Neelakanta consuming poison.
4. **NPA problem can't handled by banks alone** , because many governance problems like environment clearance, delay in project approvals, export import policies, and destructive technologies like jio also cause npas. So here both banks and govt work together to resolve the npa problem. There are many steps like asset reconstruction companies, SDR, ,S4DR, insolvency and bankruptcy code, joint lending forum, 5/20 scheme, are taken but much more need to done.
5. "RBI had identified — based on cyber-risk considerations —the exact source of operation hazard, through which we now understand that fraud has been perpetuated. In particular, the RBI had issued precise instructions via three circulars in 2016 to enable banks to eliminate the hazard. It turns out, ex-post; the bank had simply not done so, while RBI will initiate action against the bank, its powers over PSBs would still be limited under the Banking Regulation Act.
6. There are three deterrents to fraud – investigative or legal action, market discipline and regulatory discipline. As far as investigation goes, RBI data showed that only a handful of cases over the past five years had closure and those o substantive economic significance remained open. As a result, the overall enforcement mechanism, at least until now, is not perceived to be a major deterrent to frauds relative to the economic gains from fraud, Market discipline also did not apply to PBSs because of the perceived sovereign guarantee. This should imply that the government should prefer a stronger regulatory discipline of these banks… the situation in India is exactly the reverse. RBIs regulatory powers over PSBs are weaker than over private sector banks.!
   [Top comment:** All the banks should be privatized to stop looting by the rich and to stop loan forgiveness agitations .Nehru created the Kashmir fiasco and his daughter the bank fiasco!.**]
7. RBI is the regulatory power and monitors the banks functionality. However there are many functions to RBI and it can't check each and every transaction so problem raised.
8. There are many statutory audits, multiple checks and balances before do any transaction, however in PNB scam , many audits are bypassed. In the core banking solutions, bank must align with swift, but synchronization not happened, why regulatory failed to check it? After the scam RBI simply banned the letter of undertakings, is it a viable step ???
9. As per bank rules employee need to transfers at regular periods so they can't abuse the position, however in PNB same employee handled the issue for 5 years, failure of RBI in ensuring compliance.
10. Recently CBI questioned the former deputy governor over bypassing statutory audits, this also reveal some laxity from RBI. Internal risk management is crucial while sanctioning loans, here this system failed, but regulatory could not find it, till the scam exposed.
11. However it is not to blame regulatory because public sector banks have more powers when compared with private sector, and RBI is asking for same powers in public sector also.

▪ Some more Specific Solutions to Banking Crisis in India

So from the above paper, failure of governance and regulation both are reasons for crisis in banking sector. There are some good steps like;

1. Amendment in banking Regulation act to give more power to RBI to take decisions to reduce NPA, and above 50 crore bad loans are monitored by enforcement agencies.
2. Steps like big private audit firms must audit which public sector banks would not allow now, and
3. Independence and autonomy to banks while ensuring compliance,
4. Market based salaries to higher professionals,

5. Clearing the balance sheets would ensure sustainability of banking sector.
6. Laws like confiscation of property of fugitives, and extradition treaty with nations like UK and western nations help to repatriate those absconders like Malya,Modi.

Recent Developments and Ways to tackle NPAs

6. **Insolvency and Bankruptcy Code (IBC)** – With the RBI's push for the IBC, the resolution process is expected to quicken while continuing to exercise control over the quality of the assets. There will be changes in the provision requirement, with the requirement for the higher proportion for provisions going to make the books better.
7. **Credit Risk Management** – This involves credit appraisal and monitoring accountability and credit by performing various analysis on profit and loss accounts. While conducting these analyses, banks should also do a sensitivity analysis and should build safeguards against external factors.
8. **Tightening Credit Monitoring** – A proper and effective Management Information System (MIS) needs to be implemented to monitor warnings. The MIS should ideally detect issues and set off timely alerts to management so that necessary actions can be taken.
9. **Amendments to Banking Law to give RBI more power** – The present scenario allows the RBI just to conduct an inspection of a lender but doesn't give them the power to set up an oversight committee. With the amendment to the law, the RBI will be able to monitor large big accounts and create oversight committees.
10. **More "Hair-cut" for Banks** – For quite some time, PSU lenders have started putting aside a large portion of their profits for provisions and losses because of NPA. The situation is so serious that the RBI may ask them to create a bigger reserve and thus, report lower profits.
11. **Stricter NPA recovery** – It is also discussed that the Government needs to amend the laws and give more power to banks to recover NPA rather than play the game of "wait-and-watch."
12. **Corporate Governance Issues** – Banks, especially the public sector ones, need to come up with proper guidance and framework for appointments to senior level positions.
13. **Accountability** – Lower level executives are often made accountable today; however, major decisions are made by senior level executives. Hence, it becomes very important to make senior executives accountable if Indian banks are to tackle the problem of NPAs.

- **Using unclaimed deposits** – Similar to provisions for unclaimed dividends, the government may also create a provision and transfer unclaimed deposits to its account. These funds in return can be transferred to banks as capital.
- **Monetization of assets held by Banks** – In this case, banks with retail franchisees should create value by auctioning a bank assurance association rather than running it themselves as an insurance company. The current set-up blocks capital inflows and doesn't generate much wealth for the owners.
- **Make Cash Reserve Ratio (CRR) attractive** – At present, the RBI asks Indian banks to maintain a certain limit on CRR on which the RBI doesn't pay interest and hence, banks lose out a lot on interest earnings. If the CRR is made more financially rewarding for banks, it can reduce capital requirements.
- **Refinancing from the Central Bank** – The US Federal Reserve spent $700 billion to purchase stressed assets in 2008-09 under the "Troubled Asset Relief Program." Indian banks can adopt a similar arrangement by involving the RBI directly or through the creation of a Special Purpose Vehicle (SPV).
- **Structural change to involve private capital** – The compensation structure and accountability of banks create a problem for the market. Banks should be governed by a board while aiming to reduce the government's stake and making the financial institutions attractive to private investors.

▪ Conclusion

To conclude, in India banking is not simply an institution to save money, but a way of life, part of life. Any major activity like marriage, seeding, education would not start without withdrawing money from bank. Although banks don't offer big interest rates, people deposit money out of Nostalgia, safe venture or out of habit. But now this great sector is facing many scandals.

Some people are using banks to become richer, willfully not paying bank loans. In that case how banks give loans to start ups? Although RBI reduced repo rate, banks are not willing to reduce credit rate due to fear of NPAs, thus credit growth declined. Many bank officials are fear of CBI, Ed and not taking risks to avoid torture. This scenario should be altered. Future belongs to credit availability. Hence RBI has increased the repo rate (key lending rate) by 25 basis points from 6.25% to 6.50%. This is the second hike in repo rates this year. The reverse repo rate has also increased to 6.25% from 6% and the Marginal Standing Facility Rate (MSF) and the Bank Rate has increased to 6.75%.

Agriculture sector alone need 11 lakhs crore loans, how we meet huge demand if banking sector in crisis. So both govt. and RBI must implement all steps to regain credibility of banking, and people also should not lose faith due to one or two scams, and support the sector by reposing unflinching faith, in that case banking sector would easily overcome this crisis, like it did in the past.

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Appendix-1

Financials of 12 companies that are likely to be in the RBI's 12 big NPA accounts referred for insolvency						
Company	Year	Net worth	Gross debt	Total assets	Total income	Net profit
Essar Steel	FY16	8617	29488	62700	14379	-5800
Lanco Infratech	FY17	-2074	43502	45065	7510	-2255
Bhushan Steel	FY17*	4658	42356	48327	13778	-3121
Bhushan Power#	NA	NA	37248	NA	NA	NA
Alok Inds	FY17	1703	23443	25432	8988	-3072
Monnet Ispat	FY17	-1602	10333	8902	1275	-1870
Era Infra Engg	FY17	-1981	10129	8377	1286	-1414
ABG Shipyard	FY16	-2822	8742	5926	38	-2730
Jaypee Infratech	FY17	5921	8606	14871	1164	-989
Electrosteel Steel	FY17	-568	7505	6946	2635	-1463
Amtek Auto	FY17	2467	3928	14404	2719	-3253
Jyoti Structures	FY17	-1700	3387	1885	916	-1426
Total		**12620**	**228668**	**242834**	**54687**	**-27394**
*Figures in Rs crore; *Net worth, gross debt and total assest are for FY16; #data from media reports Source: CapitalinePlus*						

The above table -1anks to initiate forced-bankruptcy proceedings against 12 large defaulters that, between them, account for 25 percent of the banking system's non-performing loans; another 26 defaulters are scheduled to be forced into bankruptcy in December if their restructurings have not been resolved by then. This high level of non-performing loans is eroding the ability of public-sector banks to retain earnings and is thereby damaging their capital positions. Under Basel III, banks must have capital ratios of at least 11.5 percent by March 201

Appendix -2 The Roots of the current Banking Crisis

i. **Which shows bank credit as a proportion of gross domestic product, or GDP?**

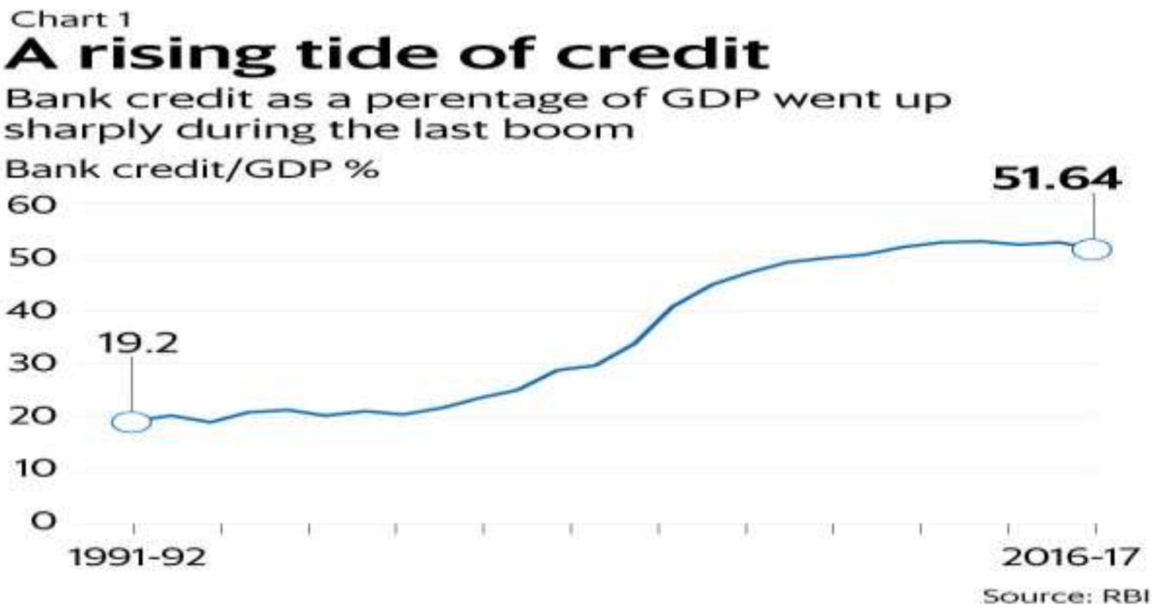


Chart 1 shows that from 1991-92 to 2001-02, or the first decade after economic liberalization, the bank credit-to-GDP ratio expanded from 19% to about 25%. In the next decade, that includes the boom period and the fiscal stimulus that followed, this ratio more than doubled from 25% to 52%. The percentage by itself is not very high—indeed, China's bank credit to GDP ratio is three times as much. But the point is the rapid rate of credit expansion during the boom period. This is perfectly normal, as credit is needed to fuel the boom. The credit cycle expands with the business cycle and collapses with it.

ii) Which bank groups were lending the most during the boom years?

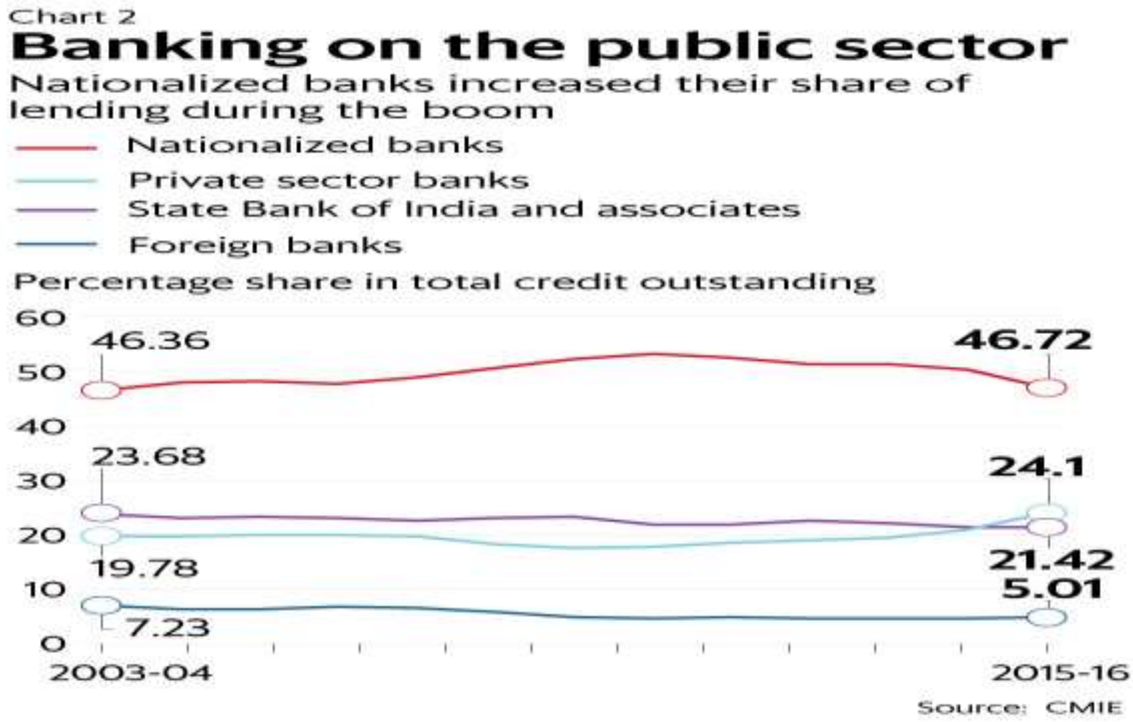
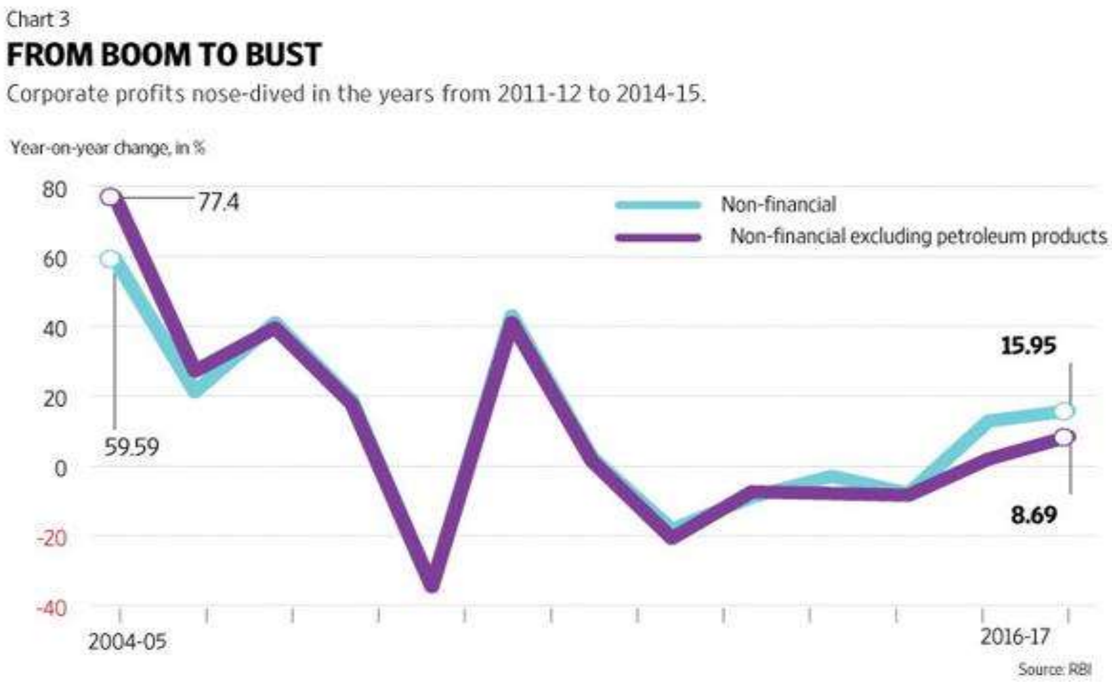


Chart 2 **has the answers**.

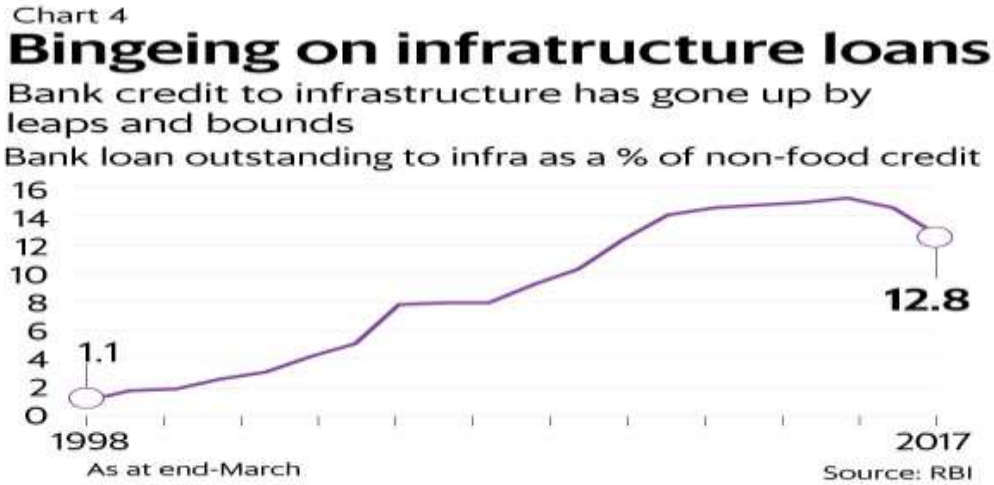
1. While the share of private banks in total bank credit was more or less the same in 2003-04 and 2013-14, the share of nationalized banks went up sharply during the period, especially after the global financial crisis. Those loans are now coming home to roost. Private sector banks, as a result, are now increasing their market share.
2. The boom of 2003-08 saw some of the highest GDP growth rates for the country. It was part and parcel of a global boom; so, when the financial crisis struck in 2008, India, too, was badly affected. The government, in an effort to cushion the economy from the global contagion, rushed to administer a stiff dose of fiscal stimulus. As a result, the combined deficits of the central and state governments went up from 4% of GDP in 2007-08 to 8.3% in 2008-09 and further to 9.3% in 2009-10. Even in 2011-12, it was as high as 7.8% of GDP.
3. This fiscal push to growth, together with the Reserve Bank of India's (RBI's) loose monetary policy, led to rampant inflation, which was exacerbated by a steep increase in the price of crude oil. Prices for industrial inputs also soared, because China, too, was trying to grow its economy by a massive dose of stimulus.

iii) State of Corporate Profits



The upshot was the government push wasn't enough to keep growth rates up. The aggregate profits of non-financial private sector companies started shrinking from 2011-12, according to data from the Centre for Monitoring Indian Economy *(see Chart 3)*. The interest cover of companies fell, affecting their ability to service and repay bank loans. As a result, loans started going bad and the increase in non-performing assets (NPAs) was aided by an RBI determined to clean up banks' books.

iv) Status of Infrastructure Lending by Banks since 1998



Were the bad loans the result of the credit cycle then? Not all of them. Consider *Chart 4*, which shows bank loans outstanding to infrastructure as a percentage of non-food credit. Note the sharp rise from 1.1% of non-food credit in 1998 to 15.4% by 2015, before the lending spurt led to a build-up of bad loans and stranded assets, and banks beat a hasty retreat. As I had pointed out three years ago, the government used bank funds to plug its investment deficit.

v) Lion share of Bad loans by Public sector banks

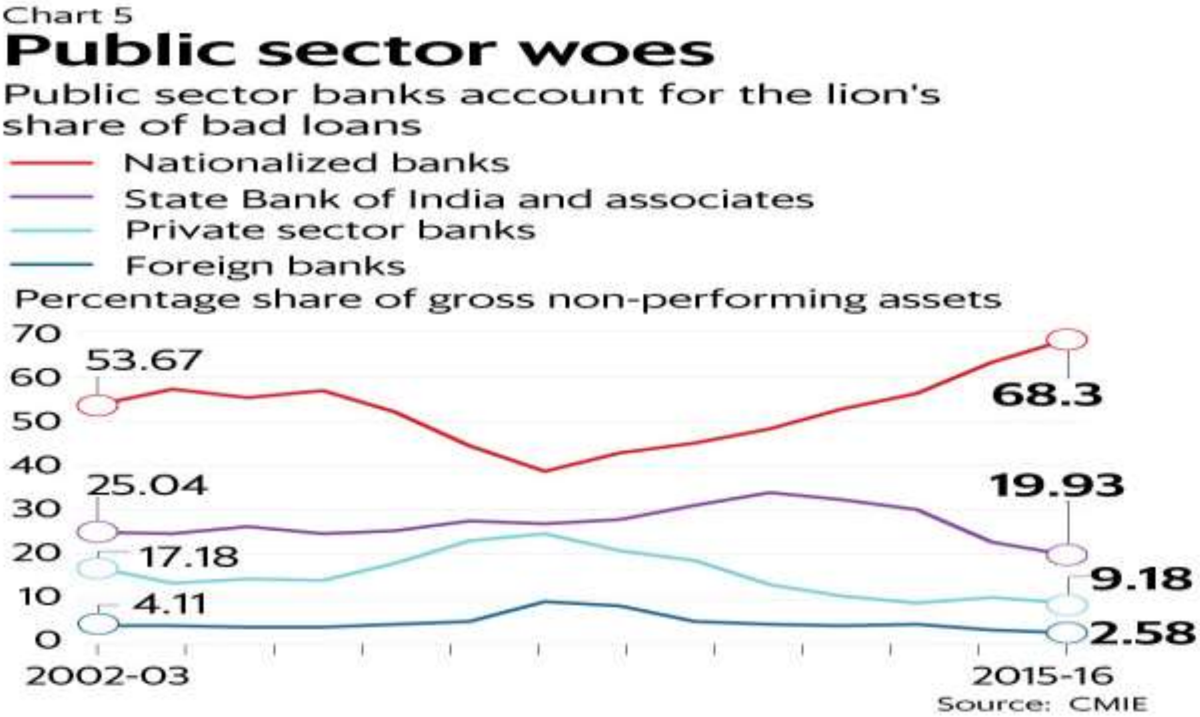


Chart 5 gives the share of bad loans among bank groups. Rather strangely, the share of NPAs for nationalized banks went down in 2008-09, at the height of the financial crisis. The data show that while the share of NPAs of private and foreign banks fell from 2010 onwards, the share of nationalized banks continued to rise. This was partly because the share of nationalized banks in loans went up during this period and also because they hid their bad debt. If we add restructured accounts, nationalized banks will have an even bigger share of the pie.
So, the bad loan mess in banks today, as well as the revelations of fraud and malfeasance, is related to the credit boom of earlier years. During the good years, profits and animal spirits are high and all kinds of investments are undertaken, many of them hare-brained. When the cycle turns, banks are often left holding the can.

Are bad loans and frauds an inevitable consequence of a boom then? That is only one part of the story. The data also show state-owned banks are the ones most prone to going overboard during the boom, while racking up the most in bad loans during the bust. Poor controls and oversight, political interference and a faulty incentive structure are all responsible.

As former RBI deputy governor K.C. Chakrabarty said in a speech in 2013, “PSBs (public sector banks) suffer from some structural deficiencies related to the management and governance arrangements. Instances of lax credit management (credit appraisal, credit supervision, etc.,) and poor governance and management standards which, though persisting even before the crisis, were not dealt with in time and, eventually, impacted much more emphatically than was anticipated.” Sadly, nothing much seems to have been done about it since then.
That said, at least we now have an insolvency and bankruptcy mechanism that will force banks to resolve their bad loans quickly when the next surge in the NPA cycle occurs.

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