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How to Sustain the Good News on NPAs

Bank governance, bond market regulation key

In its twice-annual report on financial stability released on December 31, the Reserve Bank of India (RBI) finds that bad debt held by banks fell from 11.5% of all loans to 10.8% between March and September 2018, and could fall further to 10.3% by March 2019. A drop in non-performing assets (NPAs) is welcome. The new package of debt restructuring announced for small borrowers with total loans of up to ₹25 crore might dent this trend. But not much, as large entities accounted for 55% of bank borrowings, but near-84% of defaults. The real deal for small industry lies in genuine financial inclusion, so that they can access the bulk of their financing from the formal sector. Forcing banks to pick up the tab for the demonetisation blunder and clumsy GST implementation will not help.

RBI's optimism for the future hinges on several factors. One, lenders have to be empowered further, possibly with greater protection from arbitrary charges of mala fide while taking decisions on haircuts while resolving bad loans. Two, banking sector governance and regulation must change, to preclude re-emergence of another NPA build-up. Three, RBI must keep a keen eye on financial companies that fund everything from tractors to infrastructure. The collapse of Infrastructure Leasing & Financial Services (IL&FS) showed the risks of circular lending via complex, layered structures Four, we face a dilemma reconciling money borrowed short term, but lent out for longer to, say, build slow-moving infrastructure projects. The only way to cut through this asset-liability mismatch is to create and nurture a market for long-term bonds. Some may have sovereign backing, bonds could originate from public or private lenders, but sensible prudential regulation is the only guarantee against a bond bubble.

Finally, the health of a financial system is only as good as the state of the real economy. January-June 2019 earnings are likely to be buffeted by risks of US rate hikes, oil price hardening, sluggish domestic demand and the outcome of summer's Lok Sabha elections, risks that nimble-headed policies can mitigate and resolve.