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Abstract: India's financial system has never collapsed – unlike many other emerging economies. But it suffers from a deep and expanding silent crisis, which has made it one of the most inefficient and non-inclusive financial systems in the world. This paper unravels the reasons for this deep crisis – who is responsible – the regulators, populist politicians, crony capitalists and India's fiscal dominance. It shows that all the above are culpable. It lays out the major reforms needed and argues that if deep surgery is not performed India cannot emerge as a global economic powerhouse in the 21st century and will remain stuck in a low middle-income trap.

JEL Codes: G00, G01, G18, G21, G32, G33

Key Words: Financial Crisis; Public Sector Banks; Financial Inclusion; Banking Reform

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'If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem.'

—J. Paul Getty, American-British Industrialist

India's financial system is in trouble, and unless it's fixed there is not a hope in hell it will become an economic powerhouse in the twenty-first century. It's like a patient with serious cardiac disease. At a minimum, it needs something akin to multiple bypass surgery but even simple angioplasty, to fully clean the clogged arteries, has not been performed.

The banking system, which is the heart of the financial system, has been weakened over the years. The cardiologists (regulatory bodies) overseeing this patient have been arguing for many years that India's financial system is fine because it has not suffered a cardiac arrest (a banking crisis). Individual banks have gone under, but they have typically been dealt with by merging them with another bank—the most recent, at the time of writing this, being the Laxmi Vilas Bank—merged with a subsidiary of DBS Bank in November 2020.

Multiple committees have been set up to improve the financial and banking systems, but their recommendations have been ignored or at best taken on piecemeal. Some minor reforms are undertaken—especially after another failure like the collapse of Infrastructure Leasing & Finance Services (IL&FS) Ltd or the exposure of a financial scam such as the Vijay Mallya or Nirav Modi scandals, but then inertia sets in. While the financial system has not suffered a fatal cardiac arrest—there has been no run on the banks—smaller heart attacks have occurred and been patched up. Rising non-performing assets (NPAs) are a sure sign of the growing disease. The NPAs have been there for some time, growing rapidly during India's credit boom of the 2003–2008 high-growth period but then exploding after the 2009 financial crisis when India opened the credit spigots to help the economy recover.[i] Efforts to resolve them began after the passage of the Insolvency and Bankruptcy Code (IBC). But the decline was very slow and even that stalled

after several court rulings weakened the process, by stopping the takeover of the companies which were in default.

The government announced a large package termed Atma Nirbhar Bharat Abhiyan (Self Reliant India Mission) in 2020. Much of it provided relief through financial forbearance (including a hold on the IBC) and lowered interest rates. But subsequently the budget for FY21-22, acknowledged substantial contingent liabilities – especially relating to the Food Corporation of India and by doing so increased the fiscal support. A second package was announced in June 2021 to help companies deal with the economic impact of the second COVID-19 surge. The bulk of this is once again done through credit guarantees – especially directed this time to health and tourism related sectors. Whether the first round and subsequent financial forbearance will lead to larger NPAs remains to be seen.[ii]

If you look deeper, India has been underserved by its financial system more fundamentally than just the issue of bad loans. India has the least efficient and the least inclusive financial system in the world as well. The intermediation cost—the difference between the average deposit rate and the average lending rate—of India's financial system is over 500 basis points. The credit-to-GDP ratio, another indicator of a healthy financial system, has grown—but very slowly to reach 50 per cent in 2019 (figure 11.1)—much lower than the fast-growing economies of East Asia, where that ratio is well over 100 per cent.[iii] India has opened new accounts for tens of millions under the Jan Dhan scheme but, on most usage indicators, India's financial system remains the least inclusive.

There is collective and accumulated responsibility for the mess the financial sector is in—from scam artists, populist and corrupt politicians, crony capitalists, supplicant bankers and unclear regulations, to a web of relationships between the Ministry of Finance and the Reserve Bank of India. It's an Agatha Christie whodunnit like the *Murder on the Orient Express*, where the famous detective Hercule Poirot discovers that everyone is to blame for the murder.[iv]

Let us try and disentangle this web to understand the collectiveness of the crime—the victim is, of course, the taxpayer and the Indian economy.

Efficiency of India's financial system

The job of any financial system is to take deposits and efficiently transfer them to borrowers who can use these financial savings to generate economic activity, which creates jobs and improves people's livelihoods. Credit flow is like blood circulation in a human body, pumped by the heart to different parts of the body to sustain life and activity. How effectively it does that depends on the strength of the heart and clear pathways (arteries) to different parts of the body.

The banking system provides that same function for the economy. How efficiently does it do that? There are reams of reports on the Indian financial system and much technical jargon to analyse it, but some basic facts and figures, with some international comparisons, will tell us in simple and understandable terms how India's financial system performs. One basic measure for a financial system's effectiveness is the cost of banking intermediation, measured by the difference between the average lending rate and the average borrowing rate. On average globally, that difference is about 200–300 basis points, whereas in India it is over 500 basis points (table 11.1).

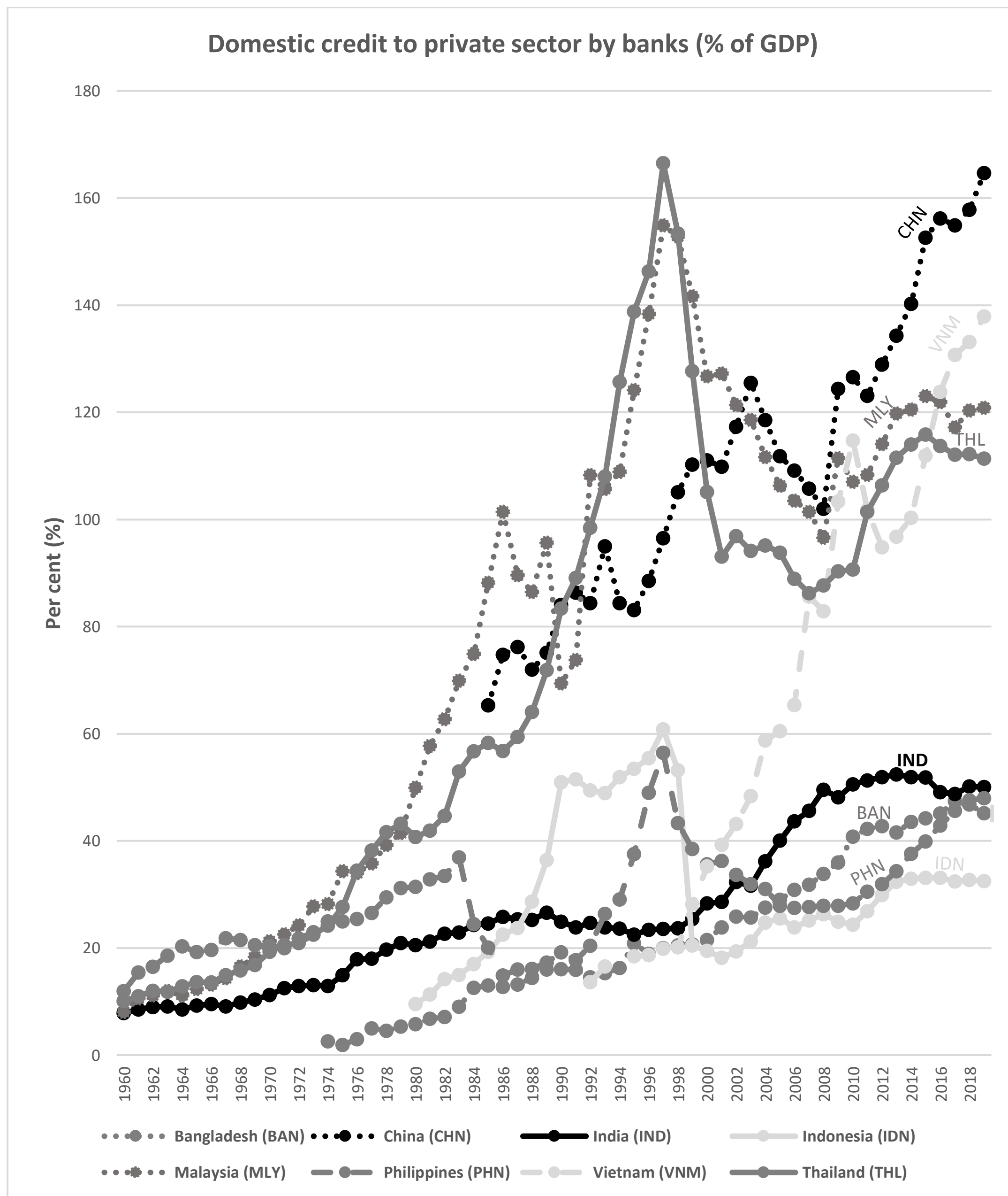
Very few countries have an intermediation ratio higher than 500 basis points. Argentina, Kenya, Russia, and Venezuela are in that group. Thailand, Indonesia, Bangladesh, and Pakistan have intermediation costs in the range of 300–400 basis points—lower than India. China, Sri Lanka, and Viet Nam are in the range of 200–300 basis points, and Japan, Korea and Malaysia are the most efficient with intermediation costs under 200 basis points. Surprisingly, Singapore and Hong Kong have intermediation costs of 500 basis points. Nevertheless, within Asia, India has the most inefficient financial system, and these costs are passed on to borrowers, reducing India's competitiveness.

Table 11.1: Bank lending–deposit spread for select countries

Country	2014	2015	2016	2017
Argentina	4.3	3.7	7.0	9.7
Venezuela, RB	2.5	4.5	5.7	6.3
Kenya	8.1	6.9	7.9	6.0
India	6.5	6.0	5.4	5.1
Singapore	5.2	5.2	5.2	5.1
Myanmar	5.0	5.0	5.0	5.0
Hong Kong SAR, China	5.0	5.0	5.0	5.0
Russian Federation	5.1	6.5	5.6	4.7
Mexico	2.7	2.8	3.4	4.6
Indonesia	3.9	4.3	4.7	4.6
Bangladesh	3.1	3.5	4.2	3.9
Philippines	4.3	4.0	4.0	3.7
Pakistan	4.5	4.2	3.9	3.7
Australia	3.0	3.3	3.3	3.2
South Africa	3.3	3.3	3.3	3.1
Thailand	3.2	3.3	3.2	3.1
Israel	3.1	3.0	2.9	3.0
China	2.9	2.9	2.9	2.9
Viet Nam	3.2	2.3	2.2	2.6
Canada	2.5	2.7	2.6	2.6
Sri Lanka	0.3	1.0	3.4	2.6
South Korea	1.7	1.7	1.8	1.8
Malaysia	1.5	1.5	1.5	1.7
Japan	0.8	0.7	0.7	0.7

Source: Global Financial Development Database (October 2019).

Figure 11.1: Credit-to-GDP growth; India and selected comparators



Source: *World Development Indicators,* World Bank (October 2020).

One would expect high NPAs if the banking system provides a lot of credit to the private sector. But despite all the pressures for directed lending and a huge unmet demand for credit, the amount of credit India's banking system provides to the private sector is relatively small. In

2019, the ratio of credit to the private sector by the banking system to GDP was only 50 per cent—similar to Bangladesh and to weaker economies in East Asia such as Indonesia and the Philippines, and much smaller than the rapidly growing economies of China, Malaysia, Thailand and Viet Nam, where that ratio is well over 100 per cent of GDP and in the case of China, over 150 per cent of its huge GDP (figure 11.1). Not only is banking intermediation costly in India, but there is also, as a result, much less of it.

Why is India's banking system so inefficient?

There are at least four factors that explain why India's banking system is so inefficient.

1. High non-performing assets (NPAs)
2. Statutory liquidity requirements
3. Directed lending requirements
4. Inefficiencies in public sector banks and costs of financial inclusion directives

Rise in non-performing assets

The issue of NPAs is not a new one. In the past, it was kept hidden. India nationalized a large part of its banking system in 1969. Since then, public sector banks (PSBs) have dominated Indian banking. Subsequently, private, and foreign banks were allowed in—especially after India liberalized its economy in 1991 and grew so rapidly that by 2018-19, almost 40 per cent of gross advances were from private banks. In 2008, just before the global financial crisis, private banks had more NPAs than public sector banks. Revealed NPAs in public sector banks were surprisingly small. But once more stringent criteria were applied, especially after 2015, the hidden NPAs in public sector banks were exposed (tables 11.2 and 11.3).

Part of the reason for large NPAs was directed lending. Public sector banks were required to lend 40 per cent of their total loans to the farm sector and to micro, small and medium-sized enterprises (MSMEs). If farm debt got too high and farmer agitations began, mass loan waivers were introduced.[v] Pressure would also build up just before a major election to write down MSME

loans. But a bigger part of the NPAs comes from connected or crony lending, which went to politically well-connected corporates. And when they were unable to pay, instead of their loans being declared NPAs, corporate debts were restructured, especially for well-connected crony capitalists. It was known as 'phone call' banking where a phone call from the finance ministry to the manager of the state bank called for a restructuring of loans to a major corporate, presumably with some payback to the party in power.

Table 11.2: NPAs in all commercial banks—public and private

Year (End March)	Gross NPA as % of total assets	Gross NPA's as % of gross advances	Net NPA's as % of total assets	Net NPA's as % of net advances
Mar.2021		7.5		2.7
Sep 2020		9.3		3.7
Mar2020		8.5		3.0
2018-19	5.6	9.1	2.1	3.66
2017-18	6.8	11.22	3.4	5.96
2016-17	5.6	9.34	3.1	5.34
2015-16	4.7	7.49	2.7	4.43
2014-15	2.7	4.27	2.5	2.38
2013-14	2.4	3.84	2.3	2.12
2012-13	2	3.25	2	1.68
2011-12	1.7	3.08	0.8	1.28
2010-11	1.4	2.45	0.6	0.98

Source: RBI Financial Stability Reports

Once a public sector bank was in serious difficulties, it was either merged with a bigger public sector bank and fresh capital at taxpayers' expense was injected to reach capital adequacy requirements. Private banks did not suffer from these pressures. Things got worse after the global financial crisis: as India used fiscal and monetary stimuli to revive the economy, public sector banks were instructed to lend heavily. These loans also formed a substantial part of the subsequent NPA problem. Raghuram Rajan, then governor of the RBI, called it 'riskless capitalism'[vi] and Arvind Subramaniam, the chief economic advisor, called it 'stigmatized capitalism'.[vii] The NPAs contributed considerably to the high intermediation spread as banks were required to provision against these NPAs and these provisioning needs kept rising.

Table 11.3: NPAs in public sector banks

Year (End March)	Gross NPA's as % of total assets	Gross NPA's as % of gross advances	Net NPA's as % of total assets	Net NPA's as % of net advances
Mar.2021		9.5		4.8
Mar.2020		10.8		5.1
2018-19	7.3	11.6	2.8	4.81
2017-18	8.9	14.59	4.5	7.97
2016-17	7	11.68	3.9	6.89
2015-16	5.9	9.28	3.5	5.72
2014-15	3.2	4.95	1.8	2.92
2013-15	2.9	4.37	1.6	2.57
2012-13	2.4	3.62	1.3	2.01
2011-12	2	3.32	1	1.52
2010-11	1.4	2.44	0.7	1.09

Source: RBI Financial Stability Reports

In 2015, the RBI persuaded the government to allow it to get tough with recalcitrant corporates. There was a moment, a fleeting one though, at the end of 2015 when we thought the system was seriously going to address the NPA problem. An IBC legislation was introduced into Parliament. At that stage, gross NPAs (GNPAs) were some Rs 4 trillion (lakh crores) and net NPAs (NNPAs) around Rs 2 trillion—provisioning was around Rs 2 trillion (tables 11.2 and 11.3). A strict regime of classification and provisioning was introduced, made even stricter in early 2018. The balance of power shifted from the borrowers to the bankers. India's 'riskless capitalism' now became risky. Corporate bosses could not borrow with impunity and faced the threat of losing their companies.

Harsh Vardhan (2021) argues that this pressure led to deleveraging by large corporations whose debt-equity ratio fell from over 0.25 in 2014 to under 0.20 by 2018.[viii] Banks also became more risk averse, and their risk weighted assets dropped from over 70 per cent in 2014-2017 to 65 per cent by 2019 and even further in 2020 and 2021. They shifted their lending to consumer lending and through non-banking financial companies (NBFCs) at least until 2018 when the IL&FS crisis halted NBFC lending. The share of industry in bank credit fell from 43 per cent in 2011 to 31.4 per cent by 2020. Consumer loans rose from 18.7 per cent to 27.6 per cent.

The first round of resolution was started, especially in the steel sector, where valuations increased, and recovery rates were high. But the process was slow. The IBC was a good reform, but it was useful only for dealing with one-off bankruptcies. It was too slow to deal with systemic problems where large parts of the corporate sector and the banking system were in distress. For that, an asset resolution trust company was needed. But such an approach would require that the government put up the money to take these assets off the books of the banking system and park them in an asset resolution agency.[ix] Instead, the government doubled down to make the IBC process stronger. Stricter ordinances were brought in to strengthen the IBC process and a clever piece of financial engineering was used to recapitalize the state banks, without the cost showing on the fiscal balances of the government.[x] According to a World Bank assessment in 2018, before IBC, the time taken to resolve stressed loans was 4.3 years and the recovery rate

was 26 per cent for financial creditors. Two years into IBC, this improved to 48 per cent recovery, which takes about 1–1.5 years through the IBC (79 resolution cases).

But as GNPAs rose above Rs 10 trillion (above 6 per cent of GDP and over 11 per cent over advances) and pressure began to build up in the system, also exacerbated by demonetization and global oversupply in some sectors such as steel, and overcapacity in some like the power sector, the cry for latitude went up again. Corporate bosses (promoters) realized for the first time that they could lose their entire company or companies. Several went to court and while initially, the court upheld IBC, subsequent rulings raised doubts on some interpretations of the Act. For example, the Supreme Court ruled that the National Company Law Tribunal (NCLT) has jurisdiction to adjudicate disputes related solely to the insolvency of a corporate debtor and not beyond that. It also held up taking power companies into the resolution process. That fleeting moment when it looked like India might get serious about banking reform was lost.

With COVID-19, as the lockdown sent the economy off the cliff, the IBC has been shelved for at least one year and may never be the same again. And a much bigger stock of NPAs may emerge post COVID-19. The Reserve Bank of India financial stability report for 2020 estimates:

> "Macro stress tests for credit risk indicate that the GNPA ratio of all SCBs may increase from 8.5 per cent in March 2020 to 12.5 per cent by March 2021 under the baseline scenario. If the macroeconomic environment worsens further, the ratio may escalate to 14.7 per cent under very severe stress. "
>
> But surprisingly, despite the pandemic, the GNPA ratio for all commercial banks declined from 8.5 in March 2020 to 7.5 in March 2021. It did rise for private commercial banks from 4.8 in March 2020 to 5.1 in March 2021 and rose for foreign banks as one would expect during a pandemic. But for public sector banks it has fallen very drastically from 10.8 in March 2020 to 9.5 by March 2021. Some argue that the rapid recovery is responsible for this improvement. Others say the state banks have made efforts to resolve bad loans through the IBC process more aggressively. And there is some evidence that some borrowers are taking on new loans with the government guarantees provided post-

COVID to pay back some loans classified as NPA's. Whichever of these is the right explanation needs to come out – if the RBI's regulatory role in monitoring state banks has not been compromised again. The RBI's ability to regulate and monitor state banks was compromised earlier and we could end up back to the bad old days of Indian banking. The RBI's 2021 Financial Stability Report still shows that under extreme stress GNPAs for the system could rise to over 11 percent in the future, down from its scenario projection of 14.8 per cent in the 2020 report. The share of large borrowers in the aggregate loan portfolio of State Banks stood at 52.7 per cent in March 2021, but they accounted for a share of 77.9 per cent of the total GNPAs – so they account for a larger part of the problem – not smaller borrowers.

Sane and Feibelbaum (2021) argue that the IBC process should be fixed to allow more restructurings – even by existing promoters if they bring in new capital.[xi] They believe that the IBC process is much too fixated on resolution and liquidation rather than on restructuring. It had become a very mechanical process, with very little judicious and discretionary judgements on future viability of firms. As they say, 'bank employees – both public and private –are considered public servants under the Prevention of Corruption Act (POCA). As a result, they face perceived legal risks in the judgments they make about restructuring loans. In such a position, it is easier to mechanistically choose among bids rather than engage in complex negotiations with borrowers.'

The IBC no doubt needs improvement, but it's a useful mechanism for dealing with individual cases – not systemic problems which will require much more drastic and quicker methods – such as an Asset Resolution Agency, to quickly clean up the large block of NPAs. Delay will be very costly for the post-pandemic recovery. The Indian Banks' Association (IBA) has moved an application to the Reserve Bank of India (RBI) seeking license to set up a Rs 6,000-crore National Asset Reconstruction Company Ltd (NARCL) or bad bank. This application needs speedy approval.

Statutory liquidity requirements (financial repression)

Fiscal dominance is the other reason why India's banking system is so inefficient. Financial repression—a method by which the government forces the financial system to finance its deficit—has a peculiarly Indian term called the statutory liquidity ratio (SLR). The SLR is the amount of its assets the banks are required to hold in liquid assets. Very conveniently, the government's security bonds were declared to be liquid assets, so a bank could meet SLR requirements by buying them.[xii] The SLR rate[xiii] was around 20 per cent in 1949 but reached a peak of 38.25 per cent in 1992 and since then has been declining but remains at 18 per cent. Very few countries in the world have SLR requirements, and even in Bangladesh and Pakistan, which still maintain SLR requirements, they are lower than in India.

There is also a complex and nested relationship between the RBI and the government, which weakens the former's ability to supervise the banking system and carry out monetary policy. The RBI stopped buying government bonds in 1997 so that the automatic monetization of the deficit was curtailed. But the RBI remained the debt manager for the government, whereas in most countries, debt is managed by the finance ministry or by an independent debt office. The problem with having the RBI as the debt manager is that it sets up a conflict of interest for the RBI. Its primary mandate is to control inflation, for which it may need to keep interest rates high, but as debt manager, it wants to keep interest rates low to sell government bonds.

These conflicts then create incentives for the RBI to force the banking system to hold government bonds—especially after it stopped buying government bonds. For this, the SLR is a useful tool and explains why SLR has remained so high for so long. Another cost of all this financial repression is that the development of the corporate bond market has been held back.[xiv] And it may also help explain why the government is reluctant to further privatize the banking system.

Directed lending

All commercial banks – not just state banks or one or two of them - are required to lend 40 per cent to agriculture, exports and MSMEs. This directed lending ostensibly to priority sectors puts additional burden on the banking system. In 2015, not satisfied with these directives, a Micro

Units Development and Refinance Agency Bank (or MUDRA Bank) was established to ensure more funding to micro-enterprises. Much of the initial advances were simply old loans which were reclassified as MUDRA loans. With the downturn due to COVID-19, almost all of it will have to be written down as a loss to the taxpayer. But the amounts are small compared to the large NPAs of the corporate borrowers. They nevertheless add considerable costs to the banking system. Until 2012, bank lending to NBFCs, which was on-lent to priority sectors, was counted as meeting part of that bank's priority sector lending requirement. But that was stopped and added to the burden for banks to now compete with NBFCs for priority lending borrowers.

One reason for directed lending is to improve inclusion. But as NPAs in priority sectors have gone up, it is not clear that this is the best way to improve financial inclusion. In most countries, specialized banks or development finance institutions are created to cater to priority sectors. In no country do you find all commercial banks having to direct a part of their lending to priority sectors—at least not as high as 40 per cent of all lending. It would be better to designate one or two banks for this kind of priority lending and back them with fiscal support for subsidized lending and leave the remaining banks to do 'proper and fit' commercial banking. And NBFCs can play a much better role in reaching these priority sectors as they are closer to the ground and have much better information of the risks involved in such lending, and much lower transaction costs due to less burdensome regulations.

Inefficiencies in public sector banks and costs of financial inclusion directives

One of the most momentous decisions of India's move towards a socialistic economy was the nationalization of the banking system. A major reason why India nationalized its banking system in two phases in 1969 and 1980 was to direct lending to priority areas—agriculture, MSMEs and exports.[xv] Other factors were that many banks were owned by corporate promoters who were usurping much of their lending towards their own companies. But this problem could have been resolved by forcing them to put limits on self-lending or by forcing corporate businesses to sell their banks to non-business owners, as is the case in the USA and UK. Instead, Prime Minister Indira Gandhi wanted to send a loud political signal of her government's socialistic orientation

through bank nationalization.[xvi] Nationalization put over 90 per cent of India's banking system into state hands.

State banks have dominated Indian banking since 1969, when the first wave of nationalization was enacted, followed by a second round in 1980. By 1992, there were twenty-one state banks that controlled more than 90 per cent of Indian banking (in terms of deposits and loans). There is still considerable debate in India on whether nationalization was a good thing. Since the liberalization of the economy in 1991, private banks have been licensed and grown rapidly so that state banks now control 70 per cent of the banking system.

Until recently, when the BJP-led government announced its intention to sell two state banks, no major political party in India has ever been for the privatization of state banks. Private banks were licensed for the first time again after liberalization and several of them, such as HDFC (India's largest private bank), ICICI and IDFC, emerged from state-owned development finance institutions into banks. India today has twenty-two private sector banks. They grew rapidly, especially during India's high-growth period from 2000 to 2012. State banks' shares in the market have gradually declined so that by 2019 they now have around a 40 per cent share of the Indian banking sector (about 63 per cent of deposits and 57 per cent of loans). These shares would have fallen further but all government deposits and those of state-owned entities must be kept in state banks. No state bank has been privatized but over time there has been de facto privatization of the Indian banking sector. Several sectors, such as airlines, telecommunications, and retail banking, have been dominated by private banks.

Rising NPAs—especially in state banks—have resulted in reduced stock market valuations of state banks. One single private bank, HDFC, had a valuation larger than all state banks combined in 2019. There has been a growing clamour for reform and even privatization of state banks. Over the years, innumerable committees have been set up to reform the banking system, but their implementation has been limited and spotty. The most comprehensive of these was the Narasimham Committee II report of 1998 which led to a wide set of recommendations on the role of the RBI, reform of the banking system and the role of state banks. Reforming state banks has been the most difficult aspect of these recommendations. Recently, the focus has been on

mergers and consolidation. A Bank Business Bureau (BBB)[xvii] was set up to improve the selection of bank managers and monitor the progress of state banks—but its powers are limited and often overruled by the banking department of the finance ministry.

Facing mounting losses, India has been forced to recapitalize its state banks. A partial recapitalization was carried out in 2018 with a clever piece of financial engineering. Banks issued bonds, which were purchased by the government and used to recapitalize the banks themselves. This meant that the fiscal liability of the government was only the interest payment on these bonds—no market player was involved in this transaction. But in return, the state banks were asked to carry out some internal reforms, such as better credit controls and risk management to improve their efficiency. The government then announced a mega-merger of state banks and in 2020 reduced their number from twenty-one to twelve—but whether this merger will improve the efficiency of the banking system remains to be seen.

The Oriental Bank of Commerce and United Bank were merged with the Punjab National Bank (PNB) to create the country's largest state-run bank after SBI. Similarly, Syndicate Bank was amalgamated with Canara Bank, and Andhra Bank and Corporation Bank merged into Union Bank. Also, Allahabad Bank was amalgamated with Indian Bank. But such mergers are not a serious reform, as merging weak banks with stronger banks often ends up weakening the entire banking system. There was an expectation that much of the money would go to stronger banks and the weakest ones would be shut down. Instead, a larger share went into the weaker banks.

Another source of transactional costs is the Jan Dhan scheme, by which state banks were forced to open accounts for the unbanked. Only 53 per cent of people aged fifteen and over had a bank account in 2014. Under the Jan Dhan scheme, this shot up to 80 per cent by 2017. These accounts however were not very active until recently. According to the World Bank's Global Financial Inclusion Report 2017,[xviii] 48 per cent of these had not made a deposit or withdrawal—amongst the highest percentages in the world, only 8 per cent had borrowed from a financial institution, and only 20 per cent had saved at a financial institution. These numbers have increased a bit after the government deposited small sums of money into the Jan Dhan accounts but even so their usage is low-partly because these are one-time transfers and some of them may

be precautionary savings. Kale, Nageswaran and Bhandari (2021)[xix] estimate that the share of bank account holders not using their accounts in the previous 3 months is down to 30 per cent — and these are prominently women, who are poor and under 35. They suggest improvements in the incentives and functioning of Banking Correspondents (individuals engaged by banks to serve the unbanked) to target greater usage among this group. The RBI has started preparing a new Financial Inclusion (FI) Index. The index will be a single value between 0 and 100, where 0 represents complete financial exclusion and 100 shows full financial inclusion. And, it will have three broad parameters with weights — access (35 per cent), usage (45 per cent), and quality (20 per cent). The full details of this index are not yet available but a press release from the RBI states that the FI-Index for the period ended March 2021 was 53.9 as against 43.4 for the period ended March 2017, suggesting some improvement over the last 4 years – but the Index needs more scrutiny. [xx]

Nevertheless, despite all these efforts by the government, financial inclusion remains low. Forcing state banks to open accounts for the unbanked increases their costs but does not genuinely increase financial usage. For many of these people, a postal bank would probably be a better solution, as access would be much easier. Mobile banking is another mechanism that has worked well in some developing countries. Forcing banks to open accounts is not the way forward. Neither is having all state banks pursue directed lending. The government is better off having one or two banks focus on specific sectors or establish development finance institutions for these purposes—not mess it up with state commercial banks.

Non-bank financial companies (NBFCs)

The NBFCs play that role in the financial system.[xxi] If you think of the banking system as the main vessels, i.e., they bring the blood into the heart and carry it out, the NBFCs are the smaller vessels and capillaries. They typically do not take deposits, but they can raise funds in the market, and they also borrow from banks to on-lend in the market. They are also much better at reaching the last-mile customer often not reached by banks, due to asymmetric information and the costs of reaching creditors with weaker financial assets. About half of their funding comes from banks, about one-quarter from mutual funds, another 20 per cent from insurance

companies and the rest from deposits. NBFC lending accelerated in the decade 2004–2014 when India grew at a rapid rate, but really took off at a tearing rate in 2015–2018, when the banking sector lending ground to a halt as NPAs were revealed. In 2008, when total formal credit was Rs 30 trillion, the share of NBFCs was 12 per cent and by 2018, with total formal credit rising to Rs 118 trillion, the NBFC share had risen to 18 per cent. They were also a major supplier of retail credit to the MSME sector and played a key role in housing finance.

Table 11.4 Non-Performing Loans in the NBFC's

	GNPA Ratio	NNPA Ratio
Mar-2015	4.1	2.5
Mar-2016	4.5	2.5
Mar-2017	6.1	4.4
Mar-2018	5.8	3.8
Mar-2019	6.1	3.3
Mar-2020	6.8	3.4
Mar-2021[32]	6.4	2.7

Source: RBI Financial Stability Report 2021.

But that tearing growth came to a grinding halt with the collapse of IL&FS, a large NBFC mired in debt to the infrastructure sector, when it suffered a minor cardiac arrest—India's Lehman moment. It also exposed the weakness in the regulation of the NBFC sector by RBI, which, as supervisor, had allowed this very rapid growth, creating the conditions for NPA problems in the NBFCs. Their GNPAs, while rising, have remained lower than banks at around 6.8 per cent in March 2020 but, as with state banks, have surprisingly now fallen to 6.4% in March 2021. Once again, this could be due to new government guaranteed loans being used to pay back old NPA's. The RBI has now required a 20 per cent liquidity credit requirement for NBFCs above Rs. 50 billion and enhanced supervision. But an asset quality review will be needed to decide which NBFCs should be allowed to continue.

This shadow banking is an important part of any growing financial system and provides an important source of funding to parts of the economy that banks do not service efficiently but clearly needs more attention and better supervision.

The role of the regulator

There are five regulatory bodies in the financial system in India. The dominant ones are the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) for capital markets. There is also a regulator for insurance—Insurance Regulatory and Development Authority of India (IRDAI), one for pensions—Pensions Fund Regulatory and Development Authority (PFRDA), and another for commodity markets—Forward Markets Commission (FMC).

Of these, the relationship between the RBI and the government has been the most complicated and debated. There is a web of nested relationships between North Block (Ministry of Finance) and Mint Street (RBI), which has created huge conflicts of interest and needs to be untangled for a modern financial regulatory system. It has often been described as a traditional marriage between a husband (Ministry of Finance) and wife (RBI), and the government is the mother-in-law; where disputes are settled within the home, not in public; and there is no question of divorce. But recently the disputes have spilled out in the open and become more like a modern marriage and divorce as well.[xxii]

With the appointment of outside experts as RBI governors, there was increasing hope that gradually the RBI would be made more independent[xxiii] but that hope has been belied and the RBI governorship has gone back to the bureaucracy. The establishment of a monetary policy committee (MPC) and inflation targeting was another signal of greater independence. But by keeping interest rates too high the MPC lost credibility with the business community, while it became the darling of the financial investors. India's economy, with a heavy weight of food and fuel inflation, driven by supply shocks, is in any case not suitable for inflation targeting and may have ended up doing more harm than good.

The relationship between the regulator RBI and the owner of state banks, the government, is complex. The RBI is the regulator of the banking system and approves the appointment of bank CEOs to ensure they are 'fit and proper'. It has often turned down CEOs for private banks—but for public sector banks (PSBs), those appointments are made by the Ministry of Finance. In general, the supervisory power of the RBI over state banks is diluted. RBI staff sit

on the boards of PSBs, and RBI is thereby complicit in all their decisions, which it is supposed to supervise and regulate. RBI is the debt manager for the government, which complicates its monetary policy role.

Most other regulators are too weak or too compliant with the government. When the Life Insurance Corporation (LIC) was forced to take over the bankrupt IDBI bank, the regulator Insurance Regulatory and Development Authority of India (IRDAI) did not even raise an objection. The Forward Markets Commission (FMC) should, in any case, be merged with SEBI to avoid overlapping regulatory authority.

The way forward

Who is to blame for the mess? India now has the least efficient financial system in the world, and it is also amongst the least inclusive. India has, so far, avoided a financial collapse—but has come close to it. The large share of public sector banks has meant that depositors have not been concerned that their banks will collapse. Despite very low deposit insurance,[xxiv] there is no run-on weak banks as the public expects the government to cover the losses. Perhaps a collapse would have forced quicker reforms, as was the case in the Asian Financial Crisis or the Turkish crisis for those countries affected. But in India, despite rising NPAs, the problems have been largely swept under the rug.

Like in the *Murder on the Orient Express*, everyone involved is to blame for the situation India finds its financial system in. Some, such as former Deputy Governor of the RBI Viral Acharya, blame everything on the government—that fiscal dominance is the cause of all problems.[xxv] Others such as former Chief Economic Advisor Arvind Subramaniam, blame crony-capitalism—that India's 'stigmatized' capitalism is the cause of all problems. Yet others blame populist politicians, who led to nationalization, and subsequent directed lending and forced financial inclusion initiatives such as Jan Dhan accounts, for the woes of the financial sector. A weak and compromised regulatory system—some might even call it regulatory capture—is also a contributor. Just because India escaped the Asian financial crisis and to a large extent the global

financial crisis, top regulators crowed that India's financial system was safe and sound. All these actors are collectively responsible for where things stand today.

Underlying governance is also a mismatch between assets and liabilities. India is trying to use banking deposits (typically short-term) to finance infrastructure projects or other industrial projects with longer gestation times. There is a mismatch. India must rely much more on bond issues for this type of financing. But as Vardhan (2021) points out over 85per cent of bond issues are AA, whereas the average commercial borrower is rated BBB. He suggests a well-run, independent credit-enhancement institution to handle this problem. But how to run such an institution transparently and professionally will itself be a challenge in India.

The decision to allow corporates to own banks, as proposed by a recent RBI committee, is not the right way forward. Imagine Vijaya Mallya, wilful defaulter, owning an entire bank. India will move from a corruption-ridden state banking sector to one in which the keys to the banking sector will be handed back to corporate houses to take deposits and do with them as they wish. India will then become a typical crony-capitalist country if it is not one already. We have seen this story before, during the run-up to the Great Depression in the 1920s—made famous in the movie *The Great Gatsby*—and in subsequent crises in many parts of the world including the Latin American debt crisis of the 1980s, the Asian Financial Crisis in 1997 and the Turkish banking crisis of 2001. It's a movie that ended badly. The decision to allow some large well-run NBFCs to be allowed full bank licences may be acceptable—if they are not owned by corporates. Instead of handing over the keys of the banking system to the corporate sector,[xxvi] it would be better to focus on genuine and much-needed reforms.

The seven key elements of reform needed are:

1. **Re-privatization of the banking system**: After consolidation, India now has 12 PSBs—these could be reduced to at best four PSBs to ensure regional coverage and the remaining privatized. The sale of two PSB's has been agreed and how this is implemented will be a signal of the government's intent.

2. **Remove directed lending from commercial banks**: Establish or designate one or two banks to perform priority sector lending. For MSMEs, a Mudra Bank to provide non-collateralized lending has already been set up and NBFCs are a major source of credit for MSMEs; their growth should be encouraged. Jan Dhan accounts could be transferred to the newly established Indian Post Payments Bank, a more suitable entity for such accounts than a scheduled commercial bank.
3. **Swift clean-up of the existing NPAs:** For a quick recovery NPA resolution, should be swift. The costs to the economy of delays are too high. The IBC process was not designed for system-wide problems. An asset resolution agency will be needed to remove the NPAs from the banks for separate resolution. In any case, no privatization of PSBs will be possible without removing their NPAs. Promoters whose NPAs are transferred must lose their equity.
4. **RBI should be given full supervisory powers over all PSBs,** and they should not sit on the boards of these banks.
5. **The RBI should not be the debt manager for the government:** This function should be with a treasury department in the Ministry of Finance and removed from the RBI.
6. **SLR requirements should be eliminated** to encourage fiscal discipline. Statutory liquidity ratio (SLR) requirements are a rarity and have been eliminated in most modern emerging economies. Such a move will also encourage the development of a corporate bond market.
7. **An asset quality review of the NBFCs** should be performed, weaker ones closed, and stronger ones encouraged; particularly for priority sectors such as housing, exports and MSMEs—especially as banks are released from directed lending requirements.

This will no doubt not be an easy reform. But without such sweeping reforms India will plod along and be stuck for a long time in the low-middle income category of countries.

[i] Serious recognition started only in 2015 and peaked in 2017-18—at which time they were over 11 per cent of all advances.

- [ii] RBI Financial Stability Report 2021 now states "Macro stress tests indicate that the gross non-performing asset (GNPA) ratio of SCBs may increase from 7.48 per cent in March 2021 to 9.80 per cent by March 2022 under the baseline scenario; and to 11.22 per cent under a severe stress scenario, although SCBs have sufficient capital, both at the aggregate and individual level, even under stress". The previous RBI FSR showed that under the severe stress test scenario GNPAs might rise to 14%. Reserve Bank of India - Financial Stability Report (rbi.org.in)

[iii] 'Domestic Credit to Private Sector (% of GDP)'. *World Development Indicators* (World Bank, October 2020).

[iv] Liaquat Ahamed made this point in a talk at the Envisioning India series at IIEP, George Washington University. 'Fiscal Dominance: A Theory of Everything in India (Webinar)', *Envisioning India*, Institute for International Economic Policy (George Washington University, 2020). iiep.gwu.edu/2020/08/04/fiscal-dominance-a-theory-of-everything-in-india/.

[v] The first farm loan waiver was introduced in 1990 by the V.P. Singh government. A second large one was introduced in 2008 for small and marginal farmers well before the global financial crisis but in preparation of upcoming elections. State-level loans waivers have been done in 2014 in Telangana and Andhra Pradesh, and lately in 2017 in UP, Punjab, Karnataka, and Maharashtra.

[vi] Raghuram Rajan, 'Has Financial Development Made the World Riskier?', NBER Working Paper 11728 (2005).

[vii] 'Economic Survey: From Crony Socialism to Stigmatised Capitalism', *Bloomberg Quint* (29 January 2018). bloombergquint.com/business/economic-survey-from-crony-socialism-to-stigmatised-capitalism.

[viii] A decade of credit collapse in India (ideasforindia.in)
[ix] Both the CEA Subramaniam and the Deputy Governor Viral Acharya initially favoured such an approach but eventually backed off as it became clear the government was going with the slower IBC process. But with rising NPAs the government should rethink its approach as the revival of the IBC process may be difficult.
[x] The Banks issued bonds which were bought by the government and used to recapitalize the banks – so that only the interest cost of the bonds shows up as a fiscal cost in the year when interest is to be paid.

[xi] Saner Writing: A Post-Pandemic Assessment of the Insolvency and Bankruptcy Code (sanerlog.blogspot.com)
[xii] They are liquid assets, as they can be transacted in the market, but their value can fluctuate depending on the yield.

[xii] Calculate as liquid reserves divided by time and demand liabilities.

[xiii] Calculated as liquid reserves divided by time and demand liabilities.

[xiv] Viral Acharya (2020) believes this fiscal dominance explains many of the problems of India's banking system. Viral Acharya, *Quest for Restoring Financial Stability in India*, (SAGE Publications, 2020).

[xv] Niranjan Rajadyaksha writes in *Live Mint* in July 2019, 'Banks were asked to push funds towards sectors that the government wanted to target for growth. Indira Gandhi told the Lok Sabha on 29 July 1969 that the "purpose of **nationalization is** to promote rapid growth in agriculture, small industries and export, to encourage new entrepreneurs and to develop all backward areas"'.
Niranjan Rajadhyaksha, 'The 1969 Bank Nationalization Did India More Harm Than Good', *Mint* (16 July 2019). livemint.com/opinion/columns/opinion-the-1969-bank-nationalization-did-india-more-harm-than-good-1563295097940.html.

[xvi] Morarji Desai, then finance minister, resigned over the decision and Mrs Gandhi took over the finance ministry.

[xvii] A respected chair of BBB, the former Comptroller and Auditor General of India resigned as its chairman when he was often not consulted on major issues.

[xviii] Asli Demirgüç-Kunt et al., *The Global Findex Database 2017* (Washington, DC: World Bank, 2017).

[xix] ICFI - BC Network - White Paper.pdf

[xx] Reserve Bank of India - Press Releases (rbi.org.in)

[xxi] For a good description of India's financial system and the role of NBFCs, see Rashmi U. Arora and Quanda Zhang, 'Banking in the Shadows: A Comparative Study of China and India', *Australian Economic History Review* 59, no. 1 (2018): 103–31.

[xxii] In recent years two RBI governors and one deputy governor has been at public loggerheads with the government and have either resigned or left.

[xxiii] They turned out to be too independent and openly expressed disagreement.

[xxiv] In India, deposit insurance was only Rs 100,000 per bank per depositor. It has been raised to Rs 500,000 in the 2020 budget after the collapse of a cooperative bank.

[xxv] Viral Acharya, *Quest for Restoring Financial Stability in India* (SAGE Publications, 2020).

[xxvi] This was the argument made by Mrs Gandhi in 1969 to nationalize the banking sector; those banks were under corporates who cornered the bulk of the credit to their own in-house companies.