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ECONOMICS

## Addressing Financial Malpractices: India's Recent Initiatives

In article 04:16 AM, Oct 27, 2018

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MINISTRY OF  
FINANCE

There has been public focus and concern about financial malpractices in India. Such practices are gender neutral, and they occur in all types of societal organizations and institutions.

This column however primarily focuses on explaining the causes of financial malpractices in India's financial sector, particularly in the Indian banking system, and the recent initiatives of PM Narendra Modi -led government to address them.

This issue is timely as the 10<sup>th</sup> anniversary of the 2008 Global Financial Crisis (GFC) has just been observed. Many institutions and analysts contend that the lessons of the 2008 GFC have not been learnt sufficiently. Thus, the October 2018 Global Financial Stability Report (GFSR), finds that the global near-term risks to financial stability have increased somewhat.

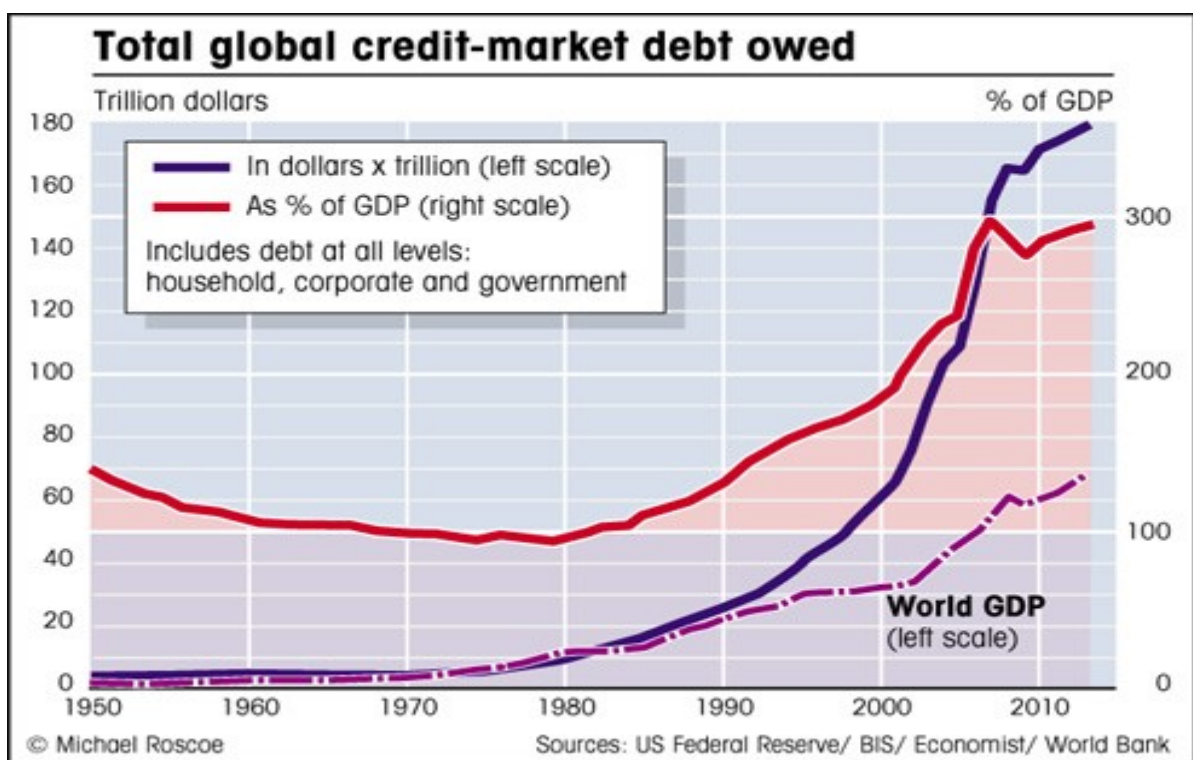
It goes on to argue that "Medium – term financial stability risks remain elevated, driven by high non-financial sector leverage in advanced economies and rising external borrowing in the emerging economies. ... The global banking system is exposed to highly indebted borrowers as well as to opaque and illiquid assets and foreign currency rollover risks".



Along with the financialization, Fintech (Financial Technology) has added to the complexity of pursuing financial stability and preventing malpractices. Not all of the financial risks arise from the unethical or malpractices in the financial sector. Nevertheless, minimizing them is essential for both financial stability, economic growth, and to sustain business profitability and competitiveness.

Financialization of the global economy, along with FinTech has contributed to both unethical or malpractices and to weakening financial stability. Research and global experience suggest that these can be mitigated through appropriate economic reasoning and sound institutional and regulatory structures both globally and in India. Therefore, this is where the public policy focus ought to be in addressing financial malpractices.

**Chart 1** shows how financialization of the global economy as proxied by total global credit-market debt owed has increased from less than 100 percent of GDP in 1980 to nearly 300 percent by around 2015. Total global debt currently is around USD 182 trillion.



The topic has terms “unethical Practices” (a term with varied and complex meaning and layers but this is not the occasion to discuss them) and India’s economy. Let us first briefly review India’s economic position in the World.

**Chart 2** shows 2000 years of economic history, including India’s share in the global economy.

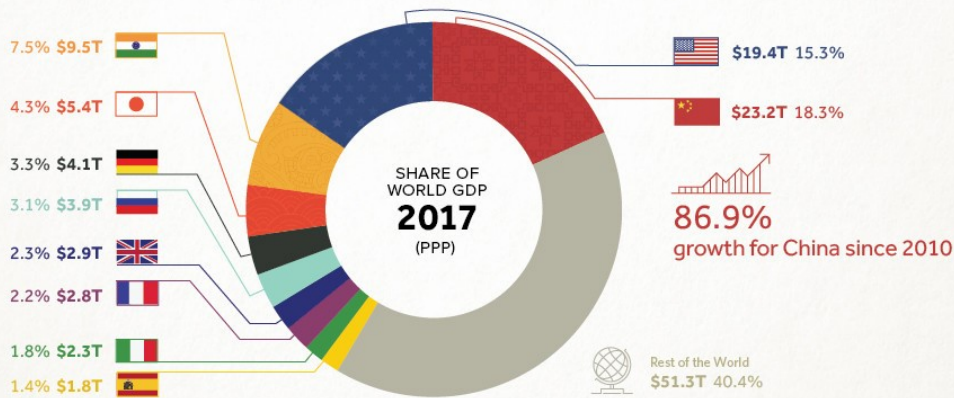
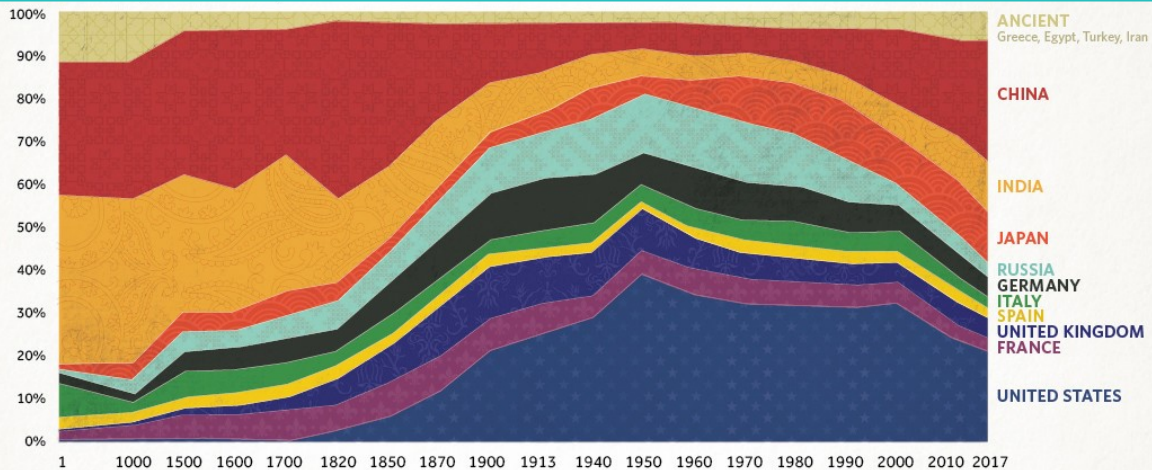
Chart of the Week

## 2,000 YEARS OF ECONOMIC HISTORY IN ONE CHART

All major powers compared by GDP from the year 1 AD

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SHARE OF GDP (WORLD POWERS)



SOURCE: "Statistics on World Population, GDP, and Per Capita GDP, 1-2008 AD"; Angus Maddison; IMF

visualcapitalist.com

India's share of Global GDP was high till around 1700, it began to decline after that, and has begun to very gradually rise since 1991 reforms. India's efforts energy and focus should be on how to continue to expand its share of the global economy.

**Chart 3** shows that accelerated growth in global per capita income occurred first after the industrial revolution. But because the benefits of industrial revolution until about 1950s were confined to relatively small proportion of global population, the acceleration was not as steep as after the 1950s. So, India needs to increase its global share of GDP when relatively higher growth as become the norm. There are however, concerns about environment and ecological sustainability of such high global growth continuing. India has a lot to gain in pursuing its growth strategy an in environmentally and ecologically sustainable manner.



World GDP Per Capita (1990\$)

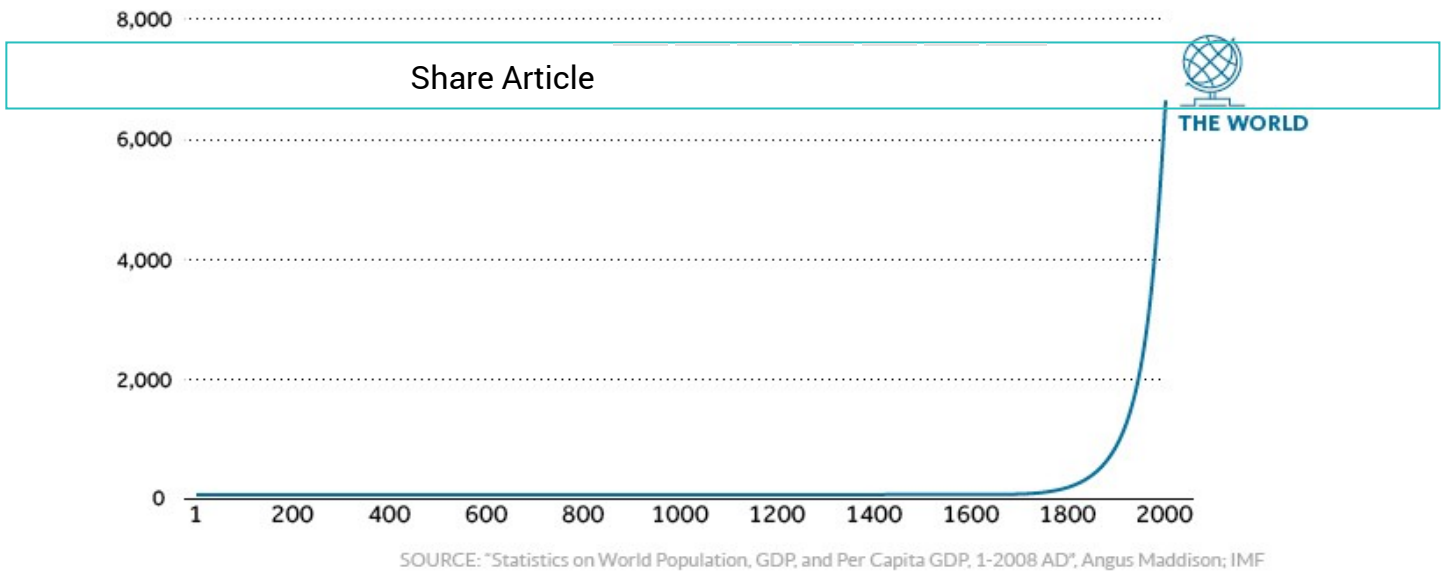
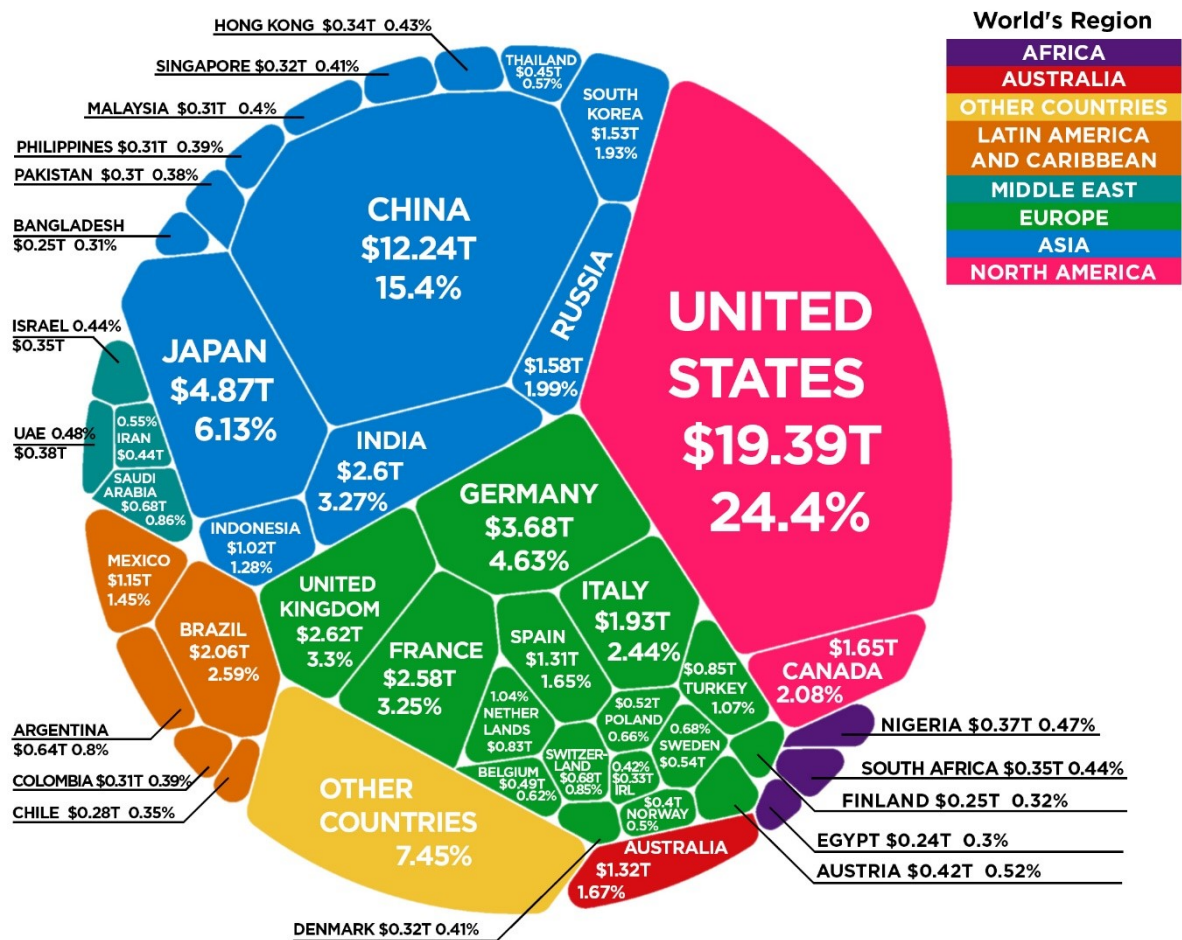


Chart 4 shows that India, with about 17 percent of the global population, accounts for only 3.27 of Global GDP. It will however, be the fifth largest economy globally by the end of 2018, overtaking the United Kingdom (UK).



Article and Sources:  
<https://howmuch.net/articles/the-world-economy-2017>  
<http://databank.worldbank.org/data/download/GDP.pdf>



Financial malpractices have not significantly affected India's overall economic growth. Indeed, it is among the fastest growing large economy globally. Thus, the IMF, in its October 2018 Global Economic Outlook, projects India's 2018 real GDP growth at 7.3 percent as compared to

4.7 percent for emerging markets and developing countries, and 3.7 percent for the world as a whole. Similar trends are projected for 2019 as well. Other multilateral institutions, such as the World Bank, and the Asian Development Bank exhibit similar projections.

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The above sets the context for analysing the issue of financial malpractices in India's financial sector and the initiatives being taken to address them.

Let us first review some stylized facts:

- India's main financialization indicator Since the 2008 global crisis is the following:

Bank loans in India which from the Independence to 2008 at INR 18 Lakh Crore (INR 18 Trillion), increased between 2008 to 2014 to INR 52 Lakh Crore (INR 52 Trillion). This staggering acceleration of bank loans given without proper credit assessment and controls, the applying relevant economic reasoning concepts such as moral hazard (when there is an incentive on the part of the stakeholders to behave inefficiently; and adverse selection, when 'wrong' individuals have incentives to participate in an activity lies at the root of the many malpractices in the banking sector.

- This occurred at a stage when severely negative impact of bank nationalisation of 1969 has become severely detrimental to India's further progress.

Thus, India's 21 public sector banks held about 70 percent of total bank assets, but accounts for 87 percent of the total Non-Performing Assets (NPAs) of INR 10.4 trillion (6.2 percent of India's GDP) as of March 2018.

- The bank frauds involving all banks, exceeding INR 1 lakh in 2017-18 had 5879 cases, involving INR 320 billion.
- India's Public-Sector banks made a loss of INR 1.7 trillion between December 2015 and June 2018.
- There have also been financial malpractices in other segments of India's financial sectors, including the Non- Bank Financial Companies (NBFCs). Another example is the malpractices by those responsible for managing and overseeing the Infrastructure Leasing and Financial Services (ILFS).
- The malpractices in India's Cooperative banks segment, due to large part because of close connections with the political operatives, has been well-known. Here also, moral hazard and adverse selection. Problems have been massive.
- The financial malpractices are not just in the non-government financial sector. They are also found in public financial management. Moral hazard of adverse selection contributes to malpractices in this sector as well.



The Reports of CAG (Comptroller and Auditor General of India) over many years have documented this at both the Union, State Governments, and Public Enterprises, and others. The CAG has publicly stated that due to non-cooperation of some governments (a recent case is that of the government of West Bengal), proper auditing of the financial transactions cannot be done.

A recent CAG Report on poor public financial management of the previous Uttar Pradesh Government is also instructive. It points to major weaknesses in the public financial management, including in procurement practices, in Uttar Pradesh.

This is a large and separate area. The government has taken several initiatives such as the PFMS (Public Financial Management System), new GFR (Government Financial Rules) and GeM (Government Electronic Marketplace) to improve public financial management.

A strong case can be made that unethical and malpractices in the financial sector have been accentuated by India's societal norms, inappropriate regulatory practices, and lack of focus on sound institution building.

The societal norms where stakeholder's financial malpractices are considered as routine, and when banks loans are considered as, to use Urdu words, "JAGIR" rather than "AMANAT", the former meaning loans taken as ownership, the later meaning loans as public trust to be repaid, are not conducive to preventing financial malpractices.

The simplest definition of the term 'Corruption' is to abuse public trust for private material or for non-material gain. Each person, all of us, need to ensure that our own behaviour and choices, both personal and when participating in public decision making, are as consistent as feasible with creating an environment in which financial malpractices meet with societal disapproval and disincentives.

### **Government's Approach and Initiatives**

The overall approach of the current government is that preventive vigilance through appropriate incentive structures, and sound regulatory and institutional design is better than the practice of punitive vigilance to which India has over-relied for addressing financial malpractices in both the private and the public sectors. This has, as the evidence strongly suggests, not worked well in the past.

Among the recent initiatives by the government, the following may be noted. The list draws on some of the points raised in October 13, 2018 article by Manish Sabharwal in the *Indian Express*. <https://indianexpress.com/article/opinion/columns/rbi-policies-banking-insolvency-5399925/> (<https://indianexpress.com/article/opinion/columns/rbi-policies-banking-insolvency-5399925/>)

Some of the initiatives may appear seemingly small, but cumulatively they are altering the incentive structure, and setting sound regulatory and institutional framework to help mitigate adverse impact of the past malpractices and help in minimizing future malpractices.

In April 2016: **Banks Board Bureau (BBB)**, under first Chairman Vinod Rai, former CAG, (Comptroller and Auditor General), started functioning from April 1, 2016. It has six members, three former bankers, two professionals, and one government official.

It is regarded as a step in the direction of holding company structure of Public sector Banks, some of whom may be merged. SBI's (State Bank of India) merger with its Associate Banks is a part of this process.

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New members of the BBB were appointed in April 2018. Strengthening human resources of the banks is an important mandate.

([www.livemint.com/Industry/VQTZmpXMm0ksMU8LoGv4pJ/Bhanu-Pratap-Sharma-to-be-new-chairman-of-Banks-Board-Bureau.html](http://www.livemint.com/Industry/VQTZmpXMm0ksMU8LoGv4pJ/Bhanu-Pratap-Sharma-to-be-new-chairman-of-Banks-Board-Bureau.html))

(<http://www.livemint.com/Industry/VQTZmpXMm0ksMU8LoGv4pJ/Bhanu-Pratap-Sharma-to-be-new-chairman-of-Banks-Board-Bureau.html>))

Banks have asked for data from the income tax and GST data bank to help evaluate large loan applications.

In April 2016: ***Insolvency and Bankruptcy Code (IBC)*** was established. The IBC has gradually been strengthened, with the eventual goal of the establishing a full-fledged bankruptcy code for the first time since India's independence. The Non-Bank Financial Companies (NBFCs) can use the IBC.

In June 2016: ***The National Company Law Tribunal (NCLT)*** was established. It is a quasi-judicial body that resolves issues relating to Indian Companies. The NCLT procedures have been evolving.

According to the official data, by the end June 2018, creditors have recovered nearly INR 50,000 Crore (500 billion), or almost 56 percent of their admitted claims, from 32 stressed companies where insolvency resolution plans were approved by the NCLT.

(<http://epaper.financialexpress.com/1781007/Mumbai/August-18,-2018#page/1/1>)

(<http://epaper.financialexpress.com/1781007/Mumbai/August-18,-2018>))

Recovery is also taking place through routes other than the NCLT.

There are attempts to resolve the cases of business groups referred to NCLT faster, and to realize greater value from their assets. As an example, as reported in the MINT (October 24,2018), the State Bank of India (SBI) is to appoint an advisor to coordinate among the separate resolution professionals (RPs), and prospective bidders for the 15 Videocon group entities which have been referred to the NCLT.

In march 2017: ***Enemy Property (Amendment and Validation) Bill*** was passed. Such property is estimated at INR 1 Lakh Crore.

In April 2017: Mandatory three- tier action on troubled banks based on transparent matrix of Capital, asset quality, profitability and leverage. It is well known that lack of transparency which gives rise to information asymmetry between stakeholders, is not conducive either to fairness, to efficiency and to addressing financial malpractices.

In June 2017: Banks must refer to IBC all accounts with loans over INR 5000 Crores, with at least 60 percent of which are non-performing.

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In January 2018: Defaulting promoters cannot participate in the bankruptcy proceedings. It is reported that many promoters of the companies have paid back their loans, in some cases by selling their assets (unprecedented) for fear of losing controls.

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In February 2018: NPA recognition is mandated to be timely, real and unavoidable. No discretion is to be permitted in this area.

Individual accountability for banks managers is being set. The Finance Ministry has decided to remove any banker from exercising the power if investigating agencies find evidences of their complicity in any bank fraud.

The former Punjab National Bank (PNB)'s managing director, and two executive's directors of the bank are being prosecuted in connection with USD 2.2 billion fraud involving the PNB.

The Government has replaced the Board of ILFS to address the problems being faced by the entity, and to minimize any spill over effects.

The RBI's IT Division has directed banks to have a protocol in place to ensure quick response (within 24 hours) to a cyber heist to enhance probability of recovering the amounts. Some of the cyber crimes in the banking sector occur due to cross-border malware.

The RBI's June 2018 Financial Stability Report has argued that there are three specific advantages of an aggressive asset cleansing strategy being pursued as outlined above.

First, it brings in a lot of transparency to the quality of the asset portfolio thus possibly crowding in potential investors; second, marginal pricing without provisions of legacy assets can be more competitive going forward; and third, to put an end to frittering away opportunity costs in the eternal hope of a miraculous turnaround of stressed assets' quality when a significant part of the assets owe their current status to operational risks contributing to or amplifying credit risks.

In this regard, the current capital adequacy regime of banks is in alignment with global norms while the lingering impact of past forbearance on asset provisioning implies that there are unrecognized credit losses in the books.

The lesson which emerges from the Indian and the global experiences is that the substance and the spirit behind regulation and institutional structures in the financial sectors is more relevant for mitigating financial malpractices, rather than its mere form. The German word for preserving form but draining substance is "ersatz". This is a continuing challenge globally.

For India, the responsibility for ensuring that organizations and institutions being constructed through recent initiatives do not become *ersatz* rests with the Reserve Bank of India, NCLT, and other financial regulators, and with the current and future governments. The current government authorities have given positive indications that these organizations and institutions will not become ersatz. This is an encouraging sign.

### Concluding Remarks

In analysing financial malpractices, only a handful of which surfaces in the wider public domain as 'Scams' excessive pre-occupation with personalities, and with proximate causes, or symptoms should be avoided.



The experience both globally and India is that preventive focus, with appropriate application of economic reasoning to get incentive structure correct, and sound regulation and institutional structures would help mitigate unethical practices, and financial malpractices in both private and public-sector organisations. This is not an easy task as the authorities need to deal with massive financialization which continues unabated, albeit at a slower pace, and with fast emerging Fintech.

Social norms which strongly disapprove of those responsible for designing or tolerating inappropriate incentive structures (including those created by excessive forbearance in recognizing bad loans which induces unwarranted risk taking by the borrowers), or deliberately lax credit assessment, need to be cultivated. Only then such malpractices would translate in choices people make individually and in collective decision making, one of whose manifestations is in voting in political contests. The importance of societal norm of not violating public trust cannot be over emphasized.

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