Raghuram Rajan: Saving credit

Talk by Dr Raghuram Rajan, Governor of the Reserve Bank of India, at the Third Dr. Verghese Kurien Memorial Lecture, Institute of Rural Management Anand (IRMA), Anand, 25 November 2014.

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Let me start by thanking the Director of IRMA for inviting me to deliver the Third Dr. Verghese Kurien lecture. Dr. Kurien was a pioneer in the co-operative movement. He not only was instrumental in bringing about the White Revolution but he also built a variety of institutions, including Amul, IRMA, and NDDB. In creating the means by which farmers could get remunerative, stable incomes, even while professionals managed their interactions with the modern market economy, Dr. Kurien created a uniquely Indian model that has brought millions out of poverty. A man of strong convictions, determination, and integrity, he truly is a giant of post-independence India.

Dr. Kurien showed people the way to remunerative livelihoods, perhaps the best form of economic inclusion. I have little expertise on the technologies and institutions he pioneered, so I will not opine on them. Instead, I want to focus on another instrument for expanding human wellbeing, credit. At a time when demand for bank credit is weak, even while we are likely to have enormous demand for it if investment picks up, we have to ask if India's system of credit is healthy. Unfortunately, the answer is that it is not. We need fundamental reforms starting with a change in mind set. A public lecture in the memory of a great Indian who did much to change our mind sets is a perfect place to make the case.

The debt contract

The flow of credit relies on the sanctity of the debt contract. A debt contract is one where a borrower, be it a small farmer or the promoter of a large petrochemical plant, raises money with the promise to repay interest and principal according to a specified schedule. If the borrower cannot meet his promise, he is in default. In the standard debt contract through the course of history and across the world, default means the borrower has to make substantial sacrifices, else he would have no incentive to repay. For instance, a defaulting banker in Barcelona in mediaeval times was given time to repay his debts, during which he was put on a diet of bread and water. At the end of the period, if he could not pay he was beheaded. Punishments became less harsh over time. If you defaulted in Victorian England, you went to debtor's prison. Today, the borrower typically only forfeits the assets that have been financed, and sometimes personal property too if he is not protected by limited liability, unless he has acted fraudulently.

Why should the lender not share in the losses to the full extent? That is because he is not a full managing partner in the enterprise. In return for not sharing in the large profits if the enterprise does well, the lender is absolved from sharing the losses when it does badly, to the extent possible. By agreeing to protect the lender from "downside" risk, the borrower gets cheaper financing, which allows him to retain more of the "upside" generated if his enterprise is successful. Moreover, he can get money from total strangers, who have no intimate knowledge of his enterprise or his management capabilities, fully reassured by the fact that they can seize the hard collateral that is available if the borrower defaults. This is why banks offer to finance your car or home loan today at just over 10 percent, just a couple of percentage points over the policy rate.

Violating the spirit of debt

The problem I want to focus on in this lecture is that the sanctity of the debt contract has been continuously eroded in India in recent years, not by small borrower but by the large borrower. And this has to change if we are to get banks to finance the enormous infrastructure needs and industrial growth that this country aims to attain.

The reality is that too many large borrowers see the lender, typically a bank, as holding not a senior debt claim that overrides all other claims when the borrower gets into trouble, but a claim junior to his equity claim. In much of the globe, when a large borrower defaults, he is contrite and desperate to show that the lender should continue to trust him with management of the enterprise. In India, too many large borrowers insist on their divine right to stay in control despite their unwillingness to put in new money. The firm and its many workers, as well as past bank loans, are the hostages in this game of chicken – the promoter threatens to run the enterprise into the ground unless the government, banks, and regulators make the concessions that are necessary to keep it alive. And if the enterprise regains health, the promoter retains all the upside, forgetting the help he got from the government or the banks – after all, banks should be happy they got some of their money back! No wonder government ministers worry about a country where we have many sick companies but no "sick" promoters.

Let me emphasize that I do not intend in any way to cast aspersions on the majority of Indian businesspeople who treat creditors fairly. I also don't want to argue against risk taking in business. If business does not take risks, we will not get architectural marvels like our new international airports, the "developed-for-India" low cost business model in the telecom sector, or our world class refineries. Risk taking inevitably means the possibility of default. An economy where there is no default is an economy where promoters and banks are taking too little risk. What I am warning against is the uneven sharing of risk and returns in enterprise, against all contractual norms established the world over – where promoters have a class of "super" equity which retains all the upside in good times and very little of the downside in bad times, while creditors, typically public sector banks, hold "junior" debt and get none of the fat returns in good times while absorbing much of the losses in bad times.

Why does it happen?

Why do we have this state of affairs? The most obvious reason is that the system protects the large borrower and his divine right to stay in control.

This is not for want of laws. The Debts Recovery Tribunals (DRTs) were set up under the Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993 to help banks and financial institutions recover their dues speedily without being subject to the lengthy procedures of usual civil courts. The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act, 2002 went a step further by enabling banks and some financial institutions to enforce their security interest and recover dues even without approaching the DRTs. Yet the amount banks recover from defaulted debt is both meagre and long delayed. The amount recovered from cases decided in 2013–14 under DRTs was Rs. 30590 crore while the outstanding value of debt sought to be recovered was a huge Rs. 2,36,600 crore. Thus recovery was only 13% of the amount at stake. Worse, even though the law indicates that cases before the DRT should be disposed off in 6 months, only about a fourth of the cases pending at the beginning of the year are disposed off during the year – suggesting a four year wait even if the tribunals focus only on old cases. However, in 2013–14, the number of new cases filed during the year was about one and a half times the cases disposed off during the year. Thus backlogs and delays are growing, not coming down.

Why is this happening? The judgments of the DRTs can be appealed to Debt Recovery Appellate Tribunals, and while there are 33 of the former, there are only five of the latter. And even though section 18 of the RDDBFI Act is intended to prevent higher constitutional courts from intervening routinely in DRT and DRAT judgments, the honourable Supreme Court recently lamented that

"It is a matter of serious concern that despite the pronouncements of this Court, the High Courts continue to ignore the availability of statutory remedies under the RDDBFI Act and SARFAESI Act and exercise jurisdiction under Article 226 for passing orders which have serious adverse impact on the right of banks and other financial institutions to recover their dues."[1]

The consequences of the delays in obtaining judgements because of repeated protracted appeals implies that when recovery actually takes place, the enterprise has usually been stripped clean of value. The present value of what the bank can hope to recover is a pittance. This skews bargaining power towards the borrower who can command the finest legal brains to work for him in repeated appeals, or the borrower who has the influence to obtain stays from local courts – typically the large borrower. Faced with this asymmetry of power, banks are tempted to cave in and take the unfair deal the borrower offers. The bank's debt becomes junior debt and the promoter's equity becomes super equity. The promoter enjoys riskless capitalism – even in these times of very slow growth, how many large promoters have lost their homes or have had to curb their lifestyles despite offering personal guarantees to lenders?

The public believes the large promoter makes merry because of sweet deals between him and the banker. While these views have gained currency because of recent revelations of possible corruption in banks, my sense is that Occam's Razor suggests a more relevant explanation – the system renders the banker helpless *vis-a-vis* the large and influential promoter. While we should not slow our efforts to bring better governance and more transparency to banking, we also need to focus on reforming the system.

Who pays for this one way bet large promoters enjoy? Clearly, the hard working savers and taxpayers of this country! As just one measure, the total write-offs of loans made by the commercial banks in the last five years is 161018 crore, which is 1.27% of GDP. Of course, some of this amount will be recovered, but given the size of stressed assets in the system, there will be more write-offs to come. To put these amounts in perspective – thousands of crore often become meaningless to the lay person – 1.27% of GDP would have allowed 1.5 million of the poorest children to get a full university degree from the top private universities in the country, all expenses paid.

The consequences

Let me emphasize again that I am not worried as much about losses stemming from business risk as I am about the sharing of those losses – because, ultimately, one consequence of skewed and unfair sharing is to make credit costlier and less available. The promoter who misuses the system ensures that banks then charge a premium for business loans. The average interest rate on loans to the power sector today is 13.7% even while the policy rate is 8%. The difference, also known as the credit risk premium, of 5.7% is largely compensation banks demand for the risk of default and non-payment. Since the unscrupulous promoter hides among the scrupulous ones, every businessperson is tainted by the bad eggs in the basket. Even comparing the rate on the power sector loan with the average rate available on the home loan of 10.7%, it is obvious that even good power sector firms are paying much more than the average household because of bank worries about whether they will recover loans. Reforms that lower this 300 basis point risk premium of power sector loans *vis-a-vis* home loans would have large beneficial effects on the cost of finance, perhaps as much or more than any monetary policy accommodation.

A second consequence is that the law becomes more draconian in an attempt to force payment. The SARFAESI Act of 2002 is, by the standards of most countries, very pro-

[1] Supreme Court, January 22, 2013 in Union of India v. DRT Bar Association

creditor as it is written. This was probably an attempt by legislators to reduce the burden on DRTs and force promoters to pay. But its full force is felt by the small entrepreneur who does not have the wherewithal to hire expensive lawyers or move the courts, even while the influential promoter once again escapes its rigour. The small entrepreneur's assets are repossessed quickly and sold, extinguishing many a promising business that could do with a little support from bankers.

A draconian law does perhaps as much damage as a weak law, not just because it results in a loss of value on default but also because it diminishes the incentive to take risk. For think of a mediaeval businessman who knows he will be imprisoned or even beheaded if he defaults. What incentive will he have to engage in innovative but risky business? Is it any wonder that business was very conservative then? Indeed, Viral Acharya of NYU and Krishnamurthi Subramanian of ISB show in a compelling study that innovation is lower in countries with much stricter creditor rights. Or put differently, the solution to our current problems is not to make the laws even more draconian but to see how we can get more equitable and efficiency-enhancing sharing of losses on default.

A final consequence of the inequitable sharing of losses in distress is that it brings the whole free enterprise system into disrepute. When some businessmen enjoy a privileged existence, risking other people's money but never their own, the public and their representatives get angry. I have met numerous parliamentarians who are outraged at the current state of affairs. If the resolution of these issues is taken out of the realm of the commercial into the realm of the political, it will set back industrial growth. Reforms therefore assume urgency.

What we need is a more balanced system, one that forces the large borrower to share more pain, while being a little more friendly to the small borrower. The system should shut down businesses that have no hope of creating value, while reviving and preserving those that can add value. And the system should preserve the priority of contracts, giving creditors a greater share and greater control when the enterprise is unable to pay, while requiring promoters to give up more.

A better balance

How do we achieve this better balance?

- Let us start with better capital structures. The reason so many projects are in trouble today is because they were structured up front with too little equity, sometimes borrowed by the promoter from elsewhere. And some promoters find ways to take out the equity as soon as the project gets going, so there really is no cushion when bad times hit. Lenders should insist on more real equity up front, and monitor the project closely to ensure it stays in. Promoters should not try and finance mega projects with tiny slivers of equity. We also need to encourage more institutional investors, who have the wherewithal to monitor promoters, to bring equity capital into projects.
- Banks need to react more quickly and in a concerted way to borrower distress. The longer the delay in dealing with the borrower's financial distress, the greater the loss in enterprise value. Some banks are more agile (and have better lawyers), so the promoter continues servicing them while defaulting on other banks. In the absence of an efficient bankruptcy process that brings lenders together, the RBI has mandated the formation of a Joint Lending Forum (JLF) of lenders when the first signs of distress are perceived. The JLF is required to find a way to deal with the distressed enterprise quickly, with options ranging from liquidation to restructuring. In this way, we hope to coordinate lenders and prevent the borrower from playing one off against the other.
- The government's plan to expand the number of DRTs and DRATs is timely, and will be most effective if also accompanied by an expansion in facilities, trained

personnel, and electronic filing and tracking of cases, as suggested by the Supreme Court. Also

  - Some monetary incentives to tribunals for bringing down the average duration of cases, without compromising on due process, could be contemplated.
  - Some limit on the number of stays each party can ask for could also be thought of.
  - Appeals to the DRAT should not be a matter of course. Indeed, DRATs should require borrower appellants to deposit a portion of the money ordered to be paid by the DRT as laid down in the law[2] as a matter of course, rather than routinely waiving such deposits as is reported to be the current practice.
  - It is worth examining if appellants should be made to pay the real costs of delay out of their own pockets if unsuccessful, where the costs include the interest costs of postponed payments.

- As suggested by the Supreme Court, Constitutional Courts should respect the spirit of the laws and entertain fewer appeals. It is hard to see what points of law or judicial administration are raised by the standard commercial case, and routine judicial intervention favours the recalcitrant borrower at the expense of the lender.
  - Challenging the orders of DRT and DRAT before courts should be made costlier for the appellants. Courts should require them to deposit the undisputed portion of the loan before admitting the case so that routine frivolous appeals diminish.
- The system also needs professional turn-around agents who can step in the place of promoters. Asset Reconstruction Companies (ARCs) were meant to do this, but they need more capital and better management capabilities. Also, there is a requirement that they hand the enterprise back to the original promoter once they have generated enough value to repay the original debts. Such a requirement is misconceived and needs to be repealed, else ARCs have little incentive to spend effort and money to turn around firms. They will simply be liquidators, as they have largely proven to be so far. I should mention that the RBI is open to more firms applying for licenses as ARCs.
- The government is working on a new bankruptcy law, which is very much needed. Properly structured, this will help bring clarity, predictability, and fairness to the restructuring process.

Flexibility not forbearance

Finally, let me end on a current concern that pertains to the RBI's regulation that is not unrelated to the issues discussed in this lecture. Today, a large number of industries are getting together with banks to clamour for regulatory forbearance. They want the RBI to be "realistic" and postpone any recognition of bad loans.

This is short-sighted, especially on the part of the banks. Today, the market does not distinguish much between non-performing loans and restructured loans, preferring to call them both stressed loans and discounting bank value accordingly. Mutilating Shakespeare,

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2 Section 21 of RDDBI Act requires deposit of 75% "of the amount of debt so due from him as determined by the Tribunal...". In appeals to DRAT from action initiated under SARFAESI Act, under section 18(1) second proviso of SARFAESI Act, "... no appeal shall be entertained unless the borrower has ***deposited with the Appellate Tribunal fifty per cent of the amount of debt due from him,*** as claimed by the secured creditors or determined by the Debt Recovery Tribunal, whichever is less."

an NPA by any other name smells as bad! Indeed, because forbearance makes bank balance sheets opaque, they may smell worse to analysts and investors. The fundamental lesson of every situation of banking stress in recent years across the world is to recognize and flag the problem loans quickly and deal with them. So regulatory forbearance, which is a euphemism for regulators collaborating with banks to hide problems and push them into the future, is a bad idea.

Moreover, forbearance allows banks to postpone provisioning for bad loans. So when eventually the hidden bad loans cannot be disguised any more, the hit to the bank's income and balance sheet is larger and more unexpected. This could precipitate investor anxiety about the state of the bank, and in the case of public sector banks, leave a bigger hole for the government to fill. These are yet more reasons to end forbearance. Or put differently, forbearance is ostrich-like behaviour, hoping the problem will go away. It is not realism but naiveté, for the lesson from across the world is that the problems only get worse as one buries one's head in the sand.

At the same time, the banks have also been asking the regulator for greater flexibility to restructure loans so as to align them with the project's cash flows, and for the ability to take equity so as to get some upside in distressed projects. These are more legitimate requests as they imply a desire to deal more effectively with distress. The regulator has been reluctant to afford banks this flexibility in the past because it has been misused by bank management. Nevertheless, recognizing that it cannot micromanage the resolution of distress, the RBI is exploring ways to allow banks more flexibility in restructuring. This is a risk we are prepared to take if it allows more projects to be set on the track to recovery.

In sum, the RBI opposes forbearance which simply pushes problems into the future, while it will allow more flexibility so that problem loans can be dealt with effectively today. Let us also be clear that we will be watchful for misuse of flexibility and will deal severely with it if it occurs.

Conclusion

Let me conclude. Perhaps the reason we have been so willing to protect the borrower against the creditor is that the hated moneylender looms large in our collective psyche. But the large borrower today is not a helpless illiterate peasant and the lender today is typically not the *sahukar* but the public sector bank – in other words, we are the lender. When the large promoter defaults wilfully or does not cooperate in repayment to the public sector bank, he robs each one of us taxpayers, even while making it costlier to fund the new investment our economy needs.

The solution is not more draconian laws, which the large borrower may well circumvent and which may entrap the small borrower, but a more timely and fair application of current laws. We also need new institutions such as bankruptcy courts and turn-around agents. Finally, we need a change in mind set, where the wilful or non-cooperative defaulter is not lionized as a captain of industry, but justly chastised as a freeloader on the hardworking people of this country. I am sure that is a change in mind set that Dr. Verghese Kurien would approve of. Thank you!