AS SAFE AS A BANK?

Money Matters

M Damodaran

It is rare that a well-intentioned statement has both positive and negative consequences. On 4th October, 2019, a few days after the shenanigans in the Punjab and Maharashtra Cooperative (PMC) Bank were out in the public domain, the Governor of the Reserve Bank of India (RBI) stated thus: "I would like to make it very clear that the banking system remains sound and stable, and there is no reason for any panic." If this was meant to calm the banking world and assure the markets that all was well, it ended up with additional questions being raised. Firstly, was the head honcho of the banking regulatory system required to make a statement of this kind when it was only a case of failure of one multi-state cooperative bank? Secondly, did the fact that the Governor made such a statement point to a situation where there was more trouble ahead, with more such banks falling like ninepins? Official statements, especially given a context of this kind, are often taken with more than a pinch of salt, even in these hypertensive times.

At the heart of the matter is the failure of a multi-state cooperative bank, which is no more than a cooperative society doing banking business in more than one state. Even when multi-state cooperative societies came into being through an Act of Parliament, ostensibly to serve public interest in more than one state, questions were raised on the possibility that the federal system was getting diluted. In the distribution of subjects between the Union and the States, cooperative societies figure as entry 32 of the State list. Did cooperative societies, functioning on the basis of common or shared ownership, need to extend beyond State boundaries, especially when it was a subject falling within the province of the State? Whenever a cooperative bank goes belly up, we hear of duality of regulation being identified as the villain of the piece. The explanation trotted out then, as well as now, is that with the Boards and the managements of cooperative societies being under the jurisdiction of the Registrar of Cooperative Societies, and with provision for audit and inspection for such societies being made in the relevant statute, the role of the RBI as the banking regulator is circumscribed and rendered less effective. Several committees have given reports on how this perceived problem is to be addressed, and yet, this might not be the last instance of a cooperative bank going under because of inadequate, ineffective and delayed regulatory intervention.

A cooperative society can undertake the function of banking only if it is permitted to do so by the RBI. Before granting permission, it is incumbent on the RBI to ascertain whether the cooperative society has been properly constituted, and has put in place the requisite checks and balances for the conduct of safe banking. After the society commences the business of banking, in its avatar as a cooperative bank, the RBI is expected to carry out annual inspections. In addition, there are audits by statutory auditors as well as inspection by the Registrar of Cooperative Societies. In the case of multi-state cooperative banks, such as the PMC Bank, there is also a Central Registrar of Cooperative Societies whose powers and functions in respect of the conduct of banking business, are either inadequate or unclear. One is tempted to ask whether this is yet another case of the existence of too many cooks spoiling the broth.

The now discredited Managing Director of PMC Bank has stated that a number of bogus accounts were opened to funnel the funds to a large infrastructure company. In these days, when genuine bank customers are being bombarded with messages on updating their KYCs (Know Your Customers), it is inconceivable that no one chose to ascertain how so many accounts were opened ostensibly without KYCs.

For all its claims of having its hands tied by the duality of regulation, the RBI will find it difficult to explain why it allowed the bank to continue doing business when its directions to remove the Chairman more than a year ago had not been complied with. It is also understood that in the 2017-18 inspection, the RBI had asked the bank to classify the entire Housing Development and Infrastructure Limited (HDIL) account as a Non-Performing Asset (NPA) and the bank got away by stating that the exposure to the group was only Rs. 258 crores, and it was fully collateralised. How that amount increased to Rs. 6,500 crores, constituting 73 per cent of the assets of the bank, is a matter that merits forensic scrutiny by a credible independent agency.

Even after the whistle blower report reached the RBI, the restrictions limiting withdrawals took a few days to be put in place, by which time, a few large depositors of the beleaguered bank had already made massive cash withdrawals.

Making appropriate regulatory noises about putting controls in place after the horse has bolted, yet again, does not help anyone's cause. Blaming duality of regulations is an excuse past its sell-by date. What needs to be done is to undertake detailed inspections of the larger urban cooperative banks, with business above a certain threshold, to ascertain whether the right persons are in charge, and whether right practices are being followed. Separately, the RBI should ask itself whether it has the bandwidth to undertake regulation of such a large number of cooperative banks. A leaf can be taken out of its own book by going back to 1998 when, after taking into account a large number of Non-Banking Financial Companies (NBFCs) in its regulatory domain, the RBI decided that it would regulate only deposit taking NBFCs. Can some similar carve-out not be attempted for cooperative banks? Also, since the control over cooperative banks by the State authorities cannot be wished away, should RBI not consider deputing its own experienced officers to the offices of the Registrars of Cooperative Societies to strengthen their audit or inspection function?

This piece started with the statement of the Governor that the banking system is safe and sound. It might be worthwhile to end with another statement attributed to the Governor to the effect that no more cooperative banks will be allowed to fail. The Annual Reports of the Deposit Insurance and Credit Guarantee Corporation (DICGC) list the number of cooperative banks that have failed year after year. Systemic safety demands that banks whose operations are unsustainable, must be allowed to fail, because a chain is only as strong as its weakest link. Depositors who chase higher returns without giving equal attention to safety and liquidity, ought to be appropriately sensitised. Easier said than done, when a cooperative society of RBI officials is reported to have deposits of more than Rs. 100 crores in the troubled PMC Bank.

The only silver lining in the episode is the knowledge gained that joy need not usher in happiness.

The writer is a former Chairman of the SEBI, UTI and IDBI, and is now the Chairperson of Excellence Enablers.

Syndicate: The Billion Press