e-Resources Module-XI

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BALANCE SHEET MANAGEMENT OF BANKS IN POST-REFORM INDIA

Owing to the paramount importance of banking for the growth process of the Indian economy, proper balance sheet management by banks is of utmost importance so as to prevent any episode of banking crisis. For, a banking crisis typically starts with poor balance sheet management on the part of commercial banks that manifests itself in the form of accumulation of bad debts and Non-Performing Assets (NPAs) in their balance sheets. Still we find that banking crises seem to have become the order of the day in the Indian economy so much so that even in the post-reform era, India has witnessed two major banking crises. In this context, it is worth noting that while the banking crisis of 1997-2002 was essentially the outcome of post-reform structural changes in the Indian economy, the roots of present banking crisis in India that has erupted since 2008 can be located in the excessive lending done by banks for infrastructure and project financing during the investment and credit boom of 2003-2008.

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In a bank-centric economy like India, proper balance sheet management by banks is of utmost importance since owing to the paramount importance of banking for the growth process of the economy, a *strong*, *safe*, *stable* and *sound* banking system is absolutely essential to prevent a banking crisis as also an economic crisis. Still we find that banking crisis seems to have become a *recurrent phenomenon* in India so much so that even in the post-reform era, the Indian economy has witnessed two major banking crises.

More specifically, in the wake of South-East Asian crisis in 1997, a major banking crisis occurred in India that practically lasted till 2002. Subsequently, in the aftermath of the U.S. Sub-prime lending crisis in 2008, another banking crisis occurred in India which has still not been resolved. All these banking crises start with poor balance sheet management on the part

of commercial banks in India that manifests itself in the form of accumulation of bad debts and Non-Performing Assets (NPAs) in their balance sheets.

On closer examination, however, we find that the underlying reasons for the accumulation of NPAs with commercial banks could differ over time depending upon the prevailing macroeconomic environment at the domestic and international levels when the concerned banking crisis occurred. For instance, the main reason behind the banking crisis of 1997-2002 in India was the adoption of policies of *deregulation*, *liberalisation*, *privatisation* and *globalisation* ever since early 1990s that led to a "credit boom" but eventually several of market participants could not withstand the fierce competition and were forced to close down thereby failing to repay the loans taken from banks.

To be precise, inspired by the liberal economic policies pursued under the economic reforms of 1991 in India, several new firms entered the domestic market and many of the existing firms tried to expand their capacity relying on huge borrowings from commercial banks. But since under the policy of globalisation, even foreign firms were allowed to enter the domestic market, the competition became "too tough to bear" for a number of domestic firms who were unable to adapt to the emerging economic environment. Evidently, such firms were competed out of existence and as a result the loans taken by them from banks became bad debts and NPAs that could never be repaid. This is what explains the genesis of the problem with balance sheets of commercial banks in India at that time.

As far as the Development Financial Institutions (DFIs) specialising in the provision of long-term finance to the industrial sector at that time are concerned, they too faced rough weather in as much as their access to "low cost capital" from the side of monetary authority was withdrawn under the pretext of banking and financial reforms in India. Even their borrowings from banks through bonds issued by them that qualified for Statutory Liquidity Requirement (SLR) of banks suffered a major jolt when statutory pre-emption of public funds by channels such as SLR was curtailed under reforms of the banking and financial sector in India. Consequently, the financial position of the DFIs worsened to such an extent that they were no longer economically viable.

Thus, it follows that the banking crisis of 1997-2002 was essentially the outcome of post-reform structural changes in the Indian economy. In sharp contrast, the roots of present banking crisis in India that has erupted since the North Atlantic Financial Crisis in 2008, can be located in the excessive lending done by banks during the investment and credit boom of 2003-2008.

In this context, it is worth noting that the credit boom of mid-2000s in India was much larger than the credit boom of 1990s and consequently, the extent of resulting NPA problem too was far more acute during the latter banking crisis vis-à-vis the former one. In fact, the growth rate of NPAs with banks is much higher in the ongoing crisis in comparison to the one witnessed during 1997-2002.

One major factor contributing to the accumulation of NPAs with commercial banks during 2003-08 that eventually culminated into the banking crisis of 2008 was the transformation in composition of bank lending. With the demise of DFIs during 1997-2002 on account of banking and financial reforms that withdrew their access to low-cost capital and curtailed borrowing from banks by lowering SLR, banks were forced to enter the arena of "project financing" *i.e.*, long-term financing for new industrial projects.

But as opposed to DFIs that were funded through long-term bonds, the commercial banks essentially relied on their deposits as the main source of funding and bank deposits by their very nature largely tended to be short-term in their maturity profile. Evidently, when commercial banks tried to finance long-term projects on the basis of short-terms deposits, it was bound to generate serious "asset-liability mismatches" in their balance sheets.

Another factor that aggravated the problem of NPAs during 2003-08 was that during this period, banks tried to meet the emerging demand for credit arising out of *infrastructure* development firms such as aviation, telecom, mobile telephony etc. But, unlike DFIs, banks had little experience or expertise in assessing the credit-worthiness and commercial viability of such schemes.

In addition, lending to infrastructure exposed banks to "risks" they were not accustomed to such as those arising out of long gestation lags, delays and roadblocks on account of environmental clearances, political problems such as policy paralysis, corruption scandals and the like. This lack of requisite *capabilities*, *expertise* and *experience* on the part of commercial banks to handle *project financing* and *lending to infrastructure* during the credit boom of 2003-2008 led to improper assessment and inappropriate credit appraisals thereby leading to the accumulation of bad debts and NPAs in their balance sheets that in turn culminated into the banking crisis of 2008 in India.