HEB **The Growing Threats to India's Financial System** CASS

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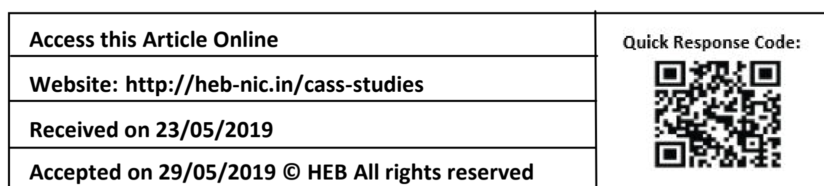
ABSTRACT:

India's banking industry is the largest in the world and is expanding rapidly. It is currently worth of about Rs. 81 trillion. Today, the banking industry in our country is stronger and capable of withstanding the pressures of competition. It withstood Global Financial Crisis (2008). In the era of Globalization Banking Sector in India is fastly changing since 1990s due to technological innovation, financial liberalization with entry of new private and foreign banks, and regulatory changes in the corporate sector. Indian banking industry is gradually moving towards adopting the best practices in accounting, internationally accepted prudential norms, with higher disclosures and transparency, corporate governance and risk management, interest rates have been deregulated, while the rigour of directed lending is being progressively reduced. In our country, currently we are having a fairly well developed banking system with different classes of banks–public sector banks, foreign banks, private sector banks–both old and new generation, regional rural banks and co-operative banks with the Reserve Bank of India as the leader of the system. In the banking field, there has been an unprecedented growth and diversification of banking industry and our banks are now utilizing the latest technologies like internet and mobile devices to carry out transactions and communicate with the masses. In these circumstances, this Paper is an attempt to review the banking system in our country.

Keywords: **Financial crisis, financial liberalization, corporate governance.**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INTRODUCTION

Introduction Over the past three years, the Indian media and corporate circles have focused on delays in land acquisitions and environmental clearances as a key source of India's economic woes. Investors and rating agencies have warned that investors are increasingly being driven away by unpredictable losses caused by these regulations.

Simultaneously during the past year, there has been growing concern about the growth of bad loans in the banking system – now estimated to account for at least 14 percent of total bank credit,1 and exceeding the total net worth of India's banks. The non-performing assets in the banking sector have ballooned to Rs. 4.85 trillion (US$78 Billion) by Dec 2014.3 This is threatening public sector banks in particular, and there has been a growing concern about the enormous financial burden that a bailout would impose on already strained government finances. Agencies have begun to predict that banks will require a giant capital infusion to meet Basel III norms before the March 2019 deadline (for example, Fitch Ratings estimates $200 billion).4 Reserve Bank Governor Raghuram Rajan recently revealed that almost Rs. 1.6 trillion (US$27 billion) in bad loans have been written off in the last five years alone.

Since infrastructure and resources sector companies form the largest chunk of loan defaulters, the bad loan problems of financial sector are all too often described as a consequence of delays in land acquisitions and environmental clearances. It is then concluded that easier and faster clearances to large projects will result in relief to the financial system. It is also thought that "easier" access to land and natural resources will ease mounting stress on the financial system, generate employment, and contribute to economic growth.

Unfortunately, much of this analysis is based on a superficial understanding of how India's financial and environmental regulations actually work. In this brief, we present an analysis of the actual mechanics of these regulations, and how they relate to each other. In doing so, we reach exactly the opposite conclusion of the government of India and the financial media.

We find that India's current system of financial and environmental regulation is jeopardizing India's financial system for entirely different reasons to those often argued. And the planned "reforms" of this system will exacerbate these growing threats.

Key Features of the Current Natural Resource Regulatory System in India

India's current set of regulations around natural resources – minerals, land, forests, environment and pollution – is a complex web of State and Central laws that require permissions from multiple authorities. The system has certain basic features:

- Decision making is done on a project by project basis – there is no structure for overall local, regional, or national regulation.
- As a corollary, decisions on individual projects are made without regard for overall resource availability or cumulative impacts.

- Decision making is highly compartmentalized. The Mines Ministry allocates mines with no consideration for environmental regulations; the Environment Ministry considers each project regardless of the policy priorities of other Ministries; and, as we shall see, financial regulators and institutions generally have very little information on other regulations.
- Final decision making power rests with small groups of bureaucrats, either at the Centre or the State.
- Regulators have very little access to neutral or objective information. Assessments are either by local officials (and very poor in quality) or by paid consultants (such as Environment Impact Assessments). External inputs are either impossible or severely discouraged (at most, regulators may hear project proponents).There is no information available on which people are impacted and how. The complete failure to carry out the procedures that would provide such information, such as recognition of rights under the Forest Rights Act or social impact assessments, means that decisions are based essentially on figures that have no relationship to reality.
- Transparency is very low. Public disclosure is very poor and difficult to access, even for project proponents. Reasons for decisions are either not given at all or are extremely perfunctory.
- Accountability is similarly limited. Legal provisions do not provide for action against officials engaged in illegal or mala fide decisions. False and incorrect information is routinely given to the public.
- Monitoring and follow-up practices are extremely poor. Once a license, allocation or clearance is granted, the project proponent is essentially free to do as they like. For example, forest and environment clearance conditions are practically never monitored. Holders of captive coal mines frequently break rules barring sale of the mine (for instance, through selling the company itself) or sale of coal.
- Unpredictable: For applicants, affected communities, and the public in general. The only safe prediction is that practically all projects will eventually be cleared. Approximately 99 percent of all projects receive forest and environmental clearancerejection of private projects is extremely rare. But there is no clarity regarding how long a clearance will take or whether laws will be followed.
- Arbitrary: There is no consistent behaviour regarding conditions, statutory compliance, or studies. A decision once made could be reversed; projects rejected twice or thrice will then suddenly be cleared. As noted above, the reasons behind decisions are rarely stated.
- Irrational: All commentators agree that India suffers from scarcity in vital resources, either because of lack of reserves or poor utilisation. But resource use is decided on an entirely ad hoc basis and without any relationship to any overall policy goal.

Key Features of the Current Financial Regulatory System

Financial regulators typically maintain an “arm’s length” approach to resource issues, perhaps lacking in the capacity or manpower to evaluate them. For instance, key regulators take the following stands on natural resource issues.

- Reserve Bank of India (RBI): Regulations forbid granting loans to private companies “purely for land acquisition.” Special Economic Zones must be treated on par with commercial real estate projects, and hence require higher reserves.
- Securities and Exchange Board of India (SEBI): Only a general requirement to disclose risk to investors is imposed.
- Private rating agencies sometimes seek to take regulatory compliances into account, but not always.
- Our research indicates that the RBI does not regulate due diligence by banks further than this. For instance, there appears to be no guidance regarding provision of credit to projects that have not received environmental or forest clearances.

  Similarly, there do not appear to be any explicit requirements from SEBI to disclose regulatory compliance or the status of clearances. These problems are then compounded by what RBI Governor Rajan has described as the “large borrower’s divine right to stay in control.” India lacks bankruptcy legislation, meaning lenders cannot effectively coordinate to salvage their loans. Moreover, RBI guidelines and bank practices permit projects to be funded almost entirely by debt (in Rajan’s words: “promoters should not try to finance mega projects with tiny slivers of equity”). As a result, when projects go bad, the banks are left holding bad loans and the promoter frequently escapes any consequence at all. In sum, the system protects the promoter at every turn – when seeking access to resources and approvals, when seeking finance, and when failing to repay loans.

Impacts of this Form of Regulation

This combination of regulations has a very specific impact on the kind of projects that are promoted. It has two specific consequences: rewarding “fixers” and those who can manipulate bureaucracies; and resulting in devastating impacts in local areas, thereby triggering social conflict, which is then blamed for more “delays.”

Encouraging “Fixing,” Cronyism, and Regulatory Arbitrage Since the current system is so heavily tilted towards unaccountable decisions by small groups of bureaucrats, it rewards those who can navigate the system. It also does not impose any penalty for false claims or for willful failure to either complete projects or to comply with conditions. Indeed, it rewards those whose intention is to engage in speculative activity, since they can simply leverage access to assets rather than engaging in the risks of actual production.

Evidence of this is available from a variety of locations:

- In Orissa, a CAG audit of land acquisition between 2001 and 2012 found gross illegalities. Most telling of these was that the State Industrial Development Corporation permitted companies to mortgage 46,533 acres of publicly acquired land – despite not having the power to do so. Nineteen of these companies (the CAG could not track the remainder) raised close to Rs. 52000crores (US $8.5 billion) by mortgaging this land. The IDCO did not check if these loans were for the purposes of the project. As of March 2012, out of 89 memorandums of understanding (MoUs) signed by the State

government, only two projects were actually ready to start production. There were numerous other illegalities as well: urgency clauses invoked with no justification; objections from landholders ignored; compensation paid years after the event; and so on.

- In Rajasthan, a similar CAG audit found that as of June 2014, only 34,108 out of 72,709 acres of acquired land had been allotted. Out of the allotted plots, 27 percent were not being used for industrial production. As such, only an estimated 30 percent of land that was acquired was actually being used. Regulations say that only one third of a proposed project needs to be built up area, meaning that companies can get three times as much land as their factory will occupy. There is no bar on resale of land allotted by the Rajasthan State Industrial Development Corporation.
- In November 2014 the Comptroller and Auditor General tabled its report on Special Economic Zones (SEZs) in Parliament. The report found that most SEZs were massively "underperforming" on the key indicators of employment, investment and export, and said, "The achievements of SEZs in the country are contributed by a few SEZs located in some developed States, which were established prior to enactment of the SEZ Act."

  The report's executive summary bears quoting in extenso:

  "Land appeared to be the most crucial and attractive component of the scheme. Out of 45635.63 ha of land notified in the country for SEZ purposes, operations commenced in only 28488.49 ha (62.42 percent) of land. In addition, we noted a trend wherein developers approached the government for allotment/purchase of vast areas of land in the name of SEZ. However, only a fraction of the land so acquired was notified for SEZ and later denotification was also resorted to within a few years to benefit from price appreciation. In terms of area of land, out of 39245.56 ha of land notified in the six States3, 5402.22 ha (14 percent) of land was denotified and diverted for commercial purposes in several cases. Many tracts of these lands were acquired invoking the "public purpose" clause. Thus land acquired was not serving the objectives of the SEZ Act....In four States (Andhra Pradesh, Karnataka, Maharashtra and West Bengal), 11 developers/units had raised Rs. 63.09 billion of loan through mortgaging SEZ lands. Out of which, three developers/units had utilized the loan amount (Rs. 22.11 billion i.e 35 per cent of Rs. 63.09 billion) for the purposes other than the development of SEZ, as there was no economic activity in the SEZs concerned (emphasis added)."
- According to the Centre for Science and Environment, between 2007 and August 2011, 267 thermal power projects with a total capacity of 2.1 lakh megawatts were granted environmental clearance. Actual installation pace was six times less than the speed at which projects were being cleared. Moreover, in just these five years the cleared capacity was approximately 2.5 times greater than the total capacity installed since independence. By 2011 the government had cleared enough capacity to generate more than 40 percent more power than the total generation target for 2017. In other words, it is highly unlikely that all of the projects that received clearance are going to come into existence.
- In Chhattisgarh, according to the Economic Times, the private power producers' association itself estimated that only 15 out of a planned 60 private projects – for most of which land had been acquired

– would ever become operational. In one case, a five crore company signed an MOU for a Rs. 1,000 crore thermal power plant. The story quotes a former member of the State Electricity Board stating that 45 to 50 companies were sitting on land and trying to sell their projects.

- In 2012, a report released by the Ministry for Housing and Urban Poverty Alleviation stated that 62 percent of the new housing built in the country between 2007 and 2012 was "vacant or locked up" even as the country continues to suffer from a severe housing shortage. This is mostly because no serious assessment was done about the affordability of the housing being built, and the project was based largely on speculation.

These projects are not only a waste of resources or a question of bureaucratic malfeasance. They also pose a direct threat to the banking system and to investors' interest. When such projects are granted credit – either on the basis of resources they have received or on the promise of doing so – their promoters are essentially gambling with public money. When such projects in turn begin to face problems, they give rise to constant pressure for more clearances to be granted – in order to "rescue" investors or projects that should never have been cleared in the first place.

For instance, Hindalco and Essar built power plants in Singrauli, Madhya Pradesh without any coal linkage - with a total investment of Rs. 20,000 crores. When the forest clearance for the coal block was first questioned on grounds of falling in the then "no-go" zone for mining (and subsequently on grounds of violation of the Forest Rights Act), the two companies put enormous pressure on the government – such as writing to the Prime Minister's Office that 65 percent of the project was completed and rejection would result "in an avoidable huge loss to us as well as the country." Such "fait accompli" arguments, as the Supreme Court observed in its judgment in the Lafarge case, have become all too common. Finally, given that the clearance and regulatory process lack any objective information on a project, there is no way of evaluating whether even "successful" projects have in fact produced a net contribution or not.

Deepening Social Conflict

The above process does not go uncontested. An increasing number of protests are taking place across the country against resource takeover for large projects. In a recent compilation, the Rights and Resources Initiative (RRI) and the Society for Promotion of Wasteland Development (SPWD) found that at least a quarter of India's districts are witnessing some form of conflict over land and resource takeover. Nor is this unusual – a 2013 survey of 29 emerging economies found that social conflict affected projects in most of them, resulting in project timelines up to five times longer than originally planned.

In India, the most well-known case of such conflict is the POSCO project; the country's largest planned foreign direct investment where the company has not been able to take possession of a single inch of land in almost a decade. Yet, similar conflicts affect projects across sectors and have stopped projects of both the public and private sectors. Mining projects, such as the Mahan, Ganeshpur and

Sarguja coal mines are being fiercely contested. Dam projects in Arunachal Pradesh, Andhra Pradesh, Uttarakhand and Himachal Pradesh are facing strong opposition as well. The violence and mass demonstrations against the Nandigram and Singur projects in West Bengal contributed to the fall of the Left Front government in the state in 2011.

As noted above, such conflicts have, once again, grave impacts for banks and investors. Money tied up in these projects is lost, and, as we saw above, the promoters rarely pay any price for this. The net result is that the state either must bail out the creditors in question (since public sector banks are likely to be involved), or use force to ram a project through against the law and without respecting the rights of the local community. Neither of these choices yields any benefit to the financial system or the economy, while carrying high costs.

Commentators frequently blame these conflicts on “instigation” by NGOs, Maoists, or simply “vested interests.” But it is not clear how these vested interests are able to mislead people more effectively than corporations and the state machinery, which frequently have massive budgets and workforce for precisely this purpose.

Moreover, from the point of view of the financial system, such presumptions amount to burying one’s head in the sand. Conflicts are spreading across the country. As noted above, the regulatory process lacks any ability to objectively measure the social and human impact of projects. Increased compensation, which is the only solution offered by proponents of “fast clearances” is hence irrelevant, as the regulatory authority can have very little idea about who is affected, who should be compensated, and by how much.

Moreover, this ignores the fact that many such projects are not beneficial in the first place, and hence likely to be opposed regardless of the compensation amount. Whether one believes that they are “instigated” or not, conflicts are not going to vanish. Rather, they will continue and almost certainly spread, putting at risk the money invested in misguided and illegal projects, money that often ultimately has to be repaid by the Indian government and people.

Reforms since 2011 and their Likely Effects

Despite these realities, the frequent demands for faster clearances have already resulted in a series of “reforms” that are in fact likely to exacerbate the system’s underlying problems.

Some of these steps include:

- Environmental clearances: The requirement for public hearings has been effectively removed for expansion of coal mines. The Expert Appraisal Committee has now been directed to not ask for additional studies beyond those done in the original environmental impact assessment (which is paid for by the project proponent). It has been reported that the Confederation of Indian Industries has asked for a standard format of terms of reference to be provided for all environment impact assessments in each sector, meaning that all environment impact assessments would then assess only the points covered in the “template” terms of reference. Finally, there have been proposals to replace

inspections for compliance with "self-certification" by project proponents. The TSR Subramanian High Level Committee on environmental law reforms essentially repeated these proposals in their recommendations. In addition, the committee recommended the framing of a new law that would drastically curtail the requirement for public hearings, impose very short deadlines on appeals against illegal/fraudulent clearances, and simultaneously require authorities to take the statements of project proponents on "utmost good faith". At the time of writing this paper, the government had called for bids from private consultants in order to draft a new law on the lines recommended by the High Level Committee.

- Forest clearances: The provisions of the Forest Rights Act require that forest land can only be diverted for non-forest use after obtaining the informed consent of the affected villages (through their gram sabhas), and after they certify that recognition of rights is complete. Notwithstanding strident and repeated protests from the Ministry of Tribal Affairs, the Ministry of Environment and Forests has essentially ignored this requirement in its forest clearances, and is now seeking to dilute it. On October 28th, the Environment Ministry issued a new order stating that the District Collector (in non-tribal areas) may certify whether the area is a "plantation" or not and hence whether the Forest Rights Act is applicable or not. This letter too was strongly opposed by the Tribal Ministry, but at the time of writing it remains operational.
- Land acquisition: The 2013 Right to Fair Compensation and Transparency in Land Acquisition, Resettlement and Rehabilitation Act (the 2013 Land Acquisition Act for short) provided a number of new measures as part of the land acquisition process–among them requiring the consent of 70 percent or 80 percent landholders in cases where acquisition is for a private party or a public private partnership, and providing for a Social Impact Assessment. However, on December 31, 2014, the NDA government amended this Act through an ordinance. This ordinance removed the consent and social impact assessment requirements for the vast majority of projects, whether private or public sector, effectively restoring the 1894 Act except for an increase in compensation and rehabilitation amounts.
- Financial regulations: In July, the Reserve Bank of India directed that banks do not need to hold the normally required cash reserve ratio and statutory liquidity ratio when issuing bonds for infrastructure lending, while also making it easier to extend long-term loans to infrastructure companies.
- All of these reforms share certain common themes. First, they reduce the access to external and objective information in the regulatory process – by restricting the impact assessments that can be carried out and by reducing the already very limited role of public input. Considering that the lack of such objective information is a key problem in the current system, further reducing access to it is only likely to severely worsen the situation.
- Second, they reduce transparency in decision making and public input. The provision for gram sabha consent in the Forest Rights Act, for instance, at least results in forest officials revealing plans for diversions and projects to affected communities. In practice, since forest officials in any case have an

enormous amount of power over forest dwellers, the idea of the latter arbitrarily exercising a "veto" does not arise. Similarly, exempting coal mine expansions from public hearings means that the affected communities often will not even come to know that an expansion is planned. Given that rehabilitation is abysmal in practice, this will mean that officials can further escape their legal and administrative responsibilities. Such arbitrary decision making will in turn lead to further conflict as local people are highly likely to oppose forcible expropriation of their lands and resources.

- Third, they fail entirely to address the existing problems in the system. Rather than addressing the large numbers of fake, non-serious, and corrupt projects currently receiving clearances, they would in fact make it easier for such project proponents to receive approvals.

Finally, the RBI's regulatory changes mean that banks are likely to increase their exposure to this sector – even as these reforms exacerbate the threat to the financial system from poor resource regulation.

Recommendations for Financial System Reform

In light of the above, India's financial and regulatory architecture requires certain critical reforms in order to stop encouraging the damaging and destructive patterns of regulation and resource use and their harmful financial consequences.

1. First, financial regulators need to ensure that the process of granting credit to resource intensive projects is reformed after a detailed study of conditions on the ground. Appropriate regulations on due diligence should be imposed, as well as increases in reserve requirements. It must be recognised that in a country like India, with its complex land use rights and regulations, overlapping regulatory jurisdictions and an enormous range of types of resource use, infrastructure projects are inherently risky. Such risk does not flow from the regulatory system but from the nature of such projects.
2. Second, as part of such due diligence, financial regulators should ensure that credit is only extended when proponents have completed necessary clearances both for the projects in question and for any other ancillary activities (such as mining linkages). Prior to such clearances, large amounts of credit are in any case not required, as work on the project cannot begin. The practice of granting loans purely on the basis of the project proponent's assurances – or the assurances of government agencies – should be halted immediately.
3. An integral part of this due diligence should include evidence of the consent of affected communities to the project and to compensation/rehabilitation being offered. This will be a step towards reducing the tendency of reckless financial activities to result in violations of rights and social conflict. The RBI should issue guidelines in this regard, taking into account existing legislations, including the Forest Rights Act.
4. Finally, all financial institutions and the RBI should have ombudsmen whose task is to consider and respond to complaints of either illegal or fraudulent projects. These ombudsmen

should provide swift internal administrative remedies. This will reduce the need to approach the courts for remedying every violation. These recommendations are independent of the extensive reforms required in the environmental and resource regulation system, which requires a major overhaul to make it democratic, transparent, and accountable, as well as to halt the trend of illegal, corrupt, and unjustified approvals.

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