The Big Read Reserve Bank of India

How the rise of shadow banking fed India's 'clash of egos'

With elections next year, Narendra Modi is keen to see a change in approach from the central bank to help avert a slowdown

Simon Mundy and Henny Sender in Mumbai NOVEMBER 21, 2018

For most of the past 83 years, the directors of the Reserve Bank of India went almost unnoticed as they met for regular board meetings to discuss mostly administrative affairs.

But when the 18 central board members filed in for this week's meeting at the RBI's Mumbai headquarters, they were the object of a media frenzy, with additional police drafted in to monitor a gaggle of cameramen jostling outside the building's fortified entrance.

For the past month, India's central bank has been at the centre of a political storm like few others in its history. The controversy was triggered by a sudden liquidity squeeze that severely affected India's non-bank lending sector, a key driver of credit growth over the past three years. Amid fears of a hit to the economy during its drive for re-election, Prime Minister Narendra Modi's government ramped up pressure on the central bank for stronger action and implicitly threatened to give it direct orders — sparking fears for the institution's prized, but legally fragile, independence.

RBI governor Urjit Patel: beginning to toe the government's line? © Bloomberg

After nine hours, the board — including governor Urjit Patel and his four deputies, as well as two senior finance ministry officials — reached a compromise. The RBI would reassess its handling of its reserves and its lending restrictions on troubled banks — both key targets of government lobbying.

But the agreement left open the questions that had dominated debate before the meeting. Uncertainty remains about the outlook for credit growth, with non-bank lenders eyeing sharply slower expansion, and the state-owned banking sector struggling under a mass of bad corporate debt. Mr Modi's government is expected to continue pushing the RBI to fend off a slowdown that could damage its chances in the next general election, which must be held by May.

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After a three-decade period during which central banks have moved towards greater independence, the Indian drama is part of a recent trend in which leaders in major economies — from the US to Turkey to Japan — have openly pushed monetary authorities to prioritise growth.

The statement issued after the meeting "looks like an attempt to paper over the differences between the RBI and the finance ministry", says Vivek Dehejia, a fellow at the IDFC Institute, a Mumbai think-tank. "But this is not over. This is a crisis deferred, not a crisis averted."

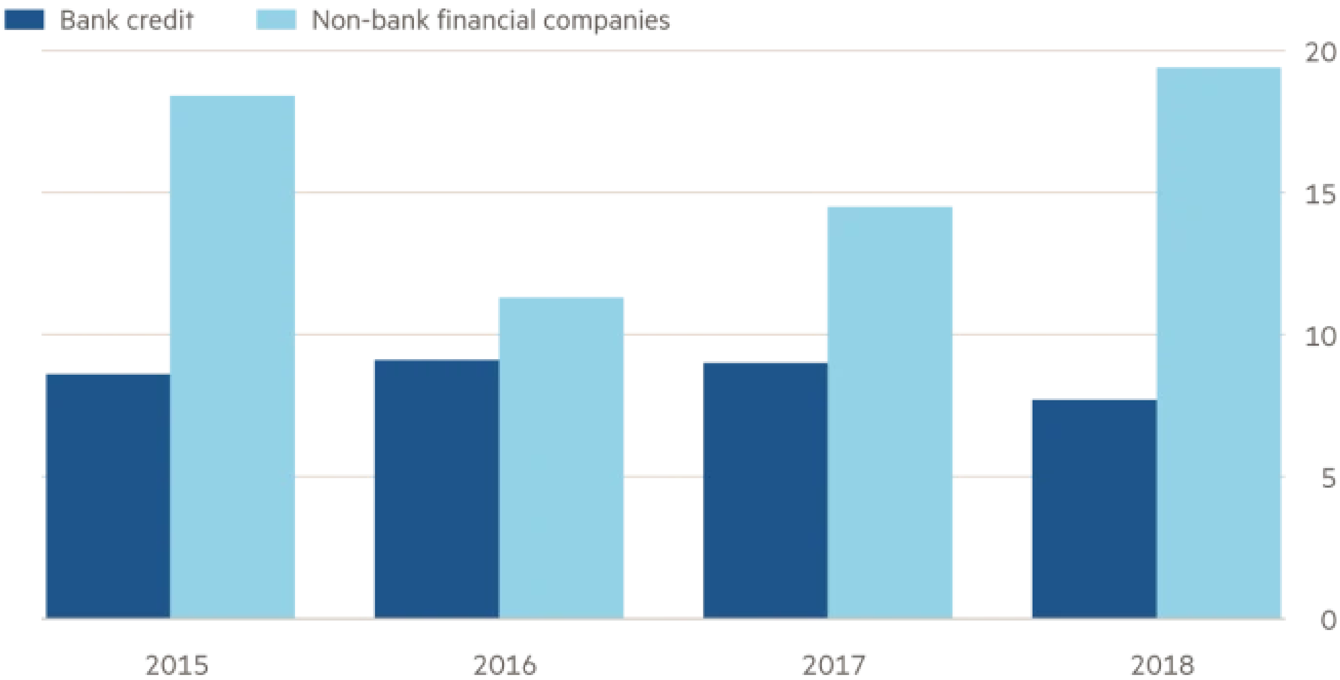
As India's state-controlled banks were sucked into a crisis of non-performing corporate debt over the past four years, following a glut of lending to ill-fated projects in infrastructure and industry, an opportunity appeared for non-banking financial companies, or NBFCs. Thousands of shadow banks, which face broadly less rigorous regulation than formal banks, rapidly took market share, ramping up loans to customers from scooter buyers to construction companies.

They were led by a handful of large, blue-chip names favoured by foreign investors, such as Bajaj Finance, part of the Bajaj conglomerate. A growing band of housing finance companies funded a real estate investment boom in India's largest cities, lending to both homebuyers and developers. A number of smaller NBFCs focused on consumer lending in communities that had been neglected by mainstream banks.

Over the past three years, non-bank lenders accounted for nearly a third of all new loans in India, according to Neelkanth Mishra, equity strategist at Credit Suisse in Mumbai. The trend averted a serious hit to credit growth and enabled the economy to expand at a rate of 7 per cent a year. By the end of March, the sector's aggregate balance sheet had reached Rs22tn ($309bn), according to the latest figures available from the RBI.

The boom in lending by India's shadow banks

Annual increase in total loan value* (%)



*Financial years ending March
Source: Nomura
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But the NBFCs' rapid growth was built on a risky approach to liabilities, with a heavy reliance on short-term corporate debt. "The tragedy is that housing finance companies, with 10-year home loans, were borrowing money from mutual funds that had overnight redemptions," says Uday Kotak, founder of Kotak Mahindra, one of the largest private-sector banks. "There was a huge mismatch."

This source of funding was turbo-charged after the government's controversial "demonetisation" of higher-value banknotes in November 2016, which forced Indians to deposit their old notes at banks. This resulted in a flood of money into the financial sector, much of which flowed into fixed-income mutual funds.

As NBFCs' short-term debt issuance soared, there was little difference in borrowing costs between the strongest and weakest — much like the minimal spread between Greek and German sovereign bonds before the eurozone debt crisis, says Sanjeev Bajaj, managing director of Bajaj Finance.

The risks of this model became painfully clear in September, after a string of defaults by entities within IL&FS, a finance and infrastructure group that was one of the biggest issuers of short-term corporate bonds — and had enjoyed a triple-A rating from rating agencies until the first of the defaults in late August, which followed disappointing returns on some of its key projects.

Uday Kotak, chairman of Kotak Mahindra Bank, has become non-executive chairman at troubled finance and infrastructure company IL&FS © Bloomberg

A decade on from the US subprime crisis, some observers saw uncomfortable parallels with the sudden downgrades of groups such as AIG — comparisons that added to investor jitters as IL&FS's woes rippled through the credit markets. In September, nervous investors pulled a net Rs2.1tn from fixed-income mutual funds, which in turn were forced to sell securities to meet the redemption requests. The share price of Dewan Housing Finance — one of the larger NBFCs — plunged by 42 per cent in a day, after one mutual fund sold its debt at a steep discount.

"It created the biggest fear psychosis I've seen for some time," says one top financial executive in Mumbai. "When a triple-A goes into default, everyone thinks: who can I trust?"

The government took dramatic measures to tackle the problems at IL&FS, unilaterally sacking the entire board and appointing a new one chaired by Mr Kotak. State-controlled banks, too, stepped in to provide liquidity to NBFCs, which had until recently been poaching their customers: State Bank of India, the largest of them, announced plans to buy up to Rs300bn of assets from NBFCs over six months.

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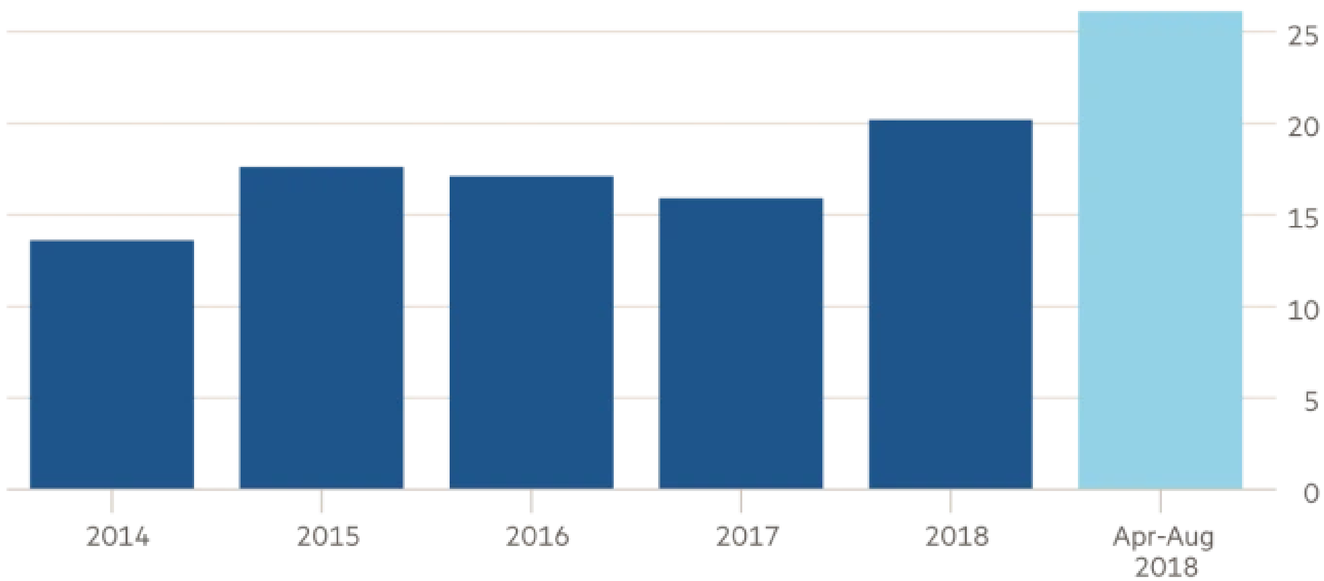
The RBI opened the way for further intervention by the state banks, allowing them to provide partial credit guarantees to NBFCs. To boost liquidity in the broader system, it sharply increased its purchases of government bonds, to Rs560bn in October and November.

The interventions helped to calm the jitters, with Indian money market funds enjoying modest net inflows in October. The worst fear of investors — more shadow banking defaults soon after the IL&FS missed payments — was avoided. But tensions were brewing between the government and the RBI, as Mr Patel fended off finance ministry pressure to do more to avert a lending slowdown.

The disagreement burst into the open with a provocative speech in October by Viral Acharya, a New York University economics professor who became an RBI deputy governor in 2016.

India's housing finance companies are reliant on short-term funding

Short-term funding as a proportion of total* (%)



*Financial year ending March
Source: Nomura
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In a thinly veiled attack on the government's approach, he cited the precedent of Argentina as he warned of the dangers of undermining central bank independence.

Since its election in 2014, Mr Modi's government has presided over four years of robust growth and moderate inflation. But the administration has persistently urged the central bank to do more to boost growth. The tensions were widely seen as a factor behind the exit of governor Raghuram Rajan, a former IMF chief economist, in 2016.

When he took the helm, Mr Patel faced scrutiny as to whether he would maintain his predecessor's focus on monetary discipline and uncompromising approach to cleaning up bank balance sheets. Some in Mumbai's financial sector believe that, in his efforts to do so, Mr Patel lapsed into stubbornness, leading to an adversarial relationship with the government.

Demonetisation of higher value banknotes increased flows into the financial sector, and then into fixed-income mutual funds © AFP

"This is a clash of egos," says one Indian bank chairman. "If Urjit Patel had taken the trouble to develop personal relations with the minister of finance, this would not have happened."

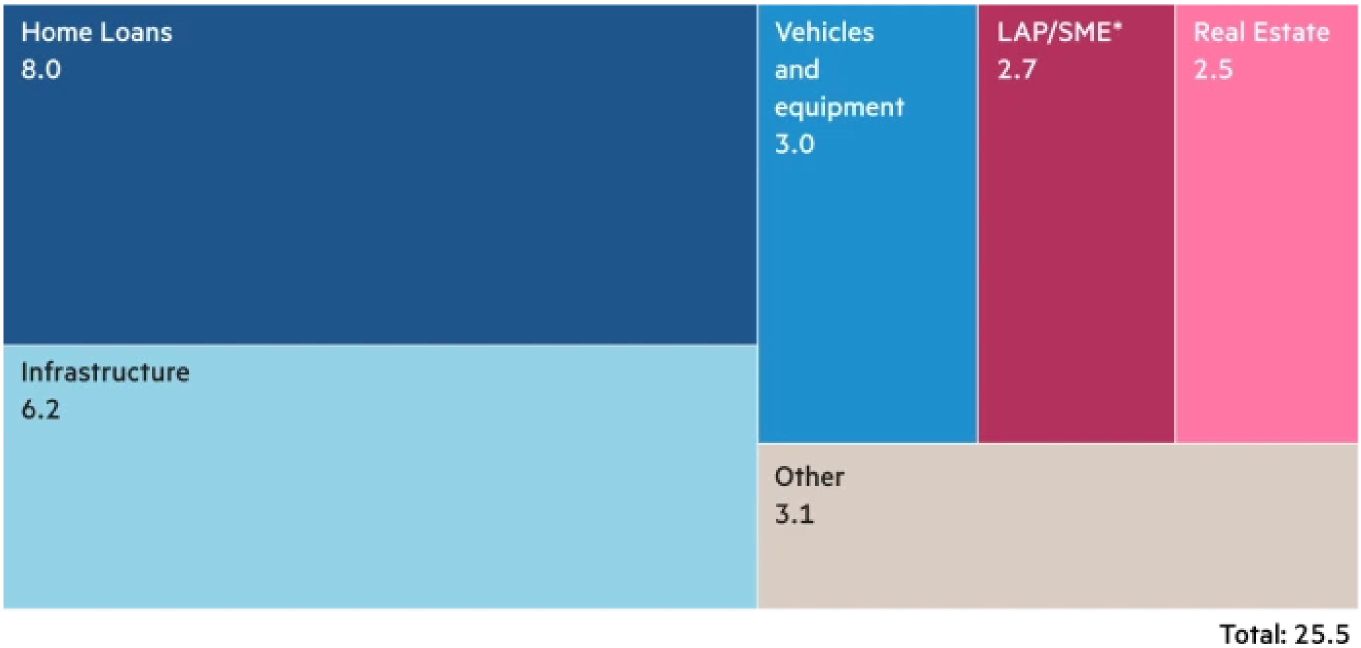
Mr Patel stoked speculation about this relationship in February when, in the aftermath of a $2bn fraud at Punjab National Bank, he remarked on the RBI's limited powers over state-controlled banks — for which it shares regulatory powers with the finance ministry.

Meanwhile, the RBI's relatively hawkish policy approach — including lending restrictions on struggling state-owned banks and two consecutive rate hikes in 2018 that brought the policy rate to 6.5 per cent, the highest level for two years — was winning Mr Patel powerful enemies in Indian business. "All the corporate daddies hate him," one senior banker says.

As concerns mounted about the shadow banks' ability to raise funding amid September's debt market squeeze, the finance ministry wrote to the RBI asking it to set up a special credit facility for the sector, according to a person with direct knowledge of the communications. In doing so, the ministry invoked Section 7 of the act governing the RBI — a clause, never before activated, which permits the government to give direct instructions to the central bank after consulting its management.

Nearly a third of India's shadow bank loans are for home ownership

Loan mix in non-bank system, Jun 2018 (Rs tn)



*Loan against property and small and medium-sized enterprises
Source: Morgan Stanley
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The invocation of Section 7 sparked concern about a threat to RBI independence, seen as a bulwark of Indian economic stability. "If the government starts directly interfering in the core functions of the RBI, it could lead to the RBI becoming less credible and less effective," says Eswar Prasad, a senior fellow at the Brookings Institution in the US.

The statement issued on Monday was silent on a credit facility for NBFCs — but it contained other agreements seemingly aimed at placating the government. The RBI would reassess a scheme that had restricted the lending of 11 ailing state-controlled banks. The phased introduction of new capital adequacy requirements would be pushed back by a year. And a new committee would be formed to assess the RBI's handling of its reserves, after government lobbying for a bigger payout to the state.

Critics of the government have accused it of a short-sighted effort to boost growth ahead of the election.

"The timing makes the motivation of the government suspect," says one former central bank official.

Viral Acharya, a deputy RBI governor, attacked the government's approach in a speech last month © Bloomberg

But the outcome of the meeting was welcomed by those who argue that the central bank has erred too far on the side of monetary caution at the expense of supporting growth. "You don't want the central bank to be politically driven," says the head of Indian credit operations for one major international investment firm. "But the agenda of a central bank can't just be about targeting a certain level of inflation."

The debate over the RBI's economic role is set to continue as the ramifications of the NBFCs' funding squeeze become clear. Mahendra Jajoo, head of Indian fixed-income for Mirae Asset Global Investments, says the worst of the seize-up in the corporate debt market has passed, noting narrowing spreads between commercial paper and sovereign bond yields.

However, many in India's financial sector are bracing themselves for a bruising second phase of upheaval, stemming from the country's luxury property market, which has seen a glut of investment over the past five years.

The luxury World Towers residential project in Mumbai. Money from India's shadow banks has poured into property in recent years © Bloomberg

Shadow banking loans to property developers, and similar assets, are worth about Rs4.6tn, according to analysts at Morgan Stanley. With developers facing a sales slowdown, there are fears that defaults from the sector could undermine the fragile return of confidence to the debt market.

Even without such a crisis, however, analysts warn, the market squeeze will continue to weigh on credit growth as newly cautious NBFCs curtail their lending, with weakly capitalised state banks in no position to make up the shortfall. Having predicted aggregate credit growth of 10.5 per cent for India in the current financial year, Morgan Stanley now expects it to be as low as 8.3 per cent.

Such a slowdown could increase the pressure on the RBI to do more — a worrying prospect, argues Mr Prasad, who says India is fortunate to stand apart from other emerging markets where central bank independence is "a dubious concept".

Others say the recent crisis has forced long-overdue scrutiny of the shadow banking sector — and has provided an opportunity to reach consensus in the sometimes fiery debate over the RBI's economic role.

"The relationship between the government and the RBI will be clarified as a result of this crisis," says Rashesh Shah, chairman of Edelweiss Financial Services, one of the largest NBFCs. "A lot of us don't appreciate that India is a work in progress, and the institutional framework is evolving in real time."

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