Collateral-free loans in a $5 trillion economy

President Kovind's address to Parliament raises questions on the government's economic policies

RAISINA HILL

A K BHATTACHARYA

The address of President Ram Nath Kovind to a joint sitting of the two houses of Parliament last Thursday stood out for the way it articulated the Modi government's economic goals. For a better understanding of what one can expect of the Modi government in its second term, it would be useful to examine the salient economic promises made in the speech.

The goal of growing the Indian economy to $5 trillion by 2024 has understandably grabbed the newspaper headlines. Questions are obviously being raised on whether this is only one of those catchy slogans or the government is serious about achieving in just five years what is clearly a highly ambitious target.

Note that the $5 trillion target was also mentioned by Prime Minister Narendra Modi in his address at the meeting of the governing council of the NITI Aayog on June 15. Modi admitted that the target was challenging, but he also said it was achievable. He added that the "states should recognise their core competence, and work towards raising GDP targets right from the district level". The President too underlined the role of the states in achieving this target. He said the goal would be achieved in collaboration with the states.

It is true that the states growing faster can help the country's overall economic growth. But putting the onus of achieving that challenging target on the states is significant. It might be a way of the Modi government displaying its faith in cooperative federalism. It could also be an escape clause. If the 5-trillion-dollar target is not met, the states could easily become the scapegoat.

Either way, the Indian economy's growth performance in the past provides some indication of the difficulty in achieving the new target. India's dollar GDP was nominally estimated at about $2 trillion in 2013-14. It is estimated to have grown to $2.7 trillion in 2018-19, an increase of 35 per cent. If the target of $5 trillion is to be achieved in 2024, the growth during this period should be 85 per cent. This is going to be a tall task. Was this idea adequately thought through before making it an official goal?

The President already admitted that India was no longer the fastest growing economy in the world. He said: "Today India is among the fastest growing economies in the world." The RBI Governor also admits that economic activity in the Indian economy is losing traction. Experts point out it would take a few more quarters before the Indian economy could revive growth. The recent GDP growth numbers do not offer any hope either. So, why was that target set?

The President also said that "keeping in view Industry 4.0" the government would soon announce a new industrial policy. The reference to Industry 4.0 as the context of the new policy is significant. The fourth industrial revolution has promoted the use of technology, automation, artificial intelligence and data analytics. At the same time, it has also threatened the existing types of jobs, posing difficult policy challenges for a country like India where unemployment continues to be a major problem. So, what kind of a new industrial policy can the new government formulate?

The government's promise that it would formulate a national retail trade policy is also replete with possibilities. The objective of this policy will be to promote retail business, but foreign investors as well as large Indian companies would be eagerly looking forward to its contours. The Modi government's policy on organised retail, particularly with regard to foreign investment, has been a little ambiguous. One of its core constituencies, small traders, has remained opposed to the opening up of the retail sector. The advent of large e-commerce players has only increased its vulnerability.

The recent disclosure of the Indian joint venture of Walmart having made some improper payments to Indian government officials in 2011 may also influence the Modi regime's approach to foreign investment in the retail sector. Will the new retail trade policy make foreign investment norms more restrictive to address such concerns or win over the small traders through some other incentives while opening up the sector?

Referring to the entrepreneurs' need for capital, the President said that the government would make available loans up to Rs 50 lakh to them, without any guarantee. Loans of this size, without any collateral, are deeply problematic for the health of the financial sector. Banks have just begun to tackle their non-performing assets. Allowing loans up to ₹50 lakh without any guarantee can also open the floodgates to politically motivated loans, whose repayments would be highly uncertain. Unfortunately, the burden of such collateral-free loans would have to be borne largely by the already beleaguered public-sector banks. Is the government encouraging loan *melas* by a different name?

CHINESE WHISPERS

Waste not, want not

As the Tamil Nadu government faces brickbats for not being able to manage the worst water shortage in the history of the state, the ruling All India Anna Dravida Munnetra Kazhagam has decided to knock at the doors of the gods. Local Administration Minister S P Velumani, who had earlier stated that the water scarcity was "manufactured news", was seen participating in a special *puja*, organised by the Hindu Religious and Charitable Endowments Department, part of the state government, to appease the rain gods. Chief Minister Edappadi K Palaniswami (*pictured*) is also in the line of fire. Frustrated with questions on the allocation of water to VVIP homes in Chennai, he declared, "I drink four litres and use only two buckets of water per day."

No cheers!

To boost revenue collection, officers of the Madhya Pradesh excise department came up with an unusual idea. In the proposed excise policy, there was a suggestion to deliver liquor online, directly to the customer's doorstep, a la Domino's or Pizza Hut. The department said it would allot licences to two companies for this purpose. The logic was the state would keep the margin, which went to contractors in conventional selling. When the proposal came to the knowledge of state Chief Minister Kamal Nath, he lost his cool. He trashed the idea saying it would severely dent the image of the state government.

DMK jittery after TDP flux

After a bunch of Telugu Desam Party (TDP) members — including party chief Chandrababu Naidu's close confidantes Y S Chowdary and C M Ramesh — joined the Bharatiya Janata Party (BJP) last week, the Dravida Munnetra Kazhagam (DMK) leadership is feeling jittery. Two DMK members met Vice-President Venkaiah Naidu around the same time, sparking speculation that some party members, including Dayanidhi Maran, were mulling a switch. Later, the DMK had to issue a clarification that it was a mere courtesy call. But the brass of DMK, which won 23 of the 38 Lok Sabha seats in Tamil Nadu in the elections held in April, is not taking any chances. Insiders say their party president has unofficially warned party Members of Parliament not to even greet BJP leaders when they meet on the Parliament premises. He has also designated some older members of the party to keep a watch on the younger ones.

A new challenge for the microfinance industry?

"Fresh start" is a welcome step as it will free up debtors from archaic laws but they need counselling to prevent misuse

BANKER'S TRUST

TAMAL BANDYOPADHYAY

In October 2010, the enactment of a law in the southern state of Andhra Pradesh, then a hotbed of the microfinance industry, almost killed it. The law came into force in the wake of a spate of suicides by microfinance borrowers, allegedly harassed by the coercive measures adopted by the collectors of such loans.

The Reserve Bank of India (RBI) stepped in with regulations capping the interest rates, quantum of loans and the number of borrowers a microfinance company can entertain, and formation of credit bureaus, among other things. These brought the industry back from the brink of a collapse. The fact that eight of the 10 small finance banks were microfinance institutions (MFIs) testifies to the resurrection of the industry.

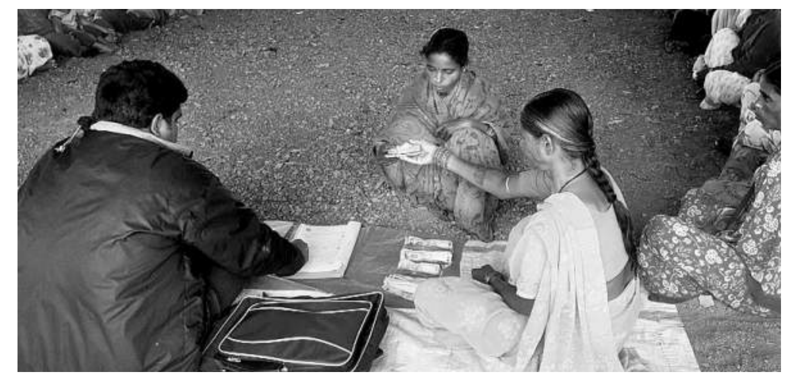
The next blow was demonetisation. In the 50 days between November 10 and December 30, 2016, ₹15.4 trillion worth of currency notes of denominations of ₹1,000 and ₹500 — some 86.9 per cent of the value of the total number of notes in circulation then -- were withdrawn. That hit the microfinance industry hard as till that time most transactions of small loans were in cash. Their loan growth slowed and bad assets zoomed. The MFIs, which were transforming into small finance banks, also could not escape the brunt of the problem.

Is there a new challenge for the MFIs round the corner? Many in the industry believe so. The origin of the challenge is the so-called "fresh start" process, part of the personal insolvency law. The regulations, part of the Insolvency and Bankruptcy Code 2016, have already been in place but they have not been notified. This will be done over the next few months.

Under the "fresh start" scheme, small borrowers unable to repay unsecured loans up to ₹35,000 can apply for the automatic debt relief. To qualify for this, the debtors' gross annual income should not exceed ₹60,000; the limit for the aggregate value of assets is ₹20,000. The debtors owning a "dwelling unit" will not qualify for this.

Under Section 80 of the IBC code, the debtors can apply for the relief. The day the application is filed, an interim moratorium on all debt will come into effect and the lenders will not be able to initiate any legal proceedings against such a debt. The debtors need to move the debt recovery tribunals or DRTs for filing such an application and if the relief is given, the debtors come out of bankruptcy and the unsecured loans are waived off.

As a concept, "fresh start" is an integral part of the US insolvency law.



Those borrowers who can no longer pay their creditors get a "fresh start" by liquidating assets to pay their debts or by creating a repayment plan. They pay their creditors what they can afford but what they cannot afford is discharged; a debt discharged through bankruptcy is no longer legally enforceable against the debtor. According to the US Supreme Court, "(Bankruptcy) gives to the honest but unfortunate debtor... a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."

Any attempt to collect or coerce payment from such debtors can be penalised by contempt of the bankruptcy court. In the US, this includes a bill through the mail, a telephone call, or a lawsuit. However, a "fresh start" does not "erase" a debt; the discharge is an injunction that makes a debt uncollectible. The debt still remains and may show up on a credit report, but all activity on the debt stops from the day the bankruptcy is filed.

Many in the microfinance industry as well as commercial banks which lend to such institutions apprehend that such a law in India will encourage small unsecured borrowers to default and destroy the credit culture.

For the record, the average ticket size of a small loans is less than ₹35,000 — around ₹33,665. Data collected from an industry body show the number of small borrowers across financial segment — MFIs, banks, non-banking finance companies (NBFCs) and not-for-profit entities — are close to 50 million and the outstanding corpus of small loans has been close to ₹1.8 trillion. The average bad loans of banks in this segment is less than 2 per cent, that of MFIs over 3 per cent and NBFCs at least 4 per cent. It is more than 4.5 per cent for not-for-profit organisations.

I could not get data on average assets of such borrowers and also how many of them have their own dwelling place. The MFIs need to give unsecured loans to 85 per cent of their customers. Under the RBI norms, the annual household income of a small borrower from an NBFC-MFI cannot exceed ₹1 lakh; for urban and semi-urban borrowers, this amount is ₹1.6 lakh. The loan given to such borrowers should not exceed ₹60,000 in the first cycle and subsequently, it can be raised to ₹1 lakh.

To seek a fresh start, the insolvent borrowers need to move the debt recovery tribunals (DRT) and therein lies the catch. There are less than three dozens of DRTs and half a dozen appellate tribunals across the country. Most of them are located in state capitals. Over 100,000 cases have been pending before them. It will not be easy for small borrowers to get relief and make a "fresh start" unless the government decides to set up thousands of DRTs even in small towns where the small borrowers live. The cost and time taken to approach the DRTs and get relief may not justify such efforts if we do not have sufficient number of such tribunals.

The biggest challenge before the government is to educate the borrowers about the "fresh start". Otherwise, it runs the risks of being misused and create a fresh round of problems for the micro lenders. Post demonetisation, when the RBI allowed the MFIs more time to classify a loan as bad because of the external shock which affected the borrowers' ability to repay loan instalments, many, including politicians, interpreted the central bank's directive as a licence to default. Frequent farm loan waivers too affect the credit culture as those who can pay up refuse to pay.

"Fresh start" is a welcome step as it will free up the debtors from the archaic laws of the colonial era such as the Presidency-Towns Insolvency Act of 1909 and the Provincial Insolvency Act of 1920 but the debtors need handholding and counselling to prevent any misuse.

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INSIGHT

Pledging shares & the mirage of prosperity

NUPUR PAVAN BANG & KAVIL RAMACHANDRAN

Pledging shares has become an easy option to raise funds, even for many well-known business families. Unfortunately, they do not seem to visualise scenarios where the optimistic assumptions about future performance may not always materialise. As of May 2019, 62 per cent of all listed companies in India had pledged at least some (in a few cases all) of their promoters holding. As many as 193 companies' promoters had pledged 75 per cent or more of their shares and 327 companies' promoters had pledged at least 50 per cent of their stake. The scenario of lenders liquidating the pledged shares of defaulted borrower is very scary.

Pledging of shares where promoters use their shares as collateral to raise money is not a new phenomenon but has become popular amongst promoters in recent years. It was after the scam involving Satyam Computers in 2009 that the Securities and Exchange Board of India (Sebi) made it mandatory for promoters to disclose to the stock exchanges of any pledging of shares. It is often understood as pawning the "family jewel" as a last resort to tide over difficult times. Stock market sees it as a sign of weak financial position of the promoter. Promoters often pledge shares for personal use like investment in another venture or buying more shares of the company. Pledging shares in a "cash cow" company to fund a risky untested startup or a fledging business may spook the investors.

Similarly, when the promoters pledge their shares to buy more shares of their own company, it signifies that the promoters think the share is undervalued and/or have confidence in the prospects of the company. It therefore should send a positive signal to the market. However, promoters are not only putting more of their eggs in the same basket but also taking on leverage to do so. Adding to this, the increase in control in the company is based on information asymmetry that exists between the promoters and the minority shareholders. This gives rise to insider trading and governance concerns. In a recent amendment to insider trading regulations, to promote fair market conduct, the Sebi has plugged this gap by closing the trading and pledging of shares window for the promoters starting from the end of a quarter to 48 hours after the declaration of quarterly results by the company.

Trouble begins when the value of the pledged shares falls below the agreed level with the lenders. Many promoters get into the trap of pledging more shares to fill the drop in value in the hope that they will soon be able to revoke the shares by repaying the amount to the lenders.

When stock prices fall or go in a downward spiral and the promoters are no longer able to either pay the money or pledge more shares, the lenders invoke the shares, and sell them in the open market. The promoters may even end up losing control, as has happened with a few companies recently. The implications for business families are grave, particularly with a lot of their family wealth blocked up in the business. Family splits, loss of reputation and bleak career possibilities for the next generation do happen in such cases, resulting in formation of entirely new trajectories of life for everyone.

In a rapidly growing economy, entrepreneurial promoters naturally tend to assume that the rising graph of growth and prosperity will never fall. This is a myth. Pledging beyond small quantities is very dangerous, like over leveraging. Shares are virtual collaterals with very high potential for volatility, due to known as well as many unknowns, including news or events that are totally not related to the company, its performance or management. There is a huge possibility of share prices falling anytime.

Most bankers and lenders fail to learn from history that in a crisis, most assets become illiquid. Most of the risk models do not account for illiquidity. They assume that markets are perfectly liquid. However, that is not the case. Lenders often invoke the pledge and dump shares in the market at very low prices, translating the already downward spiral into a shock. Financial Institutions need to have built-in mechanisms and standards to ensure that investments are made in assets that can be liquidated at the lowest possible cost.

The Sebi must also put in place a limitation to the percentage of shares that can be pledged, including the cumulative pledged shares after margin calls. Having pledged most of the shares and yet maintaining the voting rights may seem like a good situation to the promoters when in reality their fate is hanging by a day's movement on the stock exchange. Or, pledging should also suspend voting rights till the pledge is not revoked. If the promoters need to raise more money, they should take a conscious decision to sell their stake in a phased manner or through a strategic sale.

The board of directors must also assert and prevent promoters from taking this treacherous road to the mirage of prosperity. As the custodian of the wealth of all stake holders, the board has a vantage view of the things to happen. It has to exercise its rights instead of being a rubber stamp.

Bang is associate director and Ramachandran professor and executive director at the Thomas Schmidheiny Centre for Family Enterprise at the Indian School of Business

LETTERS

A conflict of interest?

This refers to "Do not throw away the baby with the bathwater" by Somasekhar Sunderesan (June 20). The author has admitted that he is professionally attached to the assurance industry. So it is a case of conflict of interest. Even taking his argument on merit, one can hardly agree that the assurance industry is being thrown away with the bathwater. The assurance industry has been defined by him as the chartered accountants and auditors who are required to certify the correctness of the financial transactions of a company which appoints them. I have worked as independent director in several private companies after my retirement for much more than a decade. I have been chairman of Audit Committee also. I realise the importance of the auditors (who are chartered accountants) who really know the details of all the transactions of the company as they examine all vouchers and find out if the various corporate rules have been obeyed by the company. The summary of the transaction details, gross profit and net profit etc are placed before the Board of Directors. If they do not provide a correct set of figures due to inefficiency or collusion, the decision of the Board will never be correct. Presently, the regulators have punished a few of the auditors by banning them for some length of time. This is highly praiseworthy and will prevent corporate fraud. Such move cannot be called a knee-jerk reaction. Good result has followed due to this as Price Water House, a famous audit company has walked out of auditing the accounts of a suspect company. Calling such action as theatrical and based only on suspicion is most unwarranted. The author is an interested party and his opinion is clearly prejudiced for obvious self-interest and is vitiated by conflict of interest.

Sukumar Mukhopadhyay via email

Note from the editor: The author had made a clear and explicit disclosure of his role as a lawyer so that his opinion was read along with the perceived interest in his views.

Plan wisely

This refers to "Making dam water reach the farmer" (June 21). The geographical terrain, geological condition sand hydrological requirements vary from place to place in a vast country like India and distribution of water should be made according to the requirements of the local environment. Covering both the geographical and local requirements while considering construction of dams is very important as the level of the water table varies from place to place.

C Gopinath Nair Kochi

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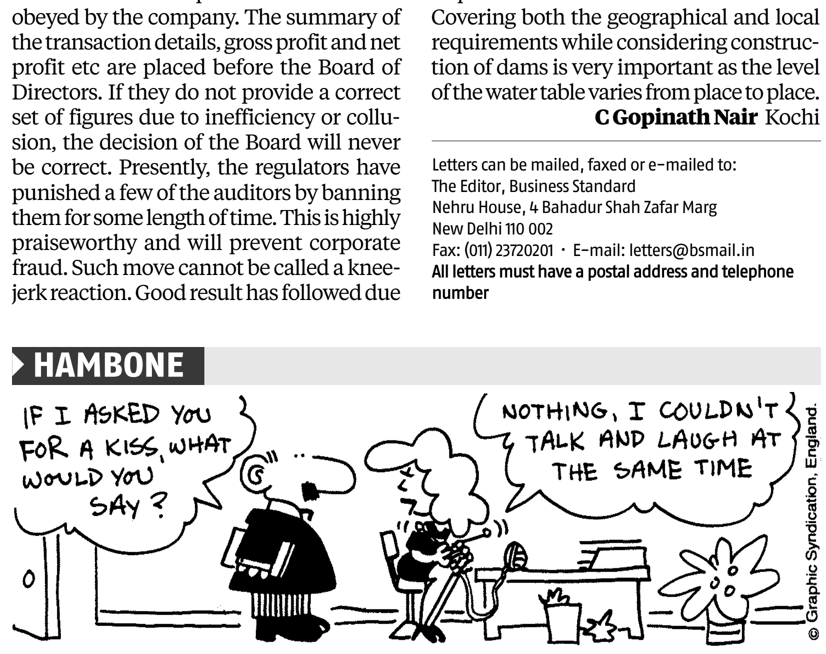
HAMBONE



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Raw deal

GST Council has gone overboard on anti-profiteering

The first meeting of the Goods and Services Tax (GST) Council under Finance Minister Nirmala Sitharaman continued the healthy tradition of a consultative process, followed in all the previous meetings. On Friday, the Council refrained from taking any decision on rate restructuring and focused more on bringing in stringent norms to check tax evasion. While the much-anticipated proposal for reduction in rates on electric vehicles and chargers was referred to a fitment committee, the contentious issue of a uniform GST rate on lotteries was sent to the Attorney-General. In a signal to taxpayers that it was alive to their concerns, the Council did well by extending the deadline to file annual GST returns for 2017-18 by two months till the end of August and announced that the one-form new return filing system will be applicable from January 1 next year. The in-principle clearance to an electronic invoicing mechanism for business-to-business transactions through a designated official portal was another prudent step.

The same, however, can't be said about the decision to impose a higher penalty on the so-called profiteering by companies. Under the changed rules, if companies guilty of pocketing the benefits of tax cuts meant for consumers do not return the amount within 30 days, they will have to pay a penalty of 10 per cent of the profiteered amount. This is in addition to the requirement of returning the profiteered amount either to the consumer or to the consumer welfare funds set up by the government. The additional penalty would be hard on businesses, specially in the absence of rules and guidance as to what constitutes profiteering. The law does not specifically provide for whether the benefit has to be passed on at a business-entity level or at a product-category level, or at a stock-keeping unit level. This has already led to a series of interpretational disputes involving some of the biggest companies. In other jurisdictions that have undergone the transition to a GST, such as Australia, it has been specified how the equivalent authority should investigate the net margin on a particular product. But in India, nothing is specified other than the process to be followed. It's strange that the GST Council has opted for tougher measures against companies despite its failure to formulate rules even two years after the GST regime was rolled out.

The decision to extend the National Anti-Profiteering Authority's (NAA's) life by two more years is also questionable. The NAA, which was earlier supposed to have a two-year sunset horizon, was in any way a bad idea, made worse by poor implementation. In any case, companies should be free to respond to tax changes, particularly complex ones such as the GST, which have multiple conflicting effects on their costs, in a manner determined by competitive dynamics and commercial considerations. If competitive dynamics are weak and do not allow for a proper transmission of tax cuts, that is the business of the Competition Commission. It is anyway unfair to assume that competition would not result in passing on cost reduction from lower taxes. Even if a temporary authority was required in the initial years because the purpose of the GST introduction was to minimise the effect on the consumer, the NAA should have been wound up within its stipulated time.

Revive Inter-State Council

Institution can give substance to slogan of co-operative federalism

Last week, the prime minister chaired the fifth meeting of the Governing Council of the NITI Aayog, where many issues of national importance, involving coordination between the Centre and the state governments, were discussed. However, not all chief ministers attended the meeting — three were absent. One of those chief ministers, Mamata Banerjee of West Bengal, wrote to the prime minister, saying that attending the NITI Aayog meeting was "fruitless" because the body had no powers to support state plans, as distinct from the now defunct Planning Commission. While Ms Banerjee's refusal may have a great deal to do with politics — the Trinamool Congress is fighting off the expansion of the Bharatiya Janata Party in West Bengal — there is also something in what she says that should be taken seriously. Her letter suggested that the Inter-State Council should be revived as the "nodal" location for discussing matters that involve both the Centre and the states. This suggestion was also made in his speech to the NITI Aayog Governing Council by Kerala Chief Minister Pinarayi Vijayan.

This is a possibility worth considering. The Inter-State Council is indeed the appropriate location for many major issues of national scope to be discussed. For example, the question of simultaneous elections to the Centre and the states, which has been a pet subject of Prime Minister Narendra Modi, should ideally be discussed at an Inter-State Council. Coordination between states on counter-extremist and counter-terror operations is another such issue. Past attempts to knit together separate efforts, such as against the Naxalites, did not necessarily do well and foundered on various questions to do with federalism and states' power to control law and order. Even Bihar Chief Minister Nitish Kumar, whose Janata Dal (United) is an ally of the BJP, has spoken of how centrally sponsored scheme drain state resources unduly without giving state leaders even leeway. This is another question that could and should be discussed fruitfully within the context of the Inter-State Council, given that other chief ministers also agreed with Mr Kumar. Many also asked for the backlog of the Mahatma Gandhi Rural Employment Guarantee Scheme payments to be released. Karnataka Chief Minister H D Kumaraswamy complained that revenues from the GST were proving to be disappointing and thus asked that the compensation to the states be extended beyond 2022.

The speeches of chief ministers at the NITI Aayog Governing Council revealed that there are many such issues that go beyond the five-point agenda set out by the Centre for the meeting. The co-operative nature of the GST Council, in which the Centre and the states meet to determine the outlines of the GST, has shown that there is considerable scope for such institutions that give substance to the prime minister's promise of "co-operative federalism". It is time therefore to revive those institutions that could serve to arrive at a consensus on such issues. Certainly, the Inter-State Council is one such.

ILLUSTRATION: AJAY MOHANTY

Whither central bank independence

The signal from the RBI governor is that the balance will tilt in favour of the inter-dependence of policies and implicit coordination with the government

WHAT NEXT

Y V REDDY

For the past five years, the relations between the government and the Reserve Bank of India (RBI) have been debated. Much of this debate, however, is based on an inadequate understanding of central bank independence.

Central banks perform four functions: Price stabilisation, which is essential for maintaining trust in the currency; financial sector development and stability, in particular, because of it being the lender of the last resort, especially for banks; reducing volatility in and maximising of output and employment; supporting government borrowing when appropriate; and, very importantly, restraining the use of such borrowing when necessary.

Central banks, however, are creatures of governments, which give them some independence or autonomy. This is to ensure that people have trust and confidence in matters relating to money and finance. At the same time, governments have to ensure that central banks are accountable.

The emphasis on autonomy and accountability varies, depending on the context. To illustrate, during times of crisis and structural transformation, coordination between the government and central banks takes precedence over autonomy.

The period of the 1970s was one of confusion for central banks, with the collapse of the Bretton Woods system, the onset of the significant euro-dollar market, and severe inflation, partly caused by the oil shock in 1973. The US Federal Reserve's success in containing inflation during 1979-82 shifted focus to price stability and increased the role of central banks. The dominance of market ideology in the 1980s also contributed to a reduction in the role of the government in an economy. Consequently, the independence of central banks and inflation targeting dominated policy thinking, especially in the Anglo-Saxon world.

The global financial crisis of 2008, however, raised doubts about the efficacy of the nature of central bank independence. Ironically, central banks had to address the problem, which, in some ways, they caused.

There have been three features of the response of central banks to this crisis, namely, (a) unconventional monetary measures; (b) closer coordination with governments and other regulators; and (c) reviewing the approach to central banking. In brief, the emphasis on a single objective and independence stands diluted globally.

Now a decade after the global crisis in 2008, central banks are being attacked by political leaderships. This could be due to governments looking for a scapegoat for the current problems they face, or to the ineffectiveness of monetary policy in many countries, or to the monetary authorities running out of options.

The world is now searching for a new framework. In any case, to quote Professor Charles Goodhart: "*The idea of the central bank as an independent institution will be put aside*."

How independent has the RBI been?

To answer this, we must bear in mind that central banking became an instrument of planned development after 1950. The RBI had to create money whenever the government wanted it. This lasted till 1996.

In 1969, private banks were nationalised by ignoring the RBI's views. The transmission of monetary policy through the banking system depended thus on the cooperation of the government.

Since the financial sector reforms of the 1990s, however, there have been two elements relevant to independence, namely, an end to automatic monetisation and regulation of public sector banks consistent with global standards as well as opening up banking for the private sector. Fiscal dominance, however, continued, constraining the exercise of independence in monetary policy.

In the late 1990s, suggestions were made to adopt inflation targeting, which the RBI opposed. But in 2016, at the instance of the RBI, the government amended the RBI Act to introduce inflation targeting. An institutional mechanism for an independent monetary policy was also put in place.

Since 2016, prima facie, the objectives of monetary policy set by the government have been met but the period was characterised by unprecedented tensions between the RBI and the government.

Personnel independence was diluted in the manner of appointment to the RBI board and of senior functionaries. Financial independence was threatened by demands made by the government on the annual surplus and even the reserves, apart from introducing the concept of advance dividend.

Operational independence was eroded by statements from government officials on the board of the RBI, culminating in the unprecedented act of giving notice under Section VII of the RBI Act to give directions. The contentious operational matters included liquidity and regulating banks, especially public sector banks.

An indication of a recent shift in policy has been given by the governor in his recent speech on "Evolving Role of Central Banks", delivered on June 17, 2019. He said, "... the fact remains that though the focus of monetary policy is mainly on inflation and growth, the underlying theme has always been financial stability."

The signal from RBI Governor Shaktikanta Das is that the balance will tilt in favour of the inter-dependence of policies and implicit coordination with the government and the full service nature of the RBI. The next step will presumably be in favour of negotiation for greater autonomy for the RBI within the ambit of the government's policies, in preference to asserting independence.

This will test everyone's skills and patience as the art of central banking lies in convincing the people that the RBI is independent, while assuring the government that its policies are consistent with the government's intentions.

The author is former governor, Reserve Bank of India

Truth & fairness of the auditing profession

IRRATIONAL CHOICE

DEBASHIS BASU

Until earlier this month, one of the most farcical professions was auditing. Under the Companies Act, almost all types of companies have to get audited. Then the charade begins. Auditors are supposed to be appointed by the owners — the shareholders — and not the management. But as anyone knows, in all private companies and most public limited ones, it is the promoter families that control both the management and the shareholding. In a tiny number of listed companies where promoters do not have a majority stake, only the management selects the auditor, and outside shareholders are too uninterested to appoint or change auditors. Hence the first ground rule of auditing is "don't rub the managements the wrong way".

What makes life easy for auditors is the second ground rule — they are supposed to be watchdogs, not bloodhounds, in the memorable phrase of Lord Justice Lopes, who ruled in the Kingston Cotton Mills Co (1896) case. A third ground rule makes life even easier: Auditors are supposed to express an opinion on the true and fair view of accounts. The audit report is merely an opinion, not a certificate or a guarantee of anything. These three ground rules defined the (in)effectiveness of auditors for generations.

This isn't a story of small companies and small auditors alone. When Tata Finance was involved in huge speculative market operations, circular transactions and other suspect deals in early 2000s, the Tatas commissioned A F Ferguson to do a special audit. The Ferguson report, supervised by senior partner Y M Kale, did not give a clean chit to Tata directors. The Tatas rejected the report and Ferguson, heavily dependent on the Tata group for its revenues, sacked Mr Kale.

The system allows for redress against misdemeanours but only on paper. You could complain to the professional body, the Institute of Chartered Accountants of India (ICAI), against "professional misconduct" but I know of cases where the ICAI disciplinary council sided with the auditor (who of course had helped bury the accounting fiddle-diddle). Insiders know how this works, so many bright CAs stay away from auditing. The ethical ones (and there are many) feel frustrated.

Earlier this month, in a stunning turn of events, two sleepy but potentially powerful arms of the government changed the rules of this cosy game. On June 11, the Ministry of Corporate Affairs (MCA) moved the National Company Law Tribunal (NCLT) to debar auditors of IL&FS Financial Services (IFIN) — Deloitte Haskins & Sells and BSR & Associates — from doing any business for five years for their alleged collusion with the IFIN management. BSR is part of the mighty KPMG network of accounting firms. The MCA's move came after a sterling job done by another organisation, one whose existence we tend to forget — the Serious Fraud Investigation Office (SFIO). It alleged that the IFIN auditors connived with former directors to conceal information about wrongdoing. All this has started to have a salutary effect. Price Waterhouse & Co, another giant in audit, tax and consulting, (banned in 2018 for two years by the securities market regulator for its role in the Satyam scam), resigned as statutory auditor of Reliance Capital in June. It claims that the company "prevented it from performing its duties ... and exercising independent judgment".

These episodes have come at the right time as institutional change is already underway with the establishment of the National Financial Regulatory Authority (NFRA) to regulate audit, accounting and financial standards. The ICAI opposed the NFRA tooth and nail from 2010 till 2017. The ICAI argues it is a world-class regulator and the NFRA will only impose additional costs, will create multiple regulatory bodies, and will not have competent staff in adequate numbers. But the general perception is that the ICAI has failed as a self-regulatory organisation and so the NFRA is a reality.

Keep up the momentum

Auditors help regulators, the government, investors, bankers and the public at large, not just the shareholders who appoint them. Hence, the current clean-up drive is badly needed and must be sustained to ensure that it is not limited to a few incidents that penalise just a few high-profile accountants. The first step would be to empower thousands of smaller CAs who want to act independently, but are at the mercy of promoters/managements. I personally know that when CAs set up shop, all of them are keen to do a professional job. They don't want to be part of accounting fiddles. They need to see that the NFRA succeeds and witness the triumph of fairness and truth in their own profession.

The second step would be to raise auditing standards. For instance, the Securities and Exchange Board of India is thinking of making the auditor of parent companies responsible for the accounts of subsidiaries. Other countries have also slowly moved away from the watchdog metaphor and now demand a far greater duty of care. The third step would be to impose special standards for auditors of financial firms, where fragility is the highest, because they are always playing with large sums of other people's money. Lord Denning wrote about auditors in 1958: "To perform his task properly he must come to it with an enquiring mind — not suspicious of dishonesty." However, I suspect if Denning and Lopes were to rule today, they would say when it came to banks and financial institutions, auditors should be bloodhounds, with minds that are not only enquiring but also suspicious.

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The politics of the US Supreme Court

BOOK REVIEW

EVAN THOMAS

On February 12, 2016, Justice Antonin Scalia died of a heart attack at a remote luxury resort in West Texas. The Republican Senate leader, Mitch McConnell, wasted no time declaring that his party would not allow President Obama to fill the Supreme Court vacancy.

There were still more than 340 days left in Obama's term, plenty of time for confirmation hearings, but the Republican senators wouldn't even talk to Obama's nominee, the thoroughly worthy and decent Merrick Garland. Democrats loudly protested, portraying McConnell as "the obstructionist in chief." (McConnell "happily embraced his image as the dark lord of the Senate," Mr Hulse notes, and covered a wall of his office with prints of editorial cartoons "saying all sorts of nasty things about him.") But the Democrats were hardly in a position to complain.

In 2003, the Democratic Senate leader, Harry Reid, had led the first-ever successful filibuster of a nominee to the federal court of appeals, Miguel Estrada. Then, in 2013, when the Republicans played tit-for-tat and began holding up Democratic nominees to the federal courts in the Obama administration, Mr Reid "went nuclear," in Senate parlance, engineering an end to the filibuster in judicial nominations — a move that left lingering "bitterness," Mr Hulse says.

"Blatant hypocrisy," Mr Hulse declares in this entertaining and shrewd book, is a "defining characteristic" of the United States Senate, certainly in the 21st century. "With control of the Senate frequently shifting between the parties, senators had to master the art of the 180-degree turn, instantly adopting the language and tactics of the opposition party as soon as they exchanged places."

Shamelessness paid off for the Republicans. Mr McConnell boasted that by preserving an open seat on the Supreme Court, he helped elect Trump president, and Mr Hulse offers polling data to back up this claim. President Trump gloated over the opportunity to stock the rest of the federal bench with conservatives. "You know, when I got in, we had over 100 federal judges that weren't appointed," Mr Trump declared to a crowd in March 2018. "Now I don't know why Obama left that. It was like a big, beautiful present to all of us. Why the hell did he leave that? Maybe he got complacent." Actually, Mr Obama left so many judgeships unfilled because the Republicans were able to obstruct and delay.

The Trump administration would not let the same thing happen. Mr Hulse colourfully describes Trump's all-out assault. His chief strategist was the White House counsel Don McGahn, "an unusual mix of conventional Washington Republican and former long-haired radical libertarian who was an excellent guitar player in a beach bar cover band on the side," Hulse writes.

He set about this with a single-minded zeal that would have made James Madison blanch. "Previous administrations reviewed and picked judges via judicial recommendation committees, exhaustive review and consultation with the Justice Department," Hulse says. With Mr Trump's backing, Mr McGahn "wanted to dispense with all that," and by and large he was able to, thanks to a compliant Republican Senate leadership. Well into Mr Trump's term, the president had appointed 30 federal appellate judges (about one-sixth of the total) and 53 lower court judges, as well as a Supreme Court justice — Neil Gorsuch, who filled Scalia's vacant seat.

At the same time, Mr McGahn could be subtle. He signaled to Justice Anthony Kennedy, who was nearly 82 years old, that if he stepped down, Trump would replace him with a former Kennedy clerk, Brett Kavanaugh. Kennedy may have been anxious about Trump's somewhat highhanded view of the judiciary, but Mr McGahn knew that Kennedy had a vain side. Gorsuch had also clerked for Kennedy at the Supreme Court.

Mr Hulse, the chief Washington correspondent for *The New York Times*, is not a knee-jerk Trump critic. He actually credits Mr Trump with "cutting through much of the high-minded malarkey about the neutrality of judges with a single tweet."

Still, as Mr Hulse points out, there is a reason judges go to great lengths to appear impartial and neutral (and, of course, some truly try to be). The legitimacy of the court depends on a public perception that the justices are fair-minded referees in the political battles that break out between branches of government (Exhibit A: the constitutional crisis now erupting over enforcement of congressional subpoenas on the Trump administration). Democracy depends on customs and norms as well as written rules; civility and comity as well as up-or-down votes. Trashing the time-honoured process for nominating and confirming justices can have unintended consequences.

Power can cut both ways. In personnel as well as policy, the rule is live by the sword, die by the sword: The all-powerful Don McGahn was sacked by Trump for disloyalty when he evaded the president's apparent bidding to obstruct justice. As a longtime Washington correspondent, Mr Hulse is an expert guide through the machinations on Capitol Hill. He does not offer any revelations about Mr Kavanaugh, searingly accused of sexual assault as a high school student. But he offers a telling scene of Mr McGahn coaching Mr Kavanaugh to push back, hard, against his congressional inquisitors. The tactic worked; Mr Kavanaugh survived. But the spectacle was unedifying and, possibly, a harbinger of worse to come.

CONFIRMATION BIAS
Inside Washington's War Over the Supreme Court, From Scalia's Death to Justice Kavanaugh
Carl Hulse
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