Dear RBI, you do not lack power to clean up banks, you lack the will: Damodaran

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NEW DELHI: Governor Urjit Patel may have gone to town complaining about RBI's perceived lack of power over public banks, but former Sebi chief M Damodaran is not impressed.

Powers are often what you exercise, notwithstanding what the statute provides, he told ET Now.

"I was both surprised and saddened by that statement," Damodaran said, noting that Patel is representing a central bank which is in existence since 1934. "To say in public that my organisation does not have powers does not inspire confidence."

In a recent address in Gandhinagar, Patel spoke of how RBI's legal powers to supervise and regulate public sector banks (PSBs) are constrained. His remarks came close on the heels of the Rs 13,000 crore PNB scam, billed to be largest banking fraud in India's history.

In fact, the Governor listed out the factors seen as a drag on RBI's regulatory powers. One, the central bank cannot remove PSB directors or management, who are central government appointees, nor can it force a merger or trigger liquidation of the lender.

"The RBI will undertake actions against the bank that it is empowered to, but this set is limited under its Banking Regulation (BR Act) powers over PSBs," Patel had said.

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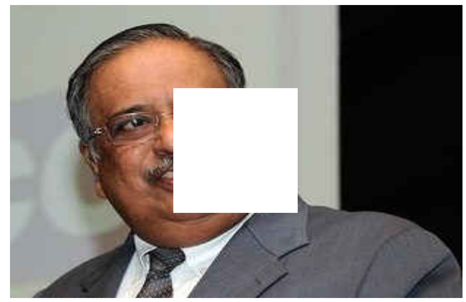

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Rules say RBI cannot remove directors and management at PSBs since Section 36AA(1) of the BR Act is not applicable to them. Supersession of a bank board also does not apply to PSBs and regional rural banks as they are not banking companies registered under the Companies Act.

The clause dealing in removal of the chairman and managing director (MD) of a banking company does not cover PSBs.

Damodaran asserted that these issues have been raised before. "The RBI cannot remove a public sector bank chairman. But many years ago, the RBI once spoke to the government and got rid of one executive director/chairman in a public sector bank. The regulator and the owner act together. It does not matter where formal power resides. What matters is you are on the same page as far as the person is concerned," he said.

RBI's inability to force a merger in the case of PSBs is also seen as a sticking point. Under the guidelines, the PSBs' banking activity does not require a licence from the RBI, which means RBI cannot revoke the licence, unlike their private counterparts. Last, the central bank cannot trigger liquidation of PSBs.

"Furthermore, in a remarkable exception of sorts, in some cases there is duality of managing director and the chairman – they are the same – implying the MD is primarily answerable only to himself or herself," Patel had said on March 14.

Putting out his understanding, Damodaran told ET Now that the Reserve Bank is being attacked and maybe, Patel felt obliged to make that statement. "I was a little disappointed to say the least, maybe he had his reasons," he added.

Patel in his speech had suggested three ways to keep banking frauds in check

1. Investigative/vigilance/legal deterrence: Criminal investigation of frauds and attached penalties can serve as an effective deterrence if reporting and investigation are expedient and penalties are adequately severe relative to the gains from fraudulent activity.

2. Market discipline: Fraudulent activity can be a net loss to the bottom line. In this case, bank investors would impose deterrence, e.g. uninsured creditors might "run" on the bank inducing liquidity problems, or shareholders might "exit", effectively raising the cost of capital and inducing solvency questions. In anticipation of such disruptive outcomes that might cause loss of control, management and board members may put in place governance mechanisms to prevent or reduce the incidence of fraud and/or hold larger buffers in the capital structure to bear losses when fraud materialises.

3. Regulatory discipline: Banks in most parts of the world, however, have a significant portion of deposit funding that is insured. And since banks serve critical payments and settlements function, they are often too big to fail or too many to fail. Hence, a part of the market discipline is weakened as a trade-off with financial stability and is substituted by delegation of supervisory and regulatory powers to a banking regulator. Detection and punishment by the regulator then need to be effective to discipline fraud.