The Final Push?*

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A report of an internal working group (IWG) set up by the Reserve Bank of India (RBI) has revived discussion on the wisdom of allowing entry of corporate players, including large business groups, into India's banking space. Though the process of licensing a new generation of private banks began in 1993, primarily non-financial corporate entities have been eligible under the RBI's guidelines to apply for banking licenses only since 2013. Their entry, when permitted, was to be subject to rules such as functioning through a Non-operative Financial Holding Company as a means of ringfencing financial activities or banking operations from the non-financial business of these entities. Despite this possibility, and applications submitted by many aspirants, none of the 14 licenses issued thus far have gone to corporate entities.

Even though applications from non-financial business were permitted in the licensing round for which guidelines were issued in 2013, the committee that scrutinised them chose to recommend the issue of only two licenses to IDFC and Bandhan Bank, neither of which were non-financial entities. Clearly access to adequate capital or a track record in business could not have been the criteria on which those non-financial players who made the bid would have been ignored. Applicants included some leading corporates that would have qualified on these grounds.

The committee's decision must have been influenced by considerations that have since the nationalisation of banks in 1969 determined RBI policy on the matter. Banking is among those activities where equity capital and promoter's contributions are a small proportion of the resources available to be deployed by decision makers with access to depositors' savings and other borrowed funds, with capital adequacy norms that regulate the use of those resources a minimal constraint. There is always the danger that these leveraged funds, if controlled by promoters with non-financial business interests, would be diverted to related or interconnected enterprises through innovative means that exploit loopholes which ringfencing measures cannot plug.

This would not only restrict access to credit of other sectors such as agriculture and small business, but encourage advances based on criteria (whether they be expectations of super profits or external interests of the promoters) that do not focus on limiting and managing risk. Further, entry of corporate players with deep pockets into the banking space could trigger processes of concentration, that would both place lendable resources in fewer hands and concentrate risk. Even among corporate players, only the biggest would be able to enter, since the IWG recommends raising the minimum capital requirement for a banking licence from Rs. 500 crore to Rs. 1,000 crore, with the promoters' initial share in equity kept at 40 per cent. If entities they promote begin to accumulate non-performing assets and there is a threat of a run on the bank, the government would be forced to intervene and bail out the bank concerned, because of the adverse systemic effects that failure can give rise to. Confidence that such support would be unavoidable gives rise to moral hazard, as promoters do not fear that depositors would be left in the lurch if their actions damage the bank's balance sheet. Creating conditions where such tendencies can unfold would be a betrayal by the regulator of depositors who have no control over the management of their savings.

The 2013 guidelines began a process that could erode the caution that banking policy based on this understanding encouraged. The IWG report extends and provides what it believes are justifications for that process. Surprisingly, it seems to suggest that private entry post-liberalisation has rendered the banking system more robust, as evidenced by a rise in the share of private banks in deposits and advances during a period when the banking business has boomed. This is by no means convincing. At one level, it seems inevitable that with as many as 14 new private banks licensed, private share in the business would rise. However, what is noteworthy is that after a small rise between 2000 and 2005, the share of private banks in advances stagnated till 2015. Much of the rise in private share occurred after 2015, when non-performing assets (NPAs) in public banks rose sharply because of overexposure to a few corporates, especially in infrastructural areas, encouraged by the government. It was a weakening of public banking rather than the robustness of private banking that explains the shift in shares. What is more relevant is that, of the 14 new generation private banks that were licensed since 1993, only 9 are in existence as of now. The others either failed, such as the much-celebrated Global Trust Bank (which was force-merged with public sector Oriental Bank of Commerce in 2004) and Yes Bank, or chose to exit by voluntarily merging with other private entities. And recent allegations regarding the functioning of the top management in private sector leader ICICI Bank raise a host of issues regarding private bank governance. The record with regard to survival and growth among new generation private banks is by no means encouraging.

IWG also says it is in favour of private entry, especially by large players, because the ratio to GDP of bank advances to the private sector in India at just around 50 per cent is low when compared with developed countries, China and a few developing countries. The point to note, however, is that even with this level of lending NPA ratios in India are extremely high, which is in fact explained by the sharp rise in this ratio from just above 20 per cent in the mid-1990s to 50 per cent currently. Excessive rather than inadequate credit expansion is at the root of India's banking problem.

The IWG also argues that big players are needed because Indian banks are pigmies by international standards, with only one bank included in the list of the top-100 global banks by size. However, size is not inherently an advantage. There is no clear evidence of economies of scale in the banking area. Big global banks were as or more vulnerable than smaller ones during the financial crisis of 2008. And developed countries are grappling with the problems associated with banks that are "too big to fail", and there are many in favour of breaking up the biggest banks.

Sensing that there would be adverse reaction to its recommendations, the IWG, besides referring cursorily to arguments that favour allowing corporates to enter because "they can be an important source of capital and can bring in their experience, management expertise, and strategic direction to banking," asserts that the "critical question" when considering the issue of allowing corporate entry is "the robustness of the institutional and legal setting". Holding that any "inherent conflict of interest could be addressed through strong regulation relating to connected lending, mutual lending to each other's sponsor groups, ring fencing of the activities, governance standards and exposures", it concludes that these "could be clearly addressed through licensing conditions", and recommends that "large corporate/industrial houses may be

permitted to promote banks only after necessary amendments to the Banking Regulations Act, 1949".

This structure of reasoning does raise the suspicion that the primary intent of the working group exercise is to pave the way for corporate entry. In fact, while the IWG claims to have consulted with a range of experts with experience in the field of which there were at least ten, it tucks away in an Appendix the information that: "All the experts except one were of the opinion that large corporate/industrial houses should not be allowed to promote a bank," for reasons of the kind discussed here.

However, the government and the RBI must be stunned by the range of opinion outside of its chosen experts that is against the recommendation that corporate entities should be permitted in banking. Many of those who have responded critically, which includes former RBI Governor Raghuram Rajan and Deputy Governor Viral Acharya, are staunch supporters of private entry into banking and some even of privatisation of public sector banks. Their opposition to the licensing of corporate entities seems partly driven by a fear that this is a means of opening doors to cronies of those in decision making positions. In an interview to Bloomberg/Quint Rajan asks: "The question is why now? Who is there knocking on the door wanting a licence? Are you doing it only for a few? Or is it because this is in the larger interest of the economy?"

An issue Rajan flags is the risk of "greater concentration of economic and political power". That risk is all the greater because there is a strong possibility that once a cash rich corporate enters the banking space through a private vehicle, it would be offered the opportunity to take over public banks on the grounds that they have been weakened by accumulated NPAs and the government cannot keep recapitalising them. In a speculative report, Reuters claims to have learnt from unidentified official sources that in an effort to mobilise budgetary resources the government has decided to privatise Punjab and Sind Bank, Bank of Maharashtra, UCO Bank and IDBI Bank. Once that process begins other banks would be targets for disinvestment and privatisation.

It now appears that in such a process the choice of buyer can be completely arbitrary. While Lakshmi Vilas Bank (LVB) has been tottering on the brink of failure, the regulator stood by as its promoters and shareholders went about looking for a buyer willing to offer a lucrative deal. That did not happen and bankruptcy that would hurt, not just shareholders but depositors as well, seemed imminent. Possibly fearing the impact this would have on depositor sentiment across the country, the RBI stepped in and announced a scheme of amalgamation of LVB with DBS Bank India Limited (DBIL), the Indian subsidiary of DBS Singapore. This involves many firsts. While voluntary mergers of private sector banks have been common, all enforced mergers of failing private sector banks have involved amalgamation with a public sector bank chosen by the RBI. This is the first time that an enforced merger, wiping out the equity of pre-existing shareholders of a bank, has involved "choice" of a private bank, and that too a foreign private bank, by the RBI. The decision to choose a private player may have been influenced by the view that caught with having to address their own fragility because of large NPAs, public banks could not be expected to fold in a bank in as dire a situation as LVB. But turning to a foreign bank for the purpose is indeed a surprise. DBIL is clearly keen on the merger as it can quickly acquire a branch network, even if concentrated in the South. It is willing to bring in an extra Rs. 2,500 crore by way of capital to restructure operations.

Having stepped out of the universe of public banks for the takeover, the RBI, it is to be expected, will adopt a policy of calling for proposals from competing suitors, both domestic and foreign. There is no clear indication as to whether any such process was gone through, but even if it was it would have been “informal” and non-transparent. The decision was clearly discretionary and arbitrary.

Such arbitrariness is ominous. If DBIL can be called upon today to take over an ailing private bank, the next step could be an enforced merger of an ailing public bank with a private bank launched by a cash-rich corporate. That can take concentration to high levels. Clearly, there is much that is brewing, and only time will tell what directions these new interventions will take and who will be the beneficiaries.

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