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HOW RBI HAS SENT PAYMENTS BANKS ON A ROAD TO EXTINCTION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

A fear of private bank ownership may explain why it’s pushing its own innovation out of existence

The Reserve Bank of India’s (RBI) brave new world of differentiated banking has largely come a cropper. Over the last few years, the central bank offered opportunities for setting up four types of differentiated banks, including small finance banks, payments banks, wholesale banks, and custodial banks. The last two ideas have not even taken off, and of India’s remaining two payments banks are on the road to extinction.

The two major payments banks with a wide reach, India Post Payments Bank and Paytm Payments Bank, are both seeking to convert themselves into small finance banks. One does not know whether small finance banks, too, will survive the long run, given their high-risk quotients in lending small amounts to a large number of small borrowers. Thanks to the high tendency among politicians to offer loan waivers of all kinds (Maharashtra has just announced its second farm loan waiver in less than three years), and the Reserve Bank’s own inclination to impose mindless regulations, combined with ineffective supervision, one should not bet on the long-term survival capabilities of small finance banks.

The case of our payments banks is illustrative of what all the regulator can do wrong. Payments are always big businesses and often serve as major support props for companies with large customer bases. So, in theory at least, payments banks should have had a great future. However, RBI, given its suspicion of private bankers, has essentially killed its own innovation. If the regulations prescribe that 75% of liabilities have to be tied down in government paper of less than one year’s maturity and that payments banks cannot lend one paisa to anybody, what business model does RBI leave them with? Put another way, RBI has imposed heavy downsides on payments banks without any upside. They not only have to maintain the usual cash reserve ratio (CRR, which earns no interest), but 75% is effectively statutory liquidity ratio (SLR). There is also no lending whatsoever. Can any bank that can’t lend ever make a business model out of such regulations?

On the other hand, consider how most big retail companies now have their own wallets. From Amazon to Google to Paytm to IRCTC to Jio, anyone with lots of customers and financial transactions now owns a wallet as a business support operation. What RBI has essentially done is made wallets with know-your-customer compliance more attractive than payments banks. It has legislated its own innovation out of existence. It is now busy preparing a formal funeral for them—by allowing payments banks to convert to small finance banks if they have been in existence for five years.

One can understand imposing extremely cautious regulations while announcing a new reform initiative, but regulations must be liberalized as lessons are learnt and early feedback comes in. What, for example, prevented RBI from allowing payments banks from offering overdraft facilities to bankable customers with a track record? What kept it from reducing the amount of money to be kept in short-dated securities steadily?

RBI’s fundamental problem has been its extreme suspicion of private players in banking. It seems to think that private players will game the system and route loans to themselves or their

cronies if they were allowed into banking. The opening up of payments and small finance banking to corporations was possibly intended as a compromise to give them an entry while imposing excessive restraints. If this was the convoluted thinking that opened up differentiated banking to private players, RBI need not have bothered at all.

RBI surely knows that if crooks want to game the banking system, they do not have to own large chunks of equity in banks directly. The story of the United Progressive Alliance years has been one of crony capitalists helping themselves to large chunks of loans with very little equity in play. Cronies looted both gullible public sector bankers and private ones. Large frauds at Punjab National Bank and huge discrepancies in bad loans discovered since in private banks such as Axis Bank and Yes Bank, where chief executive officers were ultimately forced out by the central bank, suggest that bad lending, even mala fide lending, can happen everywhere. It is not really about who owns the majority shares in a bank.

RBI would do well to give up its phobia of private bank ownership. While it could ban direct corporate ownership, there is no reason why it should expect successful private bankers to keep reducing their holdings to low levels when they have otherwise been diligent and careful in their lending practices, following all prudential norms and regulations.

High private shareholdings should be seen as a plus, and not a minus, for it means that any hanky-panky in operations carries a reputational risk for the owner. It is difficult to believe that an Uday Kotak or Aditya Puri or Romesh Sobti, if they had been majority owners of their banks, would endanger their reputations by indulging in skulduggery. Bankers with no skin in the game could easily be more vulnerable to fraud and bad practices than those with a reputation to lose.

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