Narrow banking is an idea whose time has come

The most heartening takeaway from last week's public sector bank executive jamboree was the discussion around differentiated lending structures. The ThinkShop (earlier editions were called Gyan Sangams) suggested that large banks focus on corporate lending, while smaller lenders focus on retail loans or specific geographies. It is a good start.

One of the key things the three credit crises in the Indian banking system over the past three decades have taught us is how little progress has been made to improve the impaired credit culture of state-owned banks.

Taking differentiated lending to its logical end, the time has come to consider converting the worst performers among state-owned lenders to narrow banks, which won't lend at all.

Narrow banks are safe banks. By not lending, and using their deposits to buy government bonds, they carry virtually no credit risk. There is no danger of non-performing loans and frequent injections of equity capital that has to be funded by taxpayers. For the Reserve Bank of India (RBI) too, supervision gets easier. There is no need for deposit insurance.

Take for instance, lenders such as IDBI Bank and Indian Overseas Bank. For both banks, close to one in every Rs4 they have lent has turned bad. They are both under the so-called prompt corrective action (PCA) framework of RBI; the central bank has placed restrictions on their lending in a scramble to ensure that their capital adequacy ratios don't plummet. Such lenders could just become large payment banks. It need not be done overnight, but can be done on an incremental basis by slowly whittling down their loan books.

Traditionally, the argument against such conversions has been that narrow banks do not perform certain crucial functions such as giving loans to the so-called priority sectors. Such an argument might have been valid two decades ago. India doesn't need so many universal banks to achieve financial inclusion.

Remember, that even the 1991 Narasimham Committee had recommended moving to a structure which would have four lenders as global banks and only 10 nationwide universal banks, besides local banks.

RBI has already laid the foundation when it introduced differentiated licences. So, even if the worst of state-owned banks are converted to narrow banks, there are enough private and small finance banks out there to lend to the small borrower. Newer technologies such as peer-to-peer lending, for which RBI has come out with regulations recently (although unsatisfactory), will further financial inclusion.

For larger borrowers, banks have been replaced as the largest source of funds over the last two years by other means such as debt securities market and the equity market. In any case, RBI is moving to a system where it wants large borrowers to shift their incremental borrowings to the bond market. Indeed, financial sector reforms that inject more life into the bond markets will do more to prevent the problems of future bad loans building up rather than throw more money into weak banks.

Narrow banks should be considered seriously to ensure that the mistakes of the past are not repeated at this scale. They will ring-fence a good part of the banking system from repeated failure that necessitate grand bailouts. Although, the government is planning to infuse Rs2.1 trillion into state-owned banks over the next two years (a right and long-overdue step), the recapitalisation fails to address the critical issue of improving credit culture. What is being done to prevent future non-performing loans from building? How is the capital going to be allocated?

It will also be a better alternative to merging banks, another popular proposal to increase efficiency. The finance ministry is moving in this direction by setting up a ministerial panel to nudge banks into consolidation and for considering merger proposals. But merging weak banks won't solve the problem of a improving a lending culture that seems beyond repair. What good will it do if the merged bank has to listen to the same finance ministry mandarin pushing for extending a loan to a crony capitalist?

Yes, the history of implementation of narrow banking has been patchy at best because governments, especially in developing nations, want lenders they own to further financial inclusion. But in the current context of Indian banking which has repeatedly thrown up crises in state-owned banks, narrow banking may be an idea whose time has come.

Ravi Krishnan is assistant managing editor, Mint.

END