Source : www.thehindu.com Date : 2020-11-25

SAY 'NO' TO CORPORATE HOUSES IN INDIAN BANKING

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

An Internal Working Group of the Reserve Bank of India (RBI) has recommended that corporate houses be given bank licences. In today's pro-business climate, you would have thought the proposal would evoke jubilation. It should have been hailed as another 'big bang' reform that would help undo the dominance of the public sector in banking. Instead, the reaction has ranged from cautious welcome to scathing criticism. Many analysts doubt the proposal will fly. It is worth examining why.

The idea of allowing corporate houses into banking is by no means novel. In February 2013, the RBI had issued guidelines that permitted corporate and industrial houses to apply for a banking licence. Some houses applied, although a few withdrew their applications subsequently. No corporate was ultimately given a bank licence. Only two entities qualified for a licence, IDFC and Bandhan Financial Services.

Dangerous suggestion: On allowing corporate houses to set up banks

The RBI maintained that it was open to letting in corporates. However, none of the applicants had met 'fit and proper' criteria. The IWG report quotes the official RBI position on the subject at the time. "At a time when there is public concern about governance, and when it comes to licences for entities that are intimately trusted by the Indian public, this (not giving a license to any corporate house) may well be the most appropriate stance."

In 2014, the RBI restored the long-standing prohibition on the entry of corporate houses into banking. The RBI Governor then was Raghuram G. Rajan. Mr. Rajan had headed the Committee on Financial Sector Reforms (2008). The Committee had set its face against the entry of corporate houses into banking. It had observed, "The Committee also believes it is premature to allow industrial houses to own banks. This prohibition on the 'banking and commerce' combine still exists in the United States today, and is certainly necessary in India till private governance and regulatory capacity improve. (https://bit.ly/3ftp7Yf)" The RBI's position on the subject has remained unchanged since 2014.

What would be the rationale for any reversal in the position now? The Internal Working Group report weighs the pros and cons of letting in corporate houses. Corporate houses will bring capital and expertise to banking. Moreover, not many jurisdictions worldwide bar corporate houses from banking.

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It is the downside risks that are worrying in the extreme. As the report notes, the main concerns are interconnected lending, concentration of economic power and exposure of the safety net provided to banks (through guarantee of deposits) to commercial sectors of the economy. It is worth elaborating on these risks.

Corporate houses can easily turn banks into a source of funds for their own businesses. In addition, they can ensure that funds are directed to their cronies. They can use banks to provide finance to customers and suppliers of their businesses. Adding a bank to a corporate house thus means an increase in concentration of economic power. Just as politicians have used banks to further their political interests, so also will corporate houses be tempted to use banks set up by them to enhance their clout.

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Not least, banks owned by corporate houses will be exposed to the risks of the non-bank entities of the group. If the non-bank entities get into trouble, sentiment about the bank owned by the corporate house is bound to be impacted. Depositors may have to be rescued through the use of the public safety net.

The Internal Working Group believes that before corporate houses are allowed to enter banking, the RBI must be equipped with a legal framework to deal with interconnected lending and a mechanism to effectively supervise conglomerates that venture into banking. It is naive to suppose that any legal framework and supervisory mechanism will be adequate to deal with the risks of interconnected lending in the Indian context.

Corporate houses are adept at routing funds through a maze of entities in India and abroad. Tracing interconnected lending will be a challenge. Monitoring of transactions of corporate houses will require the cooperation of various law enforcement agencies. Corporate houses can use their political clout to thwart such cooperation.

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Second, the RBI can only react to interconnected lending ex-post, that is, after substantial exposure to the entities of the corporate house has happened. It is unlikely to be able to prevent such exposure.

Third, suppose the RBI does latch on to interconnected lending. How is the RBI to react? Any action that the RBI may take in response could cause a flight of deposits from the bank concerned and precipitate its failure. The challenges posed by interconnected lending are truly formidable.

Fourth, pitting the regulator against powerful corporate houses could end up damaging the regulator. The regulator would be under enormous pressure to compromise on regulation. Its credibility would be dented in the process. This would indeed be a tragedy given the stature the RBI enjoys today.

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What we have discussed so far is the entry of corporate houses that do not have interests in the financial sector. There are corporate houses that are already present in banking-related activities through ownership of Non-Banking Financial Companies (NBFCs).

Under the present policy, NBFCs with a successful track record of 10 years are allowed to convert themselves into banks. The Internal Working Group believes that NBFCs owned by corporate houses should be eligible for such conversion. This promises to be an easier route for the entry of corporate houses into banking.

The Internal Working Group argues that corporate-owned NBFCs have been regulated for a while. The RBI understands them well. Hence, some of the concerns regarding the entry of these corporates into banking may get mitigated. This is being disingenuous.

The Hindu In Focus podcast | What if corporates owned banks?

There is a world of difference between a corporate house owning an NBFC and one owning a bank. Bank ownership provides access to a public safety net whereas NBFC ownership does not. The reach and clout that bank ownership provides are vastly superior to that of an NBFC. The objections that apply to a corporate house with no presence in bank-like activities are equally applicable to corporate houses that own NBFCs.

There is another aspect to the proposal that cannot be ignored. Corporate houses are unlikely to be enthused merely by the idea of growing a bank on their own. The real attraction will be the possibility of acquiring public sector banks, whose valuations have been battered in recent years. Public sector banks need capital that the government is unable to provide. The entry of corporate houses, if it happens at all, is thus likely to be a prelude to privatisation. Given what we know of governance in the Indian corporate world, any sale of public sector banks to corporate houses would raise serious concerns about financial stability.

India's banking sector needs reform but corporate houses owning banks hardly qualifies as one. If the record of over-leveraging in the corporate world in recent years is anything to go by, the entry of corporate houses into banking is the road to perdition.

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