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PERMITTING INDUSTRIAL HOUSES TO OWN BANKS COULD UNDERMINE ECONOMIC GROWTH AND DEMOCRACY

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

An internal working group of the RBI has recently made a far-reaching recommendation: To permit industrial houses to own and control banks. We believe that this step would be a grievous mistake, one that would seriously set back Indian economic and political development. Accordingly, we urge that this proposal be shelved.

Why do we have such serious misgivings? One clue is given in the report itself, which acknowledges that it ignored the experts the group had consulted. The report states that all the experts except one “were of the opinion that large corporate/industrial houses should not be allowed to promote a bank.”

Experts hold this view because allowing industrial houses to own banks has few benefits and many risks. According to the report, the main benefit is that industry-owned banks would increase the supply of credit, which is low and growing slowly. Credit constraints are indeed a real problem, and creating more banks is certainly one way of addressing the issue. But this is an argument for encouraging more banks and more types of financial institutions, generally. It is not an argument for creating banks specifically owned by industry. The other powerful way to promote more good quality credit is to undertake serious reforms of the public sector banks.

The problem with banks owned by corporate houses is that they tend to engage in connected lending. This can lead to three main adverse outcomes: Over-financing of risky activities; encouraging inefficiency by delaying or prolonging exit; and entrenching dominance. Consider each.

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First, lending to firms that are part of the corporate group allows them to undertake risky activities that are not easily financeable through regular channels. Precisely because these activities are risky, they often do not work out. And when that happens, it is typically taxpayers who end up footing the bill.

In principle, connected lending can be contained by the regulatory authority. Indeed, Indonesia tried to do this: It banned the practice. But as the authorities there found to their dismay, no matter how often they tightened the definition of connected lending, conglomerates were always able to find loopholes to exploit. Experiences in other nations have been similar, convincing most advanced countries that regulating connected lending is impossible; the only solution is to ban corporate-owned banks. It is also why Indian policymakers over seven decades have consciously and wisely drawn a lakshman rekha between banking and industry.

Crossing this lakshman rekha looks particularly unwise in India’s current circumstances. After all, the RBI has encountered enough difficulty in dealing with banking irregularities at Punjab National Bank, Yes Bank, ILFS and Lakshmi Vilas Bank. Expecting the RBI or other institutions to effectively regulate the practices of corporate houses-turned-banks is to ask the impossible. Regulation and supervision need to be strengthened considerably to deal with the current problems in the banking system before they are burdened with new regulatory tasks. Equally,

the fiscal position needs to be repaired after the considerable damage done by the COVID-19 pandemic before the government takes the risk of assuming an enormous future cost.

Second, the Indian economy today suffers from a serious lack of exit. The economic landscape is littered with failed firms, kept alive on life support, making it impossible for more efficient firms to grow and replace them. While some progress in clearing the landscape was initially made under the Insolvency and Bankruptcy Code (IBC), this had stalled even before the pandemic, largely because existing promoters and owners mounted a stiff resistance. If industrial houses get direct access to financial resources, their capacity to delay or prevent exit altogether will only increase.

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Finally, crossing this lakshman rekha will mean that the existing patterns of industrial dominance will become ruinously entrenched. The Indian economy already suffers from over-concentration. We not only have concentration within industries, but in some cases the dominance of a few industrial houses spans multiple sectors. The COVID-19 crisis is aggravating this picture because those with deep pockets will not only more easily survive the crisis, they will be able to take over small, medium and large enterprises that have not had the resilience or resources to weather the COVID-19 gale. After all, if large industrial houses get banking licences, they will become even more powerful, not just relative to other firms in one industry, but firms in another industry. For example, one can imagine a corporate house trying to assume dominance in the payments space and using that to dominate the e-commerce space. Getting the rights to own a bank could facilitate the former, thereby enabling the latter.

Moreover, the power acquired by getting banking licences will not just make them stronger than commercial rivals, but even relative to the regulators and government itself. This will aggravate imbalances, leading to a vicious cycle of dominance breeding more dominance.

For more than a quarter of a century, Indian financial sector reforms have aimed at improving not just the quantity, but also the quality of credit. In other words, the goal has been to ensure that credit flows to the most economically efficient users, since this is the key to securing rapid growth. If India now starts granting banking licences to powerful, politically connected industrial houses, allowing them to determine how credit is allocated, we will effectively be abandoning that long-held objective.

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But the real problem is much deeper and broader. Indian capitalism has long been stigmatised because of the murky two-way relationship between the state and industrial capital. If the line between industrial and financial capital is erased, this stigma will only become worse. Corporate houses that are already big will be enabled to become even bigger by having access to raise and redirect resources, allowing them to dominate the economic and political landscape. A rules-based, well-regulated market economy, as well as democracy itself — already shaky and ravaged by broader trends in India and also internationally — will be undermined, perhaps critically.

The conclusion is clear. Mixing industry and finance will set us on a road full of dangers — for growth, public finances, and the future of the country itself. We sincerely urge policymakers not to take this path.

This article first appeared in the print edition on November 27, 2020, under the title 'A

capital mistake'. Kelkar is former Finance Secretary and Acharya and Subramanian are former Chief Economic Advisors

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