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BANKING MUST EXPAND RAPIDLY TO SUPPORT INDIA'S ECONOMIC GOALS

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

Let us consider opening this sector up to India Inc once technology allows much closer supervision

There are four broad themes that run in the Reserve Bank of India's working group report reviewing the ownership and structure of private banks in the country. The first is the creation of a holding structure for overall governance. The second addresses the dilution of equity in banks by promoters. The third is how non-banking finance companies (NBFCs), which are growing larger, should be dealt with. And fourth is the entry of corporates to the banking sector. Let's take a dispassionate approach to these.

Holding companies for banks need to be created at the earliest. It will help ring-fence their integrity. At ICICI, going back about 20 years, when we were thinking of merging the parent organization with the bank, a holding company would have been an ideal structure, with the bank as a subsidiary, but it wasn't feasible at the time because of a lack of regulatory underpinning. With financial institutions and their subsidiaries getting larger and more complex, now is the right time. This urgency is visible in the RBI note, and there could be a tax neutral way to do it.

As for the promoter's shareholding, the draft offers a sufficiently long period of time, a 15-year horizon, for the entity to establish itself and the sponsor to provide a guiding hand before it needs to dilute its stake. This is what almost everyone who has promoted a bank has sought to do, and should not be an issue. The promoter's eventual equity cap being raised from 15% to 26% may provide a degree of stability, allowing continuity of management. It's pragmatic.

On NBFCs, these are far more complex than they were even five years back. They've become sizeable players, in their own right, in terms of the assets they have, the lending they do, and their presence in the financial sector. To use the regulator's term, they have become systemically important, as seen in the consequences of an NBFC getting into trouble some two years ago. We need to prevent any such failure. The RBI paper suggests a tighter supervisory structure, which the regulator must move on, but also asks whether enabling legislation would be needed.

On the fourth issue, the note is quite comprehensive. It has spelt out the rationale for looking at new entrants, and this has been done very well. It cites the size of the banking system in India, compares it with other countries, be it data on the share of players, capital utilization and operating costs, and goes on to say that when the time is right—i.e., when consolidated supervision can be tightened further, and when the legislative regime is right—we could look at corporate entry. This would take time, so their entry does not look imminent.

Currently, India's banking system as a percentage of gross domestic product (GDP) is just 70%. The only other large nation with rapid growth is China, which has a figure of 170%. That's nearly twice. For India to meet its economic aspirations, its economy 10 years ahead would have to be three to fourfold today's size. It is our dream, but it's not an unreal one. So, by China's benchmark, banking in India must become eight times its current size in the span of a decade. This calls for acceleration in the sector to support growth. Either existing players have to grow at the required pace, or we need new entrants.

The RBI paper's analysis shows that private players have done better than public-sector banks both on asset build-up and the raising of capital, which was got from the market (and not taxpayers, a point it makes subtly), and speaks of other inefficiencies. Either these inefficiencies have to be fixed, or we need players with better capital and operating efficiency coming in.

Since we are saying we don't want foreign players, that this is a domestic play, who can enter India's banking sector? That's what the paper is asking and it has done its duty in doing so. Most commentators have spoken of governance issues likely to come up if private corporate players are allowed entry. While we think about these, we must also answer this question: If this country has to grow, what will underpin this growth?

As for the narrow issue of risks in allowing corporate houses into the sector, such risks are true of any sector. The question is how we mitigate this risk with checks and balances. The regulator has a priori said that supervision has to be better, both by way of tools and structure. Given emerging technologies, there are several ways those concerns can be addressed. For example, just five years ago, and my view would have been different back then, there was no consolidated picture across banks of exposure to an entity. Now that's available. It's a huge step forward. Next would be giant leaps in technology that allow us to track every single payment virtually in real time. With these advances, many of the worries that have been raised will have been addressed.

Since India must broaden and deepen its financial system to achieve its national goals, we need to seriously consider letting corporate players in, albeit once appropriate checks and balances are in place to ensure systemic stability.

We would have to stay one step ahead of anyone trying to game the system. In the final analysis, it comes down to this: What is the common good? And the answer is clear. We need a $10 trillion economy in 10 years.

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