# India needs a new banking policy framework

The recapitalization of public sector banks has been rightly welcomed by most analysts. The Narendra Modi government has decided to spend big money to clean up the banks it owns, despite the obvious risks of moral hazard that bank bailouts across the world have inevitably faced. The next step should be a clear roadmap for future financial policy, before India stumbles into its next banking mess.

Take a look at what happened in the recent past. Three important policy documents laid the groundwork for banking reforms since the 1991 reforms: The report of the first Narasimham committee set up in 1991, the report of the second Narasimham committee set up in 1998 and the report of the Raghuram Rajan committee that was released in 2009. Not all their ideas were implemented, but they did set the ball rolling for a structural transformation of Indian banking. It is now time for a fourth comprehensive look at the issue, as a new set of challenges emerge.

Much has changed over the years. For example, Indian banks now have to meet international capital adequacy standards, a smaller portion of their deposits has to be handed over to fund the fiscal deficit, interest rates are determined by the market, branch expansion policies are more liberal and new private sector banks offer competition to the public sectors banks.

Yet, despite this undoubted progress away from the days of financial repression, this is the third banking mess India has had to deal with over the past three decades. Compare this instability with what has happened in the equity markets over the same period of time. Policy reforms in the equity markets have ensured that there has been no systemic crisis even in moments of immense stress, which is a far cry from the days when Dalal Street would grind to a halt in periodic payments crises.

What now? Here are some of the important banking policy issues that the government needs to deal with in the coming years.

First, the need for public sector bank autonomy has been recognized for long. It is time to recognize the harsh truth that such autonomy is impossible given the political interests involved, when a phone call from New Delhi is enough to clear the way for dodgy loans to favoured industrial groups. India needs to now shift the needle from autonomy towards privatization. Banking is the only important sector of the economy in which the private sector is dwarfed by the public sector. The share of public sector companies has fallen sharply in most sectors such as airlines. Banking is an exception—and it is time this changes.

Second, the first Narasimham committee had said that India should move towards a three-tier banking structure. Four large lenders were to be developed as global banks, 10 banks were to become nationwide universal banks and local banks would concentrate on specific regions. It is not necessary to chart the future out in such granular detail, but the underlying issue of banking structure is an important one. The ongoing debates about bank consolidation and differentiated licensing require a framework rather than the current ad hoc statements.

Third, the weakest banks cannot be shut down at once because of the disruption such a move would cause. However, there is a strong case to convert at least some of them into narrow banks that use all their deposit money to buy government bonds. They could in effect become large payments banks rather than the more traditional financial intermediaries. Narrow banking is an idea that needs serious attention.

Fourth, this newspaper has earlier argued that India needs to move towards a financial structure in which large companies get mostly funded by the bond markets while smaller firms depend more heavily on banks for their finance. We have already seen some of this happening as companies have raised money from the bond markets when bank lending stagnated. The problem is that the corporate bond market is still illiquid, with most bonds held to maturity by a narrow set of investors. Deepening the corporate bond market is critical.

One of the grand lessons of the global financing crisis is that no country has figured out how to maintain financial stability. Credit booms have inevitably left bad loans in their wake. Bank-led financial systems such as Japan have been in trouble. And so have financial systems such as the US where the bond markets are more important.

There are no binary answers, but what is clear is that unstable financial systems hurt economic growth and job creation in the long run. The fiscal costs of bailouts can also be staggering.

The Indian political leadership needs to get a sense of what financial structure it desires—and then get experts to advise it on how to achieve it that goal.

*Does the political leadership have the will to reshape and strengthen the banking system? Tell us at views@livemint.com*

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