

## Do we really need Indian corporations in banking?<sup>1</sup>

The Reserve Bank of India (RBI) recently released a report of an Internal Working Group (IWG) to review bank ownership guidelines. The Reserve Bank reviews its regulations periodically, and by and large this working group has done the usual thorough job. Yet its most important recommendation, couched amidst a number of largely technical regulatory rationalizations, is a bombshell: it proposes to allow Indian corporate houses into banking. While the proposal is tempered with many caveats, it raises an important question: Why now? Have we learnt something that allows us to override all the prior cautions on allowing industrial houses into banking? We would argue no. Indeed, to the contrary, it is even more important today to stick to the tried and tested limits on corporate involvement in banking.

As in many parts of the world, banks in India are rarely allowed to fail – the recent rescue of Yes Bank and of Lakshmi Vilas Bank are examples. For this reason, depositors in scheduled banks know their money is safe, which then makes it easy for banks to access a large volume of depositor funds. The rationales for not allowing industrial houses into banking are then primarily two.

First, industrial houses need financing, which they can get easily, no questions asked, if they have an in-house bank. The history of such connected lending is invariably disastrous – how can the bank make good loans when it is owned by the borrower? Even an independent committed regulator, with all the information in the world, finds it difficult to be in every nook and corner of the financial system to stop poor lending. Information on loan performance is rarely timely or accurate. Both ILFS and Yes Bank managed to conceal their weak exposures for considerable periods. Moreover, regulators can succumb to either political pressure or the urgency of the moment. The RBI recognized the risk of excessive exposures to specific houses in 2016 by announcing group exposure norms, which limit how much exposure the banking system can have to specific industrial houses. These norms have been relaxed recently. Moreover, as the WGI suggests, discerning the connections that make a borrowing entity part of an industrial house is always difficult, and some favored ones are expanding merrily, financing asset purchases with yet more borrowing, imposing greater risks on the system.

Second, easy access to financing via an in-house bank will further exacerbate the concentration of economic power in certain business houses. Even if banking licenses are given out fairly, it will give undue advantage to large business houses that have the initial capital that has to be put up. Moreover, highly indebted and politically connected business houses will have the greatest incentive and ability to push for licenses. That will increase the importance of money power yet more in our politics, and make us more likely to succumb to authoritarian cronyism.

Can the regulator not discriminate between “fit and proper” businesses and shady ones? It can, but it has to be truly independent, with a thoroughly apolitical board. Whether these conditions will always pertain is debatable. Moreover, once the license is given, absent close regulatory supervision the licensee’s temptation will be to misuse it because of self-lending opportunities. India has seen a number of promoters who passed a fit and proper test at the time of licensing turn rogue. The bailout costs to the exchequer could be significantly more when it comes to bank licenses to industrial houses, which will start out big.

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<sup>1</sup> By Viral Acharya and Raghuram Rajan.

Why is there urgency to change the regulation? After all committees are rarely set up out of the blue, suggesting someone has to have an interest in the outcome. Indeed, the IWG reports in its appendix that all the experts it consulted except one “were of the opinion that large corporate/industrial houses should not be allowed to promote a bank”. Yet it recommends change!

It is true that India needs more banking services – as the IWG points out, India’s credit to GDP ratio is abysmally low. It is equally true that despite the low level of lending, our banks incur huge loan losses, which ultimately fall on the taxpayer. Is it wise then to induct corporate houses with significant conflicts of interest into banking? If the aim is to bring in more managerial capabilities, the RBI already allows business houses that don’t have more than a certain fraction of their business in non-financial enterprises to apply for a bank license. Why not encourage more of these less-conflicted houses to apply for a license?

The RBI also allows business houses to apply for a payment bank license. This allows telecoms and possibly internet platforms to offer deposit accounts. If they want to make retail loans, they can tie up with a bank, and share any resulting profits. Why again do we need industrial houses to get full-fledged bank licenses? So, why now, at a time when we are still trying to learn the lessons from failures like ILFS and Yes Bank?

One possibility is that the government wants to expand the set of bidders when it finally sets to privatizing some of our public sector banks. It would be a mistake, as we have said in an [earlier paper](#), to sell a public sector bank to an untested industrial house. Far better to professionalize public sector bank governance, and sell stakes to the broader public – that would help promote a shareholder culture, as well as distribute wealth more widely. This could be coupled with some large stakes sold to financial institutions, who can bring governance, and financial and technological expertise to the bank. It would be “penny wise pound foolish” to replace the poor governance under the present structure of these banks with a highly conflicted structure of ownership by industrial houses.

A second possibility is that an industrial house holding a payment bank license wants to transform into a bank. One recommendation of the IWG that is equally hard to understand is to shorten the time for such transformation from 5 to 3 years, so perhaps the surprising recommendations have to be read together.

One can speculate endlessly. In the IWG’s favor, it has suggested significant amendments to the Banking Regulation Act of 1949 to increase RBI’s powers before allowing corporates houses into banking. Yet if sound regulation and supervision were only a matter of legislation, India would not have an NPA problem. It is hard not to see these proposed amendments as a subtle way for the IWG to undercut a proposal it may have had little power over. In sum, many of the technical rationalizations proposed by the IWG are worth adopting, while its main recommendation, to allow Indian corporate houses into banking, is best left on the shelf.