The Slow Regress in Banking

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July 1 is the last date for receipt of applications in a third post-liberalisation call for grant of licences to private sector entities wanting to establish banks in India. In the first round, ten banks were licensed based on guidelines issued in 1993. This was followed by the grant of licences to another two almost ten years later, based on revised guidelines issued in 2001. This third round call is based on new guidelines issued on February 22 this year.

It should be obvious why each call for applications has followed the issue of a new set of guidelines. Over time the kind of private entities that can enter banking have been redefined and the terms on which they can do so have been diluted. Experience, the government would argue, calls for revisions in policy. When policy is revised, eligible players must be given another chance to consider entering the banking sector.

Given this background, one tendency would be to dismiss the current call as just another step in the long liberalisation journey the Government of India embarked on in the early 1990s. However, there is one feature of the February 22 guidelines that do make this round of potential private entry special. This is that entities and groups in the private sector that are ‘owned and controlled by residents’ are to be allowed entry into banking. Read otherwise, this means that business groups and other private corporate entities are also allowed to enter banking, subject to the conditions specified in the new guidelines.

Given India’s post-Independence banking history this is indeed a major shift in stance. That history was one in which the government, through its designated regulator the Reserve Bank of India, not only sought to strengthen a poorly developed banking system afflicted by periodic bank failures, but also attempted to impose a degree of ‘social control’ over banking, so that the latter can serve a host of developmental objectives. For a little more than two decades after Independence this attempt to gain control over private banking was reflected in a series of legislative and administrative initiatives. But in terms of the spread of banking, the growth in deposits and lending, and the distribution of credit across sectors, units and households, the writ of the government was noticeable more in its absence.

Nothing illustrated this more than the fact that the share of credit provided to the agricultural sector in total advances barely exceeded two per cent at its peak. A sector that accounted for between 40 and 50 per cent of GDP and two-thirds of the nation’s workforce was almost completely excluded from the formal credit system. The reason was obvious, a series of official committees found. Big business houses had a stranglehold over the private financial sector, with some directly owning and controlling banks. Punjab National Bank, Universal Bank of India and Bank of Lahore were controlled by the Sahu Jain group; United Commercial Bank by Birla, Oriental Bank of Commerce by Thapar, Hindustan Commercial Bank by Juggilal Kamlapat and Indian Overseas Bank by Muthia, to name a few. Many of these banks featured among the top 20 of that time. Such corporate control over banking had resulted in the disproportionate diversion of credit to large industry, especially to segments of it that were directly in control of the banking system. The Dutt Committee found that in 1960 the top 20 private sector banks accounted for 61.7 per cent of all scheduled bank deposits and 73.2 per cent of scheduled bank advances. Around 10 per cent of the aggregate advances made by these banks went to companies in which their directors had an interest. This convinced the government of the time that public ownership was a prerequisite for both the spread of banking and the advent of socially relevant banking. It opted for the nationalisation of leading banks.

The results in terms of the spread of banking, the growth in deposits and advances and the distribution of credit were dramatic. Whatever else may be said of the nationalisation of banking, its success in terms of realising what the government did not manage to achieve between Independence and 1969 cannot be denied. This history had four implications. The first was that, despite some obvious inadequacies, the credibility of public sector banking was high in India, both from the point of view of ensuring financial stability and from the point of view of financial development and inclusion. The second was that the Reserve Bank of India as regulator not only shared this glory, but also grew accustomed to the power and the prestige that its role as banking regulator gave it. The third was that there were strong forces within the public sector, at the level of both bank officers and employees, which were interested in protecting the public banking framework and could find good arguments to support their cause. Finally, even when the advocates of liberalisation made a case for revisiting the question of permitting the entry of private banks, the need to keep the corporate sector at bay was more or less taken for granted.

One consequence has been the neoliberal transition in the banking area has been disappointingly slow from the point of view of the 'reformers'. Two decades after the doors were reopened for private interests, not much has been achieved in terms of private presence. In the first round of private entry in 1993, ten banks were allowed to emerge out of existing financial institutions or be set up anew, which included ICICI Bank, HDFC Bank, UTI Bank (which later became Axis Bank), Global Trust Bank (that failed and merged with Oriental Bank of Commerce), Times Bank (that merged with HDFC Bank) and IndusInd Bank. In the second round in 2004 Kotak Mahindra Finance Ltd was permitted to convert itself into a bank, and YES Bank was granted a new licence. Overall only 12 private banks were established. Of these a few have merged with other banks, both public and private.

This raises the question whether the current third-round call for applications for establishing private banks, by private entities which includes corporates, would be the final push that would transform Indian banking once again, restoring this time the control that big capital had and lost. The evidence seems to be that the Reserve Bank of India is trying hard to ensure this does not happen. While having to succumb to pressures that have been building since the Narasimham Committees of the 1990s and allow corporate entry into banking, the RBI has sought to "ring-fence" banking activity, in the hope that it would ensure substantial control by the regulator, and would keep the number of new entrants low and their intent clean.

To that end it has opted for a specific corporate governance structure for banks being set up under the new guidelines. To start with Promoters and Promoter Groups seeking licences to establish new banks will have to do so by creating a "Non-Operative Financial Holding Company" (NOFHC), which does not itself directly engage in financial activity. The NOFHC shall hold 40 per cent of the paid-up voting equity of the bank, which shall be Rs. 5 billion at the minimum. Individual promoters (including their relatives and companies in which they have 50 per cent or more equity holding) cannot each hold more than 10 per cent of the voting equity shares in the NOFHC. In addition, the promoter group must include one or more companies in which the public holds no less than 51 per cent of the voting equity, and this company (or companies) must hold at least 51 per cent of the voting equity shares in the NOFHC. The idea is to diversify ownership. However, promoters with 10 per cent voting rights can own a significant share and even controlling block (so long as it is less than 50 per cent of total voting equity) in the company/companies that are part of the promoters group, giving them substantial control over management of the bank. So the victory, if any, is only partial. The weapon the RBI has is its right to decide whether a promoter or promoters group is "fit and proper", in the sense of having sound credentials, with that decision being "a matter of overall judgment" and not based on specified criteria

The RBI has also sought to ensure the separation of bank and non-bank financial activities. To that end it has specified that the NOFHC established by potential promoter groups must as a holding company, "hold the bank as well as all the other financial services entities of the Group regulated by RBI or other financial sector regulators". Two separations are sought to be ensured here: one is between all regulated financial activities, and the other industrial, commercial and unregulated financial activities of individuals and entities in the promoters group; the other is between the banking and the regulated non-banking financial activities of these individuals and entities. The objective according to the RBI is that the corporate structure should be such that it does not "impede the financial services entities held by the NOFHC from being ring fenced", that the RBI "would be able to supervise the bank, the NOFHC, and its Subsidiaries/Joint Ventures/Associates on a consolidated basis", and that, the RBI "will be able to obtain all required information relevant for this purpose, smoothly and promptly".

There is a problem here to. Many regulated financial activities are subject to regulators other than the RBI, and the proposed structure does involve the RBI stepping beyond its turf. In the event the RBI has had to issue a clarification that "while the structure prescribed in the guidelines is the preferred structure, the intending applicants should approach the other financial sector regulators for bringing the entities regulated by them under the NOFHC." Their decision would prevail, with the minimal requirement that all RBI regulated entities will necessarily be under the NOFHC

Thus, the process of liberalisation having begun, the loss of the RBI's control and the restoration of private influence over banking is difficult to stall, let alone reverse. Perhaps for that reason the RBI has not kept its promise made in the February guidelines to come out with an overall policy discussion paper on banking structure in India within two months. Realising that structure may not be possible. All the RBI has managed to do and is likely to strive to ensure is that the transition is slow and long drawn, much to the irritation of the 'reformers'.

But the pressure is on. After the RBI issued its new guidelines in February it had to agree to issue a clarificatory note in response to queries that it chose to formally entertain. It received 443 queries from 34 individuals/ organisations. As a result, while the guidelines themselves filled just 19 pages the clarifications (including questions) run into 165 pages. It must be said that despite the unnecessary officialese in the RBI’s guidelines note, the answers to many of these questions are self-evident. The fact that they have been raised does not inspire confidence in the concerned potential applicants for bank licenses. But, perhaps, the real intent of the questions is to keep the pressure on the RBI, so as to prevent it from turning down too many applications and being too overbearing as a regulator as and when the new banks commence business.

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