The “Remaking” of Indian Banking

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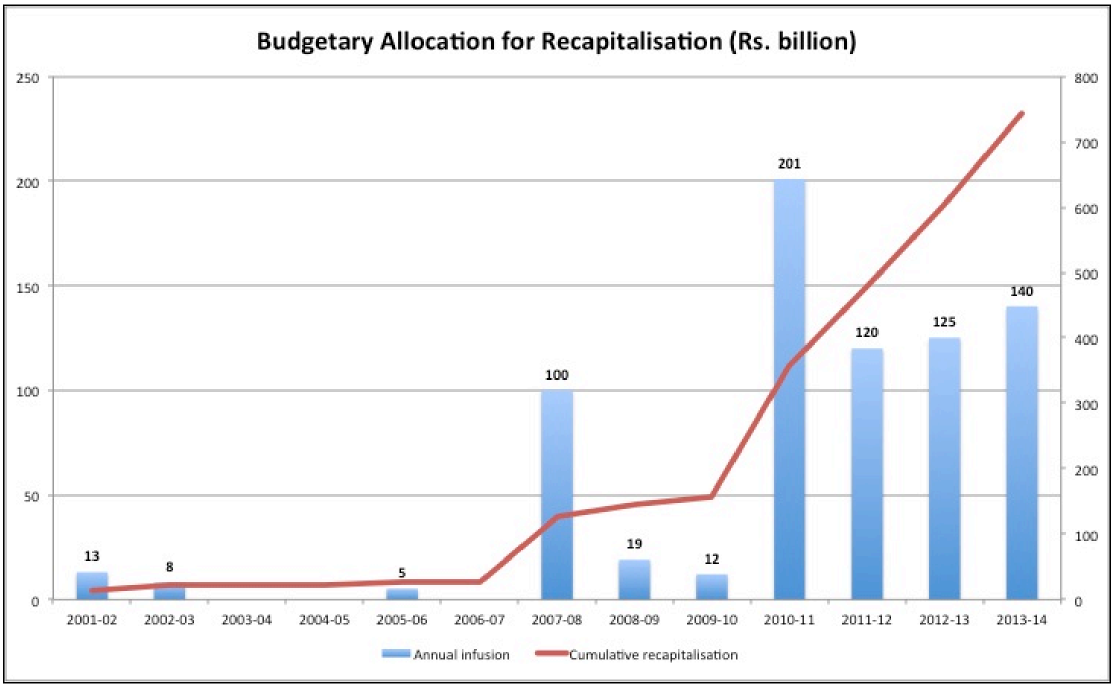
Reserve Bank of India governor Raghuram Rajan has declared that he intends to launch on a “dramatic remaking” of Indian banking. In fact, his case for a ‘remake’ had been made as far back as 2009 through the Committee on Financial Sector Reforms that he chaired. But with far less influence and power then, that case was for reform through “a hundred small steps”. Since taking over as RBI governor he has been far more enthusiastic.

It must be noted that there is little innovation in the nature of the remaking Rajan recommends. What is being done and what is planned to be done are all proposals that have been unveiled in the past, by a series of “committees” (from Narasimham I and II, through Tarapore and Mistry, to Rajan) that were set up to launch the trial balloons that would test the political and public response to various kinds and degrees of financial sector “reform”. They are also proposals that have been adopted, in almost tiresome fashion, in one or other developing country seeking to remake its financial system in the image of the post-1980s Anglo-Saxon ‘model’, which still rules despite being discredited by the global financial crisis.

Rajan’s contribution lies in the fact that he has, since taking over as governor, begun implementing in right earnest the different proposals and initiatives that were in process. There has been substantial advance in two areas. One is the set of measures that give foreign banks greater access to and more freedoms in the domestic banking space. The other is the issue of new private bank licences, for which applications have been entertained from domestic corporations and business groups as well. The latter had been kept out of this space since bank nationalisation. But now, with the committee to examine and decide upon the applications in place, expectations are that one or more business group would re-enter Indian banking. The Rajan machine seems to be working, facilitated by substantial media support, and possibly the fact that Parliament has hardly functioned and now elections would occupy the nation’s political attention.



But from the point of view of those expecting much from the current governor, the big test is still to come, and that is the promise to 'shake-up' the state owned banks. Thus far, the government's post-reform attitude to public banks has been contradictory. One the one hand, banks have been prodded (and not just encouraged) into lending to areas such as the retail sector and infrastructure, resulting in a rising volume of non-performing loans and a growing volume of restructured corporate debt. While restructuring has helped conceal the extent of implicit default and dress up the financial accounts of banks, even the RBI's recently released report on trends in banking expresses concern about the state of public bank balance sheets.

On the other, the RBI and the government appear committed to ensuring that Indian banks meet the increasingly stringent capital adequacy requirements set by the reformed Basel guidelines. There are three consequences flowing from this commitment. First, since the early 2000s, the government has been forced to infuse capital into the public banking system to strengthen their balance sheets and bring them into conformity of globally recommended standards. As the accompanying chart shows, the government has thus far infused Rs.743 billion into the public banking system, with much of it having been provided since 2010. But even this is far short of estimates of what the banks would require if Basel III has to be complied with. One estimate places the requirement at Rs.5000 billion over the next five years.

Second, with the government still looking to the banks to provide the credit that would finance private investment (in areas varying from housing to power) and consumption (of automobiles and much else), non-performing loans are bound to increase. Hence, expectations are that the sums required for recapitalising increasingly weak bank balance sheets would increase.

Third, since the process of recapitalisation started, the kind of capital required to beef up the Tier I (or best and least committed) capital on bank balance sheets has changed. Increasingly what is required is tangible common equity capital. If this has to be ensured while keeping the government's equity holding in public banks constant, much public resources would be required. The previous governor of the

RBI, D. Subbarao, had estimated that the government, which owns 70 percent of the banking system, will have to pump in Rs 90,000 crore equity to retain its shareholding in the Public Sector Banks (PSBs) at the current level to meet the norms.

If the government is to meet this requirement it will not be able to do it with off-budget measures such as issue of recapitalisation bonds as it did before 2010. It must now provide resources in the budget to buy into equity, with attendant implications for expenditures. If revenue increases cannot finance those expenditures, the fiscal deficit will widen, which goes against the self-imposed targets of the government. This has set off a demand that public sector banks should sell new shares in the open market to finance recapitalisation. But there could be one problem. Current law requires that the government should hold at least 51 per cent equity in public sector banks. A case is being made that reducing public shareholding from current levels to 51 per cent will not yield adequate capital for recapitalisation that permits realisation of Basel III standards. Subbarao, for example, is reported to have argued that “fiscal constraints pose significant challenges” to the effort to re-capitalise banks and ensure they meet Basel III norms, but bringing down government holding to below 51 per cent can resolve the problem. The case for recapitalisation has been converted into a case for privatisation.

Thus the call for privatising public banks also predates Rajan. The Narasimham Committee on Banking Sector Reforms had as far back as 1998 called for a reduction of the government holding in ‘public’ banks to 33 per cent to make them more dynamic. The Percy Mistry Committee had gone further to argue that privatisation is needed because state-ownership had adversely affected the quality of financial intermediation. The only change now is the case is being built on the grounds that privatisation is needed to ensure capital adequacy.

Thus, when delivering on public bank segment of his agenda to ‘remake’ Indian banking, Rajan would only have to implement a policy that has been pushed for quite some time now. But implementing this feature of the financial reform agenda is more difficult, since it requires changing the law, which in turn needs political support. That may be difficult to garner. But Rajan’s brief clearly is that he must give it a try.

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