Corporates as banks - Concerns

Related article: RBI's IWG Recommendations

Why in news?

- An Internal Working Group (IWG) of the RBI constituted to "review extant ownership guidelines and corporate structure for Indian private sector banks" recently submitted its report.
- Among the recommendations, a key and controversial one is to do with allowing large corporate/industrial houses to be promoters of private banks.

Had there been similar recommendations before?

- In February 2013, the RBI had issued guidelines that permitted corporate and industrial houses to apply for a banking licence.
- Some houses applied, although a few withdrew their applications subsequently.
- No corporate was ultimately given a bank licence.
- Only two entities qualified for a licence, IDFC and Bandhan Financial Services.
- The RBI maintained that it was open to letting in corporates. However, none of the applicants had met 'fit and proper' criteria.
- RBI had also emphasized on the public concern about bank governance at that time.

- In 2014, the RBI restored the long-standing prohibition on the entry of corporate houses into banking.
- The RBI Governor then was Raghuram G. Rajan who had headed the Committee on Financial Sector Reforms (2008).
- The Committee had been against the entry of corporate houses into banking.
    - It felt back then that it would be premature to allow industrial houses to own banks.
    - This prohibition on the 'banking and commerce' combine still exists in the United States today.
    - The same is certainly necessary in India till private governance and

regulatory capacity improve.
- The RBI’s position on the subject has remained unchanged since 2014.

What is the rationale now?

- The Indian economy, especially the private sector, needs money (credit) to grow.
- The government-owned banks are far from being able to extend this credit.
- Even more, the government-owned banks are struggling to contain their own non-performing assets.
- Government finances were already strained before the COVID crisis.
- With growth faltering, revenues have fallen and the government has limited ability to push for growth through the public sector banks.
- Given all these, large corporates are the ones with the financial resources to fund India’s future growth.
- Corporate houses can bring capital and expertise to banking.
- Moreover, not many jurisdictions worldwide bar corporate houses from banking.

What are the concerns with 'corporate-owned banks'?

- **Concentration of economic power** - Corporate houses can easily turn banks into a source of funds for their own businesses.
- In addition, they can ensure that funds are directed to their cronies, provide finance to customers and suppliers of their businesses.
- Even in private bank ownership, past regulators have preferred it to be well diversified i.e. no single owner has too much stake.
- **Risks** - RBI has always been of the view that the ideal ownership status of banks should promote a balance between efficiency, equity and financial stability.
    - A greater play of private banks comes with its own risk element. The global financial crisis of 2008 is a case in point.
    - On the other hand, a predominantly government-owned banking system tends to be more financially stable given the trust in government as an institution.
- Moreover, banks owned by corporate houses will be exposed to the risks of the non-bank entities of the group.
    - If the non-bank entities get into trouble, sentiment about the bank owned by the corporate house is bound to get affected.
    - In that case, depositors may have to be rescued through the use of the public safety net.
- **Connected lending** - The main concern in allowing large corporates to open their own banks is a basic conflict of interest, or more technically,

"connected lending".

- In simple terms, connected lending refers to a situation where the promoter of a bank is also a borrower.
- In other words, it is possible for a promoter to channel the depositors' money into their own ventures.

Why is connected lending a big challenge?

- Connected lending has been happening for a long time and the RBI has been falling short in having a check on it.
- The recent episodes in ICICI Bank, Yes Bank, DHFL etc. were all examples of connected lending.
- The so-called ever-greening of loans is often the starting point of such lending, wherein one loan after another is extended to enable the borrower to pay back the previous one.
- **Regulation** - The IWG has called for a legal framework to deal with interconnected lending.
- It also recommended having a mechanism in place to effectively supervise conglomerates that venture into banking.
- However, any legal framework and supervisory mechanism will be less adequate to deal with the risks of interconnected lending in the Indian context.
  - Corporate houses are proficient at routing funds through a network of entities in India and abroad.
  - So, tracing interconnected lending will be a challenge.
  - Also, monitoring of transactions of corporate houses will require the cooperation of various law enforcement agencies.
- **Ex-post** - The RBI can only react to interconnected lending ex-post i.e. after substantial exposure to the entities of the corporate house has happened.
- Given this, it is less likely to be able to prevent such exposure.
- Even after spotting, it is challenging to make course corrections.
- This is because any action that the RBI may take in response could cause a flight of deposits from the bank concerned and precipitate its failure.

- **Public sector banks** - Beyond the idea of growing a bank on their own, the real attraction for corporate houses will be the possibility of acquiring public sector banks (PSBs).
- Notably, the valuations of PSBs have been weakening in recent years.
- Public sector banks now need capital that the government is unable to provide.
- So, the entry of corporate houses, if it happens at all, is likely to be a prelude to privatisation.

- In that case, any sale of public sector banks to corporate houses would raise serious concerns about financial stability.

How about NBFCs conversion into banks?

- The IWG argues that corporate-owned NBFCs have been regulated for a while and thus the RBI understands them well.
- However, there is much difference between a corporate house owning an NBFC and one owning a bank.
- Bank ownership provides access to a public safety net whereas NBFC ownership does not.
- The reach and influence that bank ownership provides are vastly superior to that of an NBFC.
- In all, it is advisable in the present context to keep the class of borrowers (big companies) apart from the class of lenders (banks).

Source: The Indian Express, The Hindu