Say 'no' to corporate houses in Indian banking

Context: An Internal Working Group of the Reserve Bank of India (RBI) has recommended that corporate houses be given bank licences. At a time when there is public concern about governance, and when it comes to licences for entities that are intimately trusted by the Indian public, this (not giving a license to any corporate house) may well be the most appropriate stance.

RBI's Long-Standing position

1. 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. Mr Rajan had headed the Committee on Financial Sector Reforms (2008). The Committee had set its face against the entry of corporate houses into banking.
2. It had observed, "The Committee also believes it is premature to allow industrial houses to own banks. This prohibition on the 'banking and commerce' combine still exists in the United States today, and is certainly necessary for India till private governance and regulatory capacity improve. The RBI's position on the subject has remained unchanged since 2014.

Rationale

The Internal Working Group report weighs the pros and cons of letting in corporate houses. Corporate houses will bring capital and expertise to banking. Moreover, not many jurisdictions worldwide bar corporate houses from banking.

The worry is the risks

1. As the report notes, the main concerns are interconnected lending, the concentration of economic power and exposure of the safety net provided to banks (through the guarantee of deposits) to commercial sectors of the economy. It is worth elaborating on these risks.
2. 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. They can use banks to provide finance to customers and suppliers of their businesses.

3. Adding a bank to a corporate house thus means an increase in the concentration of economic power. Just as politicians have used banks to further their political interests, so also will corporate houses be tempted to use banks set up by them to enhance their clout.
4. Not least, banks owned by corporate houses will be exposed to the risks of the non-bank entities of the Corporate group. If the non-bank entities get into trouble, sentiment about the bank owned by the corporate house is bound to be impacted. Depositors may have to be rescued through the use of the public safety net.

Regulatory Difficulties

1. It is naive to suppose that any legal framework and the supervisory mechanism will be adequate to deal with the risks of interconnected lending in the Indian context.
2. Corporate houses are adept at routing funds through a maze of entities in India and abroad. Tracing interconnected lending will be a challenge.
3. Monitoring of transactions of corporate houses will require the cooperation of various law enforcement agencies. Corporate houses can use their political clout to thwart such cooperation.
4. Second, the RBI can only react to interconnected lending ex-post, that is after substantial exposure to the entities of the corporate house has happened. It is unlikely to be able to prevent such exposure.
5. Third, suppose the RBI does latch on to interconnected lending. Any action that the RBI may take in response could cause a flight of deposits from the bank concerned and precipitate its failure. The challenges posed by interconnected lending are truly formidable.

Regulator credibility at stake

1. Fourth, pitting the regulator against powerful corporate houses could end up damaging the regulator. The regulator would be under enormous pressure to compromise on regulation. Its credibility would be dented in the process. This would indeed be a tragedy given the stature the RBI enjoys today.

Other Routes for Corporates

1. There are corporate houses that are already present in banking-related activities through ownership of Non-Banking Financial Companies (NBFCs).
2. Under the present policy, NBFCs with a successful track record of 10 years are allowed to convert themselves into banks. The Internal Working Group believes that NBFCs owned by corporate houses should be eligible for such conversion. This promises to be an easier route for the entry of corporate houses into banking.
3. There is a world of 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.
4. The reach and clout that bank ownership provides are vastly superior to that of an NBFC. The objections that apply to a corporate house with no presence in bank-like activities are equally applicable to corporate houses that own NBFCs.

Conclusion:

India's banking sector needs reform but corporate houses owning banks hardly qualifies as one. If the record of over-leveraging in the corporate world in recent years is anything to go by, the entry of corporate houses into banking is the road to perdition.

Diplomatic offensive

Bottom line: With more details coming in of a planned terror strike in Jammu and Kashmir by four men, believed to be members of the Pakistan-based Jaish-e-Mohammed, who were gunned down by security forces last week, and the discovery of a tunnel in the Samba sector from where the men are supposed to have infiltrated into India, the government has decided to step up its diplomatic campaign to hold Pakistan accountable. India did well to highlight the terror threat from Pakistan amid steps along the border.

The Offensive

1. By appraising the international community, it would seem the government has a multi-pronged strategy.
2. The first imperative is to ensure that the full implications of the aborted attack and what could have occurred are understood worldwide, and the threat India continues to face from cross-border terror is acknowledged.
3. The second is to put Pakistan, which has itself been making allegations about a terror threat from India, squarely on notice.
4. Pakistan still faces the final FATF decision in February 2021 on whether it will be blacklisted for its inability to curb terror financing and to shut down groups such as the JeM and the LeT.
5. However, the Modi government must also remember that invoking the international community can be a double-edged sword in its bilateral conflict with Pakistan, that could invite discomforting interventionary interest.

Conclusion:

Eventually, India's success lies in protecting its borders, as done in Nagrota, and by providing a peaceful and stable environment in J&K so as to restart the much-delayed democratic process there, despite all attempts to derail it.

Dangerous suggestion

Crux: Industrial houses should not have access to household savings through their own banks

Concerns:

1. Experts clearly acknowledge that all but one of these outside experts were unequivocal in their opinion that given the prevailing far-from-ideal corporate governance culture, corporates ought to be barred from promoting banks.
2. The difficulty in ring-fencing "the non-financial activities of the promoters with that of the bank", was flagged by these experts as the central concern, a fear that was echoed by S&P Global Ratings too.
3. Experts have pointed to the bailouts of Yes Bank and Lakshmi Vilas Bank as examples of the heightened risk posed by any move to loosen bank licensing norms.

4. For all its regulatory powers and supervisory capabilities, the RBI failed to spot the build-up of troubled exposures at Yes Bank in time.
5. The dangers posed to overall financial stability by letting industrial houses have access to relatively inexpensive capital in the form of household savings through banks, howsoever legally regulated, are far too great to risk at the altar of liberalisation of ownership norms.

Learn Through Graphics: What Experts Say about Corporate Led banks