Banking as the New Frontier

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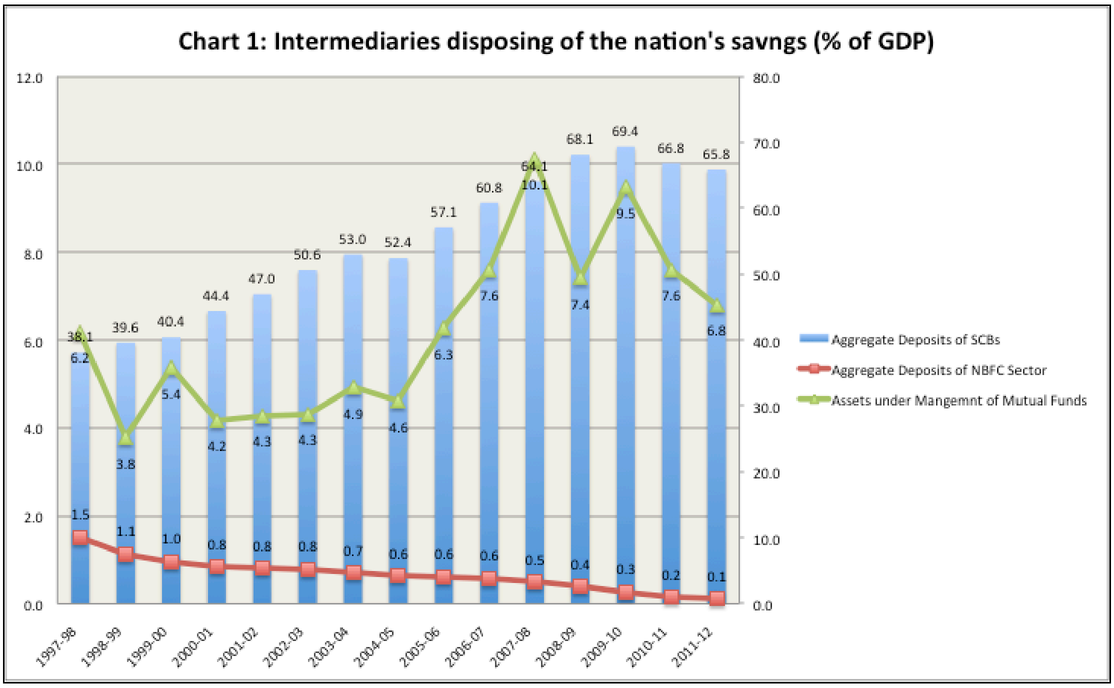
As the July 1 deadline for applications for new licences in the post-liberalisation third call for private entry into commercial banking approaches, speculation is rife on how many applications will be received and how many finally accepted. There is one reason why the response to the call is expected to be strong. This time the call is open entities and groups in the private sector that are ‘owned and controlled by residents’. That is, India’s corporate sector, which was shut out of banking after nationalisation in 1969 and later, is being allowed to return subject to conditions.

The conditions have disappointed corporate India. Besides having to commit much capital without the guarantee of full control, the new banks will have to immediately meet norms with respect to capital adequacy, rural banking and financial inclusion. That would make profits moderate and deliver returns only in the long haul. This creates some uncertainty about the success of the current call.

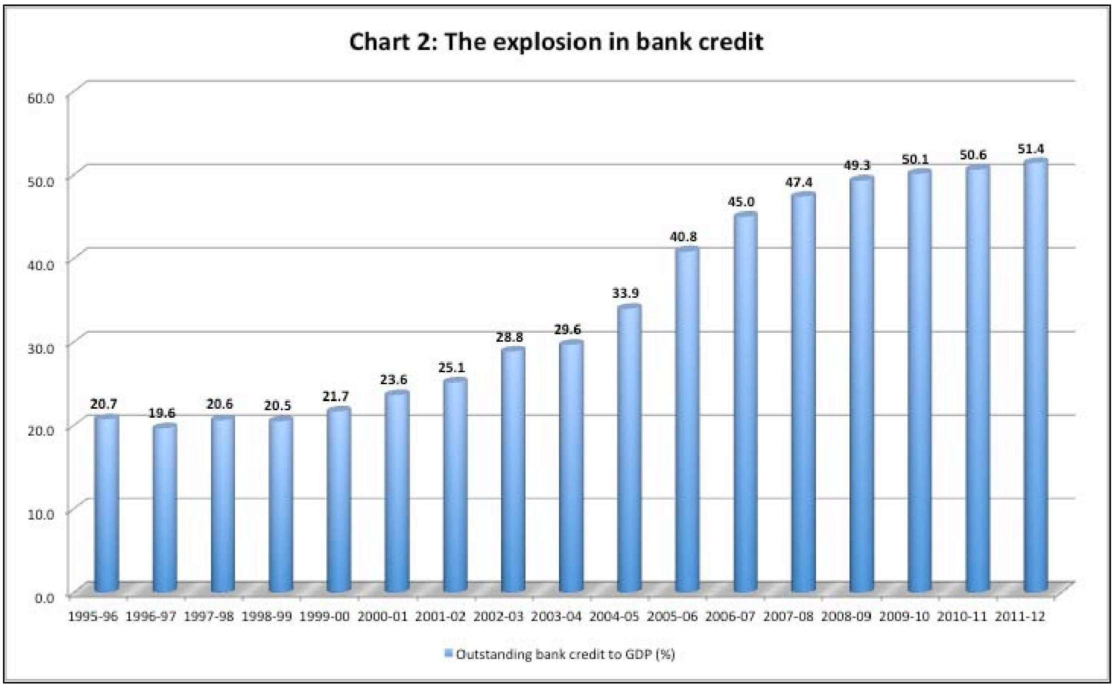
Further, matters have changed much since the 1970s. Those were the days of banking dominance, when regulation of the financial sector ensured that banks were the principal actors (other than the government with the right to tax) in the game of mobilising savings and allocating them to those who wanted to invest or spend more than their current incomes allowed. Banking, therefore, was an important space not merely because of the profits it promised, but because it provided access to the nation’s savings. That access was used by India’s business houses to finance their expansion at relatively low cost and without having to risk too much of its own capital. Control over finance ensured control over economic activity in general. Bank nationalisation disrupted that cosy world in which Indian big business straddled the real and financial sectors.

Liberalisation, however, was partly geared to changing this scenario. While it promised a small role for domestic and foreign private capital in the banking sector, it primarily opened up new financial activities such as mutual funds, a liberalised new issues and debt market, private placement and private insurance and pension fund management, to name a few. This was to result in some degree of disintermediation with savers being offered more lucrative investment options, encouraging them to place their surplus funds with intermediaries outside the banking sector. These non-bank financial intermediaries were expected to offer not just better returns but ways to hedge against risk of various kinds. It was in these areas, besides equity, commodities and derivatives trading, that the innovative private sector was expected to grow and thrive.



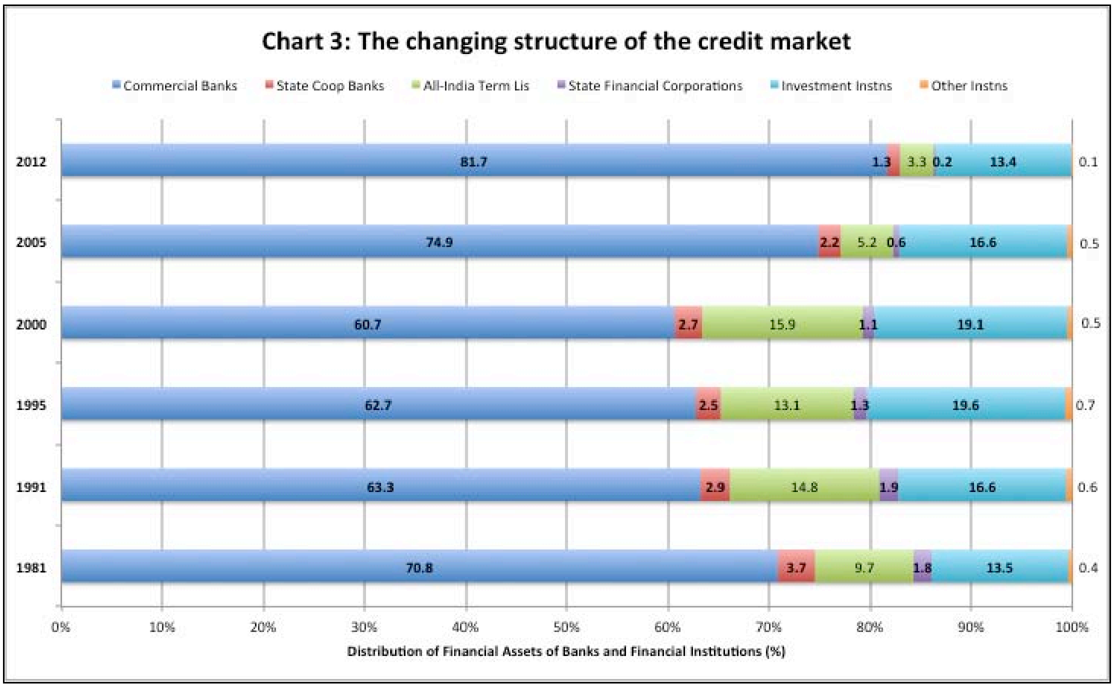
Yet, there now seems to be more private interest in the offer of entry into the staid world of banking rather than in expanding in these "new" areas. Understanding this requires turning first to the evidence on financial expansion over the last two decades or more. As Chart 1 shows, the promise and thrust of financial liberalisation notwithstanding, growth in the financial sector seems to have occurred largely in banking. This is because the first port of call of the nation's savings has remained the banking system, with the ratio of deposits outstanding with the scheduled commercial banks to GDP having doubled since the mid-1990s from its already high levels, whereas deposits in the non-bank financial companies (NBFCs) and assets managed by the mutual funds are either negligible or a fraction of banks deposits. (The NBFCs here include Deposit taking NBFCs (NBFCs-D), Mutual Benefit Financial Companies (Notified Nidhis), Mutual Benefit Companies (Potential Nidhis) etc., till 2004-05 and only NBFCs-D thereafter. This does make the figure an underestimate, and reporting is also possibly poor, but given the orders of magnitude involved the point being made would hold.)

As a result of this and the greater flexibility afforded to banking, including through reductions in the statutory liquidity ratio and the cash reserve ratio, banks have been able to create more credit on their rising deposit base. The result has been an explosion in credit growth (Chart 2). While the ratio of scheduled bank credit to GDP stood at around 20 per cent through much of the 1980s and 1990s, it has risen by two-and–a-half times between 2000-01 and 2011-12, to touch 51.4 per cent. This increase, it must be noted, occurred in a period that includes the high growth years between 2003-04 and 2008-09, which makes the rise in the ratio of credit to GDP even more significant. The high expansion in the universe of borrowers and the level of exposure per borrower implies increase in risk. But associated with that is higher returns. So long as the boom lasts, this points to a huge expansion in profit-making opportunities in the banking area.

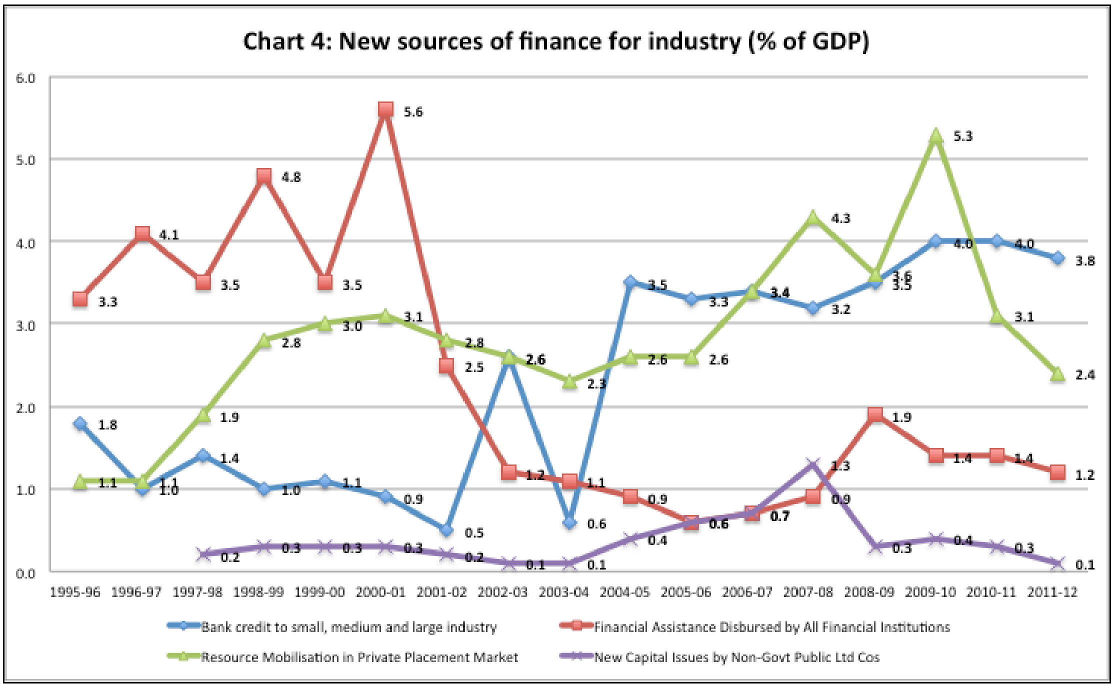


Moreover, post-liberalisation changes have made banking extremely important from the point of view of the financing of economic activity. Prior to liberalisation the understanding was that banks could provide long-term funding to industry and the housing market only to a limited extent. Being dependent on relatively small depositors who would like to hold their savings in highly liquid deposits, lending to long-term, illiquid projects would result in maturity and liquidity mismatches. So the resulting shortfall in the financing of long-term investment had to be met by creating specialised financial institutions with access to more long-term capital directly from the government or the central bank, or through pre-emption of a part of the resources of commercial banks.

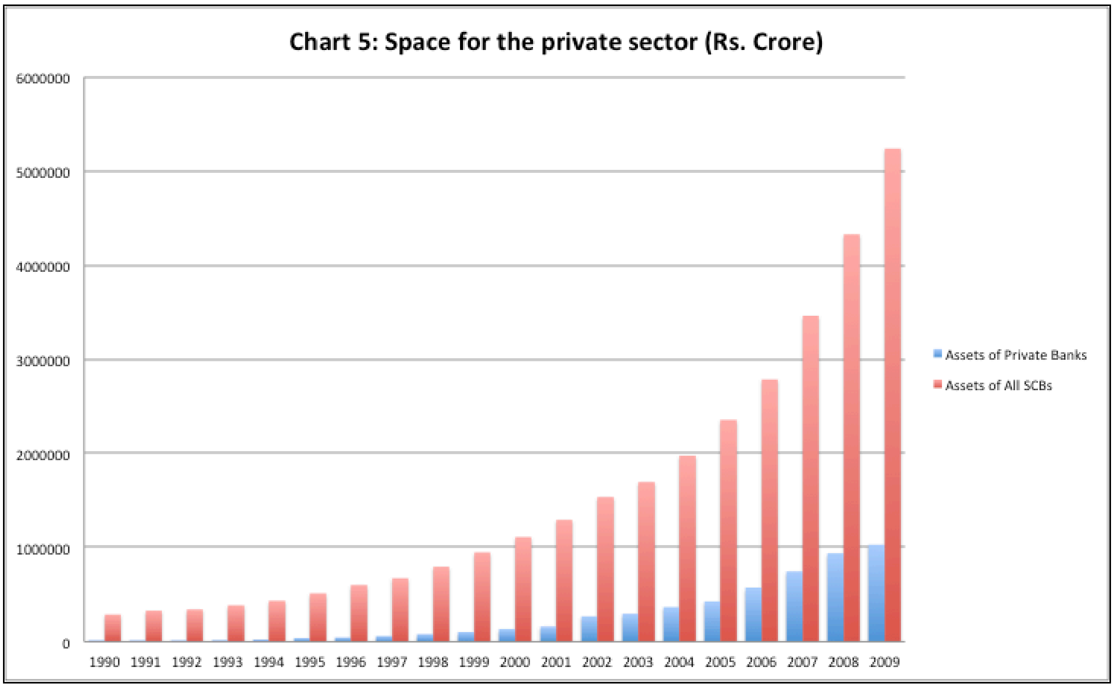
Liberalisation involved ending that dichotomy, with banks now being encouraged to foray into term lending of different kinds. The development financial institutions were also allowed to diversify into commercial banking and then merge into their commercial bank arms. Other development banks were downgraded or shut down. Even the public sector insurance companies, which played a role in financing long-term investment in the public sector, were now subject to competition from new private entrants and lost out in terms of the share of assets they managed. The net result is that if we examine the distribution of financial assets among banks and the financial institutions (such as the cooperative banks, the development financial institutions, the nationalised insurance companies and sundry other public institutions), we find that the share of the banks that had declined from 71 to 61 per cent between 1981 and 2000, rose to 82 per cent by 2012 (Chart 3). In this sense too, banking was gaining in prominence rather than shrinking relative to other markets and institutions after liberalisation.



One result of these changes has been a transformation of the structure of financing of productive activity, especially industry (Chart 4). Measured as a ratio to GDP, the importance of financial assistance from the erstwhile development finance sector has diminished considerably after 2000, partly because the DFIs had become banks and partly because they had been rendered irrelevant. On the other hand the capital market has not emerged as a substitute for these institutions, with the new capital issues market virtually absent, excepting for periods of an engineered speculative boom as in the early 1990s.The two main sources of external finance for industry seem to be the banks or the private placement market, with the latter now the target of foreign investors looking for high and/or quick returns.



In sum, banks have now come to dominate the financing business in India. However, thus far the private sector has not gained much from this explosion in banking. There have been two earlier post liberalisation rounds in which private entities were considered for entry into the banking industry. Ten banks were licensed in the round initiated in 1993 and another two in that initiated in 2001. However, one of these, [Global Trust Bank had to be force-merged with the public sector Oriental Bank of Commerce] and the [Times Bank voluntarily merged with the HDFC Bank]. There are now only 10 'new' private banks. Two of these emerged either from a quasi-public, government-sponsored entity (ICICI Bank) or from a public sector development finance institution (IDBI Bank). In sum, the growth of new private presence in banking has been limited. Further, many of the 'old' private banks that were not subject to nationalisation have not been performing too well. In the event, as Chart 5 shows, assets of the public sector banks have grown much more and much faster than those of the private sector banks as a group.



This 'failure' of the private sector to move into the expanding banking space has been attributed to two factors. The first is that the regulations and social obligations imposed on banking activity, and the caps on private shareholding and (more importantly) 'voting rights' are seen as having dissuaded private expansion. The second is that the really big players with deep pockets, the Indian corporate groups, have been hitherto kept out of the sector. The current call for applications for banking licences has responded to the resulting pressure from private capital wanting a share in banking and dropped the second of these constraints. The first still remains, even if in diluted form. It needs to be seen whether this would indeed trigger a private banking boom, to exploit the opportunity that obviously exists. If not, given the current policy bias, we can expect another round of liberalisation followed by a new call for applications.

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