Levelling the Playing Field

chapter 4

In an efficient financial system, the playing field is level so that different institutional forms compete to provide a function, no institutional form dominates others because of the privileges it enjoys, competition results in resources being allocated efficiently, and society gets the maximum out of its productive resources. This is also equitable for only thus will the interests of the consuming masses be served, instead of the more usual trend of privileged producers being protected. However, it will be a challenge to level the playing field in India because history has given us a peculiar legacy of financial institutions and a set of interest groups ranging from employees to regulators and politicians, who will support special privileges to their favoured institutions.

The tilted playing field is central to understanding some of the features of the Indian financial system. In India, the liquidity, safety, and payment services, offered by bank deposits have made them an investment vehicle of choice for the public. Banks can provide depositors with the product they need because of their access to certain public institutions, including the discounting or repo facilities at the central bank, the deposit insurance system, the payment system, and credit enforcement rights. Access to depositors gives banks a source of low cost financing. In return for this, made possible in part by privileged access to state institutions, banks are required in India to fulfil certain social obligations such as lending to the priority sector, as well as meeting prudential norms such as statutory liquidity ratios that also have a quasi-fiscal objective of funding the government. This is the grand bargain underlying the treatment of banks in India.

For the bargain to hold, there must be a rough balancing of the costs and benefits of being a bank. Yet competitive changes are making it much harder to maintain the balance without standing in the way of development. Consider payments. With technological improvements and the advent of real time gross settlement systems, more institutions such as money market mutual funds can be allowed access to the payment system and given the ability to offer customers checking accounts, much as they are in industrial countries.[1] But then banks would be right to ask why they should bear unremunerated obligations, such as priority sector lending if money market funds are given a free pass. Should banks be absolved of priority sector obligations, or should it be imposed on money market funds? As these questions suggest, the grand bargain will become harder and harder to sustain, and require ever increasing intervention by the authorities, as competition increases. Moreover, intervention will come in the way of efficiency.

Rather than regulatory authorities trying to determine what institutions should be privileged, and how costs and benefits should be balanced, this Committee believes they should let competition decide. This would require steadily lowering privileges, obligations, and regulations that differentiate one institution performing a function from another institution performing that same function, so that the most efficient form can prevail. To the extent that differences serve a social purpose, this suggests more direct attempts to achieve that social purpose by the government. It would also imply greater tolerance for a variety of institutional structures and linkages so that needed products can be created. Institutional structure should drive regulatory structure rather than vice versa.

Artificial differences abound in the Indian system. For example, money market mutual funds have a tax advantage over deposit-taking institutions with what are effectively interest payments to holders being taxed at a lower dividend rate. This gives money market funds an undue advantage, best removed by equalizing interest and dividend taxes, or setting the personal tax rate on mutual fund dividends in proportion to the fund's receipt of equity and debt income—in other words the mutual fund should pass through tax obligations instead of distorting them.

While we will offer more examples of institutional privilege that should be done away within the chapter, we cannot be exhaustive for the Indian financial system has many. The ultimate aim is to have a level playing field where institutional form does not affect the costs of undertaking an activity other than for purely economic reasons.

Another important source of differentiation is ownership—whether private, government, or foreign. For example, government ownership automatically confers benefits (government guaranteed support, favours by regulatory authorities, guaranteed public sector customers) as well as costs (politicization of decisions, limitations on pay, unremunerated activities for the public or support for public sector entities, extra layers of oversight by government organizations and the resulting inflexibility, difficulties in raising capital). If government ownership made a structural difference, with government owned institutions performing certain activities better simply because they were government owned—for example, if public sector employees treated the poor better than did private sector employees—there might still be a case for differentiation. There is, however, little evidence that government ownership creates deep differences in employee actions and behaviour.

Indeed, it is increasingly evident that when asked to generate profits, public sector entities do exactly what private sector entities do, though less well because they have more constraints, a poorer skill pool, and poorer incentives. The danger is that unless they are unshackled and their privileges minimized, they will slow growth and increase instability. For instance, the skill deficit will make public sector firms less effective at pricing risk. But they may still be able to win business, given their access to low cost financing (resulting from government backing). This will crowd out the private sector, which will not be able to compete at such un-remunerative prices. The distorted prices will inhibit the financial sector's effectiveness in allocating resources and risks. And the costs will partially have to be borne by the government when the underpriced risk eventually hits public sector balance sheets.

The Committee believes the way forward is to make institutions 'ownership neutral'. For the public sector, this means removing the overlay of costs and benefits imposed by government ownership. One way is bank privatization, or reducing the government's majority stake so that even if the government has de facto control, the bank is not 'public sector'. The other is through serious governance reform. The Committee believes that while this debate has become entangled in politics and ideology, pragmatic steps are possible in both directions so that experience can guide future moves. It makes recommendations along these lines.

Consider next foreign ownership. Many arguments are put forward for treating foreign firms differently. Yet the country has had a generally good experience with foreign direct investment elsewhere. And given that there are strong domestically incorporated firms in almost every segment of the financial sector, 'infant industry' arguments for protecting domestic financial firms at the expense of domestic financial service consumers hold little water.

What would foreign financial firms bring? The past Indian experience may not have much bearing for the future, given the substantial changes in the Indian economy. But cross-country studies indicate foreign financial institutions would bring competition that would improve service and prices for the consumer—indeed a study finds foreign entry is the single biggest factor in enhancing domestic competition and efficiency.[2] They would also bring skills that are needed in the Indian economy, and the talent they bring to India, or train in India, would become part of the domestic labour pool, leading to cross-fertilization. Particularly useful might be evaluating and channelling credit to small and medium enterprises.[3] Finally, they will have access to foreign capital that will be available even if the Indian economy is doing badly, thus providing a valuable source of insurance.[4]

There are, no doubt, concerns about foreign financial firms. There is some academic evidence that their entry is not particularly helpful when an economy is at a low level of financial development.[5] India's financial sector is probably much above that threshold. Also, to the extent foreign financial firms are not domestically incorporated, regulatory authorities may not have full control over them. This is remedied by requiring domestic incorporation in exchange for full domestic business privileges. Yet another concern is reciprocity. Domestic banks would like to expand abroad and feel that some countries erect undue hurdles in their way. It is important for the Indian authorities to exert every pressure on foreign governments to extend reciprocal privileges to Indian banks. However, we believe that the expansion of foreign banks in the Indian economy is beneficial to the Indian public and should not be held hostage to the vagaries of foreign governments. In the same way as India benefited by liberalizing trade over and beyond its foreign commitments, India will benefit by welcoming foreign financial firms. The high road seems to be the most beneficial one for our country here.

The Committee would offer some cautions about any reforms. First, it may be impossible to level the playing field completely. Some differences may be warranted, for example, for prudential reasons. For instance, a bank making certain loans has a capital requirement that a NBFC does not have to meet. This is because the bank has issued demand deposits, which entail a higher supervisory burden (see Chapter 6). Of course, the more an NBFC approaches the characteristics of a bank by issuing short-term deposits, the greater should be the similarity in treatment. Indeed, this principle is being followed by the RBI in its approach towards deposit taking NBFCs.

There are, however, differences that are not essential, and deserve to be eliminated. These differences are often highlighted through competition, as one entity or product appears to gain a seemingly unfair advantage. There are obviously two ways of eliminating burdensome differences. One is to place the burden on everyone. The second is to eliminate it for everyone. In general, the Committee would favour equalization by removing burdens rather than by adding burdens. To the extent that a burden cannot be removed for sound economic reasons, it would suggest a 'warranted' difference that might have to remain, rather than a need to increase burdens for everyone.

Second, institutions should be given time to adjust, so that legacy institutions can compensate for the loss of rents by developing new skills and businesses, or by shrinking gracefully, rather than by taking risks they do not understand or cannot manage. A time bound, pre-announced, steady withdrawal of differentiation is usually better than an overnight change.

Third, as financial integration proceeds apace, a variety of institutional linkages may emerge to provide the products people need. For example, a loan linked with crop insurance (or alternatively, one where interest and principal payments are linked to rainfall) seems to be a felt need of farmers. Given the desire of investors for safety, an equity linked deposit account, with a guaranteed minimum interest rate, liquidity, and some (but not full) upside performance related to the performance of the stock market could be popular. Such products would require linkages across institutional and regulatory silos, some of which is already happening. More needs to be encouraged. Holding company structures could help facilitate such linkages, and we will offer some recommendations. Regulatory reforms will also be needed and we will offer views in Chapter 6.

Fourth, care should be taken that institutions do not misuse their freedom of activity and structure to create fragile institutions that impose charges on the system. Certain activities do tend to create fragility, and should be monitored particularly closely or, in extremis, even prohibited for certain structures. For example, key to open-ended mutual funds being safe is the fact that their assets are liquid and continuously marked to market. An open ended real estate mutual fund has neither characteristic and can be very fragile—mutual fund 'runs' have occurred in some countries like Germany. Similarly, banks, mutual funds, or insurance companies with guaranteed returns necessitate additional monitoring to ensure that the institutions are managing their assets to produce the guaranteed returns, else they too could suffer runs and become a public charge.

The point therefore is to proceed steadily, predictably, but with care to reduce privilege and obligations, while expanding permissible activities wherever possible. This chapter contains some proposals towards these goals but it cannot be exhaustive. The main focus will be the banking sector, but the annex offers examples from other sectors.

TAKING STOCK

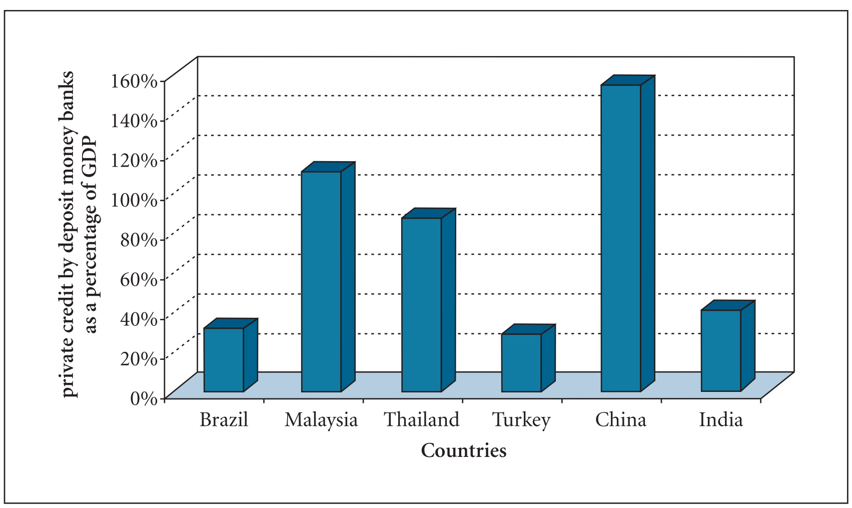
Key to growth with equity is an efficient and competitive banking sector providing the full range of products and services to individuals of all incomes and locations, as well as corporations of all sizes. The system should be stable with banks and bank employees appropriately incentivized so that there is little systemic propensity for sloth, excessive risk taking, fraud, or customer abuse.

By some of these counts the banking system has been very successful. Steady growth has come without significant instability, in contrast to the experience of some other emerging markets. Historically, our banks have attracted some of the best talent available. Some of our banks are setting world standards in the use of technology, and the recent thrust into housing and retail credit suggest banks are prepared to meet demand when it arises. Banks are also in fairly good health, as suggested by low NPAs and sizeable profits.

One cannot be complacent though because periods of strong growth are also periods when banking system problems build-up. While the rest of this section will attempt to understand the deficiencies in the banking system and possible areas of concern, this should not detract from past successes, which are considerable.

1. The role of the Indian banking sector is still small relative to GDP. While the size of the banking sector relative to the economy has more than doubled between 2000 and 2007, with bank loans to GDP ratio rising from 22.7 per cent to 46 per cent, the banking sector in India is still relatively small compared to other emerging markets (see Figure 1).
2. Even the largest Indian banks are relatively small, and account for a small share of the banking sector. India has only one bank (State Bank of India) that features among the top 100 banks in the world in terms of assets with a rank of 80. By contrast,

Figure 1: Size of Bank Credit



Source: Financial Structure Database, World Bank.

four Chinese banks feature in the top 30 banks. While banks of all sizes can be efficient—with technology allowing even small banks to flourish by making local, relationship intensive loans, size can bring some scale economies and allow banks to make loans to large projects while remaining diversified.

Indian corporations are also relatively small, hence the size of the capitalization of the 10 biggest Indian banks to the 10 biggest Indian corporations is not disproportional to ratios elsewhere (2.72 in India versus 2.45 in the USA in terms of total assets though a lower 0.23 to 0.44 respectively in terms of market capitalization). But as Indian corporations and projects grow in size and ambition, especially through mergers and acquisitions, some Indian banks will have to grow in size and capabilities.

3. If countries are ranked by the share of the top three banks in total banking assets, India comes in at number 102 in 2005. Of course, this is assuming that public sector banks should all be treated differently. While public sector banks do compete with each other, they do have a common owner, whose policies thus influence the activities of 70 per cent of banking sector assets.
4. India is an outlier in the extent of state ownership of the banking sector. Out of 138 countries surveyed by Barth, Caprio and Levine (2006), only nine had a predominantly state owned banking sector. India and China are in this group, along with Bhutan, Libya, Algeria, Belarus, Turkmenistan, Egypt, and Costa Rica. No high income country has a state dominated banking sector, and we should note that China has recently made moves to introduce strategic foreign partners in its large state owned banks.
5. In March 2007, there were 82 scheduled commercial banks in India (see Table 1 and Figure 2). Together, they accounted for about 80 per cent of the total assets of all formal institutions in the Indian credit market. Among the scheduled commercial banks the public sector banks accounted for about 70 per cent of the total assets in March 2007, Indian private banks 22 per cent and foreign banks 8 per cent. Interestingly, the share of the foreign banks has remained steady at about 8 per cent over the last decade or so even while the private sector banks have gained. Among the commercial banks, only eight are 'new' private sector commercial banks—banks that have been allowed to enter since the beginning of reforms in 1991.

India does not have many small private banks. The United States has over 7,000 banks, over 85 times the number of banks

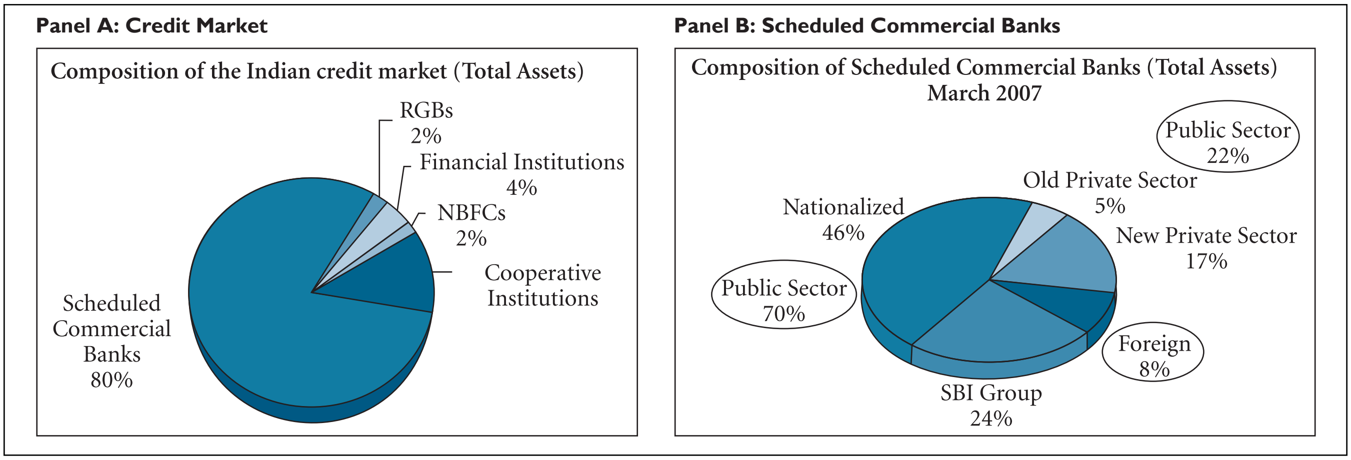
Table 1: Credit Market Structure in India

(Figures in Rs. Lakh Crores)

		Number of banks		Total assets		Loans and advances	
		2006	2007	2006	2007	2006	2007
1	**Commercial Banks**	**217**	**178**	**28.76**	**35.69**	**15.55**	**20.29**
	Scheduled Commercial Banks	84	82	27.86	34.63	15.17	19.81
1.1	Public Sector Banks	28	28	20.15	24.40	11.06	14.40
1.1.1	Nationalized Banks	19	19	12.34	15.30	6.82	8.95
1.1.2	SBI Group	8	8	6.92	8.06	3.72	4.82
1.1.3	Other Public Sector Banks	1	1	0.89	1.04	0.53	0.62
1.2	Private Sector Banks	27	25	5.72	7.45	3.13	4.15
1.2.1	Old Private Sector Banks	19	17	1.50	1.61	0.83	0.93
1.2.2	New Private Sector Banks	8	8	4.22	5.85	2.30	3.22
1.3	Foreign Banks	29	29	1.99	2.78	0.98	1.26
2.1	Regional Rural Banks (RRBs)	133	96	0.90	1.06	0.39	0.47
2	**Financial Institutions**	**55**		**1.45**	**1.67**	**1.11**	**1.32**
2.1	All India FIs	4					
2.2	Specialized FIs	7					
2.3	State Level Institutions	44					
2.3.1	State Financial Corporations						
	State Industrial Development	18					
2.3.2	Corporations	26					
3	**NBFCs**	**13,014**	**13,369**	**0.60**	**0.71**		
3.1	NBFC—D	428	401	0.38	0.48	0.11	0.11
3.2	RNBFC and Others	12,586	12,968	0.22	0.23		
4	**Cooperative Institutions**	**111,777**	**109,310**	**4.76**	**4.99**	**2.27**	**2.49**
4.1	Urban Cooperative banks	1,853	1,813	1.51	1.60	0.72	0.79
4.2	Rural Cooperative Institutions	109,924	107,497	3.25	3.39	1.56	1.70
4.2.1	Short Term	109,177	106,781	2.81	2.93	1.50	1.65
4.2.1.1	STCBs	31	31	0.72	0.76	0.44	0.48
4.2.1.2	DCCBs	367	369	1.33	1.43	0.66	0.74
4.2.1.3	PACs	108,779	106,384	0.75	0.73	0.39	0.43
4.2.2	Long Term	747	716	0.45	0.46	0.06	0.05
4.2.2.1	SCARDBs	20	20	0.24	0.25	0.03	0.03
4.2.2.2	PCARDBs	727	696	0.20	0.21	0.03	0.02

Source: RBI, Trend and Progress in Commercial Banking 2006–07. Number of reporting companies in case of NBFCs is 435 in 2006 and 362 in 2007. The total assets and loans and advances figures for the cooperative institutions are for the years ending 2005 and 2006.

Figure 2



Source: RBI, Trend and Progress in Commercial Banking 2005–06 and 2006–07 respectively.

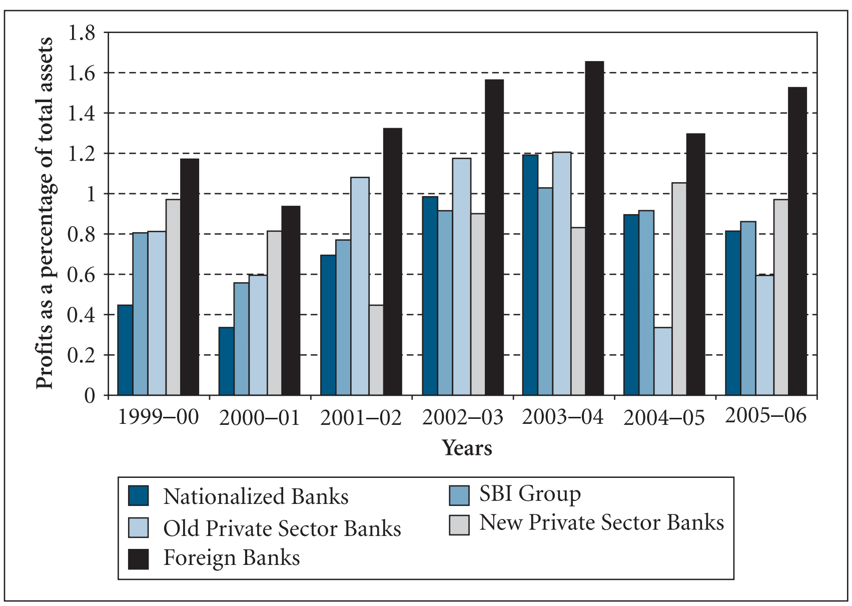
in India, handling total deposits that are merely over eight times larger. It should be noted that many of these banks are small community banks, comparable to our cooperative banks, of which we have a vast number. But these have a different governance and funding structure from the typical bank. While there are a number of notable exceptions, the experience with cooperatives has been mixed, in part due to problems with governance. These issues are addressed in Chapter 3, and the rest of this chapter will focus on scheduled commercial banks.

6. As a group, Indian banks have done exceedingly well in providing high returns to shareholders, registering the highest regional growth rate in assets, deposits, and ROE as well as one of the highest total returns globally according to a recent detailed survey of 14 leading public sector, new private sector and foreign banks conducted by McKinsey for the Indian Bankers Association (IBA).[6] Banks' contribution to GDP in India is comparable to the ratios in developed and developing world. Significant improvements were made in capital allocation between 2003 and 2007 reducing the share of industries with returns lower than cost of debt from 56 per cent to 22 per cent. NPA levels have been cut to about a third during the same period.

   Among the different bank ownership categories, foreign banks are clearly the most profitable (see Figure 3). Apart from fee-based activities, these banks enjoy a significantly higher interest spread (Figure 4). Part of their success in maintaining this margin lies in their ability to attract low interest corporate checking account deposits (Figure 5). The profitability levels of Indian bank groups are largely comparable.

7. With an average spread exceeding 5 per cent, intermediation costs in India remain high compared to other countries in the world as well as in the region. For example, spreads between borrowing and lending rates are 4 per cent in Thailand, 3.4 per cent in China, and only 2.4 per cent in Singapore. The high spreads are more than offset by unprofitable priority sector obligations and statutory requirements, as we will argue later. But this means that the burden of these social and public obligations are borne by the Indian saver, whose low return pays for the grand bargain described in the introduction.

Figure 3: Group-wise Bank Profitability

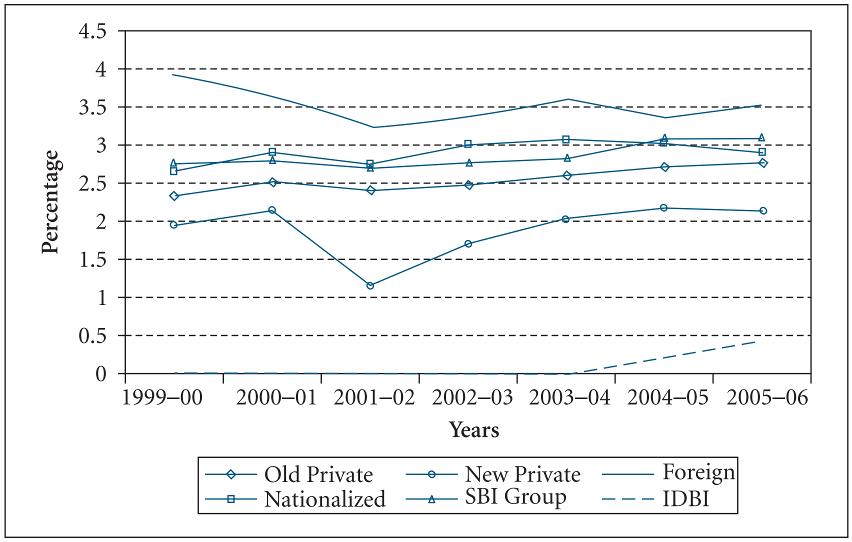


Source: RBI, Trend and Progress in Commercial Banking 2005–06.

8. While Indian banks are fairly efficient in their spending on IT, the use of technology to reduce transactions costs of outreach is still at a nascent stage. For example, there are 19 ATMs per million people in India, compared to 51 in China or 193 in Brazil. Clearly, the cost of human-intermediated transactions is still low in India, but it is sufficiently high that significant portions of our population do not have access to financial services.
9. There are, however, fundamental differences between new private banks and foreign banks on one hand (the 'attackers' in the IBA-McKinsey study) and the public sector banks and old private sector banks (the 'incumbents') on the other. The largely comparable profitability levels across leading banks today conceal critical differences in the underlying economics that is likely to shape the future. The first group enjoys significant relative advantages in terms of organizational capabilities, sales and distribution channels, credit and risk management practices and use of information technology and operation. Moreover, they target more affluent segments of the population in urban areas (see Box 1). Not surprisingly, therefore, since 2000 they have more than doubled their share of total assets, raised their share of total profits by more than 50 per cent, and account for almost half of the total market capitalization of the industry today enjoying over three times higher market valuation.
10. We have mentioned bank privileges and obligations a number of times. Before concluding this section, it is worth asking whether the banking system is benefited or hurt on net by obligations, pre-emption, and interest rate caps. While a detailed exercise is beyond the scope of this report, a quick estimate by McKinsey (see Figure 6), with all the caveats that accompany quick estimates suggests:

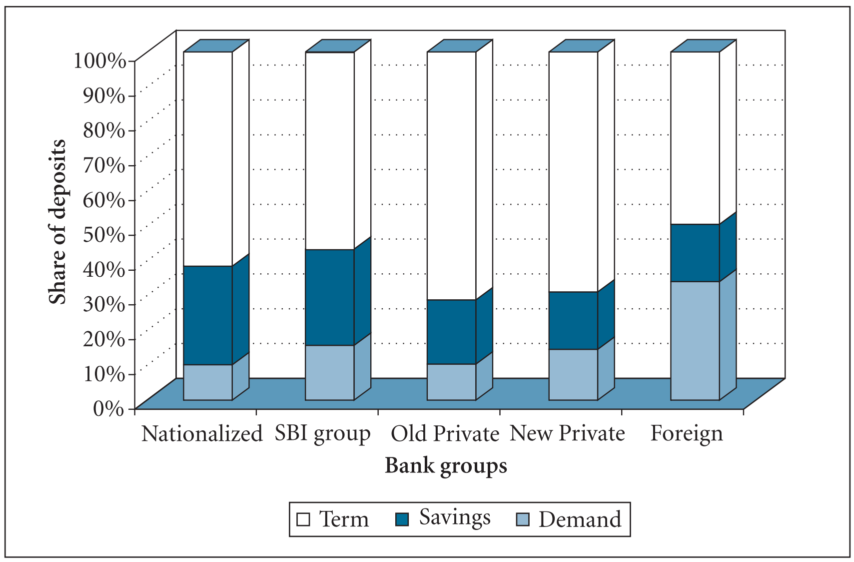
    (a) The banking sector is, on net, hurt to the tune of Rs. 10,000 to 15,000 crores by the 'grand bargain'.
    (b) The greatest benefit from getting rid of both the obligations and benefits would accrue to the public sector banks, whose profitability would rise by between 8,000 and 13,000 crores, a sizeable proportion of their current operating profits of about 42,000 crores.
    (c) The likely consequences are much smaller for foreign banks and private sector banks.

Figure 4: Net Interest Margin as a Percentage of Total Assets



Source: RBI, Trend and Progress in Commercial Banking 2005–06.

Figure 5: Share of Deposits: 2005–06



Source: RBI, Trend and Progress in Commercial Banking 2005–06.

In sum, while currently in robust health, India's banking sector is relatively small and intermediates less than half the country's household savings. The sector enjoys very high spreads, in part through controlled interest rates on savings and checking accounts, but this last benefit is more than offset by the pre-emption of bank assets into government mandated channels. Banking could become increasingly unprofitable as competition from other institutions increases. Moreover, the system is relatively unsuccessful in reaching

Box 1: Private and Foreign Banks vs. Public Sector Banks: The IBA-McKinsey Study

New private and foreign banks are much more profitable in wholesale businesses than the public sector and old private banks. The latter group mainly depends upon its valuable legacy retail franchises enjoying a massive ROE (return on equity) of about 33 per cent on their retail banking portfolios. Retail banking profitability is largely driven by access to retail banking and the 'attackers' today are investing heavily in building large-scale retail franchises.

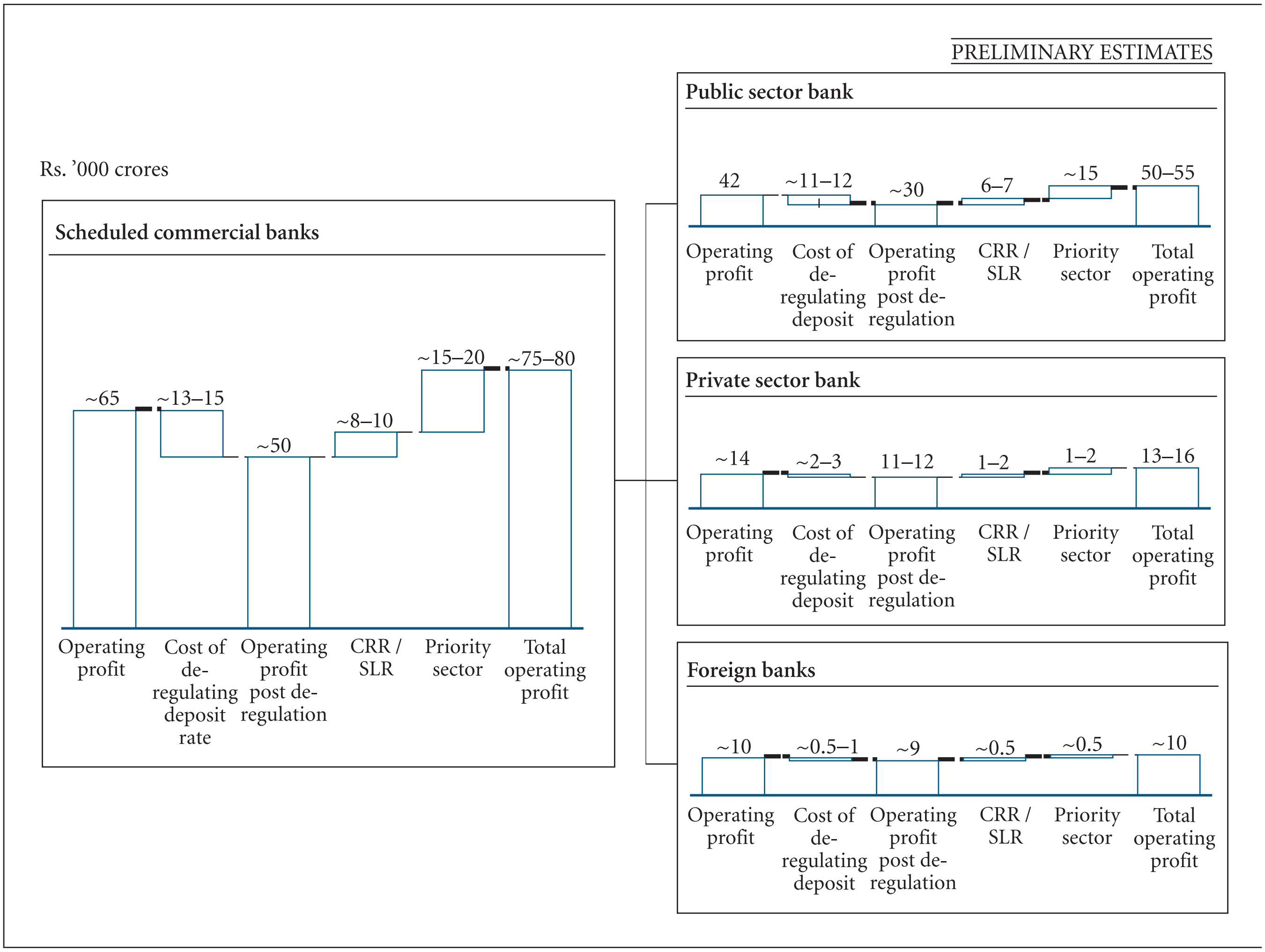
Customer experience is the critical value driver in banking anywhere and given that the young and affluent section of Indian customers are more demanding and discerning and are less credit-averse, customer experience and tailored offerings are increasingly becoming key to bank profitability. In this area foreign and new private sector banks have set themselves apart by superior levels of convenience and customer service. However they have also created more customers with negative experiences. Besides this customer segment is prone to greater diversification.

Indian banks have traditionally had better access to superior talent compared to other global banks leading to better average organization performance. However, public sector banks suffer from a crippling lack of specialist skills and new-age leaders. While foreign and new private banks are currently in a better position on this front, they will also have to deal with severe talent shortage soon.

Treasury is a significant contributor to bank earnings in India, managing capital market businesses and credit and market risk. Here while many foreign and new private sector banks are using sophisticated and world standard risk management techniques, public sector banks have fallen behind often simply conforming to regulatory and compliance measures.

In terms of use of information technology, in general Indian banks enjoy a competitive advantage even by global standards. But here too, new private banks and foreign banks have done better primarily because they could avoid legacy systems and had better governance practices. Most public sector banks have made large investments in technologies such as core banking solutions, are yet to use them effectively to enhance levels of customer service.

Figure 6: Costs vs. Benefits of Deregulating Interest Rates, CRR/SLR and Priority Sector Obligations



Source: McKinsey analysis, RBI.
*Operating profit as defined by the RBI

the very poor. Indeed, the strategy of attempting to reach the poor through large national banks branching into rural areas is reaching diminishing returns. The banking system therefore needs to change, both to prepare for a more competitive future, as well as to remedy current deficiencies. Perhaps the greatest area of concern is the public sector banks. That is what we turn to now.

PUBLIC SECTOR BANKS: AN OVERVIEW

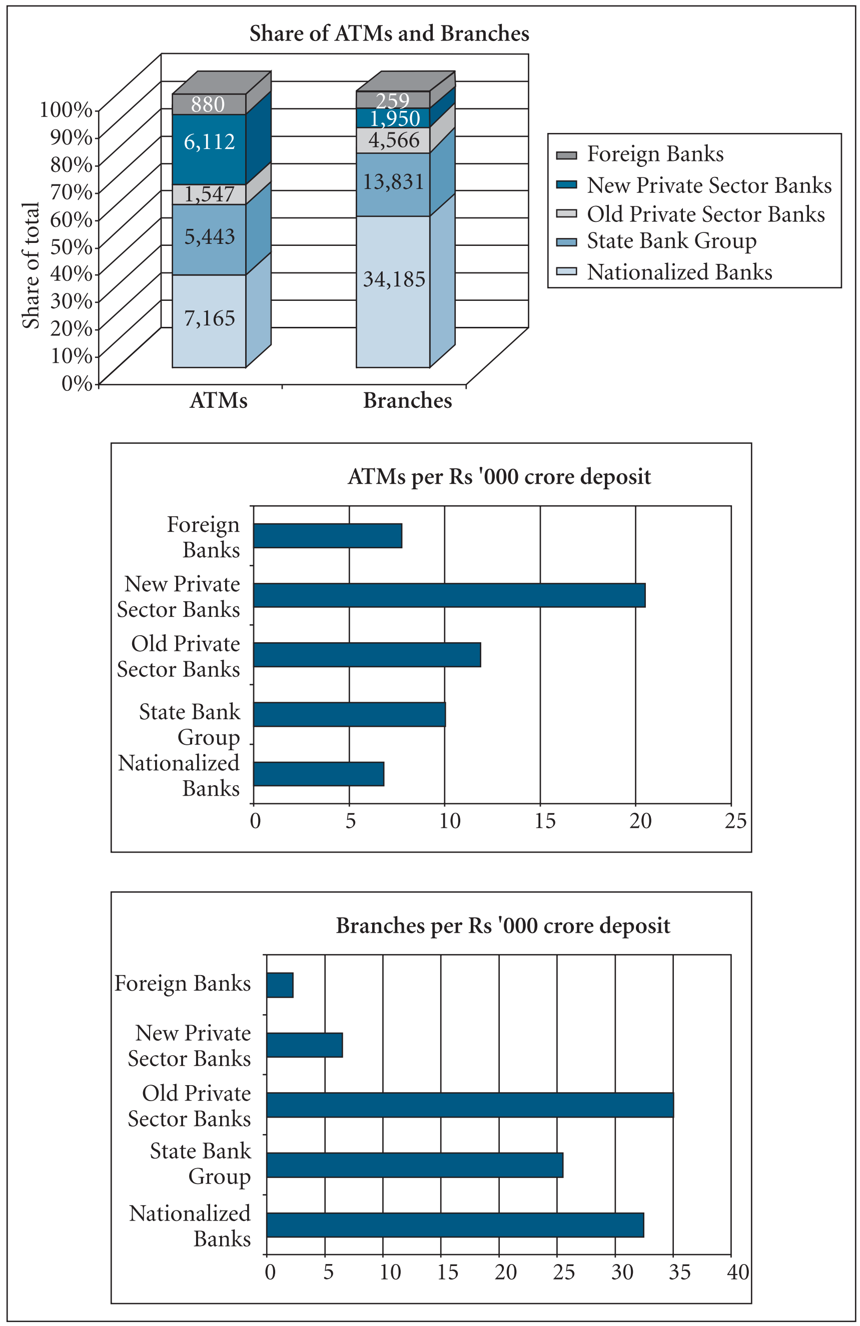
In simple profitability terms, the performance of public sector banks in India has, in recent years, been comparable if not better than that of other groups of domestic banks (see Figure 3). The future, however, looks more challenging for the public sector banks than those in the private sector, especially the 'new' ones.

In the past decade, public sector banks have witnessed a gradual erosion of their share in total assets of the banking sector from over 80 per cent to close to 72 per cent. During the period 2003–07, public sector bank balance sheets have grown at a compounded annual growth rate (CAGR) of 16 per cent, less than half that of private banks at 35 per cent. At these rates of growth, the public sector banks' share of total banking assets is expected to drop to about 56 per cent in 2012. Of course, given private sector banks started from a lower base, such differentials may not persist forever.

Public sector banks have lower productivity—profit per branch for public sector banks at Rs. 0.5 crores, is a fifth of the Rs 2.5 crores figure for private banks. Profit per employee at Rs 2.6 lakhs is only a third of the Rs 7.6 lakhs figure for the private banks. In part, some, but not all, of these differences come from a greater presence of public sector banks in lower profitability rural areas. For example, profit per rural branch for State Bank of India (SBI) is just 0.2 crores while profit per employee is 1.67 lakhs, and SBI has twice as many rural branches as urban branches.

In part, the differences come from better use of technology. For example, private and foreign banks' share of ATMs is significantly greater than their share of branches (see Figure 7). Moreover, they have been better at reducing costs by centralizing processing through the use of technology, even while using employees to get out of branches on to the street to sell products.

Figure 7



Source: Report on Trend and Progress of Banking in India 2006–07, RBI.

Equally portentously, the demographic profile of public sector bank customers is quite different from that for the private banks. While 60 per cent of foreign and private banks customers are below the age of 40, the corresponding share for public sector banks is only 32 per cent. Further, the economic profiles of the customers differ considerably as well. Public sector banks today have a much lower share of the more profitable 'mass affluent' segment of the population as compared to their private competitors. These differences have implications for the future growth potential of public sector banks, particularly relative to their private sector counterparts.

Another trend in banking—both global as well as in India—that does not portend well for public sector banks is the shift in revenues from traditional lending to more complex areas like bond-currency-derivatives products and fee-based wholesale and retail banking services like M&A advisory, institutional investments, and insurance. These are precisely the areas where public sector banks are at a relative disadvantage, primarily because of their inability to attract and retain talent or provide employees strong incentives, and their inability to make rapid investments in the technology necessary for being competitive in these segments.

The public sector market share in the bancassurance market in March 2007 stood at 32 per cent (compared to its 72 per cent share of assets) while in mutual fund sales it was about 5 per cent. Between 1997 and 2007, cash management throughout rose at a CAGR of only 16 per cent for public sector banks as opposed to 28 per cent for private sector banks. Between 2002 and 2007, the number of credit cards issued and spending in credit cards rose at CAGRs of 24 per cent and 44 per cent respectively as opposed to private sector CAGRs of 57 per cent and 71 per cent. In services like debt syndication and wealth management the public sector share has been a minuscule 2.7 per cent and 0 per cent respectively with foreign and private sector banks completely dominating the space. All these activities have taken-off recently, so the public sector starts from the same low base as the private sector, and should not, in principle, have a lower growth rate.

Perhaps most telling are the numbers on productivity. A McKinsey study in 2001[7] found that productivity of bank employees in India based on the number of transactions and the number of loan and deposit accounts opened per hour was a miserable 12 in comparison to 100 in the United States. The public sector banks were particularly backward on this dimension, scoring 10 while the old private sector banks scored 32 and the new private sector banks scored 55. By comparison, Brazil scored 32 and Korea scored 55.

These considerably poorer prospects of public sector banks relative to their private sector counterparts are reflected in their significantly lower valuation in the marketplace. At March-end 2007, public sector banks traded at an average price to book ratio of 1.11 while for private sector banks the ratio was 2.96. The price-earnings ratios were 6.85 and 25.19 respectively.

SERVING PUBLIC POLICY OBJECTIVES

It may be argued that profitability and valuation should not be the sole measures to capture the effectiveness of public sector banks in India since they have to fulfil important public policy objectives like inclusion and development of priority sectors in the country—objectives that often conflict with the profit motive. It is therefore important to evaluate the efficiency and effectiveness with which public sector banks have served these public policy goals.

Inclusion

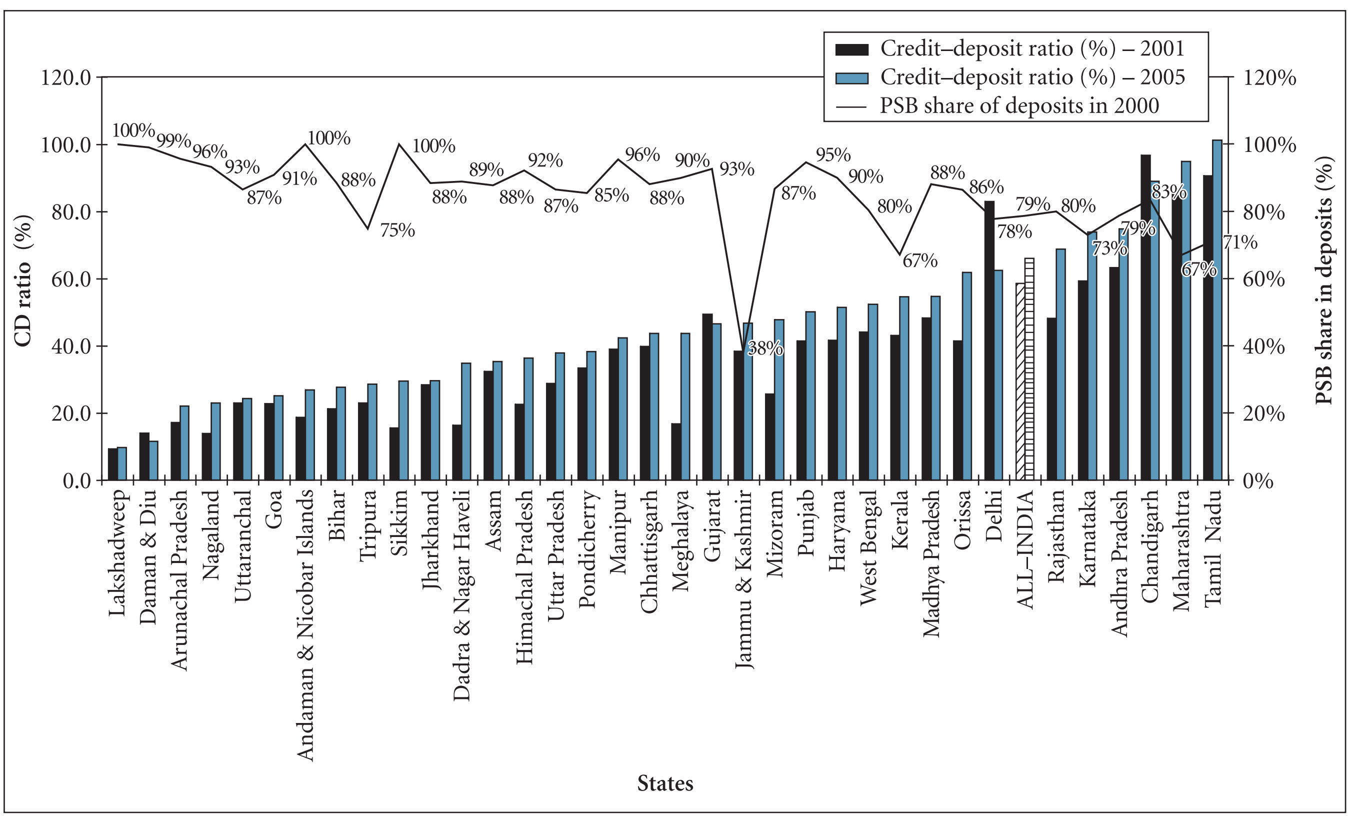
Inclusion has certainly been a public policy objective in the area of banking and it is undeniable that public sector banks have played a pivotal role in this area. Public sector banks account for 88 per cent of all commercial bank branches in India and in rural areas the proportion rises to 95 per cent.

Rural and semi-urban branches expansion was driven in the 1970s and 1980s by the 4:1 rule which required banks to open four branches in rural or semi-urban areas to get a license for opening a single new branch in the urban or metro areas. There are, however, differences in where they are to be found. Public sector banks expanded in rural areas where there were people—the correlation between the number of public sector branches in a state today and state rural population is 0.9. By contrast, private sector banks, perhaps because they have really grown after the period of enforced branching, may have been more selective in where they grew. The corresponding correlation for private sector branches is only 0.2.

Another demonstration of the private sector's location preference for areas with more lending opportunities (and thus probably more growth) is in Figure 8, which shows each state's credit-deposit ratio plotted against the share of public sector banks in total deposits in the states in 2000. The correlation of public sector bank share in deposits and the credit deposit ratio in 2001 and 2005 are –0.50 and –0.54 respectively, suggesting that in states with lower lending opportunities (lower bars in the figure) public sector banks are indeed the primary provider of banking (the dark line indicating the PSB share of deposits is higher). Interestingly, the correlation between percentage changes in credit–deposit ratio during the period and the deposit share of public sector banks in 2000 is a statistically insignificant 0.16, suggesting no systematic relationship between improvement in the regional credit disbursement and public sector bank presence during this period.

Since the reforms began however and the pressure to open new rural branches eased for public sector banks, the nature of branch expansion has also changed drastically. While

Figure 8: Credit–Deposit Ratio



Source: RBI, Trend and Progress in Commercial Banking, several years.

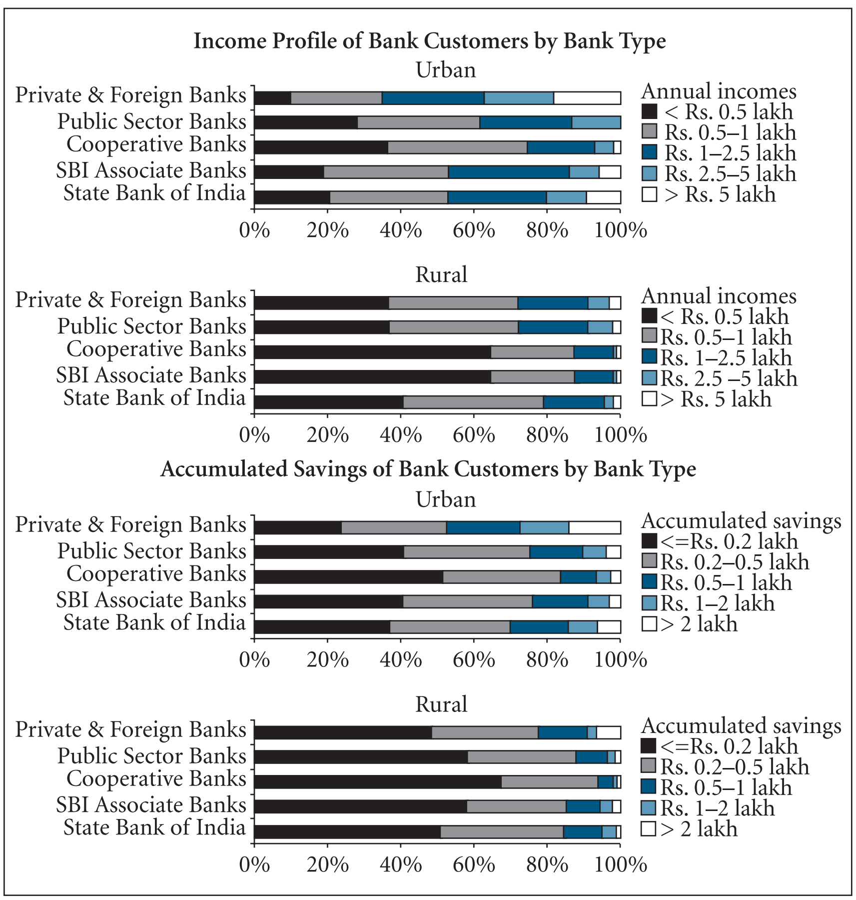
the preference for private sector banks for the more profitable urban locales is clear, in 2005–06 public sector banks as a group did not open a single new rural branch though they added 486 branches to their network (in 2006–07, a total of 1,014 branches were added by PSBs of which 69 were rural). A variety of explanations for the paucity of rural branch openings are possible. It may be that rural coverage is complete so few new branches are needed. However, it may also be that banks have realized rural branches are really not the most cost-effective way to achieve outreach. It may also be that when public sector banks are tasked with being profitable, they gravitate to similar behaviour to private sector banks.

This last point of the relative similarity in behaviour between public and private sector when in the same environment and facing similar incentives deserves further reinforcement. Note from Figure 9 that the difference in customer profiles between public sector banks and private sector/foreign banks in rural areas is quite narrow (for example, just over 80 per cent of public sector bank clients earn incomes below 1 lakh per annum, while the comparable figure for private and foreign banks is over 70 per cent), while private sector/foreign banks attract a much richer clientele in urban areas. This suggests that in the rural areas they choose to be present in, private sector/foreign banks do serve the local clientele, and do not discriminate against the poor, at least not significantly more than the public sector banks. In urban areas though, where the public has more choice (and where banks can be more selective in their clientele), private sector/foreign banks have significantly greater share amongst the more affluent. Put differently, in markets where the bankable population is small, private/foreign banks go after nearly everyone the public sector reaches out to.

These observations have profound implications for the rationale of using public sector banks to facilitate branching and thus inclusion in rural areas. First, additional rural branching is not very profitable, and when given a choice, everyone stays away from it—public sector banks and private sector banks alike. Low rural incomes may not warrant the posting of an employee of a large national bank, who enjoys the same wages as an urban employee (and some hardship perks to boot) in the rural area. One alternative may be to recruit from the local area, at local wages, but such pay differentiation is typically not possible in a large bank (or, in RRBs, as history has suggested). A better alternative is the licensing of new small finance banks proposed in Chapter 3. But we also have to rethink modes of delivering financial services, abandoning the emphasis on fixed-location branches that cannot be used intensively, and focusing on electronic or multi-use delivery channels such as shops—the large bank linkages proposed in Chapter 3.

Second, when in a rural area, differences in bank ownership do not significantly affect the kind of clientele that is served. Money has no odour, and when there are profits to be made, the private sector will reach out for it.

Figure 9



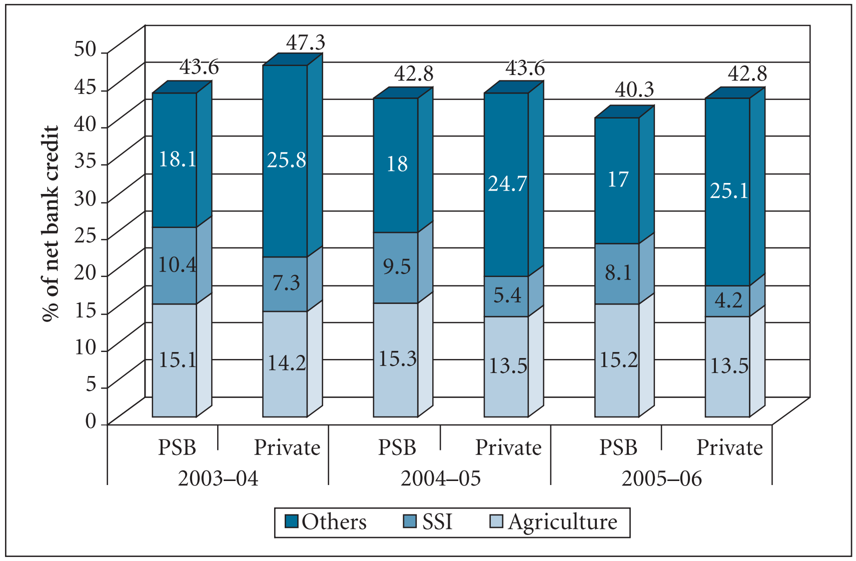
Source: IIMS Dataworks.

The answer to inclusion is not to rely solely on the 'public spirit' of public sector banks but to make the poor worth competing for.

Third, efficiency and innovation are critical to reaching the underserved profitably. The relatively low productivity of public sector banks is an important impediment in using the public sector banks as the primary instrument to achieve inclusion.

Finally, there is large population of poor and unbanked in urban areas as well. The Committee believes the proposals for expanding inclusion in rural India will also address the concerns of the urban poor as well, perhaps a little more effectively given the large urban presence of banks.

Figure 10: Priority Sector Lending



Source: RBI, Trend and Progress in Commercial Banking 2005–06.

Directed credit

In recent years, private banks have actually done better than public sector banks (see Figure 10) in terms of fulfilling the overall priority sector quota, though in the sub-component of agricultural credit, public sector banks have done a slightly better job. When we consider the share of net bank credit to weaker sections (mandated at 10 per cent of net bank credit), however, public sector banks are significantly ahead at 7.7 per cent in 2005–06 as compared to 1.6 per cent for private banks. Taking a more long-term perspective, public sector banks have generated more credit to agriculture and rural areas and government enterprises, less credit to the trade, transport and finance sector, with little difference in credit to small-scale industries and industries identified for support in the post-1980 five-year plans.[8]

In terms of impact of the additional agricultural credit from public sector banks, agricultural investment and output growth do not reflect any effect of increased agricultural credit either, raising questions about appropriate end-use of agricultural credit provided by public sector banks (though the absence of supportive public investment could also be a factor). In terms of loan timing, in times of drought in a district, private sector banks appear to provide more agricultural loans, while public sector banks provide more consumption loans. On net, there is little difference in overall lending in times of drought between public sector banks and private sector banks, though private sector banks are significantly more likely to lend in times of plentiful rainfall than public sector banks.[9]

Finally, there is variance in the quality of directed lending. The share of non-performing loans in the priority sector lending has been higher for nationalized banks than for the private banks with some indication that political interference has reduced credit quality.[10]

In March 2007, though priority sector lending constituted a slightly higher share of total lending for private sector banks (42.7 per cent) than the public sector banks (39.6 per cent), less than 32 per cent of the former's NPAs came from priority sector activities, while for public sector banks, over 59 per cent of their NPAs came from priority sector lending. NPAs in agriculture constituted 3.1 per cent of total outstanding direct agricultural credit for private banks as opposed to 4.4 per cent for public sector banks. The corresponding figures for small scale industry were 4.9 per cent and 5.6 per cent respectively, and for other priority sectors, 1.8 per cent and 5.3 per cent respectively. Total priority sector NPAs constituted 2.4 per cent of total priority sector lending less indirect agricultural advances for the private sector banks as opposed to 5.0 per cent for public sector banks.

In this regard, it is disheartening that after a period when governments desisted from announcing waivers, agricultural loan waivers have returned to the policy discourse. As Chapter 3 on inclusion suggests, the poor are not the largest recipients of bank loans even though they are highly indebted, so bank loan waivers are typically poorly directed—though it is debatable whether they are more poorly directed than other government transfers. More problematic, the anticipation of a loan waiver, especially if only loans to defaulters are waived, creates enormous moral hazard and reduces everyone's incentive to repay. It also increases corruption as everyone attempts to get classified as a past defaulter. Politicians who exhort people not to repay loans are particularly irresponsible for they ensure that future credit dries up, in part because the lender is weakened, and in part because the lender has little confidence of getting paid. This Committee strongly counsels against short-sighted indiscriminate waivers, or loose talk about defaulting.

Finally, some would see the employment the public sector provides as an important function in its own right. While the public sector banks employ proportionately more people than private sector banks by most metrics, this does hamper their efficiency and their growth. Furthermore, overstaffing results in stagnation, which further hampers the banks' ability to retain talent. It is time to ask whether the nation would be better served by freeing public sector banks to generate jobs through efficient growth rather than through forced mandates and constraints that compromise their ability to compete, and will eventually shrink their share.

To sum up, it does not seem that public sector lending to the priority sector has been markedly higher or of better quality than private sector lending. Again, differences in bank ownership have limited influence on whether the public purpose is served, once mandates are imposed equally across banks. This then leads to the obvious question—is there any purpose in continuing the status quo for public sector banks when their ownership and governance structure offers little specific benefit for the nation, and possibly leaves these important national assets vulnerable for the future? We think not, and this is the rationale for the proposals that follow.

PROPOSALS

The intent of the proposals that follow are:

1. To free the public sector banks from factors that cripple their ability to compete.
2. To improve variety and efficiency in the banking sector specifically, and in the financial sector more generally.
3. To reduce the overlay of obligations and benefits on the banking sector as a whole.
4. To allow for a more effective provision of products that cut across financial activities.

Proposal 1: Reforming the public sector banks

The public sector banks (henceforth PSBs) have a number of strengths including their historic ability to attract talent (a number of successful private and foreign banks are staffed by former public sector employees), their vast branch network, their strong name recognition, and their association with safety, especially in rural areas. While these strengths offer an opportunity, their ability to compete is hampered, in part by their governance structure. Consider some of their handicaps compared to private banks:

- Both the level of pay as well as its sensitivity to performance are limited, making it hard to attract new talented employees, retain superior old ones, or incentivize them to perform better.
- Promotion is typically on the basis of seniority, and it is hard to let go of employees for non-performance. The talented young are more attracted towards private banks where they can get significant responsibility quickly. Public sector banks used to be

much larger than private banks, and thus be able to promise much greater influence and a broader range of experience eventually. As bank sizes become more equal, even that is not possible. Public sector banks have a legacy of talent from their past, but that talent pool is ageing and is not being replenished.
- The most important corporate decision, appointment and dismissal of the bank's top management, is not taken by the board, but by the central government. This limited delegation of power to the bank board, despite the board consisting of a majority of government nominees, inhibits the board's ability to guide bank strategy and limits the responsibility it has to shoulder for bank performance. At the same time, the government's power to appoint and transfer management introduces political influence over day-to-day decision making. Governments have differed in the extent they have used influence, but this issue, with important economic consequences, should not be left to the ballot box.
- Unlike private companies, the bank's board is not considered an adequate trustee for the interests of its owner. Instead, additional layers, for example, the Central Vigilance Commission, second guess all important bank decisions. This induces delay as every decision has to be documented for a possible future enquiry, risk-aversion, and an excessively bureaucratic decision process through all levels.
- Unions can be a very positive force in employer–employee relations, and indeed some public sector banks enjoy model management–union relations. To the extent, however, that public sector bank unions can use their proximity to political power to have an added influence over the management of some public sector banks (an influence that would be weaker in private sector banks), it creates an imbalance that can be detrimental to the bank as a whole.
- Because the government is strapped for resources, and because a number of PSBs are at the limit of their ability to issue shares to the private sector without altering majority government ownership, capital is increasingly constraining their growth.

In many ways, therefore, government ownership does not increase the efficiency with which state owned banks carry out their functions, and probably imposes constraints. Unprofitable activities, such as providing financial services in remote thinly-populated areas, which need to be carried out for the greater benefit of society, can be encouraged through targeted subsidies. What matters for the nation is how efficiently these activities are carried out, not who owns the bank producing the activities. Similarly, other activities can be better encouraged through a combination of mandates and incentives, with the latter being emphasized over time. Again, these should apply uniformly across banks, independent of ownership.

Some of the other discretionary activities forced on public sector banks are, of course, undesirable activities involving pure patronage. Even those that are not should either not be undertaken by government banks (such as supporting prices in various financial markets) or are more transparently undertaken by the government (such as providing fiscal transfers through debt relief to drought hit areas). Indeed, because the public has a direct sizeable minority shareholding in public sector banks, it is important that the government respect the minority interest (as promoters in the private sector are forced to) by allowing these banks to be run efficiently to maximize their value. That will also be in the national interest.

An immediate question then is how to distance public sector banks from the government. One option is privatization. The majority of this Committee does not see a compelling reason for government ownership. There are other activities where government attention and resources are more important. However, the Committee does recognize that public opinion in the country is divided on the issue of privatization. An alternative approach is to undertake reforms that would remove constraints on the public sector, even while keeping it under government ownership.

Unfortunately, ideology has overtaken reasoned debate in this issue. The pragmatic approach, which should appeal to practical people of all hues, is to experiment, as China does so successfully, and to use the resulting experience to guide policy. One aspect of the pragmatic approach would be to sell a few small underperforming public sector banks, possibly through a strategic sale, so as to gain experience with the selling process, and to see whether the consequences are acceptable or not.[11] This would allow some facts and experience to enter the public debate, something which is sorely lacking.

For the largest PSBs, the options are more limited. The selling of large PSBs to large private sector banks would raise issues of concentration. The selling of banks to industrial houses has been problematic across the world from the perspective of financial stability because of the propensity of the houses to milk banks for 'self-loans'. Without a substantial improvement in the ability of the Indian system to curb related-party transactions, and to close down failing banks, this could be a recipe for financial disaster. While large international banks could swallow our largest banks, it is unlikely that this would be politically acceptable, at least in the foreseeable future. That leaves a sale through a public offering. But such a sale would require confidence in the corporate governance of these enterprises so that a high price can be realized.

This Committee therefore believes that the second aspect of the pragmatic approach should be to focus on reforming the governance structure and perhaps also acquiring strategic partners for large and better performing public sector banks, with the eventual disposition determined based on experience with privatization, the public mood, and the political environment. Governance reform, we should emphasize, is needed not simply as a matter of fashion, but so that PSBs can survive the coming competitive onslaught. The reforms we propose would reduce the constraints imposed by government ownership, allowing public sector banks to hire more talent, make needed investments, and react more dynamically to the rapidly developing environment.

The major steps include:

1. Create stronger boards for PSBs.
   (a) Government nominees: Some governments have seen appointments to the boards of public sector banks as a means of distributing patronage. Other government appointees have limited understanding of the business of banking and are on boards simply because of their eminence in other areas. Board members must be chosen based on their capacity to guide the bank's business to maximize value creation for all its stakeholders and balance stakeholder interests in areas of conflict. This is why we suggest the government set up an independent Selection Board of eminently qualified individuals from varied backgrounds to propose board members for various PSBs. The Selection Board's members should retire at staggered intervals so that no future government can easily change its character.

   When an incumbent PSB director's term expires, the Selection Board will propose qualified individuals to replace them. So long as the individual meets 'fit and proper' criteria, the government should accept the proposal, or offer a written rationale for why the nomination is rejected.
   (b) Shareholders nominees: Non-government shareholders should be allowed to appoint board directors following the same regulations that apply to private companies—minority shareholders in public sector banks should not be treated any differently. Moreover, it should be possible for PSBs to seek out strategic partners among other financial institutions (including private and foreign ones), with partners allowed a voting stake of up to 20 per cent. Given that even Communist China allows this, it is time for India to liberalize.

   In addition, board seats allocated to shareholder directors should be more proportional to their voting stake. For instance, out of 14 directors on SBI's board, only four are elected by shareholders, even though the government only holds 59.7 per cent of the equity in SBI. Five directors are appointed by the government and the

RBI, three consist of management, and two are employee appointees. But since the government appoints management, eight directors are effectively government appointees. The balance would become more equitable if the board appointed management (see below). Pending that, it would be sensible to give more seats to shareholders.

Of course, given that the shareholding in PSBs is dispersed, the slate of potential directors proposed by management to the minority shareholders for election is likely to win easily. To prevent the formation of 'pet' Boards, it will be important to devise a transparent process of consultation with shareholders and independent directors in coming up with the proposed slate of directors. This is not to say that the process is perfect in private sector banks, but reasonable processes can be formulated for both. The process by which shareholders can also propose alternative nominees should be simplified, and the process of voting made easier.

(c) Delegate all decision making to the bank board: The bank board, which is closer to the real needs of the bank, should make all decisions including selecting the Chairman and CEO of the bank and all its important officers, as well as terminating them. While the appointment may have to go through the Appointments Committee of the Cabinet (ACC), such appointments should be approved as a matter of course. In the rare case the appointment is rejected, the ACC should explain the grounds for rejection and ask for a new nominee. In the long run, the ACC should not play a role in selecting bank management.

The board should also set performance bonuses for senior management and the objective and transparent parameters that will trigger these bonuses. Larger bonuses will make the job more attractive, and help attract talent, but the quid pro quo should be greater effort to achieve those bonuses and a greater risk of losing one's job (and bonuses) for underperformance.

With greater authority over top management, the board can help guide the company in the national interest, and also protect management, when it is performing its duties, from political interference. Greater pay for directors, of which a significant portion is stock-based, is also warranted in order to attract capable individuals and to give them a greater sense (and duty) of responsibility. This is a small price to pay to safeguard the value of the national assets that the PSBs represent.

The Committee recognizes that it will take time for boards to become fully self-governing, and the Finance Ministry will have to disassociate itself from decision making steadily. One useful change would be for the government, through its directors, to evaluate management and its performance through a broader set of parameters than just current profitability, inclusion, and growth. Forward looking measures including human resources development and the quality of risk management will need greater attention. Management institutes could help through comprehensive training programmes to acquaint new directors with their responsibilities and to impart skills to carry them out. Better governance will, however, have immense payoffs and will be worth the time and effort.

2. Delink banks from the government.

Part of the problem PSB managements face is that they are directly owned by the government, and therefore come under government administrative norms. Bureaucracy and business are fundamentally incompatible, especially in a dynamic open economy. It is also better that management decisions be vetted by boards rather than by criminal investigators. While there is growing acceptance of these truths, more effort should be made to remove management from the shadow of the government.

One possibility is that large PSBs create financial holding companies (see later), with the bank and other financial firms as subsidiaries, so as to better realize economies of scope from providing multiple financial services. The governance proposals listed above should then apply to the holding company board also, especially if the bank is a wholly owned subsidiary. As the PSBs become more indirectly owned by the government, and as their boards become more vigilant in safeguarding the value of the bank, and as their management are better paid and better incentivized, the rationale for maintaining oversight of the banks through administrative means such as the Central Vigilance Commission become weak. Indeed, when the PSB boards are functioning effectively, the government should legislate to remove the oversight of bodies such as the CVC over PSBs. Holding company structures could also allow the bank to sell more shares to the public even while the government retains majority control over the holding company, and thus over the bank. This would enable banks to raise more capital for growth.

A second possibility, which was recommended by the Narasimham Committee, is to reduce the government stake to below 50 per cent, so that the bank no longer comes under government statutes. The government will still have a controlling stake, so this could be politically more palatable than full privatization to some. Moreover, no large sale of shares is required for a number of banks. Nevertheless, such a move will require a change in the statutes, and the political difficulty may be no less than for outright privatization. Yet another option is to explore the possibility of divestment of government shares to other public sector entities (such as provident funds or insurance companies), if that process can reduce some of the aforementioned constraints on public sector banks, even while retaining ownership within the government broadly defined.

Proposal 2: Encourage, but do not force, consolidation

Given the fragmented nature of the Indian banking system and the small size of the typical bank, some consolidation may be in order for banks that aim to play on a larger stage. Of course, there could still be room for small banks that have different aims (see Chapter 3). The main concerns of the regulatory authorities should only be whether the takeover will impair competition in key areas and whether acquirer management has the capabilities of managing the merged entity without impairing stability.

Following these criteria, it should be clear that small, regional, and unprofitable banks would be a natural candidate for takeover by well-managed financial institutions that seek complementary assets.[12] The screening criteria for identifying weak banks may include parameters like capital adequacy ratio, proportion of NPAs in total credit, return on assets, return on equity and net interest margin. Responsible boards of target banks will recommend offers to shareholders that are in the larger interest of their bank. There is little role for the authorities here other than to welcome such consolidation and stay out of the way. One question is whether the authorities should interfere in direct approaches to shareholders, bypassing the target board (the so-called 'hostile' takeover). So long as potential acquirers are deemed fit and proper, there is no reason again for them to intervene.

(a) Takeovers of PSBs: A takeover of a PSB by a private or foreign bank will effectively be a privatization. Until the political will is found to amend the relevant acts, these takeovers will be ruled out. Till such time though, takeovers of PSBs by other PSBs or public financial institutions should not be discouraged (though there is no point in one weak bank taking over another). Takeovers of PSBs should be no different from takeovers of private banks, with boards playing a key role. This is yet another reason for strengthening the PSB boards.

The key problem, though, is that a number of interest groups in potential target banks have little incentive to be acquired, even if acquisition is in the larger interest of the bank. These include all those who will lose position or power in the enlarged entity, including some managers, board members, and union officers.

More incentives may be needed for banks to seek out matches. One is simply for matches to be brokered in the Finance Ministry. This will defeat the objective of decentralizing decision making, and may not be fair to shareholders. The

Committee recommends against such 'marriages made in heaven'. Another is to identify the banks the government wants reformed based on transparent criteria, and set a reasonable time horizon during which the board (perhaps led primarily by the non-government shareholders) has leeway to act—whether by merging or seeking out strategic partners. At the expiry of this time the government could take action, exercising its rights as majority shareholder.

(b) Takeovers by private banks and eligible financial institutions: Private Indian banks and eligible financial institutions (appropriately structured as holding companies—see below, and satisfying the fit and proper criteria) should have full freedom to take over other private banks today provided the above-mentioned concerns of regulatory authorities are met. They should also be permitted to take over small PSBs that are offered for sale.

A possible route for large public sector banks to acquire more talent, once they undertake the governance and compensation reforms suggested above, may be to acquire a smaller well-functioning private sector bank. While not minimizing the required cultural adjustment, and while recognizing the risk that talent may leave if the acquisition is not handled well, this Committee believes that such possibilities should be considered.

Foreign banks that create a separately incorporated domestic subsidiary in India should have the same rights that private sector Indian banks have from April 2009, as suggested in the RBI roadmap (2005). The RBI should allow such incorporation freely. Foreign banks that seek to operate through Indian branches should be accorded permission based on reciprocity. The Committee would strongly urge the government to pressure foreign governments to extend to Indian banks the liberal rights that are proposed here for foreign banks.

(c) Takeovers of large Indian banks: To the extent that takeovers of large Indian banks (or domestically incorporated subsidiaries of foreign banks) do not raise issues of excessive concentration or stability, they should be permitted. It may be sensible to start by being more liberal towards the takeover of small banks with a view to allowing bidders, targets, regulators, and market participants gain experience in how to manage takeovers.

Proposal 3: Reduce barriers to competition

1. Other methods of restructuring.
   Takeovers are just one way to improve bank structure. But they constrain the mode of restructuring to whole company transactions. Other actions should include:
   (a) Abolish branch and ATM licensing immediately (other than licensing for foreign incorporated banks in metro and urban areas based on reciprocity). While the RBI as supervisor could curb branch expansion for specific banks that it has prudential concerns about, the norm should be that once a bank is licensed, where it puts up branches is its own business decision. As suggested in Chapter 3, the differentiated license for small banks could include an initial constraint on the overall number of branches and asset size, but this should be removed on review.

   Domestic banks have not been able to set up branches freely thus far, and will not have anticipated such liberalization (which was not an element of the RBI roadmap). Given that foreign banks have deeper pockets, experience, and skills relative to domestic banks in rolling out a branching strategy in the newly liberalized environment, the Committee believes it necessary to allow a period of say two years from the announcement of the policy till the liberal licensing policy applies to domestically incorporated foreign banks. Till such time, the existing policy of branch licensing should apply to foreign banks. They will, however, be able to acquire branches through takeovers of existing Indian banks.

   (b) Part of the rationale for branch licensing is the RBI's attempt to force banks into under-banked areas in exchange for permission to enter lucrative urban areas. Regardless of what views are on overall de-licensing, there is absolutely no reason to not de-license under-banked areas immediately for all banks. Furthermore, banking in underserved areas can be encouraged by instituting a norm—for every x branches that are opened in urban branches, y branches have to be opened in semi-urban or rural areas. In other words, enforce the norm that is now implicit in RBI's licensing decisions, but allow banks the freedom to choose how many branches to open, where, and when. Since branches are likely to become less important channels for outreach, it may be better to focus the norm on more objective measures of service (which also focuses on including the urban poor, an increasingly important category as migration increases). For instance, the norm could be for every x savings accounts that are opened in high income neighbourhoods, y low-frill accounts have to be opened in low income neighbourhoods. Finally, it may be that the bank is not the best institution to offer financial services over the last mile to the poor. In that case, the service provision obligation could become traded (much as the priority sector norms earlier), with small banks or cooperatives acquiring certificates for the excess accounts they provide and selling them to deficient banks.

(c) Allow banks to freely exchange or buy branches, and close branches as alternative mechanisms of delivery of financial services emerge. If a branch closure will significantly impact services in an area, the authorities could negotiate a transition period.

Eventually all branches that are forcibly kept open to fulfil universal service requirements should be paid for through an auction where qualified banks bid for the minimum subsidy they need to meet an objective level of service.

(d) Entry into banking should be made more liberal. The purpose of this entry is not primarily to increase the level of competition, but to bring new ideas and variety into the system through entry. For scheduled commercial banks, the minimum scale for entry right now is Rs. 300 crores (of capital). This immediately means only large players can enter, and given the commensurate asset size (Rs. 3,000 crores at a 10 to 1 leverage), few banks can start out de-novo. The only entry is likely to be foreign institutions, or through conversions of domestic financial institutions to a banking license. But as India grows, it is hard to imagine that all the valuable financial ideas will only originate in existing institutions. The way to allow entry for smaller and possibly more innovative players is to license small banks thus facilitating both entry and competition (see Chapter 3 for details).

The Committee would also urge the licensing authorities to not focus overly on the level of capital. Large players are not necessarily the most capable, and in the dynamic financial markets of today, large quantities of capital can be quickly dissipated. What matters is not the quantity of capital but the quality of the promoters, their management capabilities, their capital adequacy (relative to the size of the tasks they undertake) and their systems. Provided regulators apply stringent entry criteria to banks on these dimensions, the minimum capital requirement could be relaxed considerably even for scheduled commercial banks, and the resultant entity nevertheless easy to supervise. While the process of freeing entry should be undertaken carefully, stability concerns can be alleviated by requiring high governance standards, higher capital and reserve ratios, more transparent and automated risk measurement processes linked to a vigilant supervisory regime, and a strict prompt corrective action regime. Indeed, the last two steps should accompany the process of liberalizing entry.

(e) More generally, the prompt corrective action regime (see Chapter 6) should be strictly enforced, after offering a period of notice, so that undercapitalized banks and cooperatives are forced to wind down. It will be particularly risky if they are allowed to continue to operate in a time of enhanced competition. Thus freer entry should be accompanied by stricter enforcement.

2. Levelling the playing field.

(a) Banking privileges such as access to the payment system or check writing facilities should slowly be reduced by allowing more institutions access, but in tandem with reductions in banking obligations such as priority sector lending and other modes of pre-emption such as the Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR). While the obligations are in place, though, all entities that are allowed to issue demand deposits should also have to undertake these obligations. Once the procedural improvements that are contemplated on priority sector lending are implemented, all foreign banks should be asked to meet the same obligations as domestic banks.

(b) The practice of the government giving preference to public sector entities in matters such as where to place deposits should also cease, as should unremunerated obligations such as forced support of public issues by other public sector entities. The preferences tend to be at a cost to the public exchequer and to the taxpayer, because the government could get a better deal through a more competitive bid. The obligations hurt the PSBs, and typically also tend to create other distortions because they are non-transparent and not paid for.

Proposal 4: Moving to holding company structures

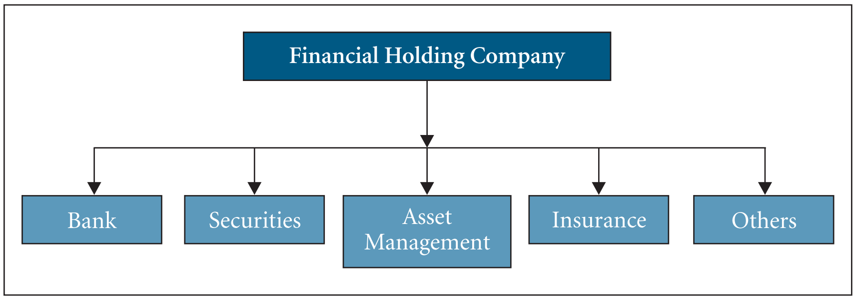
Increasingly, financial firms will provide services that come under different regulators, and products that combine different activities. While some entities may choose to remain specialized and provide services through joint ventures or collaborations with other specialized entities, others may choose to provide a variety of services under one roof. The best way to undertake these activities, while ensuring appropriate regulation, is through a holding company structure. The purpose of a financial holding company is to raise and allocate resources in various subsidiary companies depending on their needs, thereby using capital efficiently within the group as well as segregating risks across various financial businesses. The structure also allows the parent to coordinate and bring together activities of the different subsidiaries in providing products to customers.

The absence of a viable holding company structure means that parent companies that are fully engaged in regulated activities may have to hold subsidiaries in other (possibly differentially regulated) activities. This can create problems, especially in India, where banks are the typical parents, because:

1. The risks from its investment in lightly regulated and volatile businesses can feed onto the bank's balance sheet. This makes the task of the bank regulator more difficult. Also to the extent that the bank benefits from flat-priced deposit insurance, some of the costs are ultimately borne by the taxpayer.
2. The need to raise large resources for deployment in subsidiary companies strains the parent company's ability to fund its own core business. Moreover, under current regulations, a bank's aggregate investment in financial services companies (including subsidiaries) is capped at 20 per cent of the concerned bank's paid-up share capital and free reserves. This clearly limits its ability to grow those services (especially the insurance business where significant accounting losses accompany a start-up).
3. Regulatory restrictions on the heavily regulated parent bank's exposures (to capital markets and to single parties) can limit its overall ability to do business elsewhere.
4. Tax rules may prevent losses at a subsidiary from being offset against parent profits, even while they need to be recognized for accounting, disclosure, and capital maintenance purposes. Similarly, investments in a subsidiary may have to be carried at book value, even though the market value could contribute substantially to the parent's net worth and capital.

The holding company structure

Typically, the holding company does not engage in any operating activity and its leverage is limited (typically to not more than 20 to 25 per cent of the capital). The cash flows of the holding company come through dividends paid by the subsidiary companies and royalties received for use of the brand name.



It also does not raise short-term public deposits. It should, however, be allowed to raise resources through short-term debt, subordinated debt and hybrid debt for investment in its subsidiary companies. Both the holding company and the underlying subsidiary companies should be allowed a listing on the stock exchanges. This would enable the holding company and the underlying companies to access the capital markets from time to time. In particular, if the holding company owns a bank, the holding company will have to list and be well-diversified.

Regulation and supervision

The Committee envisages that each holding company will be supervised by the Financial Sector Oversight Agency (FSOA, see Chapter 6). Each subsidiary will be regulated and supervised by its activity regulator. Of course, the supervisors of the largest subsidiaries will play an important role in the supervisory discussions held at the FSOA.

Taxation related issues

The holding company should present its accounts on a consolidated basis. Currently, the Indian system of taxation does not permit consolidation of accounts at the holding company level for tax purposes. The holding company as a standalone entity and the subsidiaries in their individual capacities are liable to pay taxes on their profits. The double taxation within the group has to be done away with to ensure the effectiveness of the holding company structure.

The re-organizing of current structures into financial holding companies will entail either a transfer of assets or a share swap by the bank/financial institution to the newly created holding company. These de-merging/restructuring transactions will attract payment of stamp duty and will also have capital gains tax implications. A one-time waiver is required, along the lines of the benefits accorded stock exchanges at the time of demutualization.

Legislative issues

The creation of such a structure would require amendments to certain rules and regulations. For instance, Section 12 of the Banking Regulation Act, 1949 prohibits the exercise by any single shareholder of voting rights in excess of 10 per cent, irrespective of the level of shareholding. This would need to be altered in light of the holding company structure. The RBI's desire for diversified ownership of banks can be implemented at the holding company level, with the holding company listed and diversified. In addition, the holding company could also list the subsidiary bank and have only a simple majority holding in it. Diversification at this second tier will allow the bank a liquid stock, which can be used to raise capital when in times of need.

Conclusion

We have made a number of proposals for reforming the banking sector and to create a more even playing field, that can increase the level of competition, efficiency, and thereby growth and inclusion in the sector. In the annex that follows, we will offer some additional proposals for other segments of the financial sector.

ANNEXURE 4.1

We do not have the space to go exhaustively in how the playing field is tilted, sector by sector, and between sectors. Instead, we will offer a taxonomy of the kind of impediments that are placed in the way of efficient allocation of resources. There is no clear pattern of who is discriminated against, with foreign investors or producers being favoured sometimes relative to domestic ones, but also discriminated against on many occasions. Similarly, the public sector can be favoured or disfavoured relative to the private sector. We will not attempt to diagnose why the financial sector has arrived at these patterns. Instead, we should focus on reducing them to the essential.

Regulatory limitations on product offering

A recent controversy should make the point clear. Insurance companies offer products that look similar to mutual fund products, but with an insurance component (of varying magnitude). One such product is an unit linked insurance plans (ULIPs), which has been very successful. While mutual funds allege that this is because insurance companies have an unfair regulatory advantage, insurance companies deny any advantage whatsoever.

The purpose of this example is not to take sides on who is right. Instead, it is to suggest there are two fundamental ways of dealing with this problem. One is to keep insurance companies from providing cheap asset management products by forcing a more significant insurance layer on the products they offer. This hampers competition and is not in the best interest of the consumers. A better approach would be to diagnose more carefully why ULIPs are popular, and see if there are any government/regulator induced differences that make them so. To the extent that mutual funds have undue burdens, the focus should be on reducing them rather than on constraining insurance companies. To the extent that success stems from lack of transparency about costs or benefits, there is a need to increase transparency. But to the extent that insurance companies have devised a more attractive product, there is no reason why they should be prevented from selling them. Indeed, it should be possible for mutual funds to tie up with insurance companies so that each provides their specialty (funds management and insurance) more efficiently in a joint product.

Of course, products such as insurance will require some regulation, to ensure that the firm has the ability to deliver its promise. The mutual fund company will not be able to offer ULIPs without an insurance license. But this is why entry barriers into insurance should be kept relatively low so there are no excess profits in that industry.

Put differently, any institution should be allowed to offer any financial product provided prudential and consumer protection issues can be addressed. No product should be 'reserved' for a particular type of entity, simply because it has historically focused on it, or because it has a protective regulator. For instance, mutual funds and insurance companies should be able to compete to offer defined contribution pension schemes to firms and government organizations. Regulatory silos should be brought down.

Differences in taxation

Taxation should not create artificial differences between financial institutions. For instance, a corporate investor in the highest tax bracket will pay 34 per cent tax on interest from bank deposits and an effective 22 per cent tax rate on funds deposited in debt mutual funds. This immediately creates a preference for debt mutual funds, which has nothing to do with its inherent capacity to invest assets. Such artificial differences should be done away with.

As another example, foreign institutional investors who invest in India through Mauritius are exempt from taxes on short-term capital gains while Indian firms that manage foreign money while resident in India are not. This creates an incentive for Indian firms to send asset managers to reside abroad so that they enjoy the same tax treatment. While the magnitude of such tax-related migration is likely to be small, in the longer run it could come in the way of creating a strong asset management industry in India managing foreign money for domestic investment. While it is probably unwise to tax FIIs unduly some way of minimizing the difference in tax treatment may eventually become necessary to prevent an asset manager drain.

Differences in creditor rights

Some institutions are offered more rights than others. For instance, only banks, public financial institutions, and housing finance companies have the right to seize collateral under SRFAESI or Debt Recovery Tribunals. It is not clear, for example, why a registered deposit-taking NBFC should not have a similar right—after all, SRFAESI only helps enforce a secured creditor's rightful claim. This will assume importance if the economy slows, because of the increasing exposure of NBFCs to weaker credits in a search for yield. We discuss differential creditor rights in more detail in Chapter 7.

Another example is asset reconstruction companies (ARCs). Asset reconstruction companies have powerful rights (such as replacing firm management) when they hold sufficient secured debt of a defaulting firm. This is useful in securing repayment, and a source of value to the ARC, which is why there should be many more providers of ARC services—it should not be an oligopoly, let alone a monopoly. While the authorities have licensed a number of ARCs, high capital requirements and strong explicit and implicit restrictions on foreign participation and control make many inoperative, leaving only a very few active. While the reluctance of the authorities to confer such powerful rights on all and sundry is understandable, it is also unwise to create rights that only a few can be trusted with. In some ways, it may be better to have a more competitive industry with fewer rights than an oligopoly with powerful rights. Better still would be a competitive industry with appropriate creditor rights.

Differences in access to the sovereign, the regulator, or other public sector entities

Public sector entities have the possibility of a government bailout, which lowers their cost of funds considerably. Short of privatization, there is little one can do about this. And as we have argued, there are other government-imposed constraints on public sector firms that offset these advantages.

This does not mean, however, that attempts should not be made to make the playing field more level both in terms of advantages and in terms of costs. For instance, the LIC Act stipulates a sovereign guarantee for the policies issued by the Life Insurance Corporation of India (LIC). This explicit guarantee should be revoked through legislation so that the guarantee is left implicit for new policies.

In addition, public sector firms have a greater duty to follow prudential requirements so that they limit the advantage they get from the implicit government guarantee. In this regard, it is unfortunate that LIC, being governed by the LIC Act and not by the IRDA, does not need to comply with the solvency margin requirements stipulated by the IRDA. There is a strong need to repeal legislation that creates a special status for entities like LIC or SBI.

Finally, regulations or guidelines requiring public sector entities to favour other public sector entities are no longer warranted and should be repealed. For example, there is no reason why Navratnas and mini-ratnas, or the gems among state-run enterprises, should invest up to 30 per cent of their surplus funds in *public sector mutual funds only*. Similarly, private sector mutual funds should also be invited to bid to manage the pension contributions of central government employees, instead of reserving this for the public sector alone. From a national perspective, what matters is how efficiently the task is carried out, not whether a public or private fund manages it.

Different application of regulations

Regulators should not override more generally applicable regulations in order to favour particular entities. For instance, accounting rules are there for a purpose, to present a true and fair picture of a firm's condition. A regulator cannot simply decide to waive rules for its regulated entities because the rules would reveal inconvenient losses or reduce profits.

When the RBI allows small urban cooperatives to maintain lower SLR or extends to 180 days from the normal 90 days the period of delinquency before assets have to be provisioned for as non-performing, and relaxes these requirements in order to boost the cooperatives' capital and profitability, it is indirectly suggesting that the weaker norms will not affect their stability. In that case, all banks have the right to ask why they too cannot be subjected to weaker norms, so that they can boost profitability. Of course, no one would question the RBI if it tightened regulations beyond the norm for some risky banks—that is its job.

As another example, minority shareholders in public sector entities should have the same protections against mis-governance by the majority shareholder as do minority shareholders in private sector firms. The government should not have the right to erode the value of public sector firms (other than wholly owned ones) through directives to undertake unremunerated activities, at the expense of the minority shareholder. As a first step towards this, the rights of minority shareholders in PSUs should be brought on par with those of minority shareholders in private firms. A necessary step in this direction is for PSU

Banks' Accounts to be put to vote at the annual general body meetings by the shareholders.

Limitations in investment choice

There are many examples where the asset choices of an institution are limited through regulation. One reason is prudential—for liquidity or solvency reasons, the regulator requires some investment in safe assets. A second reason is the capability of the fund manager—when an industry like insurance or pension management starts out, it may be prudent to limit investment choices till the manager (and the regulator) acquires capabilities and confidence.

But maintaining such limitations beyond when they are strictly needed can be both inefficient and de-stabilizing. For example, given the strength of India's capital markets, there is really no need to use bank statutory liquidity ratio requirements to fund government debt. Instead, these should be lowered to a level consistent only with prudential requirements. Indeed, too much exposure to government debt has proved a source of significant banking system risk in other countries (though Indian bank exposure is certainly not at alarming levels today).[13] More important, a captive market for government debt prevents it from being priced properly, and from sending the right signals to the market and to the government.

Similarly, restrictions on the types of private securities that insurance companies and pension funds can hold tends again to artificially boost demand for government debt, while limiting their risk diversification. It also reduces the access important sectors of the economy have to long-term funds. For instance, there is no reason why these institutions should not hold diversified portfolios of domestic corporate assets, private equity positions, and securitized retail assets as part of their overall asset portfolio. This would give a boost to sectors of the economy like infrastructure, technology, and housing that provide the kind of long-term financial assets that insurers and pension funds like, and would end the anomalous situation where foreign pension and insurance funds are extensive users of the Indian equity market but domestic pension funds are not.

Equally important, given our enormous surplus foreign reserve position, it is high time we encouraged our financial institutions to diversify into foreign government and corporate assets (see Chapter 2). This can be done at relatively low cost.[14] Not only will this reduce the burden on the RBI of managing foreign inflows, it will provide useful diversification to our insurance and pensions—as it stands, they are overly exposed to India risk. Alternate asset classes may also be considered in due course.

In liberalizing restrictions, however, it is important not to attempt to direct flows to favoured sectors through selective liberalization, but to liberalize more generally. India's experience with directed credit has been abysmal, with flows historically going into sectors with low productivity that happen to be favoured.[15] Selective liberalization will tend to push resources to the selected sectors only, distorting prices, inhibiting resource allocation, and increasing risk. For example, it may be tempting for the authorities to allow insurance companies or pension funds to invest some of their assets in infrastructure. But if these asset managers have no other choices (other than government securities) they may under-price credit to the infrastructure sector, and finance too many unviable infrastructure projects, at great risk to their policy holders or pensioners. Infrastructure is risky, and while it is good to allow insurance companies and pension funds to build exposure to it, it should be out of choice and not because it is the least bad of their limited options. Liberalization of asset portfolio choices should be broad based so that credit is not directed, however well-meaning the intention, into the wrong places.

Finally, before closing this section, it is useful to note another example of how well-meaning policies can indeed build-up costs and risk. Currently GIC is the sole re-insurer in the Indian market, with the general insurers having to compulsorily cede 15 per cent of their business to GIC. Foreign re-insurers can only operate in India as joint ventures with the 26 per cent FDI cap. So far no foreign re-insurer has shown interest in entering the Indian market with a joint venture.

The net effect is that the prime source of re-insurance within the country is a domestic insurer, whose capital is likely to be greatly impaired if the country is hit by a calamity. Of course, GIC may have laid off the risk in international markets through re-insurance. But then it will have added multiple and costly layers of intermediation that could have been avoided simply by freeing insurers to reinsure with whomsoever they please. The point is requirements such as these tend to concentrate risk and increase costs. Moreover, there are some types of business—such as catastrophic re-insurance—that should be exported simply because foreign capital, not domestic capital, is most appropriate to insure Indian entities against large shocks (much as foreigner funded ARCs are appropriate). It is therefore entirely appropriate that the decision to steadily eliminate compulsory cessation has been taken.

Discriminating against service providers based on national origin

If India is to build a strong asset management industry, Indian asset managers should be able to provide foreign investment opportunities to domestic investors, as well as domestic investment opportunities to foreign investors. It is somewhat paradoxical that our system bars domestic asset managers from providing portfolio management services for overseas clients, unless they create asset management vehicles outside India. This creates additional transaction costs and makes Indian AMCs even less viable while competing with tax-favoured foreign asset managers for fund management business from foreign clients.

We also create roadblocks in asset managers taking money out—in their managing offshore equity under portfolio management schemes, or offering products that invest in domestic as well as offshore equity. All this while residents can move capital out of India and then purchase products offered to them by foreign product providers. At a time when India would like to export capital, as well as boost the asset management industry and the high-paying jobs it creates, these impediments may stunt growth.

NOTES

1. There are some restrictions. In the United States, for example, only checks over US$250 can be processed by money market funds. With time and inflation, this is becoming less and less of a constraint.
2. Claessens and Laeven (2004).
3. See Beck, Demirguc-Kunt and Macsimovic (2004).
4. See, for example, Schnabl (2008), who looks at the case of Peru in the 1998 crisis. Foreign banks brought in capital when capital dried up for domestic banks, and were a significant factor in financing domestic firms during the crisis.
5. This evidence comes from a study of very poor countries—Detragiache et al. The Mexican experience, where a huge part of the domestic banking sector was sold to foreign banks, which were cautious in lending, with attendant effects on aggregate credit growth, is also a salutary one.
6. McKinsey (2007).
7. McKinsey Global Institute (2001).
8. Banerjee, Cole and Duflo (2005).
9. Cole (2007).
10. Cole (2007).
11. The rationale for focusing on underperforming PSBs is simply that the need for governance improvement (and thus the possibility of transformation) is much greater there, and the political willingness to sell is likely to be higher.
12. We refer to weak banks only because there is greater value to taking them over, and less controversy. Nevertheless, no bank should be immune from takeover, except on grounds of excessive concentration.
13. Even in India, US 64 was included in the list of approved securities till the scheme ran into difficulty, forcing the government to bail it out. This highlights the hazards of labelling securities as preferred and hence safe investments.
14. For instance, moderate amounts of foreign equity or corporate debt exposure can be acquired by buying exchange traded indexed funds or investing in index portfolios, a relatively low cost way of acquiring exposure without significant management fees.
15. See Wurgler (2000) for evidence.

REFERENCES

Banerjee, Abhijit V., Shawn Cole, and Esther Duflo, 2005, 'Bank Competition in India', Sixth Annual Conference on Indian Economic Policy Reform, Stanford Center for International Development.

Barth, James, Gerard Caprio, and Ross Levine, 2006, *Rethinking Bank Regulation: Till Angels Govern*, Cambridge, UK: Cambridge University Press.

Beck, Thorsten, Asli Demirguc-Kunt, and Vojislav Macsimovic, 2004, 'Bank Competition, Financing Constraints, and Access to Credit', *Journal of Money, Credit, and Banking*, 36(3): 627–48.

Claessens, Stijn, and Luc Laeven, 2004, 'What drives Bank Competition? Some International Evidence,' *Journal of Money, Credit, and Banking*, 36(3): 563–83.

Cole, Shawn, 2007, 'Fixing Market Failures or Fixing Elections? Elections, Banks and Agricultural Lending in India', Working Paper.

Detragiache, Enrica, Thierry Tressel, and Poonam Gupta, 2006, 'Foreign Banks in Poor Countries: Theory and Evidence,' IMF Working Paper 06/18. Washington: International Monetary Fund (January).

IIMS Dataworks, 2007, 'Financial Inclusion and Access', Discussion Paper, 25 October.

McKinsey & Co., 2007, 'Indian Banking: Towards Global Best Practices—Insights from Industry Benchmarking Surveys', November.

McKinsey Global Institute, 2001, 'India: The Growth Imperative', September.

Schnabl, Phillip, 2008, *Financial Globalization and the Transmission of Credit Supply Shocks: Evidence from an Emerging Market,* Working Paper, MIT.