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India needs new banks, liquidity: Pratibha Jain, Head of Banking, Finance and Public Policy at Nishith Desai Associates

PRATIBHA JAIN Nov 30, 2011, 05.36am IST

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The recent downgrade of the Indian banking system by Moody's, from stable to negative, should make the Reserve Bank of India (RBI) rethink some of its existing policies. Whether the downgrade is justified or not will only be known over time. However, the inability of the banking sector to raise sufficient capital to support credit growth now is a cause of concern.

The RBI has postponed the release of guidelines for new banking licences in the private sector. But it surely has to device ways to pump more money into the economy and the banking system to meet the demands of the industry. Against this background, a close look at two important pending banking sector guidelines is warranted.

First, following an announcement by the finance minister in the 2010-11 Budget speech that the RBI was considering giving new banking licences to private players, the RBI released the draft guidelines on August 29, 2011.

Second, the RBI released a discussion paper on the modes of entry for foreign banks in India on January 21, 2011 (discussion paper) six years after the RBI released the original road map for their entry in February 2005. In the interim period, RBI allowed some foreign banks to open branches in India, but no Indian corporates were awarded banking licences since 2003/04.

The pending guidelines need to be looked at conjointly to formulate a comprehensive entry policy for the banking sector in India, especially in light of the liquidity pressures on the sector. At policy level, the RBI has to review the raison d'être for allowing the two classes of applicants (domestic corporates and foreign banks) to open banks here and compare the advantages and disadvantages of awarding them a banking licence.

Let's look at the Indian corporate houses that are vying for a banking licence. Most of the aspirants don't have experience in banking, although some of them have existing non-banking finance companies.

However, an entity like Kotak Bank, which started with no prior banking experience, has now become one of the leading private banks in India, taking head on the large and more experienced foreign banks.

Another concern with respect to corporate houses entering the banking space is the abuse of the licence for the benefit of group companies. This can be addressed by safeguards already put in place by the RBI, such as limiting the exposure of the bank to any entity in the promoter group, and by other guidelines for related party transaction to ensure arms' length dealings with group companies.

Overall, under the tight regulatory framework for private banks in India, the entry of Indian corporate houses can act as a catalyst for further expansion of banking in mid-sized cities and rural India, apart from bringing in the much-needed funds to the sector, which can help spur industrial growth and infrastructure development.

As far as foreign banks are concerned, the RBI has raised concerns regarding their presence in India through the branch route, because it fears that the current rules do not provide sufficient ring fencing in the event of bankruptcy.

RBI's solution to the problem is to ask the banks to come through the wholly owned subsidiary (WOS) route, if some of the important criteria are not met. The central bank holds that the banks will have to take the WOS route if they come through a jurisdiction where depositors/creditors get preferential treatment, if the particular jurisdiction does not have adequate disclosure norms, and if the bank's holding structure is complex and not widely held. However, the consequences of coming through the WOS route are myriad and complicated in a regime where most existing banks have come through the branch route.

Even though the RBI has offered sops for banks opting the WOS route, such as allowing them to undertake branch expansion in line with local banks and raise funds locally, the applicability of certain other provisions makes the WOS route extremely onerous for banks. Some of those provisions are:

*They would need to comply with the minimum capitalisation norm of $50 million instead of $25 million for branches.

*They need to have independent directors even if they are 100% owned by the foreign parent; there is no such requirement for branches.

*The bank will be subject to all local regulations (including the Companies Act) as it will be locally incorporated as opposed to branches, which are only subject to RBI rules. *Priority sector lending requirement is 40%, compared to 32% for branches.

Therefore, for the new banks desirous of setting up shop in India, it would be unfair to insist on coming through the WOS route while existing banks continue to function through the branch route. In the interest of letting the right applicants enter, the RBI should take a holistic approach to the issue. To the extent the foreign business group applying for a licence meets the criteria, RBI should not insist on the entity (an arm of the group) applying for the licence to meet the criteria. This would lend some flex bility.

The only exception can be that creditors/depositors in the host country shall not be given preference over Indian creditors/depositors.

RBI has recognised that foreign banks play an important role in providing trade finance. It needs to also consider the fact that they also provide many other key services.

The RBI should consider the global know-how and experience that foreign banks bring with them, not to mention their deep pockets that can help alleviate liquidity issues, if any, of the local branch or WOS. While globally this is accompanied with exposure to global risks, RBI has already proposed mechanisms for limiting these risks, by providing proper ring fencing mechanisms.

Further, the business an Indian bank can undertake is limited. Banks are not allowed to deal in complex derivatives or engage in proprietary trading, while higher capital adequacy norms and exchange control regulations make it difficult to take money out of the country. Above all, there is tight monitoring and principle-based regulation by the RBI.

We should feel confident about the resilience of our financial regulatory system, which has been tested in the recent crisis and seize the opportunity to expand when most other markets are shrinking.

Our central bank steered us well through the financial crisis. It will be sad if it doesn't take us to the next step of growth due to cold feet.

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