Allowing Corporates To Own Bank

drishtiias.com/current-affairs-news-analysis-editorials/news-editorials/07-12-2020/print

This article is based on **“Crumbling Firewalls”** which was published in The Economic and Political Weekly on 05/12/2020. It talks about the pros and cons of recent RBI’s Internal Working Group recommendation of allowing industrial houses to promote or own banks.

Recently, Internal Working Group (IWG) to the Reserve Bank of India the recommended making necessary amendments to the **Banking Regulation Act, 1949** so as to allow industrial houses to enter into Indian Banking system.

This recommendation of opening up of the banking sector to the corporate sector is in consonance with the policy for giving additional banking licences to more aspirants, including non-banking financial companies.

However, ownership of banks by business groups has always been a contentious idea. In the world , many countries have opted to build strong firewalls between banks and other businesses.

Thus, there is a need to weigh in the pros and cons of allowing industrial houses to promote or own banks.

Pros of Allowing Corporates To Own Bank

- **Plugging Capital Gap:** The biggest pro will be that India’s banks need capital. Currently, the government keeps picking money from the taxpayers pocket and funding the public sector banks.
    - Hence, by allowing the big corporates into the banking sector the capital requirement can be fulfilled.
- **Facilitating Financial Inclusion:** As a lot of people do not have access to banking in the country, the entry of corporates into the banking sector would mean the opening of more branches and subsequently bringing more people into the banking net.

- **Improving Competition:** Privatization of banks has been a long-proposed reform in the Indian banking industry. Allowing corporates into the banking sector will further pressurize Public sector banks to become competitive.

Cons of Allowing Corporates To Own Bank

There are many reasons for onerous restrictions on bank ownership by industry groups, which are as follows:

- **Connected Lending & Moral Hazard:** A bank with no connections to business houses can effectively screen loan applicants and thus ensure efficient allocation of funds to accelerate the overall growth of the economy.
    - Industry-group-owned banks, on the other hand, will be under constant pressure to favour group companies, at the expense of more deserving ones, which can be labelled as connected lending.
    - Connected Lending can effectively transfer the project risks from the business group to the banks, with the costs finally being borne by the other shareholders of the bank or even by the taxpayers in the case of a bank collapse.
    - In economic terms, it may deter efficient fund use and affect profitability & solvency.
    - In ethical terms, this will erode the bank's role as an effective financial and create a moral hazard or conflict of interest situation.
- **Circular Lending & Difficulty In Regulation:** Another risk associated with banks owned by industry groups is circular lending.
    - Under circular lending, corporate bank X funding projects of an industry group, which owns corporate bank Y, and corporate bank Y funding projects of an industry group owning bank Z, and finally, corporate bank Z funding projects of industry group owning bank X.
    - With available legal structures and the proliferation of shell companies, makes it hard to track such lending on a real-time basis.
- **Inequality & Concentration of Wealth:** Corporates owing banks will add more muscle to big industry groups, which already dominate many important sectors of the economy, including telecom, organised retail, aviation, software and e-commerce.
    - Their tie-up with banks, which is the core of the financial sector, will not only jeopardise the interests of smaller players but also help them leverage their strength into other new markets.
    - This will further accelerate the concentration of wealth and increasing inequalities.
    - This may lead to the emergence of new big power centres that would soon throttle the government's ability to steer the economy in the right direction.

- **Contradicting the Previous Ruling:** The banking sector in India has been in trouble for the last few years, keeping that in mind the RBI in 2016 had created new guidelines on the limit of lending to a single company.
    - The rationale behind this ruling was that if a bank lends too much to one company only then it risks losing that money if the company sinks.
    - Therefore, the recommendation of allowing the entry of industry groups in the banking sector is in contraction with the above-said ruling in 2016.

Conclusion

The pros and cons analysis of mixing industry and finance indicates that the move may not be conducive to growth, public finance and the future of the Indian economy itself. So rather than concentration of too much economic power in the hands of corporates, it will be wise to carry out the long-pending banking reforms and strengthen the functional autonomy of RBI.

Drishti Mains Question

There is a need to conduct a thorough analysis before allowing industrial houses to promote or own banks. Discuss.