Banks in India: Too few to fail

Recapitalizing banks alone will not ensure that sufficient credit flows to revive and sustain economic growth. India urgently needs more banks.

Schumpeter saw credit creation and its contraction as being at the heart of capitalism. In India credit growth has remained anaemic even as we have maintained social distancing from market-linked reforms. BIS data shows that India's credit to the non-financial sector as a percentage of its GDP has consistently lagged but that it now seems to be stuck in a rut. Consequently, growth too has remained anaemic.

Exhibit 1: Total Credit to the non-financial sector (as a % age of GDP)

	2004	2008	2009	2014	2018	Q4 19
G20 (aggregate)	216.6	203.8	232.2	220.5	234.3	244.7
All reporting economies	215.2	201.3	230.9	218.7	232.6	243.2
Advanced economies	238.8	239.3	267.4	255.7	265.5	274.5
Emerging market economies	122.0	106.0	140.1	156.2	181.0	194.2
India	125.0	128.7	130.9	126.1	123.1	125.5

Source: Bank of International Settlements; Aggregates based on conversion to US dollars at market exchange rates

To get growth back we need to revive the animal spirts that fuelled the economy in the early years of this millennium and to move money from those who don't need it today to those who can benefit from its access. And the banking sector does this best.

The finance Minister, Nirmala Sitharaman unveiled an INR 102 trillion plan over five years to revive growth. for infrastructure. India Ratings expects credit requirement of healthy borrowers of INR2.49 trillion in incremental/fresh credit and INR3.77 trillion in refinancing requirement in FY21. They also estimate INR4.21 trillion Debt to Become Stressed in FY21-FY22. These India Ratings estimates are for the debt heavy top-500 private sector companies, which represent 70% of corporate debt. Add to this the requirements by other corporates and PSU's, consumer lending, agricultural loans, money needed by the MSME sector to restart business and all else, and the scale of what needs to be done stares back.

Given these numbers, the health of the banks alone should not be worrying the regulators. The lack of number of banks through which financial intermediation can take place, that should be equally worrisome.

After the next round of PSU bank mergers, I can count just 15 or so banks of any meaningful size or ratios or a willingness to lend to meet the economy's needs. You can increase this tally by totalling foreign banks, small finance banks, payment banks, urban and state co-operative banks, and regional rural banks, but with approximately 10% of the banking sectors assets, these will not move the needle on credit creation. And most are too small to survive. Even considering institutions like PFC, REC and even the insurance companies, the picture does not change.

Exhibit 2: Banks: Select Data, Regarding size, NPA's and Capital Adequacy

Name	Owner-ship	Assets in INR Bn	Gross NPA (%)	CRAR (%)	Tier I (%)
State Bank of India	PSU	32475.7	7.5	12.7	10.7
HDFC Bank Ltd.	Pvt	13225.7	1.3	18.5	17.2
Bank of Baroda	PSU	9266.2	9.4	13.3	10.7
ICICI Bank Ltd.	Pvt	8552.4	5.5	16.1	14.7
Punjab National Bank	PSU	7053.0	14.2	14.1	11.9
Axis Bank Ltd.	Pvt	6903.1	4.9	17.5	14.5
Canara Bank	PSU	6002.3	8.2	14.0	10.1

Name	Owner-ship	Assets in INR Bn	Gross NPA (%)	CRAR (%)	Tier I (%)
Bank of India	PSU	5185.2	15.8	13.7	10.6
Union Bank of India	PSU	4584.8	14.2	12.8	10.8
Kotak Mahindra Bank Ltd.	Pvt	2860.0	2.3	17.9	17.3
Central Bank of India	PSU	2825.0	18.9	11.7	NA
Indian Bank	PSU	2767.0	6.9	14.1	12.1
IndusInd Bank Ltd.	Pvt	2384.3	2.5	15.0	14.6
IDBI Bank Ltd.	PSU	2130.1	27.5	13.4	10.6
Yes Bank Ltd.	Pvt	1994.2	16.8	8.5	6.5
Indian Overseas Bank	PSU	1876.8	14.8	10.7	8.2
UCO Bank	PSU	1872.1	16.8	11.7	9.0
The Federal Bank Ltd.	Pvt	1551.8	2.8	14.4	13.3
Bank of Maharashtra	PSU	1419.1	12.8	13.5	10.7
IDFC First Bank	Pvt	1206.9	NA	NA	NA
Punjab & Sind Bank	PSU	945.7	14.2	12.8	NA
The Jammu & Kashmir Bank	Pvt	885.9	11.0	11.4	9.9
The South Indian Bank Ltd.	Pvt	808.6	5.0	13.4	11.0
Bandhan Bank Ltd.	Pvt	792.9	1.5	27.4	25.2
The Karnataka Bank Ltd.	Pvt	738.4	4.8	12.7	10.7
RBL Bank Ltd.	Pvt	730.6	3.6	16.4	15.3
Karur Vysya Bank Ltd.	Pvt	625.6	8.9	15.9	14.1
City Union Bank Ltd.	Pvt	417.2	4.1	16.8	15.8
AU Small Finance Bank Ltd.	Pvt	368.4	1.7	22.0	18.4
D C B Bank Ltd.	Pvt	323.3	2.5	17.8	13.9
The Lakshmi Vilas Bank Ltd.	Pvt	280.5	25.4	1.1	1.1
Dhanlaxmi Bank Ltd.	Pvt	102.9	5.9	14.4	11.2

Source: Latest annual reports, quarterly financial statements of banks

We need to quickly increase the number of banks in the system. Put differently, there is need to license many more.

The quickest way will be to convert NBFC’s to banks, for which RBI needs to establish a ‘glide path.’ Ashish Gupta of Credit Suisse advocates that the moment an NBFCs asset size crosses a threshold - as a percentage of outstanding total credit, it can apply to become a ‘small bank,’ and on reaching the next threshold, a ‘universal bank.’ The pain of meeting the reserve requirements may hold NBFC’s back from converting unless RBI gives a liberal time frame for full compliance. "RBI should think of conversion to a bank as not just a 'privilege' but a 'cost' as well" says Ashish Gupta. Moving forward he advocates that reserve requirements kick in for NBFC's as they grow - albeit beginning as a smaller percentage and ratcheting-up as the NBFC gathers heft. This implies that the cost of remaining an

NBFC will be higher for those that choose not to become a bank. In his view, RBI facilitating conversion of large NBFCs/HFCs to banks will improve financial sector stability as they migrate to a more stringent regulatory/supervisory regime and also more diversified and stable funding sources.

You can extend the same reasoning to converting co-operative banks to 'small/universal' banks.

Such conversions have advantages. First, you can jumpstart bank licensing and quickly have more banks of scale in the system. Second, these entities have an established track-record, built on the back of reasonable underwriting practices; they have been lending and more important recovering money over the years: survival instincts should be lauded, not questioned. Third, RBI struggles to regulate NBFC's and co-operative banks. This will help.

The question of what to do when dealing with NBFC's that form a part of a business group is still unanswered. I favour it with regulatory guide-rails but am willing to concede this need greater debate.

The last time around when a few NBFC's applied to RBI for a license to convert themselves into a bank, RBI wrote to other regulators seeking feedback. It is difficult to argue not too. But in doing so, RBI must be mindful that 'retail' complaints will always be there be it brokerage charged, execution of trades or sale of insurance policies. Unless there is a systemic issue, these should not be the basis for denying a license. Further, let the other regulatory and other judicial bodies respond in a time bound manner, classifying transgressions, if any, as serious (enough to deny a license), wrap on the knuckles (- a fine) or to be condoned (do nothing). Also, with RBI being the primary regulator, for NBFCs (and now HFCs as well), the ball is in its court anyway.

Admitted NBFC's and cooperative banks is just one option, but it should be an opportunity that should be grasped.

There are other issues like minimum share capital, ownership and voting, bank holding companies, globally successful bankers starting banks in India and a host of other matters. And we can imbibe lessons from bank failures. But for each example that can be offered to support a point of view, another can be proffered showing that the opposite as being equally true.

The extensive debates on various issues enumerated and a listing of the reasons for bank failures should be used to better regulate banks, not to strangulate or abort them. And whatever else you might conclude from these deliberations you just cannot argue with the fact that India has too few banks.

A modified version of this blog first appeared in Business Standard on 18 August 2020. You can access it by clicking on this link: https://www.business-standard.com/article/opinion/banks-in-india-too-few-to-fail-120081800008_1.html

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