New Generation of Banking Reforms

This article is based on [“Time for 5th generation banking reforms”] which was published in The Hindu Business Line on 06/05/2021. It talks about the new set of banking reforms in India’s baking industry.

The Indian banking sector has been evolving on a continuous basis, from being exclusivist to becoming a carrier of social reform and financial inclusion. However, in recent times, the banking industry has experienced many issues.

For instance, a decline in asset quality, financial soundness, and efficiency has marred the functioning of the Indian banking industry.

Given the current challenges of a burgeoning population, the ongoing Covid-19 pandemic, and the West’s intention to shift its manufacturing base to India and elsewhere, it is essential to say ‘yes’ to fifth generation banking reforms.

Evolution of Indian Banking Industry

- **First Generation Banking:** During the pre-Independence period (till 1947), the Swadeshi Movement saw the birth of many small and local banks.
    - Most of them failed mainly due to internal frauds, interconnected lending, and the combining of trading and banking books.
- **Second Generation Banking (1947-1967):** Indian banks facilitated concentration of resources (mobilised through retail deposits) in a few business families or groups, and thus neglected credit flow to agriculture.
- **Third Generation Baking (1967-1991):** The government was successful in breaking the nexus between industry and banks through the nationalisation of 20 major private banks in two phases (1969 and 1980) and introduction of priority sector lending (1972).
    - These initiatives resulted in the shift from ‘class banking’ to ‘mass banking’.
    - Further, it had a positive impact on the expansion of branch networks across (rural) India, massive mobilisation of public deposits and incremental credit flow to agriculture and allied sectors.
- **Fourth Generation Banking (1991-2014):** This period saw landmark reforms such as issue of fresh licences to private and foreign banks to infuse competition, enhanced productivity as well as efficiency.
    - This was done by leveraging technology; introduction of prudential norms; providing operational flexibility coupled with functional autonomy; focus on implementation of best corporate governance practices; and strengthening of capital base as per the Basel norms.
- **Current Model:** Since 2014, the banking sector has witnessed the adoption of the JAM (Jan-Dhan, Aadhaar, and Mobile) trinity, and issuance of licences to Payments Banks and Small Finance Banks (SFBs) to achieve last-mile connectivity in the financial inclusion drive.

Way Forward: Fifth Generation Banking

- **Big Banks:** The Narasimham Committee Report (1991), emphasised that India should have three

or four large commercial banks, with domestic and international presence, along with foreign banks.
    - The second tier may comprise several mid-size lenders, including niche banks, with economy-wide presence.
    - In accordance with these recommendations, the government has already merged a few PSBs, initiated steps towards setting up of DFI, Bad Bank, etc.
- **Need for Differentiated Banks:** Though the universal banking model has been widely preferred, there is a need for niche banking to cater to the specific and varied requirements of different customers and borrowers.
    - Essentially, these specialised banks would ease the access to finance in areas such as RAM (retail, agriculture, MSMEs).
    - Further, the proposed DFI/niche banks may be established as specialised banks to have access to low-cost public deposits and for better asset-liability management.
- **Blockchain Banking:** Risk management can be more specific and the neo-banks can leverage the technology to further (digital) financial inclusion and finance higher growth of aspirational/new India.
    - In this context, technologies like **Blockchain** can be implemented in Indian Banking.
    - Blockchain technology will allow prudential supervision and control over the banks may be easier.
- **Mitigating Moral Hazard:** Till date, failure of public sector banks has been a rare phenomenon and the hidden sovereign guarantee is the main reason for superior public confidence in the banks.
    - However, with the privatization drive of PSBs, this may not be always true.
    - Therefore, fifth generation banking reforms should focus on the need for higher individual deposit insurance and effective orderly resolution regimes to mitigate moral hazard and systemic risks with least cost to the public exchequer.
- **ESG Framework:** Differentiated Banks also may be encouraged to get listed on a recognised stock exchange and adhere to ESG (Environment, Social Responsibility, and Governance) framework to create value for their stakeholders in the long run.
- **Empowering Banks:** The government should tighten the loose ends by allowing them to build diversified loan portfolios, establishing sector-wise regulators, bestowing more powers to deal effectively with wilful defaulters.
    - There is also a need to pave the way for the corporate bond market (shift from bank-led economy) to create a responsive banking system in a dynamic real economy.

Conclusion

Present scenario calls for a paradigm shift in the banking sector to improve its resilience and maintain financial stability. In this context, the government has recently announced new banking reforms, involving the establishment of a **Development Finance Institution** (DFI) for infrastructure, creation of a **Bad Bank**, and **privatisation of public sector banks** (PSBs) to ease its burden in terms of mobilising additional capital.

However, governance reforms will always form the underlying layer of every generation of making reforms.

Drishti Mains Question

Present scenario, triggered by Covid-19 pandemic, calls for a paradigm shift in the banking sector to improve its resilience and maintain financial stability.