Raghuram Rajan: Competition in the banking sector – opportunities and challenges

Talk by Dr Raghuram Rajan, Governor of the Reserve Bank of India, at the Annual Day Lecture of the Competition Commission of India, New Delhi, 20 May 2014.

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Good evening. Shri Ashok Chawla, distinguished invitees, our friends from the press, and ladies and gentlemen:

It is a great honour to be invited to deliver the Annual Day lecture at the Competition Commission of India. Competition is the life force of a modern economy – it replaces dated and inefficient methods while preserving valuable traditions; it rewards the innovative and energetic and punishes the merely connected; it destroys the stability of the status quo while giving hope to the young and the outsider. True competition eliminates the need to plan, for as gravity guides water through the shortest path, competition naturally guides the economy to the most productive route.

Healthy competition is not just the best way to grow but also the best way to include all citizens; what better way to get needed services to a poor housewife than to encourage providers to compete for her money? What better way to uplift a member of a backward community than for private employers to compete to hire her for a good job?

Healthy growth-inducing inclusive competition does not, however, emerge on its own. Without intervention, we get the competition of the jungle, where the strong prey on the weak. Such competition only encourages a certain kind of winner, one who is adapted to the jungle rather than the world we want to live in. In contrast, healthy competition needs the helping hand of the government; to ensure the playing field is level, that entry barriers are low, that there are reasonable rules of the game and clear enforcement of contracts, and that all participants have the basic capabilities such as education and skills to compete.

Governments have historically found it difficult to ensure such healthy competition because intervention has to be just right. Governments typically are tempted to go beyond intervening to create a fair competitive environment, and instead have turned to determining winners and losers themselves. This typically has not worked out well. With this caveat, the creation of a healthier, more competitive environment in India could be the government's most important contribution to sustainable economic growth in India over the medium term. And the Competition Commission will be a central player in this endeavour. Whether in questioning existing government monopolies or the excessive market power of private players, you will be a key institution in the years to come. And for the sake of our country, I wish you the very best of success.

Today, I want to focus on the coming competitive environment in the banking sector. At the Reserve Bank of India, we have spent a few months thinking about how we see that shaping up, and I want to share that vision with you. My intent here is to further the debate rather than to announce any final decisions.

The grand bargains

Competition in the banking sector in India is best seen as the product of two grand bargains. The first was between successive governments and the banks, whereby banks got privileged access to low cost demand and time deposits, to the central bank's liquidity facilities, as well as some protection from competition, in return for accepting obligations such as financing the government (through the Statutory Liquidity Ratio or SLR), helping in monetary transmission (through maintaining the Cash Reserve Ratio or CRR), opening branches in unbanked areas and making loans to the priority sector.

The second grand bargain was between the public sector banks (PSBs) and the government, whereby these banks undertook special services and risks for the government, and were compensated in part, by the government standing behind the public sector banks. As India has developed, both these bargains are coming under pressure. And it is development and competition that is breaking them down.

Today, the investment needs of the economy, especially long term investment in areas like infrastructure, have increased. The government can no longer undertake these investments. Private entrepreneurs have been asked to take them up. To create space for financing, the government has to pre-empt less of the banking system's assets. But the nature of financing required is also changing. Private investment is risky, so there has to be more risk absorbing financing such as from corporate bond markets and from equity markets. As more sources of financing emerge, not only will banks no longer be able to have a monopoly over financing corporations and households, they will also have to compete for the best clients, who can access domestic and international markets.

Similarly, deposit financing will no longer be as cheap, as banks will have to compete with financial markets and real assets for the household's savings. As households become more sophisticated, they will be unwilling to leave a lot of money in low interest bearing accounts. Of course, households will still be willing to accept low interest rates in return for liquidity. So privileged access to the central bank's liquidity windows will allow banks to offer households these liquidity services safely and get a rent, but this advantage will also become eroded as new payments institutions and technologies emerge.

The first grand bargain – cheap deposits in return for financing the government – is therefore being threatened from both sides. Deposits will not continue to be cheap, while the government cannot continue to pre-empt financing at the scale it has in the past if we are to have a modern entrepreneurial economy. This is yet another reason why fiscal discipline will be central to sustainable growth going forward.

Public sector banks are, if anything, in a worse position than private sector banks, which is why the second bargain is also under threat. As low risk enterprises migrate to financing from the markets, banks are left both with very large risky infrastructure projects and with lending to small and medium sized firms. The alternative to taking these risks is to plunge into very competitive retail lending, so public sector banks may have little option especially if the government pushes them to lend to infrastructure.

Many of the projects being financed today, however, require sophisticated project evaluation skills and careful design of the capital structure. Successful lending requires the lender to act to secure his position at the first sign of trouble, otherwise the slow banker ends up providing the loss cover for more agile bankers or for unscrupulous promoters. To survive in the changing business of lending, public sector banks need to have strong capabilities, undertake careful project monitoring, and move quickly to rectify problems when necessary.

In the past, PSBs had the best talent. But today, past hiring freezes have decimated their middle-management ranks, and private banks have also poached talented personnel from PSBs. PSBs need to be able to recruit laterally, while retaining the talent they have, but to do so they need to be able to promise employees responsibility as well as the freedom of action. Unfortunately, employee actions in public sector banks are constrained by government rules and second-guessed by vigilance authorities, even while pay is limited. It will be hard for public sector banks to compete for talent. If, in addition, these banks are asked to make sub-optimal decisions in what is deemed the public interest, their performance will suffer more than in the past. This will make it hard for them to raise funds, especially capital. With the government strapped for funds, its ability to support the capital needs of public sector banks as part of the second grand bargain is also coming into question.

We cannot go backwards to revive the two bargains – that means reversing development and bottling the genie of competition, neither of which would be desirable for the economy even if feasible. Instead, the best approach may be to develop the financial sector by increasing competition and variety, even while giving banks, especially public sector banks, a greater ability to compete. Let me be more specific.

Increasing competition in banking

The Reserve Bank of India is committed to freeing entry in banking. We just announced two new commercial bank licenses after a rigorous vetting process. We are examining this experience, and after making appropriate changes, will announce a more regular process of giving licenses – what has been termed licenses on tap.

Because of the public's trust in banks and the presence of universal deposit insurance, we have to be careful in giving out the normal commercial bank licenses. To be absolutely confident of the capabilities and integrity of applicants, we give licenses only to those who have a proven track record and reasonable capital. But what of those who have no track record or no large fund base but do have capabilities? And what of those who see synergies in doing only one part of the banking business such as payments?

The RBI can take more of a chance with new players if they get the license to open only a small bank or to conduct only one segment of banking business. Such differentiated licenses – licenses with restrictions on the geographical reach or the products offered by a new bank – can generate more organizational variety and efficiency. Small banks tend to be better at catering to local needs, including needs of small and medium businesses. A payments bank, which will take deposits and offer payment and remittance services but be constrained to invest all its funds in safe instruments such as government securities, could be very synergistic with other existing services. For example, the proposed Post Bank could start as a payment bank, making use of post office outlets to raise deposits and make payments.

Key in any new structure is that there should be no arbitrage possibilities hurting the current banking system. Today, a commercial bank can convert itself into a payment bank by maintaining 100 percent SLR margins. Of course, it may not want to, because it seeks to make more money through corporate lending, but this possibility indicates regulations will not favour a payments bank unduly. Some of my colleagues believe a payments bank will be unviable, while others believe that it will skim the cream of banking business away from regular commercial banks. We can debate this issue for a long time, or we can experiment by allowing a few payments banks and monitoring their performance. The RBI proposes to discuss further steps with stakeholders in this regard.

If payments banks are successful, they will allow us to steadily reduce some of the obligations we impose on commercial banks. For instance, as payments banks hold government securities for liquidity purposes, we can reduce the quantity of government securities we ask commercial banks to hold as part of SLR.

While on the issue of bank obligations, there is an area where they do seem to be at a disadvantage vis-a-vis other financial institutions – in the raising and lending of long term money. This becomes especially important for infrastructure, where banks can be essential in early stage construction financing. Since construction lasts for 5–7 years, banks should be able to raise long tenor money for these purposes. But if they raise such money today, they immediately become subject to CRR and SLR requirements, and any lending they do attracts further priority sector obligations. To the extent that banks raise long term bonds and use it for infrastructure financing, could we relieve them of such obligations? This will immediately put them on par with other financial institutions such as insurance companies and finance companies in funding long term infrastructure.

The priority sector obligation will probably be necessary for some more time in a developing country like ours, though we need to deliberate more on what sectors should constitute priority as the economy develops. But even without entering this potentially contentious debate, can we allow banks to fulfil existing norms more efficiently? For instance, if one bank is more efficient at rural lending, can it over-achieve its obligations and then "sell" its excess to another bank that is an underachiever? We are examining such possibilities.

Finally, we have had only limited success in achieving inclusion when it is seen as a mandate. Banks sometimes open branches in remote areas but the officers that staff them do not really reach out to the local population; banks open no-frills accounts but many lie dormant. The reality is that if the mandate is unprofitable, banks will find ways to avoid them. Not all forms of inclusion can be made profitable, but we should give banks the freedom to try new approaches, perhaps drawing in other institutions that can traverse the last mile to the underserved where necessary. The RBI will come out with new relaxations on business correspondents shortly. Also, some of the entities that become payments banks may be very well suited to support or substitute commercial banks in reaching remote areas.

In sum then, we can increase competition in the banking sector while, at the same time, strengthening banks by reducing the burden of obligations on them. In this way, they will be able to contribute to sustainable growth even after the breakdown of the first grand bargain.

Freeing public sector banks to compete

Let us turn next to the public sector banks. There are well-managed public sector banks across the world and even in India today. So privatization is not necessary to improve the competitiveness of the public sector. But a change in governance, management, and operational and compensation flexibility are almost surely needed in India to improve the functioning of most PSBs, as the Dr. P.J. Nayak Committee has just reiterated.

A number of eminently practicable suggestions have been made to reform PSBs, such as creating a holding company to hold government PSB shares, increasing the length of PSB CEO tenures, breaking up the position of Chairman and CEO, bringing more independent professionals on bank boards and empowering boards with the task of selecting the CEO, becoming more selective in cases that are followed up for vigilance investigations.

We need to examine all these ideas carefully, many of which will help give public sector banks the flexibility to compete in the new environment. Let us remember that what is at stake is not just the tremendous amount of national value that is represented by public sector banks but future financing and investment in our economy.

If public sector banks become competitive, and especially if they do so by distancing themselves from the influence of the government without sacrificing their "public" character, they will be able to raise money much more easily from the markets. Indeed, the better performers will be able to raise more, unlike the current situation where the not so good performers have a greater call on the public purse. Competition will improve efficiency. The second grand bargain will also become irrelevant.

Conclusion

The banking sector is on the cusp of revolutionary change. In the next few years, I hope we will see a much more varied set of banking institutions using information and technology to their fullest, a healthy public sector banking system, distant from government influence but not from the public purpose, and a deep and liquid financial markets that will not only compete with, but also support, the banks. Such a vision is not just a possibility, it is a necessity if we are to finance the enormous needs of the real economy. As India resumes its path to strong and sustainable growth, it is the RBI's firm conviction that the Indian banking sector will be a supportive partner every inch of the way.