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"Large corporate/industrial houses may be permitted to promote banks only after necessary amendments to the Banking Regulation Act, 1949" – IWG Report on Corporate Ownership of Private Sector Banks.

On November 20, the RBI released the Internal Working Group (IWG) report that reviewed the existing licensing and regulatory guidelines relating to ownership, control, and corporate structure of private sector banks in India. The IWG examined existing guidelines within a larger context of meeting the credit demands of a growing economy; nurturing greater competition in the domestic banking sector through the entry of new players; and scaling up the presence of India's banks in the world rankings.

The most significant but contentious recommendations are:

- ✓ ***To allow large corporate and industrial houses to promote and operate banks in India and***
- ✓ ***Awarding banking licenses to "well-managed" NBFCs including those owned by corporate houses, with assets of INR 50,000 crore and > 10 years of operations into banks.***

At a time when our economy is in doldrum and the financial institutions are facing serious capital crunch, these recommendations of the IWG raises several questions.

First, if not regulated well, corporate ownership of banks may raise the risk of intergroup lending, diversion of funds, and reputational exposure. Also, the risk of contagion from business defaults to the financial sector increases significantly due to such ownership. Apart from the inherent conflict of interest, the "quality" of corporate governance practices is another key reason why the RBI had not issued banking licenses to corporate houses earlier. The IWG admits that ***"the prevailing corporate governance culture in corporate houses is not up to the international standard and it will be difficult to ring fence the non-financial activities of the promoters with that of the bank. Stress in non-financial activity may spill over to bank."***

Second, RBI has shortcomings in its oversight role. While allowing NBFCs to become banks is well intentioned and could improve financial stability as the NBFCs will then have access to larger pool of capital at lower costs, the RBI will face challenges in supervising these entities and supervisory resources could be further strained at a time when the health of India's financial sector is weak. The liquidity risks, frauds, and malpractices witnessed recently in banks and NBFCs (from PNB, Yes Bank, PMC Bank, ICICI Bank, IL & FS to DHFL) have brought to the fore the shortcomings in the RBI's regulatory oversight.

Third, the IWG report does not examine our earlier experience with corporate-owned private banks. Before 1969, large part of our banking system was controlled by the private sector. Most of the privately-owned banks were in the form of joint-stock companies controlled by large industrial houses. Connected lending practices were rampant in private banks. As owners of banks, industrial houses used to channel large sums of low-cost depositors' money into associate entities. With many private banks pursuing imprudent lending, bank failures were the norm. During 1947-58, for instance, 361 banks of varying sizes failed.

Fourth, most crucially, ***'circular banking'*** is a large potential risk posed by corporate-owned banks because of the prevalence of business cartels in India. Under circular banking, a corporate-owned bank A would finance the projects of corporate B, B owned would finance the projects of corporate C, and Corporate C owned bank would finance the projects of A, hence completing the cycle. The RBI needs to have very strong supervision to check such activities.

Fifth, the level of urgency is a bit unsettling. The IWG deliberated on these important policy issues having far-reaching ramifications on the stability of the banking system and submitted its report on October 26, a span of ~ 4 months! The RBI has offered <2 months to submit comments on the report. If previous RBI reports are any sign, the usual time-period involved between issuing committee reports and final guidelines is over 2 years. This time, however, the RBI appears to be in a big hurry to complete the process, raising some unsettling questions.

Lastly, what is even more perplexing is that the IWG has endorsed its recommendation despite overwhelming evidence to the contrary. In the report's Annex 1, the IWG has admitted that ***"all the experts it consulted except one 'were of the opinion that large corporate/ industrial houses should not be allowed to promote a bank."*** Despite suggestions by the experts to the contrary, why this crucial recommendation is being made by the IWG?

OUR VIEW

We believe that the RBI does recognize the potential risks associated with large corporates owning banks. In fact, the IWG lists several such risks including misallocation of credit, conflicts of interest, extensive anti-competitive practices, risks relating to intra-group transactions, moral hazard risks, and the risk of contagion. But what is surprising is that despite recognizing such risks, the IWG still endorses the entry of large corporate houses in the banking space.

Overall, our views are that conflict of interest, concentration of economic power, and financial stability in allowing corporates to own banks are significant risks. We are skeptical of allowing corporate ownership in banks, given our less than stellar corporate governance record amid large corporate defaults over the past few years, and lack of corporate governance and checks within our lending institutions. We believe that in case the RBI accepts the IWG's recommendations to allow corporate ownership in banks, a question on our mind would be: Does the RBI have the capacity to track connected lending, circular banking, loans to front companies controlled by corporates, loans to suppliers and vendors of a corporate group, creation of fictitious loan accounts, and other fraudulent practices on a real-time basis?

To conclude, we believe, evidence to support the entry of large corporate and industrial houses into the Indian banking sector has not yet faced enough empirical scrutiny. The potential benefits do not outweigh the potential risks inherent in corporate ownership of banks. It is an idea which is premature and fraught with risk.

A. India further eases tax regulation for foreign Sovereign Wealth Funds (SWF)

- **Abu Dhabi's SWF first to receive 100% income tax exemption**
  Our Finance Ministry announced on Wednesday that Abu Dhabi's SWF - MIC Redwood 1 RSC Limited - has become the first foreign SWF that has been notified and granted 100% income-tax exemption for the long-term investments to be made in the specified priority sectors in India. The exemption applies to income from interest, dividend, and long-term capital gains for its investment in India's priority sector as per the Finance Act, 2020 – Energy, water and sanitation, communication, and transport and logistics. With this exemption, we believe that India can tap into the huge pool of foreign capital for its cash strapped and investment hungry infrastructure sector.

B. A few large transactions have been announced in November 2020

- **Saudi Arabi's PIF to invest INR 9,555 crores for a 2.04% state in Reliance Retail**
  This investment — a record 8th investment by a global investor— values Reliance Retail Ventures Limited (RRVL) at a pre-money equity value of INR 4.59 lakh crore (around USD 62.4 billion). RRVL has already raised INR 47,265 crores for a 10.09% stake offload. This investment will further strengthen PIF's presence in India's dynamic economy and promising retail market segment. This follows an earlier investment by PIF in Reliance's Jio Networks.

- **Goldman Sachs invests USD 150 mn in Biocon Biologics, a subsidiary of Biocon**
  Biocon Ltd has announced that its subsidiary Biocon Biologics Ltd has received an INR 1,125 crore (USD 150 million) capital injection from Goldman Sachs. As per the proposed investment, Goldman Sachs will be issued Optionally Convertible Debentures (OCD) at a post money equity valuation of USD 3.94 billion.

- **Embassy REIT to Acquire Embassy Tech Village for USD 1.3 bn**
  In the largest single commercial property transaction in India, Embassy Office Parks REIT — India's first listed REIT — is acquiring Embassy TechVillage's (ETV's) assets in Bengaluru for USD 1.3 billion. This deal will make Embassy REIT the largest in Asia in terms of office space. The Blackstone-backed REIT will be acquiring 6.1 million sft. of completed area, 3.1 mn sft. of under-construction area, of which 36% is pre-leased to JPMorgan, and 2 proposed 518-keys Hilton hotels within the campus. This deal increases Embassy REIT's commercial office portfolio by 28% to a total of 42.4 mn sft.

- **RIL – Future Retail get CCI approval**
  The Competition Commission of India (CCI) on Friday approved Future Retail Limited's asset sale to Reliance Industries Ltd (RIL), in a setback for Amazon.com Inc., which had approached the anti-trust watchdog to halt the INR 24,700 crore deal. Amazon had complained to CCI as well as the Securities and Exchange Board of India (SEBI) that the sale violated contractual agreements between Future and Amazon.

- **AU Small Finance Bank sells 4.46% stake in Aavas Financiers for INR 530 crores**
  AU Small Finance Bank Ltd on Monday sold 35 lakh shares of Aavas Financiers Ltd worth Rs 530 crore through an open market transaction. In a regulatory filing, the bank said it has offloaded 4.46 per cent stake in Aavas Financiers, formerly known as AU Housing Finance Ltd. According to bulk deal data available on the BSE, AU Small Finance Bank offloaded a total of 35,00,000 shares at an average price of INR 1,515 / share. This values the deal at INR 530 crore. As many as 15,60,000 shares were purchased by Nomura India Investment Fund Mother Fund and SBI Life Insurance Company Ltd at this price. The balance shareholding of AU Small Finance Bank stands at 3,383 shares in Aavas.

C. India in technical Recession

Economy contracted 7.5% in July – September Quarter

India's National Statistical Office released economic data for the July-September quarter earlier this week confirming that the country was amid a technical recession because of the pandemic. According to the NSO's data, our economy contracted by 7.5% in the quarter ended September 2020 following an unprecedented contraction of 23.9% in the previous quarter. The latest contraction has taken place despite the central government gradually lifting restrictions on commercial activity. While the Festive season showed some uptick in consumer exuberance and spending, India, is now technically in a recession as GDP in two consecutive quarters have shown a contraction. This was not unexpected as most economists and policy makers expected that our economy will be in a recession for this year. As a matter of fact, most policymakers expect the economy to be contracting for another quarter till December before rebounding.

Our View

- ✓ We wrote in our preceding newsletter that we believe the worst of the economic fallout of the pandemic may be behind us. We stand by our belief. While the economy may still contract in the current quarter ending December, the economic indicators do show a steady recovery with the economy substantially narrowing its contraction to a single digit in Q2. The manufacturing and construction sectors made a jump in Q2. While the fall in construction sector narrowed from ~ 50% in Q1 to 8.6% in Q2, the manufacturing sector registered a marginal 0.6% growth in Q2, against a contraction of ~39% in Q1. The mining sector also improved by reducing the contraction of ~23% in Q1 to ~9% in Q2. On the other hand, the agriculture sector once again registered a growth of 3.4% in Q2, showing a resilience not witnessed in the other sectors.
- ✓ While Q2 GDP made a sharp sequential rebound, the market will be focusing more on the prospects of recovery in H2 of FY21. Given a 2.5% drop in core industries output for October 2020 and a sharp 13% drop in consumptions in Q2 FY21, a meaningful recovery in Q3 FY21 looks uncertain. Consumption has always played an important role over the years to support economic growth, hence a faster recovery in consumptions is of utmost importance for our economy to rebound to a growth trajectory.
- ✓ Our concern is that the population should not get into a debt-averse mode thereby focusing on savings instead of consumption which could really slow down recovery. Data released show a dip in private consumption by 11.5% indicating that aggregate demand is still far from normal and that the supportive measures from the government may need to continue.
- ✓ We believe that the real test for us will be in the 4th Quarter of FY 21 when the festive season gets to a closure and sustaining the demand would be a challenge. If demand grows, it will limit the overall economic damage.

GLOSSARY

CCI	Competition Commission of India
NBFC	Non-Banking Financial Company
INR	Indian Rupees
IWG	Internal Working Group
OCD	Optionally Convertible Debentures
RBI	Reserve Bank of India
RRVL	Reliance Retail Ventures Limited
SEBI	Securities and Exchange Board of India
SWF	Sovereign Wealth Funds

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- Exit advisory
- Asset Management Tool

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- Risk Management
- IFC Review
- Background Check
- Process Improvement
- Cost Reduction
- Working Capital Optimization
- Data Analytics
- Physical Verification

Assurance & Regulatory

- Compliances
- Accounting & Reporting
- Regulatory Compliance Audits
- Financial Audits
- FEMA / RBI Regulatory Compliances
- RERA Compliance
- Secretarial

IT Risk, Forensics

- Information Security Management Services
- Forensics
- Technology Risk Solution
- Security Risk Management
- Creative Training Solution

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