How parliament can reform its ailing public sector banks

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India needs a strategy to get the government out of banking. Non-performing loans among state-owned banks -- a legacy of India's socialist past which account for nearly 70 percent of deposits -- have crossed 5 percent of GDP. The central bank has restricted lending at 11 of them and forced one, IDBI Bank Ltd., to sell itself to the government-owned Life Insurance Corporation of India.

State banks have repeatedly been a burden on the exchequer and will almost certainly continue to be so. The great need is to increase the number and size of private banks, which have performed better than their public-sector counterparts. Unfortunately, the government just abandoned the one policy that would have eased such a transition.

Earlier this month, according to reports, the administration of Prime Minister Narendra Modi decided to withdraw the Financial Resolution and Deposit Insurance bill from parliament. The bill was meant to address the biggest hurdle in dealing with failing banks: There's no way to sell them off.

The current legal framework only allows struggling banks to be merged or liquidated. While the banking regulator, the Reserve Bank of India, has in the past forced healthier banks to swallow up weaker ones, there are very few state banks strong enough now to take on such a burden. The only other option is to sell off each loan or asset one by one, which can take as long as 10 years.

With no other options, the government has been recapitalizing loss-making banks -- essentially pouring taxpayer money down the drain (including into Punjab National Bank, which lost nearly $2 billion in a corruption scandal). Selling off IDBI only puts the bank's problems onto the balance sheet of LIC, one of India's biggest insurance companies.The FRDI bill would have done two critical things. Most directly, it would have created a mechanism to sell a bank as a living entity to another bank. A Resolution Corporation, similar to the Federal Deposit Insurance Corporation in the U.S., would have been created to take over failing banks and either run them temporarily, sell them, infuse equity or, as a last resort, liquidate them.

Second, once such a framework was in place, the RBI would have had much greater flexibility to give out licenses for more private banks. The central bank has hesitated thus far to increase their number, despite repeatedly promising to do so, because there was no easy way to deal with the new banks if they ran into trouble. The FRDI bill would have made the prospect of creating new banks much less risky.

Politics doomed the bill. One clause gave the proposed Resolution Corporation the option of "bailing in" troubled banks -- using uninsured depositor money to infuse equity into the bank if a buyer couldn't be found. The optics, at a time when many state banks look like they're on the verge of failure, were terrible. Worse, most Indians didn't realize that their deposits were only insured up to 100,000 rupees (less than $1,500). Pensioners worried they might be stripped of their life savings.These problems could easily have been fixed. The "bail in" clause could have been scrapped, and insurance limits raised. If the insurance were raised to $20,000, virtually all depositors would be covered.

Abandoning the bill entirely, by contrast, will have far-reaching effects. Unless India can find a way to shrink the state banking sector, it'll be hard if not impossible to revive lending and investment. Small enterprises in particular are desperate for bank finance.

The Modi government may be right that "big bang" reforms -- liberalizing land and labor markets, for instance -- are too politically difficult. But it's done a good job thus far implementing smaller changes that can have a big impact, such as the Bankruptcy Code passed last year that does for companies what the FRDI bill would have done for banks. If India can't even manage these less-striking reforms, the chances of boosting growth into the double-digit range are remote.

And there's a scarier prospect as well. The share of deposits in private banks have increased in the last two years from a quarter to a third of the total. Under current conditions, it's not clear what the government and RBI would do if a big private bank failed. There are no public-sector banks healthy enough to buy out a big bank. There's no fiscal space to infuse equity, as public banks are already bleeding the government's coffers.

A high-profile liquidation could possibly trigger a contagion. Many countries set up resolution regimes after the global financial crisis, understanding the grave impact of a banking failure on the real economy. India may soon come to regret not doing so as well.

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