Working paper

Bargains and Banking: How Institutionalized Political Bargains Have Shaped the Development of Indian Banking

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Abstract: This essay shows how the sectoral political network in India's banking sector has structured its development from the era of dirigisme beginning under the Nehru government in 1947 to the more liberalized contemporary period starting in 1991. We show that political bargains, or institutionalized agreements among actors in a sectoral political network, are mechanisms through which the legacies of earlier eras shape developments in subsequent periods. Our study of India's banking sector examines two varieties of political bargains. Politicians created an *entrenched political bargain* during the dirigiste era by nationalizing India's banks to assert control over bank governance. Entrenched bargains limit subsequent reforms to policies that address their negative consequences but not the underlying causes emanating from the interests of powerful actors. *Principal-agent relations* are the second type of political bargain. Politicians struck this evolving bargain by establishing an asymmetric relationship between the government and India's central bank, the Reserve Bank of India (RBI). We analyze how these entrenched and principal-agent bargains have shaped the development of Indian banking by examining their impact on the banking sector's recurring non-performing asset problem and its dynamic payment system.

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> "Banks' strengths and shortcomings are the predictable consequences of political bargains and … those bargains are structured by a society's political institutions."
>
> Calomiris and Haber (2014, X)

This essay investigates how the sectoral political network in India's banking sector has structured its development from the era of dirigisme beginning under the Nehru government in 1947 to the more liberalized contemporary period starting in 1991. By sectoral political network, we mean the configuration of political actors -- politicians, government agencies, business associations, unions, think tanks, and international institutions -- that shape sectoral political economies. The concept of a "sectoral political network" builds on the concept of "policy networks" or "sets of formal institutional and informal linkages between governmental and other actors structured around shared if endlessly negotiated beliefs and interests in public policy making and implementation" (Rhodes 2008, 427). Sectoral political networks are similar to policy networks in that they focus on constellations of actors who influence policy formation and implementation; however, they differ from policy networks in that they are not oriented around policies but arise through the interaction of sectoral traits such as industrial structure, economic governance, and the purposes and users of its products, on the one hand, and the mix of policies affecting a sector on the other. Our analysis emphasizes the political aspects of sectoral political networks in that we analyze 1) how the distribution of political power within the network shapes policy formation and implementation and 2) the distributional consequences of how network boundaries include some actors and exclude others.

We draw on Calomiris and Haber's (2014) seminal study of banking sectors to contend that political bargains, or institutionalized agreements among actors within the sectoral political network, are the mechanisms through which the legacies of earlier eras shape developments in subsequent eras. Our study of India's banking sector examines two varieties of political bargains. Politicians created an *entrenched political bargain* during the dirigiste era by nationalizing India's banks to assert control over bank governance. The bargain is "entrenched" in that it persists regardless of the ruling party. Bank officials and public sector bank unions were junior partners in the bargain. In the wake of nationalization, the government influenced public sector lending by mandating that as much as 40% of bank loans go to "priority sectors," periodically ordering loan waivers, and issuing informal, verbal instructions to the banks. Our study of the banking sector's recurrent problem with non-performing assets demonstrates that political control over India's public sector banks has persisted even when patently problematic, as illuminated by the government's own committee reports. The enduring persistence of political control of India's public sector banks has forged a developmental trajectory where banking reforms are limited to those that can be "layered" upon this institutionalized arrangement (Mahoney and Thelen, 2010).

The second political bargain that has shaped the development of India's banking sector is the bargain between politicians via the Ministry of Finance and India's central bank, the Reserve Bank of India (RBI). We can best conceptualize this bargain as a *principal-agent relationship* (Miller 2005). The relationship is well-characterized by former RBI Governor Y.V. Reddy, who declared, "The RBI is independent but within the limits set by the government." (*Business Standard*2017) The institutionalization of the relationship between the government and the RBI began when the colonial government passed the 1935 Reserve Bank of India Act. The legislation made the colonial government a powerful principal by giving its Governor-General the right to appoint and remove the bank's Governor and Deputy Governors, supersede the central board, and require its approval before making regulations. It so closely tied the RBI to the colonial government that in later parliamentary debate over legislation to nationalize the central bank, the RBI was described as "the slave, -- the maid of the old lady of Threadneedle Street – the Bank of England." (Simha 1970, p. 524) After independence, the government maintained most of the provisions of the Reserve Bank of India Act. It quickly strengthened its control by nationalizing the central bank through the Reserve Bank (Transfer to Public Ownership) Act, 1948. The RBI was extraordinarily subservient to the government during the dirigiste era. It lacked the authority for independent monetary policy and serviced the government's fiscal needs by monetizing the debt, repressing the financial sector, and implementing a rigid regime of capital controls. The RBI assisted the government's economic planning by mobilizing savings and institutionalizing credit to industry and agriculture. It also played a critical role in managing exchange rates and the sale of government debt.

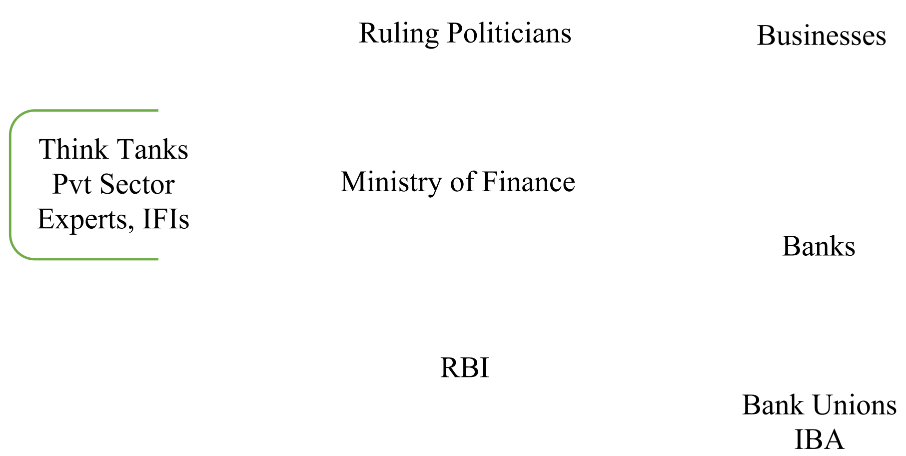
Miller (2005) points out that as political scientists have adopted the model of principal-agent relations to political contexts, they have reconceptualized the relationship as being shaped by negotiations of administrative procedures rather than imposition of outcome-based incentives by the principal. The negotiated approach to principal-agent relations helps to portray the dynamic nature of the relationship between the government and RBI. As the RBI performed its subordinate role, it built expertise, legitimacy, and political support that gradually enabled the central bank to put up limited resistance to the government's authority within the constraints of their asymmetric relationship. The development of global markets for trade and finance, the rise of monetarism, and the emergence of an international consensus on central bank autonomy further empowered the RBI, which came to use its authority to impede government efforts to liberalize the financial sector. Nonetheless, the RBI remained an indispensable government agent. Our essay shows how the government's principal-agent relationship with the RBI and its desire to maintain a central role of banks in India's financial system shaped the development of India's dynamic digital payment system by delegating a crucial role to the RBI and banks in developing digital payments.

The paper begins by describing the development of the banking system during the dirigiste era, focusing on how the political bargains affected the banking sector's political network and subsequent development. Next, we analyze the evolution of the banking system's non-performing asset problem. We show how the entrenched bargain between ruling politicians and the banks created a pattern of economic reforms that failed to address the critical ways banking governance and poor regulation contributed to the NPA problem. Then, we examine the developmental trajectory of the payment system and highlight how the bargain between the government and the RBI shaped India's approach to the opportunities and challenges of this technologically dynamic domain. We conclude by suggesting fruitful areas for new research.

A Government-Dominated Sectoral Political Network that Subordinates Banking Institutions to Its Political and Economic Objectives

India's pursuit of a planned economy at the beginning of its post-colonial era led it to emphasize the role of banks in its financial sector and subordinate the banks to its developmental goals. Banking became a strategic sector (Hsueh 2022) where state ownership prevailed. As we elaborate below, politicians nationalized India's banks to institutionalize their interest in controlling them for their economic and political objectives. Direct links between politicians and banks in the sector's political network (See Figure 1) were largely covert, and political interests were most apparently channeled through the Ministry of Finance. Though the Finance Ministry exerted direct influence over the nationalized banks, it also controlled them through the Reserve Bank of India. The RBI acted as the Ministry of Finance's agent in the financial sector. As is characteristic of many principal-agent relationships, the interests of the Ministry of Finance and the RBI did not always coincide. Over time, the RBI accumulated political resources in the form of expertise, legitimacy, and political allies that enabled it to resist some of the Ministry of Finance's initiatives that were detrimental to its interests. The tensions grew when the Finance Ministry began supporting financial sector liberalization advocated by think tanks, private sector experts, and international financial institutions. The RBI, often bolstered by support from public sector banks and bank

Figure 1: Banking Sector Political Network



unions, resisted many liberalization initiatives and opposed reforms that threatened the interests that it developed under the dirigiste regime.

The boundaries of the banking sector's political network changed in one consequential manner. Beginning in the 1990s and through the first two decades of the new millennium, the Ministry of Finance increasingly incorporated input from policy experts in the private sector, think tanks, and international financial institutions. This counsel contributed to tensions within the banking sector policy network between the Ministry of Finance and the RBI. At the same time, the technical expertise associated with financial sector issues has enabled government agencies and financial institutions to maintain network boundaries that limited the articulation of popular interests through public mobilization. This boundary has been sustained even during banking scandals involving billions of dollars.

Soon after independence, India's ruling politicians passed the Reserve Bank (Transfer to Public Ownership) Act, 1948, authorizing the state to purchase all the RBI's privately held equity and extending control over the central bank. Politicians then initiated three waves of bank nationalization in 1955, 1968, and 1980. The laws nationalizing Indian banks included provisions affecting bank governance that institutionalized the politicians' power to instrumentalize the banks to achieve their policy and political objectives. At the same time, the government's emphasis on planning subordinated the RBI to the Ministry of Finance in the economic policy-making process. Only with the liberalization of monetary policy in the 1990s did the RBI gain a measure of countervailing power in its relationship with the Ministry of Finance.

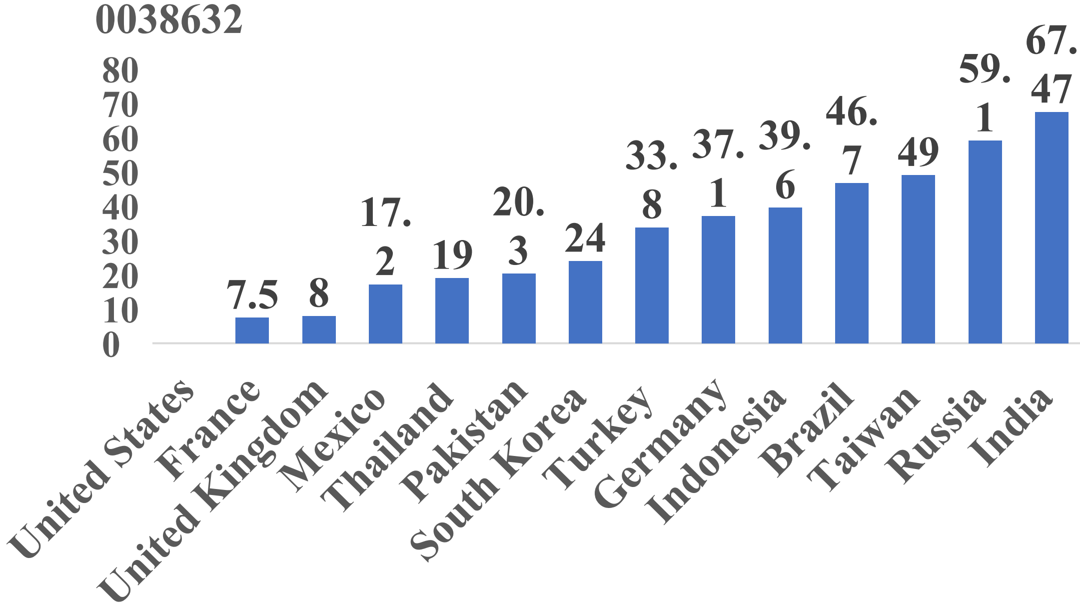
Bank nationalization in 1955, 1969, and 1980 institutionalized politicians' authority to utilize the banks to achieve their policy and political goals. Of course, governments around the world have policy objectives that they attempt to achieve through their banking sector institutions. The difference is that in most countries, governments attempt to create incentives that align the commercial interests of banks with their policy goals while banks retain their independent decision-making authority. In India, the government intervenes in ways that limit banks' ability to pursue their commercial interests when they conflict with its policy goals. For instance, the government issued directives mandating as much as 40% of all banking credit to government-determined strategic sectors, requiring the banks to hold as much as 15% of their deposits in interest-free cash reserves with the central bank, and ordering the banks to hold as much as an additional 38% of their deposits in public sector securities whose interest rates were controlled by the RBI at below-market rates. Government regulation of public sector banks is most extensive since government control over bank management incites the banks to provide loans and debt forbearance according to the government's development and political goals.

The government's difficulties controlling the banks were an important motivation for nationalization. It nationalized India's largest bank, the Imperial Bank, and transformed it into the State Bank of India in 1955 after the Imperial Bank's managers refused to cooperate with government initiatives to expand banking into the rural hinterland. (Balachandran 2005, 322-23) While the political objective of presenting a progressive image and building support among allies on the left motivated the wave of bank nationalizations under Indira Gandhi in 1969, even Mrs. Gandhi's archrival, Morarji Desai, had begun implementing measures to establish "social control" over the banking system as her finance minister in the late 1960s. (Bajoria 2020, 70) India's final wave of bank nationalization in 1980 came only after RBI governor I.G. Patel urged the action because the RBI was unable to regulate banks "that had become personal fiefdoms of individuals who disregarded all rules" (Patel 2002, pp. 165-67). Banking nationalization enabled the government to place its nominees on the nationalized bank's governing boards. Through its nominees, as well as those of public sector financial institutions and the RBI, the government exercises direct control over the banks.

Despite repeated problems with bad loans, controversial scandals, and various inefficiencies, India's banking sector remains dominated by public sector banks. Though the share of private banks has gradually increased in recent years, public sector banks owned nearly 60 percent of banking sector assets in 2022, a larger share than in any other country in the world. (See Figure 2). The political usefulness of the banks has limited reforms, and critical problems continue to plague the sector. Former RBI governor Urjit Patel expresses concern about "banking sector fiscalization" which he defines as using "ownership of banks as a means for day-to-day macroeconomic management rather than primarily for efficient intermediation between savers and borrowers." (Patel 2020, p. 3). Patel (2020, p. 7) declares, "As successive governments have found their capacity for further fiscal expansion becoming constrained, it has [*sic* they have] used the banks that it owns to fire up and pump-prime the economy." Banking sector fiscalization has been institutionalized through the "credit budgets" the finance minister elaborates for the banks. Repeated farm loan waivers since 1990 – at least two ordered by India's central government (1990, 2008) and eleven by state governments from 2014-20 (Patel 2020, pp. 117-120) – are also evidence of the politicization of bank credit as well as "banking sector visualization." Economist Shawn Cole (2008) found that public sector bank lending is positively associated with state-level electoral cycles, and where the incumbent party at the state level faces the most competition, directed lending by public sector banks is significantly higher than in less competitive districts while there is no significant difference for private sector banks. The RBI's 2014 "Report of The Committee to Review Governance of Boards of Banks in India" (pp. 47-48), also known as the PJ

Nayak Committee Report, found that governmental "suasion" through which its agencies "issue informal oral instructions or proffer advice which may never be put on the official record" has "deeply politicized bank governance" resulting in loan sanctions to favored

Figure 2: Government Controlled Banks' Percent Share of Banking Sector Assets, 2016Source: BRSS World Bank Group – 2019 Database >> https://datacatalog.worldbank.org/search/dataset/0038632



corporate promoters and other borrowers as well as the rise of informal intermediaries that pitch loan proposals to banks. A study of the 419 non-financial firms on the S&P BSE 500 index over the period from 2002 to 2015 found that political connections have a significantly positive impact on firms' access to credit and profitability and that the impact is positively associated with the strength of the connection (Chahal and Ahmad 2018).

State influence over public sector bank governance has been protected from efforts to check the politicization of lending. As early as 1998, the Narasimhan Committee II recommended reducing government ownership of banks because it resulted in mismanagement. (Narasimhan 1998, 11) The 2014 Nayak Committee observed that the government's procedures for nominating bank directors are flawed. Bank chairmen who have the best knowledge of their bank's needs are excluded from the selection process, while government officials lacking the expertise to select people with the necessary technical skills control the process. The result is that appointees have desirable credentials rather than technical skills at a time when good bank management requires increasing technical expertise. The Nayak Committee Report (p. 41) expressed the concern that the government-controlled appointment process, lacking a fit and proper assessment of incoming directors, raises "suspicions of the directors owing political allegiance." These suspicions compound the difficulties of the selection process because professionals with high standing become inclined to think that good governance is not a primary objective of public sector banks, and they hesitate to join the boards. The Nayak Committee conducted a detailed examination of the deliberations of public sector bank boards. It found that at a time when the quality of their assets was deteriorating, the boards of public sector banks failed to adequately discuss the problems of stressed assets as well as long-term competitive strategies (p. 43). Finally, the Nayak Committee Report states that bank loan officers are intimidated by the scrutiny of the government's Central Vigilance Commission and the Central Bureau of Investigation, agencies responsible for detecting corruption in government agencies. Patel (2020, 22) notes that the desire to avoid investigation by the CVC and CBI encourages "evergreening," or rolling over distressed loans.

Not only does direct government intervention diminish the effectiveness of public sector bank governance, but it also limits the efficacy of banking sector regulation. An essential part of the problem is that public sector banks suffer from "dual regulation," i.e., regulation by the Ministry of Finance and the RBI. In addition to the RBI's regulation of banking finances, the Ministry of Finance issues frequent authoritative directives to public sector banks – 82 from October 2012 to January 2014, according to the Nayak Committee (p. 33). Khatkhate (2005, p. 334) contends that during the dirigiste era, RBI regulation focused more on whether the banks were implementing the government directives than on how they managed their risks. Even as the RBI began implementing greater prudential regulation, the government limited the central bank's regulatory authority. Under the Banking Regulation Act, the RBI lacks the authority to remove public sector bank directors and managers. It cannot hold public sector bank boards accountable for replacing non-performing senior management and government-appointed board members. It lacks the authority to force bank mergers or to liquidate a non-performing public sector bank. In addition, the government has historically acted as the final arbiter on regulatory action. It has often overruled the RBI's recommendations (Chandravarkar 1996, p. 239, Khatkhate 2005, p. 333) as illustrated by the Palai Central Bank case (Balachandran 1998, pp. 767-93). Furthermore, the RBI's role as banking regulator is compromised by its equity ownership in banks and other financial institutions

(Narasimhan 1998). Due to the regulatory ineffectiveness of the RBI, India's banking sector has experienced repeated banking scandals.

The evolving political bargain between the government's Ministry of Finance and the RBI is important in shaping banking sector development. The legislation that created and nationalized the RBI – the Reserve Bank of India Act, 1934, and the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 – provided the government with dominant authority over the central bank, and during the dirigiste era, the RBI acquiesced to a subordinate role helping the government achieve its economic objectives. In return, the government recognized the RBI's expertise and prestige. The government's dominant position is apparent by the fact that when tensions arose with the RBI Governor, in at least four cases, the Governor felt obliged to resign without the government exercising its authority to dismiss him– Rama Rau in 1956, K.R. Puri in 1977, RN Malhotra in 1990, and Urjit Patel in 2018.

If implementing monetary policy to control inflation is a core objective of central banks, the RBI made concessions to the government that drastically limited its authority in this crucial domain. In 1955, the RBI accepted the Ministry of Finance's suggestion to issue ad hoc treasury bills to provide the government with funds whenever its balances dipped below Rs 50 crore at the end of each week. The RBI controlled interest rates and kept them low to minimize the cost of government debt. It began to use the Cash Reserve Ratio (CRR) – the share of the net demand and time deposits that it required banks to hold in interest-free cash reserves with the central bank – and the Statutory Liquidity

Ratio (SLR) – the share of net demand and time deposits that it required the banks to hold in public sector securities whose interest rates were controlled by the RBI at below-market interest rates – as fiscal as well as monetary and risk management policy instruments. By 1989, the CRR reached 15 percent and the SLR rose to 38 percent. According to economist Arvind Panagariya, the RBI's extension of credit to the government comprised as much as 85 percent of the variation in reserve money during the 1980s, and the money supply "became entirely subservient to the fiscal needs of the government." (Panagariya 2008, p. 218)

The RBI's experience during the era of Indian planning profoundly shaped its worldview. As the government's concern for promoting development increased at the onset of the planning era, it called upon the RBI's expertise and initiative in a broad range of developmental endeavors, including agricultural credit, developmental financial institutions providing term finance to industry, the development of small industry, the financing of exports, the implementation of capital controls, the administration of exchange controls, and even the promotion of tourism. (Balachandran 1998, 701) Monetarism and the importance of central bank autonomy were less appreciated in the first decades after Independence. As the RBI's developmental role expanded, it bought into the dirigiste developmental approach which justified its widespread interventions. L.K. Jha, RBI Governor from 1967 to 1970, retrospectively observed that while serving at the central bank he held a "basic reservation about conservative monetary policy." He considered "development to be a more important goal of economic policy … than [the] stability for which central banks normally strive." (Balachandran 2005, p. 711).

The dirigiste era left another legacy that continues to shape India's financial sector – the underdevelopment of its private debt market. Planning and industrial licensing obliged Indian corporations to secure a vast share of their project financing through loans from development finance institutions and banks. The RBI owned the debt market trading system and infrastructure. Due to its preoccupation with financial market instability, it limited debt market development and severely restricted domestic and foreign market participants. Consequently, India's underdeveloped corporate bond market has remained unable to supply adequate project finance.

In the 1990s, after India decided to gradually open to international capital markets, banking sector reforms began to curb financial repression and increase the RBI's authority over monetary policy. The RBI reduced the CRR to four percent by 2004, and after an increase in response to the global financial crisis, it has remained between three and five percent since 2013. The RBI halved the SLR to its 2022 rate of 18%. Having reduced the importance of targeting reserve money as a monetary policy and fiscal policy instrument, the RBI created a system of liquidity management through open market operations. It established the liquidity adjustment facility (LAF) in 2000, using auctions to set repo and reverse repo rates. The repo rate became the RBI's primary policy rate, signaling its monetary policy stance.

Economic liberalization brought about a change in the RBI's relationship with the government. As the reforms enhanced the independence of the RBI, the central bank frequently opposed many liberalizing reforms, especially those that eroded the ideological justification for its interventions and threatened its control of policy domains.[1]

When the Ministry of Finance – increasingly informed by experts with international training and experience – promoted a range of liberalizing financial reforms from the early 2000s to 2016, the RBI took a cautious approach that led it to resist many reforms. Long-time financial sector analyst Deena Khatkhate (2005, 323) observed, "Even under a new liberalized environment; … the RBI remained a prisoner of its past, hobbled by the bureaucracy with its ingrained habits of thought and the intensity of the political pressure groups."

Other actors in the banking political network supported the RBI's approach. The Indian Banks' Association (IBA), the business association representing the interests of banks, is a consequential actor in the network. Though it has an extensive membership including all twelve public sector banks and virtually every important private sector bank, the IBA's managing board is dominated by large public sector banks.[2] It advocates policies favoring its banking constituents,[3] yet its advocacy is never confrontational as the IBA relishes its good relations with the RBI and Ministry of Finance. Indeed, the IBA frequently offers its expertise to help formulate and implement policy. It contributed to the design of the Insolvency and Bankruptcy Code developed under the auspices of the Ministry of Finance in 2016. The Ministry of Finance asked the IBA to help ensure that the banks properly recorded customer deposits made in response to the November 2016 demonetization policy[4] (*The Economic Times* 2016). The RBI requested the IBA's help in organizing banks to become shareholders in the National Payment Corporation of India.[5] (IBA 2022) In sum, while the IBA maintains good relations with both the Ministry of Finance and the RBI, it is more supportive of the RBI's conservative approach to financial liberalization than an advocate of substantial liberalizing reforms.

Bank unions are another force that maintains the dirigiste legacy. Though the number of RBI employees has declined from its peak of 34,000 to 13,490 as of December 31, 2023 (Reserve Bank of India Annual Report 2024, 231), the RBI employees' unions actively defend the central bank's interests through their contacts with members of parliament and their strikes. For instance, when the 2015 Finance Bill proposed to hive off the RBI's role in managing the central and state governments' debt by creating a Public Debt Management Agency, the unions actively lobbied to support the RBI's opposition (Ray 2015a). They also opposed reforms configuring the Monetary Policy Committee in ways that would diminish the RBI's control (*Business Line* 2015; Ray 2015b; *Hindustan Times* 2015). Bank unions across the country took repeated strikes in opposition to the Financial Resolution and Deposit Insurance (FRDI) Bill which proposed to create a Resolution Corporation to wind up distressed banks (United News of India 2018; *Indian Express* 2018).

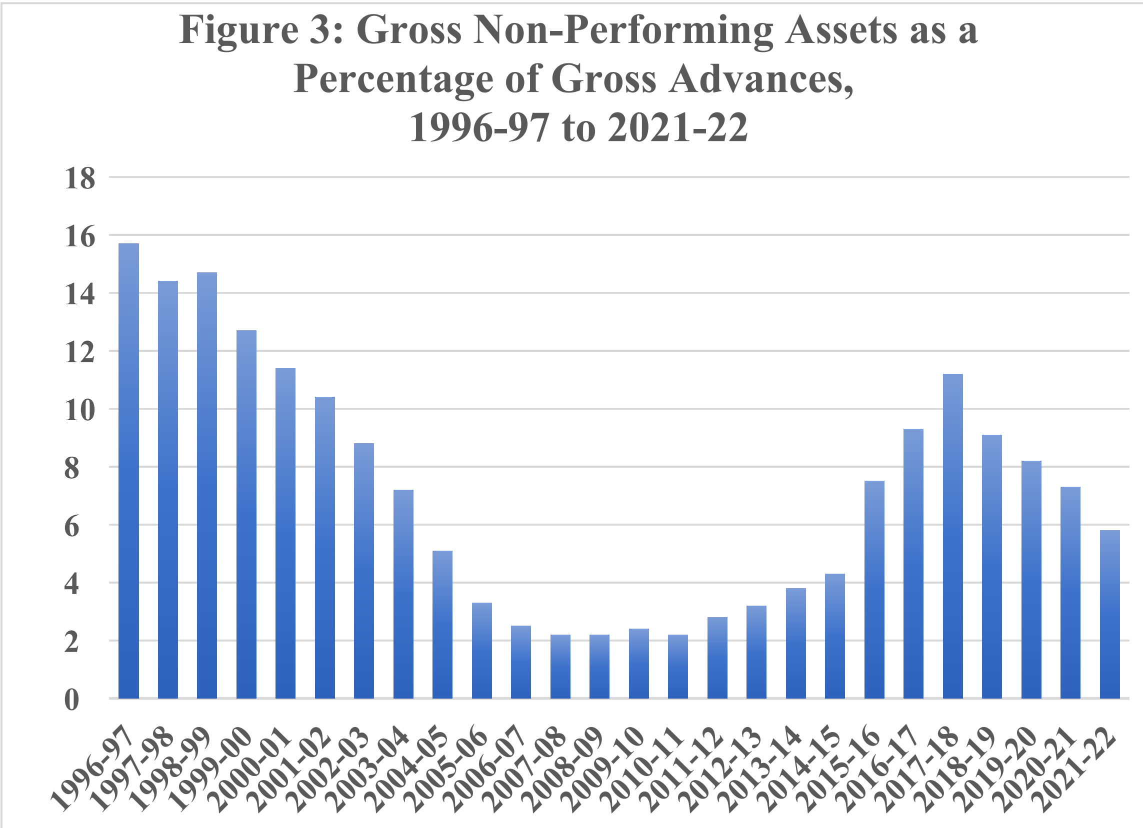
By the middle of the 2000s, the government had become increasingly dissatisfied with the RBI's competence and began accessing outside expertise. In 2006, the Ministry of Finance asked Percy Mistry, chairman of the UK-based Oxford International Group, to lead a committee to draft a report on making Mumbai an international financial center (Ministry of Finance 2007). The committee included many luminaries of Indian finance but no RBI representative. RBI officials participated in the proceedings only on an invited basis (Ministry of Finance 2007, 219). The committee made wide-ranging recommendations that, if implemented, would have substantively altered India's financial institutions. In 2007, the Planning Commission asked Raghuram Rajan, former chief economist at the IMF and professor at the University of Chicago Booth School of Business – later appointed RBI Governor – to lead a committee for financial sector reforms. The Rajan Committee membership did not include a representative from the RBI. In 2011, the Ministry of Finance appointed the Financial Sector Legislative Reforms Committee (FSLRC) under the leadership of Justice B.N. Srikrishna. Like previous committees, the FSLRC did not include any members of the RBI, though its subcommittees included several RBI representatives. Finally, in 2015, the Ministry of Finance appointed the Bankruptcy Legislative Reforms Commission (BLRC), headed by T. K. Viswanathan, former Union Law Secretary. Although the BLRC dealt with matters crucial to banks, like the resolution and liquidation of non-performing loans, its fourteen committee members included only one RBI representative. By extending the range of financial sector experts consulted beyond the RBI, these committees incorporated into the banking sector political network quasi-governmental and non-governmental organizations such as the National Institute for Public Finance and Policy, the Vidhi Centre for Legal Policy, the Finance Research Group of the Indira Gandhi Institute for Development Research.

In sum, the government dominates India's banking sector through the institutionalization of two political bargains. The government exercises control over banks through the governance provisions in the banking nationalization laws. The second political bargain shaping India's financial sector development is the bargain that created the principal-agent relationship between the government, with the Ministry of Finance as its nodal agency, and the Reserve Bank of India. By the 1990s, this relationship became more contested as the RBI increased its bargaining leverage by accumulating expertise, legitimacy, and political allies while gaining increased control over monetary policy. Below, we show how the political control of bank governance, especially that of public sector banks, is a fundamental cause of the banks' problems with non-performing assets. Then, we explain how the principal-agent relationship between the government and the RBI has given the RBI a central role in developing India's digital payment system.

Banks and the NPA Problem

The incidence of non-performing assets has a distinct historical pattern (Figure 3). The data begins with a peak ratio of gross non-performing assets to gross advances of 15.7 percent in 1996-97. They steadily decline to a nadir of 2.2 percent in 2007-08. Then, the ratio rose to 11.2 percent in 2017-18 before declining to 5.8 percent in 2021-22. To understand this pattern, we need to account for three types of causes: accounting, contextual and structural.

Analyst Anjali Sharma[6] points out the importance of distinguishing between NPAs and insolvency (Interview, Mumbai, May 16, 2022). The former is an accounting statistic. The latter is a condition suffered by a firm. In Figure 3, we have shown the most common statistic scholars use to represent NPAs, banks' ratio of gross non-performing assets to gross advances. Factors that do not reflect changes in the insolvency of firms can drive changes in this statistic. For instance, there was no NPA problem before the mid-1990s because the culture of Indian banking did not include the concept of



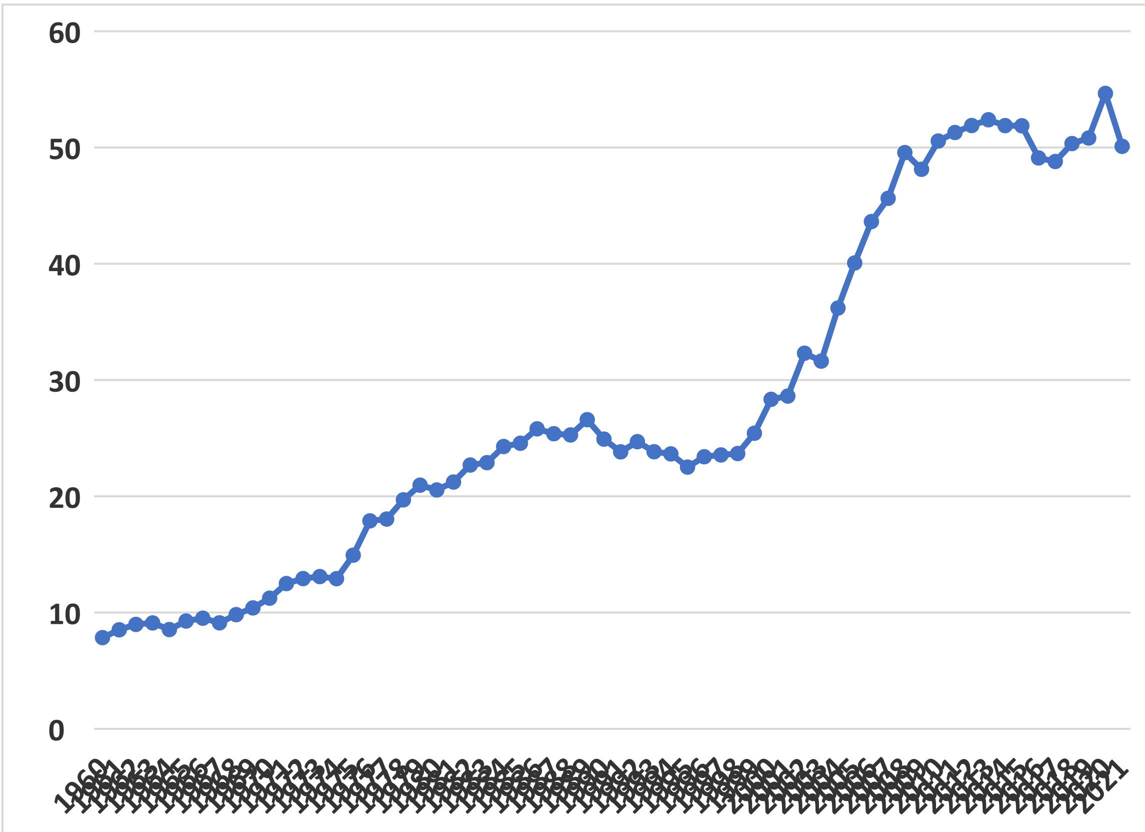
Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy, 2022-23* https://rbi.org.in/Scripts/PublicationsView.aspx?id=21860 .

NPA, and no such statistics were recorded. This did not mean that banks did not have bad loans or companies did not become insolvent. On the contrary, the number of "sick" companies -- a statistical category related to but distinct from insolvent companies -- rose steadily through the 1980s (Abraham and Omkarnath 2006). Statistics accounting for NPAs and consequent concern for NPAs as a problem came only after the banking sector gradually began to implement the 1991 Narasimhan Committee recommendations to adopt the Basel 1 norms for capital adequacy (p. 44) and use international accounting standards to measure non-performing assets. (p. 46).

Taking the steady decline of the GNPA ratio as an unqualified successful response to these changes is misleading. No doubt the "discovery" of the NPA problem and the consequent greater awareness by the banks and the RBI contributed to the decline, but much of the decline was driven by contextual factors, especially declining interest rates during the late 1990s, India's unprecedented rapid growth from 2003-2008, and the dramatic increase in bank credit during the decade from 1998 to 2008 which inflated the denominator of the GNPA (See Figure 4). There was also evidence that banks used accounting tactics to overstate the decline. The 1998 Narasimha Committee (p. 55) charged that banks were understating their NPAs by not counting bad loans with government guarantees. It also criticized the banks for "evergreening" (rolling over) loans to avoid classifying them as NPAs. The RBI was also complicit in facilitating the use of accounting measures to minimize the appearance of the NPA problem, especially when the GNPA ratio began to increase after 2011-12. The central bank initiated a series of loan restructuring programs -- e.g., Corporate Debt Restructuring in 2001, Joint Lenders Forum in 2014, 5/25 Scheme in 2014, and the Strategic Debt Restructuring in 2015 -- that not only enabled banks to move bad loans off their books, to the neglect of the insolvency of firms and the propensity of banks to accumulate bad loans, but also enabled overleveraged firms to borrow even more (Sengupta et al. 2016; Sengupta and

Vardhan 2017, p. 89). The government's repeated recapitalization of public sector banks also enabled banks to take bad loans off their books.

Figure 4: India's Domestic Credit to the Private Sector as % of GDP



Source: World Development Indicators Accessed at:

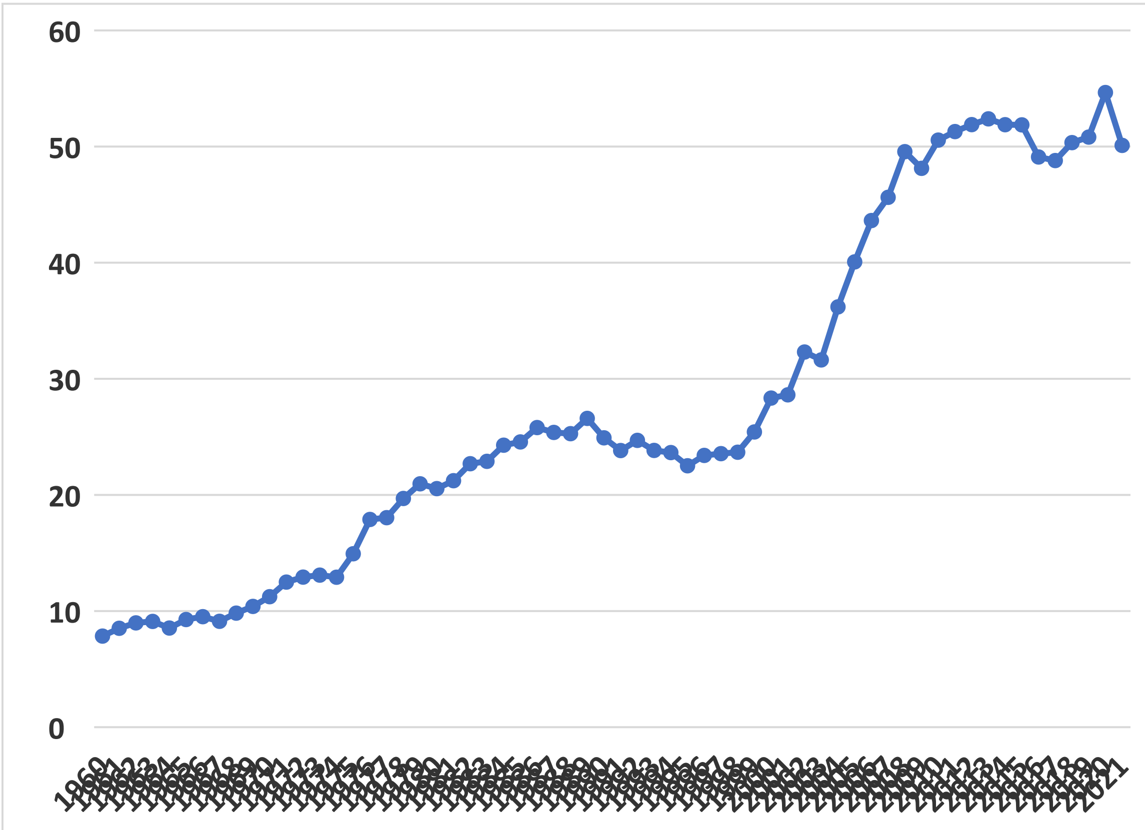
https://data.worldbank.org/ind

While accounting strategies to minimize the NPA problem persist to this day, three contextual developments contributed to the resurgence of the NPA problem from 2011-12 to 2017-18. First, beginning in 2003, the government increasingly opened infrastructure for private investment. Second, having wound up its development finance institutions at the beginning of the millennium, and in the absence of buoyant corporate debt markets, the government increasingly looked to the banks to help finance private sector infrastructure projects. The banks -- who were increasingly flush with deposits that had grown more than 17 times in current terms from 1996-97 to 2013-14 (Reserve Bank of India 2022a, 48) – were happy to oblige. The credit surge was extended when, in response to the 2008-09 global financial crisis, the RBI slashed interest rates between October 2008 and April 2009 from 9 percent to 4.75 percent and cut the bank's cash reserve ratio from 9 percent to five percent. As a result, there was an unprecedented surge in bank credit to the private sector. During the 15 years from 1998 to 2013, domestic credit to the private sector as a share of GDP more than doubled from 23.7% to 52.4% (See Figure 5). However, before the end of this rapid acceleration of credit growth, the United Front Alliance Government became plagued by policy paralysis. According to one report, 70 percent of infrastructure projects were stalled because of land acquisition disputes (Bandyopadhya 2021, p. 19). Power projects also suffered from problems with land acquisition. Also noteworthy was the inability of power generation companies to strike agreements for commercially viable prices with India's distribution companies, who were hard-pressed by powerful political interests to keep prices low. After the Supreme Court canceled the allocation of 204 coal mines in the wake of the Coalgate scandal, many thermal power plants were left without an assured coal supply.

Amidst these circumstances, declining economic growth, limited bank risk assessment capacity, and inadequate regulation conspired to increase the growth of

NPAs. The decline of economic growth after 2011 left many new projects with excess capacity. Inflation increased, and in response, the RBI began to raise interest rates. The

Figure 5: India’s Domestic Credit to the Private Sector as a Percentage of GDP



Source: World Development Indicators Accessed at:

https://data.worldbank.org/ind

resulting over-leveraged firms with plummeting profits increasingly defaulted on their loans, leaving the banks with mounting NPAs. As the RBI’s December 2017 *Financial Stability Report noted,* the banks’ deficient capacity for appraising long-term project viability exacerbated the problems presented by the challenging circumstances. The RBI added that many projects involved consortium lending whose appraisals were conducted by “professional merchant bankers with a built-in conflict of interest since they were paid by the borrowers. Public-private partnership (PPP) projects were also undertaken in project financing mode with high leverage. The exact implications of such risky projects implemented through the Special Purpose Vehicle (SPV) route were sometimes not clear to bankers.” (Reserve Bank of India 2017, 46-47).

The weakness of banking regulation by the RBI added to the problems. As noted above, the RBI's inability to remove public sector bank directors and managers or liquidate failing banks limits its regulatory authority. However, even with such authority, its regulation is likely to be ineffective due to its lack of market intelligence and weak regulation of banks' operational risk management and auditing systems. A clear example is the 2018 ICICI corruption scandal in which the CEO Chanda Kochhar chaired a committee deciding to give the Videocon group loans totaling Rs. 3 trillion. Videocon then transferred Rs. 640 million to Newpower Renewables, a firm owned by Kochhar's husband (*Business Standard* 2021). The ICICI later classified the Videocon loans as non-performing assets. The dubious transactions came to light, not because of RBI regulation but only after litigator Arvind Gupta, who runs an NGO to protect small investors, filed a court case. Former Principal Economic Advisor to the Ministry of Finance, Ila Patnaik (2018), perceptively noted that it is not clear whether the RBI's failure to detect problems was due to a lack of regulatory capacity or turning a blind eye to the problems. What is clear is that due to the nature of the RBI's political bargain with the government, there are almost no institutional mechanisms to hold the RBI accountable for its regulatory failures. The RBI is India's only regulatory agency that is not subject to audit by the central government's Comptroller and Auditor General, and the RBI's regulatory decisions can only be appealed to the Supreme Court.

Former RBI Governor Y.V. Reddy (2004) has raised the concern that the problem of India’s “credit culture” is a root cause of the banks’ limitations. Reddy observed (2004, 309) that banks, rather than conducting risk assessments of loans based on the circumstances of individual borrowers, were charging interest “on an attributable basis of a category… consistent with the ancient culture and legacy of planned administered interest rate(s).” Reddy (2004, 311) warned that simply increasing penalties for willful defaulters was not likely to be effective without a change in the “credit culture” among the banks and their borrowers that would imbue them with a “moral compulsion” to collect and repay loans. A decade later, another RBI Governor, Raghuram Rajan (2014), underscored the deep-rooted problem in his critique of India’s “riskless capitalism.”

The 2014 J.P. Nayak Report on bank governance issued far-reaching recommendations. It highlighted the importance of separating the government from bank governance and regulation. It recommended the creation of a Bank Investment Company (BIC) to serve as an autonomous holding company of government-owned bank equity. The report also recommended that the BIC replace the government in nominating board members. It urged the government to cease issuing regulatory instructions to public sector banks. It also attempted to level the playing field between the public sector and private banks by freeing the former from investigations by the Central Vigilance Commission, the Right to Information Act, and government constraints on employee compensation. The report proposed that RBI appointees step down from the bank board and that the RBI be authorized to impose penalties on bank board members responsible for evergreening. The recommendations targeted bank governance issues that were fundamental to the NPA problem. Virtually none of them were implemented. The inaction repeated the earlier failure to implement recommendations on restructuring bad loans made by the July 2012 committee on restructuring bad loans, chaired by B. Mahapatra (Bandyopadhyay 2021, p. 38).

Reluctant to address the problems of bank governance, beginning in 2014, the RBI began to take other measures to address the burgeoning NPA problem. In June it initiated the Central Repository of Information on Large Credits (CRILC), an online database that provides real-time credit information about borrowers with loans of Rs. 5 crore or greater. CRILC provides the RBI with better access to credit information and enables banks to check the credit history of corporate borrowers who apply for credit from one bank after allowing their loans to go bad at another. In June 2015, the RBI initiated a system-wide Asset Quality Review. It found that banks pursued all kinds of strategies to avoid classifying loans as non-performing. By April 2017, the RBI placed eleven troubled public sector banks and one private sector bank under a Prompt Corrective Action regime, including strict guidelines to limit their lending and prevent further capital erosion.

Having realized the immense scope of the NPA problem, the RBI looked to the 2016 Insolvency and Bankruptcy Code (IBC) to alleviate the predicament by more efficiently disposing of the mounting distressed assets. Prime Minister Narendra Modi later proclaimed, “With recapitalization and IBC, we have made Bharat’s banking system one of the strongest in the world.” (Modi 2024) However, neither recapitalization nor the IBC addresses the underlying causes generating NPAs. Though the IBC is a much-needed upgrade, it is an example of a reform layered on top of the governance issues that cause the NPA problem. It addresses the symptoms, not the causes.

The IBC improved India’s previous processes for disposing of distressed assets. However, the funds realized from the IBC have disappointed many, and lengthy delays have plagued its proceedings. Financial creditors recovered just under 32 percent of their claims as of March 31, 2024, though this percentage is lowered because 40 percent of all resolution cases became insolvent or defunct under the previous institutions and lost much of their value as they languished for years. Of the 7567 cases admitted to the IBC, 5647 have been closed; however, more than 25 percent were still ongoing (IBBI 2024, 11). The IBC initially stipulated a 270-day deadline for completing corporate insolvency resolution. As of March 2024, the average duration of the resolution process was 679 days (IBBI 2024, 3). The delays result from litigation by stakeholders with conflicting interests, the inclination of the National Company Labor Tribunal and other courts to intervene in the resolution process, and a lack of capacity of the NCLT to expeditiously adjudicate disputes (IBBI 2024, p. 3; Felman et al. 2022; and Nayak and Regy 2022). The government has recently recognized the need for increasing the NCLT’s staff to reduce delays. However, even after it augmented the NCLT’s member strength, as of September 2023, total NCLT members numbered 57, less than the 63 officially sanctioned member positions. (*Business Standard 2023*).

Recent government policies have attempted to minimize the NPA problem by promoting bank consolidation and forming a government-backed “bad bank” – the National Asset Reconstruction Company (NARC) – to purchase bad loans. These measures also do not address the causes of NPAs. While bank consolidation may promote economies in bank management, it does not alter the incentives that motivate bank managers to make decisions leading to NPAs. Though the NARC may take NPAs off the banks’ books, it will do so only to the extent that the cash-strapped government provides the trillions of rupees necessary to finance their purchase. Rather than reforming the incentives leading to NPAs, it may well create moral hazard, motivating bank managers to increase NPAs.

The failure to address the underlying causes of the banking sector’s NPA problem reflects deep-seated political forces that are a legacy of the dirigiste era. Until 2014, the RBI was willing to tackle the NPA problem only through limited measures to increase creditor rights, like the 2002 SARFAESI Act, or through restructuring programs that essentially whitewashed the problem through accounting measures. The RBI recoiled from implementing the J.P. Nayak Committee recommendations. Efforts by the RBI, beginning in 2014, to improve the reporting of NPAs met with strong pushback from bankers and the Indian Banks’ Association (Bandhyapadhyay 2021). Ultimately, the efforts to improve the reporting of NPAs and use the IBC to dispose of these distressed assets eroded the support in the banking sector for RBI Governors Raghuram Rajan and Urjit Patel. These issues, among others, contributed to the Modi government’s decision not to renew Rajan in 2016 and to Patel’s resignation in 2018.

The BJP continues to use banks as instruments to channel loans to small and medium enterprises to stimulate the economy in the wake of the COVID-19 pandemic despite the danger posed to the banks' long-term financial health. Except for the IBC, the Bharatiya Janata Party has not supported policies that address the root causes of the banks' NPA problem. The exception proves the rule. The government's support for its own IBC has been tepid at best. Not only have the BJP's recent policies limited the effectiveness of the IBC, but the Modi government's failure also to adequately staff the National Company Law Tribunal (NCLT), the legal body responsible for processing IBC cases, is central to the IBCs problems.[7]

At the end of 2021-22, many touted the end of the NPA problem as the share of NPAs to total advances fell to only 5.8%.[8] However, while the three primary reasons for the NPA decline may reduce the value of NPA statistics, they do not alleviate the underlying causes of the NPA problem. First, banks wrote off many loans. In the last nine years, banks wrote off loans worth Rs.14.56 trillion (*The Economic Times,* 2023). Second, there was an effort to recapitalize banks from the Union Budget. In August 2015, the Union Government announced the "Indradhanush plan" for revamping public sector banks. From 2016-17 to 2020-21, the government infused more than $37 billion into the banks, of which $33 billion were through recapitalization bonds (Shridhar 2023). Third, bank credit growth fell to a low of 5% by September 2020, while deposit growth remained robust at 10.3% (Reserve Bank of India, 2021). Several commentators have argued that new NPA creation has declined due to the banks not lending to the industry. As of the fourth quarter of 2022-23, the growth in new loans by banks to industry was

6.2%, while the growth in loans to services and personal (or individuals) was 15.9% and 14.7% respectively (Reserve Bank of India, 2023). This has led to concerns that the NPAs resulting from personal loans may rise in the future (Livemint, 2023).

None of these measures provide any comfort that a new NPA crisis will not reappear. While the government had indicated that recapitalization would be contingent on reforming public sector banking, it has not taken any significant actions to improve PSU bank governance or strengthen the RBI's banking regulation. The Committee on Banking Sector Reforms of 1998 (the Second Narasimham Committee) had suggested that the minimum shareholding of government in public sector banks be reduced to 33%. There has been only limited movement towards a reduction of government ownership (Kaul, 2022).

How Political Bargains Structure the Technological Dynamism of India's Payment System

India has witnessed a transformation of its payment systems. As of March 2024, there were 1 billion debit and credit cards in India. The value transacted through payment channels in India in FY2022-23 was USD 25 trillion (Reserve Bank of India, 2023, Table 62, page 116). India's payment system processes over 260 million transactions daily, two-thirds of which are handled by its Unified Payments Interface (UPI) (Reserve Bank of India 2022b). Efforts are underway to deploy the UPI platform, as well as the domestic card called Rupay, in international markets (National Payment Corporation of India, 2022). In this section, we describe the dynamic evolution of India's payment system. As in the case of the NPA problem, political bargains have structured the trajectory of change in India's technologically dynamic payment system.

A payment system a) transfers and authenticates information between different transaction partners and b) allows for the settlement of funds to complete a transaction. The settlement infrastructure in India consists of three systems: 1) the "Real Time Gross Settlement System (RTGS)"[9], operationalized in 2004 and restricted to banks (and a few non-banks permitted by the RBI); 2) the National Electronic Funds Transfer (NEFT)[10] and 3) the Immediate Payments Service (IMPS).[11] This infrastructure is the basis for the five main channels of payments:

1. The traditional channel of moving money through cheques issued by banks.

1. Internet banking through the NEFT and IMPS

1. Debit and credit cards, currently dominated by Visa and Mastercard, but including the government-promoted, domestic rival Rupay

1. Mobile payments offered by Third Party Application providers (such as Google Pay, PhonePe etc), where information exchange is facilitated through the United Payments Interface (UPI), while clearing and settlement is through the IMPS.

1. Prepaid wallets that facilitate the purchase of goods and services against the stored value on such instruments.

Synergies Between Government of India and the Reserve Bank of India

In the late 1990s, the RBI raised concerns about the backwardness of the Indian payment system. Some of these concerns resulted from the analysis of the Committee on Payment and Settlement Systems (CPSS) of the G-10 countries set up under the Bank for International Settlements (BIS). Concluding that sound payment and settlement systems played an important role in ensuring financial market stability and efficiency, the CPSS delineated best practices in its Core Principles for Systemically Important Payment Systems (SIPS) (Bank for International Settlements, 2003). The RBI adopted these principles.

The RBI began modernizing India's payment system by creating the National Financial Switch (NFS),[12] and the Real Time Gross Settlement (RTGS) system in 2004. The RBI circulated a vision document on digital payments in 2005 describing a new institutional structure for retail payment systems making it the payment system regulator. The vision document also laid the foundation for setting up a new entity to undertake the clearing function, and enacting the Payment and Settlement Act, 2007.

The RBI established the National Payments Corporation of India (NPCI) in 2009. It authorized this private limited, bank-owned, non-for-profit company to be the sole developer and operator of inter-bank online retail payment systems. Today, the NPCI owns and operates some of the core payments infrastructure and applications including the NFS, the IMPS settlement system, UPI, the Rupay card, Bharat Bill Payments,[13] Aadhaar-enabled payments,[14] FASTag or Toll collection systems,[15] the National Automated Clearing House,[16] and a USSD-based payment system.[17] Many of the payments (and digital) innovations in India have been developed by private players with the government's endorsement. They rest on a collection of Application Programming Interface (APIs) called the "India Stack" developed by Indian Software Product Industry RoundTable (iSPIRT), a private think tank based in Bangalore.

The National Democratic Alliance (NDA) promoted payment system innovation after it assumed office in 2014. One core policy initiative was the development of Direct Benefit Transfers (DBT) enabling the government to directly transfer funds to the bank accounts of welfare scheme beneficiaries. The DBT was facilitated by a program initiated in 2014 to open bank accounts for those outside the banking system called the PM Jan Dhan Yojana (PMJDY) (Ministry of Finance, 2022). It also required using the Aadhaar biometric unique ID (Unique Identification Authority of India, 2022) and Mobile (JAM) trinity to authenticate users and establish a network transfer funds *(Business Line*, 2018). Establishing Direct Benefit Transfers is an integral part of the NDA government's Digital India program, one of the most important initiatives of the NDA government aimed at transforming India into a digitally empowered knowledge economy and society (Ministry of Electronics & IT, 2022). The government's November 8, 2016, demonetization policy has provided further impetus to increase the use of digital payments (*The Economic Times*, 2021).

The government has continuously relied on the products of the NPCI to realize its digital ambitions. The RBI has been a willing participant in the provision of products to meet the government's policy objectives. For example, the RuPay card resulted from the government's desire to have a "home-grown", domestic card scheme. It found a place in the RBI 2009-2012 Vision Document Report, which stated the need for a domestic card and a PoS switch network to drive down the costs that domestic banks paid to the international card network dominated by Visa and Mastercard (Reserve Bank of India, 2010). The NDA government has aggressively promoted the Rupay card since 2014 by encouraging bank and government employees to use it as a patriotic act and by linking all its schemes to the card (Ministry of Finance, 2014). Another example of the government's reliance on the NPCI is the FASTag system rolled out by the Ministry of Road Transport and Highway (MoRTH) for online toll collection in 2014, expanded in 2016 (Press Information Bureau, 2016), and made mandatory since February 2021. The government further plans to integrate the FASTag system with the E-Way Bill (EWB) of the Goods and Services Tax (GST), allowing officers to get real-time data on GST violations by businesses transporting goods, as their vehicles pass toll plazas (Palepu, 2021).

The government and RBI reinforce each other's policies as their approach to the Merchant Discount Rate (MDR) illustrates.[i]In 2012, the RBI asked banks to cap the MDR for debit card transactions. The MDR rates were temporarily revised in December 2016 to promote increased use of card payments amid the demonetization drive. In February 2017, the RBI announced its decision to absorb the MDR charges for debit card transactions imposed by acquiring banks on payments made to the Government of India. In December 2017, the Ministry of Electronics and Information Technology (MeitY) promoted the acceptance of digital payments among small-scale businesses by exempting

MDRs for merchants on low-value transactions. The RBI inserted section 10A into the Payment and Settlement Systems Act, 2007 (PSS Act) to prohibit banks and system providers from charging transaction participants using Rupay debit cards, UPI, or the BHIM-UPI QR Code. In each instance, the government and the RBI have moved in tandem, demonstrating that they have largely been in sync on digital payments.

Economic Nationalism and State Control

Though the NDA government and RBI have shown great initiative in building and deploying digital systems, their policies' emphasis on state control and economic nationalism is reminiscent of India's "industrial policy" during its dirigiste era. The government offers a novel justification for its control over the payment system by declaring that it is creating "digital public goods" that provide citizens with "low-cost, high-volume, trusted transactions (Chandorkar, 2022). Nevertheless, its controls on financial service provider entry and placing the RBI and India's public sector banks at the system's center raise questions about India's payment system design relative to alternative designs.

The government has made the RBI the primary architect and regulator of the payment system, and the RBI has designed a system in which public sector banks play a dominant role. The RBI has historically prioritized financial stability, and it allotted a large role to public sector banks while restricting the roles of private sector banks and non-bank participation because it was concerned that they might destabilize the market.

The critical roles of the RBI and banks also provide the government with levers of influence.

In 2002, the RBI Report of the Working Group on Electronic Money (Reserve Bank of India 2002) recommended restricting the full use of electronic money to scheduled commercial banks while permitting very limited participation of non-banks. The report's intention is clear - additional participants should be included only as long as they did not disadvantage banks. This philosophy continues to this day.

Under the current system, while non-banks can be payment system providers (PSPs), only bank-led PSPs have direct access to payment systems, and non-bank PSPs can access payment systems only through a member bank PSP. The RBI and government have restricted ownership of the NPCI, the sole owner and operator of the payment system, to a consortium of banks. The PSS Act explicitly prohibits the setting up a clearing house where public sector banks do not hold at least 51% of the equity. Non-bank entities were allotted shares by private placement only in 2020. However, their shareholding amounts to only 4.63% (Panda, 2020). Even though, technically, the NPCI is a Section 8 company,[18] its shareholding by public sector banks raises concerns about it being indirectly owned by the government. Since the NPCI has been authorized to license operators and third-party apps on its platforms, it has become a de facto regulator. On August 18, 2020, the RBI issued a framework on “New Umbrella Entities” (NUEs) to allow private players (both for and not-for-profits) to offer clearing services to compete with the NPCI (Reserve Bank of India, 2020). However, after consortia, including

Amazon, Google, and Facebook, along with some of India's largest and most dynamic private sector actors like Reliance, Tata Group, and ICICI Bank placed bids for NUE licenses, bank unions protested the new policy. The RBI suspended it and convened a five-member committee to study the applications and submit recommendations regarding data storage and localization concerns (Mishra and Manikandan, 2021). The government was reportedly uncomfortable with the RBI proposal permitting private sector players to apply for NUE licenses. It preferred that India's payment system be treated as core infrastructure, implying that control would remain with government entities (Sidhartha, 2020).

The government and the RBI often favor NPCI initiatives even when they appear detrimental. For example, they have supported UPI's BBPS architecture developed by the NPCI even though technology trade journal *Medianama* charged that UPI had become a "wallet killer" because established payment gateways and bill payment companies were pushed into using it despite their capacity to transfer funds directly between people and merchants (Palepu, 2020a). The government has directed banks to promote RuPay cards over other card networks, so much so that Visa complained to the US government about a lack of a level playing field (*The Times of India*, 2021). The finance minister directed bankers to discourage non-digital payments as much as possible and promote digital payments and the Unified Payments Interface (UPI) driven payment system in an attempt to ensure that NPCI becomes a brand India product that can be promoted elsewhere in the globe (Palepu, 2020b).

Government control of India’s payments space has excluded technology companies. In jurisdictions such as Africa (m-pesa) and China (WeChat and Alipay), technology companies intermediate payments. India’s policies ensure that banks intermediate payments.[19] Given the dominant share of public sector banks in the sector, this provides the government with control over payments should it decide to use it. There are instances where the government has intervened to exercise its influence. For instance, the RBI forced the NPCI to hire the government’s preferred candidate as its CEO (Srivas, 2018).

The government has repeatedly used "protecting national sovereignty" and "national security" to justify its digital policy. The RBI issued data localization guidelines for all payment companies operating in India in 2018. The US government criticized these as disadvantaging global firms (The Office of the United States Trade Representative, 2021). The Indian government also proposed imposing data localization norms through the draft Data Protection Bill, 2021, which requires sensitive and critical personal data to be stored in India. There have been concerns that such requirements will hurt Indian start-ups (Mitaksh, 2022). The Digital Personal Data Protection Act, 2023, came into force in August 2023. It allows for cross-border data transfers to all jurisdictions unless they have been specifically barred, thus allowing for more flexibility than the draft law. The Western governments' decision to cut Russia's access to the SWIFT international payment system in the wake of the war in Ukraine has strengthened the Indian government's economic nationalism as a factor shaping the development of its payment system (Sharma, 2022). Technology analyst Nikhil Pahwa has expressed the concern that the government's economic nationalism may drive out private sector initiatives in the short term and lead to a "lock-in" to existing systems with pervasive state surveillance in the medium to long term (Pahwa, 2016). Smriti Parsheera argues that the government's policy has promoted "alt big tech" that will likely stymie competition, innovation, and the public interest in the long run (Parsheera, 2022).

Conclusion

This study of India's banking sector contributes to sector-centered, multilevel analysis by revealing how political bargains institutionalize actors' relationships in sectoral political networks. Each political bargain we have studied reflects the efforts of a powerful actor to perpetuate their influence over another actor in the network. These political bargains are one way that inequalities of power are entrenched in the institutions of modern societies (Pierson 2015). The institutionalization of political bargains perpetuates power asymmetries in ways that shape long-term sectoral development.

We have analyzed two types of bargains. Politicians established an entrenched bargain by nationalizing the banks to institutionalize their influence over bank governance to advance their political and economic goals. The bargain has led to repeated difficulties with non-performing assets and the need to spend billions of rupees to recapitalize the banks. Despite these problems and the government's own analysis by the Narasimhan and P. J. Nayak committees identifying governance as a problem, little substantial action has been taken to reduce the political control over public sector bank governance. The reforms that have been implemented have been layered on top of the governance problem. At best, they have addressed the symptoms and not the underlying cause.

The principal-agent bargain between the government and the Reserve Bank of India has been more dynamic. After the nationalization of the RBI and its assumption of a subservient position in the planning era, the central bank bolstered its bargaining power by accumulating expertise, legitimacy, and political allies. The advance of global markets for trade and finance, along with the emergence of an international consensus on monetarism and central bank independence, further strengthened the RBI's negotiating position. These developments enabled the central bank to resist government initiatives to liberalize the financial sector. Nonetheless, the RBI has remained the government's agent, and the government has relied on the central bank to develop the country's technologically dynamic digital payment system. The RBI has positioned India's public sector banks at the center of the new system, relegating private sector actors to a peripheral role. The power of the government over the sector enabled the Modi government's economic nationalism to shape the development of the payment system. The Modi government promotes the payment system as an alternative to Western private sector-based systems and a source of potentially lucrative financial service exports. However, serious concerns remain about whether a digital payment system centered on the RBI and banks can maintain the technological dynamism necessary for success.

Our study raises vital issues for future research. We have examined two types of political bargains in India. We can advance our understanding of political bargains by investigating similar bargains in other sectors and countries. We need a much better idea about the mechanisms that enable bargains to persist or that may undermine them. The two political bargains we examined do not exhaust the varieties of political bargains that may be struck. Studies of other categories of political bargains and how they shape trajectories of sectoral development are likely to add novel insights.

This essay's analytical focus and the other contributions to this special issue have prioritized explaining the developmental trajectories of various Indian economic sectors. This sectoral-centered analysis is an essential first step in explaining the variegated economic development of India's large, diversified economy. However, India's political economy is more than the sum of its sectoral parts. A vital issue for future research is investigating linkages between sectors. This will not only enhance our comprehension of sectoral development but will also enable us to understand better the developments at India's national level and, ultimately, the economic development of other large emerging economies around the world.

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End Notes

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[1] For instance, the RBI opposed many of the reforms recommended by the Ministry of Finance's 2013 Financial Sector Legislative Reforms Committee such as the Financial Redressal Agency (Interview with Dhirendra Swarup, FSLRC member and chair of the committee to make recommendations to the government on the FRA, August 16, 2018), and it secured concessions to protect its interest in the establishment of the Monetary Policy Committee (Interview with former finance secretary Rajiv Mehrishi, June 10, 2022).

[2] In 2022, the chairman and two of the three deputy chairmen were from public sector banks. The overall membership of the managing committee included twelve public sector banks, five private sector banks, one payments and small finance bank, four foreign banks, three cooperative banks, and three all-India financial institutions. See https://www.iba.org.in/managing-committee.html accessed on May 1, 2022.

[3] For instance, when the government was designing its bad bank to take on the banks' non-performing loans, the IBA lobbied for the bad bank to purchase at book value accounts where fraudulent activities had been detected. Saloni Shukla, "Why the Bad Bank Plan Could Hit a Wall," *The Economic Times* May 16, 2020.

[4] "FinMin Asks Banks to Keep Tight Watch on Cash Deposits," *The Economic Times* December 13, 2016.

[5] Indian Banks' Association, https://www.iba.org.in/payment-system/umbrella.html accessed on May 1, 2022.

[6] Online interview May 16, 2022.

[7] M.S. Sahoo, chairman of the Insolvency and Bankruptcy Board of India from 2016 to 2021, emphasized the lack of administrative capacity of the NCLT. He stated, "The NCLT currently has 60 members when it needs 360." Interview on June 7, 2022, in New Delhi. The inadequacy of NCLT staffing persists even after the November 2022 appointment of 15 additional judicial technical members.

[8] CMIE Economic Outlook, Classification of Advances: All Scheduled Commercial Banks

[9]The RTGS allows for a continuous and real-time settlement of fund transfers, individually on a transaction-by-transaction basis (without netting).

[10]The National Electronic Funds Transfer (NEFT) is a nationwide centralized payment system owned and operated by the Reserve Bank of India.

[11]The IMPS allows for a real-time transfer of funds between the remitter and beneficiary with a deferred net settlement between banks, through the RTGS.

[12]The NFS is a shared network to manage transactions across more than 250,000 ATMs in the country

[13]The BBPS is an interoperable payment system that connects all bill payers to all types of billers including utility providers, education, broadband, and others

[14]The payment system uses Aaadhar-based bio-metric authentication to send/receive or withdraw/deposit funds. This includes the Aadhaar Payment Bridge System (APBS) to enable direct benefit transfer of funds to Aadhaar seeded bank accounts, and the Aadhar Enabled Payment System (AePS) that made it possible for low-income individuals to make payments with their Aadhaar-linked bank accounts.]

[15]An automatic payment system for toll booths on highways, wherein funds are deduced from linked e-wallet.

[16]Facilitates automated payments, debit or credit, be it for loans, insurance premiums, investment contributions or others.

[17]This is similar to UPI, but works across all GSM handsets (smartphone or otherwise)

[18] A Section 8 company under the Companies Act, 2013 is a non-profit organization (NPO).

[19] India is not unique in its preference for a bank-dominated payment system. Several countries in the OECD have also adopted a similar approach. The distinction is that banking is not dominated by the public sector in these jurisdictions.