Indian Banking Sector Reforms: The Unfinished Agenda

Dr. Rupa Rege Nitsure

“Free Enterprise was born with man and shall survive as long as man survives”.

- A. D. Shroff
Founder-President
Forum of Free Enterprise

SHAILESH KAPADIA

(24-12-1949 – 19-10-1988)

Late Mr. Shailesh Kapadia, FCA, was a Chartered Accountant by profession and was a partner of M/s G.M. Kapadia & Co. and M/s Kapadia Associates, Chartered Accountants, Mumbai.

Shailesh qualified as a Chartered Accountant in 1974 after completing his Articles with M/s Dalal & Shah and M/s G.M. Kapadia & Co., Chartered Accountants, Mumbai. Shailesh had done his schooling at Scindia School, Gwalior and he graduated in Commerce from the Sydenham College of Commerce & Economics, Mumbai, in 1970.

Shailesh enjoyed the confidence of clients, colleagues and friends. He had a charming personality and was able to achieve almost every task allotted to him. In his short but dynamic professional career, spanning over fourteen years, Shailesh held important positions in various professional and public institutions.

Shailesh's leadership qualities came to the fore when he was the President of the Bombay Chartered Accountants' Society in the year 1982-83. During his tenure he successfully organized the Third Regional Conference at Mumbai.

Shailesh was member, Institute of Fiscal Studies, U.K.; member of the Law Committee and Vice-Chairman of the Direct Taxation Committee, Indian Merchants' Chamber. He was also a Director of several public companies in India and Trustee of various public Charitable Trusts.

He regularly contributed papers on diverse subjects of professional interest at refresher courses, seminars and conferences organised by professional bodies.

Introduction

The Forum was founded by Mr. A.D. Shroff, who was a titan in the field of Banking and Finance. The Forum and The A. D. Shroff Memorial Trust have been in vanguard of spreading economic education of which A. D. Shroff and later Nani Palkhivala were the prime movers. The A.D. Shroff Memorial Trust last year launched a monumental treatise “BARONS OF BANKING” which chronicles the evolution of Indian Banking in the last century highlighting the contribution of six stalwarts.

Hence we are pleased to release this booklet by Dr. Rupa Nitsure titled “Indian Banking Secor Reforms: The Unfinished Agenda”. This is indeed the opportune time to release it when “Financial Inclusion” is at the top of Government’s agenda. Nitsure has the right credentials to write a paper on this subject, given her excellent economic grounding in Economics and her wide exposure of banking in one of our leading PSU Banks.

She has beautifully and succinntly analysed and dissected the strengths and weaknesses of our present banking structure and suggested doable solutions. As the Prime Minister himself is so desirous of spreading the banking habit to reach the entire population within the next few years which undoubtedly is an admirable goal as 40%

of our population still do not have access to even elementary banking facilities.

However, in a wide and diverse country, with such varying levels of development and infrastructure, this will be a herculean task. Nevertheless it is not beyond our capabilities. The few private sector banks set up in the last 15 years have a commendable record of rapid growth combined with high profitability and superior quality of service. Some of the PSU banks which are well capitalized and managed have given a fine good account of themselves in spreading the banking habit far and wide despite the several constraints under which they operate. This amply demonstrates that given the right enabling environment for growth in the banking sector, supported by a contemporary managerial structure with considerable operational freedom devoid of political interference, we can achieve PM's laudable aim.

Indian banks made impressive strides in the last decade through application of information technology besides opening of large number of branches. ATMs were added and scope of internet banking, mobile banking, phone banking and call centers extended. This did improve to some extent the efficiency of banks. Despite this extension the county faces a huge challenge of inadequate penetration and financial exclusion. Consequently spread of banking is relatively modest compared with other countries in East Asia. In rural India,

North Eastern region, this inadequacy is particularly marked.

However, what is important is to note that hereafter the thrust will be on the growth of industry and infrastructure which would call for greater dependence on external sources of medium and long term finance from banks and specialized institutions besides private capital. In the recent Indian budget the initiative taken for setting up an Infrastructure Debt Fund as also allowing banks to raise long term bonds with certain exemptions is a welcome initiative.

The micro, small and medium enterprises sector, which is the back-bone of India's economic development, faces severe constraint in raising finances. The major handicap to expansion in this sector is non-availability of adequate and timely finance owing to the relatively high risk involved due to increasing NPAs. Besides, the banks have been adopting a more cautious approach while the access to capital markets is limited. The announced proposal to establish a Rs. 10,000 crore fund for MSMEs, is a forward looking step to help attract private capital for providing equity, soft loans for start up companies.

The recent report submitted by the P. J. Nayak Committee makes eminently pragmatic recommendations which deserve careful study and speedy implementation, with some changes which may be deemed necessary. However, the

overarching objective of the government to retain the public sector characteristics of PSU banks must be revisited in the light of experience. The “golden share” concept must be seriously considered so that the government can retain control over some policy issues within its ambit. This is imperative as PSU banks require massive recapitalization and induction of first class managerial talent to keep pace with the envisaged higher rate of economic growth and increasing globalization of the economy.

The new Pradhan Mantri Jan Dhan Yojana now proposed, providing two bank accounts each to 75 million poor families, an overdraft of R.5,000, accident insurance cover of R.1 lakh and a life cover of Rs.30,000, is a very laudable Scheme. It is reported that many people paraded by banks on the first day as new account holders turned out to be account holders already. The Yojana will require sustained efforts for several years with emphasis on quality rather than speed.

Dr. Nitsure’s paper is a very comprehensive and incisive one, lucidly written which deserves debate and reflection

Minoo R. Shroff
President
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Indian Banking Sector Reforms: The Unfinished Agenda

by

Dr. Rupa Rege Nitsure*

Many global think tanks had described India as a country of "endless unrealized potential" during the India shining phase of 2004-2012. Unfortunately, the country witnessed the worst kind of growth deceleration from an average of 8.5% in 2005-12 to 4.5-4.7% in the past two years. While global slowdown in the aftermath of global financial crisis could be blamed to a certain extent, several domestic factors like high inflation, slowing investments, undesirable levels of fiscal and current account deficits and volatile exchange rate played a much larger role in pulling down India's economic performance. The banking sector, being the mirror image of the real economic activity, has borne the brunt of this slowdown.

India's banking industry, valued at $1.8 trillion in 2012-13 (Source: IBEF) has been growing at a much slower pace since 2011-12 and is plagued by

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huge amounts of bad loans. According to Morgan Stanley Research, impaired loans in Indian banks are now at almost 12.0% compared to less than 5.0% three years ago. This has caused profitability and capital levels of a large part of the banking system to come off sharply. Public sector banks (PSBs) with a share of 73.0% in India's total banking system assets are the worst hit, as they have to work in close partnership with the Government of India to fulfill its national economic agenda.

According to Reserve Bank of India (RBI), a steep increase in bad loans of Indian banks accompanied with low capital levels has created challenges for India's financial stability. There is also a risk that banking sector problems may cause the next slowdown in the economy due to the banks' reduced capacity to dispense credit. Hence, one of the first steps that India's new government is expected to take is to fix the banking system.

Before getting deeper into the current issues and challenges facing the Indian banking sector, it is pertinent to understand how this sector has evolved in India in the post-Independence period.

Evolution of Indian Banking Industry

India has a large bank-dominant financial system similar to Japan and Germany and during 1947-2014, it witnessed three major structural breaks, notably, bank nationalization of 1969, initiation of economic and banking sector reforms in the early 1990s, and the high growth phase of the

2000s. Over the years, the reach of Indian banks has widened significantly. As per the RBI data, Commercial Bank Credit as per cent of GDP picked up steadily from 5.8% in 1951 to 56.5% by 2012. Also, the population per bank branch came down from 64,000 in 1969 to 12,300 in 2012.

While nationalisation of 14 Indian banks in 1969 and six more in 1980 facilitated geographic penetration of the banking sector, its core performance deteriorated significantly. Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15%, while capital and reserves averaged about 1.5% of assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated the banks' true performance. Further, in 1992-93, non-performing assets (NPAs) of 27 PSBs amounted to 24.0% of total credit, only 15 PSBs achieved a net profit, and half of the PSBs faced negative net worth. The major factors that contributed to deteriorating performance of Indian banks between 1969 and 1993 included high levels of resource pre-emption in the form of CRR (Cash Reserve Ratio) and SLR (Statutory Reserve Ratio); administered interest rates on loans and deposits, stringent norms for priority sector lending, lack of competition, etc. The prolonged involvement of government bodies in the business of commercial banks gave rise to an inefficient resource allocation and excessive concentration of power in few banks.

A vital link between the degree of development of the banking sector and economic growth is well recognized in economic literature. Given the critical importance of banking reforms in India's post economic liberalization phase (post 1991-92), a considerable amount of effort was concentrated on the issue of designing an optimal banking system as a major element of India's structural reforms.

Banking reforms introduced since 1992-93 primarily included easing of regulations that had restricted competition; introduction of prudential norms for income recognition, asset classification, provisioning for delinquent loans and capital adequacy; gradual reduction in the pre-emption of bank resources through SLR and CRR; de-regulation of the banks' deposit and lending rates in stages, new legislation for recovery of debt due to banks and the setting up of special recovery tribunals; liberalisation of lending norms and widening of the scope of priority sector lending; introduction of Basel norms and issuance of guidelines for risk management systems in banks encompassing credit, market and operational risks; guidelines to set up asset-liability management systems consistent with the international best practices; establishment of Credit Information Bureau to identify bad risks and introduction of derivative products like Forward Rate Agreements (FRAs)and Interest Rate Swaps (IRS), etc.

These changes resulted in the entry of new private sector banks and foreign banks into the market,

leading to increased competition. To a certain extent, reforms did improve the banks' efficiency and financial soundness ratios and led to the expansion of bank credit. Between 1992-93 and 2013-14, the total credit outstanding of Scheduled Commercial Banks (SCBs) increased from Rs 1,548 billion to Rs 59,941 billion, reflecting a CAGR of 19.0%. Total number of offices of SCBs too increased from 62,774 in 1992-93 to 100,805 in 2011-12. The banks' Non Performing Loans as per cent of Total Advances declined from close to 24.0% in 1992-93 to 2.25% in 2010-11 before again rising to 3.23% in 2012-13 due to the recent economic slowdown.

The growth in the banking sector's assets and business since the year 2000-01 was driven by India's rapid economic growth and was accompanied by a substantial rise in the nation's savings and investment rates. Before the onset of economic slowdown in the past few years, India's savings and investment rates had peaked at 36.8% and 38.1% of GDP, respectively, in 2007-08.

A rapid growth of Indian banking in the decade following 2000-01 was facilitated by the applications of information technology (IT). The IT brought about a total change in the face of Indian banking. During 2000-2010, more than 14,000 branches and 41,000 ATMs were added by Indian banks to their network, besides broadening the scope of delivery channels to internet banking, mobile banking, phone banking and call centers. While branches

continued to remain the key sale and service outlet, alternate channels like ATMs, point of sale terminals, internet and phone banking multiplied the transactions for several tech-savvy banks. The computerisation and use of technology in banks helped in a number of ways. They not just brought down costs of operations and transaction costs for customers but also improved customer service and both front and back end operations.

The industry became more efficient over the years. Currently, Indian banks are focusing on a number of IT products especially EFT (Electronic Fund Transfer) which is comprehensive, flexible and cost effective alternative to cash and paper payments. The large value electronic payment systems, viz., Real Time Gross Settlement System (RTGS) and the Retail Electronic Payment Systems, viz., National Electronic Clearing Services (NECS and ECS), National Electronic Fund Transfer (NEFT) and Card Payment Systems are the electronic payment systems available in India at present.

Responding to the changes in macro-economic environment post 2000-01, banks in India began to adopt a universal banking structure- covering all aspects of finance – wholesale as well as retail – were made available within a single institution. They developed capabilities to offer a suit of structured finance and derivative solutions to corporate and a range of products like term finance, working capital loans, mergers & acquisitions, trade finance, foreign exchange and derivatives. They started catering to

consumption demand through retail products like home, vehicle, educational loans. Several banks entered the businesses like insurance, asset management, broking and distribution of third party products to boost their fee-based income.

Current Structure of Banking in India

Institutions that serve as financial intermediaries in India can be divided into four broad categories- Commercial Banks, Cooperative Institutions, Financial Institutions and Non-Banking Financial Companies. Most banks in the category – Commercial Banks are Scheduled Commercial Banks (SCBs), which include PSBs, private sector banks, foreign banks and regional rural banks (RRBs). As stated earlier, PSBs account for 73.0% of the market in terms of total assets. RRBs were established in the 1970s to provide credit to the agriculture sector. But the number of RRBs has fallen sharply in recent years as a result of government-initiated restructuring.

The second category is Cooperative Institutions that are divided into Urban Cooperative Banks (UCBs) and Rural Cooperative Banks (RCBs). The number of UCBs, which provide credit in cities and surrounding areas, increased dramatically in the early 1990s but has declined somewhat in recent years, in part because of financial weakness. The RCBs provide short-term and long-term agricultural credit and housing loans in the rural areas.

The third category is Financial Institutions (FIs) and as per the Economic Survey-2013-14, there are four FIs under the regulation and supervision of the RBI currently. These are Export-Import Bank of India (EXIM), National Bank for Agriculture and Rural Development (NABARD), National Housing Board (NHB), and Small Industries Development Bank of India (SIDBI). Here, it is necessary to mention that India's government adopted a policy of converting development financial institutions into banks (primarily to give them access to low-cost deposits as a major source of finance) and ICICI became a bank in 2001, followed by IDBI in 2004.

Non-banking financial Companies (NBFCs) make up the fourth category. The three main types of NBFCs are asset finance companies such as leasing companies, loan companies, including those involved in consumer finance and housing finance, and investment companies, including investment trust companies and insurance companies. Some institutions in this category are also able to accept deposits. As a result of the changes to the RBI Act since the second half of the 1990s, NBFCs are now required to register with the RBI. After this, the number of NBFCs declined dramatically.

As per the RBI's latest database, India has 89 SCBs, out of which 26 belong to public sector, 20 to private sector and the remaining 43 are foreign banks. Total number of RRBs stand at 64 compared to 196 earlier as a result of amalgamation since

the year 2005. Total NBFCs in India at present are 12,029 of which deposit taking NBFCs are 241. On April 2, 2014 the RBI gave in-principle approvals to infrastructure financier IDFC Ltd. and micro-lender Bandhan Financial Services Pvt. Ltd. to start new banks. These approvals will be valid for 18 months, during which the two companies will have to comply with rules stipulated by the RBI.

Despite such varied and developed banking system, India faces a huge challenge of inadequate penetration and a large extent of financial exclusion. Its banking sector remains relatively small compared with those of most East Asian economies. According to RBI, rural India had only 7 branches per 1,00,000 adults in 2011 in sharp contrast with most of the developed and even BRICS economies having over 40 branches. Within India, north-eastern, eastern and central regions are most excluded in terms of banking penetration.

Looking ahead, India's growth will be driven more by industry and infrastructure, which are known for their higher dependence on external sources of finance. As per the RBI estimate, in order to support an economic growth of 8.0% as envisaged by the 12th Five Year Plan, banking business needs to expand significantly to an estimated Rs 288 lakh crore by 2020 from about Rs 115 lakh crore in 2012.

As Indian banking industry faces several critical and complex challenges, there is a need to find

solutions with a sense of urgency in order to fulfill India's aspirations for higher growth.

Challenges Facing Indian Banks & Possible Solutions

1. **Infrastructure Financing:** Based on projections provided in the Mid-Term Appraisal of the 12th Plan, in order to attain a 9.0% real GDP growth rate, infrastructure investment should be on average almost 10.0% of GDP during this plan period. This translates into Rs 41 lakh crore at 2006-07 prices (real terms), as estimated by the Planning Commission (PC). The PC expects 50.0% of this to be funded out of the bank finance. This looks difficult as lending for a long duration is always a challenge for banks that typically source funds for a shorter time span in the form of current and savings deposits or term deposits up to three years. Moreover, after the huge NPAs created by Indian banks in their infrastructure loan-book in the last four years, we expect them to become risk averse to lending to infrastructure.

   Solution: The government will have to find new ways to fund infrastructure in order to protect the viability of the Indian banking industry. In many countries across the globe, long-term bonds form a major share of infrastructure finance. However, Indian corporate bond market is less than even 5.0% of GDP. While the RBI and government have set up several committees

and implemented many reforms to revive the market, their efforts have not yielded much. A lack of diversity and numbers in issuers and investors has trapped this market in a vicious cycle of low liquidity. Another dampener is the dominance of government bonds due to fiscal profligacy. Whether its private placements, FII or other institutional investors or trading activity in Wholesale Debt Market, government bonds dominate by far and adversely impact investor activity in corporate bonds, thereby stunting the development of corporate bond market in India.

Also, Municipal bond market (Munis) in India has remained underdeveloped and relatively untapped. It is estimated that there is a potential of US$ 270 billion being generated through Munis provided the Municipal Bond Market is tapped properly. But this requires some critical pre-conditions such as -transparency of corporate governance within Municipal Corporations, levy and collection of appropriate user charges, innovative project structuring, supportive tax regime, better framework for security creation and enforcement. Without these developments, this route may not yield desired results for India.

Financing large requirements of India’s infrastructure sector will no doubt require huge outlays from the public sector, but these will have to be coupled with a more than proportionate rise in private investments. Private and PPP

(Public-Private-Partnership) is estimated to have accounted for a little over 30.0% of the investment in the 11th Plan. There is a need for its share to go up to at least 50.0% in the 12th plan.

In the recent Union Budget, while the new government has taken some novel initiatives like setting up of Infrastructure Debt Fund or allowing banks to raise long-term bonds for infrastructure financing with an exemption to CRR, SLR, Priority sector lending etc., there is a need to create a single regulatory window for clearing innovative debt products like rupee denominated convertible bonds or optional convertible debentures, etc. that can help develop the corporate debt market.

2. **Micro, Small & Medium Enterprises (MSME) Financing:** The MSME sector is a backbone of India's economic development as it contributes 45% of the nation's industrial output, 40.0% of the exports and employs over 60 million people. The major hindrance to the expansion of this sector is the non-availability of adequate and timely finance from banks and financial institutions (FIs) due to its high-risk profile. While banks have been making steady efforts to bridge this gap, the recent economic slowdown, the consequent burden of NPAs and more stringent regulatory framework are forcing banks to adopt a more cautious approach to MSME lending. The risk management

framework requires huge paperwork and the entire process of project appraisal for MSMEs has become very cumbersome.

Solution: In case of the MSMEs, the access to capital markets is very limited, and they largely depend on borrowed funds from banks and FIs. The government should strive to create a favourable environment for MSMEs that curbs the need for debt and capital. This could be achieved by setting up SME-focused banks and NBFCs that accord priority to SME sector lending. A low ticket, unsecured credit required by a typical MSME unit needs sophisticated risk management and cost control that is not easy in business model of conventional banks. Gaps in MSME finance can be filled with asset based lending, operating leases, and factoring. Specialised NBFCs can play a major role in this type of financing. However, a positive regulatory environment to support NBFCs will be critical.

3. **Financial Inclusion:** India has a large share of population that is still “unbanked.” Statistics shows that so far the Indian banking industry has been able to penetrate to less than half of the population over the last few decades. The RBI’s recently released Nachiket Mor Committee Report (on Comprehensive Financial Services for Small Businesses and Low Income Households) reveals new and worrisome realities. Almost 90.0% of small businesses in India still have no links with

formal financial institutions; 60.0% of the rural and urban population do not have a functional bank account; India’s bank credit to GDP ratio is 70.0%, but in a large, very poor state such as Bihar, it is dramatically less at 16.0%; savings, even for the not so very poor, are declining and, in certain areas, moving away from financial to physical assets. And less than fully regulated savings often include less than fully scrupulous providers. The reasons cited for this trend include lack of positive real return and difficulties in quick and direct access to savings accounts. Credit and access to equitable financing for low-income households and small businesses is, even less encouraging, in very poor areas. Many retail banks fail to comply with RBI’s Priority Sector Lending guidelines, which require a full 40.0% of their lending to these sectors, for the simple reason that their non-performing assets (NPAs) are almost double.

One of the biggest goals of the RBI/Government of India is to ensure credit availability to all unbanked people. This implies that banks will have to find cost-effective ways to provide banking to the masses. While the primary responsibility is upon banks to innovate and experiment, the government and the RBI can accelerate the process through interventions and encouragement. The RBI has issued draft guidelines recently (Jul 17, 2014), borrowing heavily from the Mor Committee Report for

setting up of 'local feel' small banks, which will disburse small-ticket loans to farmers and businesses. The central bank also issued draft guidelines for setting up of payment banks, which will cater to marginalised sections of society, including migrant labourers, for collecting deposits and remitting funds. Such banks can be set up with a minimum capital of Rs 100 crore as against Rs 500 crore required for normal commercial banks. The proposed small banks will provide a whole suite of basic banking products such as deposits and supply of credit, but in a limited area of operation.

Solution: The concept of "payment banks" is closer to the concept of "narrow banks" used earlier by the Tarapore Committee Report on Capital Account Convertibility, which had recommended conversion of weak banks to narrow banks. However, it was criticized then that while liquidity and credit risks could be lower for the narrow banks, they are exposed to heightened market risks unless they have good treasury management skills; and they may not also have the required deposit base (Saggar and Ghosh 1998). Besides, given the high capital requirements and restrictive operations for payment banks, it remains to be seen how far and how fast these entities take off.

In our opinion, before creating new institutional resources, it is necessary to revitalize the existing resources like rural co-operative

banking institutions. Government is already spending over Rs 14,000 crore to revitalize rural cooperative institutions under the Vaidyanathan Committee Scheme. This is a historic opportunity to once and for all pull cooperative banks out of the present mess and dysfunction. It is an important institutional resource that has the reach, local flavor and cost structures which commercial banks do not have. The growth of these entities suffered because of ineffective governance framework that resulted in poor capabilities and technology. The new government with the help of NABARD should introduce necessary skills and technology in these banks.

To improve economic activity in rural areas via creation of infrastructure and capacity-building, the development financial institution like NABARD can be given a pivotal role. It could be used as a conduit for channeling RIDF's (Rural infrastructure Development Fund) funds to various states. NABARD comes closest to an ideal institution for this purpose given its range of expertise, heritage in development financing and collaborative operating model.

To enhance economic viability of Financial Inclusion (FI), the policymakers can think of creating transaction fee based models for FI, create a shared infrastructure- for example to create a shared facility to host low value accounts, ensure inter-operability in Business

Correspondents (BC) network by incentivizing common standards, interfaces and shared infrastructure, etc.

The government has started making payments to the unbanked through banking channels, which is not just helping the cause of FI but also supporting the growth of banking transactions and improving the base of low-cost deposits for the banks. Among the many initiatives, the government's UID (Unique Identification) project is likely to have significant impact. Given the numbers out of the reach of organised banking, it can prove to be transformational by giving banks an access to a large untapped customer base. The whole range of government payments - under subsidies and benefits of various welfare schemes should be routed through banks.

As suggested by Boston Consulting Group, computerization of land records and easy accessibility and pledging of land for secured lending can unlock significant funds and convenience for customers. The government should undertake such technological up-gradation in land records on a mission mode.

Another area where policymakers can act to improve the extent of financial inclusion is to spur HR transformation in PSBs by encouraging them to recruit more specialised persons in their rural and agriculture banking divisions and not

subjecting them to frequent transfers that result in dilution of specialisation.

4. **Capitalisation – the Biggest Challenge:** If we assume Indian banks' loan growth to average at 16.0% over the next five years and 15.0% over the next 10 years (both are highly conservative estimates), then the banking sector will need to raise almost $60 billion (or Rs 3.69 lakh crore) capital over the next five years and another $65 billion (or Rs 4 lakh crore) by 2025. This demand is primarily for the new Capital Adequacy Framework under Basel III. India is among the very few countries that have issued final guidelines on Basel III implementation so far. The RBI requires banks to adopt Basel III fully by 2018-19, which means their capital needs will rise. It seems a tall order for many banks. The challenges of implementing Basel III are further accentuated by the fact that the law mandates the Central government to hold a majority share in PSBs, which control 73.0% of the banking business in India. Further, the high fiscal deficit is likely to limit the government's ability to infuse capital in the PSBs to meet Basel III guidelines. The high capital requirement will also add pressure on return of equity of PSBs and make them relatively unattractive for investors.

   The RBI has placed the minimum capital requirements as follows- minimum core tier 1 ratio has to be 5.5%; capital conservation buffer of 2.5%; counter-cyclical buffer of up to 2.5%

depending on the stage of the credit cycle and for domestically systemic banks (large-sized banks) an additional buffer of up to 0.8%. This will require significant amounts of capital to be raised.

Solution: According to stock market analysts, private sector banks will not have much problem in raising capital. Given that their capital ratios are already high, the bulk of the capital that they need is for “growth” and investors are expected to provide it without any hesitation given their relatively higher return ratios and lower delinquencies. However, the problem exists for PSBs with relatively higher NPAs and lower core capital ratios. This necessitates much larger government participation. One of the ways to invest in these banks would be through issuing recap bonds. These bonds should get the same treatment as any other government bond (ability to put in Held-to-Maturity bucket or SLR status) to enable the market to treat them as proper core capital.

Other solution could be setting up a bank holding company. The government would transfer its ownership in PSBs to a holding company and subsequently, the holding company could raise debt from the markets – quasi sovereign so fairly inexpensive. They could infuse this debt in the form of equity capital into the PSBs. The interest cost on the debt could be met through dividends received from the PSBs.

The third solution would entail the government reducing its stake in PSBs to less than 51.0% in a gradual fashion to say 33.0%. At the same time, it can keep for itself a golden share, which would keep its voting rights in PSBs at more than 51.0%. But this would require tackling the pressures from the trade unions that are against any form of privatisation.

5. **Relatively Fragmented Structure:** While India is one of the fastest growing nations of the world, its banks are conspicuous by their small size. In the Morgan Stanley coverage universe of Asian lenders, State Bank of India is only the 16th largest by balance sheet. The next two - Bank of Baroda and ICICI – are 32nd and 33rd respectively. This is due to a relatively large fragmentation in the industry, especially on the PSBs' side.

   Solution: Recent reports by RBI have called for consolidation of PSBs as it will help improve industry profitability meaningfully through economies of scale and scope. There is a significant overlap between PSBs in terms of branches, mode of operations, and clients. Consolidation would enable PSBs to extract synergies quite easily. However, this requires a strong political will given the strength of trade unions in the PSB segment. Another area of consolidation could be new private banks acquiring the old private banks that are generally owned by families and focused on single

regions. With growing regulatory requirements for "capital", these old private banks will find it increasingly difficult to compete and survive.

6. **Corporate Governance (CG):** Banking in India has become more complex over the years and there is an urgent need to attach more importance to qualitative standards like internal controls and risk management, composition and role of the board and disclosure standards. While law can control and regularise certain practices, the ultimate responsibility of being ethical and truthful to all stakeholders remains with the banks. In India, practices of insider trading, unrelated risk-taking, excessive promoters' control, etc., are always highlighted in the case of PSBs. Other frequently discussed problem is lack of transparency in the top-level appointments in PSBs. Moreover, most of these PSBs are not able to stand up to government interference and pursue a business model guided by commercial principles. As the government holds maximum stake in PSBs, there are higher chances of neglecting minority shareholders.

   Solution: The RBI had set up a panel under the chairmanship of P. J. Nayak to review the governance practices followed by banks, which submitted its report in May 2014. Without much loss of time, the key recommendations of this report need to be accepted and implemented to improve the CG framework within banks,

especially PSBs. These include privatisation of PSBs; exclusive regulatory control of PSBs by the RBI (rather than Ministry of Finance); improving the quality of PSBs' boards; the transfer of government's stake in PSBs to a holding company termed Bank Investment Company (BIC), which in turn, should be managed professionally and governed by "The Companies Act"- 2013" rather than Bank Nationalisation Act of 1970 and 1980; appointments of directors, CEOs to be the responsibility of bank boards; to have uniform bank licensing regime across all broad-based banks, and niche licenses for banks with more narrowly defined businesses; allowing mutual funds, pension funds, PE funds to hold 20.0% in private sector banks, without having to take RBI approval; allowing promoter investors to hold up to 25.0% in private sector banks, against the 15.0% ceiling currently, ensuring a minimum five-year tenure for bank Chairmen and a minimum three year tenure for Executive Directors; permission to private equity funds, including sovereign wealth funds to take a controlling stake of up to 40.0% in distressed banks, allowing voting rights in proportion to the stake held, strict punishments to bank officers guilty of ever-greening loans (offering new loans to repay old ones), etc.

Having said this, the problem of poor CG is not prevalent only in PSBs. The problem in banking

is that the combination of incentives linked to return on equity and persistent high leverage almost makes it inevitable that bank executives will look out for the sharp opportunity and the risky gamble. A modest increase in leverage does not solve the problem. Nor, as an article in the FT *(The crisis shows moral capital is in secular decline by John Plender, June, 2014)* argues, will refining executive incentives and slapping fines on banks. The problems are fundamental and they require radical solutions. The FT article suggests two solutions- One is to go after bankers and prosecute them instead of merely slapping fines on banks (which means you penalise shareholders rather than executives). The other is to treat banking as a utility, which would mean stringent regulation on what products they can offer, what returns they can make, what they can pay to their executives etc. Privatisation per se is not the ultimate solution. For good CG, what matters more is the quality of "leadership" rather than "ownership".

7. **Huge Burden of Non-Performing Assets (NPAs):** Besides capital adequacy and liquidity strength, the other indicator of the soundness of the banking system is the level of NPAs. Since the year 2007-08, the level of stressed assets (NPAs plus restructured loans) have been on rise in Indian banks, especially in PSBs. Stressed assets in India have almost doubled from 5.7%

in 2007-08 to 10.2% in 2012-13, which has impacted the banking industry adversely. The profitability of banks has come under pressure for a variety of reasons like the new capital rules under Basel III, de-regulation of savings bank deposit rate, aggressive financial inclusion agenda and higher provisioning requirements under NPAs. In this context, besides improving overall operational efficiency, more attention needs to be paid to improving the asset quality by removing the regulatory and procedural bottlenecks that come in the way.

Solution: A closer analysis reveals that majority of the stressed assets of the Indian banking sector in the past 4-5 years are in the infrastructure segment, including power and telecom, as well as textile and iron & steel. In addition to the macro-economic factors, there are industry-specific reasons that caused a rise in stressed assets levels in India. For instance, in the case of aviation, it was irrational pricing coupled with taxation issues on jet fuel pricing; for telecom – it was increasing competition and consequently irrational pricing behavior among players; for textiles – it was low scale, power availability issues coupled with shrinking global demand, etc. The RBI has taken a number of steps which are pushing banks to be more proactive in recognition of stress and to take remedial steps so as to preserve the economic value of assets. As a part of such efforts, special

mention accounts (SMAs) classification has been recently introduced coupled with defining a time-bound procedure towards deciding the course and nature of remedial actions. The RBI, in addition, is also strengthening the NPA resolution ecosystem in India including increase in foreign participation rules in Asset Reconstruction Companies (ARCs) in India and bringing a sunset clause to the regulatory forbearance accorded to restructured accounts up to March 2015.

However, in the given circumstances, the role of credit rating agencies needs to be closely examined and brainstormed over. It is imperative that the business model of the credit rating agencies need to ensure that credit ratings are of high quality, accurately measure creditworthiness and should be the product of a strong and independent process. A possible inaccuracy in ratings can pose a threat to financial stability by underestimating the riskiness of investments of regulated entities. The Regulators have to devise a framework so as to reduce the conflict of interest through disclosures, operational audits and enforcing governance in these agencies in spirit.

In order to reduce the NPA ratio, the assets are typically recovered or restructured. However, India's lack of comprehensive bankruptcy law makes asset recovery very difficult. As a result, borrowers usually resort to legal injunctions –

relying on an over-burdened court system to delay the process. As per the RBI report, only 22.0% of bad loans were retrieved in 2013 versus 31.0% in 2011. India needs to have strong and effective bankruptcy laws to smoothen the pace of liquidation in cases of stress.

Another requirement is to increase the number of Asset Reconstruction Companies (ARCs) to improve the process of price discovery. Also, in order to deepen this market to adequately compensate banks, the sale of assets between ARCs must be permitted.

Another intervention required from the government side to control the NPA menace is the development of a deep bond market and financial institutions (FIs) specialised in infrastructure financing. Out of nine DFIs, two have already converted themselves into the banks (ICICI and IDBI) for want of low-cost deposit resources and as a result, the nation has lost an important specialisation. New specialised institutions have to emerge to provide funds to long-term projects. Also, allowing insurance funds to invest in corporate debt, similar to pension fund provisioning, would also help in taking the pressure off of banks to fill in the resource gap. The development of a liquid corporate debt market has to be the major priority of India's new government to get the nation back on a high-growth trajectory.

Finally, the Credit Information Bureau India Ltd. (CIBIL) and the three private credit information companies that keep a credit record of borrowers – need to grow their base of institutions to include NBFCs, micro-finance institutions, and unregistered sources to help create a wider net to monitor borrowers and streamline lending to dubious parties.

8. **Looming Manpower Issues in PSBs:** Besides weak earnings profiles and large capital requirements, the other pressing challenge for PSBs is the massive human resource (HR) gap at the middle management level. This gap has been widening over the last four years and will continue to do so over the next five years, as there was a virtual freeze over the fresh recruitment in these banks post 1991-92 for 10 to 12 years. This led to a big gap in skills sets at the middle management level. This is one of the reasons for lower profits per employee in these banks as compared to private sector banks.

   Solution: The PSBs have to solve this problem quickly and the only way out is to hire people through lateral recruitment. However, to make this possible, the compensation levels have to go up in these banks. Further, movement towards variable performance linked salaries has to be expedited. PSBs with better overall performance need to be allowed higher levels of incentive distribution guided by their respective boards. Compensation at senior levels has to be

moved gradually closer to market to attract and retain talent. There should be differentiated HR policies for different PSBs and the government should relent from being the sole custodian of the HR policies and manage the banks purely for its own political agenda.

9. **Foreign Banks:** As of March, 2013, India had 43 foreign banks from 26 countries operating as branches and 46 banks from 22 countries operating as representative offices. In addition, a number of foreign banks have entered as NBFCs, while a considerable number have set up captive centres in the country. In earlier days, these banks were high-end service providers and employers of choice for the Indian elite. Over the years, however, they have made an effort to blend in with the local landscape, introduced products that suited Indian requirements, provided cross-border borrowings, capital and access to global markets. But by and large they are niche players, constrained by a lack of branches as India currently allows them only 12 branches to be opened every year. Foreign banks' share in banking system's loans has reduced from around 8.0% in the late 1990s to about 5.0% currently. In 2013, RBI released new guidelines that entitled foreign banks to become wholly owned subsidiaries (WOS) in India, which would grant them a near national status and allow them to open as many branches as they want -- in line with private banks with similar

regulations around rural branches. However, no foreign bank came forward to become a WOS.

Solution: The reluctance of foreign banks to become a WOS is driven by two factors. First, under Basel III, opening new subsidiaries would increase pressure on group capital; a WOS would have to follow regulations on rural branches, priority sector lending, etc. and secondly, foreign banks in India are essentially urban focused, meaning they are less inclined towards rural banking. Hence, they continue to operate in India as branches of parent entities. But this should not continue. As stated by the RBI Governor Dr Rajan, "In order to ensure banking sector stability in India, we need our large entities to be fully responsive to regulations here. And therefore, if the carrot does not work, we need to push a little harder, as some other jurisdictions across the world have done." Many experts believe this "carrot and stick" approach will lead foreign banks to opt for WOS. On the other hand, if policymakers expect a long-term commitment from foreign banks then they have the responsibility to provide a somewhat predictable growth path that can make long-term view on the India business possible.

10. **NBFCs:** NBFCs are an integral part of Indian financial system and have co-existed with banks for a long time in India. NBFCs have catered to certain customer segments, and geographies

where banks have not had their presence or not served the customers as effectively as NBFCs. They have been game changers in segments such as the second-hand vehicle financing, MSME and affordable housing. The relationship between banks and NBFCs is like wholesaler-retailer and with banks getting into the traditional domains of NBFCs, the latter have moved to newer areas and segments. India's 12th plan document states that NBFCs will have to contribute Rs 6,18,000 crore, and hence this sector is an important and integral part to the economy. The issue here is how to make this sector as active and as acceptable as banks.

Solution: First of all, if policymakers want to create convergence between NBFCs and banks on recognition norms for NPAs then the same legal and other enablers should be made available to NBFCs to maintain good asset quality. The regulatory obligations should be commensurate with regulatory privileges. As NBFC sector is vast with a variety of sizes and activities, it will be prudent to base regulatory prescriptions on the combination of size and activity of a NBFC.

Within NBFCs, there already exist differentiated licences such as CIC, MFI-NBFC, Assets Finance Company, etc. So while these categories may have been created to serve

a particular policy purpose, there is a need to rationalise the privileges provided within each category. For example, certain categories are permitted to have external commercial borrowings, whereas certain others are not, irrespective of their size.

Indian NBFCs face maximum constraints on the liability side and this is the major reason behind their motivation to become a bank. Here we feel beyond a certain size, the NBFCs should actually be encouraged to start developing as a deposit franchise because running a large balance sheet completely out of wholesale funds is a risky proposition. They may be given some kind of a specialized banking licence that allows them access to certain kind of deposits, say like deposits from institutional investors. Because NBFCs access bank borrowing as large part of their funding piece, there is a potential systemic risk even to banking system if we have large number of NBFCs at risk. Therefore when certain NBFCs achieve a significantly large size, they have to be nudged to become a bank.

Permitting NBFCs to become BCs (Business Correspondents) is another idea which must be pursued after taking care of conflict of interest and other safeguards required. NBFCs have the manpower, knowledge, skill and the requisite infrastructure to work as BC for banks. There

could be significant synergies if such networks are leveraged upon.

To conclude, adequate institutional arrangements and regulatory capabilities need to be in place in India's rapidly growing banking sector, if the nation has to extract maximum from the coming decade of significant opportunity. Fortunately, India now has a government with a strong political mandate in 30 years. With a sense of urgency, it should now formulate a reform strategy that supports its banking sector's development while ensuring its stability, accessibility and competitiveness.

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- Eugene Black
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