Indian Banking Sector-in a phase of Manthan

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Introduction

As per the Reserve Bank of India (RBI), India's banking sector is sufficiently capitalised and well-regulated. The financial and economic conditions in the country are far superior to any other country in the world. Credit, market and liquidity risk studies suggest that Indian banks are generally resilient and have withstood the global downturn well.

Indian banking industry has recently witnessed the roll out of innovative banking models like payments and small finance banks. RBI's new measures may go a long way in helping the restructuring of the domestic banking industry.

Indian Banking Sector Has Grown at A Healthy Pace

- Credit off-take has been surging ahead over the past decade, aided by strong economic growth, rising disposable incomes, increasing consumerism & easier access to credit.
- During FY07-18, credit off-take grew at a CAGR of 10.99 per cent. As of Q4 FY18, total credit extended surged to Rs 86,825,727 million (US$ 1,347.18 billion).
- Credit to non-food industries increased by 9.53 per cent reaching US$ 1,120.42 billion in January 2018 from US$ 1,022.98 billion during the previous financial year.
- Demand has grown for both corporate & retail loans; particularly the services, real estate, consumer durables & agriculture allied sectors have led the growth in credit.
- Bank credit grew at 12.84 per cent year-on-year to Rs 86.16 lakh crore (US$ 1,285.20 billion) on June 22 2018 from Rs 76.36 lakh crore (US$ 1,139.02 billion) on June 23, 2017.
- During FY07–18, deposits grew at a CAGR of 11.66 per cent and reached US$ 1.6 trillion by FY17. Deposits at the end of Q4 FY17-18 stood at Rs 114,792,883 million (US$ 1,781.12 billion).
- Strong growth in savings amid rising disposable income levels are the major factors influencing deposit growth.
- Access to banking system has also improved over the years due to persistent government efforts to promote banking-technology and promote expansion in unbanked and non-metropolitan regions.
- At the same time India's banking sector has remained stable despite global upheavals, thereby retaining public confidence over the years.
- Deposits under Pradhan Mantri Jan Dhan Yojana (PMJDY), have also increased. Rs 78,952.09 crore (US$ 11.78 billion) were deposited and 31.95 million accounts were opened in India.^

Key Notable Trends

Improved risk management practices

- Indian banks are increasingly focusing on adopting integrated approach to risk management.
- Banks have already embraced the international banking supervision accord of Basel II; interestingly, according to RBI, majority of the banks already meet capital requirements of Basel III, which has a deadline of 31 March 2019.
- Most of the banks have put in place the framework for asset-liability match, credit & derivatives risk management.

Diversification of revenue stream

- Total lending has increased at a CAGR of 10.94 per cent during FY07-18 and total deposits has increased at a CAGR of 11.66 per cent, during FY07-18 & are further poised for growth, backed by demand for housing and personal finance.

Technological innovations

- As of May 2018, total number of ATMs in India increased to 210,312 and is further expected to increase to 407,000 ATMs in 2021.
- The digital payments system in India has evolved the most among 25 countries, including UK, China and Japan, with the IMPS being the only system at level 5 in the Faster Payments Innovation Index (FPII).

Focus on financial inclusion

- RBI has emphasised the need to focus on spreading the reach of banking services to the un-banked population of India
- Indian banks are expanding their branch network in the rural areas to capture the new business opportunity. According to RBI, Under Financial Inclusion Plan, 598,093 banking outlets were provided in villages as on March 2017

Derivatives and risk management products

- The increasingly dynamic business scenario & financial sophistication has increased the need for customised exotic financial products

- Banks are developing innovative financial products & advanced risk management methods to capture the market share
- Bank of Maharashtra tied up with Cigna TTK, to market their insurance products across India.

Consolidation

- With entry of foreign banks, competition in the Indian banking sector has intensified.
- Banks are increasingly looking at consolidation to derive greater benefits such as enhanced synergy, cost takeouts from economies of scale, organisational efficiency & diversification of risks.

Growth Drivers of Indian Banking Sector

Policy support

- The government passed the Banking Regulation (Amendment) Bill 2017, which will empower RBI to deal with NPAs in the banking sector.
- The Insolvency and Bankruptcy Code (Amendment) Ordinance, 2017 Bill has been passed by Rajya Sabha and is expected to strengthen the banking sector.
- Under the Union Budget 2018-19, the government has allocated Rs 3 trillion (US$ 46.34 billion) towards the Mudra Scheme and Rs 3,794 crore (US$ 586.04 million) towards credit support, capital and interest subsidy to MSMEs.
- In May 2018, the Government of India provided Rs 6 trillion (US$ 93.1 billion) loans to 120 million beneficiaries under Mudra scheme.

Infrastructure financing

- India currently spends 6 per cent of GDP on infrastructure; NITI Aayog expects this fraction to grow going ahead .
- As per the Union Budget 2018-19, the Indian infrastructure sector requires an investment of Rs 50 lakh crore (US$ 772.32 billion).

Pradhan Mantri Vaya Vandana Yojna

- In March 2018, the Government of India launched Pradhan Mantri Vaya Vandana Yojna (PMVVY) to provide elderly people Rs 10,000 (US$ 155.16) pension per month. This scheme has an investment limit of Rs 15 lakh (US$ 23,273.86).

Government initiatives

- Reserve Bank of India (RBI) has decided to set up Public Credit Registry (PCR) an extensive database of credit information which is accessible to all stakeholders.
- A two-year plan to strengthen the public sector banks through reforms and capital infusion of Rs 2.11 lakh crore (US$ 32.5 billion), has been unveiled by the Government of India that will enable these banks to play a much larger role in the financial system and give a boost to the MSME sector. In this regard, the Lok Sabha has approved recapitalisation bonds worth Rs 80,000 crore (US$ 12.62 billion) for public sector banks, which will be accompanied by a series of reforms, according to Mr Arun Jaitley, Minister of Finance, Government of India.
- Simplification of KYC norms, introduction of nofrills accounts & Kisan Credit Cards to increase rural banking penetration.

Cause of Concern- Non-Performing Asset (NPA)

Recent news around increasing non-performing assets (NPAs) and other administrative instances have put the banking and financial services sector in jeopardy. Promoter integrity issues have implied further financial losses for banks. With a pile-up of bad loans, Indian banks seem to be winning the wrong race. The non-performing assets (NPA) accumulated by Indian lenders are higher than those of banks in most major economies, including the US, UK, China, and Japan. In fact, India ranks fifth out of 39 major world economies plagued by bad loans, according to a report by Care Ratings.

Indian banks' gross non-performing assets (NPAs), or bad loans, stood at Rs 10.25 lakh crore as on 31 March 2018. On quarter, the pile has grown by Rs 1.39 lakh crore or 16 percent from Rs 8.86 lakh crore as on 31 December 2017. This chunk now accounts for 11.8 percent of the total loans given by the banking industry. For financial year 2018, the total bad loans of these banks rose by a whopping Rs 3.13 lakh crore.

Industry leader, the State Bank of India (SBI), which tops the NPA chart, has logged an increase of Rs 24,286 crore in bad loans in the March quarter to Rs 2.23 lakh crore. Punjab National Bank (PNB) has reported the maximum rise of Rs 29,100 crore in gross NPAs to Rs 86,620 crore in the March quarter. Barring the Bank of India (BoI) and Oriental Bank of Commerce (OBC), most other PSBs' also recorded a rise in bad loans during the quarter. While Bank of India's gross bad loans declined by Rs 1,920 crore in the March quarter, that of OBC was down by Rs 1,417 crore.

Among private banks, the gross NPAs of ICICI Bank and Axis Bank have risen significantly. ICICI Bank's bad loans pile grew by Rs 8,024 crore or 17.4 percent in the March 2018 quarter to Rs 54,063 crore; Axis Bank's widened by Rs 9,248 crore or 37 percent to Rs 34,249 crore in the March 2018 quarter from Rs 25,001 crore during the December 2017 quarter.

Indeed, the government has taken steps to address the bad loans mess like the NPA ordinance, giving the central bank more power to direct banks to take action against loan defaulters, and the passage of the Insolvency and Bankruptcy Code (IBC).

Impact of NPAs on banking sector and Indian economy

In today's era of globalization, the role of banking sector is not limited to providing financial resources to the needy sectors but the banks act as agents of financial intermediation and also plays a major role in the fulfillment of social agendas of the Government. However, a steady rise in the NPA's of banks affects not only the banking sector but the country's economy as a whole. Firstly, NPAs leads to asset contraction for banks. Due

to the presence of NPAs, the banks follow low interest policy on deposits and high interest policy on advances provided. Thus, this act puts a pressure on recycling of funds and further creates a problem in getting new buyers. Secondly, as per the Basel norms all banks are required to maintain capital on risk weighted assets. A rise in NPAs pressurizes the banks to increase their capital base further. Lastly, rise in NPAs reduces the customer's confidence on the banks. Rise in the NPAs affects the profitability of the bank which further hinders the returns to be received by the customers. Decrease in profits leads to a lower dividend pay-out by the banks and affects the ROI expectations of the customers. Thus, a rise in NPAs not only affects the performance of the banks but also affects the economy as a whole.

Reasons for the rise in NPA in recent years

- **Global Economic Slowdown:** Between early 2000's and 2008 Indian economy were in the boom phase. During this period Banks especially Public sector banks lent extensively to corporate. However, the profits of most of the corporate dwindled due to slowdown in the global economy, the ban in mining projects, and delay in environmental related permits affecting power, iron and steel sector, volatility in prices of raw material and the shortage in availability of. This has affected their ability to pay back loans and is the most important reason behind increase in NPA of public sector banks.
- **Relaxed Lending Norms:** One of the reasons of rising NPA has also been not so stringent lending norms especially for some large corporate borrowers . Also, to face competition banks are hugely selling unsecured loans which attributes to the level of NPAs.
- **Frauds:** It has not been a good year for the banking sector. As top lenders of the country - SBI, PNB and Canara Bank - uncovered banking frauds, one after another.
- Other reasons which can be attributable to the account turning bad may include, wilful defaulters, mismanagement and misappropriation of funds, business failure etc.

Remedies/Measures for managing NPAs

A. Public Sector Banks:

Public Sector Banks (PSBs) constitute over 70 per cent of the banking system and are in a state of crisis. fundamental reforms tended to happen when crisis hit and this was an opportune moment for such reforms and expressed optimism that this was likely under this government.

☞ **Privatisation:** Nationalisation of banks in the 1970s was undertaken by the then Government. The "original sin" as it was called, was considered necessary at the time, given the collusion between industry and finance then. PSBs have led to a financial deepening in the country. That said, the umbilical cord connecting the PSBs to politicians and bureaucrats, which in turn stems from the ownership structure of PSBs, has led to several inefficiencies including (i) disempowered boards, (ii) muted incentives for senior management to effect organisational change, (iii) cloning of PSBs and the resultant systemic risks due to continual bureaucratic meddling, (iv) external vigilance enforcement causing paralysed decision-making, on the one hand, and widespread frauds and endemic corruption, on the other hand, (v) opacity at various levels, as well as (vi) distortions in human resource management. Diversified market ownership could bring market discipline to PSBs. Options for privatisation include the following:

- o **Bank Holding Company structure:** The bank holding company (BHC) structure recommended by the P.J. Nayak Committee, among others, involves divesting the government's shareholding to below 52 per cent and routing it through a holding company. This one level of distance would not help unless the BHC was itself professionally managed.
- o **Sovereign Wealth Fund:** Rather than the proceeds of privatisation going to the Consolidated Fund of India, a sovereign wealth fund could be created which is professionally managed. This could help "trickle down" good governance practices to PSBs.
- o **Hive off social sector lending vehicle:** The political economy of privatisation remains complex, at least in part because of social sector lending programmes routed through PSBs. Accordingly, it may be useful to consider hiving off all agricultural and social sector lending into a separate entity which may be government owned and controlled and allow the corporate lending part of the PSBs to be privatised. There is an economic rationale for this as well. PSBs (and indeed all banks) are required to lend 40 per cent of their assets to "priority sectors." Priority Sector Lending (PSL) is deemed unprofitable for several banks leading to a "PSL drag." On the other hand, microfinance non-banking finance companies (NBFC MFIs) have a cap on their earnings margins. Accordingly, the decoupling of PSL and market lending may allow market distortions in both these sectors to be corrected.
- o **Recapitalise, Reform and then privatise:** PSBs in their current state of impaired balance sheets are unlikely to find any takers. By the same token, recapitalising PSBs repeatedly creates moral hazard issues. Recapitalisation and governance reform can enhance market valuations of PSBs and should lead to a path for privatisation without accusations of "selling off the family silver."

☞ **Governance reforms:** Privatisation is, however no panacea. There are multiple other governance reforms that must be undertaken in PSBs.

- o **Role, purpose and business strategy:** PSBs suffer from a severe identity crisis and require business, not just financial, restructuring. They

do not operate as commercial banks and do not have a coherent business strategy or vision. The Ministry of Finance must ascertain whether this is the best use of public money. It is crucial to clarify the role and purpose of PSBs and for them to concentrate on specific regions or business segments. By way of example, it is unclear why certain PSBs have branches in South Africa, why a Punjab-based PSB has branches in the North-East. The need for existence of each PSB must be clear and its business and expansion should follow that. This would also force an evaluation of whether PSL lending has been effective.

- **Term lengths:** The terms of bank chairpersons must be elongated in order to effect meaningful changes and to hold them accountable. Presently, it is observed that as the Chairpersons of State Bank of India (SBI) change, there is an NPA "bloat"- the outgoing chairperson tends to backload NPAs, which obscures the situation of PSB bank balance sheets. Terms of chairpersons should align with the life of the loan, which would allow defaults to be detected and penalties to be meted out as required.
- **Professionalise, Incentivise** – Incentives for PSB personnel must be significantly augmented. The SBI chairman's salary is equal to that of a fresh business graduate in an MNC bank. Better incentive structures will attract better talent.
- **Penalise for wrongdoing:** Although vigilance mechanisms exist, lax enforcement means that wrongdoing is rarely penalized. For instance, the Chairman of Syndicate Bank who was bribed by the promoters of Bhushan Steel was in jail for barely a few months and has not been convicted as yet.
- **Rotation of staff:** The Punjab National Bank fraud demonstrates the extent of operational and risk management failures in PSBs. Improvements to HR practices can help mitigate egregious behavior like frauds. For instance, PSBs tend to man the business verticals with the brightest talent and less competent staff in the inspection and supervision roles. If officers are rotated in these roles, this could not only strengthen the supervision of banks, it would also mean that staff on the business development side have experience in supervision and inspection and will therefore self-regulate better.
- **Credit appraisal, monitoring:** Basic principles of credit appraisal and monitoring are obviated in PSBs and must be sharpened, to diagnose defects of capital, business purpose and character.

B. RBI governance and regulation:

The RBI as a regulator has had qualified success in the face of structural impediments, including limited control over PSBs. RBI's internal governance as well as its regulation of NPAs needs improvement.

- **Subsidiarisation:** The RBI may consider the Bank of England model of subsidiarising its prudential regulatory and supervision functions (the Prudential Regulatory Authourity and the Financial Conduct Authority). However, the recognition that lost synergies from such separation contributed to the global financial crisis demands caution.
- **Strengthening supervisory capacity:** RBI lacks supervisory capacity to conduct forensic audits and this must be strengthened with human as well as technological resources.
- **Preventing Evergreening:** RBI regulations have permitted banks to "ever-green" and in effect delay the recognition and therefore resolution of NPAs. RBI regulations must take away incentives of banks to kick the can down the road and "extend and pretend". This has led to a seizure of new lending and the caving in of credit culture. The recent RBI circular does remove such incentives by ending all other schemes such as CDR that allowed evergreening, which would lead to fewer delays in provisioning. This in turn, would require the recapitalisation of PSBs, which must not be carried out without the reforms set out above.

C. Reengineering of banking systems

- **Secondary Market:** A vibrant secondary market for NPAs is crucial. The lack of transparency in price of the assets is holding this back, as is the lack of autonomy in PSBs and the fear of vigilance action. However, the Insolvency and Bankruptcy Board of India (IBBI) has recently made it mandatory for a resolution professional to appoint two registered valuers to determine both the fair as well as liquidation value of a stressed company (referred to NCLT) , instead of the earlier practice of assessing only the liquidation value.
- **Concurrent Audit:** There is a real rot in the internal and concurrent audit systems of banks. The latter is intended to red flag risks in real time, but has failed and must be shored up.
- **Diagnostics for willful default:** Banks need better permanent diagnostics to get to the bottom of willful defaults. This can happen though (a) market intelligence; (b) funds flow analysis; and (c) financial analysis. Most promoters do not have sufficient "skin in the game" and rely entirely on bank borrowing.
- **Using technology for maker-checker:** Currently, the maker-checker systems require human intervention and are therefore prone to capture and corruption. The use of Artificial Intelligence for the supervision of financial transactions could prevent financial fraud. In addition, linking Core Banking Systems (CBS) with Finacle technology (as recently required by RBI) is crucial.
- **Combine with low tech – ears on the ground:** Business intelligence must use traditional means- speaking to people in the industry; supplier and customers can be an invaluable source of financial information.

Bright Spots:

Amidst the gloom, the functioning of the Insolvency and Bankruptcy Code (Code) is reason for optimism. As things stand, there is a clear visibility on the resolution of the Reserve Bank of India's (RBI) so-called dirty dozen, a group of 12 corporate defaulters, which accounted for the single-largest share of non-performing assets, amounting to Rs.2.77 trillion.

In May-2018, debt-laden Bhushan Steel Ltd earned the distinction of being the first successful resolution under the IBC, when it was awarded to Tata Steel. The NCLT has recently approved the bid of AION Capital-JSW Steel to acquire Monnet Ispat & Energy Ltd. Joint resolution plan submitted by the Reliance and JM Financials for Alok Industries has been approved by Committee of Creditors. Further, Electrosteel Steels has been acquired by Vedanta. Others such as Essar Steel and Amtek Auto have also received significant buyer interest and are likely to witness a revival soon. Outside the dirty dozen, Binani Cement's bankruptcy resolution process grabbed eyeballs, with binding bids from several suitors. The highest bid exceeded Binani Cement's total outstanding debt. Although the decision on the final ownership of the company is sub-judice, instances such as these prove beyond doubt that that for both banks and defaulting promoters, status quo was no longer an option under IBC.

Besides, mindful of the impediments in successful resolutions, the government and RBI have worked towards creating a level playing field by effecting changes not only to the bankruptcy laws (amended in 2017 to prevent corporate defaulters from bidding for distressed assets), but also to the entire ecosystem. One such measure was to raise the minimum upfront payment by asset reconstruction companies (ARC) from 5% to 15%, which discourages the use of ARC platforms by lenders for long-term warehousing of bad loans without any resolution. The fear of errant promoters playing the system to their advantage has also been addressed by a fair margin.

While the insolvency regulations have stopped defaulting promoters from bidding for any distressed asset, the involvement of multiple stakeholders in the resolution process has ensured transparency and propriety, so much so that even when decisions were challenged in court, it passed legal scrutiny.

With the dirty dozen potentially out of the way, the focus has turned to the new cases. As per industry estimates, cases involving 150 firms, each owing at least Rs.2,000 crore, need to be resolved by August, else, they will be referred to the National Company Law Tribunal (NCLT) for bankruptcy proceedings. Industry watchers say there was a high probability that a large number of these cases will finally end up in the NCLT.

There has been certain important and significant change brought about by the Ordinance. Certain key amendments are as below:

- Categorization of home buyers as financial creditors.
- Initiation of insolvency resolution process by operational creditors.
- Voting thresholds lowered to 66% for decision making by the coc.
- Applicability of moratorium to guarantors
- Section 29A of the code setting out disqualification criteria for the resolution applicant.

The amendment has brought in a slew of positive changes to the Code, which will significantly boost the framework of insolvency resolution as had been envisaged under the Code.

The road ahead:

Recently, the government agreed to a five-pronged strategy proposed by the Sunil Mehta Committee to resolve the bad loans mess. Project Sashakt is aimed at retaining the value of the asset through operational turnaround.

Under the scheme, bad loans of up to Rs.50 crore are required to be resolved within 90 days by the bank. For loans of Rs.50-500 crore, banks (22 public sector banks (including India Post Payments Bank), 19 private lenders and 32 foreign banks) have recently entered into an inter-creditor agreement, authorizing the lead bank to implement a resolution plan within 180 days. For loans above Rs.500 crore, the committee has recommended setting up an independent asset management company (AMC), supported by institutional funding or an alternative investment fund (AIF). if the AMC model is successful, it will act as a market maker in distressed asset deals. However, there should be some clarity on who will manage the resolution process.

Unlike in IBC, where the appointment of a resolution professional is a statutory requirement, there has not been any word on who will manage the entire resolution process of cases under Project Sashakt. Besides, the government must find ways in the IBC mechanism to bail out smaller operational creditors from acute distress when bigger firms fail to pay up.

IBC is still a work in progress, but in all probability, it would prove to be the key to solving India's bad loans mess.

With the various measures taken by the Government and Regulators, enhanced spending on infrastructure, speedy implementation of projects and continuation of reforms are expected to provide further impetus to growth. All these factors suggest that India's banking sector is also poised for robust growth as the rapidly growing business would turn to banks for their credit needs.