I PERSPECTIVES

The slowdown in global and domestic growth impulses in the recent past impinged on credit demand. The asset quality, capital adequacy and profitability of scheduled commercial banks improved after a long period of stress, although challenges emerged from other areas like non-banking financial companies and co-operative banks. Going forward, issues such as resolution of stressed assets, weak corporate governance, and frauds need to be addressed to reaffirm a robust financial sector that minimises systemic risks.

I.1 The ongoing implementation of international regulatory reforms is building up capital and liquidity buffers. The global growth slowdown has impacted bank lending world-wide even as heightened financial fragilities, including elevated debt levels, have mutated into pervasive risk aversion. Among emerging market economies (EMEs), profitability of banks has been dented by weak loan growth and high delinquencies.

I.2 Domestically too, the weakening of growth impulses and subdued credit off-take are playing out, with sporadic credit default events and incidents of frauds exacerbating the reluctance to lend. This is starkly evident in the slowdown of flow of resources, both from banks and non-banks to the commercial sector in the first half of 2019-20. In turn, this waning of confidence is weighing on overall economic activity. This is worrisome as it is taking hold at a time when the recent improvements in asset quality and profitability of the banking sector are at a nascent stage and capital ratios of public sector banks (PSBs) are shored up due to recapitalisation by the government. Notwithstanding the enhanced resolutions through the Insolvency and Bankruptcy Code (IBC), the overhang of NPAs remains. The health of the banking sector hinges around a turnaround in macroeconomic conditions.

I.3 Default and rating downgrades of a non-banking financial company (NBFC) and a housing finance company (HFC) recently led to liquidity constraints and interruptions in their niche-centric financial intermediation. The silver lining is that although the lending activities of non-deposit taking systemically important NBFCs (NBFCs-ND-SI) and HFCs have somewhat moderated, their loan-loss provisions remain at comfortable levels. It is important to recognise that challenges faced by some of the NBFCs were reflective of inherent fragilities rather than merely a liquidity crunch. Consequently, financial markets have been discriminating between strong NBFCs and those having perceptible weaknesses. Recent developments in the sector have brought greater market discipline and better performing companies continue to raise funds at reasonable costs, while those with asset-liability mismatches or asset quality concerns face constraints on market access and/ or higher borrowing costs. Concerted policy initiatives by the Reserve Bank and the government are expected to alleviate the liquidity constraints faced by these entities, as they gradually regain the confidence of the financial markets and continue with normal activity.

I.4 Against this backdrop, the rest of the chapter lays out perspectives on forces that are likely to shape the financial sector's ecosystem in the period ahead.

Resolution of Stressed Assets

I.5 Effective mechanisms for faster resolution of stressed assets remain key to the revival of the banking system. The recently announced prudential framework for stressed assets serves as a multi-pronged strategy in this regard, expanding degrees of freedom for lenders while prescribing disincentives for delayed implementation of resolution plans. It is expected that this framework will sustain improvements in credit culture that are in motion, in conjunction with the IBC. Under the latter, traction is gathering, with an increase in total recoveries in the recent period, although there has been some increase in haircuts.

I.6 The applicability of IBC has been expanded to cover certain categories of financial service providers (FSPs) as well, which would help in making the law comprehensive and more effective. Although the time limit for resolution under IBC has been recently extended to 330 days, some cases are delayed beyond the limit, partly reflecting repeated litigations. At the same time, improvement in supportive infrastructure is a *sine qua non* for expediting the resolution process. Even though two new benches of National Company Law Tribunal (NCLT) are being set up, more benches and members are required.

Sectoral Stress

I.7 Against the backdrop of subdued profitability of corporates, their low interest coverage ratio and deleveraging coupled with risk aversion of banks, lenders have been shifting their focus away from large industrial loans towards retail loans, as the non performing assets (NPA) ratios of the latter have traditionally been low. This diversification strategy, while helpful as a risk mitigation tool, has its own limitations: the slowdown in consumption and overall economic growth may affect the demand for and the quality of retail loans. Moreover, household leverage and indebtedness need to be kept in focus in the context of overall financial stability. The need of the hour is to kick-start industrial credit and use the impetus therefrom to regenerate a virtuous cycle of capex, investment and growth.

I.8 Some sector specific pockets of stress will need policy attention. Proper risk pricing in lending is of prime importance so that the health of the banking sector is not compromised while ensuring adequate credit to the productive sectors of the economy.

Recapitalisation of PSBs

I.9 The government has been infusing capital in some PSBs, which has been just enough to meet the regulatory minimum including capital conservation buffer (CCB). The deferment of the implementation of the last tranche of the CCB till March 31, 2020 has offered some breathing space to these banks. Their capacity to sustain credit growth in consonance with the financing requirements of the economy will, however, warrant that capital is maintained well above the regulatory minimum, providing these banks confidence to assume risk and to lend. In this sense, recapitalisation would be a continuous process. On the other hand, raising resources through public issues or private placements has been constrained, partly due to volatile market conditions. Going forward, the financial health of PSBs should increasingly be assessed by their ability to access capital markets rather than looking at the government as a recapitaliser of the first and last resort.

Mechanism for Early Fraud Detection

I.10 Frauds can occur on account of overlooking regulatory guidelines and/ or on lapses in internal risk governance, compliance, and audit functions. A number of initiatives such as dedicated market intelligence units and increased use of data analytics are being taken up, following the recommendations of the Expert Committee set up by the Reserve Bank (Chairman: Shri Y H Malegam). In addition, banks have been advised to monitor unconventional sources of information on a continuous basis confined not only to the borrowing entity but to the group as a whole. While supervisory and regulatory measures are designed to strengthen the early warning signals (EWS), the prime responsibility of identifying and managing fraud risks rests with the respective financial institution.

Corporate Governance in Regulated Entities

I.11 The growing size and complexity of the Indian financial system underscores the significance of strengthening corporate governance standards in regulated entities. The recent governance failures in some financial entities have brought to the fore the impact of the quality of corporate governance on efficiency in allocation of resources as well as on financial stability. In response, the Reserve Bank is in the process of issuing draft guidelines on corporate governance for regulated entities; the objective is to align the current regulatory framework with global best practices while being mindful of the context of the domestic financial system.

Strengthening the NBFC Sector

I.12 In order to strengthen the liquidity framework for NBFCs, a liquidity coverage ratio (LCR) has been introduced for all deposit-taking NBFCs (NBFCs-D) and non-deposit taking NBFCs (NBFCs-ND) with an asset size of ₹5,000 crore and above. This measure—covering almost 87 per cent of the total NBFC sector by asset size—will be implemented along a glide path spanning over four years, commencing from December 2020. The complex business structure of the core investment companies (CICs)—which were at the heart of the recent NBFC sector challenges—is under review. Several other measures have also been initiated to improve the resilience of the sector (Box VI.1).

I.13 Apart from strengthening the existing four pillars of supervision *viz.*, on-site examination, off-site surveillance, market intelligence and reports received from statutory auditors, a fifth pillar—periodic interaction with stakeholders like statutory auditors, credit rating agencies, and banks that have large exposures to NBFCs—is getting institutionalised as part of the supervisory process for monitoring the incipient build-up of risks so as to be able to take pre-emptive actions.

I.14 The entry of non-traditional and digital players in the non-banking space has added further complexity to the existing web of interlinkages between sectors. While it is necessary to encourage innovation in delivery of financial services, especially to the unbanked strata of the society, a close watch on potential fault lines is also important to ensure timely mitigation of risks to financial stability. The Reserve Bank endeavours to ensure an optimal level of regulation and supervision in this sector so that it is financially resilient and robust.

Regulatory Issues in Housing Finance Companies

I.15 Consequent upon the transfer of regulation of HFCs to the Reserve Bank, a review of the regulatory framework applicable to them is being undertaken with a view to aligning the regulatory regime for HFCs and NBFCs. The focus areas are capital requirements, public deposit regulations and other prudential norms. This augurs well for ensuring a sound and resilient housing finance sector. The Reserve Bank has also undertaken swift measures to address governance concerns and payment defaults by a prominent HFC, thereby facilitating faster resolution of stress in the HFC and instill confidence in stakeholders.

Co-operative Banking

I.16 Co-operative banks in India, which play a crucial role in credit delivery and extending other financial services through their geographic and demographic outreach, have been facing daunting challenges in the recent period. As dual control of the Reserve Bank and respective state governments or central government (in the case of multi-state cooperative banks) constrains timely regulatory action against weak banks, necessary legislative amendments are being discussed with the government. Concomitantly, the existing architecture of regulation and supervision of urban co-operative banks (UCBs) is also being revamped while being mindful of the evolving requirements.

I.17 Furthermore, with a view to reducing concentration risk in UCBs, strengthening their resilience and sustainability, and protecting the interest of depositors, relevant regulatory guidelines are being amended. Additionally, to strengthen off-site supervision and early recognition of financial distress, UCBs with assets of ₹500 crores and above will be brought under the Central Repository of Information on Large Credits (CRILC) reporting framework.

I.18 While the Boards of Directors of these banks oversee their functioning as a co-operative credit society, modern practices of banking are often lacking, necessitating a clearer separation of these roles. In particular, lack of prudent internal control mechanisms and surveillance systems is limiting their ability to prevent frauds. There is a need for an independent and efficacious audit system to ensure sound health of co-operative banks.

I.19 The emergence of new players such as payments banks (PBs) and small finance banks (SFBs) poses competition to UCBs. There is an imperative need to adopt technology, which will enable UCBs to provide banking services at lower costs so that they remain competitive. However, adoption of technology also considerably increases operational risks such as cyber security and UCBs need to have a robust information technology (IT) risk management infrastructure to mitigate the same. A comprehensive cyber security framework following a graded approach is being developed for UCBs based on their digital depth and interconnectedness with the payment systems landscape, digital products offered by them and assessment of cyber security risks.

I.20 The number of financially weak UCBs in the co-operative sector has declined over the years due to the measures taken by the Reserve Bank. The procedure of finding least disruptive exit routes for weak UCBs that do not come up with voluntary merger plans often become lengthy and prolonged. Such merger plans are, therefore, strongly encouraged to safeguard the interest of depositors.

I.21 UCBs cannot raise capital through public issues, limiting their ability to comply with the regulatory requirements, even under Basel I. In view of the pressing need for an umbrella organisation for the sector, which can provide liquidity and capital support to member banks, the Reserve Bank has given approval for its formation. This organisation is also expected to provide IT infrastructure and capacity building facilities to UCBs, and would contribute to their strength and vibrancy.

I.22 Looking ahead, vital financial indicators of the banking sector are gradually improving, but concerns relating to speedier resolution of stressed assets, corporate governance, and frauds remain. Elevated stress in other segments of the financial system such as NBFCs and co-operatives—although not large enough to have systemic implications—affects the confidence of investors. In view of the crucial role that the financial sector plays in revitalising the economy, it is important to build robust banking structures, backed by sound balance sheets that minimise systemic risks.