

Perspectives on the Indian Banking Sector

Domestic banks continued to manage growth with resilience during 2010-11 with ample reserves of capital and liquidity, improved performance in profitability and asset quality. With high growth potential of the Indian economy and favourable demographics, banks have immense opportunities to further expand their business both with traditional and innovative products and through financial inclusion using technology enabled sustainable business models. However, the prevailing interest rate environment and slowing growth in the near-term amidst somewhat skewed exposures to interest sensitive sectors will require adept management of such exposures going forward. Further, it will be challenging for banks to raise additional capital and liquidity to support higher growth and to comply with Basel III stipulations. This would require banks to use innovative and attractive market based funding channels, especially when capital continues to remain expensive and the Government support may be constrained by fiscal considerations. The challenge to converge with the International Financial Reporting System would require banks to upgrade infrastructure including information technology and human resources. Given the focus on inclusive growth, banks are also expected to renew efforts to broaden the scope of financial inclusion and use viable business models to achieve their targets. Finally, sustained pursuit of forward looking strategies aimed at mitigating risks, diversifying revenue sources, containing asset-liability mismatches, providing effective response to changing global market environment and improving customer relationships should strengthen the overall growth of the banking sector in the medium term.

1. Introduction

1.1 The banking sector in India emerged largely unscathed from the global financial crisis of 2007-08, but faced a slowdown in the momentum of growth due to the weakening of trade, finance and confidence channels. However, post crisis, the economic growth in most emerging market economies (EMEs) including India recovered, while growth remains anemic in advanced economies. Instability of sovereign debt markets in the Euro zone, political turmoil in the Middle East and North African (MENA) region, calamities in Japan, sovereign debt downgrade of the United States in August this year and the persistently elevated levels of commodity prices have together led to an accentuation of downside risks to global growth. While these risks are expected to recede gradually over time, the long-term sustainability

of higher growth in India will depend crucially on the ability of the banking sector to mobilise the savings and meet the credit needs of the growing economy through innovative financial instruments and services that foster financial inclusion and provide efficient and transparent delivery of credit.

1.2 Despite the challenging headwinds from domestic and international developments, the performance of Indian banks remained robust during 2010-11. The resilience of the banking sector was marked by improvement in the capital base, asset quality and profitability. The profitability of scheduled commercial banks (SCBs) improved both in terms of return on assets (RoA) and return on equity (RoE). Simultaneously, both gross and net NPA ratios declined in comparison with the previous year. Since the Indian financial system is bank

dominated, banks' ability to withstand stress is critical to overall financial stability. A series of stress tests conducted by the Reserve Bank in respect of credit, liquidity and interest rate risks showed that banks remained reasonably resilient. However, under extreme shocks, some banks could face moderate liquidity problems and their profitability could be affected.

1.3 A detailed description of perspectives on global developments is covered in Chapter II on Global Banking Developments. Against this background, some relevant perspectives about the Indian banking sector are outlined.

2. Forces Shaping the Environment

Are Indian banks adequately prepared for migration to Basel III regime?

1.4 Commercial banks in India have already adopted standardised approaches under Basel II. It is time for larger banks to seriously consider upgrading their systems and migrating to advanced approaches. Adoption of advanced approaches requires simultaneous use of the underlying processes in the day-to-day risk management of banks. In the background of the recent global regulatory developments, a question often discussed is whether the Indian banks are prepared for Basel III. The building blocks of Basel III are by now quite well known: higher and better quality capital; an internationally harmonised leverage ratio to constrain excessive risk taking; capital buffers which would be built up in good times so that they can be drawn down in times of stress; minimum global liquidity standards; and stronger standards for supervision, public disclosure and risk management. Quick assessments show that at the aggregate level Indian banks will not have any problem in adjusting to the new capital rules both in terms of quantum and quality. Indian banks are comfortably placed in terms of compliance with the new capital rules.

1.5 One point to note though is that the comparative position is at the aggregate level; a few individual banks may fall short of the Basel III norms and will have to augment their capital. There will be challenges of upgrading risk management systems and meeting the credit needs of a rapidly growing economy even while adjusting to a more demanding regulatory regime. In addition to countercyclical capital buffers, Basel III also envisages countercyclical provisions.

1.6 In India, banks have a stock of floating provisions which the Reserve Bank has not permitted to be used, except under a situation of systemic stress. While the floating provisions may serve the purpose of countercyclical provision, a framework is necessary for allowing its use. As an interim measure, the Reserve Bank has been trying to develop a methodology based on the Spanish dynamic provisioning system. This, however, has not been easy given the lack of required data and analytics with the banks. Migration to Basel III requires a high level of liquidity to be maintained through a pool of liquid assets. The definition of liquid assets is very stringent including the requirement that they should be freely available.

Are the Indian banks geared up for transition to the International Financial Reporting System (IFRS)?

1.7 Converging to global accounting standards, *i.e.*, IFRS facilitates comparability between enterprises operating in different jurisdictions. Convergence would help to reduce both the cost of capital and cost of compliance for industry. Training, education and skill development are cornerstones of a successful IFRS implementation. All the stakeholders including investors, accountants, auditors, customers, software and hardware vendors, rating agencies, analysts, audit committees, actuaries, valuation experts and other specialists will need to develop an understanding

of IFRS provisions to varying degrees and what they need to do. It is not only the accounting issues but how to address the non-accounting issues that will determine how successfully banks make a transition to IFRS. Additionally, banks will need to upgrade their infrastructure, including IT and human resources to face the complexities and challenges of IFRS. Some major technical issues arising for Indian banks during the convergence process are the differences between the IFRS and current regulatory guidelines, in particular, those within the ambit of International Accounting Standard (IAS) 39 replacement project relating to classification and measurement of financial assets and liabilities.

Interconnectedness in the banking sector and vulnerability of financial system

1.8 Post-crisis, macro-prudential policy has emerged as an important tool for addressing systemic risk, highlighting its time and the cross sectional dimensions. While the time dimension refers to pro-cyclical elements that give rise to the evolution of aggregate risk over time, the cross section dimension is concerned with distribution of risks which can be exacerbated owing to the interconnectedness in the financial system. Financial interconnectedness as a part of macro-financial surveillance is the key issue in discussions on prudential regulation policies as it can magnify idiosyncratic shocks across the financial system. To put in place an effective system of macro-prudential surveillance of the financial system, the Reserve Bank has started using network analysis techniques to model inter-bank exposures. The analysis revealed that the banking sector in India is deeply connected. Further, the contagion analysis made on the basis of network analysis underlined that interconnectedness in the banking sector gives rise to vulnerability of financial system in the event of failure of one or more banks depending on the degree of interaction. The contagion impact is relatively contained due to regulatory limits on interbank exposures. However, the

impact may be more significant if other entities like other banks, NBFCs, and mutual funds are included for analysis.

Current and emerging environment offers sound business opportunities to the banks

1.9 The emerging economic environment provides a number of opportunities for the Indian banking sector. Factors like expected positive economic performance, strong savings growth spurred by the favourable demographic dividend, emphasis on expansion of physical infrastructure and the extent of financial exclusion to be bridged will ensure growth of the banking sector in medium term. To exploit emerging opportunities and to benefit from their strengths, Indian banks need to be globally competitive. From a strategic perspective, competitiveness can be achieved by balancing factors such as scale, scope, prudence and knowledge.

3. Strategic and Operational Responses

Migration of financial conglomerates in India to holding company structure

1.10 At present, most of the financial groups in India are led by banks and organised under the Bank Subsidiary model. This model puts the onus on the parent bank for corporate governance, performance and capital requirement of subsidiaries. Besides, the parent carries very substantial reputational risk. The Working Group on 'Introduction of Holding Company structure in India for banks' has recommended migration of major financial conglomerates to the holding company structure to address these limitations to some extent. The main challenges in implementing the recommendations include, formulating a new law governing functioning of financial holding companies, providing right incentives to the existing financial conglomerates through appropriate tax treatment and resolution of strategic and public policy issues by the Government in the case of public sector banks.

Introducing innovative financial products as an efficient way to manage risks

1.11 Introducing innovative financial products is an efficient way to manage risks involved in the banking business. From this point of view, the decision to introduce credit default swaps (CDS) with effect from October 24, 2011 is a welcome development. However, given their complex nature, CDS shall be permitted on listed corporate bonds, unlisted but rated bonds of infrastructure companies and unlisted/unrated bonds issued by the Special Purpose Vehicles (SPVs) set up by infrastructure companies as reference obligations, and the reference entities shall be single legal resident entities. The guidelines also require market participants to build robust and appropriate risk management systems. Newer skill sets for managing newer areas and unfamiliar elements of risks would continue to pose questions even to the most advanced banks. The implementation of innovative financial products requires diligent assessment of counterparty and related risks. Banks will have to adopt an approach to re-evaluate their risk management acumen in a manner that calls for higher levels of transparency, structural integrity and operational control. While expanding market is a matter of survival, a further challenge for the banks would be to ring-fence their operations by establishing a sound risk management system that is not only protective but also inclusive and acts as a business enabler.

Management of asset quality

1.12 While gross NPAs, in percentage terms, have declined steadily from 15.70 per cent at end March 1997 to 2.25 per cent at end March 2011, this does not fully reveal the underlying realities and some trends are a matter of concern, which could put pressure on asset quality of banks in future. Aggressive lending during the high credit growth phase followed by the crisis resulted in slippage with gross NPA ratio steadily rising from 1.81 per cent at end

March 2008 to 2.21 per cent at end March 2010, followed by a slight moderation to 2.01 per cent in 2011. The concern is that the recoveries have not kept pace with slippages since 2007-08. Rising interest rates and substantial amount of restructuring done during the crisis period, if not done with due care, are likely to put further pressure on asset quality of banks. Further, asset quality of banks needs to be closely watched in the changing interest rate environment as the sticky loan portfolio of small and medium enterprises might rise. Therefore, there is a need for banks to step up efforts to resolve their existing NPAs and tighten their credit risk management systems.

Robust business continuity management and disaster recovery

1.13 The extensive use of technology systems in transaction processing and settlement in retail as well as inter-institution and interbank markets requires adequate availability and capacity to handle the increasing load on these systems for smooth functioning of financial markets and banking industry in India. Data centres managed by the Reserve Bank, and Indian Financial Network (INFINET), the communication backbone for the financial sector managed by the Institute for Development and Research in Banking Technology (IDRBT), continued to provide robust support during the year. Software changes were made in Real Time Gross Settlement (RTGS) and Public Debt Office-Negotiated Dealing System (PDO-NDS) applications to enhance performance and introduce new functionalities. The next generation RTGS with advanced technology and new functionalities is also in the pipeline, which would have features such as advanced liquidity management facility, extensible markup language based messaging system conforming to ISO 2002, and real time information and transaction monitoring and control system. Periodic drills were conducted to get feedback and assurance on the effectiveness of the

Business Continuity management and Disaster Recovery (BCP-DR) arrangements for shared infrastructure and Payment and Settlement Systems. A quarterly report on the BCP-DR and Vulnerability Analysis and Penetration Testing (VAPT) exercise conducted by commercial banks at their end was also obtained and significant points emerging out of the same are included in the inputs for analysis and suitable incorporation in the periodical Financial Stability Report.

4. Challenges

Need for further improving the efficiency parameters of the Indian Banks

1.14 The Indian banking sector has recorded an impressive improvement in productivity over the last 15 years; many of the productivity/efficiency indicators have moved closer to the global levels. There has been a particularly discernible improvement in banks' operating efficiency in recent years owing to technology up-gradation and staff restructuring. However, to sustain high and inclusive growth, there is a need to raise the level of domestic savings and channel those savings into investment. This implies that banks need to offer attractive interest rates to depositors and reduce the lending rates charged on borrowers - in other words, reduce the net interest margin (NIM). The NIM of the Indian banking system is higher than that in some of the other emerging market economies even after accounting for mandated social sector obligations such as priority sector lending and credit support for the Government's anti-poverty initiatives.

1.15 By far the most important task is to further improve operating efficiency on top of what has already been achieved by optimising operating costs, *i.e.*, non-interest expenses including wages and salaries, transaction costs and provisioning expenses. This will enable banks to lower lending rates while preserving their profitability. If pursued effectively, financial

inclusion will provide banks access to sizeable low cost funds as also opportunities for lending in the small volume segment. The latter should be possible since the Reserve Bank has deregulated the interest rate that can be charged on small value loans. To gainfully pursue financial inclusion, banks will need to constantly reinvent their business models and design products and services demanded by a growing economy with rapid structural transformation.

Challenges to further strengthening inclusive growth

1.16 The banking sector is a key driver of inclusive growth. There are supply side and demand side factors driving inclusive growth. Banks and other financial services players largely are expected to mitigate the supply side processes that prevent poor and disadvantaged social groups from gaining access to the financial system. Banks were advised to ensure close and continuous monitoring of Business Correspondents (BCs). They were also advised to focus, in future, on opening of some form of low cost brick and mortar branches between the base branch and BC locations. Further, banks were required to make efforts to increase the number of transactions in no-frill accounts. There should be seamless integration of the financial inclusion server with their internal core banking solution (CBS) systems and in the case of end-to-end solution, there should be a clear demarcation of the technology related activities and BC related activities of their service providers. However, banks must bear in mind that apart from the supply side factors, demand side factors, such as lower income and /or asset holdings also have a significant bearing on inclusive growth.

1.17 Banks also need to take into account various behavioural and motivational attributes of potential consumers for a financial inclusion strategy to succeed. Today, access to financial products is constrained by several factors, which

include: lack of awareness about the financial products, unaffordable products, high transaction costs, and products which are not convenient, inflexible, not customised and of low quality. A major challenge of the next decade is financing the millions in the unorganised sector, self-employed in the micro and small business sector, the small and marginal farmers as also rural share-croppers in the agricultural sector. Other challenges include financing affordable housing and education needs of low income households.

Need for effective corporate governance in banks

1.18 Banks are different from other corporates in important respects and that makes corporate governance of banks not only different but also more critical. Banks facilitate economic growth, are the conduits of monetary policy transmission and constitute the economy's payment and settlement system. By the very nature of their business, banks are highly leveraged. They accept large amounts of uncollateralised public funds as deposits in a fiduciary capacity and further leverage those funds through credit creation. Banks are interconnected in diverse, complex and opaque ways underscoring their 'contagion' potential. If a corporate fails, the fallout can be restricted to the stakeholders. If a bank fails, the impact can spread rapidly through to other banks with potentially serious consequences for the entire financial system and the macro economy. While regulation has a role to play in ensuring robust corporate standards in banks, the point to recognise is that effective regulation is a necessary, but not a sufficient condition for good corporate governance. In this context, the relevant issues pertaining to corporate governance of banks in India are bank ownership, accountability, transparency, ethics, compensation, splitting the posts of chairman and CEO of banks and corporate governance under financial holding company structure, which should engage adequate attention.

Need to review laws governing the Indian banking sector

1.19 The extant statutory arrangement is complex with different laws governing different segments of the banking industry. The nationalised banks are governed by the Banking Companies (Acquisition and Transfer of Undertaking) Acts of 1970 and 1980. State Bank of India and its subsidiaries are governed by their respective statutes. Private sector banks come under the purview of the Companies Act, 1956 and the Banking Regulation Act, 1949. Foreign banks which have registered their documents with the registrar under Section 592 of the Companies Act are also banking companies under the Banking Regulation Act. Certain provisions of the Banking Regulation Act have been made applicable to public sector banks. Similarly, some provisions of the RBI Act too are applicable to nationalised banks, SBI and its subsidiaries, private sector banks and foreign banks. Notwithstanding this wide array of legislations of varying vintage, the statutory arrangement has served the system well by helping maintain an orderly banking system. Needless to say, each of the statutes was crafted in a setting reflecting the needs and concerns of the time. Almost all the statutes have had to be amended from time to time to reflect changes in circumstances and context. There is a strong case for reviewing all the various legislations and recasting them for a number of reasons. There is also a need to iron out inconsistencies between the primary laws governing the banking sector and other laws applicable to the banking sector. The decision of the Government to set up a Financial Sector Legislative Reforms Commission "to rewrite and clean up the financial sector laws to bring them in line with the requirements of the sector" is very timely and very vital. It is important, however, to recognise that changes in policy or in the regulatory architecture cannot be the remit of a Legislative Reforms Commission. Rather, they should be debated and decided upon as a

prelude to the work of the Commission so that the Commission has a clear mandate on the policy directions.

Can the Indian banks aim to become global in stature?

1.20 Of late, there is a debate on whether the Indian banks should aim to become global? In this context, there is a need to view the related costs and benefits analytically and also view this as an aspiration consistent with India's growing international profile. Two specific questions that need clarity in this context are: (i) can Indian banks aspire to achieve global size? and (ii) should Indian banks aspire to attain global size? On the first question, it is unlikely that any of the Indian banks will come in the top ten of the global league even after reasonable consolidation. On the next question, those who argue that banks must go global contend that the issue is not so much the size of our banks in global rankings but of Indian banks having a strong enough global presence. The main argument is that the increasing global size and influence of Indian corporates warrant a corresponding increase in the global footprint of Indian banks. The opposing view is that Indian banks should look inwards rather than outwards, focus their efforts on financial deepening at home rather than aspiring to global size. It is possible to take a middle path and argue that looking outwards towards increased global presence and looking inwards towards deeper financial penetration are not mutually exclusive; it should be possible to aim for both. In the wake of the global financial crisis, there has definitely been a pause to the rapid expansion overseas of our banks. Notwithstanding the risks involved, it will be opportune for some of the larger banks to be looking out for opportunities for consolidation. The surmise, therefore, is that Indian banks should increase their global presence. In the rapidly changing global financial landscape, it is imperative for the Indian banks to think global but act local.

Costs and risks in using technology to change the face of banking

1.21 Technology adoption has changed the face of banking in India. Wide spread technology deployment in the banking business has also brought to the fore some new issues and challenges. These can be broadly divided into two categories - costs and risks. Costs, in terms of increasing expenditure on IT deployment and risks that are resulting from reliance on IT systems without necessary safeguards. Cost aspects can be addressed by synergising IT deployment objectives with the broader, strategic business objectives to ensure adequate operational and management controls over purchase as well as maintenance of appropriate technology solutions. The second aspect relating to IT risks is a very critical issue. With the increased use of IT, there are attendant risks posed to the banks as well as their customers in terms of monetary loss, data theft, breach of privacy and banks need to be extremely cognizant of such risks. Another significant aspect of banking business is regulatory and supervisory compliance. With the growth and globalisation of markets in general and in the aftermath of recent crisis in particular, number of such compliance requirements is increasing. Basel II and III implementation brings in huge challenges. Banks have adopted technology, but the benefit of technology has not fully percolated in terms of cost, speed and convenience. Empowering customers with technology-driven benefits is a big challenge.

Emerging trends in payment systems and related challenges

1.22 The smooth functioning of the market infrastructure for enabling payment and settlement systems is essential for market and financial stability, as also for economic efficiency, and for the smooth functioning of financial markets. The financial sector and the payment and settlement system infrastructure have to be subservient to the real sector. The evolving

payment systems scenario offers new challenges and opportunities to all segments of this industry. To leverage on the opportunities provided by new products, the system providers/banks need to ensure that the challenges are adequately addressed. It also has to be ensured that the products cover all segments of the population and provide an incentive to adopt these products. The regulatory process will support all orderly development of new systems and processes, within the legal mandate. The important issues in this context are how banks can provide cost-effective, safe, and speedier and hassle free payment and settlement products and solutions.

Some concerns related to financial stability

1.23 Despite the fragility of the global macro-financial environment, the macroeconomic fundamentals for India have remained robust. Further, since December 2010, the financial markets remained stress-free and the forecast of the values of the Financial Stress Indicator pointed out that they were likely to remain stable in the near term. Some emerging trends that may be of immediate concern in respect of financial stability are, (i) the possibility of spillovers from increasing financialisation of commodities to financial markets, (ii) interest rate differentials *vis-à-vis* advanced economies, which could propel foreign funding by Indian corporates leading to currency mismatches, (iii) rollover risks of maturity of Foreign Currency Convertible Bonds (FCCBs) requiring refinancing at higher interest rates, and (iv) disproportionate growth in bank credit to four specific sectors, *viz.*, real estate, infrastructure, NBFCs and retail credit coupled with persistent asset-liability mismatches, reliance on borrowed funds and enhanced requirement of provisioning for NPAs. Stress tests suggest that the banking sector remains fairly well capitalised and resilient to asset quality shocks and other plausible adverse changes in macroeconomic scenario. Issues pertaining to regulatory gaps

remaining in the NBFC sector that impinge on financial stability are being addressed by enhancing the scope of the regulatory perimeter while vulnerabilities in the liquidity risk management systems of domestic central counterparties are being weighed in terms of new mechanisms for bail-outs.

5. The Way Forward

1.24 While the opportunities to grow further are on increase, banks do have to contend with new challenges as they move forward. The recent deregulation of savings bank deposit interest rates announced on October 25, 2011 may initially lead to some competition, as banks with low share of savings deposits may like to garner a larger share of such deposits. However, this process may not be disruptive. The provisioning in lieu of pension liabilities and slippages in incrementally high growth loan portfolios in sensitive sectors such as retail and real estate sectors may impact profitability. A specific area of concern that has come to the fore is the concentrated and high pace of lending to the infrastructure sector by the public sector banks (PSBs), raising the apprehensions of increasing delinquencies in the future. As mentioned earlier, banks also face challenges in respect of demanding needs of supporting growth through financial inclusion and efficient credit intermediation through technology and product innovation.

1.25 It is important to recognise that with further globalisation, consolidation, deregulation and diversification of the financial system, the banking business is set to become more complex and riskier. Issues like complex risk management, appropriate liquidity management and enhancing skill development are some challenges already visible in the Indian context. The interface between banks and financial markets has undergone a fundamental shift in the recent times. The banks have become intricately linked to financial markets and hence more vulnerable to financial markets stress.

While technological advancements in IT have led to discernible improvement in the efficiency of banking services, banks have not gained in terms of efficiency partly because of lack of business process re-engineering. The challenge is to leverage technology optimally to balance growth, efficiency and risk management objectives.

Medium term outlook

1.26 To take full advantage of the opportunities while addressing the new challenges, the process of institutional strengthening assumes critical importance. Banks need to build on four principles, *viz.*, efficiency, stability, transparency and inclusion. The three balancing acts that the banking sector development strategy needs to perform are: between the drivers of banking sector growth and the requirements of the larger growth and development agenda; between the benefits and risks of greater global integration; and between the advantages of scale and the

compulsions of diversity. As articulated earlier, expected economic performance, robust savings, policy thrust to expand infrastructure and further strengthening of financial inclusion are expected to ensure robust growth of the banking sector in medium term.

1.27 In the long term, however, the most significant task of the Indian banking sector is to ensure that banking products and services are made available to every individual in the country efficiently to achieve total financial inclusion. Going forward, filling the void called ‘financial exclusion’ is the critical responsibility of banks. Despite all the challenges and issues to be addressed, the banking sector in India can look forward to enormous opportunities in their quest for long term growth. The banking sector needs to focus on growth through inclusion, innovation and diversification while complying with domestic regulations and internalising international best practices.