Chapter I

# Perspectives on the Indian Banking Sector

*The weakening domestic macroeconomic conditions combined with continuing subdued global growth and its increasing spillover risks posed challenges to the banking sector during 2012-13. Several policy initiatives were undertaken during the year to handle these challenges. On the regulatory and supervisory policy front, the envisaged move towards risk-based supervision, initiatives for improved cross border supervision and cooperation and enhanced oversight of financial conglomerates are important. In the short term, the stress on banks' asset quality remains a major challenge. Many policies are contemplated to expand and strengthen the banking infrastructure. Banks need to capitalise on these and play a major role in supporting economic activity and meeting the financial needs of all the sections of society.*

## 1. Introduction

1.1 Global growth continued to remain sluggish in 2012-13. Adverse international economic developments combined with the loss of growth momentum in the domestic economy posed challenges to the banking sector in India during 2012-13. There was a rise in asset impairment coupled with a dip in profitability. Macro stress tests indicate that if the current macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further[1]. However, overall the comfortable capital base still lends resilience to the Indian banking sector.

1.2 While the global banking developments are covered in Chapter II, a perspective on some of the factors that are likely to shape the banking environment in the period ahead along with strategic policy responses and the way forward for the banks are outlined here.

## 2. Emerging Operating Environment for Banks

1.3 The economic and financial environment in which the Indian banking system is operating is evolving continuously. Developments in global banking are likely to be conditioned by proposed regulatory changes aimed at ring-fencing commercial banking activities. The Financial Sector Legislative Reforms Commission (FSLRC) has suggested a number of changes in the landscape of the financial sector. The Reserve Bank has also placed in public domain a Discussion Paper on "Banking Structure in India- The Way Forward" which suggests far reaching changes in the banking structure so that it better serves the growing needs of the real economy. These suggestions/recommendations when taken up for implementation will shape the operating space for banks.

### *Global initiatives for structural regulatory reforms: ring-fencing commercial banking activities*

1.4 Several jurisdictions have supplemented or propose to supplement the enhanced prudential regulations under Basel III with structural measures to combat systemic risks. The proposed structural measures range from moving businesses identified as too risky and complex into stand-alone entities to prohibiting banks from engaging

[1] *Financial Stability Report*, Reserve Bank of India, June 2013.

in these activities altogether. The objective is to insulate certain types of financial activities regarded especially important for the real economy or significant on consumer/ depositor protection grounds from the risks that emanate from potentially riskier but less important activities.

1.5 The important initiatives in the direction of structural reforms include Volcker Rule under the Dodd-Frank Act in the US, Vickers Reform proposals in the United Kingdom and Liikanen reform proposals in the EU. While the salient features of the three proposals are driven by the overall objective of ring-fencing or constructing a firewall between the deposit taking and the core banking activities on the one hand and investment banking / proprietary trading activities on the other, they offer slightly differing approaches.

- The Volcker Rule restricts deposit-taking banks from engaging in proprietary trading and complex activities. It also forbids the co-existence of such trading activities and other banking activities in different subsidiaries within the same group. It similarly prevents investments in, and sponsorship of, entities that could expose institutions to equivalent risks, such as hedge funds and private equity funds.

- The Vickers reform proposal has recommended ring-fencing of retail banking operations of large UK banks into separate legal subsidiaries. A very narrow set of retail banking business, *i.e.*, retail deposit-taking, overdrafts to individuals and loans to small and medium sized enterprises (SMEs) must be within the protected, *i.e.*, the ring-fenced entity. Another set of activity, *e.g.*, some other forms of retail and corporate banking, including ancillary operations to hedge risks to support them may also be conducted within the protected entity. The protected activities can coexist with others in separate subsidiaries within the same group but subject to intragroup constraints and other risk management conditions (Box I.1).

- The Liikanen Report proposals seek to carve out proprietary trading and market-making activities beyond a threshold on a stand-alone basis from the deposit taking bank, but allow these activities to coexist with other banking business within the same group as long as these are carried out in separate subsidiaries. The proposals limit contagion within the group by requiring, in particular, that the subsidiaries be self-sufficient in terms of capital and liquidity and that transactions between the legal entities take place on market terms.

1.6 The nations proposing structural banking reforms are global financial centres and systemically important economies. By enhancing financial stability in these countries such policies can have positive spillovers on the global economy and financial system[2].

1.7 These reforms when implemented are also likely to limit the banks' managements' capacity for excessive risk taking and shield systemically important financial services from idiosyncratic shocks impacting other activities. It is important to recognise that the regulatory changes happening elsewhere need to be appropriately understood by Indian banks as well, as they need to interact with their global counterparts.

### *The Financial Sector Legislative Reforms Commission recommends significant reforms for the financial landscape*

1.8 The Financial Sector Legislative Reforms Commission (FSLRC) was set up by the Government of India to make the laws governing the financial

[2] "Creating a Safer Financial System: Will the Volcker, Vickers, and the Liikanen Structural Measures Help?" Staff Discussion Note, International Monetary Fund, May 2013.

## Box I.1 :
## Likely Implications of Vickers' Recommendations for Indian Banks (including UK Banks in India)

The "Independent Commission on Banking" (the Commission) headed by Sir John Vickers was established in the United Kingdom in June 2010 to consider structural changes and related non-structural reforms in the UK banking sector to promote financial stability and competition. The Commission's report presents a package of measures designed to make it easier and less costly to resolve failing banks; to improve banks' loss absorption capacity; limit excessive risk-taking; and limit the spread of contagion through the UK banking system.

**Ring-fencing of UK banks**

Under the ring-fencing proposal, the ring-fenced banks will be permitted to extend only retail and commercial banking services to a limited set of clients, including individuals and small and medium-sized enterprises (SMEs) in the UK. The Commission has specified three categorisations - Mandated, Prohibited and Ancillary - to determine services which must, and those which may or may not, be provided by a ring-fenced bank. These ring-fenced entities will also have other prohibitions and restrictions to ensure that they are not exposed to marked to market transactions and that they maintain a commercial and arm's length relationship with other entities in the group as with any other third party.

**Improving loss absorbency of UK banks and bail in tools**

- The large ring-fenced banks in the UK will be required to hold equity to risk-weighted assets (RWAs) ratio of at least 10 per cent with a provision to raise it to 13 per cent.
- All UK-headquartered banks should maintain a Tier-1 leverage ratio of at least 3 per cent, which will be 4.06 per cent for large ring-fenced banks.
- UK-headquartered global systemically important banks (G-SIBs) and large UK ring-fenced banks will have a capital of core equity and bail-in subordinated debt of at least 17 per cent of RWAs. A lower ratio would, however, be prescribed for smaller UK banks.
- The priority of creditors in insolvency may be revised so that deposits in banks insured by the UK's Financial Services Compensation Scheme are accorded preferential status (above floating charge holders).

***Likely implications of these recommendations***

**Indian banks' operations in the UK**

The retail asset size of Indian banks in the UK is currently much smaller than the 'De minimus' threshold set at £ 25 billion of mandated deposits for the Vickers Rules to apply. As such, no direct impact of Vickers' recommendations on ring-fencing is expected for Indian banks in the UK immediately. Also the business model of Indian banks does not include proprietary trading, investment banking or dealing in hedge funds at any significant levels. However, going forward, Indian banks in the UK may be required to separate their retail and commercial banking operations with respect to individuals and SMEs from their investment banking and wholesale banking activities, into separate ring-fenced entities. This would depend on the volume of operations, both in the area of the mandated/permitted activity, that is, the level of deposits from and credit services to individuals and SMEs as also the level of involvement in prohibited activities, such as investment banking, derivative transactions and proprietary trading.

Further, any separation of operations, wherever warranted, may involve creating separate infrastructure in terms of corporate structure, physical assets, staffing and manpower, capital, funding and liquidity arrangements as also the need for raising sufficient resources from the local market to take care of lending requirements. The cost of both capital and lending may increase. It is also expected to have monetary, legal and accounting implications.

**UK banks' operations in India**

As far as ring-fencing is involved, implications for Indian operations of UK banks will depend largely on the corporate structure of the respective parent company/bank in the UK and the changes and modifications that the parent company/bank is expected to bring about under ring-fencing requirements. Implications for Indian operations will also depend on whether the Indian branches are a part of the ring-fenced or non-ring fenced banking entity in the UK and how the business relocation takes place.

In general, to meet ring-fence requirements the restructuring process may be a complex one and is likely to involve administrative costs for banking groups. The recommendations may have implications for customers of the ring-fenced banks as the cost of services may go up due to the cost of restructuring and requirements of higher loss absorbing capital.

sector compatible with a growing, globalised and modernising economy; and to reflect the lessons of the global financial crisis. The Commission has proposed changes in the landscape of financial sector. The proposals cover consumer protection, dedicated and unified resolution authority, inter-

regulatory coordination, development function and providing independence to the regulators/ central bank with accountability. The Commission has envisaged a regulatory framework where governance standards for regulated entities will not depend on the form of organisation of the financial firm, such as, co-operatives, private Indian firms, foreign firms and public sector firms. The banking system needs to be prepared for some of these recommendations, when accepted and implemented.

***Discussion on a dynamic and evolving banking structure for India***

1.9 As the Indian economy has been continuously evolving, expanding and diversifying, the time is appropriate for reviewing the existing banking structure in terms of its size, capacity, ability to meet divergent credit and banking services needs, access and inclusiveness. Given the critical need for reviewing the existing banking structure, the Reserve Bank has decided to initiate a debate on various aspects of the Indian banking system. In the Monetary Policy Statement 2013-14, it was announced that the Reserve Bank will review the extant banking structure in India and prepare a policy Discussion Paper keeping in view the recommendations of, *inter alia*, the Committee on Banking Sector Reforms, 1998 (Chairman: Shri M. Narasimham), the Committee on Financial Sector Reforms, 2009 (Chairman: Shri Raghuram Rajan) and a few other relevant viewpoints. The Discussion Paper has since been released for starting a public debate (Box I.2).

## 3. Policy Responses

1.10 Considering the implications of various emerging international and domestic factors on the banking system, regulatory and supervisory policy responses during the year pertained to initiatives for implementing risk-based supervision (RBS), enhanced oversight of financial conglomerates and steps towards improved coordination among regulators, besides positioning banks to meet the needs of inclusive growth. Further, several forward looking initiatives were undertaken to expand the banking system, increase competition, further strengthening the payments and settlement mechanism and fortification of capital.

***Move towards risk-based supervision aimed at enhancing the efficacy of the supervisory review process***

1.11 The Reserve Bank is entrusted with the responsibility of supervising the Indian banking system under various provisions of the Banking Regulation Act, 1949 and the RBI Act, 1934. While the banking landscape has witnessed considerable changes over the last two decades, supervisory resources and processes based on the CAMELS[3] framework within the Reserve Bank have remained more or less the same. This has resulted in a mismatch between supervisory responsibilities and available resources necessitating a review of the supervisory processes and the rationalisation of the organisational structure for bank supervision. Post the global financial crisis, there has been a shift towards RBS away from the erstwhile CAMELS approach. CAMELS is essentially a scorecard based approach which is more of a backward looking methodology and transaction testing model operating with a lag. RBS, on the other hand, is a forward looking approach inasmuch as it assesses the risk buildup in banks. RBS also enables conserving supervisory resources by more efficient allocation based on risk perception.

1.12 Based on the principles and approach for RBS as suggested by High-level Steering Committee (HLSC), and after taking into account the uniqueness of the Indian banking system, the Reserve Bank has finalised the supervision framework under RBS. As part of RBS phase I

[3] **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ystems and Control (CAMELS).

**Box I.2 :**
**Banking Structure in India : The Way Forward**

It is recognised that the existing banking structure in India is elaborate and has been serving the credit and banking services' needs of the economy. However, since 1991, the Indian economy has undergone significant transformation in terms of its size and composition. The economic structure has diversified substantially and the economy has been opening up in its quest to further integrate with the global economy. If the real economy is dynamic, the banking system needs to be flexible and competitive in the emerging milieu. Viewed from this perspective, there is a need and scope for further growth in the size and strength of the existing banking structure to cope with the multiple objectives and demands made on it by various constituents of the economy.

The case for transforming the existing banking structure into a more dynamic banking structure stems from several considerations. It is felt that there is scope for increasing the size and capacity of the banking structure. There is also an imperative need for increasing the outreach of the banking structure. With the size of the economy increasing, banks require a large international presence. Several gaps exist in providing credit to certain sectors. These gaps need to be filled. There is also a need for the presence of specialised and niche banking entities to cater to the specific needs of a growing and dynamic economy. With a view to moving towards a dynamic banking structure that caters to these multiple functions, the Discussion Paper has suggested basic building blocks in the reorientation exercise:

- On tap licensing as compared to a block licensing approach to enhance competition and bring in new ideas and variety into the system.
- Implementing a domestic systemically important bank framework to deal with negative externalities of large banks.
- Creating three or four global sized banks to have a global presence through consolidation among large public and private sector banks (on a voluntary basis), keeping in view the need for competition within the domestic banking sector and avoiding complex structures.
- Allowing banks for niche segments to take care of specialised banking needs through differentiated licensing.
- Encouraging investment banks/investment banking activities.
- Encouraging inclusion to reach out to the excluded and under-banked regions. Small banks at the bottom of the tiered structure may be the preferred vehicle for these objectives to facilitate financial inclusion.
- Enhancing the regulatory and supervisory regimes with increased intensity of supervision for the systemically important banks.
- Evolving an efficient deposit insurance and resolution mechanism to support the envisaged tiered structure.
- Converting urban co-operative banks which meet the necessary criteria into commercial banks or local area banks/small banks.
- Enhancing the presence of foreign banks to stimulate competition and their subsidiarisation from the perspective of financial stability.
- Expanding the size and capacity of banking structure which enhances the ability of the banking system to cope with multiple demands made on it for credit and varied services by diverse customer base.

The Discussion Paper sets the tone for an informed discussion on the need for reorienting the present banking structure through a more liberalised policy regime, which will facilitate the evolution of a multi-tier banking structure.

rollout, 29 banks have been brought under RBS from 2013-14 constituting approximately 66 per cent of the total assets of the Indian banking system. Banks have also been sensitised about the minimum expectations that supervisors have from banks on aspects like risk appetite, a market related and efficient transfer price mechanism, effective business line mapping, risk-based pricing and risk-based internal audit and IT infrastructure for risk management. In this context, banks need to gear up to the challenges for a smooth transition to RBS.

***Policy initiatives for improved cross border supervision and cooperation***

1.13 The cross border operations of Indian banks are rapidly increasing. In view of this, the formalisation of the relationship between "Home" and "Host" supervisors, by way of a Memorandum of Understanding (MoU), has become an important channel for the Reserve Bank. In this context, the Reserve Bank has initiated the process of signing MoUs with overseas regulators on supervisory cooperation and exchange of information.

1.14 The Reserve Bank has executed MoUs with 16 overseas supervisors. In addition, proposals with respect to 28 other overseas supervisors are in various stages of arriving at a mutually agreeable format of MoUs. Further, the Reserve Bank has set up supervisory colleges[4] for State Bank of India and ICICI Bank Ltd. These colleges are likely to emerge as a key tool of consolidated supervision particularly considering the expanding footprints of Indian banks abroad.

***Steps initiated to enhance oversight of financial conglomerates***

1.15 One of the mandates assigned to the Financial Stability and Development Council (FSDC) is macro-prudential supervision of the economy, including the functioning of large Financial Conglomerates (FCs). In this context, an institutional structure for the oversight and monitoring of FCs has been set up in the form of an Inter-Regulatory Forum (IRF) modeled around the "lead regulator" principle.

1.16 To enable IRF to have an institutional mechanism for periodic coordination towards a consolidated supervision of identified FCs, a MoU for facilitating data/information sharing and formalising other cooperation arrangements like coordinated inspection and recovery and resolution planning, was signed by RBI, SEBI, IRDA and PFRDA under the aegis of FSDC's sub-committee. Based on the criteria for identifying FCs and their financials for 2012, IRF has identified 12 FCs for monitoring, each having a significant presence in two or more market segments from amongst banking, insurance, capital market, pension fund and non-banking finance. Of the 12 identified FC groups, the Reserve Bank is the lead regulator for five identified FC groups, IRDA is the lead regulator for four and SEBI is the lead regulator for three FC groups.

***Structured and planned approach to further financial inclusion***

1.17 The Reserve Bank has been furthering financial inclusion (FI) through a combination of strategies including relaxing regulatory guidelines and providing new products and other supportive measures to achieve sustainable and scalable financial inclusion. The Reserve Bank has adopted a bank-led model for financial inclusion which seeks to leverage on technology. A structured and planned approach was followed under financial inclusion wherein all banks were advised to implement Board-approved Financial Inclusion Plans (FIPs) congruent with their business strategies and comparative advantage for a three-year period (2010-2013). The implementation of these plans was closely monitored by the Reserve Bank. In order to take financial inclusion to the next stage of universal FI in which all eligible individuals will have transactional accounts, banks were advised to draw up FIPs for 2013-16, which have since been submitted by the banks. Banks have been advised that the FIPs prepared by them should be disaggregated and percolated down to the branch level, with a view to ensuring the involvement of base level officials in FI efforts and also for ensuring uniformity in the reporting structure under FIP.

***Issue of new bank licences to further improve competition and enhance access to banking services***

1.18 To meet the needs of a dynamic real economy, the banking system needs to grow. Increasing the number of banks will promote financial inclusion, foster competition and thereby reduce costs and improve the quality of services. Accordingly, the Reserve Bank invited applications for "Licensing of New Banks in the Private Sector". It received 26 applications for new

[4] "Supervisory colleges" refer to multilateral working groups of relevant supervisors that are formed for the collective purpose of enhancing effective consolidated supervision of an international banking group on an ongoing basis.

bank licences. The Reserve Bank will soon issue new bank licences consistent with the highest standards of transparency and diligence.

***Road map for a structured and efficient payment and settlement system***

1.19 The Reserve Bank has been laying down broad policy contours on reforms in payment systems. In this context, the latest Vision Document on "Payment Systems in India-Vision 2012-15" released on October 1, 2012, outlines the strategy to be followed over the next three years for providing safe, efficient, accessible, inclusive, interoperable and authorised payment and settlement systems for the country (Box I.3).

***Capital infusion in public sector banks to enhance capital adequacy***

1.20 The Basel III capital regulation has been implemented in India from April 1, 2013 in phases and will be fully implemented as on March 31, 2018. These norms lay more focus and importance on quality, consistency and transparency of the capital base. The Reserve Bank has estimated the additional capital requirements of domestic banks for full Basel III implementation till March 2018. These estimates are based on two broad assumptions:

(i) increase in the risk weighted assets of 20 per cent per annum; and

(ii) internal accrual of the order of 1 per cent of risk weighted assets.

1.21 The estimates suggest that public sector banks will require an additional capital to the tune of ₹4.15 trillion, of which equity capital will be of the order of ₹1.4 - 1.5 trillion, while non-equity capital will be of the order of ₹2.65 - 2.75 trillion. Being the majority stakeholder, Government has been infusing capital in these banks. During the last five years, the Government has infused ₹477 billion in the public sector banks. The Government will infuse ₹140 billion in the public sector banks during 2013-14. The present level of Government share holding in these banks ranges from 55 per cent to 82 per cent. Thus, there is sufficient headroom available to the Government for dilution of its stake in a number of public sector banks.

***Need for improving the asset quality of banks***

1.22 The NPA ratio of all major sectors weakened during 2012-13. While the primary driver of the deteriorating asset quality was the domestic economic slowdown, the contribution of other factors like delays in obtaining statutory and other approvals as well as lax credit appraisal/ monitoring by banks was also significant. Further, credit concentration in certain sectors and higher leverage among corporates also increased stress on asset quality. In recent years there has also been a sharp increase in the amount of debt restructured under the corporate debt restructuring mechanism. This has implications for the banks' already stressed asset quality in the period ahead.

1.23 In order to upgrade the banks' credit monitoring system, the Reserve Bank advised them to have a robust mechanism for early detection of signs of distress and to use such early warning signals to put in place an effective preventive asset quality management framework. The Reserve Bank has also advised banks to strengthen the information sharing mechanism among lenders by making it compulsory for banks to receive/share information on borrowers before sanctioning loans. Going forward, it is anticipated that the position may improve if there is a pick-up in the GDP growth rate coupled with an improvement in project implementation due to the Government's intent/efforts and improvements in banks' recovery efforts.

## 4. The Way Forward

1.24 In the years ahead banks are expected to play a much larger role in supporting the productive impulses of the economy. In this

**Box I.3:**
**Highlights of Vision Document 2012-15 on Payment and Settlement Systems**

The growth of electronic payments has been impressive in recent years. However, the benefits of modern electronic payment systems are not spread evenly among all sections of society and across the different regions of the country. Despite multiple electronic modes of payment being available, cash is still the preferred and dominant mode of payment in large parts of the country. Against this backdrop, Vision Document 2012-15 aims to promote a less cash/less paper society, with increased emphasis on the use of electronic payment products and services, especially by the populace which is still not covered by these products. Achieving the goal of a less cash economy and inclusiveness will require infrastructure for an underlying robust payment system. Therefore, there is a need for transforming the "fit for current purpose" payment system infrastructure into a state of "ready for future challenges" infrastructure.

The Vision Document focuses on promoting electronic modes of payment and reducing usage of cash in society by:

(i) proactively promoting electronic payments,

(ii) developing policy guidelines which are equitable, uniform and risk-based,

(iii) increasing efficiency of payments through standardisation and capacity building in terms of systems and human resources and implementing giro payments,

(iv) setting up a body for setting standards,

(v) addressing the risks in payment systems and strengthening risk management through continuous interaction with stakeholders,

(vi) promoting access and inclusion through payment system literacy initiatives,

(vii) facilitating migration of government payments and receipts to electronic mode,

(viii) promoting use of pre-paid payment instruments, Electronic Benefit Transfer (EBT), Direct Transfer of Subsidies (DTS) and e-commerce,

(ix) ensuring smooth operations of payment systems through focus on off-site surveillance, need based inspection of retail payments and annual inspections of Financial Market Infrastructures (FMIs); and

(x) ensuring compliance with new international standards.

The Vision Statement sets out the road map for ensuring the benefits of a structured modern payment and settlement system, including innovative products, to reach out beyond the currently served target groups thereby facilitating greater financial inclusion. This is to be achieved by nurturing a payment system that adequately serves the national and international transaction needs of the nation.

context, some of the key issues are highlighted below.

***Effective reduction in NPAs and improvements in the loan recovery process***

1.25 The asset quality of banks is an important indicator of their financial health; it also reflects the efficacy of their credit risk management and recovery environment. The asset quality of the banking system deteriorated significantly during the year and there was an increase in the total stressed assets in the banking system (that is, NPAs plus restructured assets). Banks need to not only follow the various measures put in place by the Reserve Bank and the Government of India effectively for resolution and recovery of bad loans but also strengthen their due diligence, credit appraisal and post sanction loan monitoring systems to minimise and mitigate the problems of increasing NPAs. There is a need to improve the effectiveness of the recovery system. Recovery should be focused on efficiency and fairness - preserving the value of underlying assets and jobs where possible, even while redeploying unviable assets to new uses and compensating employees fairly. This should be done while ensuring that contractual priorities are met. In this regard, there is urgent need for accelerating the working of Debt Recovery Tribunals and Asset Reconstruction Companies. It is also necessary to collect credit data and examine large common exposures across banks. This will enable the creation of a central repository on large credits, which can be shared with the banks. This in turn will enable banks to be aware of building leverage and common exposures. This also underscores the need for expediting the setting up of an enhanced resolution structure for financial firms. Going forward, these issues will engage priority attention of Reserve Bank.

***Renewed emphasis on banks' role in fostering inclusive development***

1.26 It is recognised that access to finance is still hard for the poor, for rural, small and medium industries and also for the small and marginal traders. Banks need to play a much larger role in a faster, broad-based and inclusive growth leading to a rapid fall in poverty. An assessment of the progress made in financial inclusion since the introduction of Board-approved Financial Inclusion Plans reveals that while there has been considerable progress in the number of accounts opened, the actual number of transactions per account or per business correspondent (BC) continues to be extremely low. The low transaction levels indicate inadequacies on both the demand and supply sides. In this context, financial literacy efforts are expected to enhance access to the financial system by increasing awareness. Banks need to appreciate that transactions will happen if account holders have a stake in the accounts which will arise only when a variety of banking services, including entrepreneurial credit like Kisan Credit Card/ General Credit Card, an overdraft for consumption needs, direct benefit transfers and other remittance facilities are provided. Business and delivery models for providing these and other financial services need to be evolved and implemented.

1.27 Technology has the potential to act as a force multiplier in efforts for financial inclusion. There is, however, also an increasing realisation that mere reliance on technology-enabled non-face to face channels alone will not be sufficient to meet the goal of creating an inclusive financial system. Wherever feasible and viable, banks may consider opening more brick and mortar outlets as delivery points, both as a control mechanism for BCs and to gain the trust and acceptability of the financially excluded segment of the population.

***Need to stimulate and foster competition in the banking sector***

1.28 One of the major objectives of financial reforms was bringing in greater efficiency by allowing more operational flexibility for banks. Accordingly, the Reserve Bank has freed bank branching for domestic scheduled commercial banks. Opening new branches needs to be left to the discretion of all scheduled domestic commercial banks except for those that are poorly managed. Of course, while making use of such freedom banks are required to fulfill certain inclusion criteria in under-served areas in proportion to their expansion in urban areas.

***Continued need to reduce pre-emption of banks' resources***

1.29 One of the mandates for the Reserve Bank in the RBI Act is ensuring the flow of credit to productive sectors of the economy. In this context, it is necessary to reduce banks' requirements of investing in government securities in a calibrated way, to what is strictly needed from a prudential perspective. It is recognised that the scope for such reduction will increase as government finances improve. Further, as the penetration of other financial institutions, such as pension funds and insurance companies increases, it will be possible to reduce the need for commercial banks to invest in government securities.

***Intensified use of technology to improve efficiency***

1.30 The public should have improved access to safe investment vehicles, to be able to transfer funds, to obtain direct benefits from the government without costly intervening intermediaries and to raise funding for viable investment opportunities. In addition, access to credit for smoothening consumption needs or to tide over emergencies is desirable, especially for households in the lower income deciles. Policy endeavours should continue to provide enabling conditions to facilitate this.

1.31 There is a need to create and foster a national giro like pan-India bill payment system so that households will be able to use bank accounts to meet the multitude of day-to-day payments and funds transfer obligations at a

single point. Payments "anywhere anytime" need to be a reality. Setting up "White Label" point of sale (POS) devices and mini-ATMs by non-bank entities to cover the country so as to improve access to modern financial services in rural and remote areas needs to be encouraged.

***Increasing the presence of foreign banks***

1.32 The objective of foreign banks' participation in India was primarily to increase competition, promote efficiency of the local banking system and also adapting their sophisticated financial services and products with respect to domestic banks. At present foreign banks are operating in India as branches. From the perspective of financial stability, a move towards subsidiarisation of foreign banks should be welcome. India needs foreign banks to participate more in the growth process, but in exchange it is important to have more regulatory and supervisory control over their local operations. Encouraging qualifying foreign banks to move to wholly owned subsidiary structures, where they will enjoy near national treatment, will be a policy that will be consciously encouraged.

***Objective assessment of the existing banking structure***

1.33 An objective assessment of the size and performance of the existing banking structure in India brings to the fore the need for expanding the commercial banking system in terms of its size and the number of banks and calls for decisive changes in the present structure to enable it to grow in size, resources, efficiency and inclusivity. The Reserve Bank has initiated a debate on reorienting the banking structure in the country to better serve the needs of the real economy. As the Indian economy expands, more resources will be needed for supporting the growth process. To support economic growth as envisaged in the 12$^{th}$ Five Year Plan, the banking business needs to expand significantly to an estimated ₹288 trillion by 2020 from about ₹115 trillion in 2012[5]. The Indian banking sector also needs to match up the likely acceleration in the credit to GDP ratio as the economy expands. The overall thrust of the reorientation should be on imparting dynamism and flexibility to the evolving banking structure, while keeping it safe from depositors' perspective.

***Need to liberalise licensing policies***

1.34 Regulators need to ensure that their regulatory stance does not create barriers to the entry or exit of institutions or result in unwarranted costs to the economy and consumers. Instead, regulation should impose restrictions on institutions in such a way that it does not cause a moral hazard problem. Accordingly, the Reserve Bank's Discussion Paper favours "continuous authorisations" of new banks and explores the possibility of introducing differentiated licences for small and wholesale banks and the possibility of converting large urban co-operative banks into commercial banks to impart dynamism to the banking system. However, this is not to undermine the need for ensuring sufficiently stringent entry norms to prevent the entry of banks of questionable soundness or competence, since their proliferation could undermine public confidence in the overall integrity of the banking system.

1.35 To sum up, banks will have to face a multitude of challenges while conforming to the emerging regulatory and supervisory framework and in meeting the divergent needs of the economy. In the near term, banks need to focus on improving their asset quality. Policy changes that are contemplated in the medium term will help further reinforce the dynamism of the banking system.

[5] *Banking Structure in India-The Way Forward*, Discussion Paper, Reserve Bank of India, August 2013.