Chapter I

Perspective and Policy Environment

Introduction

1.1 The risks to global financial stability continued to remain at elevated levels, with global growth witnessing a fragile and multi-paced pattern of recovery. In the meanwhile, the global macro-financial risks shifted from advanced to emerging economies with the latter facing pressures from weakening prospects of growth, falling commodity prices and strengthening of the dollar.[1] Within the emerging world, however, the Indian economy appeared quite resilient, given a modest recovery in the economy, declining inflation and buoyant capital flows that helped in maintaining the external sector balance.

1.2 The performance of the Indian banking sector during the year, however, remained subdued. First, the banking sector experienced a slowdown in balance sheet growth in 2014-15, a trend that had set in since 2011-12. The slowdown was most notable in the case of bank credit, which dipped to a single-digit figure during the year. Second, while profits of the banking sector turned around from an absolute decline in the previous year, this positive growth was on account of a decline in the growth of operating expenses rather than a rise in the growth of income of the banks. Third, notwithstanding the increase in profit growth, the return on assets (RoA), a common indicator of financial viability, did not show any improvement in 2014-15. In particular, the profitability of public sector banks (PSBs) diminished with their RoA declining significantly in recent years. Fourth, the deterioration in the asset quality of banks in general, and PSBs in particular, continued during the year with rise in volume and proportion of stressed assets.

1.3 The other constituents of the banking sector, namely Regional Rural Banks (RRBs) witnessed deceleration in profit growth. However, Local Area Banks (LABs) recorded an improvement in their profitability.

1.4 The operations of urban and rural credit cooperatives, another major segment of the Indian financial landscape, are fraught with concerns arising out of multiple regulatory control and governance. There has been a steady progress towards resolving these concerns by instituting appropriate regulatory changes, a process which continued even in 2014-15. These measures have by and large helped in improving the financial performance of these institutions during the recent years; the improvement, however, has been slow-paced and limited to certain segments of the cooperative system. Illustratively, while there has been a turnaround in the financial stability indicators of the state level short-term co-operative credit institutions, asset quality concerns remain for the long-term institutions.

1.5 Finally, the balance sheet and financial performance of non-banking financial companies (NBFCs), which play a vital role in catering to various niche demands in financial services, were at variance with the commercial banking sector in some respects while mirroring the sector in other respects in 2014-15. The growth in credit from NBFCs was higher than the bank credit and this also showed an increasing trend on a year-on-year basis. However, like commercial banks, the asset quality of NBFCs also deteriorated.

1.6 In sum, the operations of the banking sector and the NBFC sector for the year 2014-15, exhibited several weak spots. However, when compared with the global banking trends in profitability, asset quality and capital positions, the Indian banking sector did not appear to be an exceptional under-performer. Furthermore, the regulatory steps initiated in 2014-15 as well as in the earlier years are expected to address

[1] Global Financial Stability Report – April 2015, IMF.

many of the short-term concerns afflicting the sector, while paving way for medium to long-term reforms in this sector.

1.7 Some of the major regulatory steps taken during the year and the perspectives about how these steps would help in reforming the Indian banking sector are as follows:[2]

De-stressing the banking sector

1.8 As decline in asset quality has been a key area of concern for the banking sector in general and PSBs in particular, several regulatory measures to de-stress banks' balance sheets have been taken in the recent years, including in the year 2014-15. The basic Framework for Revitalising Distressed Assets in the Economy was released by the Reserve Bank in January 2014. Following this, several regulatory steps were taken which were aimed at instituting a mechanism for rectification, restructuring and recovery of stressed assets. These involved the preparation of a corrective action plan by the Joint Lenders' Forum (JLF) for distressed assets, periodic refinancing and fixing a longer repayment schedule for long-term projects as part of flexible structuring, extension of the date of commencement of commercial operations in the case of project loans to infrastructure sector without these loans being labelled as non-performing advances (NPAs) subject to certain conditions, strategic restructuring of debt involving the provision to convert debt into equity, issuance of guidelines about classification of wilful defaulters and non-cooperative borrowers, among others.

Reforming the public sector banks (PSBs)

1.9 The PSBs have contributed significantly to expand the outreach of Indian banking geographically and sectorally. Furthermore, they have been instrumental in providing credit support to the mammoth infrastructural needs of the country. However, the PSBs have been presently affected by several immediate concerns relating to profitability, asset quality and many long-standing issues about capital positions and governance.

1.10 A need was, thus, felt to initiate certain reform measures for PSBs. Accordingly, the government announced regulatory reforms relating to PSBs as part of 'Indradhanush' (a seven-point action plan) package in August 2015. This included a number of recommendations made by the Committee to Review the Governance of Boards of Banks in India (Chairman: Dr. P. J. Nayak) in May 2014.

1.11 The salient reforms under this package involved a restructuring of the appointment process of whole-time directors and non-executive chairmen of the PSBs while the bifurcation of the post of Chairman and Managing Director of PSBs into executive Managing Director and non-executive Chairman was done in December 2014. Both these steps would imbibe professionalism in the operation of banks' boards and improve their efficiency in the decision making process.

1.12 A fresh plan for recapitalisation was also introduced as part of the seven-point plan with the proposed capital infusion in PSBs, following a performance and need-based approach to the tune of ₹700 billion till 2019. This capital support would be vital for PSBs in light of their weakening capital positions and would enable them to adopt the Basel III framework. Furthermore, a framework for accountability for PSBs was also introduced based on Key Performance Indicators (KPI) that measured the performance of these banks using quantitative and qualitative indicators. This would improve the overall functioning of PSBs and make them more accountable to their stakeholders.

Improving monetary policy transmission

1.13 In 2014-15, following the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (Chairman: Dr. Urjit

[2] For a detailed chronology of policy measures relating to the banking sector, see the *RBI Annual Report* – 2014-15.

R. Patel), the Reserve Bank adopted a flexible inflation targeting approach in monetary policy formulation, aimed at making it more transparent and predictable. However, some of the structural rigidities within the credit market tend to impede the transmission of the monetary policy. The stickiness of the base rate system itself has been identified as an impediment to an effective transmission. Hence, in 2014-15, the Reserve Bank allowed banks to revisit their base rate methodology on a more frequent basis and also encouraged them to use marginal cost of funds instead of average cost of funds to calculate the base rate. Going forward, banks will be encouraged to move to marginal cost pricing and then to using market benchmarks.

Strengthening the liquidity standards of banks

1.14 While the Indian banks are in the process of migrating to capital standards as prescribed under the Basel III framework, the implementation of liquidity standards marks the second important step in implementing the package of reforms suggested by the Basel Committee on Banking Supervision (BCBS). Following the final guidelines from the Reserve Bank, the liquidity coverage ratio (LCR) was made operational as part of the Basel III framework on liquidity standards on January 1, 2015. The compliance to this ratio has been made easier for banks as a part of their Statutory Liquidity Ratio (SLR) investments has been deemed eligible to be classified as high quality liquid assets. Furthermore, the Reserve Bank also prescribed liquidity monitoring tools and liquidity disclosures for strengthening the liquidity management by banks.

Monitoring the build-up of leverage in the banking system

1.15 India has been in the forefront in terms of adopting capital adequacy norms as per the Basel III framework and has in fact stipulated a higher Capital to Risk-Weighted Assets Ratio (CRAR) than what is recommended by the BCBS. In January 2015, it also introduced a simple, back-stop, non-risk based measure of leverage in the form of an indicative Leverage Ratio of 4.5 per cent as part of a parallel run till the final norms for the same are prescribed by the BCBS. This ratio is expected to supplement the risk-based CRAR in monitoring excessive risk-taking and build-up of on and off-balance sheet leverage by banks.

Dealing with the concern of too-big-to-fail

1.16 The Financial Stability Board (FSB) has issued the final Total Loss-Absorbing Capacity (TLAC) standard for global systemically important banks (G-SIBs) on November 9, 2015 as part of its reforms agenda to deal with 'too-big-to-fail' for banks. The standard has been designed to ensure that the G-SIBs would have sufficient loss-absorbing and recapitalisation capacity available for implementing an orderly resolution that minimises impact on financial stability, maintains the continuity of critical functions, and avoids exposing public funds to loss.

1.17 The standard would be implemented in all FSB jurisdictions. G-SIBs would be required to meet the TLAC requirement alongside the minimum regulatory requirements set out in the Basel III framework. They would be required to meet a minimum TLAC requirement of at least 16 per cent of the resolution group's risk-weighted assets (RWAs) (TLAC RWA Minimum) from January 1, 2019 and at least 18 per cent from January 1, 2022. Minimum TLAC must also be at least 6 per cent of the Basel III leverage ratio denominator (TLAC Leverage Ratio Exposure (LRE) Minimum) from January 1, 2019, and at least 6.75 per cent from January 1, 2022. G-SIBs headquartered in emerging market economies (EMEs) would be required to meet the 16 per cent RWA and 6 per cent LRE Minimum TLAC requirement no later than January 1, 2025, and the 18 per cent RWA and 6.75 per cent LRE Minimum TLAC requirement no later than January 1, 2028. This conformance period will be accelerated if, in the next five years, the aggregate amount of the EME's financial and non-financial corporate debt securities or bonds outstanding exceeds 55 per cent of the EME's GDP. Monitoring of

implementation of the TLAC standard would be done by the FSB and a review of the technical implementation would be done by the end of 2019.

1.18 Though there are 17 G-SIBs operating in India, none of these is headquartered in India. The identification of Domestic-Systemically Important Banks (D-SIBs) and designing an additional capital charge for these institutions would be an important step in preserving systemic stability of the Indian banking sector. While the framework for regulatory treatment of G-SIBs has been designed by the FSB, the Reserve Bank has framed the guidelines for the D-SIBs. Accordingly, the list of D-SIBs was released in August 2015 highlighting the names of the two largest banks, one each from the public and private sector. This list would be updated each year in August and the identified banks have to meet the additional Tier I capital requirements.

Convergence with the international accounting standards

1.19 An important component of the ongoing global reforms for the banking sector is the accounting reforms such that banks prepare their financial statements in a standardised and internationally acceptable manner. The issue of convergence of the current accounting framework under the Indian Accounting Standards with the International Financial Reporting Standards (IFRS) has been under consideration since 2006. Towards this objective, a roadmap was proposed by the Reserve Bank for implementing IFRS which would enable both the Scheduled Commercial Banks (SCBs) and the NBFCs to migrate to the IFRS from 2018-19 onwards.

Minimising the regulatory arbitrage between banks and non-banks

1.20 A major component of the reforms envisaged by the FSB relates to treatment of shadow banking sector. In the Indian context, NBFCs are considered as shadow banks. However, the concerns that afflict shadow banks in other countries do not exist much in India as they are well regulated and do not undertake any complex financial transactions.

1.21 In 2014-15, the regulations governing NBFCs were further strengthened to minimise the scope for regulatory arbitrage between these institutions and banks. Accordingly, a calibrated strengthening of the norms for provisioning and asset classification was prescribed for NBFCs. Furthermore, like commercial banks, the NBFCs were directed to disclose their large credits and create a special sub-category of assets as Special Mention Accounts (SMAs) to detect incipient signs of stress in their loan books. Along with the regulatory requirements to step up the capital base and seek credit rating for any further deposit mobilisation for deposit taking NBFCs, these recent measures would place the entire non-banking sector on a sound regulatory footing.

Reviving the licensing and expansion of urban co-operative banks

1.22 Urban Co-operative Banks (UCBs) have played an important role in extending financial inclusion in India since their inception in the early 20th century and more so, after they were brought under the purview of the Banking Regulation Act (as applicable to co-operative societies) in 1966. However, given the rapid growth of these banks and increasing concerns about their financial soundness, the Reserve Bank initiated the process of voluntary consolidation of these institutions in 2005. This process was aimed at encouraging the growth of financially stronger UCBs and non-disruptive exit of the weaker ones. Consequently, the issuance of fresh licenses to the UCBs was also put on hold.

1.23 However, with a considerable progress made regarding the consolidation of this sector, the issue of licensing was revisited by two recent committees: the Expert Committee on Licensing of New UCBs (Chairman: Shri Y. H. Malegam) and the High Powered Committee on UCBs (Chairman: Shri R. Gandhi). The latter has suggested the timing and terms for

licensing of new UCBs taking into account the concerns relating to financial stability, financial inclusion, existing legal framework and business considerations of individual UCBs. The Committee has suggested that a UCB with business size of ₹200 billion or more may be eligible to convert to a commercial bank. Further, smaller UCBs can voluntarily convert to Small Finance Banks (SFBs) irrespective of the threshold limit, provided they fulfill all the eligibility criteria and given the availability of licencing window to the SFBs.

Making the banking sector more inclusive

1.24 Financial inclusion ranks high in the list of priorities of the Reserve Bank. Accordingly, banks were encouraged by the Reserve Bank to pursue Board-approved three-year Financial Inclusion Plans (FIP) since 2010. With the inception of the Pradhan Mantri Jan Dhan Yojana (PMJDY) in August 2014, the Government of India has accorded top priority to the pursuit of financial inclusion.

1.25 Many of the measures taken by the Reserve Bank in 2014-15 have reaffirmed its commitment to financial inclusion. The salient ones among these were: the licensing of two universal banks in August 2014 identified on the basis of their business plan to achieve financial inclusion; 10 differential licenses for payments banks and 11 licenses for SFBs catering to small payments/finance needs in the economy; revising the priority sector guidelines with a specific focus on small and marginal farmers and micro-enterprises and further simplification of the Know-Your-Customer (KYC) guidelines for low risk customers. Further, to work out a medium-term (five year) measureable action plan for financial inclusion, the Reserve Bank has constituted a Committee on Medium-term Path on Financial Inclusion (Chairman: Shri Deepak Mohanty).

1.26 To conclude, a competitive, sound and inclusive banking system is *sine-qua-non* for a growing economy like India that aspires to be globally competitive. Despite the fact that the year 2014-15 posed several challenges for the Indian banking sector, various proactive and forward-looking policy measures were taken. These policies would enable banks to face the challenges relating to asset quality and profitability in the short-term and would also support them to meet the diverse and largely unmet needs of banking services, while successfully competing with global players, in the long-term.