

Globally, as well as in India, the banking and non-banking sectors have weathered the COVID-19 disruptions well, supported by policy measures. As economic growth picks up and policy measures are rolled back, the pandemic's impact on banks' balance sheets will be clearer. Climate change and technological innovations pose medium-term challenges to the sector, which will need to be addressed through carefully crafted strategies.

I.1 Globally, the banking sector remained resilient throughout the pandemic, aided by extraordinary policy initiatives by central banks and governments. Higher capital, better liquidity buffers and lower leverage allowed them to cushion the shock of the pandemic. Measures such as moratorium on payment of loan installments, asset classification standstill, restructuring of loans and restrictions on dividend payouts alleviated the stress, while helping banks to continue to provide credit to productive sectors.

I.2 As vaccination drives gathered pace across jurisdictions and economic activity hesitantly started turning around, time-bound and smooth unwinding of regulatory forbearances assumed importance from the viewpoint of financial stability. In India, most pandemic measures had a well specified sunset clause, and some have run their course during the year. However, the impact of these transient measures on banks' financial health is not immediately clear and can be fully fathomed only after passage of time.

I.3 A fallout of the pandemic and the slowdown in economic activity is that credit growth of scheduled commercial banks (SCBs) remained subdued in 2020-21 but non-banking financial companies (NBFCs) have stepped up to fill this space. In H1:2021-22, although credit growth of SCBs has shown some uptick, concerns have emerged about NBFCs' asset quality.

I.4 The Reserve Bank, in association with the Government, had to devise strategies to resolve two private sector banks (PVBs), a large urban co-operative bank (UCB) and a few NBFCs since 2018. As a lender of the last resort, the endeavour of the Reserve Bank has been to contain spillover risks to maintain financial stability, protect depositors' interest while also ensuring that such solutions do not lead to moral hazard, going forward.

I.5 The pandemic has brought about a shift in adoption of digital technology with multi-faceted opportunities in the financial sector, while posing certain challenges of tackling cybersecurity/frauds to all stakeholders including regulators and supervisors. Climate change has emerged as an overarching concern, enveloping all aspects of human life, including the financial sector.

I.6 Against this backdrop, this chapter presents a bird's eye view of the challenges faced by the banking and non-banking sectors and offers a futuristic view about policy options available to the regulator.

Emerging from the Shadows of COVID-19

I.7 In the wake of the pandemic-related lockdowns during 2020-21, supply chains froze, and demand declined on economic agents trying to conserve cash with a precautionary motive. This resulted in sharp decline in credit growth

even as deposits increased. The fall in yields provided a silver lining, as banks booked profits on their trading accounts. Banking stocks were affected particularly adversely as markets priced in future asset quality deterioration, affecting shareholders' wealth and confidence. Although construction of a counterfactual is difficult, the benefit of hindsight indicates that the pandemic's impact on the economy would have been much sharper, had the Government and the Reserve Bank not stepped in with timely initiatives.

I.8 Data available for 2021-22 so far indicate that banks' gross as well as net non-performing assets have moderated while provision coverage ratios (PCRs), capital buffers as well as profitability indicators have improved relative to pre-pandemic levels. A closer look at granular data, however, reveals a more nuanced picture. Credit growth is muted, indicative of pandemic scarring on aggregate demand as also risk aversion of banks. Banks' asset quality may get dented, going forward.

I.9 Most of the regulatory accommodations announced by the Reserve Bank, including deferment of implementation of net stable funding ratio (NSFR), restrictions on dividend payouts by banks, deferment of implementation of the last tranche of capital conservation buffer (CCB) have already expired. As the pandemic situation is dynamic, the regulatory response will be calibrated in response to the evolving situation.

Resolution of Stressed Assets

I.10 During the two waves of COVID-19, the Reserve Bank announced Resolution Frameworks (RF) 1.0 and 2.0 to provide relief to borrowers and lending institutions. While the restructuring of large borrowal accounts under RF 1.0 could be invoked by December 31, 2020 and implemented

within 180 days from the date of invocation, they have time till September 30, 2022 to achieve the operational parameters. On the other hand, resolutions under RF 2.0 for individuals, small businesses and MSMEs could be invoked before September 30, 2021 and the resolution plan had to be implemented within 90 days from the date of invocation. As support measures start unwinding, some of these restructured accounts might require higher provisioning by banks over the coming quarters.

I.11 With the expiry of the suspension on fresh proceedings under the Insolvency and Bankruptcy Code (IBC) on March 24, 2021, creditors can again leverage on the IBC mechanism for resolution of stressed assets. This is also expected to empower MSMEs—as operational creditors—to recover their dues.

I.12 Through an amendment to the IBC Act, a pre-pack resolution window for MSMEs has been made available, which is a blend of formal and informal mechanisms having debtor-in-possession model as an option. Even before the corporate debtor's admission application is filed, debtor and creditors can negotiate and arrive at a potential resolution plan. This has considerably expedited and simplified the process up to admission in the National Company Law Tribunal (NCLT).

I.13 The setting up of the National Asset Reconstruction Company Limited (NARCL), to consolidate and take over the stressed debt from banks, is a step forward for resolution of large value legacy assets. International experience, however, suggests that for the experiment to succeed and to avoid perverse incentives, risks to banks' balance sheets are clearly identified; transparent transfer pricing for sale of assets are ensured; and management of the new entity is independent and professional.

Recapitalisation Requirements after COVID-19

I.14 Based on the capital position as on September 30, 2021, all PSBs and PVBs maintained the capital conservation buffer (CCB) well over 2.5 per cent. Going forward, however, banks would need a higher capital cushion to deal with challenges on account of the ongoing stress experienced by borrowers as well as to meet the economy's potential credit requirements. Concerted strategies for timely capital infusion need to be carried forward by the banks.

Climate Change

I.15 The assessment of the systemic impact of climate change on the economy and financial stability is still evolving and so are the responses of central banks and supervisors around the world.

I.16 While the value of green bonds issued constitutes a small portion of the total bond issuance in India, it occupies the second spot in cumulative emerging market green bond issuance during 2012-2020, as per estimates of International Finance Corporation (IFC). In April 2021, the Reserve Bank joined the Network for Greening of Financial System (NGFS)—a group of central banks and supervisors willing to share best practices and contribute to the development of environment and climate risk management in the financial sector. The Reserve Bank has begun participating in the workstreams of the NGFS, which will equip its staff with the necessary skills and knowledge on climate related risks.

I.17 The Reserve Bank is actively engaged in conducting research on areas such as green finance and the impact of climate change on various macroeconomic variables such as inflation and growth. It participates in various

international fora to discuss potential areas that need further research, methodological challenges, and ways to circumvent data challenges. The Reserve Bank has been actively assessing potential risks arising from sectors that account for a large portion of direct and indirect fossil fuel consumption in India.

I.18 A 'Sustainable Finance Group' (SFG) was set up in the Reserve Bank in May 2021 which co-ordinates with other national and international agencies on issues relating to climate change. The group would be instrumental in suggesting strategies and evolving a regulatory framework, including appropriate environmental, social and governance (ESG) disclosures, which could be prescribed for banks and other regulated entities (REs) to propagate sustainable practices and mitigate climate related risks in the Indian context. Going forward, it will analyse India-specific themes on the systemic stability impact of climate change and stress testing.

I.19 To assess the progress of REs in managing climate risk, the Reserve Bank is preparing a consultative discussion paper covering, *inter alia*, (i) governance (ii) strategy (iii) risk management and (iv) disclosure. The discussion paper will sensitise REs to incorporate climate-related and environmental risks in their business strategies as also in their governance and risk management frameworks. In line with the international best practices, banks will be guided to adopt a forward-looking, comprehensive, and strategic approach to climate-related risks.

I.20 India has reiterated its commitment to climate action at the United Nations Climate Change Conference (COP26) in November 2021 at Glasgow. In line with this resolve, and showcasing its solidarity with the NGFS, the Reserve Bank published a statement to support

greening India's financial system. Keeping in mind the national commitment, priorities and complexity of the Indian financial system, the Reserve Bank committed to (i) exploring how climate change scenario analysis can be used to identify vulnerabilities in the supervised entities' balance sheets, business models and gaps in their capabilities for measuring and managing climate-related financial risks; (ii) integrating climate-related risks into financial stability monitoring; and (iii) building awareness about climate-related risks among regulated financial institutions and spreading knowledge about issues relating to climate change and methods to deal with them accordingly.

Open Banking

I.21 Open banking frameworks allow authorised third parties to access customers' data, with the explicit consent of the latter. Benefits of the framework include convenient access to financial data and services to consumers and streamlining some costs for financial institutions. On the other hand, concerns about data privacy and security, customer grievance redressal, cybersecurity and operational risks, compliance and regulation risks need to be carefully addressed to develop a safe and secure ecosystem.

I.22 From the regulators' perspective, introduction of open banking has a wide range of ramifications. In many jurisdictions, including India, outsourcing arrangements by banks and other REs are covered under explicit regulations. Supervisors also have certain amount of oversight over third-party entities. If the relationships in the open banking extend beyond the existing supervisory and regulatory perimeters, the enforcement of standards and prudential policies may become difficult.

I.23 In contrast to the initiatives in some other countries, India has embraced an approach where both the regulator and the market collaborated towards development of the open banking space. In India, under the guidance of the Reserve Bank, the National Payments Corporation of India (NPCI) developed systems such as unified payments interface (UPI) and released its application programming interface (API) for banks and third-party app providers (TPAPs) to build upon. Market participants are also driving innovation and many banks are releasing their own APIs and joining forces with FinTech companies. Moreover, with the launch of its regulatory sandbox and the Reserve Bank Innovation Hub, the Reserve Bank has been guiding new vistas of development in financial intermediation.

I.24 At the same time, the importance of customer privacy and data protection cannot be overemphasised. Going forward, the challenge is to generate and sustain trust amongst customers about safety and security of the system while also nurturing innovation.

Digital Lending

I.25 In the recent period, many digital platforms have emerged that offer hassle-free loans to retail individuals, small traders, and other borrowers. Banks and NBFCs too, have started lending directly through their own digital platforms or indirectly through an outsourced platform. Many large multi-national corporations whose primary business is technology (e-commerce, social media, payments enablers *etc.*), popularly known as BigTechs, have started lending either directly or in partnership with regulated financial entities. Even enhancing the traditional entity-based regulatory approach with activity-based regulations may be inadequate to ensure stability, a level playing field, competition,

and customer protection. While use of digital channels in financial services is a welcome move, the potential downside risks embedded in such endeavours need to be addressed.

I.26 Taking cognisance of the recent spurt in unfair digital lending practices, the Reserve Bank had constituted a Working Group on Digital Lending that has made recommendations to foster a safe digital lending ecosystem, such as establishing a verification process for digital lending apps by a nodal agency; setting up of a self-regulatory organisation (SRO); enactment of a separate legislation to prevent illegal digital lending activities; development of certain baseline technology standards and compliance with those standards as a pre-condition for offering digital lending solutions; and consent-based data collection with verifiable audit trails. Going forward, a balanced approach needs to be followed so that the regulatory framework supports innovation while ensuring data security, privacy, confidentiality, and consumer protection.

Central Bank Digital Currency

I.27 In its basic form, a central bank digital currency (CBDC), provides a safe, robust, and convenient alternative to physical cash. Depending on various design choices, it can also assume the complex form of a financial instrument. In comparison with existing forms of money, it can offer benefits to users in terms of liquidity, scalability, acceptance, ease of transactions with anonymity and faster settlement. Central banks across the globe are now deliberating on how to implement CBDCs, moving ahead from their initial exploratory forays.

I.28 Certain crucial questions about design elements of CBDC need to be navigated before its introduction, *e.g.*, whether the CBDC would be general purpose and available for retail use

(CBDC-R), or would it be for wholesale use (CBDC-W). Furthermore, in a country like India, the decision about distribution architecture, *i.e.*, whether CBDC would be issued directly by the central bank or through commercial banks, needs to be carefully weighed. Gauging magnitude of issuance/ distribution will also help in identifying the appropriate underlying technology best suited to handle such operations.

I.29 Given its dynamic impact on macroeconomic policy making, it is necessary to adopt basic models initially, and test comprehensively so that they have minimal impact on monetary policy and the banking system. India's progress in payment systems will provide a useful backbone to make a state-of-the-art CBDC available to its citizens and financial institutions.

Payments Banks

I.30 Payments banks (PBs)—offering basic banking services to the underserved segments of the society by leveraging technology—are under constant pressure to innovate to maintain competitiveness, especially against BigTech players. As a result, their operational costs and investment needs are higher than other segments of the banking sector, affecting their profitability.

I.31 Given the higher incidence of frauds and complaints about their operations, PBs need to be vigilant on these fronts while addressing customer complaints efficiently. They have a large network of business correspondents (BCs), who facilitate wide geographical reach and financial inclusion. This, however, necessitates close oversight to ensure continued public confidence in digital transactions.

I.32 Going forward, challenges facing them will include development of technologically sound and intuitive user interfaces that attract

and retain new clientele. On the other hand, the potential increase in the volume of customers necessitates diligence in terms of security and timely resolution of glitches.

Small Finance Banks

I.33 The primary cashflows of small finance banks (SFBs) were adversely affected during the first phase of the pandemic. Even before, structural problems have beset the sector. Many SFBs have concentration risk on both sides of their balance sheets. On the liabilities side, they have low CASA/retail CASA deposits and rely heavily on bulk deposits and term deposits from co-operative banks. On the assets side, the share of unsecured microfinance loans is disproportionately large. From the perspective of sound risk management, SFBs need to diversify their assets as well as their liability profiles.

I.34 The governance culture in these banks needs improvement. High attrition levels, especially at top ranks need to be addressed. SFBs also need to strengthen their information technology (IT) infrastructure for better customer experience and for cyber security resilience.

Co-operative Banks

I.35 The co-operative banking sector in India emerged relatively unscathed from the first wave of the pandemic, although structural issues continue to mar the sector.

Capital Related Issues

I.36 Amendment to the Banking Regulation Act, 1949 granted powers to the Reserve Bank to regulate the issue of paid-up share capital and securities by co-operative banks. The amendment enables co-operative banks to raise capital through instruments such as equity shares, preference shares, special shares, unsecured debentures, and bonds, with prior permission of the Reserve Bank. It also has enabling

provisions for co-operative banks to raise capital at premium, as also take the recourse to public and private placement for raising capital.

I.37 To give effect to the above, the Reserve Bank sought comments on draft guidelines on issue and regulation of share capital and securities of UCBs. The draft guidelines permit UCBs to raise equity share capital as hitherto. Additionally, they delineate guidelines pertaining to the instruments for raising capital, suitably revising them wherever warranted to ensure congruity with the extant statutory provisions. The draft guidelines further provide the prudential criteria based on which the UCBs can refund the value of share capital to their shareholders. However, the issues of raising capital at premium and public issue / private placement of securities issued by UCBs require further examination.

Amalgamation of District Central Co-operative Banks (DCCBs) with State Co-operative Bank (StCB)

I.38 With the provisions of the Banking Regulation (Amendment) Act, 2020 being enlarged, rules governing the amalgamation of DCCBs with their respective StCB are homogenized irrespective of the provisions in their State Co-operative Societies Acts. In exercise of these powers, the Reserve Bank issued guidelines specifying requirements and indicative benchmarks/ conditions for the same in May 2021.

I.39 Statutorily, however, the state governments have a vital role in rural short-term co-operative credit structure. The legal authority to declare a co-operative society as central co-operative bank rests with the state government. The proposal of amalgamation of DCCBs with StCB needs to be initiated voluntarily by the concerned state government. The Reserve Bank typically seeks commitment from the concerned

state governments for capital infusion in cases where post amalgamation CRAR is likely to fall below regulatory requirements. Given the fiscal constraints faced by many state governments, especially in the aftermath of the pandemic, their capacity to infuse capital as and when the need arises, is severely limited.

NBFC Sector

I.40 The pandemic posed significant challenges to the NBFC sector during the first wave. Aided by various policy initiatives, NBFCs have emerged stronger, with reasonable balance sheet growth, increased credit intermediation, higher capital and lower delinquency ratio. The latest data on SMA, however, show that potential NPAs have increased significantly during 2021-22 so far. Recognising the increasing importance of NBFCs in the financial ecosystem, the Reserve Bank has implemented scale-based regulation to enhance the regulatory oversight over the sector effective October 2022. Furthermore, NBFCs need to be better equipped and focused on cyber fraud prevention as customers' adoption of digital lending gathers pace. Going forward, the sector may have to grapple with higher delinquency as and when policy measures unwind.

Micro Finance Institutions

I.41 Over the last decade, the share of NBFC-MFIs in the overall microfinance sector declined to reach a little over 30 per cent at end-March 2021. However, the extant customer protection measures applicable to NBFC-MFIs since 2011 are not applicable to other lenders. In June 2021, the Reserve Bank released a consultative document to propose a uniform regulatory framework for microfinance lenders under its regulation. The proposed framework envisages introduction of activity-based regulation in the microfinance sector, protection of small borrowers from over-indebtedness, enhancement of the customer protection measures, and enabling competitive forces to bring down interest rates by empowering borrowers to make informed decisions.

I.42 In a nutshell, the Indian financial sector is standing at crossroads: while the immediate impact of the fallout of COVID-19 will dominate the short-term, larger challenges relating to climate change and technological innovations will need a carefully crafted strategy. The Reserve Bank will endeavour to ensure a safe, sound and competitive financial system through its regulatory and supervisory initiatives.