I PERSPECTIVES

The banking system all over the world is grappling with challenges of reviving credit growth while maintaining their resilience in the face of the COVID-19 pandemic. In India, although the banking soundness indicators are obscured under the asset quality standstill, banks are raising capital in preparation of the imminent stress. Going forward, the challenging times may usher in new opportunities for the banking sector and the Reserve Bank remains committed to build an enabling environment while preserving financial stability.

I.1 At the time of publication of this Report, financial systems the world over are facing unprecedented challenges as they struggle to restore the flow of credit even while bracing up for large scale delinquencies and balance sheet stress that the ravages of the COVID-19 pandemic leave behind. In addition, they have to resume the stalled implementation of regulatory reforms, re-build and top-up capital and liquidity buffers and re-engage to nurture the economic recovery.

I.2 Domestically, an unprecedented economic contraction has taken its toll on the financials of banks and non-banks and purveyed a generalised risk aversion that has reduced the efficacy of the financial intermediation function. Prompt measures undertaken by the Reserve Bank and the Government have ensured easy monetary and liquidity conditions, orderly markets and a secure and well-functioning payment settlement environment. Although stretched asset valuations are in apparent disconnect with the real economy, life support in the form of adequate credit flows to some of the productive and COVID-19 stressed sectors has been deficient. Going forward, restoration of health of the banking and non-banking sectors depends on how quickly the animal spirits return and the revival of the real economy.

I.3 Against this backdrop, the rest of the chapter lays out perspectives on forces that are likely to shape the financial sector's ecosystem in the period ahead.

Impact of COVID-19 on Banks and NBFCs

I.4 The Indian financial system, and banks in particular, displayed resilience in 2019-20, with a strengthening of asset quality, capital positions and profitability. In 2020-21, as policy support is rolled back, the impact of the COVID-19 pandemic may dent the health of the banks and non-banks. As at end-August 2020, around 40 per cent of outstanding loans of the financial system (banks and NBFCs) availed moratorium. The data on gross non-performing assets (GNPA) of banks are yet to reflect the stress, obscured under the asset quality standstill with attendant financial stability implications. An analysis of published quarterly results of a sample of banks indicates that their GNPA ratios would have been higher in the range of 0.10 per cent to 0.66 per cent at end-September 2020. The COVID-19 provisioning and ploughing back of dividends would help shield their balance sheets from emanating stress to a certain extent.

I.5 Preliminary estimates suggested that potential recapitalisation requirements for meeting regulatory purposes as well as for growth capital may be to the extent of 150 basis points (bps) of the common equity tier I (CET I) ratio for the banking system. The Financial Stability Report (FSR), to be released shortly, will present an updated assessment of the GNPA and capital adequacy of SCBs under alternate macro stress test scenarios. While the Government has earmarked ₹20,000 crore in the first supplementary demands for grants for capital infusion in public sector banks (PSBs), they may raise more resources from the market as an optimal capital raising strategy. Prudently, some major private sector banks (PVBs) have already raised capital, and some large PSBs have announced plans to raise resources in a staggered manner, depending on the prevailing market circumstances.

I.6 The impact of the pandemic on *niche* players differed on the basis of the stage of their evolution, financial health at the time of onset of the pandemic, business model and area of operation. Consequently, the risks and uncertainties that they face also have their own characteristics.

Small Finance Banks

I.7 Those small finance banks (SFBs), which were earlier NBFC micro finance institutions (NBFC-MFIs), continue to have significant exposure to unsecured advances even as they strive to diversify their portfolio. Green shoots in the form of revival of agriculture and allied activities may augur well for financials of these banks. The collection efficiency of these banks had dropped substantially during the strict lockdown period but since then there is a strong improvement on a month-to-month basis and a catch-up with pre-pandemic levels may, in fact, be underway.

I.8 These banks have smaller low-cost current and saving account (CASA) deposit bases. While the prevailing easy liquidity conditions facilitate borrowings and refinance on which they rely, SFBs may need to focus on their bottomlines as and when financial conditions tighten. Furthermore, risk absorption cushions in the form of provision coverage ratio (PCR) is low in some SFBs, impacting their ability to withstand adverse shocks.

Payments Banks

I.9 The business model of payment banks entails dependence on transaction and investment income to meet various costs. With elevated levels of unemployment and reverse migration still to be corrected for, these banks' sources of income may come under strain. In the recent period, weighted average G-Sec yields have fallen to their lowest levels in 16 years impacting their interest income. Most of these banks are yet to break even, mainly due to high initial infrastructure costs. Generation of capital funds in the absence of credit products poses a challenge for them.

Co-operative Banks

I.10 The share capital of co-operative banks is contributed by members, each of whom is entitled to one vote irrespective of the extent of shareholding. This, coupled with the absence of a secondary market for share trading, has made mobilisation of share capital by co-operative banks difficult. Although this has been a chronic problem, the recent economic downturn resulting in loan defaults / repayment moratorium, has increased their capital requirements. Raising additional capital at reasonable cost has emerged as a key challenge for them.

Non-Banking Financial Companies (NBFC) Sector

I.11 After the IL&FS episode, the NBFC sector was inching towards normalcy in 2019-

20 when COVID-19 affected their operations. As compared with other segments of the financial system, the impact was relatively higher on NBFCs since they were unable to function during the initial phase of lockdown. On the supply side, sources of funds, especially for small and mid-sized NBFCs, dwindled on reduced risk appetite of banks for low rated and unrated exposures. Financing conditions facing them were further affected by redemption pressures of the mutual fund industry, resulting in widening of spreads. On the demand side, the prevailing economic contraction subdued credit offtake.

I.12 Specific measures taken by the Reserve Bank and the Government enabled these entities to overcome liquidity constraints and restricted market access. The share of NBFCs in total commercial paper (CP) issuances increased sharply in September and October 2020 following a decline in April-August 2020. The share of banks in total borrowings of NBFCs has consistently increased over the past two years. While PSBs dominate the bank lending to NBFCs, their share has declined since March 2020, with the space vacated being taken up by the PVBs. With market confidence restored, NBFCs are striving to augment financing to niche sectors and assist in the economic recovery.

I.13 Housing finance companies (HFCs) faced challenges due to delays in completion of housing projects, cost overruns due to uncertainty around reverse-migration of labourers and delayed investments by buyers in the affordable housing sector as incomes shrank and jobs were lost. Going forward, the sector may need to brace up for large slippages of loan assets and higher provisioning.

I.14 Keeping in view the likely impact of COVID-19 on financial conditions, banks, NBFCs—especially non-deposit taking NBFCs with asset size of ₹5,000 crore and above—and UCBs were advised to assess the impact of COVID-19 under severe but plausible scenarios on their balance sheets, asset quality, liquidity, profitability and capital adequacy for the financial year 2020-21. This proactive assessment should help these entities in estimating likely shortfalls in capital.

Risk Based Supervision for KYC and AML

I.15 With the increasing level of complexity in banking business, the need to assess systemic risks emanating from non-compliance to know your customer (KYC) and anti-money laundering (AML) directions has assumed importance. A dedicated supervisory structure is being created by the Reserve Bank to develop a risk-based approach for KYC/AML supervision of banks, in line with the Basel Committee on Banking Supervision (BCBS) principles and Financial Action Task Force (FATF) requirements for prudential supervision. The goal is to facilitate comprehensive and pre-emptive risk discovery and assessment so as to detect and address money-laundering and terror financing risks in the banking sector.

Co-operative Banking Sector Challenges

I.16 The recent collapse of a large UCB due to fraud and deficient corporate governance has dented public confidence in UCBs. Legal impediments and idiosyncratic factors tend to impede expeditious resolution. Mobilisation of additional capital is constrained by shareholding patterns and legal provisions governing them. The recent amendment to the Banking Regulation Act, 2020 has somewhat eased capital raising constraints. The Reserve Bank has been empowered to reconstruct or amalgamate these banks. Furthermore, the Reserve Bank has revised the supervisory action framework (SAF) for UCBs, which will facilitate quick regulatory/

supervisory responses for financially distressed UCBs.

I.17 UCBs lagged behind their peers in technology adoption. It is in this context that the Reserve Bank has accorded high priority to the implementation of core banking solutions (CBS) in the sector. More than 99 per cent of these banks are now compliant. In case of rural co-operatives, all except one bank is CBS compliant. Notwithstanding this progress, technological upgradation of co-operative banks remains a challenge.

I.18 The Reserve Bank has initiated the process of identifying weak and vulnerable banks, based on a revised stress testing methodology buttressed by findings of the current inspection cycle. An improvement schedule with specific time-bound targets has been finalised and continuous monitoring has been put in place.

I.19 New players in the banking arena are offering competition to co-operative banks. At the same time, emergence of technology driven financial services players has increased the number of options for customers. Co-operative banks with their grass-root level customer base and domain knowledge can attract new customers and retain existing clientele. A change in outlook, processes, business model and strategy are, however, required to achieve goals in a new development strategy that is in sync with the fast changing landscape.

Reducing Regulatory Arbitrage among NBFCs

I.20 Since 2006, the Reserve Bank implemented differential regulation and supervision for various categories of NBFCs to adapt to the heterogeneity of their business models and scale of operations. The recent failure of a large NBFC, with adverse consequences has, however, prompted a re-examination of this regulatory approach. The primary focus will now shift to identifying NBFCs with significant externalities contributing to systemic risks and subject them to a higher degree of regulation A calibrated evaluation of the prevailing regulatory arbitrage between NBFC categories has been undertaken to minimise spillover of risks. Since housing finance companies (HFCs) are treated as a category of NBFCs for regulatory purposes, the Reserve Bank has already harmonised key regulations of HFCs with those of NBFCs and complete harmonisation across the board would be accomplished in a phased manner.

Harnessing RegTech for Efficient Reporting

I.21 Recognizing that cutting-edge technology has enormous potential for preventive compliance, transaction monitoring and automated data flows, the Reserve Bank has accorded priority to adoption of RegTech. Framing of machine-readable regulations is envisaged for facilitating digital reporting to serve greater consistency and improved compliance.

I.22 Entities regulated by the Reserve Bank are already harnessing technological tools like artificial intelligence, machine learning, big data analysis for KYC/ALM purposes, regulatory reporting and management information system, payments and account aggregation as well as to judge the creditworthiness of borrowers. Notwithstanding its many advantages in terms of data and privacy protection, cyber risks are a major challenge in technology adoption. The Reserve Bank plans to undertake a broad-based survey on RegTech adoption and based on the findings, broad principles to encourage adoption of these tools will be developed.

SupTech Adoption for Proactive Monitoring

I.23 The offsite supervision architecture relies heavily on pre-defined templates to collect data, which are susceptible to inaccuracies and incompleteness of reporting. The Reserve Bank is striving to establish mechanisms to securely extract specific data sets directly from source systems for a more proactive risk-based supervision. The use of artificial intelligence and machine learning techniques are being explored to identify anomalies in the regulatory/ supervisory reporting data which can be used for predictive analysis. These techniques should pre-emptively help in micro-prudential supervision, identifying vulnerable branches, stressed exposures, unmitigated operational risks, suspicious transactions and misdemeanors. The Reserve Bank is also using state-of-the-art data visualisation techniques to identify risk areas and entities.

I.24 Looking ahead, the banking and non-banking sectors face both challenging times and new opportunities as the Indian economy returns to full vitality. New vistas of financial intermediation, leveraging on technology will open up to be exploited, and new business models will emerge. The Reserve Bank is positioning itself to provide an enabling environment in which regulated entities are catalysed to exploit these new avenues, while maintaining and preserving financial stability.