Research Imperatives for the Indian Banking Sector[1]

Introduction

Dr. J. Mahender Reddy, Vice Chancellor, ICFAI Foundation for Higher Education (IFHE) University; Shri S.V. Seshaiah, Director, IBS, Hyderabad; members of faculty from Gokhale Institute of Politics and Economics, Pune and IBS, Hyderabad; Delegates of the Research Conference; ladies and gentlemen ! I am grateful to Gokhale Institute of Politics and Economics, Pune and IBS, Hyderabad for inviting me to deliver the inaugural address at the 1st Banking Research Conference this morning. Both are premier educational institutions of the country. IBS Hyderabad has made important contribution in the field of management education and research in a very short period of time. Gokhale Institute of Politics and Economics (GIPE), Pune, is one of the oldest research and training institutes in Economics in the country and continues to be an institute of repute for economic research. I complement their efforts towards education and research.

2. Banks are the bedrock of financial system in all emerging economies and India is no different. The banks in India have been quite effectively performing the vital function of financial intermediation. The health of the banking system and that of the economy share a symbiotic relationship and at this juncture when the global growth is still stuttering, the banking system also faces a multitude of challenges. Each of these challenges has different genesis and probably different solution. But, challenges also throw up opportunities. In order to overcome current and impending challenges and also to exploit emerging opportunities, it is imperative that the sector devotes adequate time and resources in conducting meaningful research. At this stage, when the banking sector is on proverbial 'crossroads', I feel this Banking Research Conference is very timely. I am sure that the deliberations in the conference would

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provide new insights into the issues facing the banks and also pave the way for further research which would generate fresh ideas for improving the efficiency and effectiveness of the banking sector.

Why research is important?

3. According to Ben Bernanke, himself a researcher and a practitioner, research provides an important long-run perspective on the issues that we face on a day-to-day basis. Theories that evolve out of profound research remain relevant forever. Let me quote from our latest Financial Stability Report. “When current wisdom does not offer solutions to extant problems, old wisdom can sometimes be helpful. For instance, the global financial crisis compelled us to take a look at the Minsky’s financial instability hypothesis which posited the debt accumulation by non-government sector as key to economic crisis. As part of his work, Minsky identified three types of borrowers - the “hedge borrowers” (those who could meet their debt obligations – both principal and interest through current cash flows from investments), “speculative borrowers” (those who could service their debts, that is – pay only the interest but had to roll over the principal periodically through cash flows from current investments) and “Ponzi borrowers”(whose current cash flows were insufficient to meet debt obligations but borrowed on the faith that an appreciation in the asset values could take care of such obligations). The dominance of the Ponzi borrowers can cause disruptions in the financial system when asset prices stop rising.” As IMF and other financial research houses moan over high indebtedness of corporate houses in emerging markets and its consequent implications for global financial stability today, it reaffirms the relevance of Minsky’s “Financial Instability Hypothesis”.

4. Let me give another example. Many of you here must be aware of the ongoing debate on what is called as “Re-embracing Keynes.” The standard ‘return to Keynes’ argument is the need for fiscal stimulus to boost the economy from the depths of recession. The burden of the deficit is not seen as the main drawback of government intervention, but a necessary measure to address a failure in aggregate demand. It is important to emphasize here that the theory was first presented by John Maynard Keynes in his book, *The General Theory of Employment, Interest and Money*,

published in 1936, during the Great Depression. Keynes said “we cannot, as a community, provide for future consumption by financial expedients but only by current physical output.” Of course, there are many economists who vehemently oppose his views on efficacy of fiscal stimulus. Economists, both in Britain and across the Atlantic in the US have suggested that action by Government on rapid reduction of budget deficit than currently planned would be better to support a sustainable recovery. As some of you may be aware, the debate on increasing government deficit to support the economy also figured prominently in Government’s pre-budget consultations with the economist in our country. In sum, the very fact that Keynesian theory stays relevant evoking strong reactions from supporters and baiters alike even after eight decades of being first published, in itself is a great testimony to the quality of research undertaken by him.

5. The need for deep-seated research in the area of banking, which itself is a highly dynamic field, with close linkages to economic fortunes of the country, can be hardly over-emphasized. Given the dynamic nature of the sector, banking research has to continuously evolve. Failure to ignore emerging trends or risks can be catastrophic. As former FDIC Chairman Irving Sprague put it after the onset of the Global Financial Crisis, "Unburdened with the experience of the past, each generation of bankers believes it knows best, and each new generation produces some who have to learn the hard way."

6. To keep pace with the changing times and to produce relevant research, researchers today need to raise new questions, explore new possibilities, regard old problems from a new angle, which would require creative imagination and mark real advance in the field. But in my talk today, rather than discussing more distant research topics like ‘Effects of Population Aging on Economic Growth’ or ‘What ails a Demand Constrained Model of Growth’, I would like to focus on some ‘bread and butter issues’ confronting Indian banks, which the sector would do well to study in greater depth.

Some important research undertaken by RBI/ Government in past and outcome

7. As you may be aware, RBI and the Government of India have a rich history of policy research. Policy oriented research has led to adoption of various pro-active policy measures which helped in making our banking system more inclusive and development oriented. One of the earliest examples of application of research and surveys relating to credit/banking are two studies commissioned by the Reserve Bank in 1936 and 1937 which highlighted that almost the entire finance required by farmers was supplied by moneylenders and that credit co-operatives and other agencies played a negligible role. This prompted the Reserve Bank to play an active role during 1935-1950 in promoting the co-operative credit movement through a variety of initiatives.

8. Similarly, the Report of the All India Rural Credit Survey (1954) highlighted that agricultural credit not only fell short in terms of quantity, quality but also failed in serving the right purpose and the right people. The outcome of the survey was developing co-operatives as an exclusive agency for providing credit to agriculture together with outlining a role for commercial banks in delivering credit for agriculture in specialized areas, such as marketing, processing and warehousing. Similarly, All India Rural Credit Review Committee set up by the Reserve Bank in July 1966 (Chairman: Shri B. Venkatappiah) emphasized on an increased role for commercial banks in delivery of rural credit based on its research findings.

Issues at hand

9. The above instances highlight the significance of timely and effective research. As I have argued above, the need for upping the policy research in banking at the current juncture is very high. The sluggish economic revival following the GFC has adversely impacted the banking sector. Some of the issues which concern the sector relate to those of asset quality, capital adequacy, profitability, risk management and governance. Reflecting the concerns and risk aversion, banks' business (deposits and credit) continues to show moderation. Slowdown is evident in the growth in the balance sheets of banks which set in since 2011-12 and has continued during 2014-

15 as well. The return on assets (RoA) of banks, particularly public sector banks (PSBs), a common indicator of financial viability has remained weak in recent period.

10. It is well recognized that a competitive, sound and inclusive banking system is *sine-qua-non* for a growing economy like India that aspires to be globally competitive. Going forward, banks will need to achieve the mandated higher capital standards, stricter liquidity and leverage ratios and a more cautious approach to risk. This implies that the banks would need to improve their productivity and efficiency. They would also need to make a quantitative assessment of revenue streams from each product and service and an efficient transfer-pricing mechanism for efficient capital allocation.

11. At the same time, the banks would also need to venture into hitherto untapped segments to identify profitable business opportunities. One key segment that banks are increasingly looking at is the customers at the bottom of the pyramid. Financial Inclusion, as you all know, is the new buzzword. While everyone agrees that the segment has immense potential, it is certainly not a low hanging fruit. If the banks wish to profit from financial inclusion on a sustained basis, they would need to innovate and leverage technology.

12. Regulatory initiatives like opening up government business to more banks, licensing of new banks and subsidiarisation of the foreign bank branches, on the one hand, and the changing profile and simultaneously rising aspirations and expectations of customers on the other, is making the turf more competitive. Under the circumstances, the need for supportive research so as to find out an optimal business delivery model, target set of customers, product profile etc., suitable to the risk profile of each individual bank, can hardly be overemphasized. The banks also need to respond to the changing environment around them. The country is witnessing some significant changes in demographic patterns, literacy levels and resultantly in consumer behavior. The rural- urban divide is quite remarkable and also influences the choices the consumers make. Banks have to be constantly aware of the dynamic changes in consumer preferences and hence, the need for research gets buttressed.

13. Let me now come to a few 'bread and butter' areas which according to me have remained under-researched. Among others, these include, credit to agriculture,

Micro, Small and Medium Enterprises (MSMEs) and private sector leverage. An analysis of the trends in bank finance to these sectors throws up quite a few research questions. I would delve into some of these in detail.

Agriculture

14. A significant transformation has taken place in the character of agricultural credit since the decade of 2000s. The common perception about agricultural credit is that it has rural orientation and given the pre-dominance of small landholdings in the country, small-sized loans would account for a greater proportion of agricultural credit. It is also expected that there would be a fair mix of credit given for crop-loans and investment credit. However, when one analyses the data, which is the first step in any meaningful research, most of these perceptions prove to be wrong. I would present some salient features of agricultural credit in recent times purely in terms of trends which would underscore the need for research in the area.

15. As per the latest available All-India Debt and Investment Survey, the proportion of debt owed by cultivator households to formal sources stood at around 64 per cent as compared to 36 per cent owed to informal sources. Moreover, the proportion of debt owed to formal sources has seen a decline from 66.3 per cent in 1991 to 64 per cent in 2013. These figures provide an insight into the existing unmet demand for credit among cultivator households, which is evidently being met by informal sources. On the other hand, as per the recent RBI Internal Working Group[2] set up to revisit existing priority sector lending guidelines in March 2015, the commercial banks have failed to achieve the targeted level (of 18 per cent) credit to agriculture sector in all but three years between 2001 and 2014. Hence, the sector witnesses two contrasting trends: unmet credit needs of the farmers on the one hand and shortfall in lending targets of the banks on the other despite agriculture being designated as one of the priority sectors for bank lending.

[2] RBI (2015), "Report of the Internal Working Group to Revisit the Existing Priority Sector Lending Guidelines", March 2.

16. Agricultural credit, like overall bank credit in India, has traditionally been concentrated in the southern and northern regions of the country. In 2012, the southern and northern regions together accounted for about 62 per cent, with the southern region alone accounting for 41 per cent of total agricultural credit. Further, there was concentration of agricultural credit in select districts. In 2012, 15 districts accounted for about 21 per cent of total agricultural credit. Some elucidation is needed to explain this concentration.

17. The small and marginal cultivators (operating less than 5 acres of land) continue to be marginalised in terms of their share in agricultural credit. The share of small and marginal farmers has hovered around at levels less than 50 per cent despite the fact they account for more than 80 per cent of total cultivators in India. Likewise, it is also observed that the share of long-term credit in total agricultural credit has experienced a secular decline reaching 32 per cent in 2013-14 from 74 per cent in 1990-91 suggesting a neglect of capital formation in agriculture.

18. Few other patterns that are noticeable in the farm sector are:

- Decline in average size of operation landholding to around 1.15 hectare from more than 2 hectare about four decades ago. To put it in perspective, this size is 1/10th that in Thailand and about half of that in Indonesia while in the USA the average farm size is 170 hectares
- Families operating less than 1 hectare farm size are dis-savers even after including non-farm income
- 80% of the borrowings of large farmers (>10 hectare land) are from institutional sources while for the landless farmers this figure is only around 15%

19. The core areas of research which emerge from the forgoing discussion are:

- ✓ Is there a direct correlation between increased agricultural credit and productivity in agriculture / allied activities?

- ✓ Whether focus on agriculture as a priority sector has been effective in encouraging agricultural investment? Have small farmers benefited relative to large farmers?
- ✓ Have incomes of the farmers smoothened if not actually enhanced?
- ✓ While in villages, non-farm sector provides more income generating activity than farm sector, why do people still continue to stick to farming? Can 18% of GDP produced by agriculture sustain 47% of the workforce?
- ✓ What has been the impact of land fragmentation on agricultural productivity? Post-fragmentation, whether the farmers have the capacity to service the loan?
- ✓ What needs to be done for making the credit delivery system for farmers more efficient in terms of timeliness?

Micro, Small and Medium Enterprises (MSME)

20. MSMEs play a vital role in the Indian economy. They not only employ a large number of unskilled and semi-skilled people but also support large industries by supplying raw material, basic goods, finished parts and components. There are an estimated 49 million MSMEs in the country, providing employment to 111 million people which is next only to the agricultural sector. The sector accounts for 45 per cent of the manufacturing output and contributes close to 40 per cent of all exports from the country. Further, about 55 per cent of the MSMEs are located in rural areas, thus offering a great potential for rural development and inclusive growth.

21. Despite a large contribution of the MSME sector to the GDP, the sector often complains about lack of financing from institutional sources. Fourth Census of MSME sector (2006-07) revealed that only 5 per cent of the units (both registered and unregistered) had availed of finance through institutional sources. As on March 2015, only 8.4 per cent of the gross non-food credit from scheduled commercial banks (SCBs) was lent to MSMEs against 11.0 per cent in March 2010. This is despite increased distress in banks' books in their lending to large corporates over the same period.

22. There is growing realization that if the country has to move to a higher growth trajectory, then MSME sector would need to play a central role. In recent years, both Government as well as RBI have made substantial efforts to ease various constraints faced by the sector. While GoI has established Micro Units Development and Refinance Agency Ltd. (MUDRA) for developing and refinancing all micro-finance institutions (MFIs) which are in the business of lending to micro and small business entities engaged in manufacturing, trading and service activities, RBI has prescribed a target of 7.5 percent of net bank credit for micro enterprises for achievement in a phased manner. Further, medium enterprises[3] have also been brought into the ambit of priority sector credit. In order to improve liquidity for MSMEs, an electronic Trade Receivables Discounting System (TReDS) is being set up RBI to enable a speedy realisation of receivables. RBI has also launched a National Mission for Capacity Building of Bankers for MSME Financing (NAMCABS) for sensitising the bank staff about the financial and other lifecycle needs of MSME borrowers. While the steps taken by the authorities are commendable, a fundamental question remains whether the remedial measures that are being administered are based on proper diagnostics?

23. Against this backdrop, research related MSME sector could focus on:

- ✓ Reasons for sickness / quick mortality in MSME sector and to what extent is delay in sanctioning by banks responsible for it?
- ✓ What are the lifecycle needs of the MSMEs? What is the appropriate credit delivery model for the MSMEs?
- ✓ Is there a case for a differentiated prudential norm for MSME borrowers as against the rule based prescriptions applicable to big corporates?

Corporate Sector Leverage

24. Corporate sector leverage has currently become an issue of great concern for the economy in general and the banking system in particular. In the lead up to the crisis and even beyond, some of the Indian corporate houses raised unsustainable amounts of debt from various sources including bank finance and oversees

[3] Credit limit is ₹ 50 million per unit for Micro and Small Enterprises and ₹ 100 million for Medium Enterprises engaged in providing or rendering of services.

borrowings. As we notice now, several indiscriminate corporate houses continued market borrowing with a view to increase their market share and to expand capacity without any regard to domestic and global demand situation. In fact, the rate of sales growth of the corporate sector particularly of listed manufacturing companies, declined from an average of 28.8 per cent in Q1 of 2010-11 to 11.4 per cent in Q2 of 2012-13 at a time when inflation (CPI (IW)) averaged[4] around 10 per cent. Some of these borrowers necessarily fall into the category that Minsky calls “Ponzi borrowers”, which I had alluded to earlier. While banking system could also be held partly responsible for continuing to lend to these highly leveraged corporate groups, most of the times they were confounded by the labyrinthine maze that these corporate houses had created to access finance through group companies or thorough special purpose vehicles. The obvious fallout of this indiscriminate borrowing is a severe deterioration in their ability to service debt, besides casting an adverse impact on banks’ balance sheets. An indirect outcome of higher corporate leverage is also likely in terms of poor transmission of monetary policy impulses as corporates may not be in a position to benefit from falling interest rates due to already high levels of debt.

25. Against this backdrop, there are a multitude of areas that should be looked at in more detail by way of research. The distribution of leverage is very important. In India, about a third of total corporate debt is owned by companies with a debt-equity ratio of more than 3. Given the concentration of debt, there is a need to assess the risk associated with multi-layered structures - in the form of holding companies and special purpose vehicles. Further, while the corporate profits wait for a turnaround in the economy, there are also instances of companies trying to meet their debt obligations in different ways, one of which is deleveraging. Many companies are now deleveraging - paying off debt by selling off assets, more so as banks cease to restructure their bad debts. It is important to weigh the effectiveness of such methods against the costs it imposes on the growth of the economy.

26. While one is quick to demonize the borrowers that are unable to repay their debt to the lenders, it would be unfair to say that all of these highly leveraged borrowers

[4] Average over April – January 2012-13.

are “Ponzi borrowers”. Ways and means have to be found to segregate the fraudsters from the genuine borrowers. Our experience suggests that a number of these borrowers had borrowed heavily to set up infrastructure projects that have got stalled due to external factors. Several projects have faced time and cost overruns due to delays in receiving various clearances, cancellation of coal or gas linkages, protests from environmentalists etc. It is in our collective interest that productive capacity that has been created is not jeopardized and right lessons are drawn for future guidance. It is, therefore, important that some meaningful research could be conducted into 3-4 of these stalled projects, undertaking a threadbare analysis of the development of the project from scratch including the means and structures used for obtaining finance, extent and quality of equity brought in by the promoters, subsequent developments at various project stages, end outcome and so on and develop them as case studies for reference not only at management institutes but also by all stakeholders including Government machinery, regulators etc.

Conclusion

27. I have listed in brief a few basic issues that need the attention of researchers. These are indicative in nature and deal with the core areas that the bankers deal with in their everyday functioning. Besides, the issues that I have discussed in details above, some of the researchers present here could also focus their studies on the behavioral impact of credit guarantee schemes and interest rate subsidy on the end users and the intermediaries. Couple of other areas in which I would like to see some quality research done is on whether financial inclusion efforts should be savings led or credit led; and entire gamut of issues surrounding education loans. Another interesting area of research could be the policy of public sector banks with regard to posting of officers to rural branches as I feel this aspect has a significant bearing on progress in agriculture and MSME credit in rural areas.

28. While I have spoken enough about the subjects for research, there are issues related to research methodology per se. The first and foremost of which is, whether adequate and reliable data is available. Very often, even within RBI also we have to grapple with inconsistent, incoherent and incomplete data sets which severely

undermine policy formulation. There are also problems around data design and data architecture like varied definitions, different reporting dates, etc. Quality of research would also depend a lot on the survey methods employed, adequacy of sample used etc. What could be done to address these issues?

29. Before I close, I would like to thank the organizers once again for inviting me to this first ever banking research conference. The issues that I have raised during my address today are not exhaustive and I am sure there are many more interesting research ideas which would be engaging the attention of our researchers. I hope to see some quality analytical research conducted in banking in the days to come.

I wish the Conference all the success and hope that the deliberations are engaging and insightful.

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