*Indian Banking at Crossroads: Some Reflections**

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I am very happy to be amongst you today to address the first Annual Economics Conference being organised by the Amrut Mody School of Management, Ahmedabad University. The theme of the conference - '50 years of Bank Nationalisation: Indian Banking at Crossroads' - provides the perfect backdrop for a discussion on the evolution of Public Sector Banks(PSBs), their journey over the last 50 years and a vision for their future. The banking system has played a critical role in the upliftment of our country, especially in the recent decades which saw unprecedented economic growth. However, the banking system, especially the public sector banks, has experienced a large churn after the Global Financial Crisis(GFC) as it tries to grapple with multiple challenges, including high non-performing loans (NPLs), global and domestic economic downturns, adaptation of technology and competition from new age fintech companies. In my address today, I shall attempt to discuss the challenges that lay ahead for the broader banking sector and what we expect of them going forward. I shall also briefly touch upon our approach to tackling the issues in the non-banking finance companies and urban co-operative banks, which are important segments of the financial sector.

Many a time, to see through to the future, looking back at the past provides insights that are of much help. With that limited objective, I shall wade back a little to the past for the sake of contextualising our discussion. In 1967, credit to agriculture constituted only 2.2 per cent of the total advances of the Scheduled Commercial Banks in sharp contrast to industry which constituted 64.3 per cent. Five cities in the country, *viz.*, Ahmedabad, Mumbai, Delhi, Kolkata and Chennai accounted for around 44 per cent of the bank deposits and 60 per cent of the outstanding bank credit in1969. This led to the widespread political perception that, left to themselves, the private sector banks were not sufficiently aware of their larger responsibilities towards society. The solutions that the policy makers thought of at that time included exerting various degrees of control over the banking system, which ultimately culminated in the decision to nationalise 14 private sector banks in 1969, followed by the nationalisation of six more private sector banks in 1980. The impact of the decision to nationalise banks has been succinctly summarised in the History of RBI, Volume III: *'….at the time of nationalisation as many as 617 towns out of 2,700 in the country were not covered by commercial banks. And, even worse, out of about 600,000 villages, hardly 5,000 had banks. The spread, too, was uneven…..'*

Current Challenges and the Role of Exogenous Factors

Against this historical detour, let me come to the challenges faced by the banks today, many of which are a result of how various exogenous factors have played out over the years. Everyone concerned should realise that banks are in the business of taking bonafide risks. This means that out of a host of exposures which a bank chooses to take, a few may go bad. The PSBs, which have been used as vehicles to further the development agenda of the Government, had to achieve and maximise multiple objectives. The high growth phase prior to the GFC (2008) was aided by bank credit to a large extent, mostly by PSBs, leading to risk build ups in the balance sheet of the lenders. In particular, bank credit to infrastructure sector increased at an unprecedented rate. This exposed the PSBs to the travails of the infrastructure sector, which materialised significantly in the post-crisis years.

Further, the tail end of the above high growth period in advances to infrastructure coincided with a period of slowdown in economic growth and tightening

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of environmental clearances. Also, the transformation of major term lending institutions into universal banks/NBFCs led to commercial banks becoming the primary source of long-term debt financing to projects in infrastructure and core industries. An immediate consequence of these circumstances was that it led to a spurt in the level of 'restructured standard assets', *i.e.*, assets which were restructured without being downgraded as non-performing assets (NPAs). Eventually, most of the restructured assets which were allowed to be classified as 'standard' became NPAs as the restructuring packages proved to be unviable. Inadequate credit assessment by banks and governance issues also played their due part in the risk build-up.

As documented, the increase in NPAs was significantly higher in PSBs as compared to their private and foreign counterparts. PSBs, probably to fulfil the additional social objective of their mandate, had taken higher exposure in some of the critical sectors of the economy such as mining, iron and steel, and infrastructure. NPA levels in these sectors shot up as all these sectors suffered external shocks leading to the respective stress - mining and energy was hit by the cancellation of allocation of coal blocks; iron and steel sector faced cost pressures due to dumping of cheaper steel from China; telecommunications sector underwent a disruption in the form of cancellation of 2G spectrum allotment; and the construction sector was marred by delays in obtaining necessary government approvals, in particular environmental clearances.

To add to these issues, shocks in the form of debt waivers/moratoriums and payment issues of Distribution Companies (DISCOMs) also meant significant costs to the fisc and also affected the health of the banking sector as well as the credit culture. Interestingly, data put together by the Indian Banks Association shows that of the 10 states that announced debt waiver schemes since 2017, only three states have reimbursed almost completely as promised. Thus, it is imperative that write-off amounts are reimbursed to the banks and DISCOM payments are made in a time bound manner, so as to improve the health of banks and their capacity to lend in subsequent years.

Corporate Governance - The Elephant in the Room

This brings me to some of the internal challenges faced by the PSBs, and their governance could easily be identified as a central concern. In fact, many of the problems that currently seem to affect the PSBs such as the elevated levels of NPA, capital shortfalls, frauds and inadequate risk management can mostly be attributed to the manifestation of underlying corporate governance issues. The role of independent Boards in fostering a compliance culture by establishing the proper systems of control, audit and distinct reporting of business and risk management has been found wanting in some PSBs leading to build-up of NPAs. Also, the understanding of risks from a business perspective by the Boards in some banks has been inadequate due to skill gap and, competency issues. The fact remains that a strong corporate governance culture, with a focus on transparency and accountability, has to percolate from a strong Board which sets the example by leading.

Let me also touch upon governance issues in private sector banks (PVBs) which originate from altogether different set of concerns. The issues here mainly relate to incentive structure of their managements, quality of audits and compliance and also functioning of Audit and Risk Management Committees. The Reserve Bank has recently issued guidelines for compensation in private sector banks which include specification of minimum variable pay component and clawback arrangements, among others.

Resolution of Stressed Assets

Apart from governance, one of the biggest challenges faced by the PSBs, and the banking system in general, is the resolution of stressed assets. For a long time, India did not have a bankruptcy law in place, and hence the Reserve Bank introduced various restructuring frameworks which were designed to emulate the desirable attributes of a bankruptcy law. The enactment of the Insolvency and Bankruptcy Code, 2016 (IBC) has been a game changer in this regard. Despite the impression that IBC has been marred with numerous litigations leading to delays in resolution, I am optimistic that these are teething problems in a new law. Majority of the companies that went through insolvency proceedings under IBC and ended in liquidation so far were already stressed entities for a long time whose value had been eroded significantly and were pending before the Board for Industrial and Financial Reconstruction (BIFR). The real impact of the IBC is to be seen in the fresh cases where I expect the law to provide an efficient avenue to effect a resolution.

To complement these efforts, the Reserve Bank has put in place a framework for resolution of stressed assets through a circular dated June 7, 2019 which envisages a time bound implementation of a resolution plan, failing which disincentives in the form of additional provisions will kick in.

While these provisions are available for real sector firms, the situation is entirely different when it comes to resolution of financial firms. In this regard, the Government, on November 15, 2019 has notified the rules containing a framework for resolution of financial services providers (FSPs) under the IBC. The applicability of these rules would be limited to certain financial services providers to be separately notified by the Government in consultation with regulators.

Our resolute efforts towards recognition, repair and resolution have resulted in non-performing assets (NPAs) of the banking system declining for the first time in March 2019 after a gap of 7 years. Fresh slippages declined and the system-level provision coverage ratio jumped to 60.5 per cent from 48.3 per cent a year ago. The capital adequacy ratio of the banking system has increased to 14.3 per cent, much higher than the Basel norms. This has benefited from the recapitalisation of PSBs in the order of ₹ 2.9 lakh crore by the Government in the recent period.

Mergers of Public Sector Banks

The government, with an objective to create strong and competitive banks, has announced an amalgamation of PSBs in order to create stronger banks with global presence. This consolidation is in the direction of the recommendations of the first report of the Narasimham Committee in 1991, where the requirement for fewer but stronger banks for Indian economy had been highlighted. The idea was to enable such banks to compete at the national and international level. A well-executed merger generates synergies of workforce and capital, helps in streamlining of operations and leads to significant improvements in efficiency. It can also entail diffusion of best practices across the board between banks. The bigger and agile banks, in principle, could reposition themselves with better branding exercises. I must, however, hasten to add that the merger process has to be executed without creating any disruption in the normal functioning of these banks.

Non-Bank Financial Companies (NBFC) Sector

It is well recognised that NBFCs play a prominent role in the Indian financial system by catering to financial needs of a wide variety of customers and niche sectors, providing complementarity and competition to banks. The NBFC sector largely depends on market and bank borrowings, thereby creating a web of inter-linkages with banks and financial markets. As Housing Finance Companies (HFCs) now fall under the regulatory purview of the Reserve Bank, we are undertaking a review of extant regulations and are in the process of harmonising these regulations for HFCs with applicable regulations for NBFCs.

In the aftermath of the Infrastructure Leasing and Financial Services Limited (IL&FS) crisis and subsequent defaults by a few companies, asset quality concerns have emerged, which imposes liquidity constraints on NBFCs. The Reserve Bank has been proactive in taking several measures to address these concerns and strengthen the regulatory and supervisory architecture of the NBFC sector, thereby ensuring that the sector remains stable and robust.

We have attached considerable importance to make them resilient through harmonisation of regulations and a robust liquidity framework. Reserve Bank on November 4, 2019 has come out with guidelines on liquidity risk management framework for NBFCs. Our objective is to ensure proper governance and risk management structures in NBFCs.

Urban Co-operative Banks

Let me now turn to co-operative banks. They contribute significantly in credit delivery and in bringing other financial services to the people. The performance of some of these institutions, however, has been hampered due to operational and governance issues. The recent unearthing of fraud in one of the urban co-operative banks (UCBs) has brought up issues relating to their governance, prudent internal control mechanisms, and adequacy of checks and balances to the forefront.

Turning back to history, the Urban Co-operative Banks were brought under the ambit of the Banking Regulation (BR) Act, 1949 with effect from March 1, 1966. Certain provisions of the BR Act, however, were not made applicable to them, limiting the scope of regulation and supervision over them[1]. Broadly speaking, banking-related functions of cooperative banks are regulated by the Reserve Bank and management-related functions are controlled by the concerned State / Central Government. The Reserve Bank's regulatory control over UCBs is affected due to this duality of control. Reserve Bank has made concerted efforts in the past to mitigate the adverse impact of dual regulation in the form of MoUs with State/ Central Governments and setting up of a State-level Task Force for Co-operative Urban Banks (TAFCUB). However, challenges still persist. At present, the Reserve Bank is working with the Government to amend the Act governing co-operative banks. We have suggested several legislative changes to the Central Government for better regulation and supervision of UCBs. On our part, we are reviewing the existing architecture of regulation and supervision of UCBs and shall carry out necessary changes in sync with the evolving requirements.

Going forward, UCBs are likely to increasingly face competition from players such as Small Finance banks (SFBs), Payments Banks, NBFCs and Micro-Finance Institutions (MFis). It is, therefore, necessary for them to adopt robust technology to enable them to provide banking services at lower costs and with adequate safeguards. The Reserve Bank has been taking proactive steps to assist these institutions to adopt a robust IT infrastructure. The proposed national level Umbrella Organisation (UO) is expected to provide liquidity and capital support to member co-operative banks, and will therefore contribute to the strength and vibrancy of the sector.

New Frontiers of Banking

The emergence of new banking models, in the form of Payments Banks and Small Finance Banks, have widened the horizons of banking in India. The Government and the Reserve Bank have taken several initiatives to encourage greater use of electronic payments[2] to achieve a 'less cash' society. These measures have led to digital payments[3] to GDP ratio rising to 8.6 per cent at end-March 2019 from 6.7 per cent at end-March 2016. During the same period, the number of per capita digital transactions rose from 4.6 to 17.6. Similarly, Fin-Tech is offering alternative models of lending and capital raising. In this regard, crowdfunding, peer-to-peer lending, invoice financing (Trade Receivables Discounting System (TReDs)) and digital lending have made their presence felt. They have helped in improving the efficiency of intermediation by bringing down the

[1] Co-operative banks are regulated under Section 56 of the BR Act, 1949 subject to certain modifications. As Co-operative banks are exempted from certain provisions of the Act, the regulatory authority of the Reserve Bank over UCBs is limited.

[2] Such as Immediate Payments Service (IMPS), Unified Payments Interface (UPI), Bharat Interface for Money (BHIM), Bharat Bill Pay System (BBPS), Aadhaar-enabled Payment System (AePS), Bharat QR code and mobile wallets.

[3] Digital payments include RTGS (customer transactions and inter-bank transactions), retail electronic payments and card payments (credit and debit card transactions at point of sale (PoS) terminals, and payments made through pre-paid payment instruments).

costs, sachetisation of products and services and in expanding the reach of financial services to a greater number of people.

More recently, Artificial Intelligence (AI), Machine Learning (ML) and Big Data are becoming central to financial services innovation. Analysis of vast amount of data, both structured and unstructured, has been made possible using these techniques. Increasing levels of expectations of compliance to regulations and a greater focus on data and reporting has brought RegTech and SupTech into limelight. They are being applied in areas such as risk management, regulatory reporting, data management, compliance, e-KYC / anti-money laundering (AML)/ Combating the Financing of Terrorism (CFT), and fraud prevention.

In light of these developments, conventional banking is making way for next-generation banking with focus on digitisation and modernisation. The need for brick and mortar branches is being reviewed continuously as digitisation has brought banking to the fingertips of the people, obviating the need to physically visit a bank branch. The transformation of the financial services landscape caused by technological innovations can blur the difference between a bank and a technology company, as technological giants are making rapid strides into areas such as payments, traditionally the domain of banks. This will present testing grounds for the regulators to delicately balance promotion of innovation and applying uniform supervisory and regulatory framework.

Concluding Observations

Let me conclude by saying that banks have a critical role in the economy. The privilege of raising unsecured liabilities from the society and generating revenue by deploying them in various avenues and ventures necessitates prudent risk assessment of such deployment. In this process, the banks do have a responsibility to shoulder when it comes to contributing to the growth of productive sectors of the economy including infrastructure.

As we move forward, we at the RBI are focusing on governance, risk management, internal audit and compliance functions in banks more closely. In a bid to strengthen oversight of commercial banks, co-operative banks and NBFCs, we have created a unified department of supervision (DoS) and a unified department of regulation (DoR) with effect from November 1,2019. This move will enhance the efficacy of supervision and regulation as these entities operate in an increasingly integrated environment with overlapping business domains. It is our endeavour to update the knowledge and skill levels of supervisors on a continuous basis. We are adopting a multi-pronged approach in this aspect. We are in the process of setting up a College of Supervisors to augment and reinforce supervisory skills among regulatory and supervisory staff. In addition, an internal supervisory research and analysis wing is being created to supplement and support regulatory and supervisory activities. As indicated earlier, technology would continue to play a vital role in enhancing the efficacy of regulation and supervision in a continual manner.

We are also addressing some of the long persisting issues in our regulatory and supervisory framework in a systematic and time bound manner towards building a more efficient and robust financial system.

I hope the participants of the conference would deliberate on some of the issues highlighted in my remarks today in greater detail in the sessions that follow. I wish the conference all success.