*Indian Banking Sector: Current Status and the Way Forward**

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I am happy to be participating in the Fifteenth Annual Convocation Ceremony of Post-Graduate Diploma in Management (Banking and Financial Services) for the Batch of 2017-19. I thank Dr. K.L. Dhingra, Director, National Institute of Bank Management (NIBM) and members of faculty for inviting me to join the young minds at their convocation ceremony. This is indeed a moment of pride for students as it marks the fruition of years of dedication, perseverance and hard work. To the students, I would like to convey my best wishes as they embark on a new phase in their lives. I am certain that it will be a life full of opportunities and challenges, and I hope you adopt a path of integrity and ethics to be able to make tough decisions as you move forward. As the father of the nation, Mahatma Gandhi, had said, *'Always choose the right path and speak truth'*. Your self-faith and determination will provide you with the strength to march ahead. My congratulations are also for the parents and guardians who are present here.

Let me now turn to the topic which I am going to address today. I propose to cover the current status of the banking sector and would highlight some issues as a way forward.

Banking Sector

The last few years have been testing times for Indian banks as they grappled with deteriorating asset quality leading to higher provisioning requirements, falling profitability and weak capital position. However, the banking system is on the cusp of a transformation, aided by recent policy measures to reduce vulnerabilities and improve its financial health. Several initiatives have been undertaken and are also underway to strengthen the regulatory and supervisory frameworks aimed at increasing the resilience of the banking system.

Banking Regulation

As of March 2019, the capital to risk weighted assets ratio (CRAR) of scheduled commercial banks (SCBs) at 14.2 per cent remains well above the regulatory requirement of 9.0 per cent. However, if we take into account the capital conservation buffer (CCB), some banks, especially public sector banks (PSBs), are falling short of the required 10.875 per cent. Overall, the Government's efforts to infuse capital into PSBs has significantly helped them achieve these targets.

We have also put in place frameworks on Countercyclical Capital Buffer (CCCB), leverage ratio, Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)[1]. For better management of concentration risks and in order to align Indian banks with the international norms, the Reserve Bank proposed guidelines on large exposures which became effective from April 1, 2019. The latest round of reforms published by the Basel Committee on Banking Supervision (BCBS) in December 2017 have implementation timelines stretching up to 2022. The Reserve Bank is expected to come up with the draft guidelines by 2020 for consultations.

Non-Performing Assets

The deterioration in asset quality of Indian banks, especially that of PSBs, can be traced to the credit boom of 2006-2011 when bank lending grew at an average rate of over 20 per cent. Other factors that contributed to the deterioration in asset quality

* Shri Shaktikanta Das, Governor, Reserve Bank of India, Speech delivered at National Institute of Bank Management on 15th Annual Convocation of Post Graduate Diploma in Management in Pune on June 8, 2019.

[1] To be implemented from April 1, 2020.

were adverse macro-financial environment; lax credit appraisal and post-sanction monitoring standards; project delays and cost overruns; and the absence of a strong bankruptcy regime until May 2016. The Reserve Bank set up a Central Repository of Information on Large Credits (CRILC) in 2014 which was followed by an Asset Quality Review (AQR) in 2015. As a result of these initiatives, the recognition of non-performing assets improved, leading to a sharp rise in the gross NPA ratio from 4.3 per cent at end-March 2015 to 7.5 per cent at end-March 2016. It further reached the peak of 11.5 per cent in March 2018. Recent supervisory data suggests that various efforts made by the Reserve Bank in strengthening its regulatory and supervisory framework and the resolution mechanism instituted through Insolvency and Bankruptcy Code (IBC) are bearing fruit. This is reflected in significant improvement in asset quality of SCBs during 2018-19 as gross NPA ratio declined to 9.3 per cent as on March 2019.

At the same time, there has been an improvement in provision coverage ratio (PCR) of SCBs to 60.9 per cent at end-March 2019 from 48.3 per cent at end-March 2018 and 44.0 per cent at end-March 2015. Due to weak capital position of banks and risk aversion on their part, credit growth remained subdued in recent years. However, with incipient sign of improvement in the health of banks, credit growth is picking up.

Resolution of Stressed Assets

It is now well recognised that an efficient bankruptcy regime is essential for timely resolution and liquidation of stressed companies. The Insolvency and Bankruptcy Code, 2016, (IBC) has significantly altered the financial landscape as it provides a market mechanism for time-bound insolvency resolution enabling maximisation of value. The new regime is a paradigm shift in which creditors take control of the assets in contrast to the earlier systems in which debtors remained in possession of the assets till its resolution or liquidation, leading to an improvement in the credit culture of the country.

In the wake of the Supreme Court's order nullifying the Reserve Bank's circular of February 12, 2018 for resolution of stressed assets, we have issued fresh guidelines yesterday (June 7, 2019). The new guidelines provide a system of strong disincentives in the form of additional provisioning for delay in initiation of resolution or insolvency proceedings. The new framework makes inter-creditor agreements mandatory and provides for a majority decision to prevail. Further, wherever necessary, the Reserve Bank will issue directions to banks for initiation of insolvency proceedings against borrowers for specific defaults so that the momentum towards effective resolution remains uncompromised. It is expected that the revised prudential framework for resolution of stressed assets will sustain the improvements in credit culture that have been ushered in by the efforts of the Government and the Reserve Bank so far, and that, it will go a long way in promoting a strong and resilient financial system in India.

Non-Banking Financial Companies (NBFCs)

Let me now turn to Non-Banking Financial Companies (NBFCs). They play an important role in the Indian financial system given their unique position in providing complementarity as well as competition to banks. They cater to diverse financial needs of a wide variety of customers, both in urban and rural areas. This sector, with a size of around 16 per cent of the combined balance sheet of SCBs, has been growing at a faster pace in recent years. As at end-March 2019, the aggregate CRAR of NBFC sector was 19.3 per cent, while the gross NPA ratio was 6.6 per cent. The credit growth of NBFCs, which was over 20 per cent earlier, slowed down in the third quarter of 2018-19 after the debt default by a systemically important NBFC. However, market confidence somewhat resurfaced in the last quarter of 2018-19 as the major sources of funding registered a recovery.

The debt default by a large NBFC in mid-2018 highlighted the vulnerability and need for strengthening regulatory vigil on the sector in general and on the asset liability management (ALM) framework in particular. The Reserve Bank has recently come out with draft guidelines for a robust liquidity framework for the NBFCs.

Further, the Reserve Bank has relaxed the norms for NBFCs to securitise their loan books. In addition, banks have been allowed to provide partial credit enhancement (PCE) to bonds issued by the systemically important non-deposit taking NBFCs and Housing Finance Companies.

With a view to eschewing the regulatory arbitrage between banks and non-banks, the Reserve Bank has been aligning the regulatory and supervisory frameworks for NBFCs with that of SCBs. A comprehensive Information Technology (IT) framework for strengthening off-site surveillance of NBFCs is being put in place. Further, multiple categories of NBFCs are being rationalised into fewer categories in order to provide them greater operational flexibility.

The Reserve Bank has also taken steps to enhance the supervision over NBFCs. These efforts are primarily focused on improving the four supervisory pillars – on-site examination, off-site surveillance, market intelligence and annual reports of statutory auditors. A fifth pillar of supervision in the form of an institutionalised arrangement for periodic interaction with all the stakeholders including statutory auditors, credit rating agencies and banks having large exposures to NBFCs is being put in place.

Way Forward

I have already highlighted certain critical issues in the area of regulation and supervision of banks and non-banks. As a way forward, I would like to highlight some important issues which need to be addressed in the coming months. The first and foremost is governance reforms in banks and non-banks. These would include the following:

(i) In order to improve the functioning of the PSB boards and to foster corporate governance, it is important to enhance their quality and stability through further streamlining appointment process, succession planning and compensation. These aspects could be evaluated by bank boards and reviewed by the Banks Board Bureau. We also need to create a pool of independent directors across various areas of expertise.

(ii) The performance of MDs/CEOs of both public and private sector banks should be closely monitored by the Board of Directors either through a sub-committee or through an external peer group review.

(iii) An effective performance evaluation system should also be put in place for banks to improve their financial and operating parameters. The Government, the Bank Board Bureau and the Reserve Bank are engaged in developing an objective framework for performance evaluation of PSBs. This should redefine the contours of corporate governance in PSBs with a focus on transparency, accountability and efficiency.

(iv) Governance issues in private sector banks (PVBs) 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 efficient functioning of Audit and Risk Management Committees. The Reserve Bank has issued a discussion paper on proposed guidelines for compensation in private sector banks which includes specification of minimum variable pay component and clawback arrangements, among others. The Reserve

Bank will continue to play a positive and constructive role to ensure private sector banks flourish in their operations.

Second, to create potent risk management systems in banks, the Chief Risk Officers (CROs) have to play an effective role and should be directly accountable to Managing Directors (MDs), Chief Executive Officers (CEOs) and Risk Management Committee of the Board.

Third, along with risk management, compliance function in banks is one of the key elements in their corporate governance structure. These have to be adequately strengthened and made sufficiently independent. For the compliance function to be effective, it must be supported by a healthy compliance culture within the organisation. Banks should review their compliance function comprehensively to ensure compliance to all statutory and regulatory prescriptions in addition to their own internal guidelines, directions of the Board and their Committees and audit assessments. It is important that the Board of Directors are always sensitised of any compliance failures. A group-wide compliance programme would help managements and Boards in understanding the legal and reputational risks in the organisation, especially their concentration in certain areas.

Fourth, it has been observed that most bank frauds can be traced to absence of effective controls. An essential element of an effective system of internal control is a strong control mechanism. It is the responsibility of the Board of Directors and senior management to emphasise the importance of internal control through their actions and words. Banks should regularly reorient and train their personnel so that they fully understand the importance of internal controls in their respective stations. The boards of banks should specifically pay attention to creating and sustaining a culture of effective control in the banks.

Fifth, even though the Government's capital infusion has helped PSBs to improve their balance sheets, I would like to stress that PSBs should not become too dependent on this source. Depending upon individual situations, PSBs should access the capital market for mobilisation of capital.

Sixth, I have referred to the importance of the IBC and the new bankruptcy regime earlier. There are, however, delays in the resolution of cases, as a significant number of them have extended beyond 180 or 270 days. The government has already announced two new National Company Law Tribunal (NCLT) benches at Indore and Amravati. Nevertheless, more number of benches as well as members are required. On our part, we are opening a new RBI Professorial Chair at the Indian Institute of Corporate Affairs (IICA), Manesar, Haryana which is starting a two year Graduate Insolvency Programme to increase the pool of trained insolvency professionals.

Seventh, in the light of various developments in the financial sector such as the use of complex financial products and rapid technological innovations which give rise to interconnectedness and spill over effects within and between entities, there has been a move globally towards building specialised teams of bank supervisors. Even in the Indian context, some incidents in the financial sector have underscored the need for specialisation in supervision and regulation. The build-up of risks among regulated entities due to exposure concentrations, non-transparent market practices and the associated contagion effects in the banking sector have significant implications for financial stability. Considering these issues, the Reserve Bank has now decided to build a specialised regulatory and supervisory cadre for regulation and supervision of banks, non-banks and co-operatives. This specialised cadre in the Reserve Bank will play a pivotal role so that sound banking and non-banking sectors efficiently intermediate the financing requirements of the entire economy.

Eighth, the Reserve Bank has been at the forefront of creating an enabling environment for growth of digital technology for new financial products and services. We are strengthening the surveillance framework and have issued draft guidelines on Framework for Regulatory Sandbox. A committee on deepening of digital payments under the Chairmanship of Shri Nandan Nilekani was formed which has submitted its report. Recently, the Reserve Bank came up with a Payment System Vision 2021 to ensure uninterrupted availability of safe, secure, accessible and affordable payment systems. The Reserve Bank will examine the recommendations of the report of Nilekani Committee and dovetail the action points, wherever necessary, with Vision 2021, for implementation.

Ninth, we also need to address the existing inadequacies in customer service and benchmark it against international standards. Efforts in developing robust customer grievance redressal mechanisms to increase customers' trust and confidence in payment systems will be continued. Given the rising popularity of digital payments, data protection and cyber security norms need to be continuously strengthened. With the emerging threat landscape, where organised cyber-crime and cyber warfare are gaining prominence, working towards ensuring continuous protection against the changing contours of cyber security threat becomes imperative. As banks' engagement with technology is increasing at a rapid pace, the challenge for the regulator would be to balance efficiency with prudential measures to mitigate risks to be able to harness the opportunities offered by Fintech.

Let me now turn to NBFCs. The conventional approach to their regulation and supervision has been light-touch, so that they could complement banks with their diverse financial products for niche areas and reach a large cross-section of population through innovative service delivery mechanisms. However, with a view to strengthen the sector, maintain stability and avoid regulatory arbitrage, the Reserve Bank has been proactively taking necessary regulatory and supervisory steps, keeping in mind the requirements of the time. In the light of recent developments, there is a case for having a fresh look at their regulation and supervision. It is our endeavour to have an optimal level of regulation and supervision so that the NBFC sector is financially resilient and robust. At the same time, NBFCs should be enabled to operate as well-functioning entities with necessary capacity to reach wider sections of population. The Reserve Bank will continue to monitor the activity and performance of this sector with a focus on major entities and their inter-linkages with other sectors. We will not hesitate to take any required steps to maintain financial stability in the short, medium and long-term.

As you are aware, fine tuning and improving supervision and regulation are continuous exercises. Towards this direction, we have reduced the periodicity of the NBFC supervision to 12 months from 18 months earlier. We expect the Board of Directors of companies themselves to act diligently and take necessary action based on Reserve Bank's supervision reports.

Further, our objective is to harmonise the liquidity norms between banks and NBFCs, taking into account the unique business model of the NBFCs *vis-à-vis* banks. In this context, the final guidelines on the liquidity risk management framework which we have proposed recently will be issued shortly.

Let me also make a reference to Urban Co-operative Banks (UCBs). Our experience suggests that the Board of Directors of UCBs require greater expertise and skill to conduct banking business professionally. The Reserve Bank is in the process of issuing guidelines on this issue. A need is also felt for establishment of an Umbrella Organisation for UCBs which may extend loans and refinance facilities, setup IT infrastructure and provide support for capital and liquidity. The structure, functions and the regulatory guidelines of this organisation are being examined by the Reserve Bank. Mergers and consolidation in the sector will also help in reducing operating costs, encouraging greater risk diversification and economising capital. We propose to put in place a mechanism for encouraging voluntary mergers in the sector through appropriate incentives. We also propose to create a Centralised Fraud Registry for UCBs.

I have highlighted several issues in the banking and non-banking sectors. A sound and resilient financial system is a prerequisite for a modern economy that involves all sections of its society in sharing equitably the benefits of economic and social progress. As you would know, reforms are an ongoing process. The Reserve Bank will endeavour to be proactive in its approach. In the fast-changing financial landscape, we will continue to be watchful to the emerging challenges and respond to them appropriately to ensure a resilient and robust financial system.