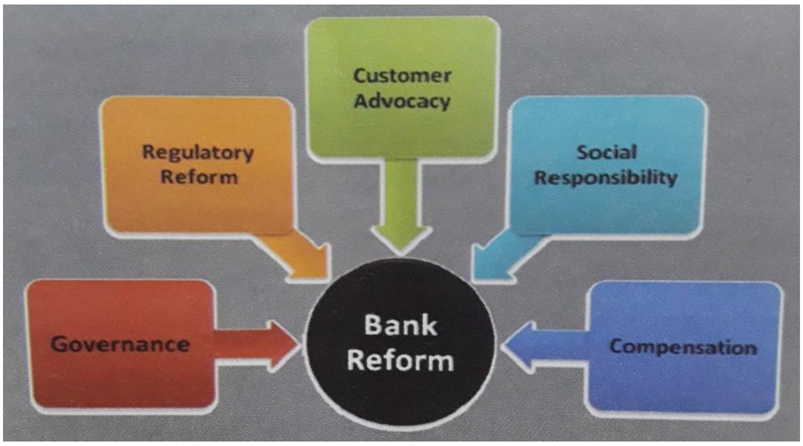
BANKING SECTOR REFORMS: ENSURING REGULATION



HISTORY OF BANKING REFORMS IN INDIA:

- In 1969, the government nationalised banks with deposits greater than Rs. 50 Cr.
- In 1980, the government again nationalised some more banks with country wide deposits more than 200Cr.
- In 1991, the government of India liberalized the economy.
- The committee on Financial systems, chaired by Mr. M. Narasimham in 1991, recommended to reduce the Statutory Liquidity Ratio (SLR), and Cash Reserve Ratio (CRR) to free up bank resources, relying on market forces to determine interest rates, making it easier for private and foreign banks to enter to enhance competition and reducing substantially the number of Public Sector Banks (PSBs).
- In 1998, the committee on banking reforms, also chaired by Mr. Narsimham recommended a further set of measures to strengthen the banking sector. The committee reviewed progress in existing measures and proposed further measures related to legislation, Capital Adequacy and Bank Mergers. The committee also recommended steps relating to greater technology use, skills training and professional management of banks.
- Many of reforms since 1991, improved the performance and strength of India's banking sector. Such as the amount of credit extended by the banking system as a share of GDP increased from 51.5% in 1990 to 53.4% in 2000.
- In 2000, the committee on Financial Sector Reforms included recommendations on Macroeconomic and regulatory frameworks for India, financial inclusion and domestic financial development.
- In 2014, P.J Nayak committee was constituted to Review Governance of Boards of Banks. It recommended on enhancing the government and management of public sector banks.

THE CURRENT SITUATION:

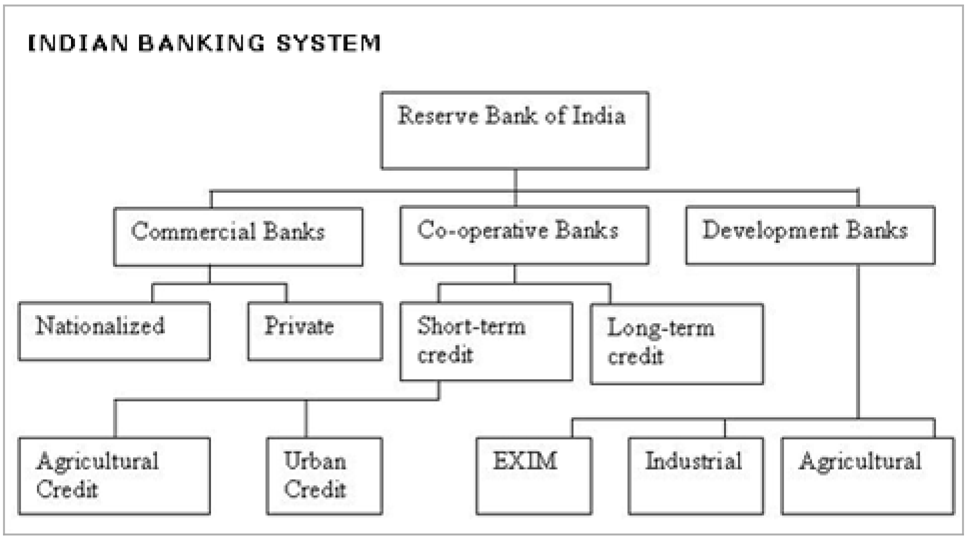
- Since PSBs account for over 70% of total assets, PSBs' performance inevitably represents the performance of overall banking system.
- PSBs are the biggest contributors with a share of 88% of the stock of March 2016.
- The share of stressed assets in PSBs is nearly 16% more than 3times that in Private banks.

Table: 1 Stressed Advances of Bank as a share of total Advances (percent)

	March 2008	March 2017
Public Sector Banks	3.5	15.6
Private Sector Banks	4.2	4.6
Foreign Banks	3.0	4.5
All Banks	3.5	12.1

- Return of Assets (ROA) and Return on Equity (ROE) ratios turned negative for the first time in a decade.
- The Gross Non Performing Assets (NPA) of scheduled commercial banks amounted to Rs. 6.1 trillion in March 2016.
- The decline in banks' profits is largely due to higher growth in risk provisions, loan write-offs and decline in net interest income.
- To counter negative effects on Economy, the Ministry of Finance announced a Rs.2.1 lakh Crores plan to recapitalize banks. These funds will not only help PSBs meet their minimum capital requirements but they will also help banks clean up their balance sheets and cover bad loans going forwarded.

GLOBAL COMPETITION:



- India's banks lag behind global counterparts in terms of financial depth or the size of banks, other financial institutions and markets relative to economic output.
- Since 1991, only 14 licenses have been granted for universal banks. In contrast, in the United States, over 130 new banks were chartered annually on average between 1976 and 2009.
- The number of foreign banks is very small i.e. 6% of total banking assets.

LOOKING AHEAD:

In the future, India should strive to have a more robust and well-capitalized banking system, with enhanced capacity to extend credit and an incentive structure suitable for productive allocation of resources. To build a robust banking system, recapitalization will have to be complemented by a host of other measures including corporate governance reforms, lower entry barriers, improved financial supervision, development of a dynamic corporate debt market and efficient debt recovery mechanisms.

There are 3 particular areas that can be prioritized:-

a. Improving Governance and Strengthening institutions.
b. Development of corporate bond markets.
c. Make the banking sector more competitive.

PROTAGONIST TO ECONOMIC TRANSFORMATION

PRIVATE SECTOR BANKS:

- After 1990, Private Sector Banks turned from being peripheral players to one of the principal drivers in the process of credit dissemination in the economy.
- As of FY07, Private Sector Banks had 20% share in outstanding credit which now stands at 29% as of FY17.
- The faster pace of growth of private sector banks can be attributed to the fact that they have been nimble in adapting to the evolving needs of the customer.
- Private sector banks' ownership of deposits has risen from 20% in FY07 to 24% in FY17.

PUBLIC SECTOR BANKS:

While the PSBs have lagged behind their peers in the private sector over the last one decade, recent structural reforms undertaken by the Government could certainly help them in consolidating their position:

- Governance reforms like setting up of Bank Board Bureau, splitting up CMD's post and recommendation for a longer tenure for CEO (5years) are expected to help improve efficiency in the longer run.
- The creation of CRILC (Central Repository of Information on Large Credits) and the implementation of IBC (Insolvency and Bankruptcy Code) have provided an institutional framework for sharing information and resolution of stressed assets.
- The large scale recapitalization plan worth Rs. 2.11 lakh Crore recently announced by the government for PSBs can be a potential Game Changer.

NEXT GENERATION BANKING:

With India expected to become the 4th largest economy in the world by 2025, the following 4Ds will determine and drive the banking landscape:

- **DEVELOPMENT:** Financial Inclusion Agenda and Other Key Sectorial and Structural reforms.
- **DEREGULATION:** Policy improvement in financial intermediation and savings propensity.
- **DEMOGRAPHICS:** Market getting dominated by young and digitally equipped population.
- **DISRUPTION:** Digitization and the integration of banking, telecom, and financial space.

Based on the above 4 Ds, the following seven trends will define the next generation banking in India:

TRANSFORMING THE WAY WE BANK

Technology will define banking contours in the future. There are over 946 million mobile users in the country but only 50mn mobile banking customers. In this respect, the JAM Trinity (Jan-Dhan-Aadhar-Mobile) has the potential to change the face of banking.

'CREATIVE DESTRUCTION' OF BANKS

Bank will need to focus on innovation that raises competition and leads to better and cheaper services for customers. Outsourcing utilities like customer authentication, fraud checking, payments' processing, account infrastructure, KYC processing could be key steps going forward.

CASHLESS AND BRANCHLESS BANKING

As per Morgan Stanley, Indian internet market could rise from $11bn in 2013 to $13bn by 2020, and this poses as an undeniable opportunity. The banking industry could soon transform from 9 to 5 brick and mortar business to a 24*7 solutions platform across the globe.

INNOVATION IN ATM USAGE

As per World Bank estimates, the operational cost per transaction for Indian Banks is Rs 48 per Branch, Rs 25 for Phone Banking, Rs 18 for ATM, Rs 8 for IVR and Rs 4 for online. India has poor ATM penetration - there are only 11 ATMs for every 1 million people in India compared to 37 in

China and 52 in Malaysia. In this regard solar ATMs could reduce set up cost by almost 50% and also cater to power scarce rural areas.

INFRASTRUCTURE FINANCING

India has about 5% share in the global infrastructure market, which is expected to increase to 9-10% by 2025.

NEW MODELS TO SERVE MSMES

The MSMEs sector contributes 8% to the country's GDP. SIDBI has estimated the overall debt finance demand of the MSME sector at USD 650 billion. MUDRA Bank, Credit Guarantee Schemes, Incubation Centres, Start-up facilities etc. will play an important role in the coming years.

COMPETITION AND CONSOLIDATION

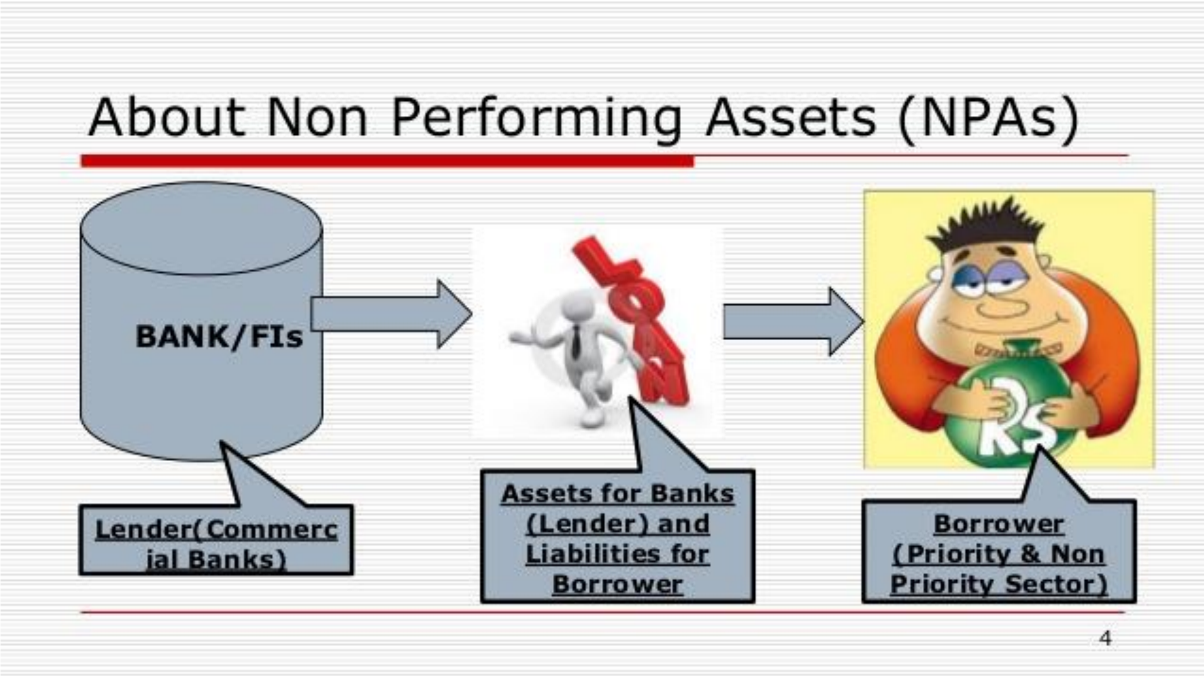
The following are a few innovative thoughts that could become a differentiating reality over the next 15-20 years.

- Account number portability
- Efficient leverage of Big Data Analytics
- Securitization of retail loans.

CONCLUSION

A complete embracement of these anticipated changes will not only put India banks in the global league, they will also help in pushing up the Indian economy to the top 4 slot in the world in the next five years.

MANAGING NON-PERFORMING ASSETS: A PARADIGM SHIFT



- Gross Non-Performing Assets i.e. Bad Loans of banks in India as on September 30, 2017 are Rs.8.40 lakh crore showing a growth of 1.31% from Rs. 8.29 lakh crore as on June 30, 2017.
- During the period of 2008 to 2014 gross advances of public sector banks grew from 18 lakh crores to Rs. 54 lakh crores and by September 17 this figure was Rs. 55.01 lakh crores. So the share of sticky assets of government owned banks in this pile of bad loan is almost 90%.
- There is a lag of nearly 3 to 4 years before NPAs out of the fresh lending appear. Fresh creation of NPAs during the phase of growth get masked by the high growth of advances and ever greening.
- Gross NPA ratio does not show alarming rise as denominator (Advances) increase much faster than the numerator (NPA).
- The provision of company law provides ammunition to bankers to initiate action and refer such cases to the Serious Fraud Investigation Office (SFIO).
- Any person who is found to be guilty of fraud can get imprisonment of 6 months but which may extend to 10 years and fine-Not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud. If the fraud in question involves public interest- Term of imprisonment shall not be less than 3 years.
- There are enabling laws which are specially meant for banks to recover default amount from borrowers are RDDBFI Act, SARFAESI Act-02 and recent legislation of Insolvency and Bankruptcy Code 2016.
- SARFAESI Act allows bankers to take possession of the assets charged to the bank and auction these without intervention of the court.
- A laudable effort made by the present government in implementing Insolvency and Bankruptcy Code on December 1, 16 is a game changer. IBC now is a potent weapon like Brahmastra to be used to destroy the demon of NPAs.
- Going forward, banks need to do forensic audit for ascertaining the end use of funds. They should use Big Data Analytics and other IT based solution for doing proper due diligence

about the borrower and his businesses. Artificial Intelligence (AI) can be leveraged to predict default at least one year in advance with confidence of 80%. Banks have to fine tune their HR policies to train the young work force, which at present lacks experience, and upgrade their skills.

- Selecting retired executives like MD and ED having impeccable track record on the bank Board is worth examining. To expedite recovery government will do well to have a few more NCLTs and large number of DRTs as present benches are woefully short to achieve this objective.

Emerging scenario after Insolvency and Bankruptcy Code has kicked in, will change the borrowing culture and make lending, in future by the banks, much safer. Kudos to GOI for the paradigm shift. The mind-set of borrowers will change for sure.

BANK RECAPITALISATION: ENHANCING CAPITAL BASE

- NPAs in the PSBs have grown to a whopping Rs 7.33 crore in June 2017, compared with Rs. 2.73 crore in March 2015. Another figure reveals that NPAs of domestic banks have reached about 10% of loans and advances recently. So the Union Cabinet finalised an elaborate Rs. 2,11,000 crore plan to revitalise the domestic banking system with a mix of instruments such Market Borrowing, Budgetary Support and most importantly – launch of bank recapitalisation bonds.
- The breakup of the Rs 2,11,000 crore bank recapitalisation plan is thus: Rs 18,000 crore from Budgetary support, Rs 58,000 from equity issuance and Rs 1,35,000 crore from issueof bank recapitalisation bonds.

RECAPITALISATION BOND

- The government will issue the bonds and banks will subscribe the instrument directly. In doing so, the sovereign money will not move out and it will simply be an accounting entry. Money not changing hands will ensure that the government remains insulated from an additional burden on the fiscal.

- It is going to be beneficial for the banks as it enhances their capital base.
- If the government allows the banks to trade the bonds in the secondary market, it will help them raise money and bolster their loan book.
- If the government does not allow banks to trade the bonds, it can serve as investments earning interest income.
- The issue of bonds is a right step owing to the deluge of deposits that have come into the banking system post demonetisation. As per the RBI, 99% of the demonetised Rs 500 and Rs 1000 notes are back into the banking channel.

CRISIL REPORT

- A Crisil report released in July, 2017 points out that banks may have to take haircuts to the tune of Rs 2,40,000 crore or 60% in case of resolution of 50 large stressed accounts.
- Metal sector accounts for 30% of the total debt, construction sector for 25% and power sector for 15%. These three sectors account for almost half of the total NPAs in the economy, as on March 31, 2017.
- The banks may has to take a haircut of 60%, worth Rs 2.4 lakh crore, to settle 50 large stressed assets with debt of Rs 4 lakh crore.
- A/c to the report, companies requiring marginal haircuts are those facing temporary setbacks, which could be corrected over time. The power sector would require moderate haircuts, while metal and construction sectors would need aggressive ones.
- The agency said "it would be in the larger interest of the economy to pop the bitter pill of haircut than kick the can down the road.

CHIEF ECONOMIC ADVISOR, ARVIND SUBRAMANIAN, LECTURE

- The annual interest cost of the bonds is likely to be in the range of Rs 8,000 crore to Rs 9,000 crore.
- The annual interest cost of issuing the Rs 1.35 lakh crore recapitalisation bonds would neither result in inflation, nor push fiscal deficit because of increased economic activities and asset creation even as it incurs an annual interest cost of Rs 8000-Rs 9000 crore.

FACILITATING FINANCIAL INCLUSION

- Financial inclusion is a process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups in particular, at an affordable cost, in a fair and transparent manner, by regulated, mainstream institutional players.

HISTORY

- In India, the financial Inclusion exercise, explicitly started with nationalization of State Bank of India in 1955. In 1967, 14 private banks were nationalized to serve the unbanked. In 1980, eight more private banks were nationalized to extend banking in rural areas and for vulnerable sections of society. In more recent years, since 2005, special efforts were made to ensure financial inclusion, by RBI by simplifying norms on know-your-customer requirements, and introducing 'no frills' account. RBI adopted a bank-led approach and encouraged technological innovations, like hand-held devices, to be used by banks in remote location.

REACH OF BANKING

- A/c to census 2011, only 58.7% of total households in India and only 54.4% households in rural areas had access to formal banking services.

EXPANSION OF BANKING AND ROLE OF MONEY LENDER

- The number of banking offices in India on the eve of establishment of the RBI in 1935 were 946. In March 1969, when banks were nationalised there were only 1,833 rural and 3,342 semi urban bank offices out of total 8,262 offices. Of these, there were 160 branches of Imperial Bank, 98 of exchange banks and 688 of Indian joint stock banks. This implied one bank branch for 3 lakhs of population.

GOVERNMENT INITIATIVES

- As of December 06, 2017 a total of 30.7 crore accounts had been opened under Pradhan Mantri Jan Dhan Yojana (PMJDY) of which 18.1 crore are in rural areas and 12.7 crore in urban areas. The number of RuPay cards have also increased to 23.1 crore. The progress has been impressive, considering that total amount of bank deposits with commercial banks was Rs. 69,841.2 crore as on December 06, 2017.

INNOVATION IN EXTENDING CREDIT

- To extend banking services to unbanked population, commercial banks began exploring alternatives to brick and mortar branch like mobile vans, banking kiosks and Business Correspondents (BCs).

SELECT ISSUES AND SUGGESTIONS

- First, there is a need to extend financial inclusion to the disabled, including those elderly where loco-motor activity, vision and hearing is impaired. There is a need for facilities like biometric-enabled and multi-lingual hand-held devices which can provide confidence in rural masses. Technological innovations like integrated machines that have functionality of cash withdrawals and deposits; facility of scanning documents to facilitate new account opening and loan disbursals; and voice commands and narration for available facilities could help increase banking penetration. Financial literacy can play a vital role.

CONCLUSION

- The successful expansion of banks is now being used to leverage the infrastructure for other financial products like Insurance schemes and Pension funds.

RESOLVING INSOLVENCY

- India improved its position on the 'Ease of Doing Business' ranking, 2018 released by the World Bank by 30 places to 100th position. Well defined and time bound norms for entry and exit are considered key to ease of doing Business.
- The improvement was basically noticed after the government put into effect the Insolvency and Bankruptcy Code (IBC) with a regulator Insolvency and Bankruptcy Board of India (IBBI) in 2016.
- Before the Code, there were about 12 laws, including the Contracts Act, the Recovery of Debts Due to Banks and Financial Institution Act, the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act.
- The Code is quite different from the earlier resolution systems as it shifts the responsibility to the creditor to initiate the Insolvency resolution process against the corporate debtor.
- The Code creates time-bound processes for Insolvency resolution of companies. If the default is over Rs. 1 lakh, the creditor may initiate Insolvency resolution process and go to NCLT.
- The National Company Law Tribunal (NCLT) adjudicates Insolvency resolution for companies. The Debt Recovery Tribunal (DRT) will adjudicate Insolvency resolution for individuals.
- After a case is admitted by NCLT, resolution processes will have to be completed within 180 days, extendable by another 90 days. However, there is a provision for fast tracking resolution process to complete it in 90 days which could be extended by further 45 days. However, only small companies (private entities having a paid up capital of up to Rs 50 lakh or turnover of up to Rs 2 crore) and start-ups could opt for this.
- The resolution processes are conducted by licensed Insolvency Professionals (IPs).

STRENGTHENING OF CYBER SECURITY

DIGITALIZATION

Digitalization is the rise of digital transaction where bank, customers, merchants, industries and other stakeholders form an interdependent financial system network.

A Less-cash Economy is an economy in which many of the transactions are carried out through digital means. It includes various modes such as internet banking, mobile banking, debit and credit cards, card-swipe or Point of Sales (PoS) machines, Unified Payments Intereface (UPI)-BHIM, QR Code (Quick response) based transactions, Touch-n-Go cards.

CYBER SECURITY

Security is to be ensured at all the touch points of the digital transactions. The complete eco-system is to be Cyber-sanitised for all transactions to be flawless and with the following Security triangulation intact along with Non-Repudiation-

- Confidentially
- Integrity
- Availability

The whole eco system of digitalization includes the following stakeholders-

- Customer/Originator
- Originating institution
- Processing agency
- Beneficiary institution
- Beneficiary

GOI MEASURES TO STRENGTHEN THE CYBER SECURITY

NATIONAL CYBER SECURITY POLICY, 2013 (NCSP)

The policy has been built to offer a secure and resilient cyberspace for citizens, businesses and the Government.

CYBER SWACHHTA KENDRA (BOTNET CLEANING AND MALWARE ANALYSIS CENTRE)

To combat cyber security violations and prevent their increase, GOI's Computer Emergency Response Team (CERT-in) in February 2017 launched 'Cyber Swachhta Kendra' (Botnet Cleaning and Malware Analysis Centre).

The Cyber Swachhta Kendra is a step in the direction of creating a secure cyber ecosystem in the country as envisaged under the National Cyber Security Policy in India.

The centre offers following security and protective tools:

- USB Pratirodh, launched by GOI to control unauthorized usage of removal USB devices such as Pen drive, external hard drives etc.
- Samvid, a desktop based application Whitelisting Solution for Windows Operating System.
- M-kavach, a device for security of Android mobile devices.
- Browser JSGuard, a tool which serves as a browser extension which detects and defends malicious HTML and JavaScript attacks made through the web browser based on Heuristics.

INFORMATION TECHNOLOGY ACT

IT Act, 2000 is the primary law in India dealing with cybercrime and electronic commerce which had subsequent amendment in the year 2008.

ONLINE FRAUDS AND IT ACT

- Phishing is the most common banking fraud which happens online.

SECTION 66- HACKING WITH COMPUTER SYSTEM

- Penalty for this section is imprisonment up to three years, or/and with fine up to Rs 500,000.

SECTION 66B- RECEIVING STOLEN COMPUTER OR COMMUNICATION DEVICE

- Imprisonment up to 3 years, or/and with fine up to Rs 100,000.

SECTION 66C- CHEATING USING COMPUTER RESOURCE

- Imprisonment up to 3 years, or/and with fine up to Rs 100,000.

CREDIT CARD FRAUD

- Section 66, Section 66C, Section 66D and Section 420 of IPC are applicable.

RBI DIRECTIONS

- Limiting Liability of Customers in Unauthorized Electronic Banking Transactions.
- Thrust upon ‘Zero Liability’ and ‘Limited Liability’ for bank customers against any fraud provided if the same is reported to the bank immediately.
- RBI has made it mandatory for the banks to register all customers for text message alerts and permit reporting of unauthorized transactions through a reply to the alert message.
- In case of loss caused by a third party, the customer will be liable for the transaction value if he fails to report the fraudulent transaction within 4-7 working days of receiving the alert

from the bank. In case the fraud is reported within 4-7 working days, a customers' maximum liability will be from Rs 5000 to Rs 25000, depending on the type of accounts and credit card limit.

WRAP UP

Security is a journey. Awareness will enable to face and mitigate the risk.

RURAL BANKING: TRANSLATING VISION TO REALITY

- Rural development is the sine-qua-non of the overall development of India. Since independence, it has been the constant endeavour of our policy makers to give adequate thrust to bringing rural prosperity in India.
- Even today, the country is home to 24% of the world's unbanked adults and about two-thirds of South Asia's. About 31 crore 'potentially bankable rural Indians' do not have access to formal banking services.
- Since rural households have irregular income and expenditure patterns, the banks have high Non-performing loans in rural areas. The loan waivers driven by political agenda, further aggravate the bankers' woes.
- The average ticket size of both a deposit transaction and a credit transaction in villages is small, which means the banks need more customers per branch or channel to break-even.
- The new rural finance paradigm needs to be based on the premise that 'rural people are bankable' and rural clientele is not limited only to the farmers and uneducated but also includes a generation which can use and adopt technology.
- In India, the 1st structured attempt towards financial inclusion, featured in 2005, when it was launched by K C Chakraborthy. Mangalam village became the 1st village in India where all households were provided with banking facilities.
- Steps taken by RBI for financial are: facilitating no-frill accounts and General Credit Cards (GCCs) for small deposits and credit, norms were relaxed for people intending to open accounts with annual deposits of less than 50,000.
- With a view to provide hassle-free and timely credit to farmers, as on September 2016, above 50 million Kisan Credit Cards (KCC) have been issued by the banking system.
- RBI directed the commercial banks in different regions to start a 100% financial inclusion campaign, as a result of which UTs like Puducherry and states like Himachal Pradesh, Kerala announced 100% financial inclusion in all their districts.
- RBI's vision for 2020 is to open nearly 600 million new customers' accounts and service them through a variety of channels by leveraging on IT.
- The latest data show that the number of bank branches in rural areas has increased from 33,378 in March 2010 to 51,830 in March 2016, while the number of branchless banking outlets in rural India has risen from 34,316 in March 2010 to 534,477 in March 2016.

- India has the largest postal network in the world with over 1,54,882 Post Offices of which 1,39,182 (89.86%) are in the rural areas. In this backdrop, all-round efforts are to be made to ensure that Post Offices play a greater and more active role due to their known advantages. Launching of India Posts Bank by GOI is undoubtedly, a remarkable step in this direction.
- The SHG-Bank Linkage programme of NABARD, has become the biggest Micro-Credit programme of the world.

The government as well as the RBI have taken various measures recently to solve the various issues:

- Enormous success in opening of about 26 crore accounts under JAN DHAN YOJANA.
- Setting up Micro Unit Development Refinance Agency (MUDRA) for providing micro credits.
- Various social sector schemes like Atal Pension Yojana, Pradhan Mantri Suraksha Bima Yojana and Pradhan Mantri Jeevan Jyoti Bima Yojana which provide social security.
- Aadhaar enabled micro ATMs and RuPay cards to replace cash transactions.
- Promoting differential banking through new licenses given to 11 payment banks and 10 small finance banks.

MISSION INDRADHANUSH: REVAMPING OF PUBLIC SECTOR BANKING IN INDIA

- The GOI announcing a massive capital infusion plan of Rs 2.11 lakh crore over the next 2 years for the PSBs.
- The GOI in 2015 developed the 'Indradhanush Plan'. This plan for recapitalising and revamping of PSBs was announced by the Central Government on August 14, 2015 in national capital and was one of the most comprehensive reforms undertaken by Government since banking nationalisation in the year 1970.

APPOINTMENTS

The Government decided to separate the post of Chairman and Managing Director.

BANKS BOARD BUREAU (BBB)

The BBB will be a body of eminent professionals and officials, which will replace the Appointments Board for appointment of Whole-time Directors as well as non-Executive Chairman of PSBs.

CAPITALIZATION

As of now, the PSBs are adequately capitalized and meeting all the Basel III.

DE-STRESSING PSBS

Due to several factors, the Infrastructure Sector and Core Sector projects got stalled/stressed thus leading to NPA burden on banks.

- The process of Governance Reforms started with "GyanSangam" – a conclave of PSBs and FIs organised at the beginning of 2015 in Pune which was attended by all the stake-holders including Governor, RBI and CMDs of all PSBs and FIs.
- Central Government also plans to come-out in near future with 'Indradhanush 2.0', a comprehensive plan for re-capitalisation of Public Sector Lenders, with a view to make sure that they remain solvent and fully comply with the global capital adequacy norms, Basel III.