INDIA’S FINANCIAL SECTOR REFORMS 2010-2016: OUTCOMES AND ISSUES

Rakesh Mohan
Non Resident Senior Research Fellow
Stanford Centre for International Development, Stanford University
and
Distinguished Fellow
Brookings India

And

Partha Ray
Professor
Indian Institute of Management Calcutta

Presentation at the SCID India Conference 2016
Stanford
June 2, 2016
I. Macro Financial Conditions
II. Central Bank Governance and Monetary Policy
III. Developments in the Banking Sector
IV. Formation of NPAs in the Banking Sector
V. Financial Inclusion
VI. Looking Ahead
Macro Financial Conditions (1)
Growth and Inflation Outcomes

<table>
<thead>
<tr>
<th>Period (Averages)</th>
<th>GDP Growth (%)</th>
<th>WPI Inflation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-60</td>
<td>3.6</td>
<td>1.2</td>
</tr>
<tr>
<td>1960-70</td>
<td>4.0</td>
<td>6.4</td>
</tr>
<tr>
<td>1970-80</td>
<td>2.9</td>
<td>9.0</td>
</tr>
<tr>
<td>1981-91</td>
<td>5.6</td>
<td>8.2</td>
</tr>
<tr>
<td>1991-92 (Crisis Year)</td>
<td>1.4</td>
<td>13.7</td>
</tr>
<tr>
<td>1992-2000</td>
<td>6.3</td>
<td>7.2</td>
</tr>
<tr>
<td>1998-2008</td>
<td>7.1</td>
<td>5.0</td>
</tr>
<tr>
<td>2003-08</td>
<td>8.7</td>
<td>5.5</td>
</tr>
<tr>
<td>2008-10 (NAFC)</td>
<td>7.0</td>
<td>5.6</td>
</tr>
<tr>
<td>2010-12</td>
<td>7.8</td>
<td>9.3</td>
</tr>
<tr>
<td>2013-16*</td>
<td>6.5*</td>
<td>3.2 (7.4)</td>
</tr>
</tbody>
</table>

* Growth figures relate to GVA at basic price with 2011-12 base year. Figures in brackets are inflation are on the basis of combined CPI.

Sources: Economic Survey, Government of India, 2015-16; RBI Bulletin,
Macroeconomic Financial Conditions (2)  
Inflation in India

<table>
<thead>
<tr>
<th>Year</th>
<th>All Commodities</th>
<th>Primary Articles</th>
<th>Fuel &amp; Power</th>
<th>Manufactured Products</th>
<th>Combined CPI Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-01</td>
<td>7.2</td>
<td>2.8</td>
<td>28.5</td>
<td>3.3</td>
<td></td>
</tr>
<tr>
<td>2001-02</td>
<td>3.6</td>
<td>3.6</td>
<td>8.9</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>2002-03</td>
<td>3.4</td>
<td>3.3</td>
<td>5.5</td>
<td>2.6</td>
<td></td>
</tr>
<tr>
<td>2003-04</td>
<td>5.5</td>
<td>4.3</td>
<td>6.4</td>
<td>5.7</td>
<td></td>
</tr>
<tr>
<td>2004-05</td>
<td>6.5</td>
<td>3.6</td>
<td>10.1</td>
<td>6.3</td>
<td></td>
</tr>
<tr>
<td>2005-06</td>
<td>4.4</td>
<td>4.3</td>
<td>13.5</td>
<td>2.4</td>
<td></td>
</tr>
<tr>
<td>2006-07</td>
<td>6.6</td>
<td>9.6</td>
<td>6.5</td>
<td>5.7</td>
<td></td>
</tr>
<tr>
<td>2007-08</td>
<td>4.7</td>
<td>8.3</td>
<td>0.0</td>
<td>4.8</td>
<td></td>
</tr>
<tr>
<td>2008-09</td>
<td>8.1</td>
<td>11.0</td>
<td>11.6</td>
<td>6.2</td>
<td></td>
</tr>
<tr>
<td>2009-10</td>
<td>3.8</td>
<td>12.7</td>
<td>-2.1</td>
<td>2.2</td>
<td></td>
</tr>
<tr>
<td>2010-11</td>
<td>9.6</td>
<td>17.7</td>
<td>12.3</td>
<td>5.7</td>
<td></td>
</tr>
<tr>
<td>2011-12</td>
<td>8.9</td>
<td>9.8</td>
<td>14.0</td>
<td>7.3</td>
<td>5.8</td>
</tr>
<tr>
<td>2012-13</td>
<td>7.4</td>
<td>9.8</td>
<td>10.3</td>
<td>5.4</td>
<td>10.1</td>
</tr>
<tr>
<td>2013-14</td>
<td>6.0</td>
<td>9.8</td>
<td>10.2</td>
<td>3.0</td>
<td>6.7</td>
</tr>
<tr>
<td>2014-15</td>
<td>2.0</td>
<td>3.0</td>
<td>-1.0</td>
<td>2.4</td>
<td>5.8</td>
</tr>
<tr>
<td>2015-16</td>
<td>-0.9</td>
<td>2.1</td>
<td>-8.3</td>
<td>-0.1</td>
<td>5.5</td>
</tr>
</tbody>
</table>
Macro Financial Conditions (3)

Inflation in India: Different Rates

![Graph showing inflation rates from April 2005 to February 2016 for WPI, CPI-IW, and CPI All-India.]
Macro Financial Conditions (4)
Bank Credit & Investments: Growth Rates (%)

Source: Handbook on the Indian Economy, RBI.
Note: Figures refer to investment and credit of all commercial and co-operative banks
Macro Financial Conditions (5)
Credit, Investments, and Deposits of Commercial Banks (% of GDP)
## Macro Financial Conditions (6)
### Payment System Indicators

<table>
<thead>
<tr>
<th>Type</th>
<th>Volume (Million)</th>
<th>Value (Rupees Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 RTGS</td>
<td>9.97</td>
<td>4.8</td>
</tr>
<tr>
<td>2 CCIL Operated Systems</td>
<td>0.3</td>
<td>0.1</td>
</tr>
<tr>
<td>3 Paper Clearing</td>
<td>98.1</td>
<td>13.18</td>
</tr>
<tr>
<td>4 Retail Electronic Clearing</td>
<td>328.3</td>
<td>37.1</td>
</tr>
<tr>
<td>5 Cards</td>
<td>917.4</td>
<td>44.8</td>
</tr>
<tr>
<td>o/w Credit Cards</td>
<td>72.8</td>
<td>23.4</td>
</tr>
<tr>
<td>o/w Debit Cards</td>
<td>844.6</td>
<td>21.4</td>
</tr>
<tr>
<td>6 Prepaid Payment Instruments</td>
<td>72.0</td>
<td>–</td>
</tr>
<tr>
<td>7 Mobile Banking</td>
<td>48.4</td>
<td>–</td>
</tr>
<tr>
<td>8 Number of ATMs (in actuals)</td>
<td>199,100</td>
<td>–</td>
</tr>
</tbody>
</table>

Data pertain to March of the given years.
Source: Database on Indian Economy, RBI
Macro Financial Conditions (7)
What did the IMF FSAP report (2013) say?

• Remarkable progress toward developing a stable financial system.
• The prominent role of the state in the financial sector contributes to a build-up of fiscal contingent liabilities and creates a risk of capital misallocation that may constrain economic growth.
• Despite risks related to worsening bank asset quality and renewed pressures on systemic liquidity, financial system vulnerabilities appear manageable.
• Sharp credit expansion with recent economic slowdown putting pressure on banks’ asset quality, especially for infrastructure and priority sector.
• Group concentrations have reached troubling levels at some banks.
• Risk of reversal of capital flows and a repeat of liquidity pressures like 2008.
• Stress tests: banks’ substantial buffers of high quality assets (cash and SLR Gsecs) enable them to deal with such pressures.
I. Macro Financial Conditions
II. Central Bank Governance and Monetary Policy
III. Developments in the Banking Sector
IV. Formation of NPAs in the Banking Sector
V. Financial Inclusion
VI. Looking Ahead
Board for Financial Supervision (BFS)

✓ Constituted in 1994 as a committee of the Central Board

✓ **Objective:** Undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies.

✓ **Members:** 4 Independent Directors from the Central Board; All Deputy Governors

✓ Meets monthly

➢ Can become formally responsible for Financial Stability and Macro prudential Regulation
Board for Regulation and Supervision of Payment and Settlement Systems (BPSS)

✓ Payment and Settlement Systems Act, 2007
✓ Sub-committee of the Central Board of the Reserve Bank of India
✓ Highest policy making body on payment systems in the country.
✓ Empowered for authorizing, prescribing policies and setting standards for regulating and supervising all the payment and settlement systems in the country.
✓ Assumes increased importance with spread of fintech
Central Bank Governance and Monetary Policy (3)  
Financial Stability and Development Council (FSDC) (1)


- Objectives
  - strengthening and institutionalizing the mechanism for maintaining financial stability
    - Macro prudential supervision of the economy, including functioning of large financial conglomerates
  - enhancing inter-regulatory coordination and
  - promoting financial sector development
    - financial literacy and financial inclusion

- Composition
  - Chairman: Finance Minister
  - Vice Chairman: Governor RBI
  - Members
    - Heads RBI, SEBI, PFRDA, IRDA
    - Finance Secretary and/or Secretary, Department of Economic Affairs,
    - Secretary, Department of Financial Services, and Chief Economic Adviser.
    - Additional Secretary, DEA is the Secretary to FSDC

- Financial Data Management Centre to be set up under FSDC
  - integrated data aggregation for analysis in the financial sector.
The FSDC Sub-committee: Chair Governor, RBI

- Meets more often than the full Council.
- Members:
  - All the members of the FSDC
  - All Deputy Governors of the RBI and Additional Secretary, DEA, in charge of FSDC
  - Executive Director, RBI (in charge of financial Stability) is the Member Secretary
  - Financial Stability Unit (FSU) of RBI is the Secretariat for the Sub-committee.
Central Bank Governance and Monetary Policy (5)
Financial Stability and Development Council (FSDC) (3)

• Working Groups/Technical Groups under FSDC Sub-Committee

✓ Inter Regulatory Technical Group: headed by ED in charge of Financial Stability, RBI
✓ Technical Group on Financial Inclusion and Financial Literacy: Chaired by DG, RBI Representatives from all regulators, DEA and DFS
✓ Inter Regulatory Forum for monitoring Financial Conglomerates: Headed by DG Representatives of all the sectoral regulators
✓ Early Warning Group: chaired by DG, RBI in-charge of Financial Markets
✓ Macro Financial and Monitoring Group: chaired by the Chief Economic Adviser
✓ Working Group on resolution regime for financial institutions
Changes in Operating Procedure: 2011

• Operating target of monetary policy: Weighted average overnight call money rate
• Repo rate: Main policy rate
• New Marginal Standing Facility (MSF) Banks: 100 basis points above the repo rate
  ✓ Banks can borrow up to 1% of their respective NDTL; now 2%
• The Bank Rate aligned to the MSF rate.
• The revised corridor was defined with a fixed width of 200 basis points.
• The repo rate was placed in the middle of the corridor
• Reverse repo rate 100 basis points below repo rate
• More recently, on April 5, 2016 with a view to “ensuring finer alignment of the weighted average call rate (WACR) with the repo rate”, the RBI narrowed the policy rate corridor from +/-100 basis points (bps) to +/- 50 bps by reducing the MSF rate by 75 basis points and increasing the reverse repo rate by 25 basis points
  • Currently, Policy Repo rate = 6.5%, Reverse Repo Rate = 6%, & MSF Rate = 7%

Liquidity always expected to be in shortage
Central Bank Governance and Monetary Policy (7)

Daily Net Injection (+)/Absorption (-) of Liquidity by the RBI (Rs. Billion)

Net Injection (+) / Absorption (-) = Repo + Term Repo + MSF + SLF + Open market purchase – Reverse repo – Term reverse repo – Open Market Sale

Source: Database on Indian Economy
Note: Call rates touched 52-54 per cent on occasions during the period March 21-31, 2007.
Flexible Inflation Targeting
- CPI 4% +/- 2%

Monetary Policy Committee
- Governor
- Deputy Governor i/c of Monetary Policy
- RBI Official nominated by RBI
- 3 “Nominees of Central Government”
  - 4 Year non renewable term
- Government can submit written views
- Governor has casting vote in case of tie
Central Bank Governance and Monetary Policy (10)
New Monetary Policy Framework (2)
MPC: Other Key Jurisdictions

• US Federal Reserve
  ✓ Chairman, All other 6 Governors, NY Fed President, 4 District Fed Presidents

• ECB
  ✓ President, All other 5 Executive Board Members, 19 European Central Bank Governors

• Bank of England
  ✓ Governor, 3 of 4 Deputy Governors, Chief Economist, 4 External (Full Time) Members, Treasury non-voting Observer

• Bank of Canada
  ✓ Governor, 5 Deputy Governors (*no outsiders*)

• Reserve Bank of Australia
  ✓ RBA Board, Governor, Deputy Governor, Secretary Treasury, 6 External (part time) Members
• Most Major Central Bank MPCs do not have part time outside voting members
  ➢ Will External Members be full time or part time?
  ➢ Conflicts of interest as external voting members?
  ➢ How much information can be shared with the members

• Most have all Deputy Governors as Members
  ➢ Synergy from other DGs with knowledge of bank regulation, supervision, financial markets, external markets
  ➢ Indian MPC has lost this synergy with their exclusion

• Government Written Submission
  ➢ How will this be treated?
Flexible Inflation Targeting has been adopted

• Consideration of other objectives?
  ✓ Economic Growth
  ✓ Employment
  ✓ Financial Stability

• US, ECB, UK, Australia, Canada, have some of these objectives
  ✓ Inflation target is primary objective
  ✓ Growth, Employment, financial stability as secondary objectives
I. Macro Financial Conditions
II. Central Bank Governance and Monetary Policy
III. Developments in the Banking Sector
IV. Formation of NPAs in the Banking Sector
V. Financial Inclusion
VI. Looking Ahead
Developments in the Banking Sector (1)
Key Features of Trends 2010-2016

- Slowdown in credit growth
- Increase in share of corporate lending by public sector banks
- Reversal of convergence in performance of public and private sector banks
- Increasing NPAs in public sector banks
- Increasing share of foreign holdings in private sector banks
Developments in the Banking Sector (2)
Productivity and Efficiency Indicators (%)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Year</th>
<th>PSBs</th>
<th>New Private Banks</th>
<th>Foreign Banks</th>
<th>All Commercial Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intermediation cost @</td>
<td>1998-99</td>
<td>2.7</td>
<td>1.7</td>
<td>3.4</td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>2008-09</td>
<td>1.5</td>
<td>2.2</td>
<td>2.8</td>
<td>1.7</td>
</tr>
<tr>
<td></td>
<td>2014-15</td>
<td>1.6</td>
<td>2.2*</td>
<td>2.3</td>
<td>1.8</td>
</tr>
<tr>
<td>Net interest margin</td>
<td>1998-99</td>
<td>2.8</td>
<td>2.0</td>
<td>3.5</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>2008-09</td>
<td>2.1</td>
<td>2.8</td>
<td>3.9</td>
<td>2.4</td>
</tr>
<tr>
<td></td>
<td>2014-15</td>
<td>2.3</td>
<td>3.4*</td>
<td>3.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Return on assets</td>
<td>1998-99</td>
<td>0.4</td>
<td>1.1</td>
<td>1.0</td>
<td>0.5</td>
</tr>
<tr>
<td></td>
<td>2008-09</td>
<td>0.9</td>
<td>1.1</td>
<td>1.7</td>
<td>1.0</td>
</tr>
<tr>
<td></td>
<td>2014-15</td>
<td>0.5</td>
<td>1.7*</td>
<td>1.9</td>
<td>0.8</td>
</tr>
</tbody>
</table>

&: Ratio of operating expenses to total income less interest expenses.
@: Ratio of operating expenses to total assets.
*: For all private sector banks (New & old).
## Developments in the Banking Sector (3)
### Bank Group-wise Shares (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public Sector Banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>82.5</td>
<td>78.4</td>
<td>68.0</td>
<td>70.1</td>
</tr>
<tr>
<td>Expenditure</td>
<td>84.2</td>
<td>78.9</td>
<td>68.4</td>
<td>72.6</td>
</tr>
<tr>
<td>Total Assets</td>
<td>84.4</td>
<td>79.5</td>
<td>71.9</td>
<td>72.1</td>
</tr>
<tr>
<td>Net Profit</td>
<td>-39.1</td>
<td>67.4</td>
<td>65.2</td>
<td>42.1</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>74.3</td>
<td>69.9</td>
<td>60.1</td>
<td>59.2</td>
</tr>
<tr>
<td><strong>New Private Sector Banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>1.5</td>
<td>5.7</td>
<td>17.6</td>
<td>23.8</td>
</tr>
<tr>
<td>Expenditure</td>
<td>1.3</td>
<td>5.5</td>
<td>17.8</td>
<td>22.1</td>
</tr>
<tr>
<td>Total Assets</td>
<td>1.5</td>
<td>6.1</td>
<td>15.2</td>
<td>21.6</td>
</tr>
<tr>
<td>Net Profit</td>
<td>17.8</td>
<td>10.0</td>
<td>16.0</td>
<td>43.5</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>2.5</td>
<td>6.9</td>
<td>17.5</td>
<td>29.9</td>
</tr>
<tr>
<td><strong>Foreign Banks</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income</td>
<td>9.4</td>
<td>9.1</td>
<td>9.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Expenditure</td>
<td>8.3</td>
<td>8.8</td>
<td>9.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Total Assets</td>
<td>7.9</td>
<td>7.9</td>
<td>8.5</td>
<td>6.3</td>
</tr>
<tr>
<td>Net Profit</td>
<td>79.8</td>
<td>14.8</td>
<td>14.2</td>
<td>14.4</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>15.6</td>
<td>15.7</td>
<td>18.0</td>
<td>10.9</td>
</tr>
</tbody>
</table>

*Figures for 2014-15 pertain to all private sector banks (as against only new private sector banks for other years).*
## Developments in the Banking Sector (4)

### Financial Performance of Commercial Banks

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar-11</td>
<td>1.1</td>
<td>13.6</td>
<td>23.6</td>
<td>21.7</td>
<td>34.6</td>
<td>0.5</td>
<td>38.6</td>
<td>-50.6</td>
</tr>
<tr>
<td>Mar-12</td>
<td>1.1</td>
<td>13.4</td>
<td>14.6</td>
<td>15.3</td>
<td>15.8</td>
<td>7.4</td>
<td>35.6</td>
<td>-13.1</td>
</tr>
<tr>
<td>Mar-13</td>
<td>1.0</td>
<td>12.9</td>
<td>12.9</td>
<td>9.9</td>
<td>10.8</td>
<td>14.4</td>
<td>10.2</td>
<td>-8.5</td>
</tr>
<tr>
<td>Mar-14</td>
<td>0.8</td>
<td>9.5</td>
<td>-14.1</td>
<td>9.5</td>
<td>11.7</td>
<td>16.6</td>
<td>41.9</td>
<td>80.3</td>
</tr>
<tr>
<td>Mar-15</td>
<td>0.8</td>
<td>9.3</td>
<td>10.1</td>
<td>11.4</td>
<td>8.5</td>
<td>17.4</td>
<td>7.0</td>
<td>23.4</td>
</tr>
<tr>
<td>Sep-15</td>
<td>0.7</td>
<td>8.5</td>
<td>-4.4</td>
<td>8.8</td>
<td>8.6</td>
<td>11.0</td>
<td>22.2</td>
<td>49.2</td>
</tr>
</tbody>
</table>

## Developments in the Banking Sector (5)
### Shareholding Pattern of Select Private Sector Banks & SBI

<table>
<thead>
<tr>
<th>Name of the Bank</th>
<th>Size (Total Assets, in Rs. Billion)</th>
<th>Share of Residents (%)</th>
<th>Share of Non Residents (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ICICI Bank</td>
<td>6,461</td>
<td>29.6</td>
<td>70.4</td>
</tr>
<tr>
<td>HDFC Bank</td>
<td>5,905</td>
<td>26.6</td>
<td>73.4</td>
</tr>
<tr>
<td>Axis Bank</td>
<td>4,619</td>
<td>49.4</td>
<td>50.6</td>
</tr>
<tr>
<td>Yes Bank</td>
<td>1,361</td>
<td>54.4</td>
<td>45.6</td>
</tr>
<tr>
<td>IndusInd Bank</td>
<td>1,091</td>
<td>28.4</td>
<td>71.6</td>
</tr>
<tr>
<td>Kotak Mahindra Bank</td>
<td>1,060</td>
<td>55.8</td>
<td>44.2</td>
</tr>
<tr>
<td><strong>State Bank of India</strong></td>
<td><strong>20,481</strong></td>
<td><strong>85.8 (58.6)</strong></td>
<td><strong>14.2</strong></td>
</tr>
</tbody>
</table>

Note: Figures in bracket is the share of Government & RBI in SBI
Source: Statistical Tables relating to Banks in India, RBI, 2014-15
Developments in the Banking Sector (6)
Capital to Risk-weighted Assets Ratio (CRAR)

- CRAR has improved greatly from 8.7% in 1995-96 to 13.6% in 2009-10.
- CRAR declined to 12.7 per cent from 13.0 per cent between March and September 2015,
- Tier-I leverage ratio increased to 6.5 per cent from 6.4 per cent during the same period

Source: Financial Stability Report, December 2015, RBI
Developments in the Banking Sector (7)

Key Policy Developments

• Governance of Public Sector Banks
  ✓ PJ Nayak Report on Public Sector Bank Reform
    ➢ Indradhanush

• Changes in Bank Licensing Policy

• Financial Inclusion

• Strengthening of Credit Culture
  ✓ Bankruptcy Code
  ✓ Strengthening of Asset Reconstruction Companies
• The Government has two options:
  ✓ Privatize these banks
  ✓ Design a radically new governance structure for PSBs.

• Govt to transfer its stake in PSU banks to a holding company (BIC)
  ✓ Appoint professional management for BIC
  ✓ Reduce Govt stake in BIC to under 50 percent
  ✓ Ownership functions to be transferred by BIC to the bank boards.
    Appointments of directors, CEO to be the responsibility of bank boards
  ✓ BIC to be assured of autonomy

➢ Thus distance between government and public sector banks...
Developments in the Banking Sector (9)
Indradhanush Framework for Transforming PSU Banks (1)

• Banks Board Bureau
  ✓ Independent Chairman, 3 Experts, 3 Ex Officio
    ○ Secretary Financial Services, DG RBI, Secretary Dept of Public Enterprises
  ✓ Recommend Selection of Chairmen and Managing Directors of PSU Banks and Financial Institutions
  ✓ Separate posts of Chairman and Managing Director
  ✓ Help Banks in developing strategies and capital raising plans.
Developments in the Banking Sector (10)
Indradhanush Framework for Transforming PSU Banks (2)

• Capitalise Banks
  ✓ Rs 1800 billion 2015-19
  ✓ Rs 700 billion from budget
  ✓ Rs 110 billion from market
  ✓ Capitalisation to be made dependent on performance

• No Interference from Government

• Plan to “DeStress” PSU Banks
  ✓ Facilitate project implementation
  ✓ Active Clearances to infrastructure and large projects
  ✓ Creation of a Central Repository of Information on Large Credits (CRILC) by RBI
  ✓ Strengthen and activate ARCs
  ✓ Set up 6 new debt recovery tribunals
Developments in the Banking Sector (11)

New Bank Licensing Policy

• Licence to two new banks after nearly 10 years
  • IDFC Ltd
  • Bandhan Financial Services

• Differentiated Banks to be permitted
  ✓ Payments banks (11)
  ✓ Small finance banks (10)
  ✓ Niche licenses for banks with more narrowly defined businesses

• Now commercial banking licenses to be on tap
• Payments banks
  ✓ Essentially narrow banks (i.e., without any lending activity)
  ✓ Can raise deposits of up to Rs. 100,000
  ✓ Interest can be paid as in savings bank accounts
  ✓ Expected to utilize newer mobile technology and payment gateways
  ✓ Transfers and remittances to enabled through mobile phones
  ✓ Can issue debit cards and ATM cards

• 11 Payments Banks licenses issued
  ✓ 3 withdrawn
    ✓ 10 microfinance entities and one non-bank financial company
    ✓ Includes some non finance business groups
Developments in the Banking Sector (13)

Small Finance Banks:

• RBI received 72 applications
✓ 11 institutions given in-principle licenses September 2015.
✓ Valid for 18 months to enable the applicants to achieve compliance

• Expected to further financial inclusion primarily through
  ✓ Mobilizing savings
  ✓ Supply of credit to small business units, small and marginal farmers, micro and small industries and other unorganised sector entities
  ✓ Use of high technology-low cost operations.

• Small finance banks similar to regular commercial banks but
  ✓ scale of services to be much smaller
  ✓ 50% of their loans to be of ticket sizes under Rs 2.5 million
Scheme of Presentation

I. Macro Financial Conditions
II. Central Bank Governance and Monetary Policy
III. Developments in the Banking Sector
IV. Formation of NPAs in the Banking Sector
V. Financial Inclusion
VI. Looking Ahead
## Formation of NPAs in the Banking Sector (1)

### Non-Performing Loans (NPL)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross NPA As % of Gross Advances</th>
<th>Net NPA As % of Gross Advances</th>
<th>As % of Net Advances</th>
<th>As % of Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002-03</td>
<td>8.8</td>
<td>4.1</td>
<td>4.0</td>
<td>1.8</td>
</tr>
<tr>
<td>2003-04</td>
<td>7.2</td>
<td>3.3</td>
<td>2.8</td>
<td>1.2</td>
</tr>
<tr>
<td>2004-05</td>
<td>5.2</td>
<td>2.5</td>
<td>2.0</td>
<td>0.9</td>
</tr>
<tr>
<td>2005-06</td>
<td>3.3</td>
<td>1.8</td>
<td>1.2</td>
<td>0.7</td>
</tr>
<tr>
<td>2006-07</td>
<td>2.5</td>
<td>1.5</td>
<td>1.0</td>
<td>0.6</td>
</tr>
<tr>
<td>2007-08</td>
<td>2.3</td>
<td>1.3</td>
<td>1.0</td>
<td>0.6</td>
</tr>
<tr>
<td>2008-09</td>
<td>2.3</td>
<td>1.3</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>2009-10</td>
<td>2.4</td>
<td>1.4</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>2010-11</td>
<td>2.5</td>
<td>1.4</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>2011-12</td>
<td>3.1</td>
<td>1.7</td>
<td>1.3</td>
<td>0.8</td>
</tr>
<tr>
<td>2012-13</td>
<td>3.2</td>
<td>2.0</td>
<td>1.7</td>
<td>1.0</td>
</tr>
<tr>
<td>2013-14</td>
<td>3.8</td>
<td>2.4</td>
<td>2.1</td>
<td>1.3</td>
</tr>
<tr>
<td>2014-15</td>
<td>4.6</td>
<td></td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>Sept 2015</td>
<td>5.1</td>
<td></td>
<td>2.8</td>
<td></td>
</tr>
</tbody>
</table>

### Formation of NPAs in the Banking Sector (2)

#### Cross-Country Comparison of NPA to Total Loans (%)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>3.5</td>
<td>3.5</td>
<td>3.0</td>
<td>3.1</td>
<td>4.2</td>
<td>3.1</td>
<td>3.5</td>
<td>3.4</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>China</td>
<td>8.6</td>
<td>7.1</td>
<td>6.2</td>
<td>2.4</td>
<td>1.6</td>
<td>1.1</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Euroarea</td>
<td>1.8</td>
<td>1.3</td>
<td>1.8</td>
<td>2.8</td>
<td>4.8</td>
<td>5.4</td>
<td>6.0</td>
<td>7.5</td>
<td>7.9</td>
<td>6.8</td>
</tr>
<tr>
<td>Indonesia</td>
<td>7.3</td>
<td>5.9</td>
<td>4.0</td>
<td>3.2</td>
<td>3.3</td>
<td>2.5</td>
<td>2.1</td>
<td>1.8</td>
<td>1.7</td>
<td>2.1</td>
</tr>
<tr>
<td>India</td>
<td>5.2</td>
<td>3.5</td>
<td>2.7</td>
<td>2.4</td>
<td>2.2</td>
<td>2.4</td>
<td>2.7</td>
<td>3.4</td>
<td>4.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Japan</td>
<td>1.8</td>
<td>1.8</td>
<td>1.5</td>
<td>2.4</td>
<td>2.4</td>
<td>2.5</td>
<td>2.4</td>
<td>2.4</td>
<td>2.3</td>
<td>1.9</td>
</tr>
<tr>
<td>Russia</td>
<td>2.6</td>
<td>2.4</td>
<td>2.5</td>
<td>3.8</td>
<td>9.5</td>
<td>8.2</td>
<td>6.6</td>
<td>6.0</td>
<td>6.0</td>
<td>6.7</td>
</tr>
<tr>
<td>United States</td>
<td>0.7</td>
<td>0.8</td>
<td>1.4</td>
<td>3.0</td>
<td>5.0</td>
<td>4.4</td>
<td>3.8</td>
<td>3.3</td>
<td>2.5</td>
<td>1.9</td>
</tr>
<tr>
<td>South Africa</td>
<td>1.8</td>
<td>1.1</td>
<td>1.4</td>
<td>3.9</td>
<td>5.9</td>
<td>5.8</td>
<td>4.7</td>
<td>4.0</td>
<td>3.6</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Formation of NPAs in the Banking Sector (3)
Asset Quality of Commercial Banks

Source: Financial Stability Report, December 2015, RBI
## Sectoral Composition of NPL of Nationalized Banks

<table>
<thead>
<tr>
<th>Year</th>
<th>Priority Sector (% of total)</th>
<th>Non-Priority Sector (% of total)</th>
<th>Public Sector (% of total)</th>
<th>TOTAL (Rs. Billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>34.6</td>
<td>65.3</td>
<td>0.1</td>
<td>2049.59</td>
</tr>
<tr>
<td>2014</td>
<td>36.5</td>
<td>63.5</td>
<td>0.1</td>
<td>1474.48</td>
</tr>
<tr>
<td>2013</td>
<td>40.2</td>
<td>58.9</td>
<td>0.9</td>
<td>1016.83</td>
</tr>
<tr>
<td>2012</td>
<td>47.0</td>
<td>51.5</td>
<td>1.5</td>
<td>690.48</td>
</tr>
<tr>
<td>2011</td>
<td>55.6</td>
<td>43.8</td>
<td>0.5</td>
<td>442.72</td>
</tr>
<tr>
<td>2010</td>
<td>53.8</td>
<td>45.4</td>
<td>0.8</td>
<td>363.95</td>
</tr>
<tr>
<td>2009</td>
<td>59.4</td>
<td>40.2</td>
<td>0.5</td>
<td>265.43</td>
</tr>
<tr>
<td>2008</td>
<td>64.0</td>
<td>34.3</td>
<td>1.8</td>
<td>249.74</td>
</tr>
<tr>
<td>2007</td>
<td>58.6</td>
<td>39.5</td>
<td>1.9</td>
<td>261.72</td>
</tr>
<tr>
<td>2006</td>
<td>51.8</td>
<td>45.9</td>
<td>2.3</td>
<td>288.17</td>
</tr>
<tr>
<td>2005</td>
<td>46.8</td>
<td>52.0</td>
<td>1.2</td>
<td>328.04</td>
</tr>
</tbody>
</table>

Source: Statistical Tables relating to Banks in India, RBI, 2016.
Formation of NPAs in the Banking Sector (5)

Four Key Reasons

1. Regulatory Forbearance in the aftermath of the North Atlantic Financial Crisis
   - We behaved as if we had similar crisis

2. Sharp fall in commodity prices leading to sharp declines in profitability of sectors such as steel

3. Aggressive Government promotion of public-private-partnership (PPP) for infrastructure
   - Enthusiastic Response from private sector
   - Entry of heavily leveraged companies
   - Problems in implementation of projects
   - Economic Slowdown

4. Governance issues with the management of select public sector banks
   - Government behest?
   - Inadequate due diligence
   - Corruption?
• IMF - “India is a pioneer in the use of macro prudential policy and has made continued efforts to strengthen systemic oversight. RBI has long-standing experience in the use of macro prudential instruments to counter credit cycles” – IMF FSAP Update (Jan 2013)

• Macro prudential policies 2005-08
  ✓ Capital risk weights were raised between 2005 and 2008 to counter rapid credit growth in five sectors
    ❖ capital markets,
    ❖ housing,
    ❖ retail,
    ❖ commercial real estate, and
    ❖ non-deposit taking NBFCs
• Macro prudential policies 2008-10

- Some risk weights lowered at onset of financial crisis to mitigate downturn,
- Sectoral provisioning requirements also adjusted during same period in conjunction with changes in capital risk weights,
- A loan to value (LTV) cap introduced in November 2010 to counter growth in housing loans and house price inflation.
• Regulatory Forbearance 2008-10
  ✓ Provisioning requirements for most standard assets reduced to a uniform level of 0.40 per cent;
  ✓ Risk weights on banks’ exposures to certain sectors revised downward
  ✓ One-time measures
    ➢ Prudential regulations for restricted accounts modified as temporary measure for applications received up to March 31, 2009
    ➢ Restructured accounts to be treated as standard assets, if standard before the crisis (September 1, 2008), even if non-performing at the time of restructuring.
• Did we overdo the counter-cyclical policies?
Formation of NPAs in the Banking Sector

Stagnation in Select Industries

- Five sub-sectors viz. mining, iron & steel, textiles, infrastructure and aviation, which together constituted 24.2 per cent of the total advances of SCBs June 2015, contributed to 53 per cent of the total stressed advances.
- Aviation sector stressed advances increased to 61% June 2015; 58.9 per cent in March 2014
- Infrastructure sector stressed advances increased to 24% from 22.9% during the same period

Financial Stability Report, RBI, December 2015
Formation of NPAs in the Banking Sector

Debt Levels of Indian Corporates

Source: Credit Suisse – House of Debt Report, October 2015
Formation of NPAs in the Banking Sector

Increase in Share of Debt for Corporates with an interest coverage ratio (ICR) < 1

- Stress tests of corporate balance sheets confirm that exposure to potential shocks is high. Corporates’ debt repayment capacity, after improving in 2013/14, showed signs of marginal deterioration in 2014/15.
- Corporate debt-at-risk—the share of debt owed by firms with an interest coverage ratio (ICR) below one—edged up to 10.8 percent, following an improvement to 10.2 percent in FY2013/14.
- An upward shift in domestic interest rates continues to be a key risk for Indian corporates, with the share of debt-at-risk estimated to increase to 17 percent in case of a 250 basis point rise in domestic rates.

I. Macro Financial Conditions
II. Central Bank Governance and Monetary Policy
III. Developments in the Banking Sector
IV. Formation of NPAs in the Banking Sector
V. Financial Inclusion
VI. Looking Ahead
Financial Inclusion(1)
Some Key Features

• Multi pronged approach towards financial inclusion via multiple channels
  ✓ postal savings bank 1880s
  ✓ rural and urban co-operative banks 1900s
  ✓ Nationalization of banks 1969/1980
  ✓ regional rural banks (RRBs) 1975
  ✓ MFIs & SHGs 1990s/2000s

• Still (From NSS 2003)
  ✓ 51% of farmer households financially excluded from both formal / informal sources
  ✓ Only 27% of total farmer households have access to formal sources of credit

• There are several diverse dimensions of financial inclusion such as, income, region / province, caste, gender, economic size of the firm / household, and type of economic activity.
Financial Inclusion (2)
Some Key Measures 1990s-2000s

- *Kisan* Credit Card allows farmers to have cash credit facilities without going through time-consuming bank credit screening processes repeatedly, 1998

- No-Frills accounts in commercial banks Introduced in 2005; Now replaced by “Basic Accounts”

- Business Correspondents (BC) introduced in 2006 third-party, non-bank agents to extend their services right to people’s doorsteps.
Financial Inclusion (3)
Recent Activist Stance

• **Pradhan Mantri Jan-Dhan Yojana** (Prime Minister's People Money Scheme) PMJDY August 2014
  
  ✓ This scheme envisages universal access to banking facilities with at least one basic banking account for every household,
  
  ✓ Apart from accessing basic banking services like credit, insurance and pension facility, the beneficiaries get a Debit card having inbuilt accident insurance cover of Rs. 100 thousand.
  
  ✓ By February 2016, over 200 million bank accounts were opened and over Rs 300 billion was deposited under the scheme.

• **Payment Banks and Small Finance Banks** 2015

• **JAM: Jan Dhan/Aadhar/Mobile**
  
  ✓ Connecting bank accounts with mobile phones through Unique Identification
  
  ✓ Enabling Direct Benefit Transfer
# Financial Inclusion (4)

## Outstanding Debt of Rural Household: Institutional versus Non-Institutional Sources

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-institutional</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>92.8</td>
<td>85.2</td>
<td>70.8</td>
<td>38.7</td>
<td>36.0</td>
<td>42.9</td>
<td>40.2</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Landlords</td>
<td>3.5</td>
<td>0.9</td>
<td>8.6</td>
<td>4.0</td>
<td>4.0</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>(ii) Agricultural moneylenders</td>
<td>25.2</td>
<td>45.9</td>
<td>23.1</td>
<td>8.6</td>
<td>7.1</td>
<td>10.0</td>
<td></td>
</tr>
<tr>
<td>(iii) Professional moneylenders</td>
<td>46.4</td>
<td>14.9</td>
<td>13.8</td>
<td>8.3</td>
<td>10.5</td>
<td>19.6</td>
<td></td>
</tr>
<tr>
<td><strong>Institutional</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7.2</td>
<td>14.8</td>
<td>29.2</td>
<td>61.3</td>
<td>64.0</td>
<td>57.1</td>
<td>59.8</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) Government</td>
<td>3.7</td>
<td>5.3</td>
<td>6.7</td>
<td>4.0</td>
<td>6.1</td>
<td>2.3</td>
<td></td>
</tr>
<tr>
<td>(ii) Co-operative societies</td>
<td>3.5</td>
<td>9.1</td>
<td>20.1</td>
<td>28.6</td>
<td>21.6</td>
<td>27.3</td>
<td></td>
</tr>
<tr>
<td>(iii) Commercial banks</td>
<td>0.4</td>
<td>2.2</td>
<td>28.0</td>
<td>33.7</td>
<td>24.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

There are issues relating to comparability of the constituent groups of data collected under 59th round of NSS (for 2002) and 70th round of NSS (2012)
non-institutional sources continued to play a major role in providing credit to the rural households

- About 19% of all rural households have acquired credit from non-institutional sources
- 10% urban households have acquired credit from non-institutional agencies.
- Two ways of interpreting such trends and one is often unable to decide whether the glass is half empty or three quarter full
Financial Inclusion (6)

JAM Trinity—Jan Dhan, Aadhaar, Mobile (1)

Coverage over time

Source: Economic Survey, 2015-16, Government of India
Financial Inclusion (7)

JAM Trinity—Jan Dhan, Aadhaar, Mobile (2)

Aadhaar coverage across states

Basic Saving Account coverage across states

Source: Economic Survey, 2015-16, Government of India
Financial Inclusion

JAM Trinity—Jan Dhan, Aadhaar, Mobile

One of the missing pieces of JAM – a thriving BC industry

Source: Economic Survey, 2015-16, Government of India
Financial Inclusion(9)
Issues with PMJDY
Financial Inclusion(10) 
Issues Arising

• How should financial Inclusion be measured?
  ✔ Access or actual

• How much is real deposit coverage?
  ✔ Bank Accounts
  ✔ Post Office savings accounts
  ✔ Urban and Rural Cooperative Banks
  ✔ Primary Agriculture Cooperative Societies

• How much is credit coverage?

• What is adequate financial inclusion?
  ✔ International comparisons

• How much debt should poor have?

• Financial inclusion as substitute for public services?
Scheme of Presentation

I. Macro Financial Conditions
II. Central Bank Governance and Monetary Policy
III. Developments in the Banking Sector
IV. Formation of NPAs in the Banking Sector
V. Financial Inclusion
VI. Looking Ahead
Looking Ahead(1)
Key Financing Needs

1. Reviving of Overall Credit Growth
2. Infrastructure Financing
   - Sources of Equity Funds
   - Sources of Long Term Debt Funds
3. Privatisation/Divestment Programmes
   - Need for Equity Fund Sources that are not concentrated
   - Need to avoid Russian type result of crony capitalism
4. Bank Ownership Reform
   - Dependent on widely held equity sources to avoid ownership concentration
5. Development of Liquid Debt Market
   - Dependent of presence of institutional investors
Deepening the Indian Financial Sector

- Bank dominated system
  - Will remain so for quite some time
  - Have to ensure equitable access
  - Lot being done: perhaps excessive attention
- Need greater attention to development of institutional investors
- Mutual funds:
  - why are they not growing faster with deeper footprint among retail investors
- Insurance Funds
  - Great need for life, health, property insurance, etc
  - Financial stability for families
- Pension Funds: Great Potential
  - Higher longevity, urbanization, breakdown of joint families
• Current Strategy
  ✓ Greater competition through greater entry
  ✓ Diversification of banking system
  ✓ Better governance of public sector banks

• New banks take a decade to provide real competition to established incumbents
  ✓ Except through use of legacy free new technology
  ✓ Greater innovation and new products

• No privatisation of public sector banks
  ✓ Attempt at better governance through Bank Board Bureau
  ✓ Existing constraints remain
    ➢ CAG, CVC, CBI, CIC, ACC
Time for Bold New Strategy

- Phased programme for active disinvestment towards privatisation
  - 18 public sector banks excluding SBI and subsidiaries
  - All have wide countrywide spread with some regional concentration
  - All have significant proportion of widely held privately owned shares
- Some best existing private banks had government parentage
  - ICICI, Axis Bank, IDFC Bank
  - So newly privatised banks can follow suit: will provide new competition quickly
- Need to deal with unions: opportune time
  - Current age structure is highly skewed to 50 +
  - Existing employees can be grandfathered
- M and As after privatisation will result in organic market based consolidation
- Privatised banks will be widely held
Looking Ahead (5)
Tackling NPAs

• Active Consideration from both MoF and RBI
• Transparent programme for capitalisation: Is it enough?
• Bankruptcy law enacted
  ✓ Need to move fast to implement it
• Need to clean PSB balance sheets
  ✓ Bank managements could be apprehensive re: valuations etc
  ✓ Fear of CAG/CVC/CBI/CIC
  ➢ Establish Bad Bank with public sector ownership
    ✓ Special governance provisions
    ✓ Board populated with citizens above suspicion
      ▪ As in rescue of Satyam
• Activate and strengthen ARCs to take over NPAs in market based mechanism
• Carefully re-examine PPPs: where are they appropriate?
THANK YOU