# The Big Picture

**Topic – Banking Sector Overhaul**

**Date** – 21st Nov 2020

**Topics** covered from the syllabus:

- **GS-3:**
  - Indian Economy and issues relating to planning, mobilization, of resources, growth, development and employment.
  - Government Budgeting
  - Effects of liberalization on the economy, changes in industrial policy and their effects on industrial growth.

**Note**:

- Following is the summary of 'The Big Picture' discussion, which was aired on RSTV.
- Host: Frank Rausan Pereira.
- Panellists: Sidhartha, Times of India; Ajay Shankar, Ministry of Commerce and Industry; P. Pullarao, expert in economics.

**Context**:

- The discussion is based on the report of the **RBI working group to review ownership guidelines and corporate structure of Indian private sector banks**.
- The report has recommended **allowing large corporates and industrial houses to set up banks** and act as their promoters. It is to be noted that RBI has been reluctant to do this till now.
- Another proposal is to **allow the conversion of large Non-Banking Finance Company (NBFCs) into banks.**

**Non-Banking Finance Company**: NBFC is a financial company which is in the **business of providing capital** or lending.

- It differs from the banks in the manner that it is **not allowed to hold demand deposits**. It means it cannot issue cheques to its customers.

**Importance of NBFCs:**

- **Provider of credit for smaller sections**: The sectors which are outside the focus of banking system, access credit from the NBFCs. NBFCs provide **working capital** to the needy cottage and small industry
- NBFCs provide credit to the entities which are **outside the formal financial and credit system** as they largely deal in cash. Banks might find it difficult to lend to such customers due to the **absence of credit history**.

**Payments Bank:** This is a new category of banks created by the RBI.

- Payments banks are different from regular banks as they are **not allowed to extend credit** to their customers. Therefore, they **cannot provide a loan or cannot issue credit cards** to their customers.
- The **maximum deposit** which can be held by the payments bank is Rs. 1 lakh.

**Need for change:**

- **Impact of COVID related restrictions:** There is a need to give relief to the small sectors, which have **shifted to private money lenders** due to COVID-related stress. Accessing credit from private money lenders might push many of them into a **debt trap because of usurious interest rates.**
- **Infrastructure Leasing and Financial Services (IL&FS)** Crisis: (see inset) IL&FS crisis, giving rise to the NBFC crisis, has led to a **rethinking into the role of NBFCs** in the economy. As a result, a growing section of economists have advocated giving a route to the **large NBFCs to convert themselves into banks.**
- **Changing perception about foreign investment**: Before 1991 New Economic Policy, the experience of freedom struggle had led Indian experts to be **biased against foreign investment,** as it was thought to bring with itself an urge for colonisation, to safeguard assets in the colony. However, of late there is a growing comfort with the infusion of foreign capital in the banks, as a **source of much-needed capital**.
- **Enhanced trust on Corporates and industrial houses**: Similar to foreign investment, there is a change in perception about the large corporates and industrial houses, which were **earlier not considered trustworthy to entrust people's deposits.**
- **Lack of capital**: Indian industry has constantly complained about **difficulties in accessing capital** in India, which has been frequently referred to as a factor leading to lower economic growth in the country.
- **Vision of $ 5 trillion economy**: With the announcement of the target of $5 trillion economy, it is important to **try creative approaches** to economic growth. In this series, the creation of private banks, owned by industrial and business houses might be a much-needed boost.
- **Enhance competition**: It is imperative to create and nurture competition so that the existing entities are encouraged to **provide better facilities and more responsive banking** to the customers.

**IL&FS crisis**: Infrastructure Leasing and Financial Services (IL&FS) was a large NBFC, which **defaulted on its debt obligations**. Not only large banks, but even small NBFCs were affected by its default. This led to a spiralling crisis in the NBFC sector, **worsened by the liquidity crunch** due to demosetisation

**Strength of Indian Banking sector**:

- **Strong foundation**: Indian banking sector has developed with an overarching vision of the government in providing best-in-class facilities, even to the remotest corner. This can be attributed to **waves of nationalisation, frequent reforms** and timely steps. Thus, it provides a strong base for economic growth.

- **Trust in RBI**: Past performance of RBI in the matters of regulation, oversight and supervision by over the banking and allied sectors and in managing crises, has enhanced its **credibility as an independent regulator.**
- **Leveraging the savings**: Indians are considered as mighty savers. In fact, till a decade ago, India's **savings rate was more than 30%.** Even though it has declined in recent times, yet it is one of the highest in the world. These savings can be leveraged as a **source of investment** in the country.

**Challenges**:

- **Linkages between banking and non-banking business of the conglomerate**: Decoupling of the industrial house into banking and non-banking sectors will be difficult. Any strong sentiment against the industrial house due to a setback in other business categories might lead to a **decline in trust in its banking entity.** For e.g., if reliance is given a licence to run a banking business, there is a possibility that its overall deposits might decline in case its other business deals go awry.
- **Connected Lending**: There is a possibility that since the management of the bank is under the direct control of business conglomerate, it may be **pressurised in the times of distress** to make lending to the other entities of the same business house.
- **Ensuring the trust in the banking system**: Banking system inherently operates on the basis of trust. It is imperative for the RBI to **safeguard the deposits** of public to continue this trust.
- **Fiscal burden in case the bank fails to safeguard the deposits of people**: Recently, the deposit insurance limit has been increased to Rs. 5 lakh. This is the amount which **Deposit Insurance and Credit Guarantee Corporation (DICGC) (which is a fully owned subsidiary of RBI)** will pay to a customer in case of a bank run. Although a good step, it might create a **fiscal burden** in case of a bank crisis, which is expected to spill over to other banks too due to interconnected nature of banking system.
- **Requirement of regular follow-ups in case of an anomaly**: This can be illustrated with IL&FS crisis, where red flags were already raised about the transactions and delays in interest payments. However, the follow-ups were missing which **ultimately led to snow-balling** of the crisis.
- **NPA crisis**: RBI and the government have taken certain relief measures to deal with the impact of **COVID related lockdown** on the business entities. For e.g. **moratorium on loan repayments, relief in the case of Insolvency and bankruptcy proceedings**. This might create an impact in the long run when the moratoria are left and new NPAs emerge. There is a need to take such future issues into account proactively.
- **Additional costs imposed due to COVID induced lockdown**: As the debt moratoria are lifted, there will be more business entities which will emerge out stressed and might be headed on the **path of becoming Non Performing Assets** (NPA, commonly referred to as bad loan). In such cases, it will be taxpayers' money, which would have to be utilised to tide over the crisis. RBI has already predicted in its **Financial Stability Report** that **NPAs could rise to as high as 12.5% in baseline and to 14.7% in the case of severe stress** scenario by March 2021.

**Recent steps to improve the banking and capital sector**:

- **Creation of new categories**: Recently RBI has allowed creation of certain categories of banks like **Payments banks, Small Finance banks** etc., to cater to a specific function. Similarly, government has created the **MUDRA bank** to refinance loans to small industries.
- **Consolidation of banks**: Recently, many small banks were merged to create **stronger and larger entities and to expand coverage**. For e.g., Oriental Bank of Commerce (OBC) and United Bank of India was merged into Punjab National Bank (PNB), Syndicate Bank was merged into Canara Bank, etc.
- **Steps in the NBFC sector**: RBI has started closer monitoring of NBFCs and asked for more **infusion of required capital** by the promoters, wherever required, to ensure a situation like IL&FS crisis is not repeated.
- **Designation of Domestic-Systemically important banks (D-SIBs**) to some banks like HDFC, SBI and ICICI bank. (see inset)

**Domestic- Systemically important banks** (D-SIB): These are some banks in an economy which are considered as '**Too Big to Fail'.** It means they occupy such a prominent space in the economy, that their **failure might create ripples** which might lead to collapse of the whole banking system.

- The regulator might create **impose additional requirements** on such banks to prevent them from collapsing. For e.g. tighter monetary controls, higher provisioning ratios etc.

**Way Forward:**

- **Stronger Regulation**: Tighter regulation of the banks would be required so that they do not fail. This includes:
  - **Constant monitoring of lending** portfolio of the banks.
  - Frequent **Asset quality Review** and recognition of bad assets.
  - **Higher provisioning for bad loans** and monitoring of **quantitative tools of credit control** by the RBI like SLR, CRR etc.
  - **Inspection of books of banks** to detect any anomalies at the initial stage itself, to avoid a crisis situation from developing.
- **Flexibility to the banks**: While regulation of banks is important, at the same time, banking sector has to be given some leverage, to provide much needed growth in the economy. It will lead to **greater willingness to take risks and confidence to take tougher decisions by the banks** like haircuts and interest waivers.
- **Insurance for protection of bank deposit**: We need to adopt the international practice where larger deposits are safeguarded only on the payment of insurance. This will not only enhance trust in the capital system, but will also be a **progressive step** as it will create additional economic movement, while taxing the super-rich.
- **Restructuring of stressed loans**: Since COVID has impacted many sectors, there would be a greater need to restructure the loans in the form of **interest waivers or increase in the duration of EMIs,** to ensure survival of the industry.

- **Ability to reinvent**: Banks have **lagged behind in the adoption of technology** as is visible from their inability to compete effectively with the **payment wallets** like PayTM, Phonepe or Google pay etc. Therefore, there is a need for quicker adoption of technology and constant innovation to exploit new growth opportunities.