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Indian Banks
Indian Challenges
Indian Solutions

A Report by Centre for Economic & Policy Research

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Abstract

Indian banks continue to face a huge challenge of bad debts, these bad loans becoming non-performing assets. The bad debts of more than Rs.14 lakh crores are eventually squeezing the credit off-take in the economy, especially infrastructure projects, along with Micro, Small & Medium Enterprises, or MSMEs et al, leading to a slower growth. MSME in India gets only six per cent of the bank loans, while the Organisation for Economic Co-operation and Development, or OECD's average is 46 per cent; there is an imminent need to increase this to the global averages. Regulatory changes along with the corrections in the policy framework are required to increase the credit outflow to the MSMEs.

Foreign investors have steadily been increasing their holdings both in private sector banks and in public sector banks. At present, India does not have one hundred per cent government owned banks. Public sector banks, with a mixed ownership (public and private), and large private sector, with sizeable foreign shareholding. This makes the landscape, where the India's banking system is predominantly owned by government, followed by the foreigners and very small portion by Indian entrepreneurs. There is need to create large Indian Banking players for which RBI's Diversified Ownership Norms, or DON need to undergo a change.

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Introduction

India aspires to be $ 10 trillion economy in next decade. The continuous disruptions in the last six years, mostly in the four years of PM Narendra Modi, another thing gets clearer that this will not happen with the continuation of the status quo. & the three pillars of our economy –industry, trade and agriculture—will not only have a larger contribution but will have to be more inclusive. Similarly, the financial markets are required to be more dynamic to these changing requirements.

The piles of non-performing assets, bad debts of more than Rs 14 lakh crore and squeezing credit off-take of MSME. The policy makers and regulators will have to play a proactive role to improve the credit off-take. It is indeed essential to define the role of government & public sector banks on one hand and the need for powerful private sector banks in commercial banking segment.

The role of ownership structure plays to make the banks more meaningful, sustainable and strong. The moot question is, can India create large banks who are equally strong in comparison to their global peers. More importantly, the present ownership & governance are hindrance towards achieving this vision of strong global banks emanating out of India.

Is current corrections pushed by the Reserve Bank of India, or RBI, like implementation of BASEL-III norms, strict prompt corrective measures, the stringent implementation of insolvency and bankruptcy code, or IBC baring the desired fruits? Or do we need course correction?

The paper is aimed at developing the understanding in context of the recent developments keeping in mind the grandeur plans of the present regime to make country a large vibrant economy in next 10 years.

Broad Issues to be Addressed

NPAs and Challenges with BASEL-III

Increased Credit to MSME

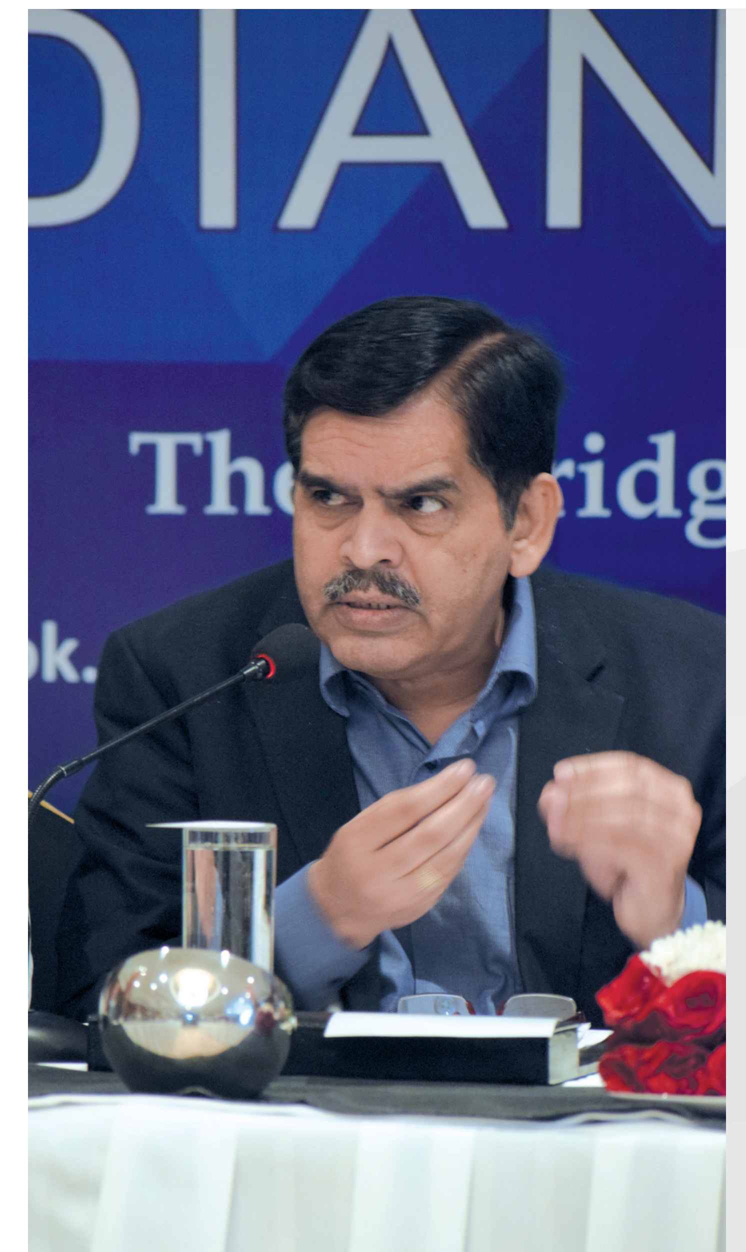
Ownership in Banks

NPAs and Challenges with BASEL-III

Indian banks continue to face a huge challenge of non-performing assets, or NPAs and the bad debts of more than Rs.14 lakh crores.

The RBI agreed in 2010, to introduce this version BASEL norms in India and aims to bring all the commercial banks by March 2019 to BASEL-III. These are the international standards, much stricter on bank capital adequacy, stress testing and market liquidity risk. In short, much more conservative and cautious. This is good enough to see the problems and challenges. Indian banks are not mere commercial banks but have universal consumer base. From debt to construct homes, educating kids, to fund big roads, bridges the entity is the same. The development finance institutions, or DFIs hardly exist. The banks dedicated to the development needs, ICICI Bank, IDBI Bank et al turned themselves into universal banks. There ought to be some discrimination in introducing these international standards. Not a one-size fit all approach.

India needs corrections in the banking system, as well as, require their capital to fuel the growth trajectory. This brings both regulators as well as lawmakers at crossroads.



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The BASEL III norms, require, the Indian banks to raise high quality capital while preserving the core capital and using it more efficiently. This may work well for the large banks but will wipe out the smaller ones. They will find it more difficult for to raise the additional funding and capital. Either they will have to sell their business to their large size peers or closure of operations. India, which is in the mid of a transformation of banking system, with one third of the population just started using banking system and there will be a huge demand for the smaller banks, with local understanding and expertise to customise

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the businesses and products will find it difficult to survive.

BASEL III will make their operations much costlier as well. Banks are required to use the newer and disruptive technologies, like big data and artificial intelligence to improve customer experience as well as make things efficient as well. The banks will have to work with predetermined margins, balancing the expectations of the stakeholders –consumers and investors—but there is common understanding that the big banks will have deeper pockets and size to outplay smaller ones.

It was the 2008, financial crisis in the US, which led to the demand of the up-gradation of the BASEL norms to reduce the risk in the banking system further. But unlike US, in India 70 per cent of the deposits are handled by government, 25 per cent of the money goes into government securities, the currency is not convertible many of these risks are already mitigated. But problem starts when the newer BASEL norms would restrict banks to maintain a certain minimum level of capital and not lend all the money they receive from deposits. On average, India's banks have around 8per cent capital adequacy. This is lower than the capital needs of 10.5 per cent (after considering the additional 2.5 per cent buffer). RBI is asking the banks to maintain capital at levels higher than the Basel-III floor, where as US has set the capital buffer level at 5 per cent and 6 per cent for systemically important entities. RBI has asked banks to keep capital at 9 per cent.

All this will require banks to increase capital, liquidity and reduce leverage. This will affect profit margins for Indian banks. Plus, when banks keep aside more money as capital or liquidity, it reduces their capacity to lend money. Loans are the biggest source of profits from banks. Plus, in India banks have to meet both LCR as well as the RBI's Statutory Liquidity Ratio, or SLR and Cash Reserve Ratio, or CRR norms. This means more money would have to be set aside, further stressing balance sheets.

Foremost, the banks are still battling with the challenges of non-performing assets, bad debts. In order to protect their margins under the new Basel III norms banks need to adopt a granular approach and a dynamic risk mitigation strategy.

The Public Sector Banks, or PSBs in India are falling short of the stipulated capital requirements under the rules of Basel III. Our estimate is that they will require additional Rs 2.6 lakh crore capital by March 2019 to meet the norms. Where will this money come from? This will be a humongous task for the banks, more so because of the large amount of bad loans on their books -- the total bad loans on the 40 listed banks in India amount to Rs 3 lakh crore. The PSBs required to raise tier- I capital of Rs 1,72,000- Rs 2,10,000 crore during FY 2016/17-FY 2018/19 to meet the higher regulatory minimum capital requirements as well as fund growth. In January this year, the government decided to pump in Rs 80,000 Cr, with a promise that these banks will not be left orphan for need of capitalisation. This was part of the Rs 2.11 Lakh Crore recapitalisation plan drawn in October last year. The rest Rs 1.30 lakh crore will be raised via bonds as well as share sales. These exercises have already squeezed the banks appetite to fund debt requirements.

Increased Credit to MSME

In growing economy like ours or even in developed economies, the bulk of the jobs come from micro and small enterprises. To increase credit growth among MSME, a more robust and dynamic structure of Non- Banking Financial Company, or NBFCs is required. To this PM MUDRA yojana requires to deepen along. The credit growth in the Indian Banking System had been happening primarily due to the bank loans which were given to the PPPs infrastructure, which is clearly not a sustainable system. The huge chunk of loans is going to go bad either because they were given for consideration beyond the efficacy of the project. There were over optimism in the system or in some cases some business calculation has gone wrong.

MSMEs can create employment but they depend a lot on credit. So, a framework needs to get developed which should support these small enterprises. Both theory and evidence suggest that banks can be the best place to give credit to the small and medium enterprises because there is asymmetric information, they can track down a project. One leg of liberalization started in 1991 but the complete financial liberalization has yet to happen. This requires more benign RBI policies.

India needs a vibrant bond market as most of the developed countries. It is not that a corporate bond market can exist without a government bond market in it. RBI must rework on depository regulation. Other than Saudi Arabia and China, every other country in the world has it and it makes a perfect sense. The solution lies in developing the bond market that will reduce a large chunk which goes to the big corporates. This requires to be regulated. The regulator at present should form such policy that the credit flows towards the smaller businesses.

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Ownership in Banks

OWNERSHIP STRUCTURE

Most countries with large domestic economy have strong presence of domestically owned and managed banks. Why not India? Indian's profile has the best brains and the best technology for global banks; and it is a concern that the Indians are not been able to own and run banks. In emerging economies, banks are more than mere agent of financial intermediation: they carry the additional responsibility of leading financial sector development and of driving the government's social agenda. It is important for an alignment of a bank with its country's objectives- such alignment starts from a deep-rooted passion for nation building and which has a long -term vision. Such passion and dedication are typical of entrepreneurs who are domestic.

INDIAN BANKING SYSTEM-MAJORITY OWNED BY FOREIGNERS

The more critical aspect of the shareholding dilution is that this share which gets ceded primarily end up with the foreign investors who now are the majority owners of the Indian Private Sector banks. India's 4 of the top 5 banks are majority foreign owned now. The foreign ownership in HDFC Bank-72 per cent, ICICI-60 per cent, Axis-52 per cent, IndusInd-73 per cent and Kotak-47 per cent. Despite the foreign funds, the size of these banks and their balance sheet continues to be smaller. The question which comes to the mind is when most countries with the large domestic economy a strong presence of domestically owned and managed banks have then why India cannot have.

In the current global scenario, it is dangerous to rest the ownership of private sector banks in the hands of foreign entities. India is not living in a complete liberal society; the country needs to take care of thing which is needed for its development. India does not have one hundred per cent government owned banks. Public sector banks, with a mixed ownership (public and private), and large private sector only with foreign shareholding being part of private share-holding. India's banking system is predominantly owned by government, followed by foreigners and least by Indians. Share of public sector banking is and will come down, and under current policy, that space will be occupied irrevocably by foreigners owned banks unless there is a change in policy.

This requires a more benign regulator, that is, RBI. There is a strong need that instead of bringing in multiple regulations, RBI may look at activity -based regulations rather than entity -based framing of rule. RBI must also consider, the health of the economy as well as behaviour of the businesses which require debts. There is no liquidity crunch but dearth of instruments which is creating challenge for MSMEs to access credit.

With the widespread acceptance of proxy advisers by foreign institutional advisers, they operate in tandem creating further challenge. There need to be an anchor, shareholder or promoter to have checks and balances in or-

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der to that they are not getting away with any governance issues. At the same time a bank will go to global scale only when there is a group which is setting the tone for how the bank does now and how it is taking it into global scale in the future. The experience suggests that it can only happen if there is an anchor investor whether it is government or whether it is domestic or private ownership. Someone needs to have significant control which would set the tone for global scale.

The diversified ownership as a buffer is a myth. The fit and proper ownership and not extent of ownership should be the criterion and it is time we have that in banking in India. Banking is too important to allow foreign presence freely and World Trade Organisation, or WTO commitments of all countries are a testimony to this. Most countries with large domestic economy have strong presence of domestically owned and managed banks.

The Anglo-Saxon model did not necessarily lead to better governance in banks. Risk mitigation, an aspect of governance in bank boards, certainly appeared to have collapsed, threatening several well –known banks with bankruptcy. The moot question to ask is whether placing stringent limits on bank ownership in India serves a desirable governance imperative.

It is also to be observed that if the maximum shareholding for promoter and investor is set very low, the alignment of incentives between shareholders and management could weaken banks could be more vulnerable as management could then be primarily concerned with their own interests rather than those of shareholders. The current policy of ownership and governance in banking needs to be reviewed.

In a new world now, foreign investors have strong presence both in private sector banks and in public sector banks. So, for policy makers, the choice is more difficult and processes are more complex than in 1969. There is no bank in India, which is completely owned by government. The foreign funds have made their inroads in the public sector banks as well. The market share of the PSBs is coming down, in the current policy and regulatory space, the share captured by the private players is shifting rapidly towards the foreign funds and players.

Over the years, the foreign funds have taken the route out of the continuous stance of RBI for diversified ownership as a buffer. There is a dearth of indigenous mature funds to keep the bank ownership in India. Along with this, there is widespread acceptance of proxy advisers by foreign institutional advisers, they operate in tandem and create these challenges. Is there a need to rethink the policy and regulatory framework? Can banks be allowed to go in the hands of foreign players, especially when there is hardly any discussion at multilaterals including World Trade Organisation, or WTO? The government is thinking about the M&A option for the PSB banks to be made bigger, along with privatisation.

There is a need to have a competitive banking for which RBI needs to give more licenses. Why it has only given two licences in the last 12 years to Indian private sector banks; why more licences were not given? The debate is what to do with the public sector banks but equally important are the 10 private sector banks who are now majority foreign owned.

India has time and again reiterated its desire to have 2-3 global scale banks from India. In that context, it is important for the regulators and policy makers in India to question the right model of governance, and ownership, that needs to be followed.

SUPPORT INDIAN ENTREPRENEURSHIP

The existing private sector banks, such as ICICI Bank, HDFC Bank, Kotak Mahindra, need to be backed with the regulatory and policy framework interventions to enable them to lead the domestic banking industry to global scale that survives decades – with the likes of JP Morgan, Santander, etc. Entrepreneurship and passion go hand in hand with ownership.

RELOOK THE OWNERSHIP GUIDELINES IN INDIAN PRIVATE SECTOR BANKS

The "On Tap Licensing Guidelines" Issued in August 2016, had for its objectives "such a policy would increase the level of competition and bring new ideas in the system. "However, the said guidelines had elaborated and complex prescriptions on ownership including by way of multi-layering, all to ensure control on "ownership".

Even as governance restrictions and regulations are strictly followed, India must not have mistakenly train its guns on the path to achieve the same – by killing entrepreneurship that is aligned with its domestic and global ambitions. It is pertinent to note, even after 24 months of announcing such on-tap guidelines, not a single institution has come forward to set up a bank – what with such complex structures and disincentives to build a bank.

The bevy of ownership prescriptions, at times contradictory and ambiguous, as well as different yardsticks for banks licensed under different conditions, some of these banks are faced with an insurmountable requirement – of diluting owner stakes by as much as the entire market capitalization of these banks.

Way Forward

NPAS AND CHALLENGES WITH BASEL-III

The capacity within the RBI to explain the real nature of extent of NPA problem is a challenge. There's an enormous divergence between what the auditors of the banks are narrating RBI.

In many banks there is a divergence of those estimates beyond 20 per cent, calling for a lot more scrutiny. There is a need to look at the structure and the over regulation and the double regulation.

Need rethink the concept of a "Bad Bank" wherein all the NPA can be put in that "Bad Bank", thus, look for resolution.

Also, there is a need to take up sector wise professionals, who can put in charge of those industries from the Bank, which have gone bad with chances that they may come out of this.

Need to spend money at one go to do a geo tagging at least for all the irremovable properties given as collateral by the borrowers to get them under central registry which the bank can refer to before giving the loan.

MORE CREDIT FOR MSME

- More credit for MSME and robust NBFC ecosystem should be developed.
- Regulation should be activity based and not entity based.
- Robust bond market is required
- More smaller banks wit access to good quality capital is needed.
- Banks require sectoral experts to understand the business needs and requirements.
- RBI requirements must be aligned to the need of business and must enable credit growth.
- Aggressive revival of Mudra Scheme

OWNERSHIP IN BANKS

RBI Policy should be more robust to enable Indian entrepreneurship. Banks such as HDFC Bank, Kotak Mahindra Bank, need to be enabled to lead the domestic banking industry to global scale that survives decades. The penetration of private sector banks should increase not only in economy but also to encourage these banks to scale up at global level.

RBI and Ministry of Finance must also discourage the migration of home -grown banks into the foreign hands. Ministry of industry and commerce must see that these foreign entities are operating in violation on WTO norms. The discussion had never taken place at multilaterals including WTO. RBI must also review ownership and control policy for banks create an environment which motivates high quality Indian entrepreneurs to come forward and build great banks.

Controlling the economic ownership of an Indian entrepreneur serves the interest of a foreign fund where investors are savers and investors are foreigners and not Indians. Importantly, Securities and Exchange Board of India, or SEBI and Competition Commission of India, or CCI have also increased "control" threshold from 15per cent to 25per cent.

Therefore, in the interest of creating large Indian private banks and in the interest of Indian investors and depositor, it is hereby submitted that the RBI should put its circular on dilution of owner's equity stake in private banks in abeyance and immediately set up a Committee to relook and re-examine the economic ownership issue. RBI should not be aggravating the economic ownership situation further by pushing for significant dilution by Promoters to as low as 15 per cent. A higher limit of 25 per cent in consonance with the voting cap is recommended.

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