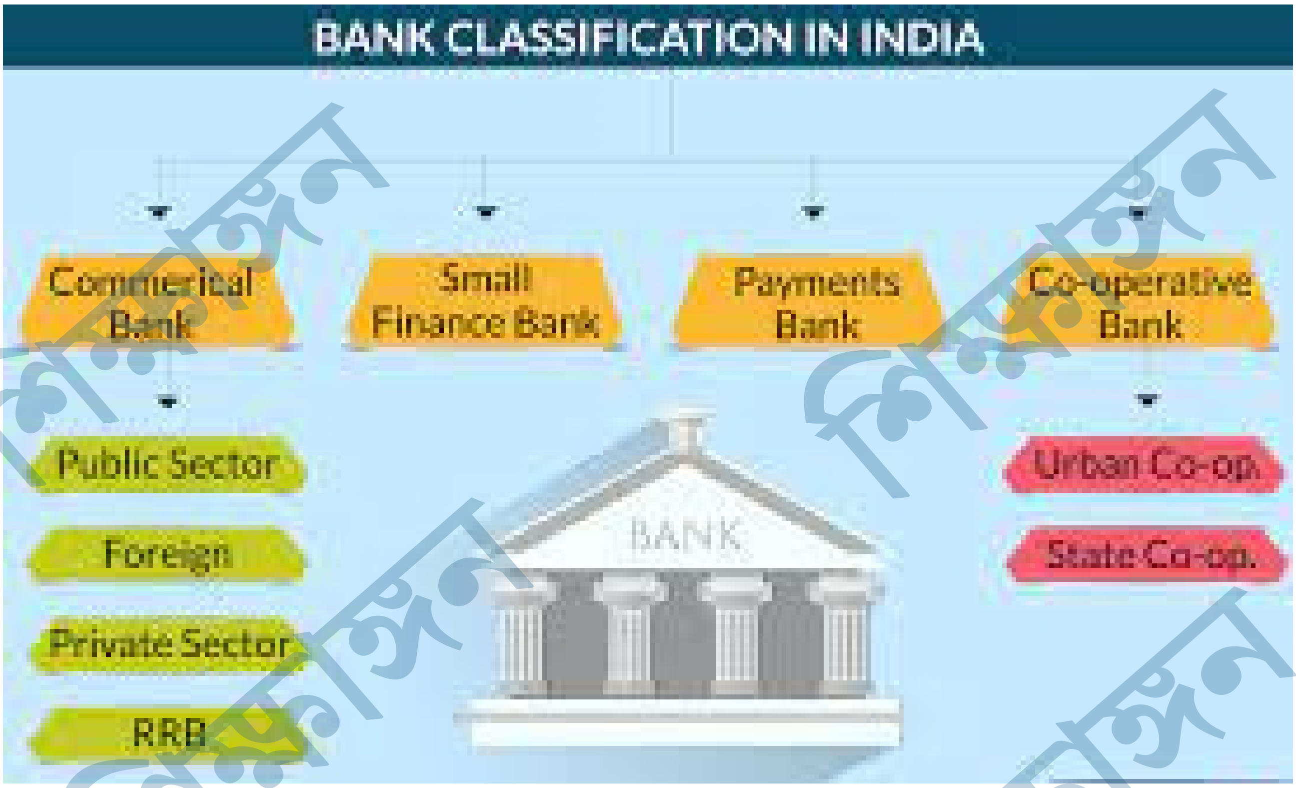
Banking Sector

- In recent times, there has been a noticeable resurgence in India's banking system following almost a decade of grappling with escalating bad loan challenges. Thanks to the concerted efforts of policymakers and the proactive measures taken by banks, the sector is currently on a more secure footing.
- Nevertheless, considering historical patterns, the positive trajectory for Indian banks remains susceptible to the impact of monetary policies and external uncertainties, such as geopolitical risks.
- How have Indian Banks Evolved over the Years?
- **First Generation Banking:**
- In the period before Independence (up to 1947), the **Swadeshi Movement** led to the establishment of numerous small, local banks, most of which faced failure primarily due to internal frauds, interconnected lending, and the amalgamation of trading and banking activities.
- **Second Generation Banking (1947-1967):**
- Indian banks enabled the consolidation of resources, mobilised through retail deposits, towards a limited number of business families or groups, consequently overlooking the flow of credit to the agriculture sector.
- **Third Generation Baking (1967-1991):**
- The government successfully severed the link between industry and banks by **nationalising 20 major private banks in two phases (1969 and 1980)** and introducing **priority sector lending** in 1972.
- These measures led to a **transition from 'class banking' to 'mass banking'** and had a favourable effect on the widespread expansion of branch networks in rural India, substantial mobilisation of public deposits, and increased credit flow to **agriculture and allied sectors.**
- **Fourth Generation Banking (1991-2014):**
- During this period, significant reforms were implemented, including the issuance of new licences to private and foreign banks to introduce competition, improve productivity, and enhance efficiency.
- These changes involved leveraging technology, introducing prudential norms, offering operational flexibility with functional autonomy, prioritising the implementation of best corporate governance practices, and fortifying the capital base in accordance with **Basel norms**.
- m 2014 onward, the banking sector has embraced the **JAM (Jan-Dhan, Aadhaar, and Mobile) trinity**, and granted licences to **Payments Banks** and **Small Finance Banks (SFBs)** to attain last-mile connectivity in the pursuit of financial inclusion.
- What is the Current Status of the Indian Banking Regime?
- **Background:**
- Not too long ago, Indian lenders faced a dire situation with bad loans, leading to a spike in stressed assets. Government-owned banks were particularly affected, with gross **NPAs** reaching 14.6%.
- To counter these challenges, the government and RBI implemented a **4R strategy**—Recognize NPAs transparently, Resolution and recovery, **Recapitalization** of **PSBs**, and **Reforms** in the financial ecosystem.
- After grappling with seething government and bad loan issues for nearly a decade, the Indian banking system has experienced a **remarkable turnaround in 2023.**
- **Profitability and Asset Quality Improvement:**
- In FY23, the gross **NPA** ratio for banks in India plummeted to 4.41%, the lowest since March 2015. Cumulatively, PSBs crossed the Rs 1 lakh crore-mark in profit.

- As per RBI's Financial Stability Report, the capital-to-risk-weighted assets ratio (CRAR) stands at a robust 16.8%, indicating a strong financial position for scheduled commercial banks.
- This underscores the sound financial health of Indian banks, reflecting positively on their ability to absorb potential risks and maintain stability in the financial system.
- Policy Reforms and Financial Discipline:
- Reforms introduced over the past eight years focused on credit discipline, responsible lending, improved governance, and the adoption of technology. Mergers of PSBs were instrumental in reducing NPAs.
- Robust Financial Indicators:
- Banks exhibit strong liquidity levels, measured by funds available for lending. Despite the RBI's recent monetary stance of "withdrawal of accommodation," banks maintain a Liquidity Coverage Ratio at least 20% higher than the minimum requirement.
- Additionally, major banks, including SBI, PNB, and Union Bank, demonstrate a capacity to lend "higher for longer," with Credit-Deposit ratios below 72%.
- What Obstacles Lie Ahead for the Indian Banking Sector?
- Infrastructure and Capital Investments Risk:
- Bank lending for upcoming infrastructure and capital investments, particularly those linked to State government entities, poses a risk of defaults due to stretched State finances.
- Banks are advised to set internal exposure limits based on fiscal/financial assessments of individual States.
- Stock Market and Retail Exposure Risk:
- The seemingly runaway stock market, creating an illusion of wealth, presents a risk to retail exposures. Increased demat accounts and high PE ratios across sectors are indicators of this risk.
- Integrated supervision and rigorous stress tests on retail portfolios are recommended to address this emerging risk.
- Interconnected Lending and Governance Challenges:
- The possibility of default becoming a contagion due to interconnected lending and lax governance norms poses a significant challenge.
- Focused risk monitoring is necessary, emphasising that regulation cannot substitute for good governance.
- SME Challenges in a Re-Globalizing World:
- The re-globalization of the world and geopolitical shifts may challenge Small and medium-sized enterprises(SMEs), especially in the face of Free Trade Agreements (FTAs) and regional ambitions.
- Banks need to carefully assess and prepare for potential risks to SMEs, considering potential disruptions to cash flows.
- Changing Liabilities Landscape:
- The character of liabilities is changing with digitisation and evolving consumption trends, impacting retail deposits. Banks with higher credit-deposit ratios may face challenges in liquidity coverage.
- A structural shift in Indian savings requires caution and prudence from bankers, necessitating a careful watch amidst favourable conditions.
- How Can the Indian Banking Sector be Fortified Moving Ahead?
- Building Big Banks:
- The Narasimham Committee Report (1991) underscored the importance of India having three or four prominent commercial banks with a presence both domestically and internationally, in addition to foreign banks.

- The second tier could include numerous mid-sized banks, including niche institutions, with a widespread presence across the economy.
- Consistent with these suggestions, the government has already consolidated certain PSBs and taken measures to establish entities like a Development Finance Institution (DFI) and a Bad Bank.
- Requirement for Differentiated Banks:
- While the universal banking approach has been commonly favoured, there is a demand for distinct banking entities to address the unique needs of diverse customers and borrowers.
- Essentially, these specialised banks would facilitate financial access in specific areas such as retail, agriculture, and MSMEs.
- Additionally, establishing proposed DFIs or niche banks as specialised entities would provide them with access to low-cost public deposits and enable improved asset-liability management.
- Blockchain Banking:
- Enhanced risk management can be achieved, and neo-banks have the opportunity to harness this technology for advancing digital financial inclusion and supporting the increased growth of an aspiring and emerging India.
- In the realm of Indian banking, the implementation of technologies such as Blockchain holds the potential to facilitate prudential supervision, making oversight and control over banks more streamlined.
- Addressing Moral Hazard:
- Until now, the occurrence of public sector banks failing has been infrequent, primarily due to the concealed sovereign guarantee, instilling greater trust in the public. Nevertheless, the ongoing privatisation of PSBs challenges this assurance.
- Consequently, the upcoming wave of banking reforms should emphasise the necessity for increased individual deposit insurance and efficient orderly resolution mechanisms. This aims to reduce moral hazard and systemic risks, minimising the financial burden on the public treasury.
- ESG Integration:
- It could be beneficial for Distinctive Banks to consider listing on a reputable stock exchange and embracing the ESG (Environmental, Social Responsibility, and Governance) framework. This approach aims to enhance value for stakeholders over the long term.
- Enhancing Banking Institutions:
- To address vulnerabilities, the government should refine regulatory measures, enabling banks to develop diversified loan portfolios, instituting regulators for specific sectors, and granting increased authority to handle deliberate defaults effectively.
- Facilitating Corporate Bond Market Growth:
- In order to establish a responsive banking system in a dynamic real economy, there is a requirement to promote the growth of the corporate bond market, thereby transitioning away from a bank-centric economic model.
- Enhancing Risk Management Models:
- Develop and implement internal risk models tailored to individual States, similar to the Bank Exposure Risk Index, to assess potential risks associated with lending to State government entities and infrastructure projects.
- Addressing Changes in Liabilities:
- Recognize the changing nature of liabilities influenced by digitisation and evolving consumption trends. Develop strategies to adapt to shifts in retail deposits, especially in Tier 1 and 2 centres.


BANK CLASSIFICATION IN INDIA
Commercial Bank
Small Finance Bank
Payments Bank
Co-operative Bank
Public Sector
Foreign
Private Sector
RRB
Urban Co-op.
State Co-op.
BANK