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Can the Financial System Support the Revival of the Indian Economy?

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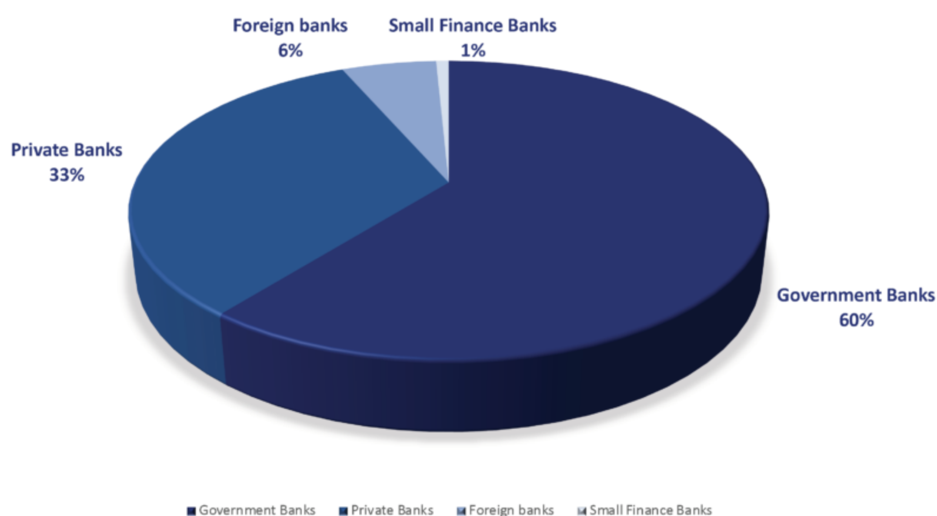
A steep, unprecedented rise in COVID-19 cases is slowing down India's economic recovery. Several businesses, especially retail, have been crippled by local lockdowns, although there have been no breaks in supply chains, and many industries are functioning. Rising unemployment and hard-hit sectors such as tourism and hospitality are pulling down the economy. The financial system, dominated by the banking sector—the backbone of the Indian economy, has not been in a healthy state over the last few years. The widely used intermediation measure, the credit-to-GDP ratio, declined consistently throughout the 2010s; during 2019-20, it further declined to 55 percent, which is low among the emerging markets[1]. The Indian banking system in terms of size (investments and advances at ₹149.91trillion) is 60 percent dominated by government banks (Figure 1), but their performance is not appealing; the net losses of government banks for the year ending March 2020 was ₹250 billion, while private-sector banks posted a profit of ₹191 billion. Bank credit plunged to an all-time low growth of 4.9 percent in the 2020-21 financial year[2], its lowest level since 1971[3]. The COVID impact is clearly visible in the decline of credit deployment, especially in large industries and the service sector. Both lenders and borrowers are risk-averse to further credit.

Figure 1: Investments and Advances of Indian Banks as on March 31, 2020



Source: Report on Trend and Progress of Banking in India, RBI, 2019-20

The gross NPA (nonperforming assets) ratio of the banking system was at 8.2 percent at the end of March 2020, when public-sector banks had 10.30-percent advances as gross NPAs. Recent relief measures to mitigate the risks arising from COVID-19, such as moratoriums on loan repayments and one-time debt-restructuring schemes for stressed borrowers, may shield the banks in reporting lower NPA ratios for the year ending March 2021. As per the RBI (Reserve Bank of India)[4], the gross NPA (GNPA) ratio of all commercial banks may increase to 13.5 percent by September 2021 under the baseline scenario; the ratio may escalate to 14.8 percent under a severe stress scenario. These GNPA projections indicate the possible economic impairment latent in banks' portfolios and their adverse impacts on performance.

In this context, will recent policy reforms and trends provide signs of hope for the Indian financial sector?

In this context, will recent policy reforms and trends provide signs of hope for the Indian financial sector? Will these reforms improve the operational efficiency and profitability of Indian banks, especially those that are government-owned?

Reforms in the Indian financial sector

Consolidation and privatization of government banks: In April 2020, 10 government banks were taken over by the four existing government banks, a mega-consolidation exercise in the Indian banking space. The perceived benefits of consolidation are a large capital base for higher loan growth, improved customer service and operational efficiency. But as stated above, the loan growth was very low. Regarding the customer-service quality of banks, many small customers shifted to other small banks. Even after a year, many bank customers face multiple issues regarding bank accounts, and banks are still facing problems in integrating technology platforms. Human-resources management was a big challenge before the banks consolidated, entangled with strong cultural biases and undue influence of unions. It will be a long road for these banks to recover from these problems.

The second important reform is that the government has expressed its intention to privatise public-sector banks. The exact model is yet to be announced. The government may target four independent banks that are not affected by mergers. All these banks have higher NPAs, huge losses with low capital bases, so the much-needed quick step is to clean off their balance sheets by going with the idea of a "bad bank". A bad bank is an asset reconstruction company (ARC) that takes over the bad loans of commercial banks, manages them and finally recovers the money over a period. Recently, the RBI has constituted a committee to review the structure of ARCs[5], probably based on the committee recommendations that the government may go ahead with the formation of a bad bank. Promoters with private equity and foreign direct investment (FDI) would be ideal candidates, but in the prevailing state of uncertainty, it would remain a challenge for the government to attract the private ownership needed in order to sell the banks.

To improve the governance of both public- and private-sector banks, the RBI has made policy announcements[6] such as restricting the tenure of the chief executive officers of private banks to 15 years, capping the age of non-executive directors to 75 years old, fixing remuneration to directors in addition to implementing sitting fees and changes in the composition of audit and risk-management committees. These reforms are likely to bring

qualitative improvements in the functioning of boards. However, in many public-sector banks, board positions and non-executive chairman positions are often vacant for more than a year, raising doubts about the government's commitment. Private banks may take it more seriously.

Entry for new private banks: The RBI[7] has proposed allowing corporations to own banks; large industrial houses may be allowed to be promoters of banks with necessary statutory amendments. The report also proposed to raise the cap on promoters' stakes in private banks from the current 15 percent to 26 percent in 15 years. This is likely to lead to a significant shift in the ownership structures of private-sector banks by allowing a new class of promoters through raising equity capital on long-term promoter shareholdings. The committee suggested that new licenses should be given to encourage the setting up of universal banks. The tough task here is to prevent connected lending and exposures between banks and other financial and non-financial group entities, as well as strengthening the supervisory mechanism for large conglomerates, including consolidated supervision. Raghuram Rajan, a former RBI governor and a professor at the University of Chicago, said, "It would be a colossal mistake to sell the banks to industrial houses."[8]

An IMF (International Monetary Fund) research paper[9] published recently warned that the rise of corporate power has become a threat to economic recovery. The coronavirus pandemic has impacted the economy with contractions, closures of millions of MSMEs (micro, small and medium-sized enterprises) and massive job losses in almost every sector of the economy. It is, therefore, not an opportune time to privatise Public Sector Undertakings (PSEs) and allow rising corporate powers to take them over, which has already started to threaten the economic recovery.

Insolvency norms: Recently, the government announced an early-stage preventive mechanism, the pre-packaged insolvency and resolution process (PPIRP)[10], to address the financial stress, mostly for MSMEs. The PPIRP framework recognises the importance of value maximisation of assets; it is a form of restructuring that allows creditors and debtors to work on an informal plan and then submit it for approval. The incumbent management typically retains control until the final settlement. This measure should reduce stress and put the firm back on track.

Insurance sector: The government announced the sale of its equity ownership of the Life Insurance Corporation of India (LIC). The LIC is the largest government-controlled insurance company with an asset size of more than ₹31 trillion and the largest institutional investor in the Indian stock market. The government-owned LIC holds a 66-percent market share in the premium underwritten by life insurers[11]. With the sale of the government stake, the LIC will be listed on the stock market, and its board structure will change with the presence of independent directors. Currently, the LIC pays 95 percent of its surplus to policyholders and 5 percent to the government, the owner. This may also undergo a change.

The second most important reform in the insurance sector is the increase of foreign direct investment (FDI) in insurance to 74 percent. In 2000, the FDI permitted in the insurance sector was 26 percent; it took 15 years to rise to 49 percent, but quickly the government increased it to 74 percent. This will help insurance companies to augment their capital funds to meet the solvency norm of a minimum of 150 percent and even move towards listing on

the stock market. This will also help Indian insurance companies collaborate with foreign partners that can bring equity capital with long-term, sustainable interest. Foreign partners could change the board-level dynamics with substantial voting rights. Accompanying the growth of the insurance sector, even India's bond market may grow, with more funds being invested in it.

With a low life-insurance penetration ratio of 2.82 percent at the end of 2019[12], the Indian insurance sector has a lot more potential. New individual policies issued by private life insurers are declining. In this context, these two measures in the insurance sector are expected to make the insurance sector competitive, with a wider product range and effective pricing.

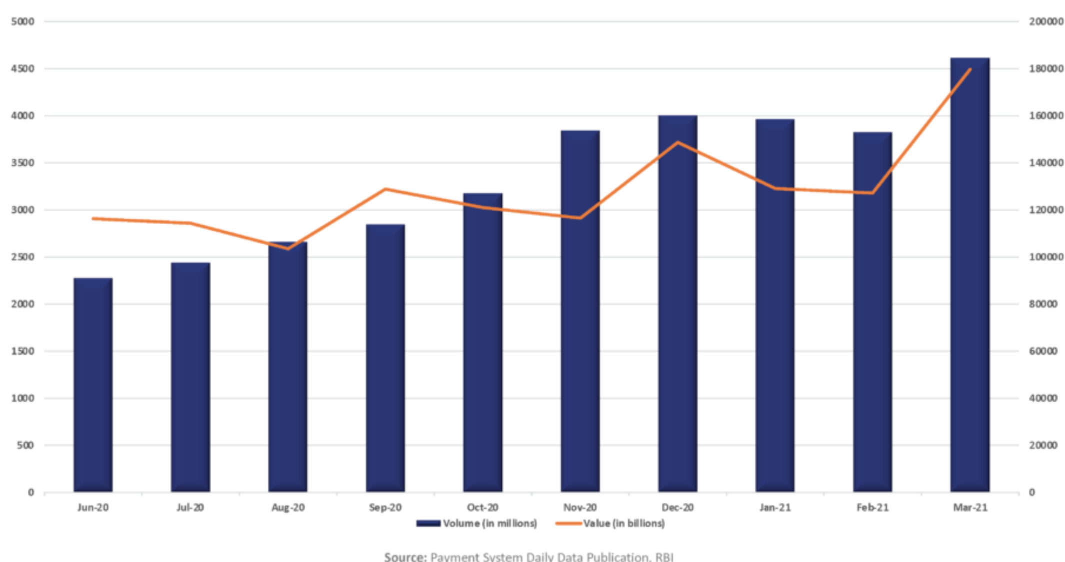
Recent trends

Digital surge: Over the last few years, India has strengthened the digital infrastructure called India Stack. The Stack comprises four layers of infrastructure and standards: (i) digital identity; (ii) an inter-operable payments interface; (iii) digitalization of documentation and verification; and (iv) a consent layer—still under construction—for the management of individual data through regulated intermediaries[13]. This digital surge in payment transactions is reshaping the business of financial services. COVID-19 has further pushed digital transactions; street vendors to medium-scale merchants have been encouraging people to use various digital platforms for meeting even the smallest cash payments (Figure 2).

An IMF working paper states, "The development of the India Stack has implemented open banking principles of competition and contestability through interoperability and data sharing in the financial sector. This architecture has potentially facilitated financial inclusion, as evidenced by the increase in high volume-low value payment transactions. The overall structure of publicly provided digital infrastructures has scope to support the provision of many financial services and to further deepen financial inclusion and development."[14]

The challenge before banks is to increase investments to meet the increased demand in transactions well before the system reaches its saturation level. The three important aspects in capacity building of digital-payment transactions are disaster-recovery (DR) plans to meet any event of outage, internal application programming interfaces (APIs) and strengthened artificial intelligence (AI) applications. Recently, the RBI[15] cautioned banks about security controls to make the sector immune to multiple risks. Banks need to develop more digital products and services to capitalise on digital-banking trends. Digital banking also facilitates the application of analytics to understand customer profiles and behaviours; banks need to leverage on this.

Figure 2: Digital Payments During Pandemic



Fintech revolution: The Indian financial-services sector is catching up with the emergence of fintechs. Thousands of Indian small-business merchants and individuals who did not have access to credit from commercial banks are now receiving credit from these technology-based firms. Fintechs are evaluating the creditworthiness of individuals and small traders by using transaction and tax data. They are providing loans to many individuals who are unable to produce any collateral; thus, these are unsecured loans. The main constraints of these fintechs are capital funds. Some commercial banks are actively stepping into this market by providing equity and required debt funds, enabling the scale of operations of fintechs. Lendingkart, a popular fintech company, has an outstanding loan book of more than Rs 60 billion with a net interest margin of 10 to 12 percent. Fintech companies are also in the business of the delivery and distribution of insurance policies (for example, PolicyBazaar) and payment transactions (BharatPe).

Most fintechs are operating by obtaining an NBFC (nonbank financial company) licence from the RBI; some are operating illegally, with repeated phone calls to customers persuading them to take loans while charging exorbitant interest rates. The pandemic has made many jobless, and with low levels of financial literacy, these individuals are in debt traps, and even suicides are reported.

FinTech Association for Consumer Empowerment (FACE), an industry body, is working with all the key stakeholders of the fintech ecosystem. FACE is evolving as a self-regulatory body, but the RBI has yet to recognise this. FACE proposed a set of best-practice standards, such as placing curbs on harvesting data from borrowers' phones. The new generation of customers are looking for "embedded" finance, integration of payment transactions, insurance, capital-market investment and opportunities to approach their banks for credit. The challenge before fintechs is to offer such integrated services.

Declining trend in corporate credit: As observed by Vivek Kaul[16], commercial banks' credit exposures to the industry are declining. Bank lending to the industry at the end of February

2016 stood at ₹27.45 trillion; after five years, as of February 2021, total bank lending to the industry remained at ₹27.86 trillion. There is hardly any increase in year-on-year growth. Over the last five years, bank lending to the industry has gone up by a minuscule ₹407 billion, an increase of just 1.5 percent—while the fall in interest rates during this period has been 235 basis points. Even with the subsegments, the micro industries, the total lending as of February 2021 stood at ₹3.77 trillion, almost the same as the overall lending of ₹3.76 trillion as of February 2016. For medium-sized industries, overall lending has gone up from ₹1.14 trillion to ₹1.30 trillion over the last five years. Industrial lending, irrespective of size, has not shown much progress, despite falling interest rates. Clearly, over the years, the business model of Indian banks has moved to retail lending, a low-risk business.

To revive the COVID-suffering economy and put it on a growth trajectory, institutional finance is essential; low interest rates and liquidity in the financial system cannot push a credit offtake.
To conclude, to revive the COVID-suffering economy and put it on a growth trajectory, institutional finance is essential; low interest rates and liquidity in the financial system cannot push a credit offtake, especially for corporate business loans. The recent trends are more tilted towards retail lending; corporate firms should initiate large capex (capital expenditure) projects for economic revival and move a step forward as risk-takers.

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