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Indian banking and Financial Sector: New Outlook for A Stronger India

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This paper provides an excellent opportunity to reflect on the ground that has been covered in transforming Indian banking into a vibrant, sound and a well-functioning system, and to chart out a plan for the future. There are several elements that must come together in order to make the Indian banking system stronger, efficient and low cost. These 'fundamentals' include: strengthening of prudential norms and market discipline; adoption of international benchmarks as appropriate to our situation; management of organisational change and consolidation within the financial system; up gradation of the technological infrastructure of the financial system, and human resource development as the catalyst of the transformation. Of course, we have made some progress in each of these areas; yet some concerns persist regarding the pace and quality of our progress. Macroeconomic and financial conditions around us are also changing swiftly, posing new challenges and lending urgency to accelerating our efforts towards our vision.

INDIAN FINANCIAL SECTOR: AN OVERVIEW

The recent macroeconomic and financial developments indicate that the global financial markets have weakened significantly since end-March 2002, reflecting a downward revision in profit forecasts and concerns about the sustainability of the recovery. Corporate sector distress and auditing and accounting irregularities in June and early July 2002 severely undermined investor confidence and deepened the slump in equity markets. Negative sentiment spilled over into the corporate bond market, reflected in a sharp rise in interest rate spreads; and portfolio changes indicate a continuing flight to quality and safety. International banking activity experienced a slowdown, affected by subdued demand for credit and consolidation of off-shore lending. Adjustments are underway between the major currencies, driven by the decline in equity markets and the realignment of the US dollar. Emerging markets have also witnessed turbulence, largely due to country-specific factors, including concerns about debt dynamics and political uncertainties. The current phase of the banking cycle appears to be driven by the downturn in economic activity rather than financial distress. Significantly, the largest financial institutions are among those affected by credit concerns. The slowdown in the demand for financing has been aggravated by deterioration in the quality of portfolios on the assets side and the consequent tightening of lending norms. All this has rendered the short-term outlook uncertain. The silver lining in the otherwise sombre global macroeconomic and financial situation has been Asia.

Emerging Asia has been experiencing a stronger than expected recovery. Although equity markets have exhibited a decline, most countries of the region have retained access to international capital markets and international bank lending. The Indian economy has recently been exhibiting signs of staying ahead of global activity. Some signs of cyclical recovery are currently evident, although border tensions, a relatively weak and uneven monsoon and concerns relating to the fiscal position are downside risks restraining a fuller surge of growth.

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Real GDP in agriculture could decline by about 1.5 per cent for the year as a whole, reflecting mainly the anticipated shortfall in food grains production. Industrial performance in the first half of the year appears to have shrugged off the sluggishness experienced in the preceding year. All constituent sectors of industry have recorded improvement in growth, led by manufacturing. Significantly, the production of the infrastructure industries and capital goods growth has also revived. Export growth has turned out to be robust in the first half of the year.

Non-oil imports have risen over last year's level suggesting that the slackening of domestic demand seems to be flattening out. Given these lead indicators, real GDP growth of 5.0 to 5.5 per cent during 2002-03 appears feasible. Inflation, measured as year-on-year variations in the wholesale price index (WPI), has been hovering around 3.0 per cent in recent weeks. The range of inflation indicators has shifted down to 2.3-3.9 per cent from 3.0-6.3 per cent a year ago.

Nevertheless, the inflation outlook is uncertain with international oil prices volatile with perceptions of war risk, and with domestic oilseeds and edible oil prices rising. For the year as a whole, inflation is expected to remain within 4.0 per cent in the current year. The financial system is also providing clear indications of a pickup in activity. There has been improvement in the growth of non-food bank credit reflecting a better outlook for industrial growth. There has been an increase in the credit disbursed to the housing sector and industries like coal, iron and steel, textiles, fertiliser, drugs and pharmaceuticals, cement, construction, petroleum, computer software, automobiles, gems and jewellery and power. The increase in credit demand is not, however, evenly spread. The investment of scheduled commercial banks in non-SLR instruments has shown a distinct improvement from a comparatively negligible level last year. Money supply (M3) has been tracking real output developments and inflation conditions with a continuing preference for safety reflected in the appetite for bank deposits. Although various segments of the Indian financial markets have remained relatively unaffected by international financial developments, equity markets have moved down along with global equity markets. On the other hand, the strength of capital flows has resulted in a modest appreciation of the exchange rate of the rupee vis-a-vis the US dollar. First quarter balance of payments data indicate that the current account remains in surplus as in the preceding year. The foreign exchange reserves have risen to a level of US $ 67 billion, currently the seventh largest in the world. Under these conditions, the stance of monetary policy, reiterated recently in the Statement on the mid-term review of monetary and credit policy on October 29, 2002, is provision of adequate liquidity to meet credit growth and support investment demand, consistent with price stability; to continue the soft interest rate stance and greater flexibility in the interest rate structure over the medium term. The policy stance was signalled through 25 basis points cuts each in the Bank Rate and the repo rate. Monetary policy also renewed its commitment to monitoring conditions in the foreign exchange market with watchfulness as well as flexibility. Financial intermediation is not just a mirror of the real economy; it is also a derivative. Around us, the prolonged global slowdown is increasingly reflected in heightened risk aversion in international financial markets. Fortunately for us in India, we seem to be breaking out early from the synchronised global downturn. Our banks, financial institutions and financial markets have responded encouragingly to the impulses for growth, reinforcing the virtuous aspects of the movement between real and financial activity. It is vital that we take advantage of this early lead and seize the opportunities for financial intermediation in the recovery phase of the business cycle.

The ongoing pandemic has forced all sub-sectors within the banking and financial services industry to innovate. The true potential kicked off with digital transformation. Today, every Indian owns a smartphone and can digitally apply for a loan, complete e-KYC, open a bank account, order food, groceries and other essentials. The Indian financial sector currently comprises several segments: commercial banks, new-age fintech startups, non-banking financial companies (NBFCs), co-operatives, pension funds, mutual funds, small and medium financial entities and recently established payment banks. These varied financial services provide solutions to a wide range of customers based on their requirements and accessibility. These customers can be individuals, public organizations or private enterprises. Here's an overview of how the Indian financial industry will look like in future

COMMERCIAL BANKS

The lion's share of the Indian financial industry in India belongs to the banking sector with commercial banks accounting for more than 64% of the total assets held by the financial system. The Indian banking system has transformed from a physical to a digital banking model. It has successfully defeated the challenges wired around the diverse Indian population with innovative technology solutions. The banks are making products that go the distance and have reformed themselves from being a conventional money-dealing enterprise. Earlier, under-represented populations living in rural areas were deprived of banking facilities. Today, banks are expanding their coverage towards the rural heartland of the country. Also, the measures taken by the Government of India to help SMEs and MSMEs tackle the pandemic crisis has swayed banks to focus on previously underserved demographics and regions. In response to the pandemic banks are busy re-assessing their operations and strategies so that they can reach out to customers better. These steps are resolving the regional banking barriers between urban and rural areas across the country.

FINTECH STARTUPS

Earlier in 2021, a report highlighted that India's fintech market is the fastest growing in the world. A study conducted by Boston Consulting Group (BCG) in association with the Federation of Indian Chambers of Commerce and Industry (FICCI) stated that India's fintech industry is estimated to reach $150-160 billion by 2025. In fact, 33 fintech investment deals worth $647.5 million were closed in the Indian market in the quarter ending June 2020. The most exciting thing about fintech is that even when every other sector was going through financial bumps, it continued to thrive. This was predominantly due to Covid-led restrictions and government-imposed physical movement barriers.

INSURANCE COMPANIES

A 2020 insurtech report stated that India's global share in the insurance market is roughly 1.7% (expected to reach close to 2.3% by 2030). The onset of the global pandemic disrupted the existing dynamics of the Indian insurance industry. However, the Insurance Regulatory and Development Authority of India (IRDAI) left no stone unturned to make the entire insurance process seamless and convenient to aid customers during these trying times. Needless to say, digitalization played a pivotal role in strengthening the growth of the insurance ecosystem. As the country reported a vast number of deaths every day, there was fear and anxiety among people as they were uncertain if deaths caused by Covid-19 would be covered under their life insurance policy. But, setting a monumental example, the IRDAI clarified that these deaths would be classified under general deaths, given the diagnosis was made after the policy was issued. Furthermore, to ease customer approval, the IRDAI also adopted e-KYC and video-KYC instead of physical documentation.

NON-BANKING FINANCIAL COMPANIES

According to Statista, 9,507 NBFCs were registered with the Reserve Bank of India (RBI) since January 31, 2021. NBFCs are playing an integral role in promoting financial inclusion and their primary objective is to provide financial assistance to one and all. These financial intermediaries have recently grabbed the attention of the Indian population, especially the economically weaker sections that find conventional banking institutions comparatively inaccessible and uneconomical. NBFCs are also proving crucial for small and medium enterprises (SMEs), which are the backbone of the Indian economy. Due to their diverse and broader client base, NBFC credit growth is comparatively more significant than traditional banks and lending institutions. A large chunk of the Indian population finds it difficult to get loan approval from banks due to low credit scores or incomplete documentation. NBFCs have emerged as a quintessential financial solution for more people to have access to financial services. As we move into the next year, NBFCs can continue to become prime loan facilitators apart from traditional lending institutions.

COOPERATIVES

The Indian Cooperative credit system has the most extensive network in the world. Since the first Cooperatives Society Act in 1904, the movement has spread across the country with an estimated 230 million members. Cooperative societies are offering much-needed strategic inputs and value to aid the growth of the agricultural sector. India is an agricultural economy and 72% of the total population who live in rural areas depend on agriculture for their livelihood. Consumer cooperative societies are trying to meet consumption requirements at concessional prices. And finally, marketing societies are aiding farmers to achieve fair rates. In addition, these societies also play a pivotal role in assisting irrigation facilities, fulfilling electricity requirements, and transportation mediums.

PENSION FUNDS

The primary objective of pension funds is to ensure that an individual saves a portion of their income in a systematic manner so that they can have a regular post-retirement income. There are various pension schemes like National Pension Scheme, deferred annuity, immediate annuity, guaranteed period annuity, life annuity, and annuity certain. Pension funds allow users to make long-term savings without going through a tremendous amount of effort. It also enables them to invest in safe government securities or non-government debt and equity investments.

MUTUAL FUNDS AND OTHER SMALLER FINANCIAL ENTITIES

The Securities and Exchange Board of India (SEBI), in a report, stated that the Indian mutual fund industry is emerging as one of the fastest growing and most-competitive segments of the present-day financial sector in India. Over the last few decades, the mutual funds industry has witnessed many developments and transformations. It has allowed users to make seamless investment decisions quickly and easily with technology and platforms provided by many companies.

CONTEMPORARY PAYMENT BANKS

The lack of adequate financial literacy in India gave rise to innovative payment banks. Before initiating and setting payments banks, the RBI went through several policy considerations to promote financial inclusion. The RBI promoted the idea of payment banks by endorsing the cashless digital banking campaign to address the constraints that exclude people from full participation in the financial sector. Despite many advances in banking technology, the rural areas remained unregulated. To undo such exclusion, the RBI introduced payments banks in India to promote financial inclusion and literacy among SMEs and MSMEs, low-income groups, rural areas and migrant workers.

According to a statement by the RBI, the extant 'Guidelines for Licensing of Payments Banks' issued on November 27, 2014 allow payments banks to hold a maximum balance of INR 1 lakh per individual customer. Based on a review of performance of payments banks and with a view to encourage their efforts for financial inclusion and to expand their ability to cater to the needs of their customers, including MSMEs, small traders and merchants, it has been decided to enhance the limit of maximum balance at end of the day from INR 1 lakh to INR 2 lakh per individual customer. The Reserve Bank of India has taken these initiatives for implementation in this regard which are: Pradhan Mantri Jan Dhan Yojna, Cashless payment through mobile applications, Introduction of electronic fund transfer mechanisms like RTGS and NEFT, Digital India campaign and Bottom Line.

According to the India Brand Equity Foundation (IBEF), by 2028, India is expected to be the fourth largest private wealth market globally. Furthermore, the leading financial service institution, the Association of Mutual Funds in India (AMFI), targets three-fold growth in the number of investor accounts, reaching up to 130 million by 2025. To cater to the ever growing demands of the steadily increasing population, the government also took steps and designed strategies to simplify payments, banking, insurance and other financial services. The industry has demonstrated resilience and adaptability and the effects are very positive. The Indian financial industry is expected to evolve rapidly in 2022 helped by the financial innovation has taken centre-stage and opportunities for consumers to invest, save and grow their wealth are set to soar.

STRONG FINANCIAL SECTOR FOR STRONGER INDIA

Strengthening of the financial sector and improving the functioning of financial markets can be described as the core principles of financial sector reforms in India. The central plank is a set of prudential norms that are aimed at imparting strength to banks and financial institutions, and inducing greater accountability and market discipline. These norms include not only capital adequacy, asset classification and provisioning but also accounting standards, exposure and disclosure norms and guidelines for investment, risk management and asset-liability management. Our approach has been to benchmark our norms against international standards.

World Bank Group President David Malpassniti, in his recent visit to India has advocated about a robust financial sector, which is vital to India's economic well-being. He remarked that India has made substantial economic progress over the past few decades. The world has made great strides in reducing extreme poverty, and India played a key role in that progress. India cut extreme poverty in half within a generation and is transforming itself into one of the world's fast-growing economies. That's very encouraging to us at the World Bank Group, because our mission is to encourage broad-based growth, reduce extreme poverty and boost shared prosperity.

In recent years, the Indian government has carried out important market-oriented reforms. We've just released our annual Doing Business report, which measures ease of doing business. For the third year in a row, India is in the top ten in terms of improvements. During that period, it has jumped from 142nd in the Doing Business rankings to 63rd. Per the new report, it's easier than it was a year ago to file for a new business, get a construction permit and trade goods across the border. He said that for reaching the Prime Minister Modi's ambitious goal of turning India into a $5-trillion economy by 2025 would be good for the people of India—and for the world. It will require even more reforms on taxes, trade, infrastructure and government structures. And it will require a strong, stable financial sector and substantial progress on financial reforms.

BOOSTING GROWTH THROUGH FINANCIAL STRENGTH

India's banking system is at a crossroads. We recognize important reforms already. We have protected home buyers by improving the transparency of funds channelled into real estate. By introducing a system of unique identification numbers has made it easier to make government transfers. This has especially benefited the poor. We have created a unified bankruptcy and insolvency code. These are welcome developments. Still, the financial sector faces a number of challenges. While there are signs that commercial banks are making progress in clearing non-performing loans, there's still much work to do.

State-owned banks account for nearly 70 percent of assets in the nation's banking sector. This heavy involvement of the public sector distorts markets, making it difficult for India to address financing gaps in key areas of development such as infrastructure, small and medium-sized businesses and housing. Non-banking financial companies, sometimes called shadow banks, have emerged as an important new source of credit for businesses and consumers. Yet their growth has also created linkages with the traditional banking sector that present new risks.

The financial sector is wrestling with these issues at a challenging moment for the global economy. Global growth is slowing amid sluggish investment and weakening trade. Like many countries, India's economy is facing challenges, with consumption softening and investment slowing. Globally, bond yields have fallen into low or negative territory for several top bond issuers, benefiting an increasingly narrow group but leaving the productive investments needed for broad-based growth under-funded, including in India. This creates a difficult backdrop for reform. At the same time, it underscores the need for decisive action to allow faster growth.

The opportunity is tremendous. If the current challenges are addressed, India has the potential to build one of the world's biggest domestic banking sectors. Faster private-sector credit growth would add directly to GDP, jobs and median income. We need to focus on three areas of financial reform where the World Bank believes India can make meaningful progress — adding private capital in the banking system, deepening capital markets, and effectively regulating non-bank financial institutions as their role in the economy evolves. On the basis of experiences from other countries our financial system will always be uniquely Indian. There's no one-size-fits-all solution, yet some of the global examples may provide useful coordinates as you chart your course. As World Bank Group president, he stressed that strong programs are urgently needed in many countries and should be tailored to the unique circumstances of each country.

INVOLVEMENT OF THE PRIVATE SECTOR

In developing countries, state banks generally comprise the minority rather than the majority of market share: closer to 20 percent versus 70 percent. The financial sector here generates a low level of credit compared with other countries. India's credit-to-GDP level is 51 percent. That compares with 136 percent in Malaysia and 70 percent in Brazil. This trend has taken hold despite the fact that India's gross domestic savings rate, at nearly 30 percent of GDP, is in line with peer countries. The savings are sufficient, but the system doesn't use them effectively. To reach the goal of building a \$5-trillion economy, credit will have to grow at a much brisker pace while maintaining good credit quality and avoiding excessive risk taking. More credit would help meet India's needs in areas such as housing, SMEs and infrastructure. India's annual infrastructure finance gap is expected to average 0.7 percent of GDP through 2035, more than twice the global average of 0.3 percent.

Productive credit growth would benefit the poor. Hundreds of millions of Indian citizens, and millions of businesses and entrepreneurs, operate in the informal economy, with only limited access to financial services. Many of them could use credit effectively to build a business or buy a motorbike to get to work. The experience of other emerging markets and developing countries offers some useful lessons. In the 1980s and 1990s, a wave of developing countries moved to liberalize their financial sectors. Countries in central and Eastern Europe privatized large parts of their financial systems in the early 1990s as they moved to restructure their previously centrally planned economies. In Latin America, countries including Mexico liberalized their banking sectors following the debt crisis of the 1980s. Most, but not all, financial liberalizations was a success. One lesson we can draw: it's important to have strong, independent regulatory authorities to oversee the transition. The global experience also suggests it's important to carry out transitions during moments of strength, when macroeconomic conditions are balanced and the nation is on a strong economic and fiscal footing.

Within this context, we recognize India's recent efforts to shore up the financial system. The

Reserve Bank of India has worked hard to monitor asset quality. The government's plan to consolidate public-sector banks is an opportunity to strengthen governance, supervision, efficiency and risk management. We hope these steps will form the basis of a broader strategy to reduce the role of the public sector in the financial system. A mix of private-capital injections into state banks and full privatizations would boost the sector's ability to support credit, would facilitate effective financial intermediation, and would reduce moral hazard and fiscal exposures.

Gradually scaling back the statutory requirement of state banks to provide liquidity, as well as the priority-sector lending policy, would also be helpful. These policies end up doing more to distort markets than to expand them. India is well positioned to take advantage of recent advances in financial technology. India has already established a good foundation for fostering Fintech, including the "regulatory sandbox" set up by the RBI, with help from the World Bank.

Group. Three of the top Fintech deals in Asia last year were based in India, and 80 percent of India's people have bank accounts. India is well-positioned to share lessons learned with other countries. India can also continue to tap into its entrepreneurial spirit and allow the private sector to continue to innovate in this area, for example in the mortgage market.

ROLE OF CAPITAL MARKETS

India's capital markets can play a pivotal role in helping the nation attain its economic ambitions. Equity market capitalization is over $2.2 trillion, up over six percent in 2018-9. However, the debt market remains at a nascent stage of development. The debt market remains highly skewed toward government securities, while the corporate bond market is dominated by top-rated financial and public-sector issuers. Corporate-bond issuance amounts to roughly 3.96 percent of GDP, much less than in other emerging markets. Funds raised through corporate bonds increased from about $52 billion in fiscal 2012-3 to $100 billion in fiscal 2016-7. Since then, corporate-bond issuance has remained roughly flat.

Deepening India's capital markets would complement bank financing in fostering growth, helping to create new market outlets and attract interest from domestic and foreign institutional investors. Deeper capital markets can be an important way to increase the flow of long-term finance, especially given the asset-liability mismatches in the banking sector. Around the world, long-term financing is increasingly a major focus of institutional investors such as pension funds, insurance companies, mutual funds and sovereign wealth funds. India should take steps to revise its guidelines for domestic institutional investors, so more resources can flow to long-term finance. Another useful measure would be to adapt the funding models of your development-finance institutions so they can expand in market-based funding. As capital markets deepen, new infrastructure-finance instruments could attract more institutional investors. Globally, pension funds and other institutional investors hold about $136 trillion in assets. Many of these funds would be able to invest more in India if it had deeper capital markets and the right mix of market instruments.

STRENGTHENING NON-BANK FINANCIAL COMPANIES

The growth of non-bank financial companies (NBFCs) has played an important role in channeling credit to under-served markets through new products. IFC, the World Bank Group's private-sector arm, has been a supporter of the NBFC sector and has helped channel credit to underserved markets. NBFCs have been a useful complement to commercial banks, helping to meet the nation's financing needs in infrastructure, and among entrepreneurs and consumers. The sector has recently experienced a downturn, leading to liquidity issues among some NBFCs. Many of these non-bank banks face asset-liability mismatches, borrowing short term and lending long term. They largely depend on commercial banks and market funds for financing. Thus, some banks have exposure to weakness among NBFCs. Resolving this "twin balance sheet" issue of weakness in NBFCs and related banks will be an important step in strengthening India's financial system and reinvigorating economic growth.

The recent softness in the NBFC sector is an opportunity for the government and regulators to reconsider the role of these institutions within India's financial system. We would welcome efforts by the RBI to strengthen its regulatory and oversight framework to capture all licensed financial institutions, including all systemically important NBFCs. Properly regulated, NBFCs will play an important role in fostering innovations in Fintech. This is why it's even more important that policymakers ensure NBFCs are properly regulated and adequately capitalized as their role in the financial system continues to evolve. The RBI has done a commendable job overseeing the growth of NBFCs. Going forward, we would recommend that the authorities view the sector constructively as broad, eclectic coalition of various types of institutions with different business models and risk profiles. India should consider applying the same risk-based approach to supervising NBFCs as we apply to banks, applying more stringent regulations and greater scrutiny to institutions, depending on the risks they present to the financial system.

TOWARD A STRONGER INDIA

We must reiterate the importance of a strong financial system to realizing India's goal of becoming a $5 trillion economy. Allowing more private sector participation in the financial system, making it easier for funds to flow into capital markets, and properly regulating systemically important NBFCs are all ways for the financial sector to evolve in a direction that can position India for fast, broad-based growth. A modernized financial system is essential to delivering it. In recent decades, India has made impressive progress in building a financial sector that fits its unique development needs. Yet in a world where payments can be sent with a click of a button from the most basic cell phone, it's crucial that countries have financial sectors that ensure stability while offering deep, well-regulated markets and being agile enough to respond to rapid innovation in the industry.

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