DVARA RESEARCH

Improving the Competitiveness of the Indian Banking System

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Abstract

This note assesses the state of the Indian banking system including its small overall size and high concentration risk, poor indicators of financial inclusion and depth, opaque balance sheets, weak profitability, and highly covariant strategies followed by government-owned banks.

It further highlights "mega-trends" that are shaping the future of banking in India such as globally heightened systemic risk concerns, the emergence of electronic money, specialised payment networks, and branch networks, the emergence of regulated non-bank intermediaries for credit delivery to the last mile, the emergence of risk transmission markets and products like securitisation and credit default swaps, and the deepening of the domestic bond and commercial paper markets.

Finally, it recommends a number of strategies for change such as identifying and designing a supervision regime for systemically important financial institutions (SIFI), separating public policy motives from prudential regulation to clearly reveal the true picture of the balance sheet, ensuring ubiquity of electronic payments in the next three years by combining bank and non-bank elements, making priority sector policy more outcome-focussed and proactively allowing for bank and non-bank partnerships, facilitating risk transmission for banks through bond markets, securitisation, and credit derivatives, and building supportive real sector and financial sector infrastructure.

Notes on the Indian Financial System
Note 3, September 2013

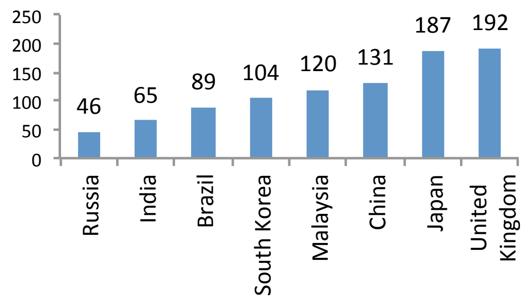
1. Introduction

Although there have been some important developments in the Indian financial markets over the last decade, India's financial sector policy has been distinctly bank-centric. Banks are also the cornerstone of the strategy for the achievement of development objectives, including via the priority sector lending policies that have been in force for the last 37 years[2]. A robust banking sector is seen as vital to (a) meet the growth aspirations of the economy through adequate and affordable credit delivery to the industrial, services and agricultural sectors, (b) channel the savings of households into the financial system (c) develop an integrated and real-time payments system for all participants in the economy, individuals and firms.

Unfortunately, despite all the policy attempts, the banking sector in India has not performed upto expectations on several dimensions:

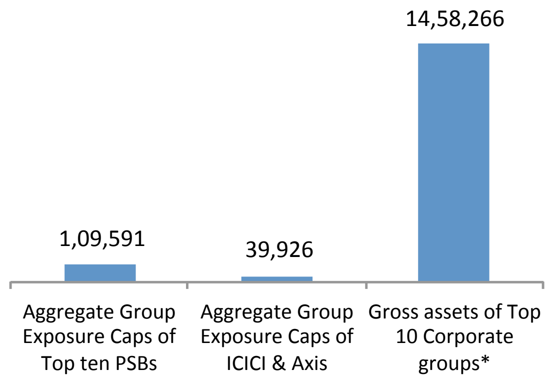
1.1 Size & Concentration: The Indian banking sector has lagged behind its counterparts in terms of share of banking sector assets to GDP as well as in the size of individual banks.

Fig 1 - Bank Assets to GDP (%)



Source: Global Financial Development Database April 2013, IMF. Data is for the year 2011

Fig 2 - Comparison to Corporate size (in Rs crore)



Source: Company data. Top 10 groups excludes banks and financial institutions

Given the large and growing requirements of the real sector (large and small companies, infrastructure and households), the size of the banking system is a significant barrier to growth of Indian GDP. A related consequence of the misalignment between the size of the financial sector and the real sector is a significantly concentrated banking system. According to a recent estimate, aggregate debt of ten corporate groups has increased by five times in the past five years and now equates to 13% of bank loans and 98% of the banking system's net worth making Indian banks rank higher than most of their Asian and BRIC counterparts in terms of concentration[3].

1.2 Financial Depth & regional disparities therein: India also has low levels of financial depth in the country as evidenced by the data on bank assets to GDP (65%), private credit to GDP (52%), or the more conventional, credit to deposit ratio (75%). The all-India figures conceal sharp regional differences. For example, the credit to gross state domestic product for the Eastern Area of India (comprising 12 states) is barely 30%;

and while the bank credit to GDP ratio is a respectable 116% in Maharashtra, in an equally large state such as Bihar, it is merely 16%. There are important inter-connections between financial depth, and economic growth and poverty reduction[4]. While recent initiatives in financial inclusion by the RBI have emphasised breadth indicators such as number of bank accounts opened and number of bank branches in unbanked locations, evidence shows that financial depth is perhaps the equally, if not the more, relevant dimension[5]. Notwithstanding the relative importance of financial depth, despite a focus on improving the levels of financial inclusion, official estimates are that close to 90%[6] of small businesses have no links with formal financial institutions and 60%[7] of the rural and urban population do not even have a functional bank account.

1.3 Balance Sheet Opacity: There continues to be significant opacity on the quality of assets in bank balance sheets as well as the nature of market risks and asset-liability management risks faced by them. The vast majority of assets are illiquid loans that are not marked to market and performance is therefore difficult to evaluate. The reporting requirements are only at highly aggregated levels and it is difficult, from publicly available sources of information, to accurately ascertain why a particular bank is performing better or worse than its peers. Within India, regulation and practice, in a variety of direct and indirect ways, has propelled banks towards building large illiquid loan books and tiny bond books. The most important being the regulations that ensure that loans can be carried on the books of banks perpetually at acquisition costs with impairment being recognised only on a realised loss basis and that too with a considerable lag. Within priority sector assets in particular, there is considerable opacity. For instance, the outstanding amount under Kisan Credit Cards (KCC) is estimated at Rs. 3 trillion, about 4% of banking sector assets. The extant provisioning norms do not apply to KCC[8] and the "true" asset quality is largely unknown. The actual picture of asset quality could therefore, be much worse if this is taken into consideration. While the RBI conducts stress tests for the banking sector as a whole, whose results are published in the bi-annual Financial Stability Report (FSR), individual banks do not have to report stress tests on an ongoing basis.

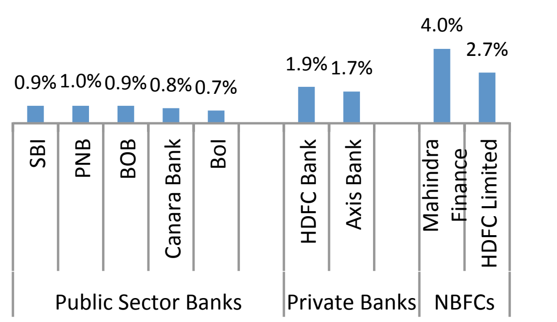
1.4 Profitability: Financial performance of the banking sector as a whole has been weak. The sector achieved NIM of 3% and ROA of 1% in FY 2013 despite an implicit subsidy of 3-5% on savings accounts, which appears to indicate a significant mispricing of risk[9] and/or high operating costs.

Fig 3 - Profitability of SCBs

	ROA	ROE	PAT Growth	NII Growth	NIM*
FY09	1.1	14.5	23.3	24.4	2.7
FY10	1.0	12.9	4.3	14.8	2.7
FY11	1.1	13.6	23.6	34.6	3.1
FY12	1.1	13.4	14.6	15.8	3.1
FY13	1.0	12.8	12.8	11.0	3.0

Source: Financial Stability Report, 2013

Fig 4 - Return on Assets

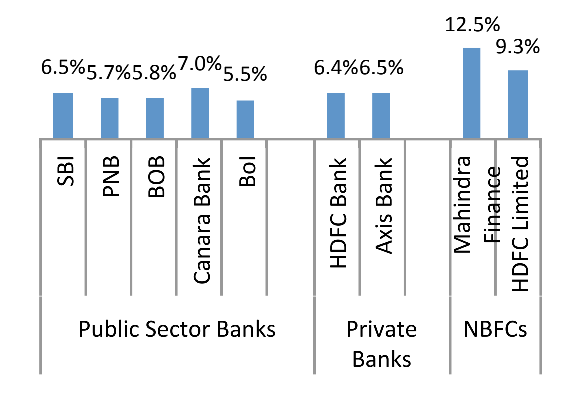


Source: Company data for FY 2013

* Net Interest Margin(NIM)[10]

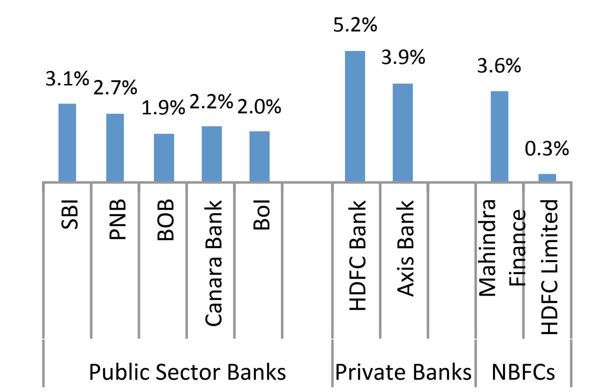
Within the banking sector, the performance of the Public Sector Banks (PSBs) is a particular area of concern. The top five PSBs reported Return on Assets (ROA) of 0.7-0.9% in FY 2013, compared to ROA of 1.7-1.9% for their private sector counterparts, and well over 2% for leading NBFCs / HFCs. This is despite the fact that the banking sector enjoys a far lower cost of funds, on account of lower returns paid on current accounts and savings accounts (CASA). Further, operating cost ratios for banks have generally been lower than NBFCs, except for specialised "monoline" HFCs that enjoy far lower operating costs. Operating cost ratios for PSBs have been lower for a few reasons: a) much larger scale of wholesale banking and treasury operations and b) lower salary structures for senior management in PSBs.

Fig 5 - Cost of funds



Source: Company data for FY13

Fig 6 - Operating Cost ratios



Source: Company data for FY13

Clearly, despite the benefit of low cost CASA (Current Account and Savings Account) balances as well as lower operating costs, public sector banks have been unable to make sufficient returns when compared to their equally large private sector counterparts. This could potentially be on account of two reasons:

1.4.1 Requirement to maintain CRR and SLR - Banks are required to maintain a large share of assets in cash and government securities. The top five public sector banks held between 17-21% of their assets in government securities.

Fig 7 - Movement in 10 year GSec yields

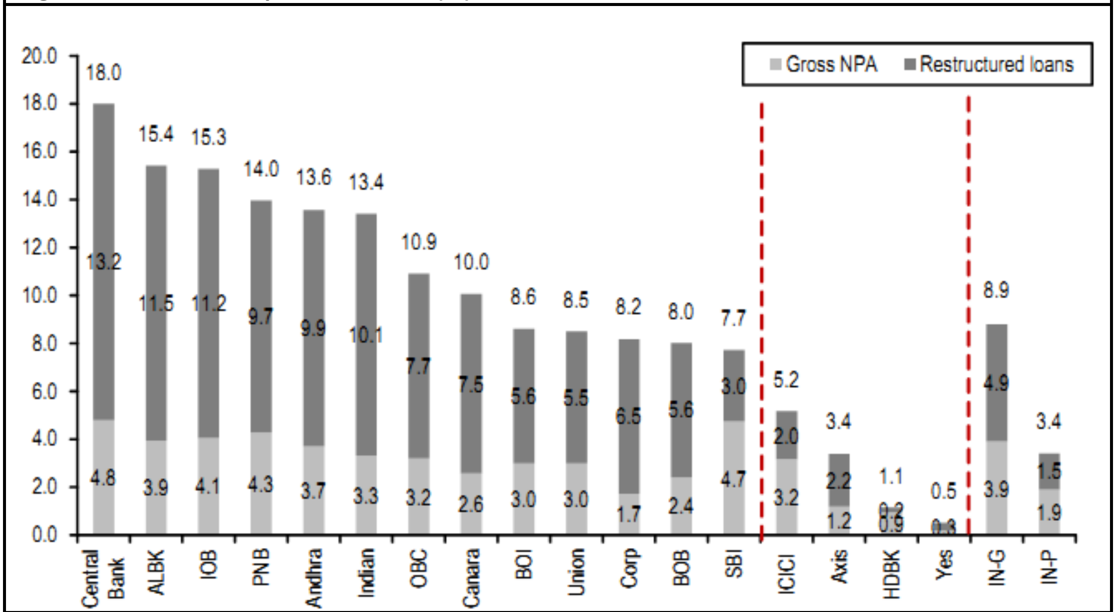
Source: Bloomberg

However, this does not appear to be the reason for underperformance. The 10-year government security yield has ranged between 7.2-8.4%, well above the cost of funds for most public sector banks. One could argue that banks could attain a 'risk-free' ROA of 1-2% by only investing in government securities.

1.4.2 Significant mispricing of risk and costs - Banks are required to maintain 40% of their assets in priority sector. This "target" is to be attained at the end of the financial year, hence there is a pattern seen every March towards purchase of qualifying priority sector assets[11]. Further, while banks need to maintain rate of advances above base rate, the rate for KCC / other agricultural advances / purchasing priority sector assets via securitisation etc. may be well below base rates. It is possible that there is similar mispricing on the wholesale / corporate banking side of the business, particularly in the case of high rated companies. Further, banks have targets on rural branch expansion and credit deployment to priority sectors, particularly agriculture. Research indicates that the total channel cost (including interest cost, cost of capital and loan losses) of delivering credit via bank branches ranges from 32.1% to 41.5%[12]. This is certain to be acting as a drag on overall bank returns without necessarily delivering a commensurate level of benefits to these sectors.

1.5 Covariant strategies of Public Sector Banks: There is considerable homogeneity in the management and governance strategies among public sector banks. They hire almost entirely from internal sources or from each other. It is an established practice for General Managers and Executive Directors to be promoted and transferred from one PSB to another. Hiring norms are standardised and common to all PSBs. Recruitment for the PSBs has been centralised as well. Further, there is a tendency within the government and the RBI to treat all state owned banks as 'one' - by forcing these banks to pursue common strategies for their businesses. Formal participation of RBI officials in the internal management of PSBs, even to the extent of credit decisions through the Board, is an example of this phenomenon. All of these actions produce a set of banks that have covariant business strategies which in turn has significant implications for systemic risk. It is pertinent to note here that the NPA behaviour of PSBs as a group is similar and quite distinct from that of private sector banks.

Fig 8 - Indian banks – problem loans (%)



Source: Credit Suisse (2013), Asia-Pacific Financials Strategy

2. A few mega-trends that impact the role of banks in the financial system

Given this background and as we contemplate the role of banks in the financial system, it is worthwhile to also take note of some mega-trends that could potentially have a bearing on the same. A few are discussed here:

2.1 Systemic risk concerns: Following the 2008 crisis, there has been a heightened concern regarding the systemic risks posed by banks, particularly the ones that are seen to be "too-big-to-fail" and those owned by the government.

2.2 Emergence of electronic money and specialised payment networks and branch alternatives: Traditionally, a central and unique role of banks has been payment clearing. Banks have had a near-monopoly on issuance of payment instruments. With the emergence of electronic money and the growth of specialised payment networks such as ATMs, POS machines, Micro-ATMs, and the growth of pre-paid instruments, the role of the Bank in this respect is evolving. For about five years now, RBI has permitted banks to appoint Business Correspondents (BCs) to transact on their behalf, as a substitute for brick-and-mortar branches. These combined with Aadhaar-enabled biometric authentication provide a powerful alternative to branches and ATMs, as far as cash-in, cash-out (CICO) transactions are concerned.

2.3 Emergence of regulated non-bank intermediaries for credit delivery to the last mile: In areas such as microfinance, small business lending, affordable housing finance, commercial vehicle finance, and equipment finance, India has seen the emergence of several strong NBFCs. This, combined with the growth of securitisation markets, enables the bank to purchase assets from other specialised originators. This provides an important alternative to banks originating directly through expensive branch infrastructure. The operating cost differences between a bank branch and the branch of an NBFC-MFI alone add 10-20 percentage points of cost on a stylised Rs. 10,000 loan[13].

2.4 Emergence of risk transmission markets: This refers to the introduction of products like securitisation and credit default swaps, as well as the deepening of the domestic bond and commercial paper markets. Development of new investor categories such as alternative investment funds and higher asset allocations by pension funds and insurance firms towards debt assets are increasing the investor base significantly. This is changing the paradigm that banks have to originate and hold all risks to maturity. There is an opportunity to tailor debt securities towards fundamental risk-return-maturity preferences.

3. Re-thinking the role of Banks

In light of the above analysis, we recommend the following:

3.1 Identify the banks that are systemically important financial institutions (SIFI) and design a supervision regime for them that reflects this character.

As per the BIS/IMF definition, "Systemic risk is a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy." While India does not have a formal methodology to identify Systemically Important Financial Institutions (SIFI), to our mind, this category would at the minimum include all PSB and some of the larger Private Sector Banks that have an implicit guarantee associated with them. It is worthwhile noting here that the SBI group enjoys a leverage ratio of over 17x (new private sector banks are much lower at 9.7x), on account of implicit government support, despite a much higher NPA ratio than the private sector banks. The current regime places too much high-risk origination onus on these institutions.

Given the implicit guarantee, it would appear that these banks need to be low-risk institutions akin to utilities so that the likelihood of a bail-out is minimised. The supervision regime must ensure a high degree of transparency with respect to the financial health of these institutions. Some measures that could create heightened transparency around these institutions could be:

a. Requirements for fair valuation of balance sheets at periodic intervals.
b. Requirements for standalone ratings (independent of government support) of SIFI-Banks to be maintained at or above a certain threshold, say AA.
c. Requirements for periodic stress testing and public disclosure of the results on a quarterly basis.
d. Careful examination of origination strategies with a view to avoiding origination of opaque assets.
e. Clearly specified concentration norms and measures of risk correlation at the portfolio level.
f. Enable portfolio rebalancing as a way to manage build-up of concentration risks.
g. Minimising covariance across SIFI-Banks by encouraging diverse strategies and independent management pools to emerge.
h. Risk-based pricing for deposit insurance.

Fundamentally, SIFI-Banks need to be much safer institutions.

3.2 Separate public policy motives from prudential regulation

Motivated by the intent of increasing financial depth and priority sector lending or the desire to "protect" banks, there are often confusing regulatory signals vis-à-vis prudential aspects of a bank. For example, provisioning norms for priority sector loans are different than those for other loans (especially KCC). Also, there tends to be further relaxation of provisioning norms on a case-to-case basis, as witnessed in various CDR cases, including the treatment of bad bank loans to MFIs in the state of Andhra Pradesh. Risk weights for low ticket housing loans have been reduced to 50%, thus potentially permitting a HFC to leverage 15 times over networth. Banks are permitted to restructure assets and reduce provisioning requirements - presently the quantum of restructured assets in the banking sector far exceeds the quantum of non-performing assets implying that this may be an easy way out for banks to maintain capital ratios. Such differential treatment creates risk of inappropriate capital allocation and sustains an opaque cross-subsidisation regime for banks. Income recognition, NPA and capital adequacy norms must not discriminate whether the underlying asset is priority sector or not and must be based on the underlying asset-type. There must be minimal room for discretionary action on these fronts.

3.2.1 Ensure ubiquity of electronic payments in the next three years by combining bank and non-bank elements

A number of measures have been taken in recent years by RBI including the creation of payment infrastructure such as NECS, NEFT, RTGS, and IMPS, permission for non-banks to operate White Label ATMs (WLAs), and guidelines for Pre-paid Instruments and Mobile Banking[14]. In addition, the roll-out of the Aadhaar number as the unique identifier and the authentication infrastructure put in place by the Unique ID Authority are an effective solution to the Know Your Customer (KYC) challenge. The vision of ubiquity necessitates 10 million effective payment points, roughly one point for every 1200 individuals. In order to create this network of payment points, the following needs to be urgently done:

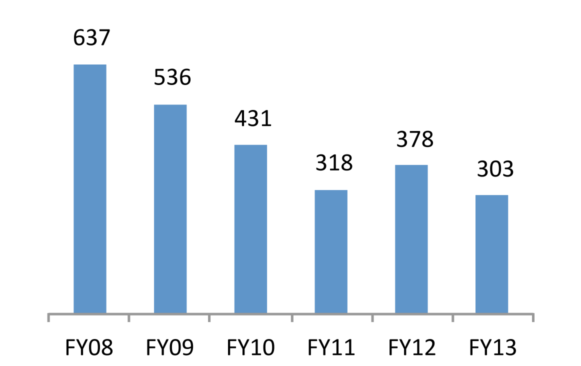
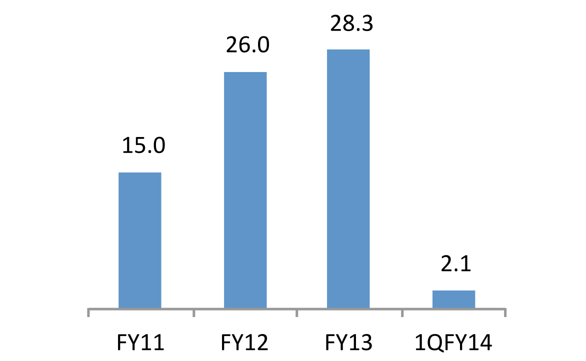
a. All bank accounts must have electronic clearing capability so that they can smoothly interface with other accounts for payments, to ensure that the one-time investment in opening bank accounts for the population can be leveraged to activate all payments functions on the account going forward.
b. Inter-operability between Business Correspondents (BC): This will remove the discrepancy between payment systems in urban and rural areas. The RBI has already issued the necessary guidelines[15] for this and the implementation by banks needs to be monitored and accelerated.
c. Current guidelines have distance restrictions for BCs while there is no such restriction for ATMs[16] or POS terminals. Interested banks may be able to move faster to create a BC network which is then accessible to all banks, if such restrictions were removed. This, combined with inter-operability, will significantly hasten ubiquity.

3.2.2 <u>Make priority sector policy more outcome-focussed & proactively allow for bank & non-bank partnerships</u>

We have already noted that priority sector assets are a significant part of bank balance sheets. Given the relatively small size of the financial system, it might be necessary to continue with priority sector lending policy in its broad form, at least in the near future. However, there is room for significant improvement in the way this is done. In the current situation, priority sector policy is very prescriptive. In addition to setting an overall lending target for banks, it also goes on to specify the channel and pricing to be followed for such lending. This forces all banks to pursue similar strategies rather than specialise according to their strengths. Some banks may choose to specialise in setting up farmer branches in agricultural markets while others may focus on payments and buy priority sector assets from other banks and intermediaries. This diversity of strategies is desirable and must be encouraged. Specifically, this means that beyond setting a volume target and specifying desired outcomes in terms of market segments to be reached, there must be no further guidelines of an operational nature.

The Narasimham Committee II (1998) had recommended in this context that "As a measure of improving the efficiency and imparting a measure of flexibility the Committee recommends consideration of the debt securitisation concept within the priority sector. This could enable banks, which are not able to reach the priority sector target to purchase the debt from the institutions, which are able to lend beyond their mandated percentage." The Committee on Financial Sector Reforms (2008) chaired by Dr Raghuram Rajan had recommended an alternative mechanism whereby "any registered lender.... who has made loans to eligible categories would get Priority Sector Lending Certificates. A market would then be opened up for these certificates, along the lines of the IBPC, where deficient banks can buy certificates to compensate for their shortfall in lending. Importantly, the loans would still be on the books of the original lender, and the deficient bank would only be buying a right to undershoot its priority sector-lending requirement by the amount of the certificate."

There have been several positive developments in the Indian securitisation market. The RBI guidelines on securitisation have laid out a clear and high-quality framework for securitisation in India[17]. The figure below depicts some early promise in the context of micro finance:

Fig 9: Trend in securitization in India (Rs bn)	**Fig 10: Trend in securitization by MFIs in India (Rs bn)**
	
Source: ICRA	Source: Micro Finance Institution Network. Data is for partner MFIs of MFIN.

Actively facilitating the participation of banks in the securitisation market will enable those with asset origination focus on "supplying assets" while others may do some combination of origination and purchase of securitised assets, particularly with respect to priority sector obligations. In addition, there are a few operational aspects of priority sector lending policy that reduce its efficacy. These may be addressed immediately:

a. Priority sector policy and targets are set at a national level, despite important regional differences in terms of capital-labour ratios. This combined with an implicit bias towards mechanisation might not serve labour surplus states such as Bihar well. This bias along the sharp regional differences in financial depth noted previously might exacerbate regional inequalities further. There is a need to examine if some or all of the priority sector targets needs to shift to a regional basis rather than the current sectoral basis.

b. Direct Agriculture, in the manner in which it is defined, appears to be inadvertently biased against landless agricultural labourers as well as marginal farmers who self-supply labour. In the case of the landless labourer, her sole factor of production is her own labour. In order to maintain this factor of production, she has to spend on health, food, life insurance and disability premia, and other critical consumption items throughout the year. Sometimes due to seasonality of farm incomes, or unanticipated expenses on items like health, this labourer will have to borrow to manage expenses. However such borrowing by a landless labourer would not qualify under direct agriculture. In contrast to this, any borrowing by a medium farmer, who relies on farm equipment as the main factor of production, to purchase or maintain such equipment is treated as Direct Agriculture. Over and above that, products like Kisan Credit Card also permit an additional outlay towards consumption of the farmer to be counted under Direct Agriculture. This artificial distinction between labour and other factors of production results in landless labourers systematically facing higher costs of borrowing relative to land-owning farmers.

This difference in costs of borrowing could be as high as 20-30% depending on the source of credit. The issue faced by the landless labourer also persists in the context of marginal farmers who self-supply labour as well as large farmers who use labour-intensive farming techniques and therefore employ a lot of labour. This discrepancy can be addressed by specifying that all borrowing, including for consumption purposes, by landless agricultural labourers and marginal farmers be treated as Direct Agriculture Finance. If there is a concern regarding over-indebtedness, all such lending must be reported to the Credit Bureau as has been successfully accomplished in the case of microfinance.

c. Currently, priority sector achievements of banks are measured only on a single day during the whole financial year ("the last reporting Friday of March"). The Umesh Sarangi chaired Task Force on Credit Related Issues of Farmers (2010) notes with concern that March alone accounts for about 23% of all disbursements and 50% of disbursements happen in the December-March period whereas the Kharif season is July-October and the Rabi season is October-March. Given the importance of continuous flow of credit to these sectors and the fact that most crop loans are short-term in nature, banks must start to report PSL achievements on a quarterly basis, even if not on a weekly basis. This will greatly improve the efficacy of PSL implementation and reduce the seasonality of farm lending.

d. Rural branch targets (from the government as well as the regulator) create significant cost pressures on the banking system. With advances in technology and payment systems, and emerging high quality business correspondents and intermediaries, it may not any longer be necessary to create a high cost banking system in rural areas.

3.2.3 Facilitate risk transmission for banks through bond markets and securitisation

The development of a well-functioning bond market, in addition to other merits, is also crucial for the banking sector. While bonds can be held to maturity just as other forms of loans can, the use of bonds as the lending instrument by banks allows them the flexibility of rebalancing their portfolio at the cost of requiring that standard clauses and documents be used in place of the entirely customised format that other forms of loans allow.

Also, given the special status that banks enjoy, any asset creation through the bank channel needs a significant amount of capital to be deployed on the bank's balance sheet. However, for very high quality assets it may be more efficient to let investors, including retail investors, insurance companies, pension funds, and mutual funds, to hold these assets directly without using the bank channel so that scarce bank capital can be preserved and bank financing not be monopolised by the largest companies in the system. The bond route makes this very feasible and allows the issuance of even extremely long maturity bonds such as 50 year or 100 year bonds which, given the deposit centric liability profile of banks makes them poorly suited to offer such long-maturity loans but makes insurance companies and pension funds ideally suited to this task.

The merits of a vibrant securitisation market in allowing banks to meet priority sector obligations and rebalance their portfolios have been noted earlier. The measures required for developing better risk transmission for banks through corporate bond markets and securitisation include:

a. Allow Pass-Through Vehicles to Remain Tax Free: The securitisation markets had been growing steadily over the past seven years, owing to a strong and conducive regulatory environment. Recently, securitised debt instruments were listed for the first time, thus improving standards of transparency and reporting and widening the potential investor base. However, post facto claims by income tax authorities in October 2011, stating that the gross income of such SPVs was liable to tax, have effectively hampered the growth of the market[18]. The matter is presently sub-judice at the Bombay High Court. The Finance Bill, 2013, has sought to clarify the tax position by stating that securitisation SPVs are not liable to pay income tax. However, the Bill also states that trustees of such SPVs must pay tax on distributed income. Clarifying the tax pass-through status of securitisation SPVs, as originally intended by the regulators will help to revive this very important market, and create both liquidity as well as risk management capability [19]for originators.

b. Remove Loan-Bond Arbitrage: Within India, regulation and practice, in a variety of direct and indirect ways, has propelled banks towards building large illiquid loan books and tiny bond books. The most important being the regulations that ensure that loans can be carried on the books of banks perpetually at acquisition costs with impairment being recognised only on a realised loss basis and that too with a considerable lag. Bonds on the other hand have to be marked to market or carried at Fair Value and therefore respond much more quickly to changes in expectations of credit losses or movement in interest rates. Quite independently of the need to develop the bond market this represents a severe distortion in the manner in which banks are assessed. The need to move the measurement of risks and bank asset quality to a forward looking basis has been recognised by the June 2012 report of the RBI's "High Level Steering Committee for Review of Supervisory Processes for Commercial Banks"[20]. This is also a central issue in the movement of Indian banks towards full compliance with IFRS 9. As these longer term issues are still being debated, some useful near-term measures would be to:

   i. Allow banks to classify (and reclassify) bond and loan assets into a held-to-maturity (HTM) or available-for-sale (AFS) bucket based on their declared intention rather than automatically based on legal documentation.

   ii. Standardised Debenture Trust Deed (DTD) templates could be developed that may be used by banks for loans as well. This will improve the tradability of loans (and their fungibility with bonds) but if discretion is permitted (as mentioned above) on HTM/ AFS classification it would serve to improve the liquidity and risk characteristics of overall bank balance sheets while removing the bias in favour of one form of documentation (loan) merely to avoid marking the asset to market. This would allow the banks also to emerge as key market-makers in the bond markets thus ensuring that the price arbitrages between loans and bonds are also eliminated while contributing to the liquidity of the market.

iii. Create "credit event infrastructure" on all multiple holder debt obligations, whether in the form of bonds or loans. For debt capital markets to develop, it is necessary to know at any point of time with a reasonable degree of certainty whether a fundamental credit event[21] such as a bankruptcy, failure to pay or restructuring has occurred or not. One way of achieving this[22] could be to recommend that independent trustees are required for all bond as well as syndicated loan issuances, any credit event could then necessarily be reported to an institution such as FIMMDA or credit bureaus such as CIBIL, which could then disseminate this information amongst market participants in a systematic way. Today, this lack of transparency even on critical information due to the largely bilateral nature of debt markets hampers the growth of both bond as well as associated credit derivative markets.

3.2.4 Create Supporting Infrastructure

There is significant room to create and support enabling physical and legal infrastructure that can help the financial sector (a) assess and measure risk, (b) develop a liquid market for such risk and (c) mitigate the risk sufficiently by creating a liquid market in the underlying security. Some of the areas that require immediate attention are:

a. Enable access to SARFAESI to a wider category of lenders including NBFCs, buyers of rated securities backed by asset pools in the securitisation market, etc.
b. Provide the tools for banks to diversify away large systemic risks, e.g. create more weather stations to enable insurance companies to offer rainfall insurance cover to banks that have large agricultural portfolios.
c. Increase the value of the security held by banks - by improving its quality (e.g. land titles) or developing a market in the security (e.g. well regulated commodity derivative markets, warehouse receipts).
d. Information on credit behaviour (e.g. credit bureaus, securitisation registry).

4. Conclusion

Indian banking system suffers from a number of limitations. The most important ones include, small overall size and a high concentration risk; very poor indicators on both financial inclusion and financial depth; opaque balance sheets which make analysis difficult and do not allow high performing banks to distinguish themselves adequately so that they can grow faster relative to the low performing ones; very poor profitability on account largely of poor pricing of risk and a massive burden imposed upon them by an excessively detailed specification of the priority sector policies; and highly covariant strategies being followed by government owned banks - effectively making more than 70% of the banking system function like a single bank.

Significant changes are needed in order to address these issues. However, before any strategies for change is implemented it is important to be aware of some of the "mega-trends" that are shaping the future of banking. Some of the most important ones are, heightened systemic risk concerns on a world-wide basis; emergence of electronic money and specialised payment networks and branch alternatives; emergence of regulated non-bank intermediaries for credit delivery to the last mile; and the emergence of risk transmission markets and products like securitisation and credit default swaps, as well as deepening of the domestic bond and commercial paper markets.

Given all of these concerns and broad trends, in the note we make the following recommendations:

- Identify the banks that are systemically important financial institutions (SIFI) and design a supervision regime for them that reflects this character.
- Separate public policy motives from prudential regulation so that the true state of affairs within a bank is easily visible.
- Ensure ubiquity of electronic payments in the next three years by combining bank and non-bank elements.
- Make priority sector policy more outcome-focussed and proactively allow for bank and non-bank partnerships.
- Facilitate risk transmission for banks through bond markets, securitisation, and credit derivatives.
- Build supportive real sector and financial sector infrastructure.

Notes

[1]We thank Sucharita Mukherjee for helpful suggestions on corporate bond markets. The authors work for IFMR Trust and IFMR Capital. Views are personal. This note was prepared for Dvara Research (Formerly IFMR Finance Foundation.

[2]Priority sector lending norms were first introduced in November 1974 when banks were advised to raise credit to priority sectors to the level of 33.3% by March 1979

[3]"House of Debt" (2012), Credit Suisse Research Note

[4]Demirg-Kunt, Asli, and Ross Levine. 2008. "Finance, Financial Sector Policies, and Long-Run Growth." M. Spence Growth Commission Background Paper 11, World Bank, Washington, DC.

[5]Ayyagari et al, 2013, "Finance and Poverty: Evidence from India", CEPR Discussion Paper No. DP9497

[6]Source: Fourth All-India Census of Micro, Small and Medium Enterprises, http://fisme.org.in/document/FinalReport010711.pdf

[7]Source: RBI, http://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=827

[8]As long as the outstanding under a KCC is within the original limit sanctioned, the account is treated as 'current'. The borrower has an obligation to repay each individual drawdown within 12 months - however he/she may make unlimited drawdowns from the facility and the size of any facility that is "current" is increased by 10% each year - which could result in ever-greening.

[9]A big reason for this is RBI's bias towards lower rates for priority sector lending. For example, interest rates on various categories of priority sector lending are capped.

[10]Net Interest Margin(NIM): NIM of SCBs is derived by taking weighted average of bank wise NIM, weighted by asset size.

[11]The Task Force on Credit Related Issues of Farmers (2010) noted that one fourth of disbursements by the banking system occurred in the month of March.

[12]Sahasranaman, Anand and Deepti George (2013), "Cost of Delivering Rural Credit in India". IFMR Finance Foundation Notes on the Indian Financial System No. 3 (2013). See the note for a discussion on costs of branch-based lending - http://foundation.ifmr.co.in/wp-content/uploads/2013/04/Cost-of-Delivering-Rural-Credit-in-India.pdf

[13]Sahasranaman, Anand and Deepti George (2013), "Cost of Delivering Rural Credit in India". IFMR Finance Foundation Notes on the Indian Financial System No. 3 (2013).

[14]See RBI Payment System Draft Vision Document (2012-15) for a detailed discussion, available at http://rbi.org.in/scripts/PublicationVisionDocuments.aspx?ID=664

[15]DBOD.No.BL.BC. 82/22.01.009/2011-12

[16]DBOD.No. BL.BC. 26 /22.01.001/2012-13

[17]http://rbidocs.rbi.org.in/rdocs/content/pdfs/FIGUSE070512_I.pdf

[18]Securitisation volumes fell by over 35% in the financial year 2012-13.

[19]Transfer of systematic risk versus idiosyncratic risk

[20]http://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/HLSC190612RS.pdf

[21]2009 ISDA Credit Derivative Definitions

[22]Market standards in European markets are to have a trustee in any syndicated bond or loan issuance.