The Changing Face of Indian Banking

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Indian banking is passing through its most severe period of stress in over a decade. It is important, however, not to draw conclusions for banking policy from a snapshot of the most recent period—the totality of the post-reform experience must be taken into account. That larger experience shows that India's public sector-dominated banking system has served the economy well by improving its performance in respect of both efficiency and stability. Looking ahead, changes in governance and management are required, but it is possible to effect these within the framework of public ownership.

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1 Introduction

The banking sector, they say, is a play on the economy. Not surprisingly, Indian banking, like the Indian economy, was in the throes of a crisis in the early 1990s. Against all odds—and the predictions of doomsayers—Indian banking recovered over the next two decades as Indian economic growth accelerated. In the India Shining period, 2003–08, it appeared that Indian banking had put the past firmly behind and was poised for new heights of performance.

This was not to be. As the Indian economy tanked in 2011–12 and thereafter, India's banking sector took a beating. Some of the questions asked about Indian banking in the early 1990s are now being asked all over again. However, there are crucial differences in the context.

First, the share of private sector banks has risen sharply over the past two decades and this part of the sector is less affected than public sector banks (PSBs), although PSBs still account for the lion's share (over 70%) of banking assets. Second, banking has grown in size and sophistication over the past two decades of banking reform—this is not the under-penetrated, primitive sector we had when we started over. Third, the banking sector is being opened up after a lull and PSBs especially face challenges from an altogether new set of players.

How has Indian banking fared in recent years? What forces of competition have been unleashed? What reforms are needed at PSBs in order to better equip them for the challenges they face? In particular, how do they deal with the mountain of stressed assets they have to contend with today? This article will seek to address these questions in the following sections.

2 Banking Sector Performance in the Recent Past

As mentioned, India's banking sector has run into serious challenges over the past three years, that is, since 2012–13. However, this should not obscure the considerable progress over the preceding decade. In the decade 2002–03 to 2011–12, the sector's performance improved on several key parameters. PSBs were very much part of this story (except for a small decline in return on assets) (Table 1, p 59):

(i) Banking penetration, measured by the ratio of bank credit to gross domestic product, rose from 29% to 59%. In the next five years or so, we should be attaining a level of penetration that is respectable by the standards of the better emerging markets.

(ii) Net interest margin, a key performance driver for banks remained largely stable at around 2.8%.

(iii) Intermediation cost, as a proportion of assets declined, with a sharper decline happening at PSBs.

(iv) Stability improved in the period. Capital adequacy increased from 12.6% to 14.1%. Gross non-performing assets (NPAs) declined considerably.

(v) Profitability in banking, measured as return on assets remained largely stable at a healthy level of around 1%. Significantly, profitability remained unaffected in the initial years after the financial crisis of 2007.

Table 1: Key Financial Indicators in Indian Banking (%)

	2002–03		2011–12	
	Public Sector Banks	All Scheduled Commercial Banks	Public Sector Banks	All Scheduled Commercial Banks
Bank credit/GDP	–	29	–	59
Net Interest margin/total assets	2.91	2.77	2.76	2.9
Intermediate cost (operating expenses)/total assets	2.25	2.24	1.59	1.77
Return on assets	0.96	1.01	0.88	1.08
Gross NPA/gross advances	9.4	8.8	3.3	3
Capital adequacy	12.6	12.7	NA	14.1

Source: RBI: *Report on Trend and Progress in Banking; Statistical Tables Relating to Banks in India; Financial Stability Report*, various years.

Any prescription for the future must take into account the very substantive improvements in the period 2002–12. These improvements were a continuation of the slower improvement that happened in the years that immediately followed the onset of banking reforms in 1993–94.

Return on assets of PSBs improved in the period 2005–09, almost matching private sector bank performance. Thereafter, performance in the two groups began to diverge although PSB return on assets continued to remain close to a healthy 1% until 2011–12.

The improvement in performance of PSBs in the post-reform period was not widely expected. On the contrary, many analysts were of the view that with new private banks taking away market share and with PSBs lagging behind badly in technology, PSBs would find it difficult to survive.

This prediction was belied for a variety of reasons: the overall market expanded rapidly so that the loss in market share of PSBs did not translate into lower volume growth; PSBs invested in technology and caught up with private banks to some extent; the commercial orientation at PSBs improved with their being listed on the stock exchanges and private retail and institutional investors coming in. The record of the post-reform period as a whole shows, at the very least, that government ownership per se does not necessarily come in the way of performance.

The picture has changed in the last three years. (We provide data for two of these three years, 2012–13 and 2013–14, as the Reserve Bank of India (RBI) website does not have data for 2014–15). As Table 2 shows, one key driver of profitability, intermediation cost, has changed very little over a three-year period. Another driver, net interest margin, declined by 19 basis points between 2011–12 and 2012–13 without making any significant difference to the return on assets. Between 2012–13 and 2013–14 there was a decline of a smaller magnitude, 12 basis points, but return on assets has fallen sharply. It does appear that the key to the deterioration in profit is neither intermediation cost nor net interest margin.

The key is the third item in Table 2, namely, NPAs. Gross NPAs as a proportion of gross advances rose from 3.2% in 2011–12 to 3.8% in 2012–13 and further to 4.6% in 2013–14.

Table 2: Key Financial Ratios of PSBs in Recent Years (%)

	2011–12	2012–13	2013–14
Net interest margin	2.76	2.57	2.45
Intermediation cost/total assets	1.59	1.57	1.62
Gross non-performing loans/gross advances	3.2	3.8	4.6
Return on assets	0.88	0.8	0.54

Source: RBI: *Statistical Tables Relating to Banks in India; Financial Stability Report*, various years.

The NPA position in recent years does fully reflect the extent of stress in bank portfolios because we have a new category called "restructured standard advances." These amounted to 7.3%, 7.1% and 7.1% in 2011–12, 2012–13 and 2013–14, respectively. The total stressed assets during the three years thus amounted to 10.5%, 10.9% and 11.7%, respectively. Note that like NPAs, total stressed assets show a jump in 2013–14 (Table 3).

Table 3: Stressed Assets of PSBs (%)

Year	Gross NPAs/Gross Advances	Restructured Assets/ Gross Advances	Total Stressed Assets/ Gross Advances
2011–12	3.2	7.3	10.5
2012–13	3.8	7.1	10.9
2013–14	4.6	7.1	11.7

Source: *Financial Stability Report*, RBI, June 2013 and June 2014; for 2011-12, *Statistical Tables Relating to Banks in India*, RBI.

For the banking sector as a whole, the ratio of gross NPAs to gross advances amounted to 4% in 2013–14. Total stressed advances were 9.8% of gross advances. Roughly, a quarter of restructured assets turn into NPAs. Thus, the ratio of total NPAs to advances in 2013-14 could be said to be 5.5% (4% of NPAs plus 25% of 5.8% of restructured assets). This is considerably below the figure of 15.7% with which the banking sector started off in 1996–97 (Gandhi 2015). So, yes, we have deterioration

Table 4: Contribution of Stressed Sectors to Advances as well as Stressed Advances (December 2014; %)

Sub-sector		Public Sector Banks	Private Sector Banks	Foreign Banks	All Scheduled Commercial Banks
1 Mining	Share in advances	1.7	0.4	0.4	1.3
	Share in stressed advances	1.4	1.1	0.3	1.4
2 Iron and steel	Share in advances	5.2	2.5	2.7	4.5
	Share in stressed advances	10.5	7.9	3.6	10.2
3 Textiles	Share in advances	3.9	2.4	1.2	3.4
	Share in stressed advances	7.5	6.4	3.4	7.3
4 Infrastructure (of which)	Share in advances	17.6	8.4	6.4	15.0
	Share in stressed advances	30.9	18.2	32.8	29.8
Power generation	Share in advances	10.1	3.8	1.1	8.3
	Share in stressed advances	17.3	7.3	0.0	16.1
Telecom	Share in advances	1.7	0.9	3.2	1.6
	Share in stressed advances	1.8	3.1	19.7	2.2
5 Aviation	Share in advances	0.6	0.1	0.6	0.5
	Share in stressed advances	2.7	0.4	0.0	2.4
Total of these five sub-sectors (1 to 5)	Share in advances	29.0	13.9	11.3	24.8
	Share in stressed advances	53.1	34.1	40.0	51.1

Source: *Financial Stability Report*, RBI, June 2015.

relative to the best numbers we have seen in the post-reform period but the situation is not alarming.

It is interesting to see where the stressed assets are coming from (Table 4, p 59). As of December 2014, five sectors accounting for 25% of the exposure of all banks had a share of 51% of all stressed advances. These were mining, iron and steel, infrastructure, textiles and aviation. Of these, steel and infrastructure accounted for 40% of the total stressed advances.

At PSBs, these five sectors accounted for 29% of the advances and 53% of all stressed advances. At private sector banks, they accounted for 13% of advances and 34% of stressed advances; at foreign banks, the shares were 11% and 40% respectively. Private and foreign banks chose to take a lower exposure to these sectors than PSBs and have been less impacted as a result. Wherever they did get exposed, they have been significantly impacted. Does this point to superior risk management? Or does it point to the ability of private and foreign banks to pursue opportunities (such as retail) that are inherently less risky in the Indian economy in a way that PSBs cannot, given their public sector character?

The boom of 2004–08 was driven by private investment, especially investment in private infrastructure. PSBs substantially funded this boom in investment and the consequent acceleration in India's growth rate. They now face the downside of the loan exposures they had taken. To the extent that private banks took lower exposures, they have been less badly impacted. Can we afford to have the entire banking sector shunning infrastructure and allied sectors because less risky opportunities are available aplenty in the Indian economy? The *Economic Survey (2014–15)* highlights this issue very well:

> Indeed, one of the paradoxes of recent banking history is that the share of the private sector in overall banking aggregates barely increased at a time when the country witnessed its most rapid growth and one that fuelled by the private sector. It was an anomalous case of private sector growth without private sector bank financing. Even allowing for the irrational exuberance of the Public Sector Banks (PSBs) that financed this growth phase, the reticence of the private sector was striking.

The point is worth keeping in mind while comparing the performance of PSBs and private sector banks in the last two or three years.

Despite the deterioration in 2012–13 and 2013–14, Indian banking does not do badly with respect to a broad range of economies (Table 5).

(i) On capital adequacy, India lags behind, given that the government has been slow to recapitalise PSBs. So also in respect of non-performing loans, given that these have shown up only recently.

(ii) In respect of return on assets and return on equity, India ranks sixth out of 17 economies.

(iii) On cost to income ratio, India ranks third out of 18 economies.

The one parameter in which Indian banking is a laggard today is the NPA ratio. But, then we must remember that many other economies have dealt with stressed assets in the years consequent to the crisis; we are in the early stages of dealing with ours.

This is especially striking when one takes into account the fact that we entered a stressed situation fairly recently whereas most advanced economies have gone a fair distance in addressing the stressed situation that arose following the crisis of 2007.

Table 5: Comparison of Economies on Key Banking Indicators for 2013

(%)

Country	Bank Regulatory Capital to Risk-weighted Assets	Non-performing Loans to Total Loans	Return on Assets (Post Tax)	Return on Equity (Post Tax)	Net Interest Margin	Cost to Income Ratio
Advanced economies						
Australia	11.62	1.37	NA	NA	NA	81.43
Canada	14.33	0.57	0.85	14.32	1.79	60.14
France	15.38	4.49	0.42	6.14	1.76	65.80
Germany	19.16	2.69	0.44	7.27	1.62	67.99
Italy	13.70	16.54	–0.56	–6.94	2.06	58.92
Japan	15.20	2.30	0.17	3.21	0.78	70.09
Switzerland	17.48	0.76	0.54	6.16	1.36	69.32
United Kingdom	NA	NA	0.77	8.67	1.50	67.08
United States	14.40	2.45	1.05	9.43	3.44	60.37
BRICS economies						
Brazil	16.11	2.86	0.43	5.52	2.67	63.17
Russian Federation	13.46	6.00	1.48	10.44	4.83	90.10
India	12.32	4.03	0.65	9.02	2.79	47.81
China	12.19	1.00	1.05	15.66	2.50	36.64
South Africa	15.58	3.64	0.32	3.89	3.75	50.35
Emerging economies						
Indonesia	19.82	1.69	1.29	11.25	4.35	54.49
Malaysia	14.58	1.85	0.27	0.98	0.58	56.38
Mexico	15.59	3.24	0.60	7.72	2.71	65.53
Thailand	15.61	2.31	0.28	1.43	0.81	43.82

Source: Global Financial Development Database, World Bank.

3 Emerging Competition in Indian Banking

Even as PSBs wrestle with an increase in the level of stressed assets, they face potentially greater competition. Competition can come from several sources: new full-scope banks, foreign banks, banks with differentiated licences and technology firms. It is worth examining how competition is likely to unfold and what its impact on PSBs will be.

Competition in banking must be managed. Too little competition places the customer at the mercy of banks. Too much competition puts pressure on bank profitability and risks inducing financial instability. A balance must be struck. One way to measure competition in banking is to look at the share of the top five banks in assets. Table 6 presents data for the Indian banking sector since 1998. Table 7 (p 61) presents data on select countries for 2011.

Table 6: Share of Top Five Banks in Banking Assets in India

1998	45.971
1999	44.433
2000	44.478
2001	45.465
2002	44.789
2003	42.723
2004	43.237
2005	43.304
2006	42.278
2007	41.388
2008	41.262
2009	39.973
2010	40.004
2011	39.517

Source: Global Financial Development Database, World Bank.

Two conclusions can be drawn from Tables 6 and 7. First, competition has increased in Indian banking in the post-reform period but at a controlled pace. It would be fair to say that the RBI has done a good job of managing competition in the banking sector. Second, the five-bank share is lower in India than in a broad cross-section of countries, which suggests that competition in Indian banking is better than in many economies.

Table: 7: Five-bank Share in Total Assets (2011) (%)

Country	
Australia	90.5
Brazil	73.5
Canada	84.2
China	68.0
France	76.2
Germany	85.6
India	39.5
Indonesia	59.1
Italy	71.2
Japan	57.7
Malaysia	67.8
Russian Federation	41.2
United Kingdom	76.7
United States	47.0

Source: Global Financial Development Database, World Bank.

Critics point out that while competition in banking has increased, going by the five-bank share of assets, the quality of competition has not changed much. We still have PSBs largely competing amongst themselves, especially if we consider the lower half of Indian banks in terms of assets. Most PSBs have the same business models and compete in the same segments, often in the same geographical areas. We have not had new entrants and new business models.

This is poised to change in the coming years, thanks to the RBI's initiatives in recent years. We shall now consider potential new entrants in turn and their possible impact on the banking sector.

(i) New Private Banks: In February 2013, the RBI announced guidelines for the licensing of new private sector banks. In April 2014, in-principle banking licences were given to two entities, IDFC and Bandhan, a microfinance company. In 2015, both received bank licences. Under the new licensing policy, it was open to industrial houses and corporates to apply for a bank licence. This raised the possibility of a serious threat to incumbents arising from entrants with deep pockets and established brand names.

In the event no industrial house or corporate qualified for a licence, so this threat has not materialised. Both IDFC and Bandhan will take a long time to establish themselves as banks—say, five to 10 years. The RBI has kept open the possibility of moving to on-tap licensing, that is, licensing new banks as and when applications are received. It is likely that the RBI will want to first assess the impact of the competition it has created thus far before it approves any more full-scope banks. In the medium term, therefore, the threat from the entry of new, full-scope banks is not significant.

(ii) Foreign Banks: In November 2013, the RBI liberalised its policy towards foreign banks. Foreign banks, in general, are free to operate as branches or wholly-owned subsidiaries (except in certain specified cases where the RBI can insist on the latter form of operation). Foreign banks that choose to operate as subsidiaries are promised near national treatment, that is, treatment on par with that accorded to domestic banks. In particular, they can expect almost the same freedom to set up branches. (Lack of branch expansion has been a big obstacle to the ability of foreign banks to effectively tap the large Indian retail segment.)

However, national treatment comes with a number of conditions, including stringent conditions related to corporate governance. These include 50% of directors of the subsidiary being Indian nationals and one-third of directors being independent directors.

After years of clamouring for greater freedom to open new branches, foreign banks have been surprisingly coy in their response to the new licensing policy. It is possible that some find the governance requirements onerous. It is also likely that some foreign banks do not have an appetite for expanding in emerging markets at a time when they have problems coping with the higher capital requirements that have come into force after the financial crisis of 2007. (Many are, in fact, cutting back on their emerging market exposures in order to focus on home and advanced country markets.)

Even if foreign banks decide to expand their presence in India by setting up subsidiaries, they are unlikely to venture into retail banking in a big way. Retail banking entails substantial upfront costs and opening of branches in underserved areas. Moreover, it is not an area in which foreign banks have any particular advantage over well-entrenched Indian banks, private or public. Even in the domestic corporate loan business, foreign banks will find it difficult to match the rates offered by domestic banks that have access to low-cost deposits or even the service quality of top Indian banks. Foreign banks are more likely to focus on the cross-border requirements of Indian companies. This is not a big source of income for Indian banks today, so Indian banks have little to lose. Thus, foreign bank entry does not pose a threat even in the medium term to existing players.

(iii) Differentiated Players: What of the newly licensed niche players, namely, payment banks and small banks? Do they have the potential to be game changers? Let us begin with the rationale for "differentiated licensing." It is that the regulator can give normal commercial bank licences only to those who have adequate funds and an established track record. However, there could be several entities that have capabilities in the banking space but lack these two requirements for a normal commercial bank licence. By giving them entry into banking, subject to certain prudential restrictions on geography or product, we can have more organisational variety and, perhaps, greater efficiency (Rajan 2015).

Following from this rationale, the RBI has licensed two new types of banks: payments banks and small banks. Payments banks can take deposits from the public up to a maximum of Rs 1 lakh per customer. They have to invest 75% of the deposits in SLR (Statutory Liquidity Requirements) securities; a maximum of 25% can be invested in fixed deposits with banks. They cannot engage in any lending operation. They can make payments and remittances through various channels such as branches, banking correspondents (BCs) and mobile banking. They can also issue financial products such as mutual funds and insurance. The RBI has issued payments bank licences to 11 entities.

Some analysts see the new set of nimble, mostly private sector players as grabbing a huge slice of the payments market from commercial banks. When one looks at the proposition closely, it is hard to see how this can happen or, indeed, what would constitute a viable business model for payments banks.

The key facilities offered by a payments bank, namely, payments and remittances, are offered by most commercial banks as well. Payments banks can attract only customers whose deposits are under Rs 1 lakh. For payments banks to entice these customers away from existing banks, they need to be able to offer much higher rates on bank deposits or charge a lower fee on their services or a bit of both. Even allowing for lower intermediation costs in payments banks, this is not easily achieved as the typical commercial bank has the advantage of spreading its costs over several products it offers to customers, only two of which are payments and remittances.

It follows that, where a customer can access a good quality commercial bank, which provides payment facilities in addition to loan and other products, a payments bank will, in general, not be a meaningful option. However, there are some PSBs that may not be offering the full range of these services or that may be deficient in respect of payments facilities. In the areas in which these PSBs operate, new players with efficient payments systems can hope to make inroads.

Payments banks can also pick up customers not catered to by commercial banks, that is, they can move into uncharted areas of financial inclusion (and this, by definition, does not pose much of a threat to existing players). They can become attractive in remote areas by facilitating a whole range of normal payments (such as for groceries) through a mobile phone (assuming the user has a smartphone). However, even the possibility of reaching out to the unbanked has diminished greatly after the launch of the Pradhan Mantri Jan Dhan Yojana which has swept 19 crore customers into the net of commercial banks.

Whichever way you look at it, it does appear that payments banks have their work cut out in establishing a viable operation. For telecom operators (such as Airtel and Vodafone which have been given licences), payments banks may be a way of preventing churn in their core customers for mobile phone services—a mobile customer who is also a customer for payments service will be less free to migrate to a competitor for mobile services.

For a player such as State Bank of India (which will be a minority partner in a joint venture with Reliance Industries), a payments bank could be a way to achieve financial inclusion at a lower cost than through the parent bank itself (as the subsidiary can opt for a wage structure that is very different from that of the parent). For players with deep pockets (such as Mahindra Tech or the Sun Group), a payments bank may simply be a way of entering the banking space and establishing a track record that could serve as a basis for converting to a full scope bank down the road. However, it is hard to see payments banks taking away customers or income from commercial banks in a big way.

(iv) Small Banks: Much the same could be said of the other set of new players, small banks. Ten entities have entered the fray. Small banks are meant to cater mainly to small farmers, small businesses, micro and small industries and the unorganised sector. Non-bank Financial Companies (NBFCs), micro-finance institutions and local area banks are among those which have catered to these sectors but they have been limited by their inability to raise deposits from the public. The idea is to allow a few to better serve these segments by getting converted into banks.

As per the guidelines for small banks, 50% of the loan portfolio should comprise loans and advances up to Rs 25 lakh with a priority sector lending target of 75%. These are not areas which are of great interest to commercial banks (and, indeed, that is part of the rationale for small banks), so there is no major competitive threat that small banks pose. At best, payments banks and small banks, if they turn out to be viable, could expand the scope and reach of the banking system.

(v) Technology Firms: Lastly, commercial banks face potential competition from technology firms. Globally, these are firms that focus on three sources of income of banks: lending, payments and asset management. Technology firms are in the business of organising loans through what is called peer-to-peer lending, that is, bringing savers directly in contact with borrowers (and thus eliminating a good bit of the spread of intermediaries such as banks). Loan appraisal by banks is substituted by massive data-crunching. This, however, requires enormous amounts of easily accessible data on retail and corporate borrowers of a sort that will take time to build in India. So, loans are not an area in which Indian banks are vulnerable to technology firms.

In asset management, technology firms substitute artificial intelligence or "robo-advisers" for people, again at a lower cost. This is not a large area for Indian banks anyway. It is in payments that technology firms—exemplified by a player such as Paytm—can best pose challenges. The innovation in payments is the use of "mobile wallets." These enable customers to store up to Rs 10,000 in a designated wallet for making various payments.

Potentially, mobile wallets can take away business from debit and credit cards issued by banks because mobile wallets are more convenient to use (they involve fewer clicks than a credit card). They also pose less of a security risk as the amounts stored in wallets are small. Paytm claims 105 million registered users as against 21 million outstanding credit cards.

However, the low payment limit on these wallets (Rs 10,000) is a constraint on the use of these wallets. More importantly, banks time and again have shown an ability to respond to threats posed by technology—by embracing the very technology that threatens them. There was a time a little over a decade ago when it seemed that online banks would render brick-and-mortar branches obsolete. However, this did not happen. Instead, banks responded by providing online services themselves.

So also with mobile technology. Several commercial banks in India have come up with their own mobile wallets which can be used to supplement a variety of other payment services they offer. True, technology firms can, in principle, score on service or cost. However, it is hard to see customers switching wholesale from banks to technology firms for the purpose of making payments. The argument is the same as in the case of payments banks: there is so much convenience to be had from being a customer of a bank that offers a range of services, not just payments.

Mobile wallets and payments, broadly speaking, are part of what has come to be known as "digital banking" which involves moving customers away from cash payments to electronic payments through a variety of channels such as ATMs, internet, mobile phones, etc. Banks that succeed in digital banking can expect to see an increase in low-cost "float" funds. They can better access and analyse data on customers (especially retail customers) and thus reduce non-performing assets. Digital banking can also increase productivity of back office operations. They can generate income on a wide range of payments.

All this could potentially translate into a higher return on assets. However, past experience suggests that new channels introduced by banks—whether telephone banking or internet or mobile—do not by themselves enhance profitability. This is because there are costs associated with providing these services and large volumes of transactions often offset lower unit cost of transactions. The boost to profitability from digital banking in the immediate future will also be limited because less than 1% of savings bank customers at PSBs and 10% of customers at private banks use mobile banking (Boston Consulting Group 2014).

The big gain from technological innovation for banks is that it improves customer retention and helps attract savvier, higher income and potentially more profitable customers. One can expect to see this happen with digital banking. Younger customers and the "mass affluent" will want the convenience provided by digital banking. They will, therefore, migrate to banks that can provide this convenience. These banks can expect some increase in their return on assets as a result.

However, over the next five years or so, the mass market for banking in India is unlikely to change materially. The importance of branches for carrying out transactions will reduce. However, branches will still be central to acquiring customers and selling most products. The core banking products—deposits, loans to companies and retail customers—can thus continue to provide return on assets of the same magnitude as seen in better times in the past (say, around 1%).

What does this bode for PSBs? The better-performing PSBs and the ones that have invested in technology will be well placed to withstand whatever competition that emerges. Once the legacy of bad debts of the recent past is shed, they will continue to earn returns consistent with what they have earned before the recent period of stress. However, underperforming PSBs will continue to lose market share—not just to existing private banks but to a whole new set of players.

In the medium term, PSBs will lose market share. In about 10 years' time, one can expect PSBs' share of assets to drop from the current level of over 70% to 60% or even less. Given that the overall pie will be growing briskly, loss in market share need not detract from the performance of the better-performing PSBs. This is the broad context in which the issue of PSB reform must be placed. To this, we now turn.

4 Reform of PSBs

India's PSBs face challenges in the years ahead. The challenge, as may have been clear from the discussion in Section 3, is not so much in the future. It arises from the past through the legacy of distressed assets. One might add that at PSBs, the distressed assets are both physical and human. The freeze on recruitment through the 1990s until the early 2000s is now reflected in a scarcity of managers at the top.

We shall take up the issue of stressed assets in the next section. Leaving that issue aside, the critical policy issue today is: what changes in governance, management and structure are needed to restore PSBs to health?

The pessimistic—or even cynical—view, reflected in the report of the P J Nayak Committee (Nayak 2014), is that there is little scope for improvement as long as the public sector character of banks is maintained. The poor performance of PSBs poses demands for fresh capital that the government cannot hope to meet.

As long as the government holds over 50% of the equity of PSBs, it will continue to make appointments of chairpersons and managing directors and independent directors. PSBs will continue to come under the purview of the Central Vigilance Commission and Comptroller and Auditor General—this will make it difficult for managers at PSBs to take the necessary commercial decisions or take them quickly enough. PSBs cannot compete with private banks in the market for talent, especially at senior levels, as long as they are hamstrung by public sector pay scales.

These are the factors which, according to the Nayak Committee, account for their sharp relative underperformance in 2013–14. Following from this diagnosis, the Nayak Committee arrives at prescriptions. Government must be distanced from the appointment of PSB chairmen and managing directors (with the two roles being bifurcated). PSBs' equity must be transferred to a bank holding company (BHC) that will be run entirely by eminent bankers and other professionals (and will not have government representation). The BHC will initially select chairpersons, managing directors and independent directors of PSBs. The equity stakes of PSBs will be transferred to the BHC which will proceed to dilute its holdings in PSBs to below 51%. Eventually, the BHC will transfer its powers of appointment entirely to professional boards of PSBs. Government's own holding in the BHC could fall below 51%.

The Nayak Committee's assessment is based on a comparison of the performance of PSBs and private banks at just one point in time, 2013–14. PSB performance, as noted earlier, has deteriorated since 2012–13 and a large gap in performance has opened up between PSBs and new private banks. However, a wide body of academic literature shows that over a longer period consequent to reforms, the performance of PSBs has tended to converge towards that of private banks (see, for instance, T T Ram Mohan 2005; Das and Kumbhakar 2012). Data on key indicators over the decade 2002–03 to 2011–12 presented in Section 2 lend support to this view.

Hence, the thesis that the public sector character of banks per se is an obstacle to performance does not stand up to scrutiny. On the contrary, the lesson of the decade of progress, 2003–12, is that, given strong management, a measure of autonomy and the discipline of the market, PSBs have the capacity to perform well in the face of private competition.

A second problem with the Nayak report is that it overstates the importance of governance or the role of boards of directors in determining firm performance. The contribution of the best of boards, we know, is far from significant. At best, boards can react quickly after an adverse event, they can penalise or change management and they can ensure compliance.

That said, there is merit in strengthening the boards of PSBs. The government and the RBI must ensure that selection of independent directors is in accordance with clearly laid-down "fit and proper" criteria. The selection may be left to a panel on which government is represented but which also includes outside experts. Independent directors selected by the panel may be vetted by the RBI. The RBI may also consider an interview process for appointment and reappointment of independent directors. The two employee representatives on the board must be given proper training so that they can perform better than they have in the past.

The onus for performance falls squarely on the management. Private bank performance in India is superior not because the boards of these banks do a better job than at PSBs but because they have better management, especially at the top. The most important requirement at PSBs, therefore, is to strengthen management, especially top management. To do so, a number of issues need to be addressed:

(i) The government has moved to separate the posts of chairperson and managing director (CMD) at PSBs. It has already done so at five PSBs. The government must tread warily. At private banks, the separation is meaningful because there is a private promoter to whom the chairperson is accountable. Accountability of a PSB chairperson to the government is not of the same order. Moreover, CEOs of PSBs have their work cut in dealing with the Ministry of Finance. If, in addition, they have to contend with a chairperson (who could be a political appointee), it could seriously undermine the ability of CEOs to perform. Separation of roles has been driven by the perception that there is concentration of power in the office of CMD and some checks and balances are required. A better way however, would be to strengthen the board, including the mechanism of independent directors. Perhaps, the government may like to see how the experiment with separation of roles works out at the five PSBs before it is extended to others.

(ii) The selection of top management of PSBs may be made by the same panel that selects chairpersons and independent directors of boards. Government should have a say in selection but it should not be the sole decision-maker. A minimum length of tenure (say, five years) must be ensured, subject to annual performance reviews to be done by bank boards.

(iii) Managing directors must be selected from within the bank wherever possible. This means that proper succession plans must be in place. The appointment of executive directors too must be from within the bank to the extent possible. The game of musical chairs at the top levels of PSBs has played havoc with their culture and performance. It must be ended forthwith.

(iv) Having strong performance-linked incentives or trying to match pay at PSBs with that of private sector banks, as the Nayak Committee proposes, is undesirable. It would undermine the cost structure of PSBs and seriously damage their culture. We need to improve pay at the top in PSBs. As pay cannot be improved all along the line, additions to pay may have to be labelled "performance-linked incentive". However, these additions cannot be benchmarked to the private sector. We will have to work backwards from an absolute total for cost-to-company for top management at PSBs. At the end of the day, PSBs must be seen as offering a composite package—in terms of pay, perquisites, pension, job security and job challenges—that is different from that of the private sector, just as the civil service offers a package that is different from the corporate sector. The civil service still attracts talent of a high quality. We must expect PSBs to do likewise with modest improvements in service conditions.

PSBs face a high level of attrition at senior levels (deputy general manager/general manager and above). They have sought to fill the gaps through accelerated promotion and, to a limited extent, through lateral recruitment. This needs to be supplemented with high quality training and rigorous appraisal in order to ensure that performance is not adversely affected. Lateral appointments for specialist positions (treasury, risk management, wealth management, etc) must be especially encouraged.

Strengthening the mechanism of independent directors, better selection of managing directors (MDs), succession planning, modest performance-linked incentives and lateral recruitment would go a long way towards improving PSB performance. The government can help out by focusing on commercial objectives and compensating PSBs out of the budget wherever non-commercial objectives are to be met.

The reflex response to the problem of underperforming PSBs is to seek consolidation, that is, to merge some of these banks with the better-performing banks. Merging a weak bank with a bank that is stronger only in relative terms (and itself needs strengthening) is likely to end up dragging down performance of the combined entity. The human resources and other challenges that go with integration should not be under-estimated. It may be better to let private investors assume control of, say, three or four of the worst performing PSBs. Reducing the number of PSBs will enable government to better focus on a smaller number of relatively stronger banks and also reduce the overall capital demands on government.

The starting point for PSB reform must be a clear recognition that the existence of public ownership is a central part of the story of the improvement in efficiency and stability in Indian banking over the post-reform period. The government and the RBI may consider setting a desirable market share for PSBs by the end of the decade—say, 60% of banking assets—and frame bank licensing policies in consonance with this broad objective.

5 Dealing with Stressed Assets

Indian banking's immediate problem is to deal with a high level of stressed assets. The challenge for the future is to make sure that risk management practices are improved so that stressed assets do not spiral out of manageable levels hereafter. We begin by outlining immediate steps to be taken to deal with today's stressed asset situation and to strengthen risk management at PSBs. Next, we review important initiatives in the area on the part of the RBI.

Dealing with stressed assets requires, first, clearly recognising such assets. Next, it involves resolving stressed assets and recognising the losses that arise from doing so. In India, there are a number of ways in which resolution can happen. Where the project is viable, the loan needs to be restructured with lenders and promoters both taking a hit. Given a limited number of lenders, this can be done through bilateral agreements.

Where the number of lenders is large, the Corporate Debt Restructuring (CDR) mechanism will have to be invoked and the consortium of lenders must decide whether to restructure the loan or opt for a one-time settlement. If neither is possible, lenders can invoke the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act and either liquidate the assets of the debtor or sell the assets to an asset reconstruction company (ARC).

Liquidation is a long-drawn-out process, it can get mired in litigation and it could involve huge losses whenever it happens. Restructuring through negotiations with the borrower—wherever it makes commercial sense—is hence preferable from the standpoint of banks, borrowers and the economy at large. It has the potential to render projects viable, thereby reducing banks' potential losses. It enables projects to go through to completion, something that is in the interest of the economy. It also reduces leverage of borrowers and puts them in a position to plan new investment.

However, in such cases of restructuring, there are three issues that need to be addressed. First, at PSBs, it is hard to determine whether the lenders' interests have been adequately safeguarded in any restructuring that takes place—or whether borrowers have got away lightly. (At private banks, whether run by promoters or management, there are incentives to ensure that lenders' interests are taken care of.) This, in turn, renders decision-making at PSBs difficult, especially in bilateral settlements.

There is a case for setting up an independent authority for vetting proposed settlements in loans above a certain value. This will give management at PSBs the confidence to go ahead with settlements. Alternatively, the independent authority could examine a sample of settlements to judge whether restructuring has met the test of fairness.

Second, all restructuring or liquidation involves losses for banks. These losses must be made good through infusion of capital by the government. Merely infusing capital to provide for provisions is not enough. All PSBs must have a buffer of capital above the stipulated minimum level of capital adequacy. Without an adequate capital buffer, PSBs cannot grow their loan portfolios, and without loan growth, performance of PSBs cannot improve.

Achieving both these objectives would require a higher level of capital infusion than has been promised (Rs 70,000 crore over four years under the Indradhanush scheme). Higher infusion of capital is desirable even if the intention is to sell some of the underperforming banks. It is in the government's interest to infuse capital and raise performance if only to get a good valuation for its shares. In the past, the government has realised an appreciation in its shareholding after infusing capital into PSBs (Ram Mohan 2015). It is important, of course, that capital infusion is accompanied by efforts to strengthen management and governance at PSBs, as outlined in the preceding section.

Third, for many of the restructuring efforts to succeed, the government needs to provide support to distressed sectors. In the case of infrastructure, it must facilitate the completion of projects that have been stalled for one reason or another, whether lack of clearances or non-availability of fuel linkages. In the case of steel, it needs to be proactive to protect Indian industry from dumping by Chinese steel makers. With textiles, appropriate incentives are needed to boost exports in the face of flagging international demand.

Over the long term, the containment of NPAs at a tolerable level has to be a priority for PSBs. This requires a combination of preventive measures as well as measures to effect recovery where loans have turned into NPAs.

PSBs need to significantly improve their risk management capabilities. This calls for several actions. Some of these have been well recognised and articulated:

(i) Greater awareness of risk management in top management;
(ii) Strengthening credit appraisal capabilities at all levels; and
(iii) Better monitoring of loans post sanction.

Other initiatives are required in light of the recent experience with NPAs. Some PSBs have been badly hurt through large loan exposures to certain corporates. Until recent management capabilities have been significantly strengthened, it would make sense for PSBs to be told to form consortia wherever a loan size of, say, over Rs 500 crore or Rs 1,000 crore is involved.

Second, the RBI needs to tweak its exposure limits for loans to companies as well as groups, depending on the financial strength of a PSB. The present limits permit larger exposures than are desirable for the weaker banks. The boards of directors or management should have taken the initiative to set lower limits. Since this has not happened, the regulator needs to step in and set prudential limits for PSBs by dividing them into three categories, based on performance. Each category must have separate exposure limits.

In respect of the management of stressed assets, the RBI has come out with a number of initiatives in recent years. Following the recommendations of an RBI committee, the provisioning norms for restructured loans have been brought in alignment for those for NPAs with effect from 1 April 2015. Concealing problem loans under the guise of restructuring is no longer possible.

An important initiative was the Framework for Revitalising Distressed Assets in the Economy unveiled by the RBI in January 2014. Some of the key features of the Framework are:

(i) Creation of a centralised repository of information on borrowers with a total exposure (fund- and non-fund-based) of Rs 50 million and above has been created. Banks are exported to report credit information to this agency.

(ii) Formation of the "Joint Lenders' Forum" with timelines to agree on a plan for resolution as soon as signs of distress become manifest.

(iii) Incentives for lenders to quickly agree to a resolution plan.

(iv) Independent valuation of large value restructuring with a fair division of losses between promoters and creditors.

(v) More expensive future borrowing for borrowers who do not cooperate with lenders in resolution.

(vi) More liberal regulatory treatment of asset sales.

The RBI followed up on this initiative by announcing the "Strategic Debt Restructuring Scheme" in June 2015. Under this scheme, banks in the Joint Lenders' Forum would have the option to convert their loans into shares and acquire majority control in the borrower company, if the borrower did not meet the milestones stipulated in the restructuring package. Once this was done, the asset would not be treated as a restructured asset for classification and provisioning purposes for a period of 18 months. During this period, if lenders can find a buyer for their equity holding, the asset would be upgraded as "standard". Thus, the scheme offers incentives for banks to change ownership where there is evidence that restructuring is not working.

Another important initiative is the 5/25 scheme introduced in July 2014 for long-duration projects such as those in infrastructure. The idea underlying this scheme is that it is difficult for a borrower in a project with a project life of 25 years or more to repay loans within the conventional period of eight to 10 years. Under this scheme, payments are amortised over 25 years but the lender has the right to exit after five years leaving the balance amount to be refinanced by another lender. This is expected to obviate the need for restructuring (and the associated provisioning) that happens in such loans when there are disruptions to cash flows in the initial years. It is essential, however, that banks get into this scheme after ensuring that promoters have enough skin in the game; else, if the promoter defaults after five years, it will be difficult for a lender to exit.

For far too long, the field, when it comes to bank loans, was heavily tilted in favour of promoters. When ventures turned sick, promoters could walk away from the problem leaving banks to hold the can. The effort in recent years has been to level the field. The RBI's initiatives to empower lenders are, therefore, entirely commendable. However, promoters have been able to use the judicial process to prevent banks from realising their claims. We must await the long-promised Bankruptcy Law for banks to be able to deal more effectively with errant promoters.

6 Conclusions

India's banking sector is going through a period of stress. It is as if the global financial crisis is affecting the Indian economy and Indian banking with a lag. It would be unwise to draw conclusions or prescriptions about Indian banking by looking at performance indicators over the past three years of stress. One has to consider the post-reform period as a whole and, in particular, the decade of 2003–12. Over a long period, there has been a secular improvement in efficiency and stability. It is important to understand that public ownership has been an important factor underlying this trend.

While competition is set to increase in the coming years, it is unlikely to have an impact on full-scope commercial banks in a significant way, except for PSBs that have lagged behind badly in technology and performance. There is scope for improvement in the performance of PSBs within the framework of public ownership. We need to strengthen management and governance at PSBs while recognising the uniqueness of the PSB model. The answer does not lie in getting PSBs to conform to practices of private banks.

It is important to find ways to deal with stressed assets in the system. This entails creation of an independent authority to vet restructuring agreements between PSB management and promoters, infusion of greater capital into PSBs than is currently envisaged and resolution of various issues in the economy at large.

Postscript

Since early 2016, three issues have acquired prominence. One, sharp rise in NPAs at banks and losses or a fall in profit at several PSBs. Two, a reported proposal to create a government entity for asset recovery. And, three, the setting up of the Bank Board Bureau (BBB) for making top appointments at PSBs.

NPAs in the banking sector have grown significantly, following the RBI's determination to have banks clean up their balance sheets by 2017. The RBI's concern is that concealment of the NPA position leads to banks throwing good money after bad and this would lead to even higher NPAs down the road.

The RBI's concern is understandable. However, this approach has its own issues. It does not allow adequate scope for banks and promoters to work out a feasible plan in cases where problems have been caused by exogenous factors and banks judge that promoters are able and willing to do what it takes to restore projects to health.

Second, it leads to a sharp erosion in capital at banks. As a result, PSB stocks have been hammered down, rendering it difficult for banks to raise either equity or bonds from the market at a time when they are hard pressed to muster the capital needed to comply with Basel 3 norms. The larger market has also been dragged down. This worsens the equity position of borrowers too and makes it more difficult for bankers to make fresh loans.

Since the market will not provide the requisite capital to banks or will do so only at poor valuations, the onus for recapitalising banks falls to an even greater extent on the government. The key question, therefore, is how much of an appetite the government has for recapitalising banks, given its focus on not veering too far from the path of fiscal consolidation and its commitment to maintaining an equity stake in PSBs of over 50% in the near future.

Unless banks have an adequate buffer of capital over and above the regulatory minimum, we cannot expect credit and private investment to revive strongly. The fortunes of the Indian economy thus hinge to a large extent on how the government intends to address the recapitalisation issue at PSBs. One option that the government is exploring is creating a separate vehicle for infrastructure investment, which has hitherto been funded mainly by PSBs. This, however, will take a while to materialise and get going.

A proposal mooted in order to clean up bank balance sheets is the creation of a government-owned Bad Bank to which banks can hive off their NPAs. This does not solve the recapitalisation problem but it does facilitate a clean-up of books because the valuation of NPAs is not such an issue when the sale is being made to a government entity. Going by media reports, the RBI has reservations about a government-owned entity getting into asset recovery. Perhaps, it doubts whether an entity answerable to political masters will have the will to effect maximum recovery from corporates. Banks are subject to a measure of market discipline and hence are, perhaps, better placed to pursue recovery—and indeed there are some PSBs which have done a good job of it.

A third item in the news is the creation of a BBB which will make appointments of CEOs and independent directors to PSBs and also advise on bank strategies. Again going by media reports, this will have three government officials and three experts. Whatever the quality and stature of experts, the government is bound to have a decisive say in appointments. Perhaps an effective check is for the RBI to apply "fit and proper" criteria to appointments made by the BBB and to do so more stringently than it has been inclined to in the past. One must also doubt whether the rumoured presence of bankers from the private sector on the BBB is a good idea, given the possibilities for conflicts of interest.

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