A BOLD STEP IN BANK REFORM

With India's economic growth faltering in the last couple of years, the government has been casting about for ways to galvanise the economy. Last November, it tried demonetisation. It was a bold move but its economic benefits will be long in coming while the short-term disruption has been very real and demoralising. This year, it pushed through the goods and services tax (GST). Again, this is hugely positive over the medium term, but is painful in the short run.

Cheering the markets

The government seems to have realised that a simpler, more effective remedy is at hand: recapitalising public sector banks (PSBs) and enhancing the flow of credit. The proposal to recapitalise PSBs to the extent of ₹2.11 trillion (₹2.11 lakh crore) is a winner by any reckoning. It is, perhaps, the most effective way to provide a much-needed fiscal stimulus to the economy and revive growth. Small wonder that the markets have given the move a rapturous welcome.

To understand the significance of bank recapitalisation, we need a little primer on bank capital. Regulation requires that banks hold assets only in proportion to the capital they have. 'Capital' is a combination of equity, equity-like instruments and bonds. For a given balance sheet, there is a certain minimum of capital that banks must hold. This is called 'capital adequacy'. The higher the capital is above the regulatory minimum, the greater the freedom banks have to make loans. The closer bank capital is to the minimum, the less inclined banks are to lend. If capital falls below the regulatory minimum, banks cannot lend or face restrictions on lending.

When loans go bad and turn into non-performing assets (NPAs), banks have to make provisions for potential losses. This tends to erode bank capital and put the brakes on loan growth. That is precisely the situation PSBs have been facing since 2012-13.

'Stressed advances' (which represent non-performing loans as well as restructured loans) have risen from a little over 10% in 2012-13 to 15% in 2016-17. This has caused capital adequacy at PSBs to fall. Average capital at PSBs has fallen from over 13% in 2011-12 to 12.2% in 2016-17. The minimum capital required is 10.5%. An estimated 10 out of 20 PSBs have capital of just one percentage point above the minimum or less. Inadequate capital at PSBs has taken its toll on the flow of credit. Growth in credit has fallen below double digits over the last three years. Between 2009-10 and 2014-15, annual credit growth was in the range of 15-20%. In the 'India Shining' period of 2004-09, credit growth had been over 20%. Some observers ascribe the deceleration in credit growth to poor demand. They say that corporates have excessive debt and are in no position to finance any investment. This may be true of large corporates. However, it is not true of enterprises in general. One study, which covered over 4,000 companies, showed that the debt to equity ratio fell below 0.8 (which is a low level of debt) in 2008-09 and remained low until 2012-13. (J. Dennis Rajakumar, 'Are corporates overleveraged?', *Economic and Political Weekly*, October 31, 2015).

Moreover, demand for investment finance may have decelerated but demand for working capital remains strong. If anything, the introduction of GST has increased small business demand for working capital. Low growth in credit is confined to PSBs. Private banks have seen loan growth of 15% this year.

Evident since 2014

The government has realised that there is a problem with the supply of credit. It has to do with PSBs' inability to lend for want of adequate capital. The National Democratic Alliance (NDA) government should have recognised the problem when it assumed office in May 2014. At the time, stressed advances were already 10% of the total. The NDA government should have moved swiftly to recapitalise PSBs.

Instead, it chose to sweep the problem under the carpet. Market estimates had placed the requirement of government capital at a minimum of ₹2 lakh crore over a four-year period. In 2015, under the Indradhanush Plan, the government chose to commit a mere ₹70,000 crore over the period.

The dominant view in government at the time seemed to be that PSBs had messed up in a big way, so putting more capital into them was simply 'money down the drain'. Their role needed to be shrunk through consolidation or by selling strategic stakes to private investors.
This is a mistaken view. The bad loan problem at PSBs is not entirely the result of mismanagement. There have certainly been cases of malfeasance and poor appraisal of credit. However, as the Economic Survey of 2016-17 made clear, these are not responsible for the bulk of the NPA problem. The problem is overwhelmingly the result of factors extraneous to management.

PSBs, unlike their private sector counterparts, had lent heavily to infrastructure and other related sectors of the economy. Following the global financial crisis of 2007, sectors to which PSBs were exposed came to be impacted in ways that could not have been entirely foreseen. Blaming PSBs for the outcomes and starving them of capital was not the answer.

The failure to quickly recapitalise PSBs has adversely impacted the economy in many ways. First, it has come in the way of adequate supply of credit. Second, it has hindered the effective resolution of the NPA problem and kept major projects from going through to completion. Resolution requires banks to write-off a portion of their loans in order to render projects viable. They cannot do so if they see that write-offs will cause their capital to fall below the regulatory minimum. Third, corporates are stuck with high levels of debt and are unable to make fresh investments.

The government's move to recapitalise banks changes the picture. Of the ₹2.11 trillion package, ₹1.35 trillion will be towards issue of recapitalisation bonds. PSBs will subscribe to these bonds. The government will plough back the funds into banks as equity. Another ₹180 billion will be provided as budgetary support. The remaining ₹580 billion will be raised from the market. Analysts believe the package should enable banks to provide adequately for NPAs and support modest loan growth. Once PSBs have enough capital and are in a mood to lend, they can liquidate excess holding of government securities and use the cash to make more loans.

Analysts worry about the fiscal impact of the recapitalisation package. International norms allow borrowings for bank recapitalisation not to be counted towards the fiscal deficit. In the past, India has used this accounting fudge. The proposed recapitalisation bonds are likely to add to the fiscal deficit unless the government resorts to other fudges such as getting the Life Insurance Corporation of India or a separate holding company to issue the bonds. The government should not worry unduly about missing the fiscal deficit target of 3.2% of GDP. The markets will understand that the fiscal stimulus is well spent.

Getting the record straight

Analysts also fret over repeated bailouts of PSBs and the costs to the exchequer. They seem to think that bank bailouts have to do with government ownership and inefficiency and the answer is to privatise some of our PSBs. They couldn't be more wrong.

The overwhelming majority of bank systems worldwide are privately owned. And yet these systems are prone to periodic bouts of bank failures. The International Monetary Fund has documented 140 episodes of banking crises in 115 economies in the world in the period 1970-2011. The median cost of bank recapitalisation in these crises was 6.8% of GDP. India's cost of recapitalisation over a 20-year period is less than 1% of the average GDP during this period.

The Modi government has shown courage in opting for substantial recapitalisation of banks. This is not something that fits into the 'reform' mantra whereby private is good and public is bad. Reserve Bank of India Governor Urjit Patel has welcomed the move in effusive terms: "The Government of India's decisive package to restore the health of the Indian banking system is in the view of the [RBI] a monumental step forward in safeguarding the country's economic future." Indeed. The government's recapitalisation move promises to do more to quickly usher in 'acche din' than any other single measure it has initiated during its tenure.

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ROLE OF BANKING SECTOR IN BHARAT (RURAL INDIA)

Introduction

Indian Banking system had played an important role in the economic growth of India since 18th century. RBI is the main authority of public sector banks, private banks, financial and non financial institutions. Banking system is classified into scheduled bank and non scheduled bank.

Role of Banking Sector in Rural India

In this current scenario there are many rural areas where the people does not know about the schemes launched by the government of India. Banking sector is the best deliver channel to make the awareness of schemes to the educated and uneducated people in the rural area. In rural area 41% of the people having the normal saving account, who does not even know the technology developed in the banking sector through **mobile banking, ATM, credit card loan facilities, net banking** etc. Only 20% of the people in India have the knowledge about the technology development in banks.The greatest impact made by the banking sector in rural India are as follows.

- Wealth to farmers.
- Wealth to education system.
- Wealth to business people.
- Retail banking.

Wealth To Farmers

Bank announces various schemes to farmers to develop their financial status and economic growth of India in rural area. Bank provides the loan amount with low interest to develop the agriculture sector through farmers. In each and every bank they have the agricultural officers to guide the farmers regarding loan facilities and schemes provided by the bank.

Wealth To Education

Educational loan provided by the bank make the fantastic impact on low level and middle level people's children education. By this loan rural area people can give the good education level to their children. Education is one of the main development of the rural area made by the banking sector.

Wealth To Business

Mundra Bank is one of the crucial steps taken towards the development in the banking sector. Mundra bank is specially devoted for the micro units/small level business people. It gives loan to start and develop the business level for low and medium level people. **PRADHAN MATRI MUNDRA YOJANA** scheme is used to develop all micro units business development.

The schemes provided by Mundra Bank are

- Shishu covers loan amount upto 50000.
- Kishor covers loan amount upto 50000-5lakhs.
- Tarun covers loan amount upto 5lajh-10lakh.
- Mundra bank makes the milestone to the small level enterprises to enlarge their business activities.

Retail Banking

Retail banking which is known as consumer banking provides the services to individual consumers rather than companies. Through retail banking ATM, Saving Account, Debit and Credit card, Personal Loan, Home Loan etc are rural area people have access to the banking sector.

Conclusion

The major advantage of banking sector is ATM which provide debit and withdraw the cash amount in 24x7 manner. Still banking sector making the awareness to the people about Net banking, Mobile banking, credit card facilities, Business loans, Home loans, Personal loans, Mortgage loans through advertisement, campaign, making calls to customers, giving the booklet which covers the banking facilities etc..Banking sector is one of the way to convey the schemes to consumers and the consumers enjoying their available schemes introduced by government of India through banks. Banking sector making a fantastic growth of rural areas which in turn develop the economic growth of the country

Source : https://gradeup.co/role-of-banking-sector-in-bharat-rural-india-i-5849eeba-2407-11e6-9436-0466a6d2d7d5

CHARTING THE INDIAN BANKING SECTOR'S FUTURE

Recent bank consolidation debates often ignore the underlying challenges of India's banking industry structure

The Indian banking sector is at a critical juncture in its evolution. It is now clear that the slump in credit growth and increase in stressed assets has affected the profitability of all banks, and threatens the very survival of some of them.

State-owned banks account for more than three-fourths of the stressed asset load, which is now far higher than their net worth. Provision levels are inadequate, as the banks hold only 28% of gross non-performing assets and restructured assets, as provisions. There is a $110 billion gap between the stressed assets in the system and the provisions made. Shifts in consumer preferences, combined with changes in technology and regulations, have created a perfect storm. The way out will depend to a large extent on the speed and direction of stakeholder reactions.

The core challenge is that many of the public sector banks (PSBs) are undifferentiated, sub-scale, and with limited capabilities to be full universal banks. About 80% of them own only 25% of the assets. They also operate in virtually every market segment with very limited sector or vertical-focused specialization. In fact, they focus on the same customer segments, offer similar products, and very often compete only on price. Some of this is because PSBs face challenges that impede them from competing effectively. They have to shoulder a disproportionate share of social and nation-building obligations. Policies on compensation and human resources reduce management autonomy, and inhibit their ability to attract and manage talent.

The recent bank consolidation debates often ignore the underlying challenges of India's banking industry structure. While it is clear that an industry with over 20 undifferentiated, state-owned banks is not working, a country of India's scale and diversity needs more and varied banks. The industry plays a fundamental role in the delivery of social schemes which are critical at this stage of India's economic development.

Empirical evidence from bad-loan crises in other parts of the world suggests that resolution often coincides with a consolidation of the banks. To that extent, it is probably inevitable in India. However, our argument is that consolidation by itself is not enough. The perils of force-fitting state-owned institutions are well documented; a lasting solution will need to offer the banks more freedom with capital and talent. Targeting a robust "end-state" industry structure and thinking beyond consolidation, are necessary for this to happen. And even as consolidation happens, innovation from existing and new players need to be encouraged to serve the large and diverse needs of the country. If well executed, such a restructuring could catalyse a transformation of India's banking sector.

PSB reform is a complex issue and there could be several paths to building a robust industry structure. One option could be to continue the status quo, where the 21 PSBs (after the merger of State Bank of India with its associates and Bharatiya Mahila Bank) operate as before, but with greater autonomy for their boards. This option will have limited impact on improving the stability and performance of the system. A far more effective but disruptive option, would be to create mega-PSBs by consolidating entities into three or four players.

While this would enhance their performance, it would be extremely challenging to implement.

Given the ground realities, the target end-state of the industry could well be a hybrid approach, creating one or two global banks and two to three large national banks through mergers. This would ensure that India has three to five banks, each with sizeable global or national presence. These large banks would offer a full-range of commercial banking services to corporate, small and medium enterprises (SMEs), retail, mass banking and international customers. The remaining banks could continue under government ownership, but eschew lending to large corporates. They could specialize, with focus on select products or geographies, largely for retail and SME customers. Alternatively, they could shed their public ownership and chart a growth plan that best suits their expertise.

Identifying anchor banks for consolidation would be a logical first step to restructuring. The top three or four high-performing PSBs with sizeable scale (including international presence), better balance sheets, progressive management and global aspirations, could be the anchors. National-scale players could be anchored by PSBs with strong national or regional brands, a multi-state presence and stronger balance sheets than regional counterparts. Some regionally focused banks could be grown through mergers to bring them to national stature.

Restructuring of banks is a multi-year journey. Aligning the sequencing of the consolidation is essential for success. The first set of mergers could be initiated by global and national anchors. Each anchor could select one or more consolidation partner, based on expected benefits from the merger and the relative ease of implementation. How smoothly the mergers are implemented would depend largely on the capital requirement, level of digitization and technological-commonality among the banks. Banks could opt for a 12- to 18-month “smart merger”, prioritizing easier decisions, and stagger more complex ones. Selecting the right architecture is vital to the process. The choice of merger-architecture could well determine the speed of business and functional integration after the merger.

While consolidation is required to address the challenges, it is not a solution by itself. The merged entities will need more oxygen to survive and thrive. Capital infusion to address stressed assets challenges, building a motivated and capable leadership team to ensure successful integration, and forging strategic partnerships to build new capabilities are crucial for success. Many leading state-owned institutions have relied on partnerships with private institutions in the past (e.g. SBI Cards was launched through a joint venture between SBI and GE Capital). Bank consolidation could offer degrees of freedom to bring new capabilities.

Alongside the mergers, avenues for privatization need to be explored for at least a few PSBs. The Bank Investment Company (BIC) with a holding structure that provides greater autonomy to boards and reduces government shareholding to below 51% in select PSBs has been talked about earlier. Overall, rationalizing the PSB industry-structure is as essential as consolidation to make sure India’s banks are able to thrive in a tough environment.

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