Indian Financial Sector – A Commentary

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Introduction

After coming a long way from a financially repressive regime to a modern financial sector in the last three decades India is now on its trajectory towards attaining a financially inclusive regime through the adoption of innovative policies. Efforts are being made on a continuous basis to maintain stability of the financial system as a whole amidst the risks emanating from global and domestic factors.

Significant structural reforms in recent years include the roll-out of the Goods and Services Tax (GST) which was targeted at improving tax compliance and boosting investments, and demonetization which was aimed at curbing black money and tax evasion, mitigating terror-financing and counterfeiting. The Insolvency and Bankruptcy Code (IBC) introduced in 2016 is targeted at major overhaul to deal with distressed or failed businesses by developing a robust framework. It is likely to help in cleaning up bank balance sheets when the banking system is troubled with rising non-performing assets (NPAs). In recent times, SEBI has also introduced important reforms related to the primary market, delisting, takeovers, buy-backs, commodity derivatives as well as cyber security and cyber resilience that stock exchanges, clearing corporations and depositories are required to adopt.

Financial inclusion has been recognized to be crucial to achieve several of UN's Sustainable Development Goals. Providing a bank account to the majority of the population is considered to be significant in this respect. Under the Pradhan Mantri Jan-Dhan Yojana (PMJDY) scheme which ensures universal access to banking facilities, financial literacy, access to credit, insurance and pension facility, around 1 per cent of PMJDY account holders have been found to use overdraft facilities available to them, and 17 per cent of PMJDY accounts are "zero-balance", implying they are unutilized according to a report published in May 2018[1]. However the percentage of "zero-balance" accounts has declined from 25 per cent in 2016 and 75 per cent in 2014. As on August 22, 2018, while the number of total beneficiaries has been 32.48 crore, balance in the beneficiary accounts has been 81523.12 crore under the PMJDY scheme.

In line with the turnaround of the global economy in 2017, the domestic growth in India also started picking up during the second quarter of 2017-18. Exports in India grew at its fastest pace in 6 years

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[1]Business Standard, May 17, 2018. https://www.business-standard.com/article/finance/80-of-indians-now-have-a-bank-account-so-why-is-financial-inclusion-low-118051700150_1.html

due to the global growth momentum during 2017-18. Other encouraging signals of improvement include the decline in number and cost of stalled projects in the second quarter of 2017-18, the efforts made to improve the quality of government expenditure, improvement in the ease of doing business ranking, India's sovereign rating upgrade by Moody's and the bank recapitalisation announcement. For the first time ever, in 2018 India has jumped 30 positions to become the top 100th country in terms of ease of doing business ranking among 190 countries. However, the banking sector continues to face mounting challenges predominantly on account of asset quality concerns.

Of late, tightening of liquidity conditions in the developed markets, expansionary US fiscal policy and increase in the strength of US Dollar have started adversely affecting emerging market currencies, bonds and capital flows. In India, the conditions that helped in maintaining fiscal consolidation, controlling inflation and a benign current account deficit over the past few years are changing, thereby signaling caution. All these developments call for more vigilance over the financial system as a whole to maintain stability.

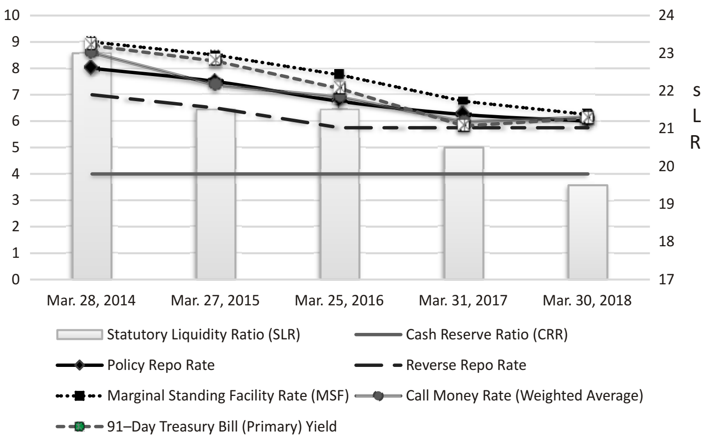
Past couple of years have witnessed intensive flows into investment avenues like mutual funds due to the creation of an enabling ecosystem by the regulators along with a serious government drive towards financialisation of savings. Moreover, demonetisation led to liquidity spurt which in turn resulted in unprecedented fund flows to both equity and debt mutual funds. Foreign portfolio investment flows into the capital market also continued to be buoyant with a greater preference for debt.

Money Market

The RBI has been trying to provide more operational flexibility to market participants and align money market rates with the stance of monetary policy. The monetary easing which commenced in 2012-13 continued till mid-July 2013. Exceptional monetary measures to address exchange market pressures were taken up between mid-July 2013 and September in the same year. The monetary policy turned exceedingly anti-inflationary commencing from September 2013. During 2014-15, the introduction of the revised liquidity management framework attempted at making liquidity management operations more flexible and transparent. It aimed at anchoring the weighted average call rate (WACR) at or closely aligned to the repo rate. A significant agreement was also signed between the Government of India and RBI to provide the formal architecture for conducting monetary policy operations consistent with flexible inflation targeting. Data pertaining to end-March over the past five financial years shows that all short term key interest rates have overall shown a declining trend reflecting easy liquidity in the system [Figure 1]. The 91-day Treasury bill yield has been increased to some extent in March 2018 as compared to March 2017.

In order to mop up the surge in liquidity in the banking system in the wake of demonetisation, the RBI took various measures like temporary imposition of 100 per cent incremental CRR on the increase in net demand and time liabilities (NDTL) between September 16, 2016 and

Figure 1: Movement of Key Policy Rates and Ratios (in per cent)

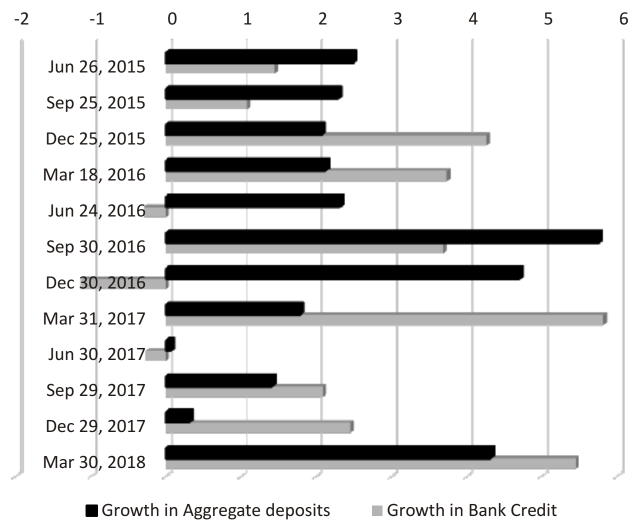


Source: RBI

November 11, 2016, issuance of cash management bills under Market Stabilisation Scheme and absorption through variable rate reverse repos of various tenures ranging from overnight to 91-days. The RBI shifted its monetary policy stance from accommodative to neutral in February 2017.

The recovery of the economy is reflected in the pick-up of deposit and credit growth in the banking system [Figure 2]. The aggregate deposits of the Scheduled Commercial Banks (SCBs) have risen over the past twelve quarters. During 2016-17, while growth in aggregate deposits (q-on-q) of SCBs picked up, bank credit growth remained comparatively sluggish, which picked up in 2017-18. The credit-deposit (C-D) ratio improved in March 2018 to 75.5 per cent as compared to 72.9 per cent in March 2017.

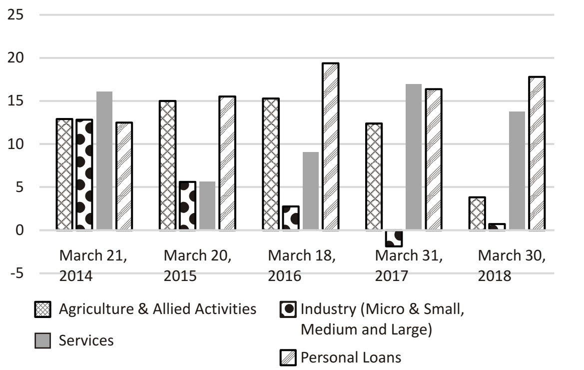
Figure 2: Growth in Deposit and Credit of SCBs (in per cent)



Source: RBI

Non-food credit that forms the bulk of bank credit is comprised of credit to various sectors of the economy, namely agriculture, industry, services and also personal loans. Year-on-year analysis of non-food bank credit pertaining to the month of March based on select SCBs shows that since 2015 till 2018 growth in non-food bank credit hovered around 8-9 per cent. Growth in credit to agriculture and allied activities declined drastically to 3.81 per cent in March 2018 as compared to 12.4 per cent a year ago, and around 15 per cent during March 2016 and March 2015 [Figure 3]. Growth in credit to industries declined from 12.84 per cent in March 2014 to just 0.73 per cent in March

Figure 3: Growth in Non-food Bank Credit for Major Sectors (in per cent)



Source: RBI

2018. However, credit to the services sector witnessed an impressive pick-up in growth since March 2017. Personal loans witnessed an impressive growth on average since March 2014.

Capital Market

The capital markets have seen phenomenal growth and significant changes in India over the last two decades. But the stock market participation on the part of the investors is still not very encouraging. The average daily turnover in BSE has grown from ₹2160 crore in January 2014 to ₹4784 crore in December 2017. Over the same period, average trade size and market capitalization have also shown significant growth, from ₹13,784 crore to ₹31,706 crore and ₹67,44,398 crore to ₹1,51,73,867 crore, respectively[2]. With a large informal sector the association between stock market and the economy is weak for India.

For India, according to World Bank data, market capitalization of listed domestic companies as percentage of GDP has been lower than the world over the years 2013-2017. It has been higher compared to the low-and-middle-income countries in East Asia and the Pacific and in Europe and Central Asia. It is also higher than South Asia [Table 1]. The turnover ratio of domestic shares[3] for India has been substantially lower compared to the world market. It is also much lower than the low-and-middle-income countries in East Asia and the Pacific and in Europe & Central Asia. It has been higher compared to South Asia.

Table 1: Stock Market Development Indicators

Country	Market capitalization of listed domestic companies (per cent of GDP)					Stocks traded, turnover ratio of domestic shares (in per cent)				
	2013	2014	2015	2016	2017	2013	2014	2015	2016	2017
East Asia & Pacific (excluding high income)	46.2	60.6	73.0	66.3	72.4	152.5	160.9	403.2	216.0	168.8
Europe & Central Asia (excluding high income)	28.5	19.5	25.6	36.5	34.6	68.0	72.8	79.8	60.0	55.0
South Asia	56.2	70.1	65.3	61.2	83.0	44.8	44.3	49.9	49.6	50.4
India	61.3	76.4	72.1	68.9	89.8	47.2	46.9	50.9	51.2	50.9
World	87.6	90.2	95.3	97.8	112.3	102.3	112.0	162.7	102.0	100.4

Source: World Development Indicators, World Bank, 2018.

A developed primary market brings together investors looking for investment opportunities and issuers willing to mobilize resources to

[2] SEBI Handbook, 2017

[3] The value of domestic shares traded divided by their market capitalization.

finance their businesses. The Indian primary markets have been buoyant for the past couple of years, due to the bull-run in the secondary markets. Fund raising through initial public offers (IPOs) hit an all-time high during 2017-18[4]. 43 companies raised a combined ₹805 billion through IPOs, beating its previous record nearly a decade ago. The money raised during FY18 is almost 5 times higher as compared to FY17, when 25 firms mobilised ₹282 billion during the year.

In the Indian primary market, capital raised during 2017 was to the tune of ₹1.6 lakh crore, 3.6 times the amount raised in 2016[5], backed by initial public offers (IPOs) and qualified institutional placements (QIP). The number of IPOs in the Indian market has increased from 38 in 2013-14 to 200 in 2017-18, while during the same period the values of IPOs raised recorded a rise from ₹12.4 billion to ₹838 billion. The amount raised under QIPs also has shown substantial increase, from ₹136.6 billion in 2013-14 to ₹673 billion in 2017-18[6].

Equity Market

On the back of recovery in the advanced economies and strengthened liquidity condition in the money market, major equity markets across the globe performed well. The global private equity industry raised a record US$452 billion from buy-out funds[7] alone at the end of 2017, providing US$1 trillion surplus to the global market. Asia Pacific-focused fund-raising levels recovered to reach approximately US$66 billion in 2017. The growth was fuelled by phenomenal growth in Indian equity market aided by Government regulations and tax breaks, launching of new asset classes like Alternative Investment Funds[8] and new laws on distressed asset management through Insolvency and Bankruptcy Code.

The annual returns of international indices based on yearly closing values reflect a clear declining trend in developed as well as emerging market economies since 2013 to 2015 with a significant recovery in 2016 and gradual improvement in 2017 [Figure 4]. Movement of India's two benchmark indices viz. Nifty 50 and BSE Sensex registered return at 10.2 per cent and at 11.3 per cent respectively at the year-end of 2017, making India one of the most attractive equity markets in emerging market economies after Brazil (32.8 per cent) and South Korea (14.0 per cent). For all other countries barring Brazil and South Korea, the annual return based on yearly closing values varied between -13.4 per cent (Brazil's IBOV in 2015) and 58.9 per cent (Japan's NKY in 2013),

[4]Business Standard, March 29, 2018. https://www.business-standard.com/article/markets/fund-raising-via-ipo-at-all-time-high-of-rs-805-bn-in-fy18-up-5-fold-y-oy-118032800260_1.html

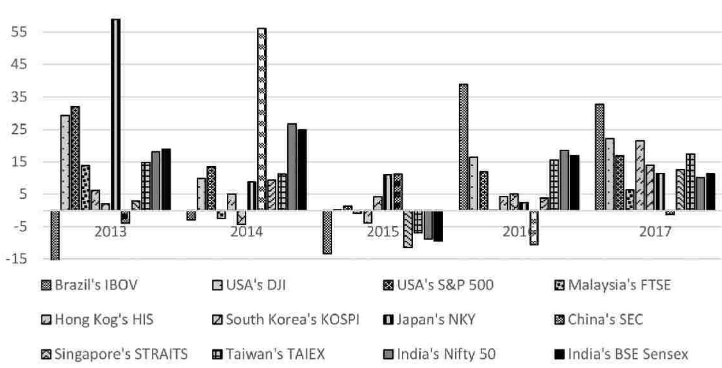
[5]Business Line, January 1, 2018, https://www.thehindubusinessline.com/markets/2017-robust-year-for-ipos-for-indian-primary-markets/article10007310.ece

[6]RBI Annual Report, 2017-18

[7]Buy-Out Fund is type of Private Equity Fund that specializes in acquiring other companies, making changes to boost profit and again sell them or taking them public

[8]Infrastructure Fund, Social Venture Fund, Venture Capital Fund, SME Fund etc.

Figure 4: Annualised Return of International Indices (in per cent)



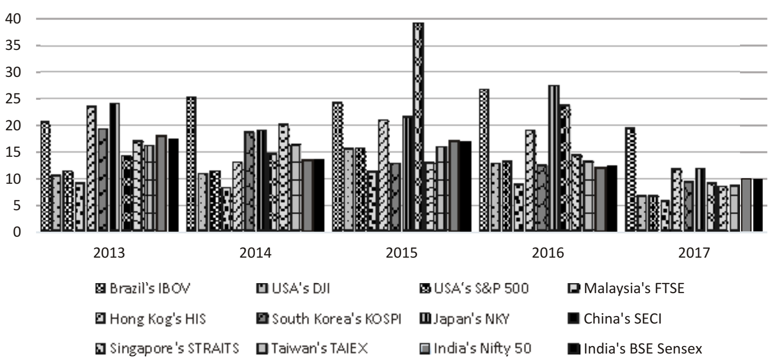
Source: SEBI, Note: For India only, it is financial year

during the period 2013 to 2017 while for India the range hovered between -9.4 per cent and 26.7 per cent during the same period (considering both the indices). The robust performance of Indian equity market was majorly driven by surge in Domestic Institutional Investment (DII) in 2017 specially in mutual fund industry where investment touched a record high of ₹1.15 lakh crore, the highest ever in a single year.

The annualized volatility of India's Nifty 50 and BSE Sensex has been on a declining trajectory for last five years, barring 2015 [Figure 5]. Notably almost all the major indices including USA's Dow Jones Index and S&P 500 have also shown an overall declining trend over last five years, except the year 2015. During 2013 to 2017, the annualized volatility of indices ranged between 5.75 per cent (Malaysia's FTSE in 2017) and 39.29 per cent (China's SECI in 2015) while for India the volatility was much low, varying between 10 per cent and 18.1 per cent during the same period (considering both the indices). In 2017, however, Brazilian IBOV (19.47 per cent) has shown the highest level of volatility amongst the major economies, which is reasonably high in comparison to its peer economies.

India's leading benchmark indices, viz. Nifty 50 and BSE Sensex have registered significant growth in the recent past. Not only the indices

Figure 5: Annualized Volatility of International Indices (in per cent)



Source: SEBI, Note: For India only, it is financial year

[9] Calculated as standard deviation of the logarithmic returns of the closing level of indices multiplied by the square root of no of trading days assumed to be 252, volatility estimates give an idea of the impact and duration of information shock in the market

have touched 10000 and 30000 marks, respectively during 2017-18, the price earning ratio (P/E ratio) for Nifty 50 also has increased from around 20 per cent on March 31, 2015 to around 25 per cent on March 31, 2018; during the same period, P/E ratio for BSE Sensex recorded an increase from 18 per cent to 23.3 per cent. An international comparison of P/E ratios at the end of 2017-18 indicate that Indian markets were comparatively priced higher among other emerging market economies as well as developed markets. In 2017-18, the P/E ratio of Nifty 50 and BSE Sensex stood at 24.7 and 22.5 respectively while Japan's Nikkei Index stood at 23.1, Brazil's IBOVESPA at 21.5 and USA's Dow Jones Industrial Index at 19.4. As of 2017-18, the stable movement of P/E ratio in the secondary market reflects the positive sentiment of investors. In synchronisation with the steady movement of P/E Ratio, the Price-Book Value Ratio (P/B Ratio) also remained stable, the P/B ratio for BSE Sensex remain unchanged at 3.0 at the end of 2017-18 compared to 2016-17 while for Nifty 50 it declined marginally from 3.5 to 3.4 during the same period[10].

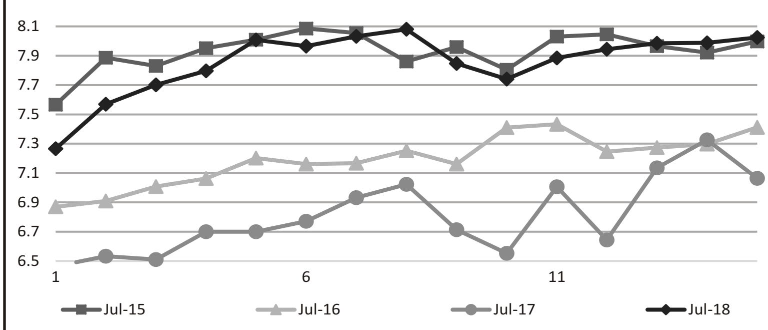
During the last six months, BSE Sensex has risen from around 34,000 in March 2018 to around 38,000 in September, 2018. However, the sentiment is dampened by factors like increase in world crude oil prices, persistent fall in rupee, widening current account deficit etc.

Bond Market

In 2018, domestic bond yields have hardened considerably over last few months due to volatile external factors such as rising oil prices and surge in US bond yields, falling rupee and a rise in fiscal and inflationary risks. In early September, the benchmark 10-year bond yield is hovering around 8.11 per cent, highest since November 2014. Trading in the bond market was significantly thin since May 2018. However, RBI's policy stance, the benchmark yield of 10 year G-Sec ranging comfortably between 7.75 per cent and 7.9 per cent and strengthened macro-stability helped the market to start its revival. The state-run banks, the largest holder of bonds, turned net buyers in the month of June and foreign investors also started buying since July for the first time after January 2018.

The yield curves for the Indian economy during last three years from 2015-16 to 2017-18 clearly point out decline in yields across all maturities, till July 2018 [Figure 6]. However, during July 2015, the yields ranged between 7.5 per cent to 8.1 per

Figure 6: Yield Curve in India (Maturity in Years)



Source: RBI

[10]SEBI

cent for 1 to 10 year bonds, while for the same maturities, yields came down to the range of 6.5 per cent to 7.1 per cent during July 2017. The spread between 1 and 5 year government securities stood at 20 basis points in July 2017, narrowing from 50 basis points two years back. However, yields across the spectrum started to harden after July 2017 owing to factors like rise in inflation in the face of oil price rise, loss of attractiveness of Indian bond returns as Indian rupee depreciated against Dollar while other Asian currencies have appreciated and the hardening of US bond yields. The yield curve for the economy has shifted entirely upwards with significant rise in yields across all maturities. However, yields have hardened more on the longer term compared to the shorter term, e.g. yield on 1-year government security has increased by 77 basis points whereas that on 5-year and 10-year securities increased by 131 and 114 basis points, respectively, between July 2017 and July 2018. Consequently, the spread between 1-year and 5-year government securities have widened to 74 basis points.

Though corporate bond market in India has witnessed a rapid growth in recent years, it still remains a limited source of funding as Indian firms heavily opt for bank credit. In 2017-18, the size of the market accounts for 17 per cent of GDP compared to equity market's share at 80 percent. A number of policy reforms have also been initiated to revive Indian corporate bond market including the launch of repo platforms by the BSE and NSE[11] for tripartite repurchase of corporate bonds, implementation of Insolvency and Bankruptcy code 2016[12], etc. According to the BIS, India's corporate debt-to-GDP ratio stood at 51 per cent in March 2016, compared to 72 percent in USA, 169 percent in China or global average of 95.6 percent. The total corporate bond issuance is highly fragmented in India as the bulk of the debt is raised through private placements[13]. Further, the market is bogged down with multiple challenges including low issuance leading to lack of liquidity in the secondary market, narrow investor base and high cost of trades which need to be addressed at the earliest.

Mutual Fund

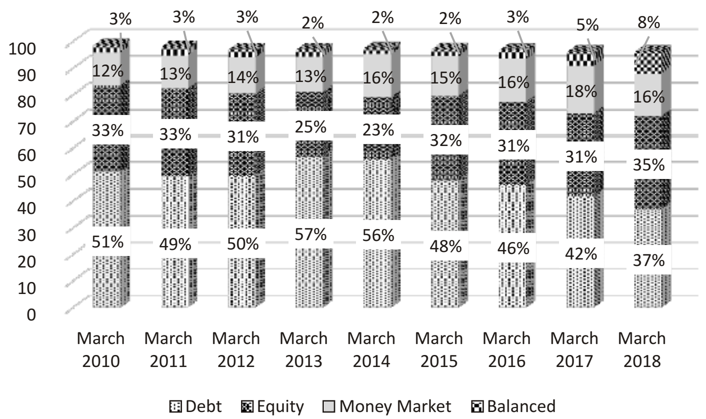
Significant participation from retail investors, robust inflow in equity mutual funds and extensive investor awareness campaign led to strong growth in Indian mutual funds (MFs) in the recent past. An interesting characteristics of Indian MFs is that debt schemes continued to comprise the majority of industry's Asset Under Management (AUM), contrary to the global trend. However, since 2015, increased demand for equity and money market funds have led to decline in the share of debt funds in the overall AUM. Factors such as favourable demographic profile, rising income levels, increasing financial

[11]It is a kind of repo contract where a third party called tri-party agent acts as an intermediary to facilitate services like collateral selection, payment and settlement, custody and management etc amongst buyers and sellers

[12]The law aims to consolidate the laws relating to insolvency of companies, limited liability entities, unlimited liability partnership and individuals into a single legislation and ensure an early identification of financial distress

[13]Private placement is capital raising event by selling directly to private investors rather than as a part of initial public offering

Figure 7: AUM across Asset Classes (in per cent)



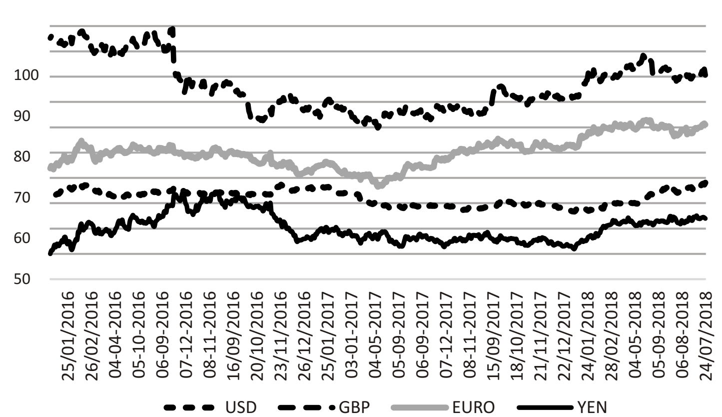
Source: AMFI

literacy and buoyancy in the capital market have contributed to such developments [Figure 7].

Forex Market

In the financial years 2016-17 and 2017-18, rupee remained robust against Dollar and Yen [Figure 8]. The appreciation in the value of rupee was driven by a number of factors. India stood strong on macro-economic fundamentals while recovery in growth helped gain momentum in foreign investment in Indian equities. The weakened Dollar provided a further boost to Indian rupee. Further, Indian political stability also provided a boost to investors' confidence. It is interesting to note that most of the emerging market currencies viz. South African Rand, Malaysian Ringgit, Chinese Renminbi and Russian Rouble strengthened against Dollar during this time period due to weak Dollar. The sound performance of rupee against Dollar seemed a bit volatile from the beginning of 2018. Increasing trade deficit, rising crude and gold prices and widening external debt pulled the rupee downwards. However, from the middle of 2017, Pound and Euro are getting stronger against Rupee reflecting the post-Brexit recovery of Euro as well as British Pound.

Figure 8: Exchange Rate of Rupee against Major Currencies



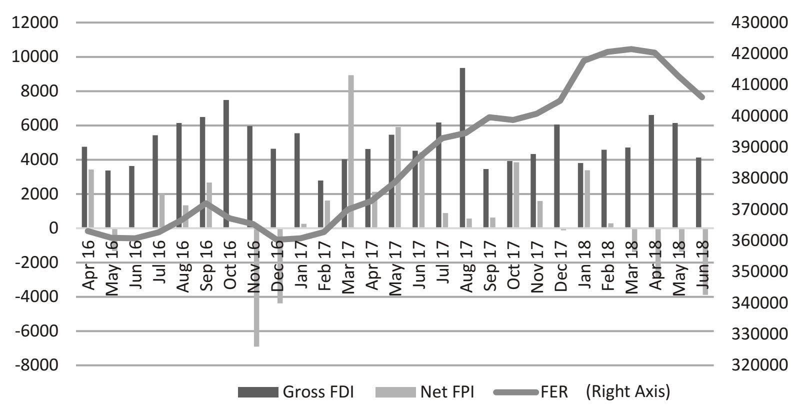
Source: RBI

Global investment has remained conducive in India. Strong macroeconomic fundamentals, favourable policy regime and robust business environment fuelled the steady growth of Foreign Direct Investment (FDI). India moved up 30 notches in one year to be at the 100th places in World Bank's "Ease of Doing Business" ranking in 2017-18. According to the Department of Industrial Policy and Promotion (DIPP), total FDI in India rose from US$45.14 billion in 2015-16 to US$60 billion in 2016-17 to US$ 61.96 billion in 2017-18 with services sector having the highest share (18 per cent), followed by Computer Software and Hardware (8per cent), Telecommunication (8per cent) and Construction Development(6 per cent). However, as per AT Kearney's FDI Confidence Index 2018, India was ranked 11th while it was ranked 8th in 2017 and 9th in 2016. The fall in India's ranking may be attributed to the temporary instability in domestic market occurred by demonetization initiative in 2016 and nationwide implementation of Goods and Services Tax in 2017.

Net Foreign Portfolio Investment (FPI) in the Indian securities market also remained positive and robust over last few years except for the year 2015-16 reflecting the confidence of global investors in stability and growth potential of Indian market. The net outflow of FPI in 2015-16 was driven by the negative sentiments amongst investors due to slowdown in China, rising apprehension over a rate hike by the US Federal Reserve and Indian tax authorities imposing taxes on capital gains of FPIs. However, in recent months the net outflow of FPI from India is observed owing to higher interest rates in the USA, a buoyant economy at US and the lowered return on Indian market due to depreciation of rupee against Dollar [Figure 9].

The build-up of foreign exchange (forex) reserves in India over the past few years can be explained primarily by an increase in foreign currency assets. The reserves touched a record high to cross the US$ 400 billion mark for the first time in September 2017 mainly due to huge inflows through foreign direct investments in projects and portfolio investment in capital market. India now holds the sixth position in forex reserve ranking while China leads the list with reserves of US$3053 billion. However, May 2018 onwards the FER started to decline due to RBI's policy interventions to strengthen Rupee. External factors like increase in crude prices, uncertainty in international trade scenario, and strengthening Dollar have created downward pressure on rupee and RBI intervened by selling US Dollar to support rupee. Concomitantly, import cover (in months), one significant trade-based indicator of foreign exchange reserve adequacy to absorb

Figure 9: Gross Foreign Direct Investment and Net Foreign Portfolio Investment in India (US$ Mn)



Source: RBI and IndiaStat

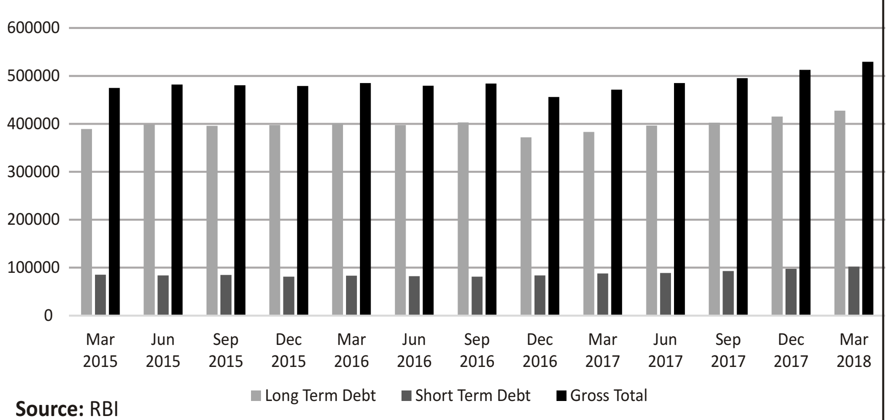
external shocks, has also started to register declining trend, from 11.3 months in March 2017 to 10.8 months in December 2017. However, India's forex reserve remains in a resilient position.

During the last three years, the external debt remained stable with a slight upward trend in 2018 [Figure 10]. The rise was due to consistent rise in External Commercial Borrowing (ECB), NRI deposits and short-term debt. Part of the increase in debt was also due to valuation loss resulting from the depreciation of US Dollar against major currencies. ECB, the largest component of external debt, accounted for 38.2 per cent at end March 2018, while NRI Deposit and Short Term Debt held 23.8 per cent and 19.2 per cent respectively. The other components of India's external debt were Multilaterals (10.8 per cent), Bilaterals (4.8 per cent), Trade Credit (1.78 per cent), IMF (1.09 per cent) and Rupee Debt (0.22 per cent). At end-March 2018, long-term borrowing comprised more than 80 per cent of India's external debt while the remaining 20 percent was short-term external debt. However, India continues to be among the less vulnerable countries in terms of external debt[14]. With continuing depreciation of rupee against Dollar and widening of current account deficit, external debt indicators show deteriorating trends. The debt-to-GDP share has increased from 20.2 percent in end-March 2017 to 20.5 percent in end March 2018 while the foreign exchange reserve–to-total debt increased from 78.5 per cent in 2016-17 to 80.2 percent in 2017-18.

The Banking Sector

The asset quality of banks, especially the public sector banks (PSBs), has been eroding sharply, necessitating ample provisioning and reduction in level of debt in recent times. This has led to adversely affecting their lending capacity, profitability and capital positions. An increased inclination of businesses shifting towards alternative and more cost-effective sources to meet their financing needs has thereby been witnessed. The banking sector is facing several challenges as it attempts to tackle asset quality concerns as well as

Figure 10: External Debt of India (US$ Mn)



Source: RBI

[14]World Bank, International Debt Statistics, 2018

conform to the convergence with Basel III and international accounting standards simultaneously.

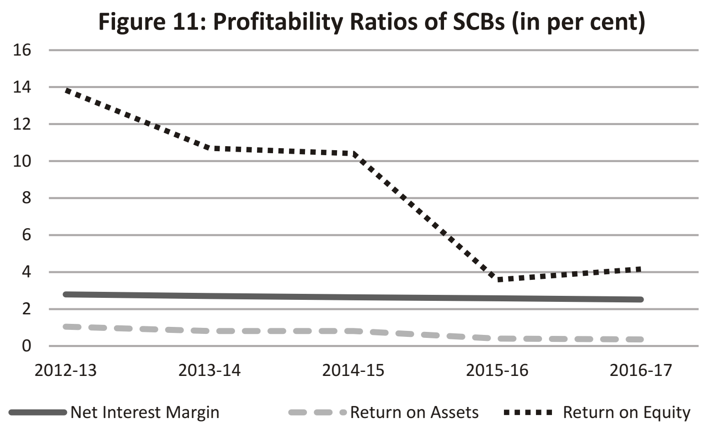
On the regulatory front, the enactment of Insolvency and Bankruptcy Code (IBC), 2016 and promulgation of the Banking Regulation (Amendment) Act, 2017 have been aimed at reduction of stress on balance sheets of banks. Banks can take the advantage of IBC to remain competitive. Instead of awaiting regulatory instructions, banks can now file for insolvency proceedings on their own for the realization of the best value for their assets in a prompt manner. Banks also need to fortify their due diligence, credit evaluation and post-sanction loan monitoring to minimize risks. Capital, asset quality, profitability and leverage are again the key areas for monitoring under the revised prompt corrective action (PCA) framework introduced by RBI with effect from April, 2017. The RBI thus endeavours to strengthen the regulatory framework through significant policy interventions. Recently, the banking regulators are also emphasizing on the full implementation of Basel III norms. Furthermore, the SCBs, excluding regional rural banks were required to implement Indian Accounting Standard from April, 2018 which has been deferred by a year.

The technology-enabled innovations and the growth of crypto currencies are presenting both opportunities and challenges for the banking sector as a whole. Creation of a less-cash economy depends on the security of financial transactions supported by a strong cyber-security framework. The banks are therefore advised to improve their security issues on a continual basis. Finally, the banks and other financial institutions can benefit each other by improving their corporate governance in the increasingly interrelated financial system.

Demonetisation had an unprecedented impact on the banking system in the country. With banks crediting the accounts of the depositors with the value of surrendered demonetised bank notes, CASA (Current Account Savings Account) deposits of banks increased steeply. With weak credit demand, term deposit rates were reduced significantly towards end-December 2016/early-January 2017. Surplus liquidity, feeble credit demand, lower cost of term deposits and sharp rise in low cost CASA deposits compelled banks to declare a large cut in their Marginal Cost of Funds Based Lending Rate (MCLRs) in January 2017. Since demonetization in November 2016, 50 million new accounts were opened under PMJDY by October 2017. Digital banking got an impetus with private sector banks taking the lead with innovative technology and government support to ensure that transactions move online.

Profitability

In terms of profitability, Return on Equity (ROE) of SCBs has demonstrated an overall sharp declining trend during the period 2012-13 till 2015-16 [Figure 11]. There has been a slight improvement in the ratio during 2016-17. The SCBs recorded lower Return on Assets (ROA) during the period 2012-13 to 2016-17. ROA has revealed a declining trend over these years. The net interest margin (NIM) has been more or less consistent during the same period. During 2016-17 interest income growth for the SCBs was



Source: RBI

RBI's sensitivity analysis shows that any severe shock to the gross non-performing assets (GNPA) ratio could bring down the CRAR of around 21 banks, mostly PSBs, below 9 per cent by March 2019.

Non-Performing Assets (NPAs)

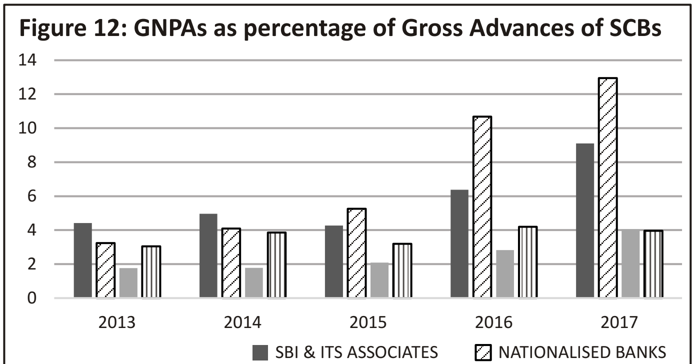
The Indian banking sector is beleaguered with the stress from the rising NPAs. GNPAs as percentage of gross advances has overall shown a rising trend for the SCBs over the last 5 years. [Figure 12]. The rise has been quite sharp for State Bank and its associates and the nationalized banks. The profitability of SCBs declined, partly due to enhanced provisioning. This in turn has added pressure on SCBs' regulatory capital ratios. The GNPA ratio of banks is expected to rise to 12.2 per cent by March 2019 from 11.6 per cent in March 2018 if same economic conditions prevail.

In the context of GNPAs as a percentage of Gross Advances pertaining to the domestic banks for priority and non-priority sectors, it has been

restrained by subdued credit growth and rise in non-performing assets (NPAs). Interest expended demonstrated a trivial growth due to the surge in low cost funding from CASA deposits because of demonetisation and the sluggish transmission of policy rate cuts. Nonetheless, with the introduction of the MCLR since April 2016 banks seemed to have tweaked their spreads over the MCLR aiming at maintaining their NIM.

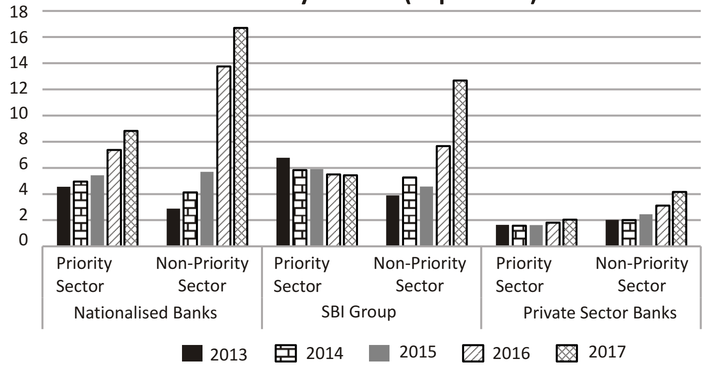
Soundness

Basel III capital requirements have provided a major thrust to the banking system to scale up capital to risk-weighted assets ratio (CRAR) in order to promote financial stability and efficiency in economic systems. The CRAR for SCBs improved from 13.4 per cent to 13.6 per cent between September 2016 and March 2017 due to the improvement in capital adequacy of private and foreign banks.



Source: RBI

Figure 13: NPAs of Domestic Banks by Priority and Non-Priority Sectors (in per cent)

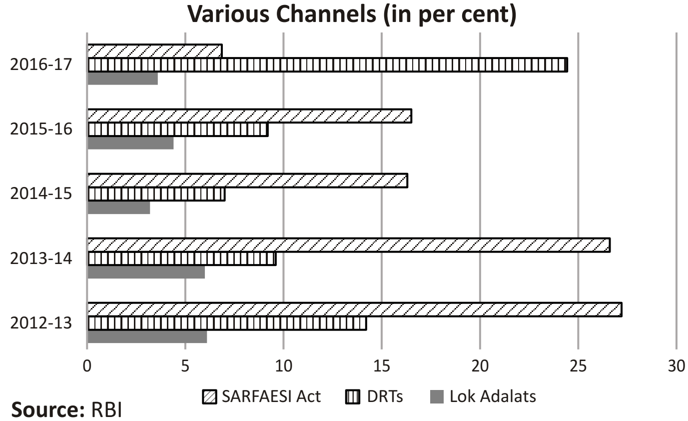


Source: RBI

found that for the nationalized banks the percentage for both sectors has risen consistently over the years 2013 to 2017, the rise being sharper for the non-priority sector [Figure 13]. For the SBI group, while the percentage for the priority sector has overall fallen, the percentage has risen drastically for the non-priority sector. For the private sector banks, interestingly the ratio of GNPA to gross advances has been quite low for both the sectors. However the share of GNPA in gross advances has risen over these years to some extent. Percentage of NPAs recovered through existing legal recovery channels, namely, Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act (SARFAESI Act 2002), Debts Recovery Tribunals (DRTs) and Lok Adalats, out of the total amount involved has degenerated from 22 per cent in 2012-13 to 10 per cent in 2016-17 [Figure 14]. Amount recovered has been on average the maximum through the SARFAESI Act over the past five years. But in 2016-17 the highest recovery took place through DRTs at 24 per cent, up from just 9 per cent in 2015-16, and this is attributed to the opening of new tribunals, strengthening existing infrastructure and computerised processing of court cases. Banks are now largely been focusing on NPA recovery through resolution under the IBC. The law stresses on time bound resolution allowing a maximum of 270 days for resolution or the defaulting company goes into liquidation.

The spate of frauds exposed recently in the Indian banking sector are again adding to the woes of the sector already laden with the mounting toxic loans. In February 2018, the $2 billion scam at Punjab National Bank, one of the country's largest public sector banks is the biggest ever

Figure 14: NPAs of SCBs Recovered through Various Channels (in per cent)



Source: RBI

banking scam in the country. In June 2018, the state-run Bank of Maharashtra (BoM) and in April, 2018, UCO Bank were also accused of committing fraud. According to RBI, 8,670 cases of fraudalent loans totalling ₹61,260 crore have been reported by state-run banks over 5 financial years up to March 31, 2017[15]. Business sentiments thus have been severely hit in the wake of such alleged frauds.

Conclusion

According to the World Bank, while growth in emerging market and developing economies overall is anticipated to strengthen in 2018 and more so a year later, there is an increased possibility of muddled financial market volatility posing enormous risks[16]. A rise in the spillover risk from advanced to emerging markets is claimed by the latest RBI financial stability report. However, the recent policy initiatives undertaken in India strengthened the underlying regulatory and institutional framework of the financial sector and helped maintaining stability in the financial system as a whole. According to a RBI survey, banks' asset quality deterioration, risk on account of extra capital requirement and cyber risk are now perceived as high risk factors for the sector. Regulatory initiatives have also been taken recently in the insurance and the pension sectors. While initiatives in the insurance sector is targeted at broad-basing the investor base, those taken for the pension sector aim at rationalising requirements for appointment as Retirement Advisors, along with easing partial withdrawal demands from pension investors.

Availability of credit continues to be a major roadblock for a vast majority of the population, especially for the unbanked segments[17]. The major deterrent to solve the issue has been the lack of tangible data to help the credit bureaus put together better underwriting models for these unbanked clienteles. Nonetheless, the rise of unique credit models backed by increasing data availability is establishing a new paradigm for lenders.

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