Indian Banking Industry

Sustaining Growth with Equity

The Associated Chambers of Commerce and Industry of India

Message from ASSOCHAM

The Indian banking sector has been one of the strongest pillars supporting the Indian economy in these challenging times. As the pace of integration of the Indian economy with the world economy increases, several new challenges emerge. The need to strengthen the banking sector has become all the more important and urgent. Since the majority of Indian population lives in rural areas, it is becoming increasingly important to bring this segment into the fold of the formal financial sector. This segment not only presents a good business opportunity but is also important for achieving inclusive growth.

Social banking and financial inclusion present a significant challenge and a unique opportunity to build a broad based and stable financial system. This will not only contribute to growth in the real sector but also to the overall economic prosperity of the masses.

Keeping this in mind ASSOCHAM in partnership with Resurgent India has come out with a background paper to generate healthy discussion on issues & challenges that need to be effectively addressed for strengthening the Indian banking sector. This paper exhaustively deals with the challenges while addressing the gaps that persist in this prominent segment.

We firmly believe that this would be a very good reference book for all the stake holders. We acknowledge the efforts made by Resurgent India Team and ASSOCHAM Team in bring out this well researched paper. Any suggestions / comments are welcome.

D. S. Rawat
Secretary General
ASSOCHAM

New Delhi
16th September, 2013

Message from Resurgent

India Banking Industry, despite serving the second most populated country in the world, reaches only half of the country's household. Further, the problems faced by the sector include raising NPA, implementing Financial Inclusion, capital adequacy and many others. However on the brighter side, the rising consumerism from the emerging 'middle' India and the higher purchasing power in rural India on account of rising employment provides opportunities for banks to look beyond the traditional customer segments. Further, banks should design flexible operating modules that would make sure that it is beneficial for the customers and bank as well.

Going ahead, financial inclusion is on promoting sustainable development and generating employment for a vast majority of the population especially in the rural areas. It has been made an integral part of the banking sector policy in India. RBI is pushing financial inclusion in a mission mode through a combination of strategies ranging from relaxation of regulatory guidelines, provision of innovative products, encouraging use of technology and other supportive measures for achieving sustainable and scalable financial inclusion. Financial inclusion is the gateway for achieving inclusive growth in India.

In this research work we have put together various aspects such as trends, opportunities, growth drivers, significant innovations and many more. We hope this Research Paper serves as an useful reference for all the stakeholders.

Jyoti Prakash Gadia
Managing Director/CEO
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New Delhi
16th September, 2013

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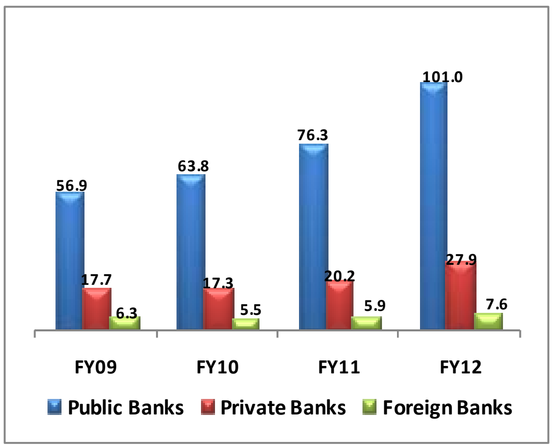
The Indian banking sector has emerged as one of the strongest drivers of India's economic growth. The Indian banking industry has attained phenomenal advancement during the last few years, despite its global counterpart struggling with financial meltdown. India's economic development and financial sector liberalization have led to a transformation of the Indian banking sector over the past two decades.

In the near future, the Indian banking industry is expected to see consolidation in the wake of future economic growth, changes in banking regulations and increase in competition from foreign banks. Further, technological innovation and especially mobile banking have paved the way for dramatic growth in the industry in the coming years.

Interest income growth in Indian banking sector (USD mn)



The growth story of banking during the last decade has been spectacular and beyond the consistent double digit growth. The key trends were strong regulatory framework, use of multiple channels and technology; strong customer oriented banking services and a growing economy. Although the past couple of years have witnessed a slowdown in the face of high domestic inflation, depreciation of the rupee and the after-math of the crisis in US and Europe, the sector still performs better in India as compared to developing countries in terms of growth, profitability, capital adequacy and asset quality etc.

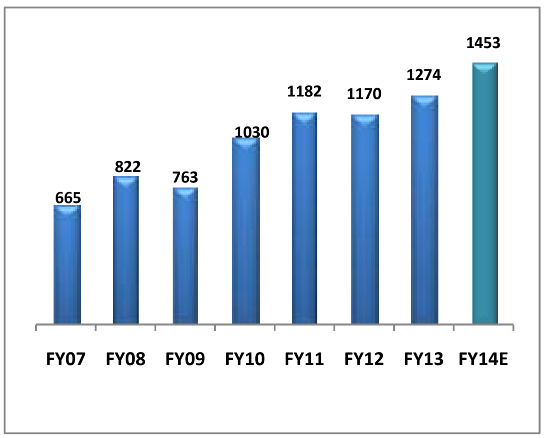
Further, the future seems to be promising despite a series of challenges like the overall slowdown in the economy impacting credit growth, deteriorating asset quality and rising NPAs, accompanying financial inclusion and Basel III implementation are all lingering issues, the sector is well cushioned with factors like a positive demographic dividend, increasing investment in infrastructure, innovation in technology and most importantly constructive regulatory policies.

Indian Banks' total asset size is recorded at US$ 1.5 trillion in FY12 and is expected to reach US$ 28.5 trillion by 2025.

Further, assets of public sector banks grew at an average of 7.5%, while Private sector expanded at a CAGR of 11.3% and foreign banks posted a growth of 6.7%. Increase in working population and growing disposable incomes will increase the demand for banking and related services. Housing and personal finance are expected to remain key demand drivers.

Currently, there are 87 scheduled commercial banks with deposits worth Rs.71.6 trillion (US$ 1.21 trillion) as on 31 May, 2013. Of this, 26 are public sector banks, which accounts for 73% of interest income in the sector. Besides, 20 are private banks and 41 are foreign banks. Of the total, 41 banks are listed with a total market capitalization of Rs.9.35 trillion (US$ 158.16 mn) as per the recent statistics.

Trends in Deposits during FY07-FY14E (USD mn)



Credit off-take has registered impressive growth during the past decade, aided by strong economic growth, rising disposable incomes, increasing consumerism and easier access to credit. During FY06–13, credit off-take expanded at a CAGR of 22.8% to US$ 991 mn. Total credit off-take is estimated to grow to US$ 1,140 mn in FY14. Demand has grown for both corporate and retail loans.

Currently, Private Banks are focusing on the faster growing retail loans and also improving the growth rate in fee income by increasing transaction fees. Whereas, Public Sector Banks are emphasising on higher recoveries and upgrades in Non Performing Loans (NPL) and also improving their deposits mix by reducing the share of bulk deposits.

However, despite the global financial crisis, net non-performing assets (NPA) of Indian banking sector have shrunk during the past few years, even though the net NPA levels increased to 1.28% in FY12 from 0.97% in FY11, it is relatively stable.

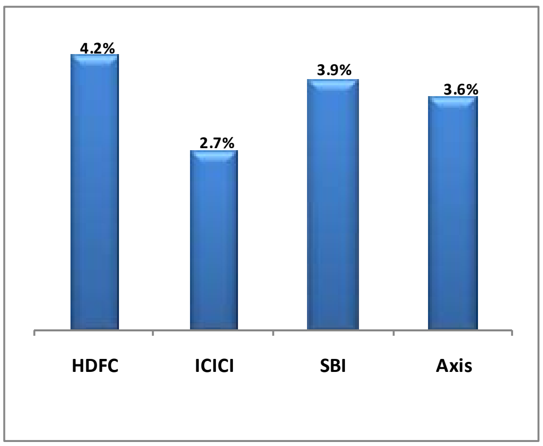
Total deposits have grown at a compound annual growth rate (CAGR) of 21.2% during FY06-13; in FY13 total deposits stood at US$ 1,274.3 mn. On the technological front, the sector has facilities such as mobile banking; internet banking and extension of ATM stations are expected to improve operational efficiency. Total number of ATMs in

India has increased to 104,500 now and is expected to double over the next two years.

Deposit growth has resulted due to strong growth in savings amid rising disposable income levels. Further, access to the banking system has also improved over the years due to continuous government initiatives; at the same time India's banking sector has remained stable despite global upheavals, thereby retaining public confidence over the years.

Net Interest Margin (NIM) upward trend continues: Scheduled Commercial Banks registered a NIM of 2.9% in FY12, as compared to 2.6% in FY08. Foreign banks, State Bank of India & its associates as well as private sector banks posted higher NIM at 4%, 3.2% and 3.1% respectively in FY12. Further, Indian banking Industry enjoys healthy net interest margins (NIM) as against its global counterparts. Private Banks have emerged as leaders, in terms of NIM, whereas on global front US banks have NIM's comparable to Indian peers, despite virtually zero cost funds.

Net Interest Margins (FY12)



Income from other source on positive trend: Public sector banks contribute for 59% of other income, i.e income other than from interest. Further, other income of public sector banks has increased at a CAGR of 5.7% during FY09-12. Overall, other income for the sector has grown at a CAGR of 4.5% during FY09-12.

Mobile Banking: A breakthrough innovation: After achieving success in online banking, mobile banking is the next revolutionary step which has attracted huge attention among the customers. Further, Mobile banking can perform all the banking functions such as money transfer, credit card payment, bill payment, account updates and other transactions. On an average, there are about 3 lakh transactions per day through mobile banking and some of the big banks have witnessed a 100% increase in mobile banking with more services likely to be introduced in the near future.

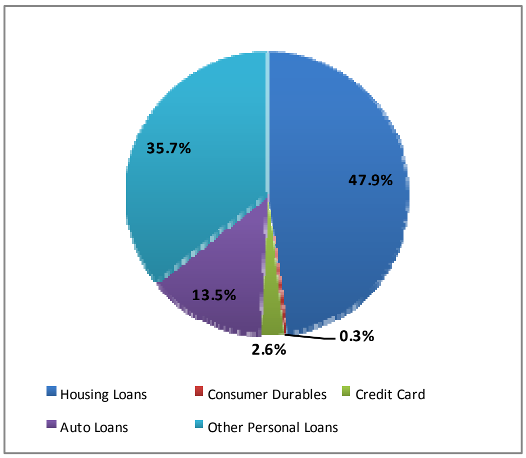
Many customer segments are finding it very useful using mobile banking. It is mostly preferred by customers in the age group of 18-32, who are more likely to adopt mobile banking than older users. Overall the growth in mobile banking that has taken place in the country till date, though at a great pace, but is yet to reach the critical mass that will enable it to deliver on its promise of taking banking, including payment services, at a cheaper, secure and seamless manner to the existing and potential customers.

Products offered by Indian Banks:

Retail Banking:

- Retail banking is a buzzword in India that focuses strictly on the consumer market
- Most banks have retail portfolios as part of their total lending portfolio (18.4% on average).
- This segment has been growing at a high rate of 30-35% per annum
- As per a survey, Consumer credit penetration is only 8% of the GDP in India, thus offering huge potential for further growth
- The growth is mainly led by growth in credit card receivables and other personal loans
- Housing loans continued to constitute almost half of the total retail Portfolio of Banks

Retail portfolio of Indian Banks (FY12)



Wholesale Banking:

- Wholesale banking provides services to large corporate bodies, mid-sized companies, international trade, other banks and financial Institutions
- This segment accounts for around 30% of India's total banking revenues, with ROE in the range of 15-30%
- From US$16 mn in FY 2010, wholesale banking revenues are expected to rise to a whopping US $40 mn by FY 2015
- Besides large corporate, huge number of SMEs also offer huge opportunity for this segment

Treasury Management:

- The core function of a treasury is of measuring, monitoring, and controlling of interest rate risk (IRR). For this banks would need various standard and proprietary models to measure this risk
- Traditionally, the treasury function in banks was limited to management of funds to meet the day-to-day requirements and deploying surplus funds from operations
- The scope of treasury has now expanded beyond liquidity management and it has now evolved as a profit centre with its own trading and investment activity
- Treasury activity in a bank depends on its size, complexity of operations, and risk profile

Indian Banking space is witnessing diversification in revenue stream and also has known the importance of technological innovation, because of which more and more banks are increasing its investment in improving technology.

Recent trends in Banking Industry:

Improved risk management practices: Indian banks are increasingly focusing on adopting integrated approach to risk management and have already embraced the international banking supervision accord of Basel II; interestingly, according to RBI, majority of the banks already meet capital requirements of Basel III. Further, most of the banks have drawn a framework for asset-liability match, credit and derivatives risk management.

Diversification of revenue stream: Banks are emphasizing on diversifying the source of revenue stream to protect themselves from interest rate cycle and its impact on interest income. Focusing on increasing fee and fund based income by launching plethora of new asset management, wealth management and treasury products

Technological Improvement: Indian banks, including public sector banks are aggressively emphasizing on improving the technological aspect of operation to enhance customer experience and gain competitive advantage. Further, internet and mobile banking are becoming popular among the customers. Further, Customer Relationship Management (CRM) and data warehousing will drive the next wave of technology in banks.

Focus on Financial Inclusion: RBI has asked banks to focus on spreading the reach of banking services to the un-banked population of India. With this regard, players are stretching their branch network in the rural areas to capture the new business opportunity.

The main focus area of Indian Banks has been Financial Inclusion, Consolidation and Increase use of Internet Banking. This signifies the changing attitude of the bankers to reach more and more customers and simultaneously provide better services.

Derivatives and risk management products: In a changing business scenario and financial sophistication which has increased the need for customized exotic financial products, Banking firms are developing Innovative financial products and advanced risk management methods to capture the market share.

Consolidation: As foreign banks ventured into Indian scenario, competition has intensified and banks are increasingly looking at consolidation to derive greater benefits such as enhanced synergy, cost take-outs from economies of scale, organizational efficiency, and diversification of risks.

Wide usability of RTGS and NEFT: Real Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT) are being implemented by Indian banks for fund transaction and have been well received by the consumers as it saves time and energy on their part. Further, regulatory body, Securities Exchange Board of India (SEBI) has included NEFT and RTGS payment system to the existing list of methods that a company can use for payment of dividend or other cash benefits to their shareholders and investors. Further, wide scope and ease of online banking has led to a paradigm shift from traditional branch banking to net banking. The total customers using net banking has increased to 7% in 2012. Besides, extensions of facilities such as fund transfer, account maintenance and bill payment at ATM stations have reduced branch banking footfall.

Challenges:

The main problem faced by Indian Banks is that, half of the population has no access to formal banking facilities. However, this challenge is blessing in disguise and also offer huge opportunity to explore untouched market.

Developing countries like India, still has a huge number of people who do not have access to banking services due to scattered and fragmented locations. But if we talk about those people who are availing banking services, their expectations are raising as the level of services are increasing due to the emergence of Information Technology and competition. Since, foreign banks are playing in Indian market, the number of services offered has increased and banks have laid emphasis on meeting the customer expectations.

Now, the existing situation has created various challenges and opportunities for Indian Commercial Banks. In order to encounter the general scenario of banking industry we need to understand the challenges and opportunities lying with banking industry of India.

Introduction of Basel-III Norms: As per Basel- III norms, Indian Banks will have to bring in an additional capital of Rs. 5 lakhs crore to meet the Basel III norms. The government on its part has to infuse Rs. 90,000 crore into the state-run banks to maintain majority shareholding as per the Basel III. Further, this norm will be implemented in a phased manner starting from January 2013 and to be implemented to the fullest by March 2018

Intensifying Competition: Intense competition due to a large number of players in the banking industry and other players such as NBFCs (less regulation) has resulted in reducing market share of the existing banks.

Increasing NPA: Economic slow-down and aggressive lending by the banks has turned loans into non- performing assets and thus impacting the profitability of the banks as they are required to have higher provisioning amounts.

Licensing requirement: For setting up of a banking business in India, a banking license from the RBI has to be acquired which has served as an associated protocol and formalities. The requirements are so stringent that the last licenses issued were to Kotak Mahindra Bank and Yes Bank in 2003 and 2004 respectively.

Opportunities:

Opportunities for the banks in India, include increase in outstanding mortgages, rapid growth in branches and ATM, Mobile Banking, Infra Financing and SME Finance.

Mortgages to cross Rs 40 lakh crores by 2020: The total mortgages in the books of banks have grown from 1.5% to more than 10% of the total bank advances/loans in the last period of 10 years. The total ratio of outstanding mortgages, including the Housing Finance Companies to the GDP is 10%. Further, as per a survey, by 2020, this ratio were to reach 20%, a number similar to that of China, then the mortgage industry can be expected to grow at an average rate of over 20% during the next decade. The outstanding mortgages are expected to cross Rs. 40 lakh crores by 2020

Wealth management to boost the growth: Further, wealth is expected to get further concentrated in the hands of a few. The top band of income distribution is expected to grow most rapidly over the next decade. By the end of this decade, the top 5% house-holds, predominantly residing in the metros and Tier I cities, will account for 30% of the total disposable income. In such a situation, wealth management services will be an integral part of the product portfolio for both private as well as public sector banks.

Rapid growth of branches and ATMs: India's penetration rate of branches and ATMs is very low as compared to other developed and developing nations. Currently there are 85 ATMs for one mn population, i.e. 1,04,500. Further, the ATMs are expected to grow and double their number in the next two years. As such, most of the new ATMs, 50-65 % will be deployed in tier 2 and 3 cities, while tier 1 cities will grow at around 20%.

Mobile banking to grow exponentially: The Internet is widely used by all banking segments around the world to purchase financial services products. Further, by 2015, it is estimated that the mobile banking transaction volume worldwide will reach US$500 mn. and on domestic front, mobile banking transactions are expected to result in a cost savings of US$ 22 mn (Rs 1,100 crore).

Nearly 35% of the Indian population has a median age of 25.5 years which signifies that India will gain from its demographic dividend. Besides, India also has a strong population of High Net worth Individuals (HNWI)

Infrastructure financing: Currently, Banking sector is the major financer for the infrastructure in India, accounting for more than half of the funding of this segment. Further, to sustain India's economic growth, the Planning Commission envisages that $1 trillion (about 10% of GDP) will be spent on infrastructure during the 12th plan from 2012 to 2017, thus providing huge opportunity for banking industry.

New Models to serve the Small & Medium Enterprises (SME): As per a survey, large customers in banking segment are more satisfied than the medium and small sized ones. Due to higher risk and lower ticket size, SMEs typically get less attention. This provides the opportunity to create innovative models to serve SMEs with sufficient and timely credit at the right price.

Growth Drivers:

Economic and demographic drivers:

- Favourable demographics and rising income levels
- The sector will benefit from structural economic stability and continued credibility of Monetary Policy
- Growth in infrastructure, industry, services and agriculture is expected to grow corporate credit in the economy
- Nearly 35% of the Indian population has a median age of 25.5 years which signifies that India will gain from its demographic dividend
- India not only enjoys a favourable demographic dividend but also has a strong population of High Net worth Individuals (HNWI)

Policy Support:

- Extension of interest subsidy to low cost home buyers
- Simplifying of KYC norms, introduction of no-frills accounts and Kisan Credit Cards to increase rural banking penetration
- RBI is considering giving more licenses to private sector players to increase banking penetration

40% of the population lack access to the simplest kind of formal financial services. With this regard, the RBI mandated banks to allocate at least 25% of the total number of branches proposed to be opened during a year in unbanked rural centres.

Financial Inclusion:

- In India, 40% of the population lack access to the simplest kind of formal financial services. With this regard, the RBI mandated banks to allocate at least 25% of the total number of branches proposed to be opened during a year in unbanked rural centers
- Banks considering Financial Inclusion as a banking opportunity rather than a Regulatory obligation are likely to see long term profitable growth and a cushion against market volatility

Technology Innovation:

- Innovation in banking services such as ATM, internet banking, mobile banking have increased productivity and helped in acquiring new customers
- As per estimates, currently banks spend around 15% of the total expenditure on technology.
- Technological innovation will not only help to improve products and services but also to reach out to the masses in cost effective way

The Micro, Small and Medium Enterprises (MSMEs) play a pivotal role in the economic and social development of the country, often acting as a nursery of entrepreneurship. They also play a pivotal role in the development of the economy with their effective, efficient, flexible and innovative entrepreneurial spirit. The MSME sector has been a significant contributor to the country, generating the highest employment growth as well as accounting for a major share of industrial production and exports.

After realizing the importance of MSME sector, Government has taken various initiatives to boost the growth of the segment. Further, the key attributes of the sector such as, high contribution to domestic production, significant export earnings, low investment requirements, operational flexibility and many others have lead to tap opportunities in various industries.

MSMEs could have contributed more, if they had access to financing, necessary facilities and skills. Considering the high growth aspiration levels of MSME promoters, lack of adequate finance has proved to be an obstacle. As per an estimate, around, 33-34% of the MSMEs have access to bank or institutional financing channels and in the absence of this finance, prefer to raise financing through personal Channels (friends, family, informal financiers etc). This situation provides, a significant opportunity for the flow of banking credit. To encourage greater bank led financing, the Reserve Bank of India (RBI) had increased its focus on this sector through directed lending policies such as priority sector lending (PSL) norms. However, given the significant demand-supply constraints, the financing gap has widen.

It is observed that, the problem faced by Indian finance system is that there is no transparency regarding the financial conditions of MSMEs. The reason for this may be that some enterprise owners themselves may not grasp their financial conditions well. This will result in hesitation from banks to give loan to small scale units. In fact, there is evidence to establish that a fairly significant proportion of loans given to small enterprises in the past have compounded the problem of non-performing assets (NPAs). Unless there is fairly detailed information on small firms, banks would hesitate to take risk. Hence, securing transparency of financial conditions, eventually, influences decisions on loan finance.

Recently, the Credit Guarantee System for MSMEs has been introduced by commercial and other financial institutions. For instance, under the Credit Guarantee Fund Trust for MSEs (CGTMSE) life insurance cover for the chief promoters of enterprises is guaranteed. Further, various industry associations have signed MoUs with commercial banks and other financial institutions to offer collateral security to upcoming entrepreneurs for their credit requirements. The CGTMSE will function under the monitoring of the SIDBI. Unless the credit guarantee system is strengthened and streamlined smaller units would continue to suffer neglect in accessing the much needed credit for both inception and expansion.

Small Industries Development Bank of India (SIDBI) has estimated the overall debt finance demand of the MSME sector at Rs. 32.50 lakh crores, 22% of which comes from the debt financed through the formal sector, in which banks have the largest share

Small Industries Development Bank of India (SIDBI) has estimated the overall debt finance demand of the MSME sector currently is at Rs. 32.50 lakh crores, 22% of which comes from the debt financed through the formal sector, in which banks have the largest share (approximately 85 percent). Most of this debt flows to the registered enterprises, as the risk perception attached to unregistered or unorganised enterprises due to a lack of transparent financial data, limited immovable collateral and lack of credit assessment skills of some sub-segments and the preference for 'less hassled', informal financing, reduces addressable demand considerably. Working capital financing, and to a lesser degree debt for capital expenditure are the two key offerings sought by MSMEs.

Geographically, MSMEs in Eastern Indian and particularly North Eastern states have been lagging behind as compared to the other states in terms of access to formal source of finance. Lack of facilities such as infrastructure and electricity and roads has been a significant obstacle for the growth of MSME industries in these regions and consequently their access to organized lending from banks. The MSME industry clusters in these states are varied and range from the trade and metal processing centres in Orissa, Jharkhand and Chhattisgarh to forest product and handloom related centres in the North Eastern states.

As awareness of formal financing opportunities increase within the MSME sector, banks get an opportunity to grow their credit exposures, limit risks and seek better spreads by developing and implementing specific policies for MSME sector. The regulatory framework defined by the Central Bank has set standards to be achieved by the Banks with regards to MSME funding. Currently, it is set at 7-15% of lending portfolio to be allocated for financing micro enterprises) and an overall 40% of their annual credit to be allocated to priority sector lending. Further, the Nair Committee has also recommended a limit to 5% on the indirect lending portfolio earlier used by banks who lent to NBFCs to further lend to MSMEs, to meet PSL norms.

In view of the significant variance in MSME knowledge, extensive branch network linked liability relationships and regional versus centralized credit assessment skills between public sector banks (PSBs) as compared to private and foreign banks on the other, it is no surprise that PSBs account for over 70% of the debt financing to this sector, while private and foreign banks account for 22% of credit flow.

Considering all these factors, the traditional challenges faced by MSMEs are:

- Limited skills in terms of market assessment at branches (and limited ability to gather and analyze proxy data)
- Centralized product design across rather than need based customized products that address the needs of specific sub segments
- Vanilla models of fund based products and limited credit assessment skills for knowledge based industries with limited immovable collateral

Most of the banks consider funding to this segment as a necessity for meeting compliance norms, rather than an opportunity. Many such banks tend to narrow the definition of such enterprises (investment in assets) rather than seek a broader definition that could include revenues, order flows, past cash flows etc.

Banks need to work with SMEs linked to the supply chains of their large corporate customers and leverage this relationship to manage and control credit exposures. Most of the banks have succeeded in implementing supplier and dealer financing products and processes and thus increasing penetration deeper and across a larger number of corporate clients. Another way could be to Co-write credit with a trusted Non Banking Finance Company (NBFC) partner, where first lien on collections remains with the bank. The main advantage of this model is that both partners leverage their respective strengths. Further, with the recently imposed limits on indirect financing, this model would be favourable and attractive due to following aspects:

1. Cluster based financing has already been implemented by many banks and has been successful by focussing on small sub-sectors that are geographically concentrated into specific areas and have very similar market cycles and supply chain linkages. By creating specialist credit capabilities for each sub-sector, banks have been able to reduce their credit risks substantially through the modulation of credit flows based on knowledge of business cycles.
2. Linking personal and small business accounts has helped many banks to develop a close link with promoters and proprietors. The availability of data linked to personal accounts provides good insight to support credit decisions to the group.
3. Strengthening of support infrastructure:

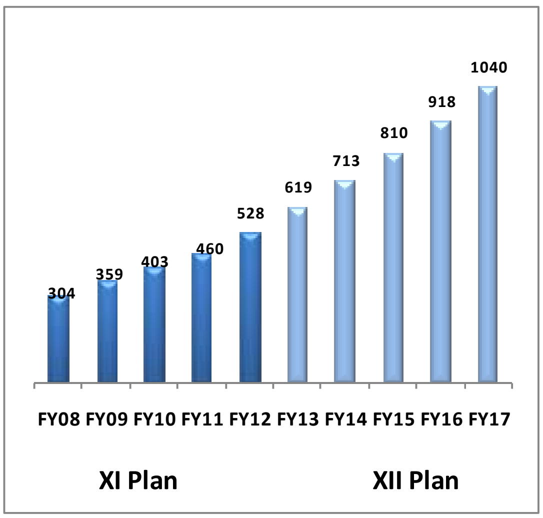
a. Legal and regulatory framework such as a single consistent definition of the sector, extending the Securitisation Asset Reconstruction and Enforcement of Security Interests (SARFAESI) coverage and also expanding the coverage of credit rating agencies, enhancing credit guarantee coverage, securitisation of trade receivables through conducive legal infrastructure, creating a single collateral registry for immovable assets, supporting Asset Reconstruction Companies (ARCs) etc.

b. Governmental support – Government should facilitate platforms for market linkages, skills development, technology up-gradation and promoting cluster development, enhancing advisory support, supporting the growth of venture funds.

INFRA FUNDING – FOUNDATION FOR OVERALL GROWTH

Indian has witnessed high economic growth in the last few years, but lately the growth has moderated. The growth rate faced strong headwinds and has declined. Along with the various reasons for slowdown in the economy, lack of adequate and quality infrastructure has also been one for them. The relationship between infrastructure development and economic growth is well established, as infrastructure development facilitates economic growth; that in turn increases demand for more infrastructure. Thus, development of adequate and quality infrastructure is a necessity to maintain growth momentum in any economy.

Infrastructure investment, FY08 - FY17 (RS. bn)



In India, escalating infrastructure spending is inevitable. The rapid growth of the economy has put a lot of strain on infrastructure areas like power, railways, roads, ports, airports, irrigation and urban/rural water supply.

The eleventh five year plan recognized inadequate infrastructure as a major constraint on rapid growth. In order to overcome this and stimulate economic growth, Government of India planned to raise infrastructure investment to over 8% of GDP by the end of the Eleventh Five Year Plan (2007-12). The total revised estimated expenditure for investment in infrastructure during the eleventh five year plan is estimated at around Rs. 21 trillion. The total investment in infrastructure is estimated to have increased from 5.7% of GDP in the base year (2006-07) of the Eleventh Plan to around 8.0% in the last year of the Plan. To step up investment in the infrastructure sector, apart from increasing budgetary allocation for the sector, the Government has been encouraging the private sector to participate and invest in the sector. Resultantly, during the past four years, a number of Public-Private Partnerships (PPP) have come up in the sector. It may be mentioned that private investments accounted for about 36% of total investment in infrastructure in the Eleventh Plan.

To support the high economic growth, the investment requirements in the infrastructure sector is estimated to be around Rs. 41 lakh crore (later revised to Rs. 45 lakh crore in the approach paper for the Twelfth Plan) during the Twelfth plan period. This implies that infrastructure investment will need to increase from about 8% of GDP in the base year (2011-12) of the Plan to about 10% of GDP in 2016-17. Over the plan period as a whole, the infrastructure investment is estimated to be about 9.95% of GDP. Financing of this investment would require larger outlays from the public sector, but this has to be coupled with a more than proportional rise in private investment. Going forward, the share of private investment in infrastructure may, in fact, have to increase to 50% in the Twelfth Plan. However, this estimate on infrastructure investment has to be understood with caution as the underlying assumption is 9% growth in GDP throughout the plan period. In any case, even with GDP growth of 7-8%, if we want to invest around 10% of GDP in the infrastructure sector, the financing requirement is going to be huge.

Going ahead, private investments which have to increase significantly to Rs. 20.5 trillion for FY13-FY17, have not witnessed necessary surge during the first year of 12th five year plan. Importantly, private sector investments are required for bridging infrastructure investments gap and meeting revised targets by the Planning Commission. Considering the 70:30 debt to equity ratio, the overall debt requirements (disbursement potential) is expected to be Rs. 14.3 trillion.

Banks had been the main source of finance for infrastructure projects in India, during the XIth plan period, especially for the power sector. However, currently the banks have become more cautious in terms of lending to the infrastructure sectors. There are several reasons for this reluctance for further funding; one of such is that, most of the banks have reached their internally approved sector-wise exposure norms. Limited availability of take-out finance is leading to the asset being on the bank’s balance sheet longer than expected. Further, difficulties in recovering dues from promoters due to stalled projects not generating revenue has increased the overall portfolio stress. The banks have limited appetite for complex structures, which are more popular with NBFCs for smaller deals.

The corporate debt market in India is not well developed, thus further restricting the channelization of capital flows towards the infrastructure sector. The corporate bond issuer profile is dominated by banks and public sector companies, with minuscule participation from nonfinancial private issuers. Besides, most of such issues are raised through private placement, with nearly no secondary market in place to encourage market-making, liquidity and price efficiency of debt issues. Without this key avenue for diversification of funding sources away from the bank dominated financial system, infrastructure developers are finding it difficult to raise long term money efficiently from the capital markets. The takeout financing scheme introduced in 2010 by the government through Indian Infrastructure Finance Company Limited (IIFCL) sought to assist banks in avoiding an asset-liability mismatch and also free up funds to finance new projects. However, the scheme experienced limited success since the government restricted IIFCL from continuing to fund the project after the lead bank exits. In April 2013, a committee comprising of finance ministry officials was established to make takeout financing work better. Besides, the government is planning to relax the norms which would assist the state-owned IIFCL provide longer-term funding to such projects at economical terms.

Insurance companies, who have access to long term funds, are restricted by regulator-imposed sector investment limits which further restrict the flow towards infrastructure projects.

Demand supply gap has lead to the rise of External Commercial Borrowings (ECBs) as a competitive alternate source of supply. Infrastructure developers have raised money in foreign currency at a significant cost advantage; however they continue to remain wary of global group policies of the lending banks which had created issues in the sector in 2008.

Developers are in a mood to agree a higher cost for structured products. Besides, as they are ending their equity investment capacity, increasing number of developers are looking for alternate options of funding the project such as quasi equity, mezzanine debt, holding company debt, viability gap funding, etc.

On the other hand, Indian banks are reluctant about innovative structures as is evident from long cycle time for sanctions, primarily a result of strict regulatory capital standards for products deemed riskier by RBI. Smaller NBFCs and foreign banks active in this space have demonstrated a more dexterous and fast-moving approach towards closing deals of this nature. These products remain significantly higher yielding than standard project loans or corporate term loans.

Lastly, a large amount of funding is expected to come from the private sector. Banks, which have been the main source of funding until now have become cautious recently as they are experiencing significant stress on their portfolio due to underlying business issues. Unless government takes strong policy initiatives, addressing the supply constraints, approval delays and creates enablers for infrastructure growth, infrastructure finance would remain a tough proposition for the financers.

Political Factors Affecting the Indian Banking Industry:

- The Indian banking Industry is governed by the monetary policy decided by the Reserve Bank of India
- Rigid norms in terms of capital and liquidity directly affects the business of banks
- Banks have to adjust their interest rates as per the direction of regulatory bodies, which may or may not be favourable for them.
- Banks have to act in accordance with the guidelines of the Central Bank, which comprises of credit growth in all sectors
- The government can also ask banks to increase credit in particular sectors such as increase in farm credit, increase in infrastructure credit etc.(priority lending)
- At times the government gives debt waivers to certain sections of the society that need to be adhered to by banks as well

Economic Factors Affecting the Indian Banking Industry:

- Economic factors prevailing in the country also effect the Banking Industry both favourably and unfavourably
- If the economy is in good state with regards to high per capita income, good agriculture harvest and normal inflation, banks have an edge as people are left with more money to deposit with banks
- This assists in more capital formation as more deposits can be realised
- Also in a situation of Economic Boom, more Foreign Direct Investment can be attracted through banking channels, that results in improving business and economy in general
- Economic prosperity encourages lending business for the banks, in the same way during the time of

distress, banks face problem in recovering money, issue fresh credit and NIMs are lower too

Social Factors Affecting the Indian Banking Industry:

- The Indian banking system has been progressing at a faster pace than before, besides, there are several untapped rural markets, despite the large number of banks in India
- Most of the farmers still take credit from moneylenders at a very high interest rate
- Changes are anticipated in near future in the unorganised space
- The growing population in the country also provides a huge opportunity as a lot of people in the country want to open a bank account and develop good savings habits
- Changing lifestyle of the Indian urban population who want easy ways of financing to their desires

Technical Factors Affecting the Indian Banking Industry:

- Indian Banking Industry has been continuously working towards the development of technological changes and its usage in its operations
- By implementing new and improved technologies in operation, the banks are anticipated to reduce costs, time and provide higher customer satisfaction
- In this regard internet banking or mobile banking has been considered as remarkable milestones
- Mobile banking enables customers to check their account balance, transfer funds 24x7, bill payments, booking of bus/flight tickets, recharge prepaid mobile and do a lot more effortlessly and securely
- Mobile banking also benefits the banks as well as it helps in cost reduction and also results in reducing employee expenses by decreasing head count at branches

- Technological developments facilitate the flow of information and data leading to faster appraisal and decision-making as well

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CAPITAL RAISING CHALLENGES FOR PUBLIC SECTOR BANKS

Capital is one of the most significant inputs of any business; same applies to the banking system as well. Capital requirement is a force that pushes the banks to maintain minimum ratio, as mentioned in the guidelines by the regulatory bodies. Some of such ratios are of capital (such as the bank's equity, long term debts etc.) to assets (such as the loans and investments it holds). The purpose of this is to ensure that banks can overcome unexpected losses of the assets they hold while still honouring withdrawals and other essential obligations. Stability in any financial system depends on effective and adequate capital availability and the 2008 crisis did reveal serious problems with the existing requirements.

Since 1992, capital in Banks was regulated with a simple guideline known as 'Basel I'. Further, a 'revised framework' known as Basel II was released in June 2004. Currently, the regulators have again agreed to add new norms for capital adequacy standards in banks.

Assessment of Capital requirement: Since 1992, capital was regulated with a simple guideline known as 'Basel I', by keeping 8% capital to risk weighted assets (RWA). A 'revised framework' known as Basel II was released in June 2004. The simplified Basel II approach was more 'granular' than Basel I, but had kept its basic features. The revised version covers minimum risk capital covering credit, market and operational risks. Banks had an option to choose between an approach based on external ratings; and second an internal ratings based (IRB) approach for sophisticated banks, driven by their own internal rating models.

Basel II was in different stage of implementation among the leading economies of the world, when the global financial crisis hit the overall economic scenario. As the global economy is on the road to recovery, the financial authorities and regulators agreed on new norms for banks' capital adequacy standards (Basel III).

Basel III – the new norms: In India, as per the guidelines of RBI, implementation of Basel III started from 1 April 2013 and has to be completed by 31 March 2018 in a phased manner. The key elements of Basel III norms are:

- Definition of capital;
- Enhancing risk coverage of capital;
- Leverage ratio; and

- Liquidity framework.

Under the guidelines of the RBI, with regards to Basel III, minimum tier 1 capital ratio has been fixed at 7% of risk weighted assets (RWAs), of which 5.5% is common equity. The unique features of Basel III is that all non-common tier I and tier II instruments issued by banks will have a provision that requires such instruments, to be either written off or converted into common equity upon the bank which has solvency issues.

Basel III prescribes a capital conservation buffer (CCB) of 2.5% of RWAs, comprising common equity tier I capital, over and above the minimum common equity requirement of 5.5% and total capital requirement of 9%.

Further, Basel III also prescribes a capital conservation buffer (CCB) of 2.5% of RWAs, comprising common equity tier I capital, over and above the minimum common equity requirement of 5.5% and total capital requirement of 9%. This can be drawn down as losses are incurred during periods of stress. In India, RBI has not published the requirements on countercyclical capital buffer (0-2.5% of RWAs), which is aimed at ensuring that the banking sector capital requirements take account of the macro-financial environment in which banks operate.

Basel III also wants the Banks to credit valuation adjustment (CVA) capital charge to protect themselves from the potential mark to market losses associated with deterioration in the creditworthiness of the counterparty, if the deals are done in over the counter (OTC) market. These capital requirement are supported by non-risk-based leverage ratio (a minimum Tier 1 leverage ratio of 4.5% in India, during the parallel run period) that will serve as a backstop to the risk-based measures described above.

Basel III has also introduced two new liquidity standards to improve the buoyancy of banks to liquidity shocks:

- The Liquidity Coverage Ratio would require banks to hold necessary high quality liquid assets (including cash, government bonds and other liquid securities) to meet a severe cash outflow for at least 30 days.
- The Net Stable Funding Ratio is intended to ensure banks hold sufficient stable funding (capital and long-term debt instruments, retail deposits and wholesale funding with a maturity longer than one

year) to match their medium and long term lending needs.

To begin with, Basel III norms on capital requirements may not affect Indian banks as most of the Indian banks are operating at 6-8% of common equity. However, as the Capital Conservation Buffer creeps in from 2015 and if loan growth outpaces the internal capital generation, banks may face challenges in terms of adequate capital for growth. The banks may have to relook into their business at this situation and change their strategy accordingly, which will be dictated by the availability of capital. One of the other challenges in terms of non-equity capital is that the Indian market has not developed an appetite for Basel III bonds, which requires a loss absorbing capacity. The banks may find it difficult to price these bonds and find buyers for the same.

For banks with subsidiaries/Joint ventures (JVs), aggregate investments in subsidiaries exceeding 10% of the bank's equity capital would be deducted from core-equity, while investments up to 10% of the equity capital would be risk-weighted at 250%. Fortunately, most of the Indian banks' holdings in their JVs and subsidiaries are less than 10% of Tier I capital.

Indian banks are already in line with the terms of RBI regulations on liquidity in terms of Statutory Liquidity Ratio (23% of Net Demand and Time Liabilities) and Cash Reserve Ratio (4% of NDTL), which acts as liquidity buffer in times of distress. Since 27% money is already set aside for statutory requirements, and given government's high deficit financing through market borrowings, it will be interesting to see how RBI allows these liquid assets to be part of the Basel III liquidity estimations. The final calibration of liquidity ratios and leverage ratio will be made after further quantitative impact study and observation.

Additional Capital Requirement under Basel III: RBI has estimated that Indian banks will require an additional capital of Rs 5 trillion to meet the new global banking norms. This would comprise an equity capital of Rs. 1.6-1.75 trillion. Since the government is the majority shareholder in PSBs it will have to pump in around Rs.

415,955 crores till FY21 to retain its shareholding in the public sector banks at the current level to meet the norms.

Further, the implementation of new norms will affect the investor returns. They have to look at a longer horizon, where a stable financial system will ensure a better and less volatile return. As these norms come into effect, sectors like retail will be attractive as these require less capital. However, banks need appropriate infrastructure (Human resource (HR), technology and analytics) to manage large pool of retail assets. The buyer of OTC derivatives will find costlier as the credit valuation adjustment (CVA) charges will be applicable for such derivative transactions from 1st January 2014. The banks will most probably pass on the same to customers.

Lastly, the question that keeps recurring is the repercussion of implementing Basel III, can capital requirements be improved without undermining economic growth. Assuming that banks may be able to raise the increased capital requirement under Basel III from the shareholders and markets, but concerns are raised of its impact on economic growth and profitability of banks. In general, the increase in equity capital requirement is likely to increase the weighted average cost of capital, part of which could be passed to the borrowers by increasing lending rates. This would result in slight increase in lending rates and result in slower credit growth. However, on the basis of past experience the financial system globally had fallout as a result of allowing the banks to expand credit on an inadequate base of capital. It is time to recognise that longer horizon of stability comprising of prudent regulations and market disciplines are better propositions to keep the banks in check while also enabling economic growth.

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The focus of financial inclusion is on promoting sustainable development and generating employment for a vast majority of the population especially in the rural areas. In the first-ever Index of Financial Inclusion to find out the extent of reach of banking services among 100 countries, India has been ranked 50. The RBI has aimed to provide banking services through a banking branch in every village having a population of more than 2000.

Out of 19.9 crore households in India, only 6.82 crore households have access to banking services. As far as rural areas are concerned, out of 13.83 crore rural households in India, only 4.16 crore rural households have access to basic banking services. In respect of urban areas, only half of the population have access to banking services and 34% of the India’s urban population with annual income less than Rs. 50,000 have access to banking services.

As a result of Financial Inclusion Plan, banking connectivity increased by threefold from 67,694 villages, at the beginning of the plan period, to 211,234 by December 2012. Besides, Basic Savings Bank Deposit Accounts (BSBDA) has gone up from 73.45 mn in 2010 to 171.43 million by 2012. Kissan Credit Cards outstanding have gone up from 24.3 mn in 2010 to 31.7 mn by 2012, while General Credit Cards outstanding have gone up from 1.4 million to 3.1 mn during the same period.

Lastly, financial inclusion has been made an integral part of the banking sector policy in India. RBI is pushing financial inclusion in a mission mode through a combination of strategies ranging from relaxation of regulatory guidelines, provision of innovative products, encouraging use of technology and other supportive measures for achieving sustainable and scalable financial inclusion. Financial inclusion is the gateway for achieving inclusive growth in India. All the commercial banks in India including cooperative banks are actively involved in financial inclusion process through opening of new branches in rural and urban areas. Thus ensuring that all the Indians should have access to basic banking services for achieving sustainable economic development.#

CONCLUSION

The financial sector reforms have brought about significant changes and had positive impact in the financial strength and the competitiveness of the Indian banking system. The prudential norms, accounting and disclosure standards, risk management practices, etc are keeping pace with global standards, making the banking system resilient to global shocks.

Recently, the Indian Banks have undergone significant developments and investments. In this sector, there are huge opportunities and numerous challenges. Challenges include, financial inclusion, deregulation of interest rates on saving deposits, slow industrial growth, management of asset quality, increased stress on some sectors, transition to the International Financial Reporting System, implementation of Basel III & so on.

The Indian Banks have managed to grow with resilience during the post reform era. However the Indian banking sector still has a large market unexplored. With the Indian households being one of the highest savers in the world accounting for 69% of India's gross national saving of which only 47% is accessed by the banks. More than half of the Indian population is still unbanked with only 55% of the population having a deposit account and 9% having credit accounts with banks. India has the highest number of households (145 million) excluded from Banking & has only one bank branch per 14,000 people. This kind of statistics shows that there is huge unexplored market for Indian Banking System.

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