Banking reforms

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1 Introduction

In this chapter we argue that the recent problems of rise of non-performing assets, of the slowdown of credit growth and the weakness in banking regulation in India are intrinsically linked to the issue of government ownership of public sector banks. Public sector banks are not allowed to fail and they are repeatedly re-capitalised by the government. This creates wrong incentives for the regulator. This has given the sector an environment of lax regulation in the face of poor performance, poor consumer satisfaction and regulations that reduce competition both for the banking sector and within the banking sector. Despite banking not being able to fulfil the needs of a growing Indian economy, important reforms for the debt market and bankruptcy laws for banks have been postponed in this perverse environment. Successive governments have tried to bring about small reforms in the banking sector, but not addressed the politically difficult issue of government ownership of three-fourth of India's banking sector. We argue that unless we squarely address this issue, India's financial sector will hold back economic growth in India.

2 Recent problems in Indian banking sector

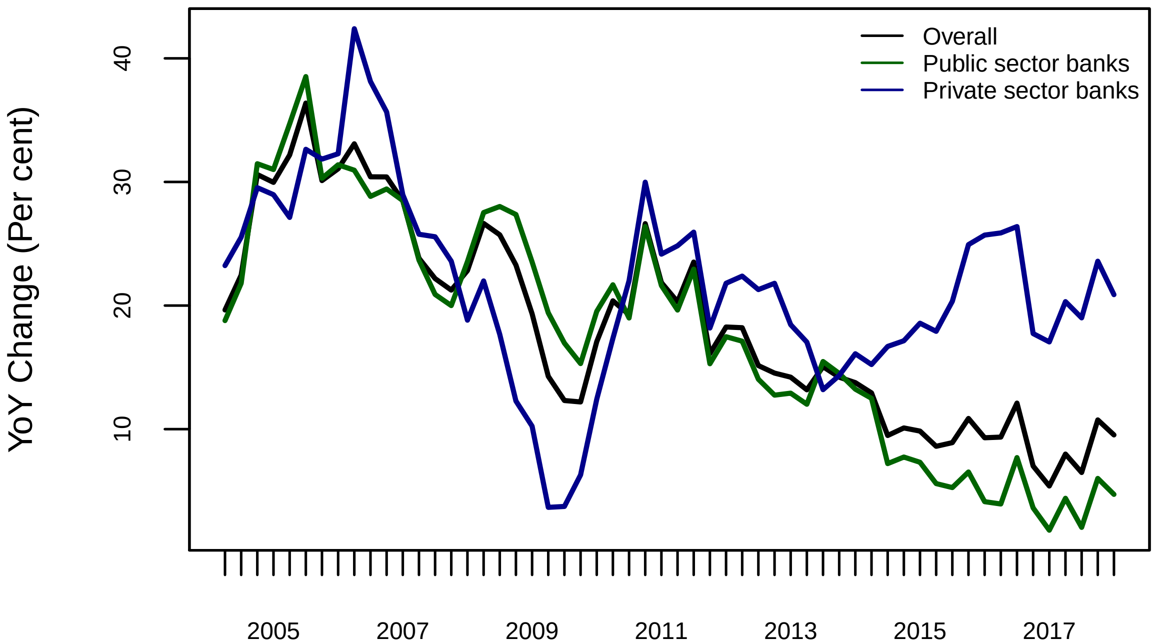
Gross non-performing assets in the banking sector have risen sharply in the last three years (See Table 1). The Financial Stability Report, Reserve Bank of India (2018) shows that the gross non-performing asset ratio of scheduled commercial banks has risen to 11.6 per cent in March 2018. The corresponding ratio of public sector banks is 15.6 per cent in March 2018. The latest Financial Stability Report shows that the problem is expected to deteriorate further.

Table 1 Gross Non-performing Assets (GNPAs) and net non-performing assets (NNPAs) of scheduled commercial banks as percent of total advances

Year	Gross non-performing assets (GNPAs)	Net non-performing asstes (NNPAs)
2010-11	2.25	1.1
2011-12	2.75	1.3
2012-13	3.23	1.7
2013-14	3.82	2.1
2014-15	4.27	2.4
2015-16	7.48	4.4
2016-17	9.33	5.5
2017-18	11.6	6.1

Source: RBI

Figure 1 Credit growth by banks



Rising non-performing assets are expected to lead to further erosion of capital buffer. According to the Financial Stability Report, Reserve Bank of India (2018), under the baseline scenario, capital adequacy levels of the six public sector banks under the Prompt Corrective Action (PCA) framework may fall below the regulatory minimum of 9% by March 2019.[1]

Figure 1 shows the weak growth of credit in recent years in both public and private banks in India. Credit disbursement to the industrial sector has shown the steepest decline.

Figure 3 above shows the *level* of bank credit of the two ownership groups and in the aggregate. The graph indicates that the current growth rates have been in place from about 2013 or 2014. The growth rates in this period are: 5.6% for public sector banks, 18.2% for private banks and 9.1% for the sum. If we extrapolate three years into the future, at the existing growth rates of private and public banks separately, this gives a projected aggregate growth rate of 10.2%. This remains a sluggish growth rate, and shows that high growth rates in private bank credit alone do not solve the problem of lack of bank credit for the economy as a whole.

We may point out that a sustained 18.2% growth of credit by private banks is also

[1]Banks whose capital, asset quality and profitability fall below certain defined risk thresholds are put under the Prompt Corrective Action framework (PCA). PCA involves imposition of various restrictions such as restrictions on dividend payments, on branch expansion and higher provisioning.

Figure 2 Sectoral allocation of outstanding credit

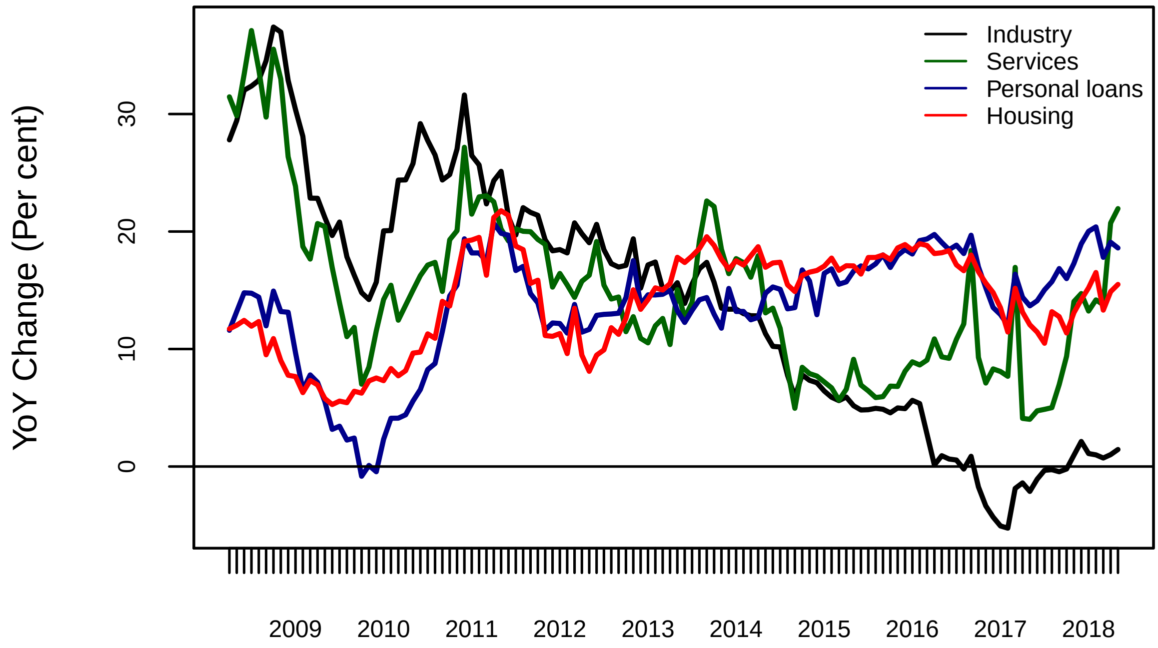
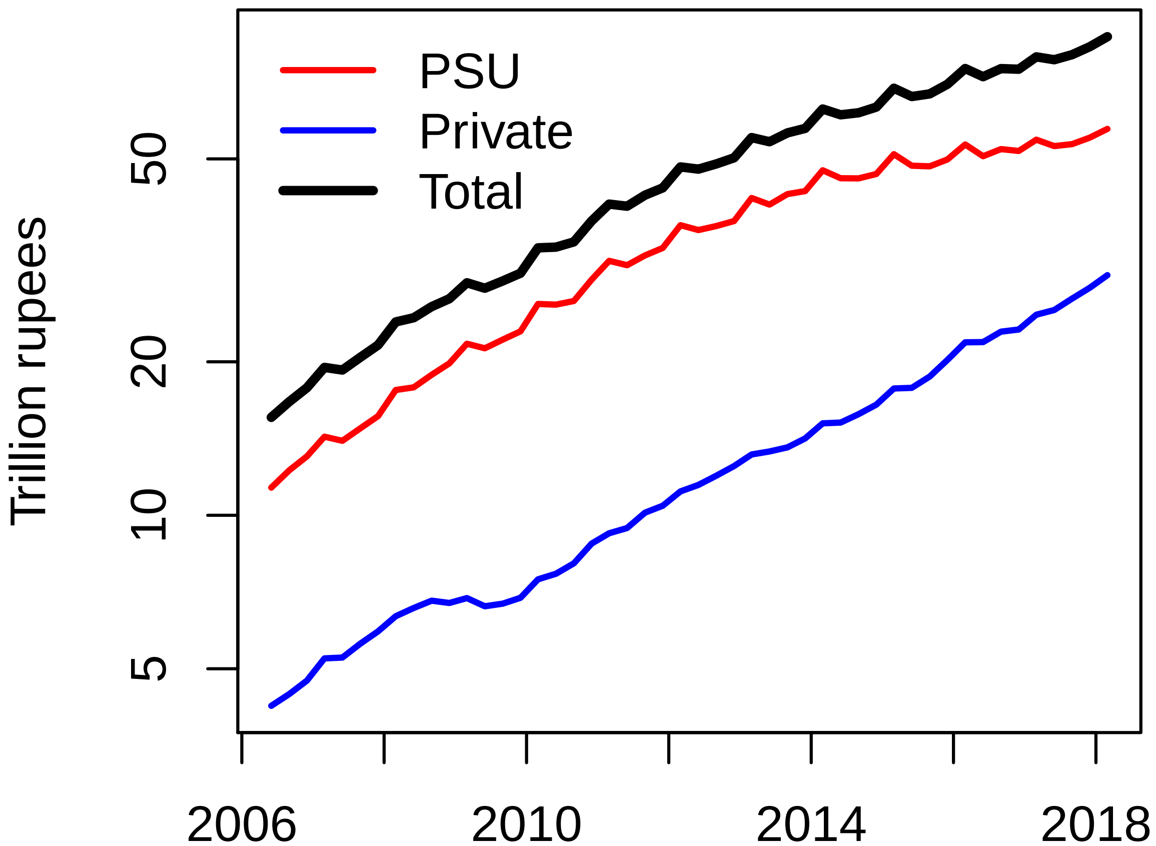


Figure 3 Credit by banks, by ownership group



doubtful. When there are difficulties in regulation, private banks fare poorly, and early evidence of the difficulties in private sector banks in India has started showing up.

3 Why did we get these problems?

What lies at the heart of India's banking sector problems? The above point to some recent concerns that have been in the news. However, banking in India has been plagued by long term issues related to financial repression, government ownership, excessive intrusion into the business of banks, pursuit of development goals, weak regulation and supervision, and poor governance. These are some of the key reasons that have perpetrated distress in the banking sector. Some of the solutions that have been attempted include bank consolidation (Times, 2013), separation of the role of chairman and managing director, change in the recruitment processes and increase in the number of independent directors in banks (P.J Nayak, 2014). Even if these reforms had been successful, it is doubtful if these would have been adequate to solve the problems being faced.

3.1 Financial repression and priority sector lending

Financial repression is a long standing feature of Indian banking. Even though it is not the biggest problem today, it remains an element that distorts the way banking is done in India. It reduces the incentive for the government to set up a debt management agency and for the regulator to do proper risk assessment of bank portfolios. Banks in India are required to maintain a certain percentage of their liabilities in the form of liquid assets. This percentage, the Statutory Liquidity Ratio (SLR), is set by the Reserve Bank. It has been reduced from 38.5 percent in the 1980s to 25 percent in the nineties, to 19.5 percent currently. Such a requirement, traditionally an instrument of financial repression, has no comparable requirement in other countries. Even though the SLR has been progressively reduced, it remains high and often banks, particularly public sector banks, hold more than the mandated ratio.

In addition to lending to the government, RBI requires banks to lend a certain percentage of their loan portfolio to priority sectors - these sectors, such as agriculture, small scale industry and exports - are areas of policy focus. All domestic banks-public and private and foreign banks with 20 or more branches are required to lend 40 percent to priority sectors(Reserve Bank of India [RBI], 2018). Priority sector ratio is not only a source of pulling down of profitability of the banking sector in India, but also reduces what banks can lend to industry and retail consumers based on legitimate business decisions. Such kind of policy design entails cost but the Government does not reimburse the cost of providing such services (Ministry of Finance, 2013).development chapter says

3.2 State ownership

Most arguments for state ownership of banks are based on the premise that profit-maximising lenders do not necessarily deliver credit where the social returns are highest (Banerjee, Cole, & Duflo, 2004). However, cross-country evidence on the impact of bank nationalisation is not encouraging (Cull, Peria, & Verrier, 2017). Evidence suggests that government ownership is negatively correlated with financial development and economic growth (La Porta, Lopez-De-Silanes, & Shleifer, 2002). Evidence on Indian bank nationalisation finds that bank nationalisation of 1980s hindered the spread of intermediation in the nineties (Banerjee et al., 2004). The authors found that credit, deposits and number of branches grew at the same speed between 1969 and 1979 for banks that were going to be nationalised in 1980s and those that were not. It is only after the 1980 nationalisation that banks that were nationalised started to grow slowly. The authors attribute this to the rigid lending rules and reluctance of bank officers to make fresh loans.

State ownership generates substantial moral hazard and perverse incentives into the banking sector. Evidence suggests that access to government guarantees and forbearance during the crisis period (2007-09) allowed state-owned banks to extend credit cheaply despite their under-performance. At the same time, the Government announced a budgetary allocation of Rs 38 billion as capital for three PSBs. Government guarantee and budgetary support enabled public sector banks to increase their deposit rates. Evidence suggests that PSBs increased lending in those sectors and to those firms that receive greater political backing, namely the priority sector (agriculture and small businesses) and state-owned firms. Additionally, the PSBs did not commensurately increase their lending rates to reflect the higher costs in borrowing (Acharya & Kulkarni, 2017). These decisions resulted in resource mis-allocation.

An implication of being owned by the State is that public sector banks bear the cost of government's social sector programmes. In addition to the goals of providing government with cheap credit, and directing credit towards priority sectors, public sector banks have been mandated with meeting other social and developmental objectives of government.

A scheme for financial inclusion shows that out of the 320 million bank accounts opened under the scheme as on 18th July, 2018, public-sector banks account for more than 80%

of all accounts opened. If we include the share of regional rural banks, the share of public sector banks and regional rural banks account for 97% of the total accounts. Similarly the management of demonetisation and its aftershocks was primarily left to public sector banks.

3.3 Management and governance issues

Publicly owned banks suffer from multiple objectives, bureaucratic and political interference, poor HR practices, mounting NPAs and difficulties arising from their ownership structure. Narasimham (1998), Rajan (2008), P.J Nayak (2014) point out that the Bank Nationalisation Acts permit the Government to form 'schemes' applicable to these banks, and thereby intervene in diverse areas such as banks' capital structure, board composition, retirement of directors and the reconstitution, amalgamation and transfer of bank shares. This intrudes on both regulation and on the law defining organisational behaviour that is the domain of company law.

Private banks, such as ICICI bank, have also seen concerns about governance issues in recent months. Others such as Axis Bank and Yes bank have seen large revisions of their NPAs. As a consequence, governance mechanisms and the role of management and boards of private banks has been questioned.

In recent years, there has been an increase in the number and quantum of frauds reported in the Indian banking sector. State owned banks have a disproportionate share of frauds significantly, exceeding their business share. Internal audits, internal controls and governance processes in banks are weak and ineffective (Financial Stability Report, Reserve Bank of India, 2018).

3.4 Weak regulation and supervision

RBI has allowed banks to hide bad loans for a long time. This has worsened the health of the banking system. When banks don't have to recognise problematic borrowers and stressed assets and provision adequately, they can continue to price corporate loans cheaply, increasing the dependence of the corporate sector on banking. This leaves the economy strewn with zombie firms.

Weak regulation and lack of regulatory capacity is related to public ownership of banks.

Public sector banks are not allowed to fail[2] On the one hand the regulator may be relaxed about applying norms because public sector banks have sovereign guarantee. Since the banking system has been public sector dominated, weak regulation also implies weak regulatory capacity and expertise within the regulator. On the other hand, there may be pressure from the government not to force banks to recognise bad assets and provision for them if the exchequer does not have adequate fiscal resources to fund the provisioning.

In addition, banking regulation is currently not ownership neutral. Public sector banks are governed under legislations framed at the time of nationalisation such as the Bank Nationalisation Act. As an example, Section 18 of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970) provides for winding up only through an order of the Government.[3] Similarly for mergers and amalgamations of PSBs, the power lies with the Government.[4] Government has the power to give directions to PSBs.[5]

The report by Narasimham (1998) recommended amendments to the legal framework to grant greater autonomy to public sector banks. The Working Group on Banking set up by the FSLRC recommended that laws relating to banking should be ownership neutral and should provide a level playing field for all banks and corporatisation of all Public Sector Banks (Ministry of Finance, 2013). This would level the playing field and will also rationalise the merger/ amalgamation provisions by bringing them under a single unified framework under the "The Banking Regulation Act" (1949).

However, weaknesses in regulation goes beyond the ownership question. RBI Governor has cited government ownership as an impediment to supervising fraud-hit banks (Patel, 2018). While stating that RBI is constrained in its ability to supervise state-owned banks, he has made a case for ownership neutral banking regulation to avert such crises in future. In the monsoon session of Parliament, in response to a query in Rajya Sabha, Government countered RBI's claim and stated that RBI has comprehensive powers over public sector banks (Ministry of Finance, 2018b). The response listed the provisions of the Banking Regulation Act and the Bank Nationalisation Acts under which RBI enjoys

[2] See Section 18 of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970) and Section 45 of "The State Bank of India Act" (1955)

[3] Section 18 of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970)

> "No provision of law relating to winding up of corporations shall apply to a corresponding new bank and no corresponding new bank shall —- be placed in liquidation save by order of the Central Government and in such manner as it may direct."

Similar provision applies to the State Bank of India

[4] Section 9(2) of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970)

[5] Section 8 of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970)

supervisory powers over public sector banks.[6]

While it is true that RBI does not enjoy regulatory control the way it has over private sector banks, the lack of some powers is balanced, to some extent, by the right to appoint a director on the board of nationalised banks.[7] Further Section 51 of the "The Banking Regulation Act" (1949) lists the provisions of the Act which are applicable to State Bank of India and other nationalised banks. These include powers to issue directions to public sector banks, mandating them to maintain records as per rules made by RBI and imposing penalties.

The issue of public sector ownership, which creates confusion about the objective function of public sector banks, distorted incentives to regulate public sector and the issue of weak regulation and supervision by RBI which affects both public and private sector banks, have to be addressed.

4 Reforms

4.1 How to address stressed assets?

The most immediate problem in the banking sector is the question of how to address stressed assets. After the failure of 'restructuring schemes' like the Strategic Debt Restructuring (SDR), Corporate Debt Restructuring (CDR) and the Scheme for Sustainable Structuring of Stressed Assets (S4A), when the the Insolvency and Bankruptcy Code was enacted to create a unified framework for resolving stressed assets, RBI moved to the new framework. In August 2017, the Banking Regulation Act, 1949 was amended to provide authority to RBI to issue directions to banks to initiate insolvency proceedings under the IBC (Ministry of Finance, 2018a). In February, 2018, RBI introduced a unified framework of resolution of stressed assets under which provisioning requirements kick in as soon as a default occurs (Reserve Bank of India, 2018). Lenders are required to put in place resolution plans within 180 days after a dafault. If resolution plans are not implemented, lenders are required to file insolvency applications, singly or jointly, under the Insolvency and Bankruptcy Code 2016 (IBC). It is expected that a fresh batch of non-performing assets would be referred to the IBC from September 1, 2018.

[6] Such as RBI has powers to inspect the bank and its book of accounts, has a nominee member on the board of state-run banks and is part of a committee within the board that approves large loans. RBI can appoint additional directors on the banks' boards.

[7] See Section 19(f) of the "The State Bank of India Act" (1955), Section 9(3) of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970).

Public sector banks have come up with a new plan referred to as *Sashakt*. The plan recommends setting up of an asset management company (AMC) to buy stressed assets from the banking sector (Ministry of Finance, 2018c). There are fears the this plan may dilute the existing RBI framework for addressing stressed assets as it aims at postponing the problem by subverting the deadlines set under the Reserve Bank of India (2018). It is currently being debated whether this may actually derail RBI's attempts or just help give some breathing space to public sector banks. In addition, there are challenges about whether it can work considering the need for capital for the AMC, a market for stressed assets and the willingness of smaller banks to follow the lead of larger banks as required by the plan.

4.2 Privatisation of public sector banks

The policy response to the growing problems of public sector banks has been to recapitalise banks. Recapitalisation from fiscal resources puts enormous stress on government finances and distorts the incentives for banks. When private sector banks raise capital-they face a market test, they have to convince investors of their investments and profitability. Public sector banks do not need to answer questions on profitability and performance. Public sector banks enjoy an implicit government guarantee. Studies on the impact of government guarantees on bank performance during a crisis find that government guarantees and forbearance during the global financial crisis allowed state-owned banks to access and extend credit cheaply despite their under-performance (Acharya & Kulkarni, 2017). They are also provided support through recapitalisation.

Table 2 traces the history of recapitalisation support provided to public sector banks. The CAG Report, Union Government, Ministry of Finance (2017) points out that during 2008-09 to 2016-17 Rs 1,187.24 billion was infused into the banking system. The report noted that while the desired objective of recapitalisation has been to improve the level of capital in banks in line with the regulatory requirements, in many instances the objective has not been fulfilled. In October 2017, the Government announced a recapitalisation plan of Rs 2.11 trillion over the next two years through budgetary provisions of Rs 181.39 billion and the sale of recapitalisation bonds worth Rs 1.35 trillion. As a first tranche of this amount- Rs 880 billion as recapitalisation bonds was infused in 2017-18 in PSBs. This amount was sufficient to tide over the losses of banks, and did not result in improvements in capital adequacy levels. Accumulated losses in the banking sector are large. Year after year we are seeing addition to this stock of losses. In 2017-18 India's public sector banks posted a combined loss of Rs 853.7 billion adding further to the stock of losses (See

Table 2 Recapitalisation of public sector banks

Year	Amount (Rs Billion)
1993-94	57.00
1994-95	56.00
1995-96	8.50
1996-97	15.09
1997-98	27.00
1998-99	4.00
1999-2000	-
2000-01	-
2001-02	13.00
2002-03	7.70
2003-04	-
2004-05	-
2005-06	5.00
2006-07	-
2007-08	100.00
2008-09	19.00
2009-10	12.00
2010-11	201.17
2011-12	120.00
2012-13	125.17
2013-14	150.00
2014-15	69.90
2015-16	250.00
2016-17	250.00
2017-18	2110.00

Source: Union budget documents and Comptroller and Auditor General of India

Table 3 Losses of PSBs as of March end, 2018

Name of public sector bank	**Losses(-) / Profits(+)** (in billion rupees)
Bank of India	(-)60.4369
Bank of Maharashtra	(-)11.4565
Bank of Baroda	(-)24.3181
Canara Bank	(-)42.2224
Punjab and Sind Bank	(-)7.438
Punjab National Bank	(-)122.8282
State Bank of India	(-)65.4746
IDBI Bank	(-)82.3792
Indian Bank	(+)12.5899
Indian Overseas Bank	(-)62.9949
Oriental Bank of Commerce	(-)58.7174
Central Bank of India	(-)51.049
Corporation Bank	(-)40.5394
Dena Bank	(-)19.2316
Syndicate Bank	(-)32.2284
UCO Bank	(-)44.3637
United Bank of India	(-)14.5444
Union Bank of India	(-)52.4737
Vijaya Bank	(+)7.2702
Allahabad Bank	(-)46.7438
Andhra Bank	(-)34.1253
Aggregate Net Losses	**(-)853.7054**

Source: Profit and Loss statements of banks

Table 3). The stress tests by the RBI shows that the NPAs of the banks that received recapitalisation support from the government, will rise further and their capital levels will deteriorate (Financial Stability Report, Reserve Bank of India, 2018).

Numerous expert committees in the past recommended reducing government stake and privatisation of public sector banks in a phased manner (Narasimham, 1998), (Rajan, 2008). This requires legislative changes such as repeal of the Bank Nationalisation Acts: "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970), "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1980), "The State Bank of India Act" (1955), "The State Bank of India (Subsidiary Banks) Act" (1959) and amendments to "The Banking Regulation Act" (1949).

Privatisation of public sector banks has not been on the government's agenda so far. Successive governments have focussed on elements of bank consolidation, financial inclusion, directed credit, discussion about holding company structure, bank boards, separation of board chairman and management, adoption of technology and change in HR practises. While some of these have been implemented in a piecemeal manner, these are business decisions and do not address the fundamental issues of objectives and incentives of these banks.

4.3 Foster competition in the banking sector

In the pre-reform period in India, telecom and airlines were completely public sector dominated. Inefficiency, loss making enterprises and low access to their services for consumers dominated the market. The policy choice was to introduce competition in the sector by allowing private firms to provide services to customers. Access of consumers across the country grew sharply, benefitting from the push by private companies to increase their market share. The burden of greater access to telecom and airways services did not fall upon tax payers.

In contrast, access to financial services remains an issue. In general, there has been low competition in the financial services sector. The domination of banks and the role of the banking regulator in protecting banks has created conditions in which there is both a lack of competition *to* the banking sector and a lack of competition *in* the banking sector. Consequently, money market mutual funds, bond markets and fintech are restricted in size and activity posing only limited challenges to the banking sector, as the RBI as the regulator of payments, bond markets and banks has tended to favour the banking sector, in this case the incumbent, which it traditionally regulates (Mohanram & Kagade, 2017). Similarly, within the banking sector, very few new entrants are permitted, thus favouring the incumbent banks.

While public sector banks have been mandated, almost throughout their existence, to provide access to rural consumers, to the poor, to small firms and so on, this strategy has seen limited success. There have been restrictions on private and foreign banks on entry and on opening branches, particularly rural branches. Since 1991, the window to allow a private entity to start a bank was opened only three times. In a Discussion Paper (Reserve Bank of India, 2013), RBI proposed to review the policy of 'stop and go' or block bank licensing policy and made a case for continuous authorisation of new banks. Consequently guidelines for on-tap licensing of universal banks was issued in August 2016 (Reserve Bank of India, 2016). The policy of on-tap licensing of banks is a promising step in the direction of increasing competition in the banking sector. However, the response to the guidelines has been lukewarm as some of the elements of the policy seem stringent. Only one application for on-tap licensing has been received. The regulator should consider revising the criteria to signal its intent to promote entry of new players in the banking sector.

4.4 Improvements in banking regulation

The process of strengthening the RBI's regulatory and accountability framework needs to begin from the top: the RBI Board. The functioning of the RBI Board is opaque. Details of the agenda, discussions and transcripts are not released by the RBI. Minutes published by the RBI are usually just a two line summary.[8] Most functions of the board have been delegated to a sub-committee (The Committee of the Central Board) where only two directors are needed to meet quorum. This arrangement circumvents the necessity of obtaining votes of the majority of members of the Central Board. The agenda and board meetings of the RBI are not made public, unlike the board meetings of other central banks like the US Fed or the Bank of England, or other regulators in India like SEBI.

The legislature needs to revisit the law, RBI Act 1934, governing the functioning of RBI to bring about improvements in transparency, accountability and governance framework including reforms in the functioning of the board. Most other regulators and central banks have introduced modern principles of corporate governance and functioning of boards. These elements of the RBI need to be revised.[9]

The second element of reform is improvements in regulation-making process. Standard setting bodies like the OECD has identified some common elements of sound regulation-making process (Roy, Shah, Srikrishna, & Sundaresan, 2018). A blueprint for improved regulation-making was provided by the *Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code, FSLRC*, Department of Economic Affairs, Ministry of Finance (2013). In 2014, all financial sector regulators had agreed to implement these recommendations. The key principles underpinning sound regulation making process are:

- No subordinate legislation may be published without a Board resolution determining the need for such subordinate legislation.
- All draft subordinate legislation should be published with statement of objectives, the problem it seeks to solve, and a cost-benefit analysis (using best practices).
- Comments should be invited from the public and all comments should be published on the website of the regulator.
- Regulations should become effective after the Board approves them.
- Board approval should take into account all comments received.

[8]As an example, see, (Reserve Bank of India: Press Release, 2016)
[9]See section 3.3. of (Ministry of Finance, 2013)

The RBI Committee on review of supervisory processes for commercial banks has recommended ways to strengthen the supervisory ability of the RBI (RBI, 2012). In today's increasingly dynamic financial landscape, supervisors need to put in place robust systems to address poor risk culture and failures in controls and governance (Caruana, 2015).

4.5 Improvements in governance of banks

A competent regulator would regulate bank management and boards such that there should be no need to separately discuss the functioning and governance of banks. However, coming from a culture of public sector banking and the practice of a representative of the regulator being a board member of public sector bank boards, there has been little focus by the banking regulator on governance issues. This has led to weak governance in banks and the need to emphasise this a separate an area of concern.

The recent spate of episodes of fraud, misreporting and conflict of interest highlight the need for improvements in governance frameworks of banks. The board should be fully responsible for governance in line with the best practices and be accountable to the shareholders for performance in full compliance with all applicable laws and regulations. Internal audit and control mechanisms—including effective monitoring of risk management in accordance with the policies approved by the board should be instituted and regular feedback and assurance mechanisms put in place. The recent episode of conflict of interest and weak corporate governance in ICICI Bank underscores the need to institute stringent and transparent conflict of interest policy and objective implementation by the Board.

4.6 Specialised resolution regime for financial firms

A critical gap in the current financial regulatory architecture is the absence of a specialised bankruptcy process for financial firms. The objective of micro-prudential regulation is to *reduce* the probability of failure. The failure probability should not be zero. When the financial health of a firm hits a critical minimum, it needs to be subject to prompt and orderly resolution. Failure of inefficient firms is important for 'creative destruction' The failure of inefficient firms is essential for shift of labour and capital to more efficient firms. But what constitutes an *orderly* failure of financial firms such as banks? Failure of a bank is orderly if the depositors either get their money back, and depositors and borrowers are assured of continuity of services without any disruption and the stability of the financial system is not compromised.

A critical milestone in the failure resolution of non-financial firms came about with the enactment of the Insolvency and Bankruptcy Code (IBC). However financial firms cannot be resolved under the IBC, as bank creditors are the depositors. The IBC envisaged process of negotiations by creditors does not work in the case of financial firms.

The present system of resolution of financial firms in India is inadequate in many respects. First, it equips the respective microprudential (e.g. RBI for banks) regulators with resolution powers. Since regulators are supposed to minimise the probability of failure, they are slow in acknowledging failures of financial firms. This breeds regulatory forbearance induced inefficiency. Second, the present legislative framework gives very limited powers of resolution such as forced mergers and winding up. Third, even these limited powers are not enjoyed over many financial firms such as the state-owned public sector banks.

A resolution framework and a Resolution Corporation was proposed by the Financial Resolution and Deposit Insurance (FRDI) Bill. This is been withdrawn in the current session of Parliament due to political opposition to some clauses in the bill. Concerns need to be addressed and the bill brought back soon. Having a resolution framework in place will be critical in case there is a bank failure, especially of a large private sector bank that no one may have the ability to buy up, or the government have the resources to bail out.

4.7 Bond market reforms

Reducing excessive bank dependence and developing the bond market is critical to empowering the health of the banking sector. In the nineties, while substantial progress was made in the field of equity markets, commensurate changes are needed to address the problem of missing markets such as the bond market and the currency market. Several committees notably the Rajan (2008), *Report of the Working Group on Development of Corporate Bond Market in India* (2016) have proposed reforms to develop the bond market.

Bond market reforms need to be prioritised to finance India's growing infrastructure needs. Banks are ill-suited to finance infrastructure as their liability profile is not suited for financing long-term, high risk infrastructure financing. As noted in section 3.1, banks also face constraint on portfolio management. Banks have to channel 40% of their net bank credit to priority sector.[10] They have to invest a further 19.5% of their deposits in Government securities (Statutory Liquidity Ratio) and 4% of their deposits have to be maintained with the RBI (Herd, Koen, Patnaik, & Shah, 2011). This results in limited resources for lending to industry and infrastructure.

Economic Survey, 2017-18 suggests that India needs USD 4.5 trillion for investment in infrastructure in the next two decades. Bond markets are best placed to provide long-term infra financing. Bond markets provide suitable avenues for investors such as pension funds and insurers that have long-term liabilities.

In India, bond market is at a nascent stage. The universe of domestic institutional investors such as insurance and pension funds is limited. They are constrained by the restrictive regulatory framework.[11].

The fragility of the bond market results in heavy reliance of large industries and infrastructure firms on bank financing. The strategy of bank-led financing was tried in the early 2000s. During 2003-2008 the growth in bank credit saw a phenomenal growth of 40%. Bulk of the bank credit went to infrastructure and construction. Table 4 shows that between 2004 and 2008 while industrial credit grew 2 times, credit to infrastructure and construction grew 4 times.

Table 4 The rise of infrastructure and construction lending

	2004 (Billion rupees)	2008 (Billion Rupees)
Infrastructure+ Construction	573	2333
Other Areas	2717	6250
Total Industrial Credit	3290	8583

Source: RBI

Banks can play a crucial role in small and medium enterprises (SMEs) external financing (Carbo Valverde, Rodriguez-Fernandez, & Udell, 2008). SMEs face considerable credit constraints. Their limited size and lower credit worthiness undermines their ability to borrow in the "impersonal" and "arms-length" environment of bond market that requires hard and objective information about the ability to repay (de la Torre, Peria, & Schmukler, 2008). As a consequence, SME financing need bank financing. However in India, SME credit constitutes a small proportion of the outstanding bank credit.

Table 5 shows the composition of outstanding non-food credit by banks. Table shows

[10]Priority sector includes the following categories: Agriculture, Micro, small and medium enterprises, export credit, education, housing, social infrastructure, renewable energy and Others.

[11]As an example, insurance companies are under obligation to invest 50% of their resources in government bonds (Insurance Regulatory and Development Authority [IRDA], 2000)

Table 5 Composition of outstanding bank credit (%)

Variable	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Agriculture and allied activities	12.74	12.11	12.04	12.76	13.49	13.99	13.40
Industry	45.16	45.80	45.51	44.27	41.71	37.77	35.11
Micro and small	5.52	5.84	6.30	6.33	5.67	5.21	4.85
Medium	2.91	2.56	2.24	2.07	1.75	1.48	1.35
Large	36.74	37.40	36.97	35.87	34.28	31.08	28.91
Services	23.85	23.65	24.19	23.54	23.54	25.40	26.67
Personal Loans	18.25	18.43	18.26	19.43	21.27	22.84	24.82

Source: RBI

that around 5% of the outstanding non-food credit of scheduled commercial banks goes to micro and small enterprises. Notwithstanding the credit guarantee support through the Mudra[12], the micro and small loan portfolio of banks has been declining from 6% in 2008 to less than 5% in 2017-18. The share of medium enterprises has declined from 5% to 1.35%.

Bond market development is needed to a) ease the burden of infrastructure and long-term financing from banks and the consequent asset-liability mismatch[13] and b) to enable them to focus on SME financing which they are traditionally meant to do.

The development of a corporate bond market requires a well developed and liquid government bond market since a market-determined yield curve is needed to serve as a benchmark for pricing corporate bonds. Government would also need a vibrant bond market as it relies less on forcing banks to hold substantial part of its debt. The Statutory Liquidity Ratio (SLR) currently at 19.5% of net demand and time liabilities of banks has been progressively reduced in the last three years. With reduced financial repression and diversified investor base, a specialised debt management agency would be needed to manage government debt (Pandey & Patnaik, 2017).

The creation of a well-developed bond market with an independent public debt management agency and integration with equity markets was proposed in the March 2015 budget. It was rolled back to give time to RBI to coordinate with the Ministry of Finance to come up with a transition plan. This work needs to be prioritised to give impetus to bond markets.

[12] To address the funding requirements of the sector, Government launched a scheme called the Pradhan Mantri Mudra Yojana (PMMY) in April 2015 for providing loans upto Rs 10 lakh to small and micro-enterprises. Under the scheme an agency was set up to refinance and provide credit support to financial institutions lending to small and micro enterprises.

[13] To deepen the bond market SEBI recently came up with a proposal mandating large corporates that have more than Rs 100 crore long term borrowing to raise 25% of their borrowing from the bond market.

5 Summary and way forward

Problems in the banking sector are pervasive across both the public and private sector. This has led to weak credit growth in the recent years, adversely impacting the real economy. Gross non-performing assets have risen sharply in the last three years. The rise in non-performing assets is projected to continue in the next year. While expert committees have raised concerns about management and governance issues in public sector banks, recent years have seen instances of mis-governance in private sector banks as well.

While these problems have surfaced in the recent years, the banking sector has been plagued with long-standing issues such as financial repression, government ownership resulting in excessive intrusion in the business of banks, and weak regulation and supervision.

With public sector banks not being allowed to fail, there is a moral hazard for the regulator. There is little incentive to detect probability of bank failure, when failure cannot happen. In addition, there may be pressure to postpone recognising bad loans due the the fiscal implications of recapitalising public sector banks.

The most pressing problem today is the issue of rising non-performing assets. RBI's various debt restructuring schemes have been replaced by a unified framework of resolution under the Insolvency and Bankruptcy Code. Recently an alternative resolution framework: Sashakt has been initialised. There are concerns that this plan may dilute the unified stressed resolution framework envisaged by the RBI.

Long term reform of the banking sector must include privatising most public sector banks. This requires amendments in the "Reserve Bank of India Act" (1934), "The Banking Regulation Act" (1949) and repeal of the "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1970), "Banking Companies (Acquisition and Transfer of Undertakings) Act" (1980), "The State Bank of India Act" (1955) and "The State Bank of India (Subsidiary Banks) Act" (1959) among others.

In addition, barriers on the entry of new banks need to be eased to foster competition in the banking sector. The regulatory and accountability framework of the RBI needs to be strengthened in line with the governance enhancing principles and non-legislative elements of the Indian Financial Code. A specialised resolution regime for financial firms must be put in place. Finally, efforts are required to develop a deep and liquid bond market to finance India's growing infrastructure needs and to enable banks to focus on financing credit needs of the SME sector.

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