R Gandhi: Indian banking sector – role in triggering future growth

Valedictory address by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the 6th ICC Banking Summit, Kolkata, 14 June 2014.

*   *   *

Assistance provided by Ms Rekha Misra, Director, Dr. Saibal Ghosh, Assistant Adviser & Shri Radheshyam Verma, Research Officer is gratefully acknowledged.

Good evening, Ladies and Gentlemen!

2. It is both an honour and a privilege to attend this important Conference at the Indian Chamber of Commerce (ICC) in Kolkata. From humble beginnings in the early 1920s, the ICC has come a long way and has presently evolved into a leading national chamber operating from Kolkata. With banks being the mainstay of the financial system, I am sure that the deliberations in the Conference would have provided important insights to all attendees on how the banks' role is getting re-oriented in the new milieu. The Conference has a healthy mix of participants spanning not only representation from the Government and eminent commercial bankers, but also people from auditing firms and general audience. I am sure that this diversified representation would have provided a varied perspective to each of the issues being debated and thrown up possible solutions.

Financial sector and economic growth

3. Banks' primary purpose is to mobilize otherwise idle savings for the purpose of lending to productive investments. A lot of research work has been undertaken to study the relationship between the financial sector and real sector economic growth. The old model of economic growth as a function of land i.e. capital, labour, technology and entrepreneurship has been modified. The new paradigm of economic growth is that it is a function of savings rate, return on investment and cost of intermediation. We can easily see the role and importance of the financial sector with regard to all of these three factors. Thus while there is consensus about finance having significant impact on the quantity, quality ie productivity and the efficiency of capital, jury is still out in determining whether it is the banks or capital market which drives economic growth. Research opinions and conclusions are equally divided. Very often the examples of the United States of America and the United Kingdom are quoted to prove that it is the capital market which drives growth. To counter that, the examples of Germany and Japan are quoted to establish that it is the banks which drive the growth.

4. Banks constitute the backbone of a nation's financial system, performing manifold functions through liquidity, maturity and risk transformation. Indeed, it needs no gainsaying that the health of the economy is, in a way, the mirror reflection of the banking system, especially in bank-based financial systems such as ours. Of course, the reverse is also equally true. I am reminded of a saying that a bank is like heart of the human body and the capital it provides is akin to the blood in it. So long as the blood circulates seamlessly, the organs remain sound and healthy. However, if for any reason, the blood were not supplied to any organ, then that part would be rendered useless. Not surprisingly therefore, there is always a conscious attempt on the part of the Reserve Bank to provide adequate liquidity and credit to all productive sectors of the economy.

Indian experience

5. India has the distinction of long history of both banks and capital market. Economic history of India narrates how both have been vibrant in many important cities, though Mumbai did dominate all others. However, slowly and steadily, especially in the last twenty five years or so after the financial sector reforms, the banking sector has emerged as THE source for investment funding.

6. What has been the actual contribution of banks for engineering investments in the Indian economy? Bank credit increased from ₹ 5 billion as at end March 1951, to ₹ 13 billion by March 1961, ₹ 47 billion by March 1971, ₹ 254 billion by March 1981, ₹ 1164 billion by March 1991, ₹ 5114 billion by March 2001, ₹ 39420 billion by March 2011 and ₹ 52604 billion by March 2013. What has been the contribution of capital market in these years? During the 1970s, while capital market helped raising ₹ 10 billion worth of equity, bonds and debentures, banks extended credit worth ₹ 207 billion in that period. During the 1980s, the corresponding figures were ₹ 233 billion and ₹ 910 billion. In the 1990s, they were ₹ 1172 billion and ₹ 3950 billion respectively and in 2000s they were ₹ 2115 billion and ₹ 34206 billion respectively. In the fiscal 2011 and 2012, ₹ 318 billion by the capital market and ₹ 13284 billion by banks.

7. Actually banks do extend funds by way of investment in the bonds and debentures. As these are heavily in government bonds, rather than in those issued by corporates and the split figures are not readily available, I have not included them here.

8. While we can lament the lackluster performance of the capital market, a redeeming feature has been the growth of private placement market in the past twenty years. Though the issues thereat had been predominantly in the form of bonds and debentures, the growth in size has been very reassuring. It gained popularity from mid 1990s; from 1995–96 to 2000–01, this market raised ₹ 752 billion, in the next ten years, it helped raise ₹ 7614 billion and in fiscal 2011–12 and 1012–13, this market raised ₹ 2009 billion.

9. While we are happy that banks have been doing such a wonderful yeoman service for the growth of the economy, will we be happy to continue to depend on bank financing as the predominant mode? Are we compelling the banks take too much risk, thereby endangering the depositors' money?

10. However, taking note of the predominant position of banks in the Indian financial system and taking a realistic view, can we expect the bank finance to comprehensively cater to all types of investment needs? Irrespective of whether it is short, medium or long term, or whether it is loan, debt or equity financing, or it is with low, medium or higher risk propositions? Should we turn our banks like the universal banks in Germany, catering to every type of investment demand of the entire economy?

11. Or, alternatively, should we develop capital market so that it can cater the increasing need for investment and also risky investments? Like those in the USA?

12. These are sets of questions that we need to ponder over and take strategic decisions.

Twelfth plan

13. 12th Five Year Plan aims to usher in faster, more inclusive and sustainable economic growth. It notes that today, India can sustain a GDP growth of 8 percent a year. Increasing this to 9 or 10 percent will need more mobilization of investment resources; better allocation of these resources through more efficient capital markets; higher investment in infrastructure through both public and PPP routes; and more efficient use of public resources.

14. Twelfth Plan has ambitious target for investments to usher in high growth rate of 8 percent during 2012–17. It aims to mobilise resources worth ₹ 5.4 trillion. The total public sector investment in infrastructure envisaged in the Twelfth Plan is ₹ 16 trillion by the Centre and ₹ 12.89 trillion by the States. Investment by the private sector, which includes PPP projects, makes up the balance of ₹ 26.83 trillion, which is 48.14 percent of the required investment during the Twelfth Plan, a much higher share than the anticipated 36.61 percent during the Eleventh Plan. Accordingly the Plan aims for an eclectic mix of development of capital market, more specifically debt market, besides exhorting bank finance.

15. Being from the Reserve Bank, let me ponder more over banks' role in the coming years.

Banking sector reforms

16. Leading economists most often cite the importance of sound financial sector reforms as being central to a healthy banking system that aids economic growth. India is the largest country in South Asia with an extensive financial system characterized by varied financial institutions, comprising of both banks and non-banks. Banks are the mainstay of the financial system with bank assets comprising, on average, around 70 percent of GDP during the post-reform period. The commercial banking segment comprises of 26 public sector banks in which government has majority equity stake, 20 private sector, including 7 *de novo* (which became operational after initiation of economic reforms in 1991) private banks, although RBI has recently done away with this distinction and over 40 foreign banks, which operate as branches.

17. Prior to the inception of financial sector reforms in 1991, the Indian financial system can best be characterized as highly regulated and financially repressed. The prevalence of high reserve requirements, interest rate controls and allocation of financial resources to pre-designated sectors adversely affected banks' resource mobilization and allocation.

18. The period 1992–97 laid the foundations for reforms in the banking system. The reforms comprised of five major planks: cautious and proper sequencing, mutually reinforcing measures, complementarities between banking reforms and other associated policies (e.g., monetary, external, etc.), developing financial infrastructure and nurturing and developing financial markets. Some of the salient reforms undertaken in the financial system, included, among others, lowering of statutory reserve requirements; liberalizing the interest rate regime, first on the lending side and later, on the deposit side; infusing competition by allowing more liberal entry of foreign banks and permitting the establishment of *de novo* private banks; institution of prudential measures (capital adequacy requirements, income recognition, asset classification and provisioning norms for loans, exposure norms, accounting norms) and enhanced disclosures and levels of transparency in their annual audited statements to promote market discipline.

19. Over the period of reforms beginning 1992 through 2013, real bank assets have grown at a compound annual rate of about 10%; the growth rate of deposits and credit both in real terms, during the same period has been roughly of the order of 10% and 12%, respectively.

20. I am happy to note that the issues deliberated today are those that are likely to shape the future of the industry, going forward. I would like to take this opportunity to share with you my views on some of these and other related concerns, which, as I see it, will shape the contours of the industry in the years ahead.

Financing of infrastructure

21. The first issue, which immediately comes to my mind, is the issue of infrastructure financing. I am sure that this issue will also be uppermost in your minds as well. Inadequate infrastructure exerts a cascading impact on the economy, negatively affecting productivity, employment, personal income and international competitiveness and costs. The 12th Five Year Plan as mentioned earlier has estimated the infrastructure requirement at around INR 56 trillion, with a gradually increasing role for the private sector. Given the limited fiscal headroom and the long gestation lags involved in its fructification, there is a need to rope in long-term providers of funds.

Can banks chip in? Yes and in fact has already done so. As the capital market's significance has been waning, bank finance for infrastructure steadily grew. The outstanding bank credit to the infrastructure sector, which stood at ₹ 72 billion in 1999–2000, has increased to ₹ 7860 billion in 2012–13, registering a compounded annual growth rate (CAGR) of over 40 per cent against an overall CAGR of bank finance to all industries at 20 percent during the same period. However, this kind of growth and the general economic downturn and policy conundrum have resulted in concentration risk for banks (Infra funding is as high as 15% in

the banking books); banks are saddled with large scale stress assets in the infra segment. Further, there is the structural problem of using short term nature of the bank funds for very long term funding. Banks did evolve a midway solution, of medium tenor funding for 12 to 15 years. This, though solved the initial problems, is fundamentally a weak arrangement and the recent stress period has brought the cracks into open. Banks will have to appropriately structure their infrastructure lending keeping in view their asset-liability mix; they also may have to raise long term resources. They should develop long-tenor fixed rate or floating rate products or develop appropriate hedging instruments to tackle counterparty and other risks. Takeout finance is another possible solution, as do Infrastructure Debt Funds (IDFs). These initiatives are presently at a nascent stage, but hold long-term promise.

22. Over the longer-term, an efficient and vibrant corporate bond market is a *sine qua non* for ensuring viable financing of infrastructure. By facilitating long-term funding for the sector, it can provide much-needed debt capital that will be beneficial to both borrowers and investors alike. This will also ensure deep and broad financial markets, one of the key pillars of RBI's financial sector policies.

Financing of SMEs

23. A second issue I would like to touch upon is the financing of micro, small and medium enterprises or MSMEs, as we call them. In 2011–12, the sector accounted for a significant proportion of manufactured output and over 12 per cent of our GDP. In addition to their strong export orientation, they also have a strong employment potential, providing bread- and butter to nearly 100 million people, perhaps next only to the agricultural sector. With a big chunk of them being located in rural areas, it also offers tremendous potential for rural development. Given their forward and backward linkages with the corporate sector, I view them as "silent" engines of growth, especially in slow economic cycles.

24. Numerous studies have documented that, given the lack of reputation and tangible collateral, debt financing, mostly from informal sources, comprises the primary source of external funds for these entities. Given the often onerous documentation requirements for banks, these entities tend to get a raw deal when it comes to bank finance. The Fourth Census of MSME revealed that only 5.2 per cent of the units (both registered and unregistered) had availed of finance through institutional sources; the majority of units – 93% of them in fact – had either no finance or depended on self-finance. A World Bank Enterprise Survey in 2011 also reinforces these conclusions. The moot point is that the credit flow to MSMEs from institutional sources is not commensurate with the economic activity undertaken by them.

25. A RBI Discussion Paper in 2013 had propounded an innovative combination of banks and private equity, with a potential role of state in providing credit enhancement mechanisms/ solutions as a way out of this credit constraint. It also put forth the proposal that small banks can provide a useful role by catering to the needs of this segment, for example, through relationship banking.

26. There is also an oft-heard complaint from bankers that MSMEs are often quite lackadaisical when it comes to settling their dues. It needs to be recognised that MSMEs often act as ancillaries to large industries, and their cash flows are lumpy. The business orientation of large industries often affects the MSMEs directly, in turn hampering the recycling of funds and business operation of MSME units. Banks need to take a proactive view, carefully analyzing the linkages of the MSME units, when sanctioning funds. The existing provisions of the Interest on Delayed Payment Act, 1998 for these entities have been suitably modified taking on board their unique characteristics. In addition, banks have been advised to sanction separate sub-limits within the overall limits sanctioned to the corporate borrowers for meeting payment obligations in respect of purchases from MSME sector. The Parliament has passed the Factoring Regulation Bill that is expected to address delays in payment and liquidity problems of micro and small enterprises. I am sure that these

measures will contribute in no small measure towards alleviating the extant constraints that plague this sector.

Mobilising resources

27. As we have seen, country needs enormous resources for its development. How do we raise them? Banking sector has a major role here, in mobilizing the savings of the people. As at end March 2014, the scheduled commercial banks had mobilized deposits to the tune of ₹ 76 trillion. There are 146 scheduled commercial banks (including the Regional Rural Banks) in the country, with more than 1.2 lakh branches undertaking this activity. However, to support economic growth, we need to reach out more and hence there is a need for more banks to be functioning in India. Not just more banks, perhaps we need more variety of banks. I am not talking about public, private, foreign bank variety here. I am talking about the variety of functions that they will undertake, the niche in which they want to excel. Accordingly, the Reserve Bank has decided to license more banks. Two licenses we have given recently. We intend to offer this on tap basis. We are working on new set of guidelines for both full service commercial banks and differentially licensed banks. We hope that with more number of players, the banking sector will mobilize more resources for funding faster economic growth, will bring in financial inclusion and thereby support inclusive growth in a sustainable way.

Conclusion

28. I have touched upon several issues that are of contemporary relevance and are expected to remain important for quite some time in the near future. Conferences such as these offer a platform for interchange of views in a structured and systemic manner, whilst taking into consideration the regional-specific concerns as well. I hope that the organizers will not stop at this one-off Conference and instead, will arrange follow-up discussions to further brain storm the issues and ensure that the discussions reach their logical conclusion.

29. Thank you.