Sector Report:

Banking Sector in India

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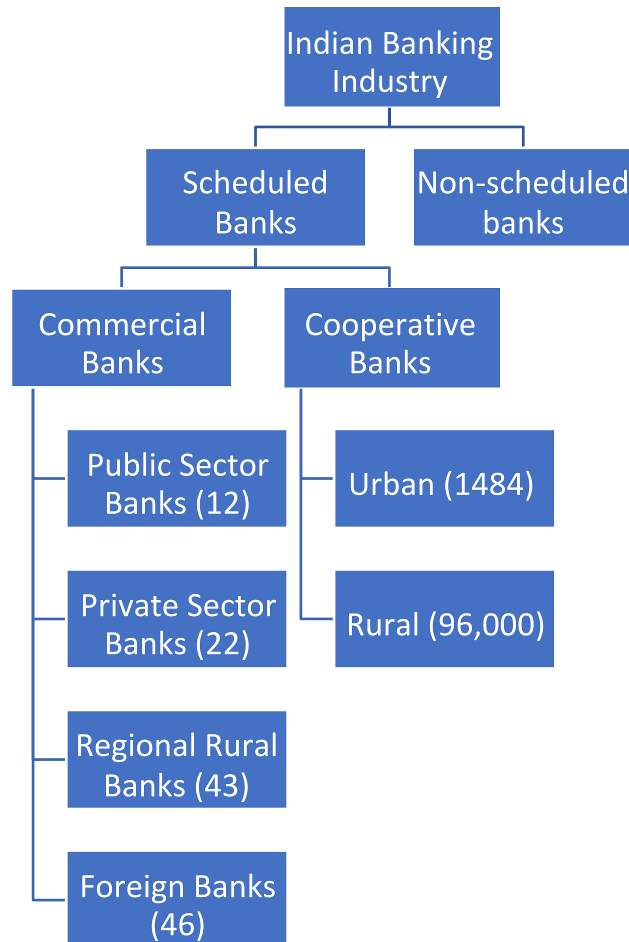
Structure of Banking in India

"Banking" means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise.

-Section 5(b), Banking Regulation Act, 1949



1. Scheduled Banks: All banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are scheduled banks. These are further classified into Scheduled Commercial Banks and Scheduled Cooperative Banks.
    a. Scheduled Commercial Banks: in India are categorized into five different groups according to their ownership or nature of operation.
        i. Public Sector Banks: Majority stake is held by Government of India.
        ii. Private Sector Banks: Majority of share capital is held by private individuals
        iii. Regional Rural Banks: RRBs were established in 1975 with a view of serving primarily the rural areas of India with basic banking and financial services

iv. Foreign Banks: Incorporated in foreign countries and operate their branches in India

b. Scheduled Cooperative Banks:

i. Rural Cooperative Banks

ii. Urban Cooperative Bank

Differentiated banks:

Banks that cater to specific segments of customers are called differentiated banks.

- **Small Finance Banks**: Focused mainly towards financial inclusivity, small finance banks provide basic banking services. They cater mainly to individuals from the underserved sections of society as well as businesses from the SME sector.
    - Similar regulatory requirements as regular commercial banks
    - SFBs are required to extend 75 per cent of its Adjusted Net Bank Credit to the sectors eligible for classification as priority sector lending by the RBI
    - At least 50 per cent of its loan portfolio should constitute loans and advances of up to Rs. 25 lakhs.

  Eg: Ujjivan, Janalakshmi, Equitas, etc.

- **Payments Banks**: These banks are allowed to accept deposits of up to Rs. 2,00,00, however they are restricted from lending and issuing credit cards. Most other banking operations like mobile payments, remittance service, issuance of ATM, debit cards, etc. are open to payments banks. Their main aim is to make financial services easily accessible to lower income groups, backward regions, etc.

  Eg: Airtel Payments Bank, Fino, NSDL Payments Bank, etc.

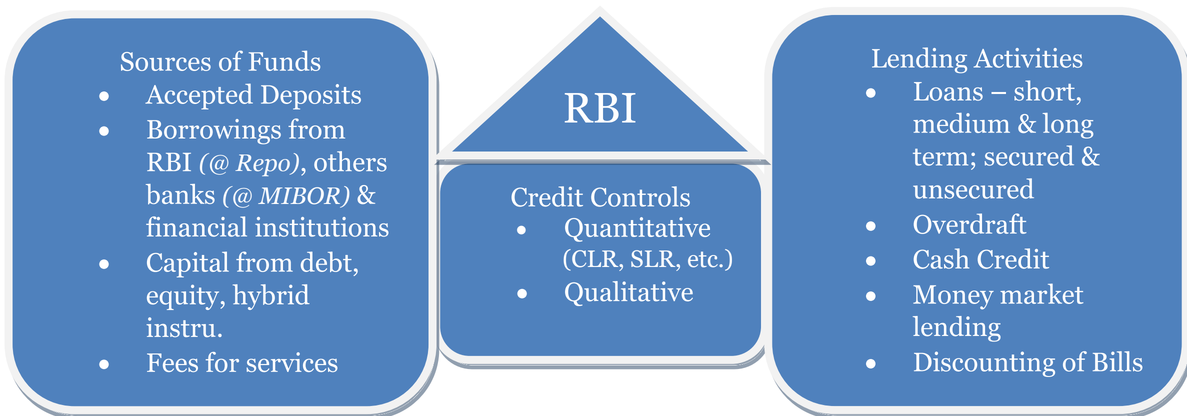
Operating Model

A commercial bank's major function is the creation of credit by lending money to individuals as well as institutions. For this purpose, it raises funds, by accepting deposits or borrowing from the RBI, other banks, financial institutions or via financial markets, by means of debt, equity or hybrid securities.
Since this model itself involves some risk, there are certain mechanisms by which the central bank controls the lending ability of commercial banks. These may be

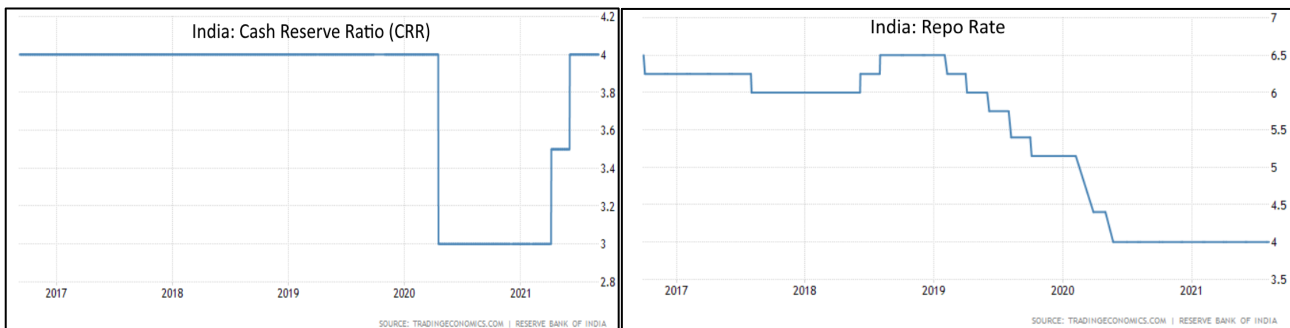
i) Quantitative: Like changes in CRR (cash reserve ratio), SLR (statutory liquidity ratio), etc.

ii) Qualitative: Like changing margin requirements which influence the amount of collateral demand of collateral, issuing directive principles, etc.

The following figure illustrates a bank's operations and some specific rates associated with them.



Ordinarily, the RBI does not often move the CRR and SLR. Under extreme situations, however, it becomes necessary to make use of these measures. The repo rate, on the other hand, is a highly used tool of the RBI.



As the figures show, the CRR has only seen a steep decline during the pandemic, when the RBI was trying to infuse liquidity into the economy. The repo rate, on the other hand, shows constant fluctuations. Although it too, has seen a considerable reduction after the pandemic.

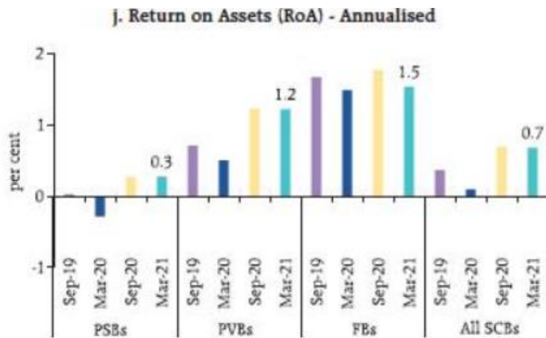
Important rates in Banking

Term	Details	Current Level
Non-Performing Assets	Loans that have not yielded interest 90 days or more after the interest payment due date.	Ratio of gross NPAs: 7.48% (March 2021)
MIBOR (Overnight)	The Mumbai Interbank Offer Rate (MIBOR) is one iteration of India's interbank rate, which is the rate of interest charged by a bank on a short-term loan to another bank	3.36% (27.8.2021)
Repo Rate	The rate at which commercial banks can borrow from RBI for short term liquidity adjustment (net amount after borrowing among themselves).	4.00%
Reverse Repo Rate	The rate at which the RBI absorbs excess liquidity from the commercial banks	3.35%
Marginal Standing Facility Rate	The rate at which banks borrow funds, in excess of the specified threshold, overnight from RBI against government securities	4.25%
Bank Rate	The rate at which the RBI lends to commercial banks for long term borrowing	4.25%
Statutory Liquidity Ratio	The proportion of Net Demand and Time Liabilities that the commercial banks have to invest in specified government securities	18.00%
Cash Reserve Ratio	The proportion of Net Demand and Time Liabilities of commercial banks that must be kept as cash or in liquid form so as to meet any unexpected demand of money by depositors	4.00%

Trends Across Key Metrics: Effects of the Pandemic

Return on Assets

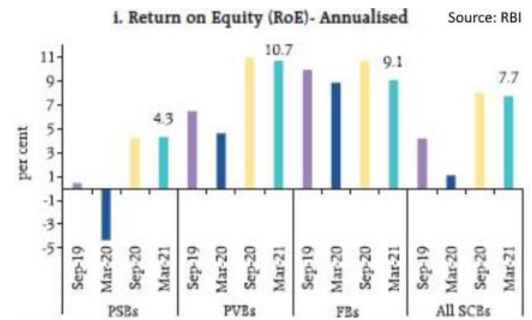
- Reflects net return per currency unit of loan
- Initial reduction, then rise during pandemic



$$RoA = \frac{Net\ Income}{Total\ Assets} \times 100$$

Return on Equity

- Measures effective utilisation of capital'
- Fell initially, then rose during pandemic



$$RoE = \frac{Net\ Income}{Shareholders'Equity} \times 100$$

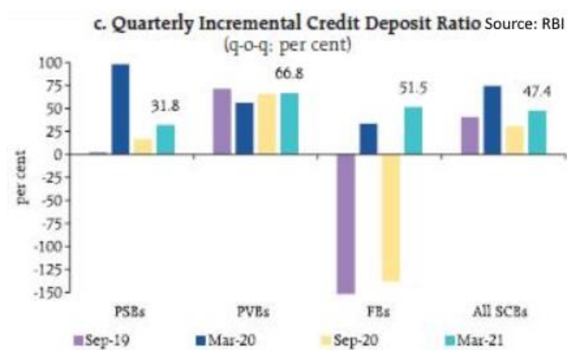
Net Interest Margin

- Measures profitability through interest spread
- Slight reduction in 2021 due to low loan growth

$$Net\ Int.Margin = \frac{Interest\ Income - Interest\ Expense}{Average\ Earning\ Assets} \times 100$$

Loan Deposit Ratio

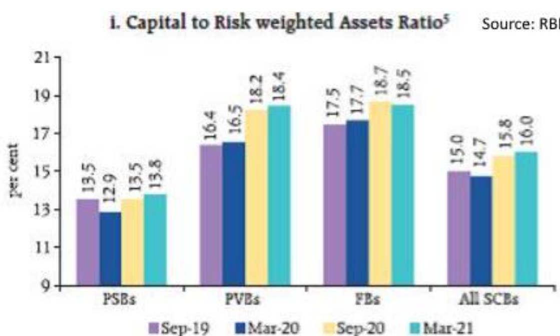
- Measures liquidiuty of a bank
- Fell a lot in 1st lockdown, still not fully recovered



$$Loan\ Deposit\ Ratio = \frac{Total\ Loans}{Total\ Deposits} \times 100$$

Capital Adequacy Ratio

- Measures liquidiuty of a bank
- Secular rise, slight fall initially during pandemic



$$Capital\ Adequacy\ Ratio = \frac{Capital\ Funds}{Risk\ Weighted\ Assets} \times 100$$

Snapshot: Financial Statements of a Bank

Income Statement

State Bank of India

Profit and Loss Account for the year ended 31st March, 2021

(000s omitted)

		Schedule No.	Year ended 31.03.2021 (Current Year) ₹	Year ended 31.03.2020 (Previous Year) ₹
I.	**INCOME**			
	Interest earned	13	265150,63,38	257323,59,22
	Other Income	14	43496,37,47	45221,47,80
	TOTAL		**308647,00,85**	**302545,07,02**
II.	**EXPENDITURE**			
	Interest expended	15	154440,63,33	159238,76,57
	Operating expenses	16	82652,22,35	75173,69,02
	Provisions and contingencies		51143,68,23	53644,50,37
	TOTAL		**288236,53,91**	**288056,95,96**
III.	**PROFIT**			
	Net Profit for the year		20410,46,94	14488,11,06
	Add: Profit/ (Loss) brought forward		(10498,30,21)	(15226,05,54)
	TOTAL		**9912,16,73**	**(737,94,48)**
IV.	**APPROPRIATIONS**			
	Transfer to Statutory Reserve		6123,14,08	4346,43,32
	Transfer to Capital Reserve		1465,12,42	3985,83,93
	Transfer to Investment Fluctuation Reserve		1928,19,63	1119,88,09
	Transfer to Revenue and other Reserves		426,70,60	308,20,39
	Dividend for the current year		3569,84,46	-
	Balance carried over to Balance Sheet		(3600,84,46)	(10498,30,21)
	TOTAL		**9912,16,73**	**(737,94,48)**
V.	**EARNINGS PER EQUITY SHARE (Face value ₹ 1 per share)**			
	Basic (in ₹)		22.87	16.23
	Diluted (in ₹)		22.87	16.23
	Significant Accounting Policies	17		
	Notes to Accounts	18		

Major components of other income include commission, exchange & brokerage, insurance premium income, P/L on sale of investments etc. Major components of operating expenses include employee expenses, rent & utilities, insurance, expenses of subsidiary businesses etc.

Balance Sheet

	Schedule No.	As at 31.03.2021 (Current Year) ₹	As at 31.03.2020 (Previous Year) ₹
CAPITAL AND LIABILITIES			
Capital	1	892,46,12	892,46,12
Reserves & Surplus	2	252982,72,85	231114,96,63
Deposits	3	3681277,07,96	3241620,73,43
Borrowings	4	417297,69,88	314655,65,21
Other Liabilities and Provisions	5	181979,66,31	163110,10,41
TOTAL		**4534429,63,12**	**3951393,91,80**
ASSETS			
Cash and Balances with Reserve Bank of India	6	213201,53,63	166735,77,90
Balances with Banks and money at call and short notice	7	129837,17,31	84361,22,64
Investments	8	1351705,20,51	1046954,51,75
Advances	9	2449497,79,11	2325289,56,07
Fixed Assets	10	38419,24,19	38439,28,18
Other Assets	11	351768,68,37	289613,55,26
TOTAL		**4534429,63,12**	**3951393,91,80**
Contingent Liabilities	12	1706949,91,17	1214994,60,69
Bills for Collection	-	56516,11,88	55758,16,19
Significant Accounting Policies	17		
Notes to Accounts	18		

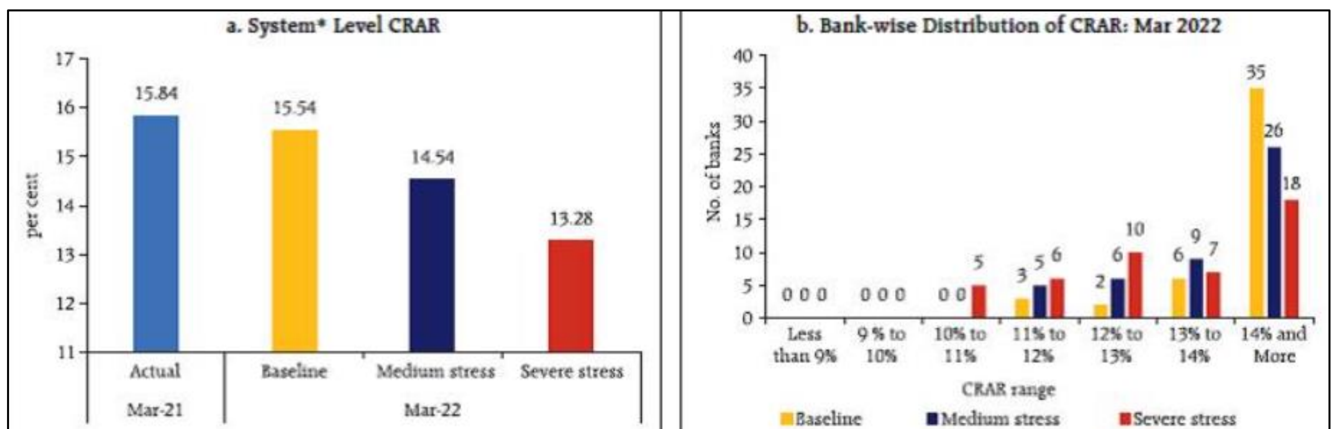
Capital Requirements

Since banks take up a considerable amount of risk through their lending operations, regulators require them to maintain a certain amount for "cushioning" the effect of potential default. These requirements are termed as Capital Requirements and the amount is held as percentage of risk weighted assets.

Capital requirements govern the ratio of equity to debt, recorded on the liabilities and equity side of a firm's balance sheet.

The main international effort to establish rules around capital requirements has been the Basel Accords. It sets a framework on how banks and depository institutions must calculate their capital. After obtaining the capital ratios, the bank's capital adequacy can be assessed and regulated.

As per Basel III regulations, all SCBs were required to maintain a CAR of 11.5% from March 31, 2020 onwards (CAR of 9.0% along with capital conservation buffer (CCB) of 2.5%). However, with the outbreak of COVID-19, RBI decided to defer the implementation of the last tranche of 0.625%. The current regulatory requirement is 9% (11.5% including the capital conservation buffer, which is another capital requirement) while the ratio observed on an average for scheduled commercial banks is 16.03%. RBI's projections for March 22, however, show a fall in the CAR, the most likely estimate being around 14%.



Further, systemically important banks need to maintain an additional requirement of over and above the 9% CAR (which includes SBI: 0.6%, HDFC: 0.2% and ICICI Bank: 0.2%).

Valuation Methods:

1. **P/B Ratio:** Assets held by banks are typically in the form of financial instruments (loans, bonds and other securities as well as derivatives) that have well defined cash flows. These are relatively liquid assets that can be valued at fair market value. Book values are much closer to market values than is the case for non-financial corporates, where most of the assets are carried at depreciated cost.

$$\frac{Stock\ Price \times No.of\ Shares\ Outstanding}{Book\ Value}$$

2. **Intrinsic valuation:** Since the book value of equity is more reliable and cash flows are highly volatile, and less accurate as a metric of assessing management competence, shareholders equity can be used as a starting point for valuing banks. This method is known as the Excess Return Model and it arrives at the value of equity as the sum of the current equity capital and the present value of expected excess returns to equity.

$$Excess\ Returns = (Projected\ Return\ on\ Equity - Cost\ of\ Equity) \times (Beginning\ Equity\ Capital)$$

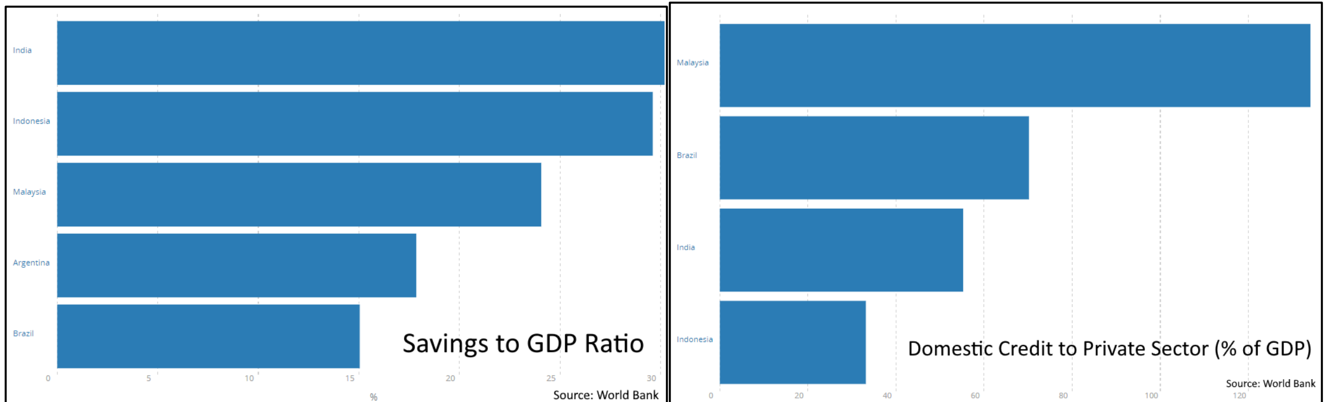
If a bank is earning extremely high excess returns, it is important to do a multi-period valuation whereby returns decline to a long-term sustainable level over time. Once the firm reaches its long-term sustainable operating level, terminal value can be calculated that incorporates this long-run moderate growth.

Other methods: Banks can also be valued by discounting the dividend stream using projected pay-out ratios, or asset liquidation values, or relative valuation methods with respect to the loan book etc.

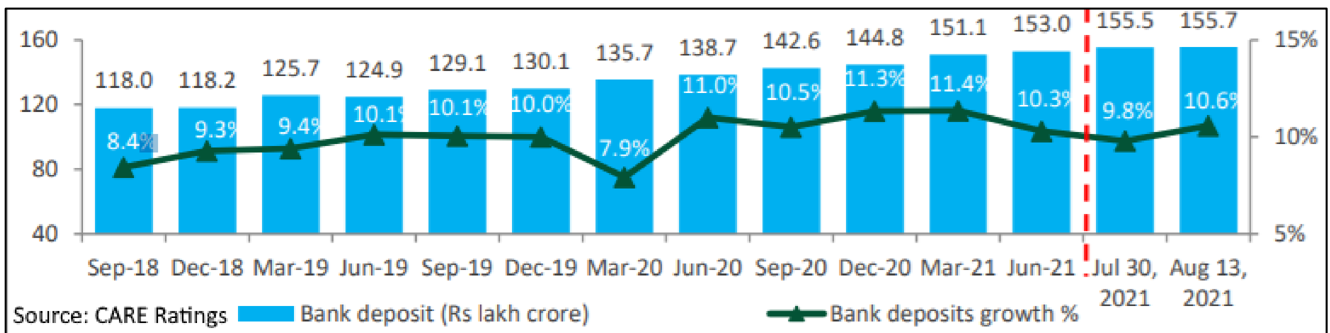
Drivers of Growth: Strengths of the Banking Sector

High Savings & Deposits Ratio

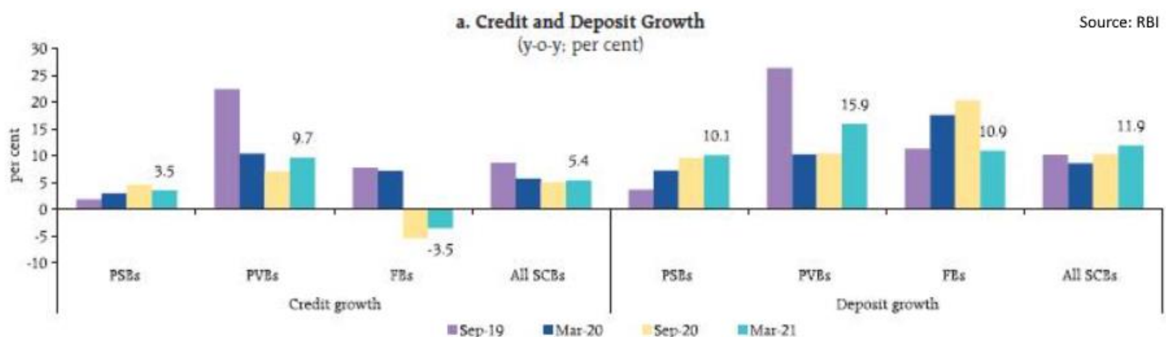
Savings as a percentage of GDP is comparable to, and in some cases much better than, other developing economies like Indonesia, Malaysia, Brazil and Argentina.



A high savings rate generates more deposits for banks and enables them to expand their scale of operations. The past few years do show a fairly consistent growth in the total deposits.



However, despite the reasonably high savings and deposits rates, India's credit-to-GDP (51%) ratio remains much below that of peers like Malaysia (136%) and Brazil (70%) [1]. This shows that although, even though a higher savings rate would add to the available deposits, banks may not be willing to lend it out to great extent. As the figure shows, this gap was further exacerbated during the pandemic.

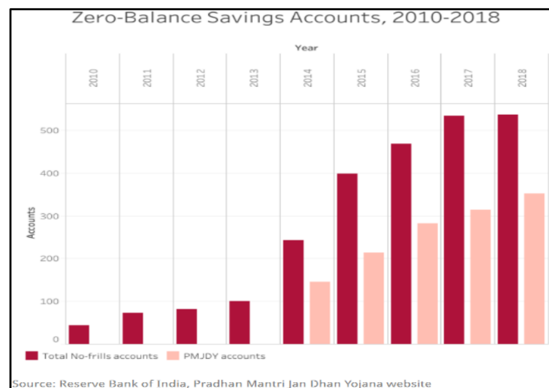


This aversion to lend is also reflected in the slow transmission of monetary policy, especially when the repo rate gets lowered. Since February 2019 to June 2021, the repo rate fell by 250 basis points, but bank lending rates fell only by 150 basis points [2]

Increasing Number of Accounts

Over the past few years, the number of bank accounts in India has increased briskly. Around 80% Indians now have bank accounts. In a country with a massive informal economy, an

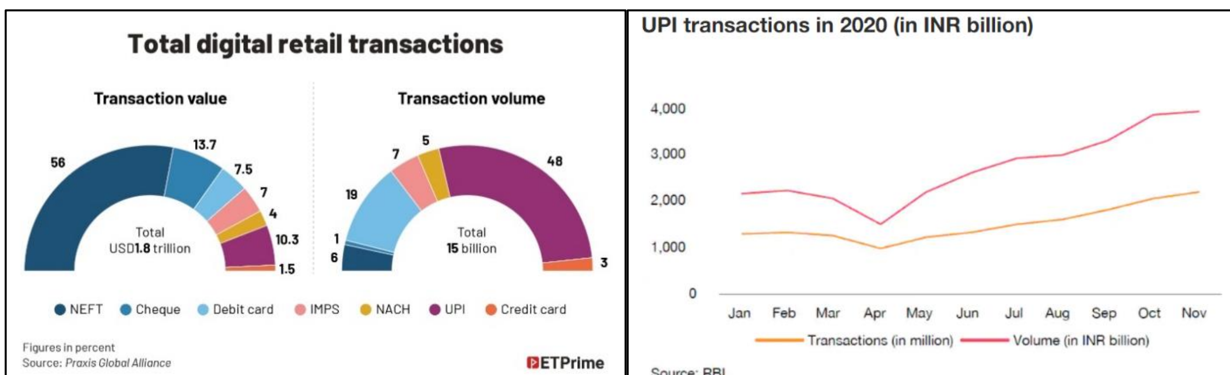
increasing number of bank accounts helps integrate the unorganised economy into the organised one. Although many of these accounts are "zero-balance", which means that they might end up not garnering any significant deposits, the percentage of zero-balance accounts has been falling over the years – from 75% in 2014 to 17% in 2018 [3].



This shows that the degree of financial inclusion is gradually rising. Although people from lower income groups, do not save a significantly high proportion of their income, since a major chunk of Indian households falls within this group, the collective amount that they add to bank deposits is considerable.

Rise of UPI

United Payments Interface (UPI), launched by the National Payments Corporation of India (NPCI) in 2016, facilitates inter-bank, peer-to-peer and person-to-merchant payments. With the increasing internet and mobile penetration, more and more transactions are being undertaken using UPI. It is the most-used mode of cashless payment, although the average size of transactions remains low. However, the growth in both, volume and magnitude of transactions has been considerable.



Incolvency & Bankruptcy Code

Before 2016, resolution of bankruptcy resolution was fragmented, stretching across multiple Acts. This greatly increased the time required to complete the process, and in turn, also led to further devaluation of the business entity, making resolution even more difficult. It would take, on an average 4.3 years to resolve a case of bankruptcy, while under IBC, the period prescribed by law is 340 days.

Apart from reducing the time, the IBC has also pursues a “Creditor in Possession” model by enabling diverse types of creditors to file for the corporate debtor’s bankruptcy. It has also eliminated the need for shareholders’ approval for the same.

According to the Economic Survey 2021, Rs. 1.73 lakh crore was recovered under IBC – this was higher than the amount recovered through all other modes combined; the recovery rate was over 43%.

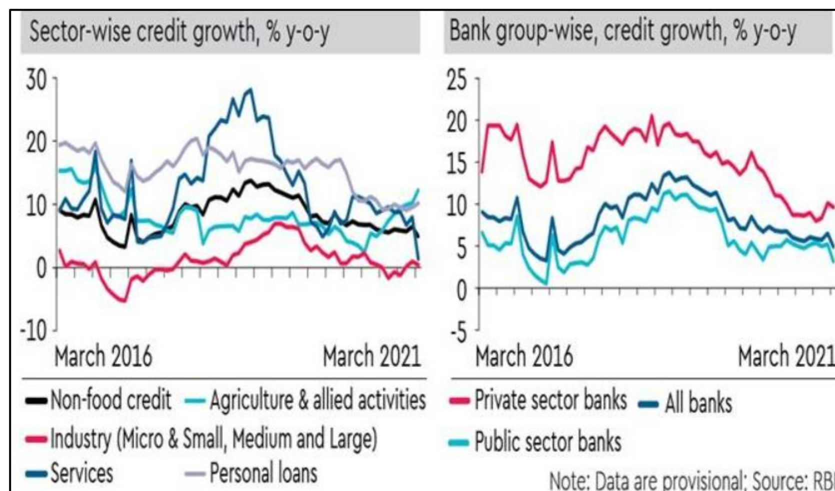
IBC is important to the banking sector because it enables efficient allocation of capital – out of sick units into better, more deserving ventures.

Constraints to Growth: Weaknesses of the Banking Sector

Loan Growth: Low for Industry

Despite a reasonable growth rate of deposits, loan growth in India has remained tepid. This was further exacerbated by the pandemic – as lockdowns were declared, the operations of numerous companies had to abruptly cease. This rendered a lot of enterprises, especially small and medium ones, risky investments, making banks wary of lending. MSMEs have historically been one of the most credit starved sectors in India, with a credit gap of $240 billion.

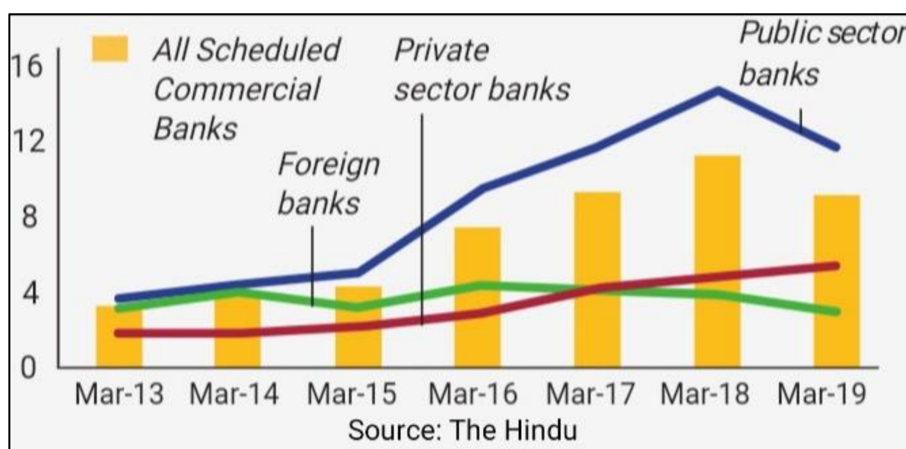
Growth in personal loans, however, has been very strong. Although it fell due to the pandemic, it has still managed to keep at a reasonable 10% y-o-y level. Growth in loans to the service sector too, have also been high historically and the pandemic has not much dampened the long term average.



Public sector banks have been more wary of lending, perhaps in light of their already high levels of NPAs. Such low loan growth to non-service industries has resulted in low leverage ratios of companies, which in turn, have restricted their growth.

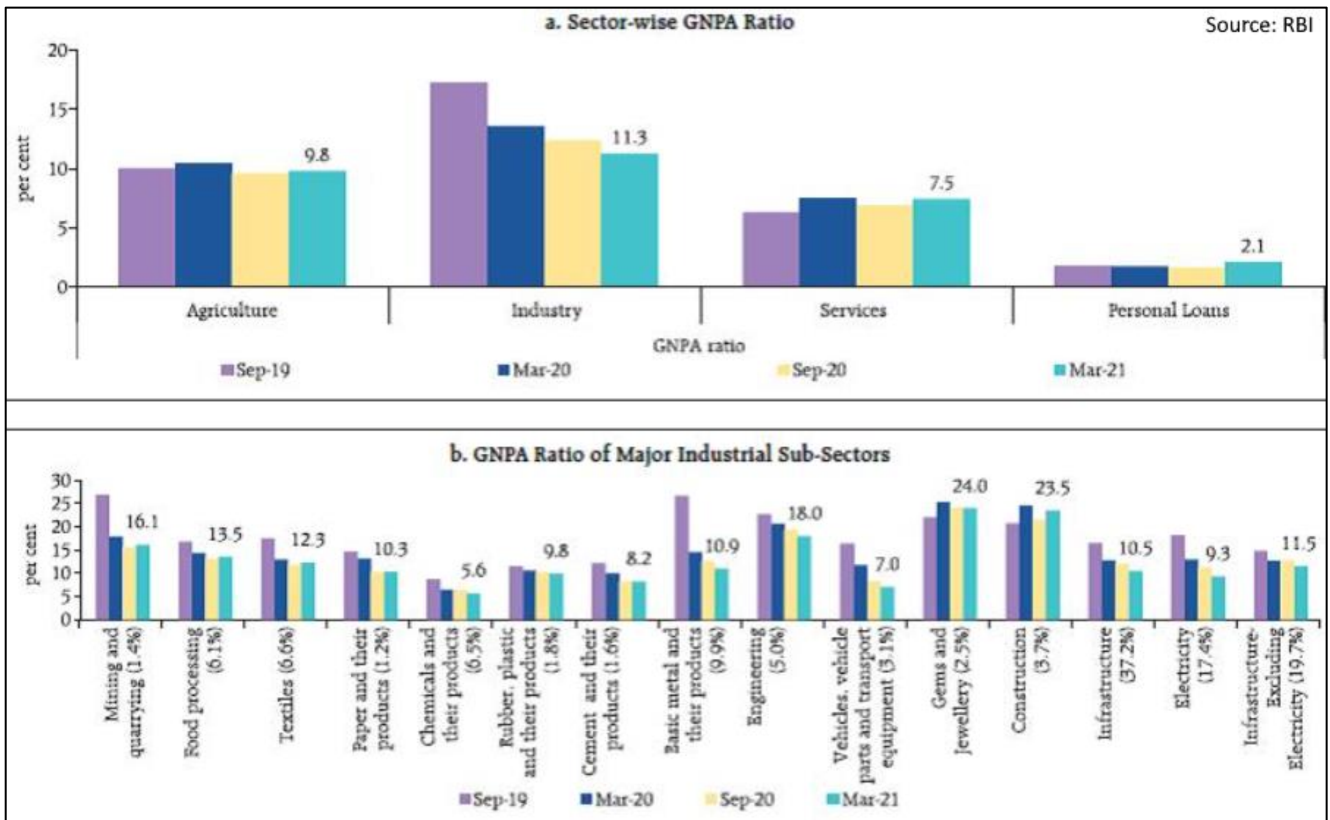
High NPAs

Non-performing assets have been a chronic problem of the Indian banking sector that came to fore in 2016. Public sector banks have much higher rates of NPAs as compared to private or foreign banks.



In terms of sectoral distribution of NPAs, it is mainly heavy industries like mining, construction, basic metals and engineering that contribute the most. Most of these sectors require high initial investments and are quite vulnerable to international price movements. For example, the metals industry has been facing long-standing

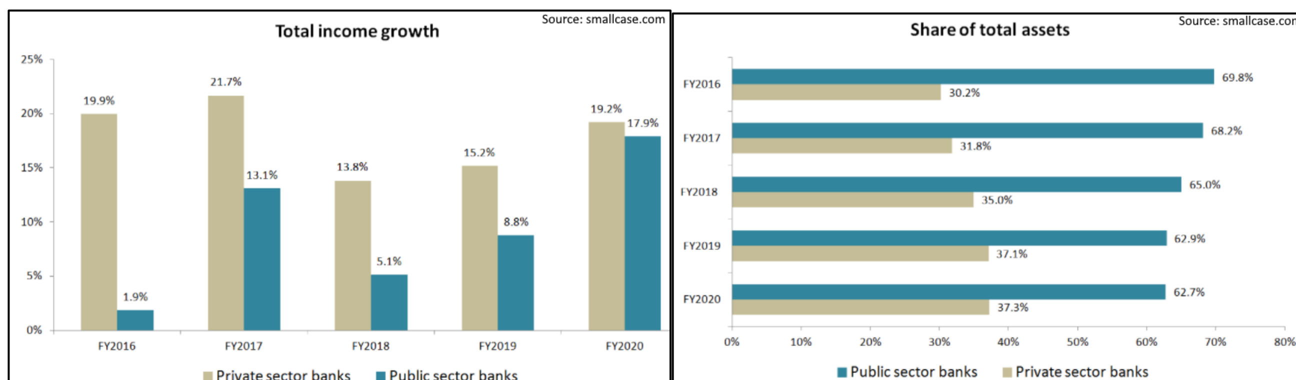
competition from low-cost Chinese products.



Private v/s Public Banks

Income Growth

The income growth of private sector banks has historically been higher than public sector banks. But during 2020, the income growth of public banks has improved substantially, lowering the gap between the growth of public and private sector banks.



Share in Assets

Currently, in India, public sector banks own about two thirds (63%) of the total assets; the average for other developing economies is around one third (33%). Since public sector banks are more vulnerable to undue influences and malpractices in lending and managerial decisions, them being in-charge of a majority of the assets, can adversely affect growth due to high defaults.

Growth Prospects

Over the years, private banks have managed to bridge the gap between the market shares of private and public sector banks. As the following trend shows, private banks now have a much higher share in both, loans and deposits, as compared to previous years. This rise has been secular and if it continues, private sector banks are poised to overtake public sector banks in terms of market share.

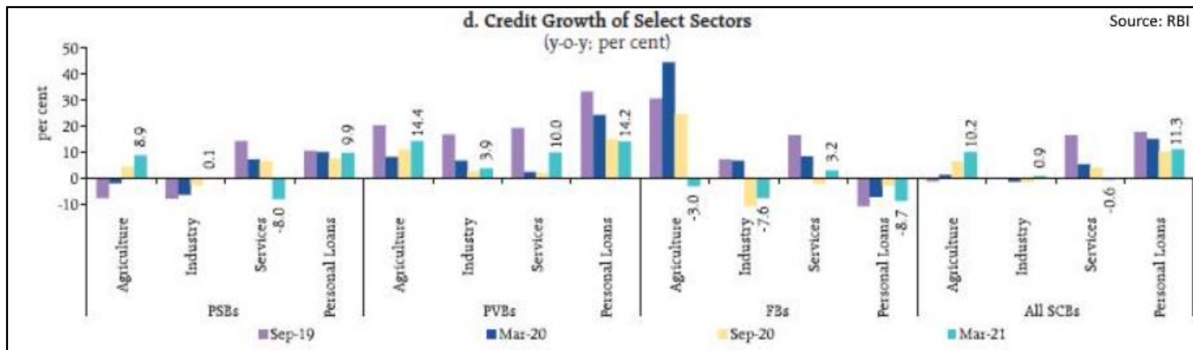
MARKET SHARE IN LOANS (in percentage)				MARKET SHARE IN DEPOSITS (in percentage)			
Year	Public sector banks	Private sector banks	Foreign banks	Year	Public sector banks	Private sector banks	Foreign banks
2000	79.41	12.56	8.03	2000	81.29	12.63	5.47
2005	74.25	19.21	6.54	2005	78.16	17.12	4.7
2010	77.24	18.08	4.67	2010	77.68	17.31	5.05
2015	74.28	21.26	4.45	2015	76.26	19.44	4.3
2020	59.8	36.04	4.15	2020	64.75	30.35	4.89

Source: RBI   Source: RBI

Impact of COVID-19

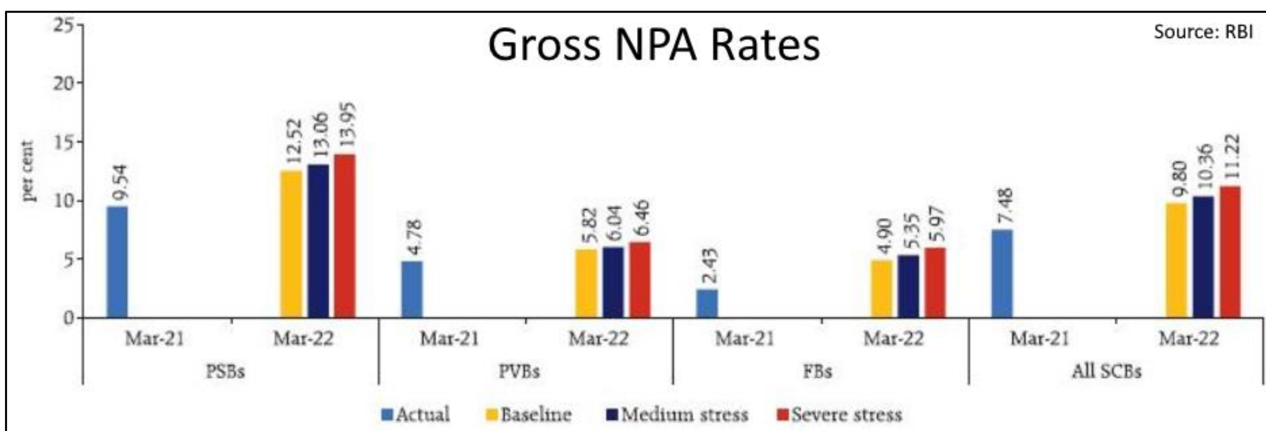
Credit Growth

The sudden external shock of the pandemic and then, the shutting down of the economy during lockdowns, led to lowering of credit growth across all sectors. While some sectors like agriculture and personal loans are on the path to recovery, others like industry, seem to have taken a major hit.



NPAs

Although the overall NPA rate has reduced slightly to 7.5% during most of 2020, despite the pandemic, this is mainly due to the RBI's one-time-restructuring policy which prevented stress assets from being written off entirely. However, given that the pandemic has caused extensive lockdowns, severely hampering productions and disrupting supply chains, it is expected that the NPA rates would rise in the coming year.



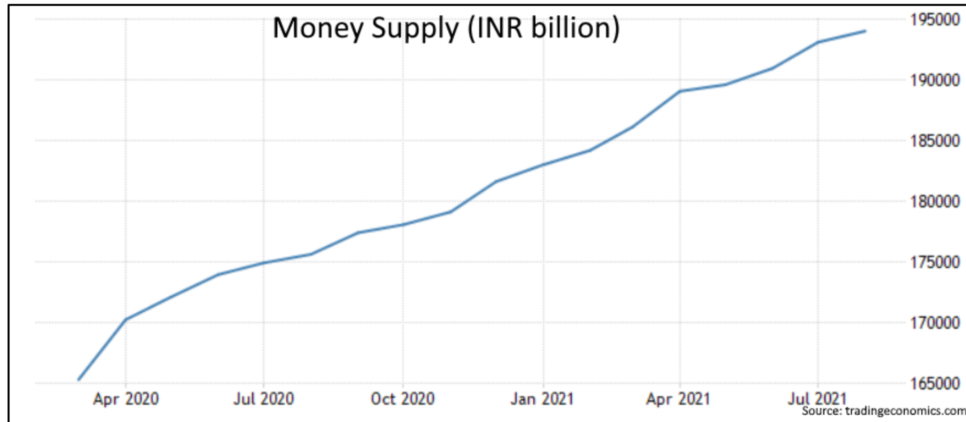
NPAs cause capital to get stuck in "sick businesses"; in a country like India, with a low rate of capital formation (28%), such inefficient allocation of capital reduces opportunities for better businesses, hindering overall growth.

Monetary Policy

Since the Indian economy got struck by the COVID-induced recession, the RBI has followed an expansionary monetary policy. Ordinarily, its major policy objective is inflation targeting. Currently, however, owing to the dire circumstances, it has maintained an accommodative stance (maintained the status quo in interest rates) despite rising inflation (CPI: 5.59% in July 2021).

Bond Purchases: Although RBI does undertake bond buying programmes as a part of its expansionary policy, its bond-buying calendar is not announced beforehand. Hence, the investors do not have prior ideas as to the timeline or the magnitude of the purchases. During FY21, it purchased bonds worth Rs. 3.13 trillion from the

secondary market. At the beginning of FY 22 however, the RBI announced the Government Securities Acquisition Program (GSAP) to buy Rs. 1 trillion over the first quarter. It has also announced a GSAP 2.0 recently, worth Rs.. 20,000 crore.
The purpose of these expansionary measures is to increase the money supply in the economy to boos consumption expenditure and ultimately, economic growth.



Market Opportunities

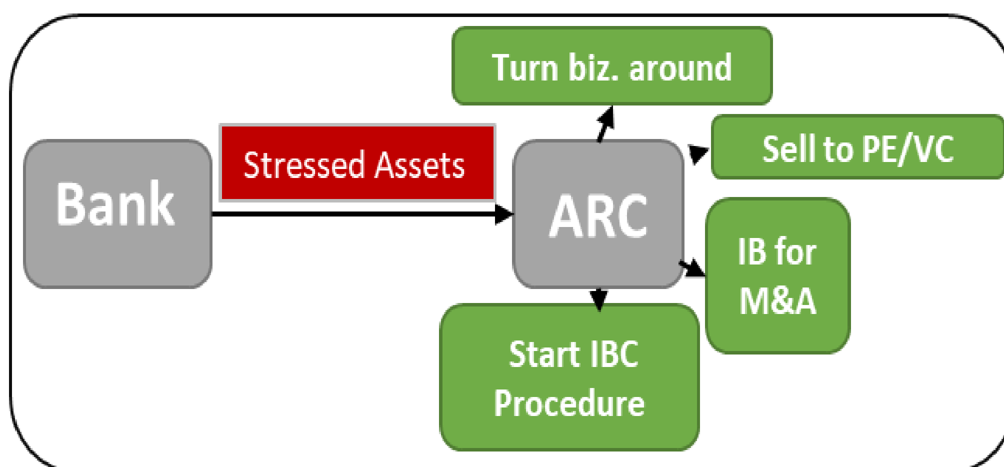
Bad Banks

The FY '22 Budget introduced the idea of setting up the National Asset Reconstruction Company Limited (NARCL) – an organisation funded, mainly, by public sector banks like SBI, Bank of Baroda, Punjab National Bank, etc. in order to purchase the NPAs of banks and obtain maximum salvage value out of them.

Since 2016, the Insolvency & Bankruptcy Code has been instituted for the resolution and as necessary, liquidation of sick units. Although the duration for resolution is, on paper, 330 days, in practice cases take an average of around 440 days [4]. It has been reported that, as the time for resolution increases, the recovered value falls from the average of 43% to 15-20% [5].

However, the introduction of NARCL will open multiple avenues for recovering the value of NPAs. The bad bank will purchase the stressed assets from the banks. In doing so, it is required to pay a fixed proportion of the value of the asset upfront. Considering the volume of NPAs in India is as high as Rs 6 lakh crore, an ARC would need to possess adequate capital if it wants to buy a significant chunk of the stressed assets. Although the required minimum capital for setting up an ARC is Rs. 100 crore, the contributing banks are providing capital worth Rs. 7000 crore for the NARCL. This would be adequate to cover the estimated upfront costs (Rs. 2000 crore) of buying the assets.

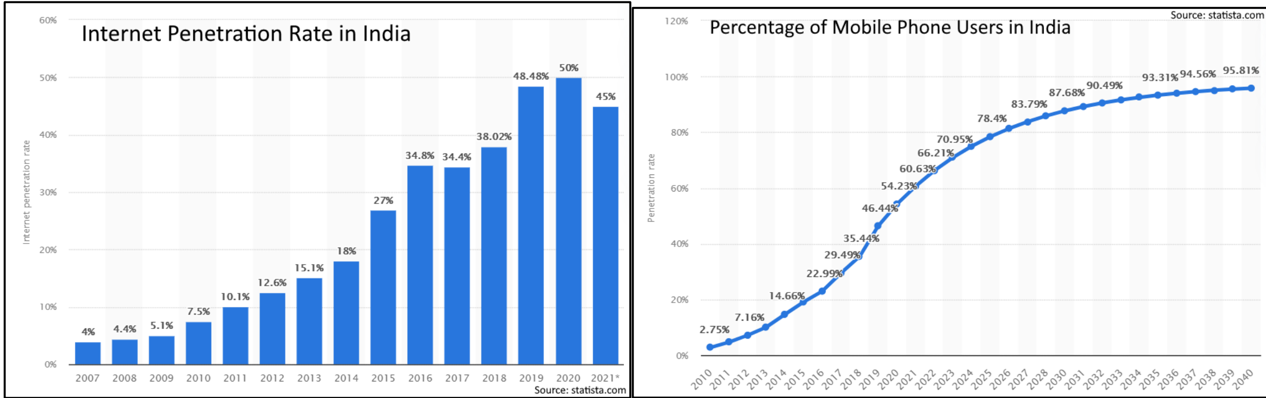
Moreover, it would also open up other avenues of recovering maximum value out of the assets.



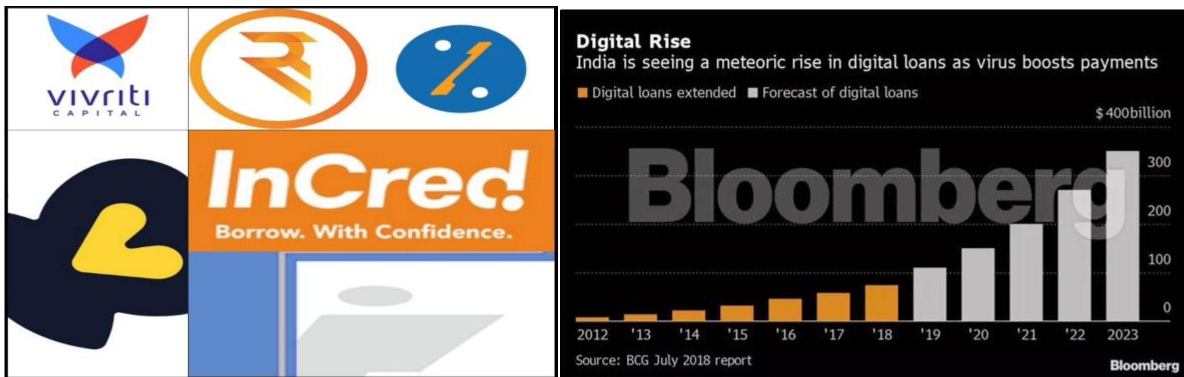
After purchasing the stressed assets, apart from initiating the I&B process, the ARC can sell the business to interested PE/VC firms, can consider merging with a firm that can possibly gain synergy through a acquisition of the stressed asset; it can even hire experts to turn around the business if it seems feasible.

Fintech Solutions & Digital Lending

With increasing internet penetration and mobile phone usage, there has been a surge in the number of digital and fintech solutions offered for banking problems.



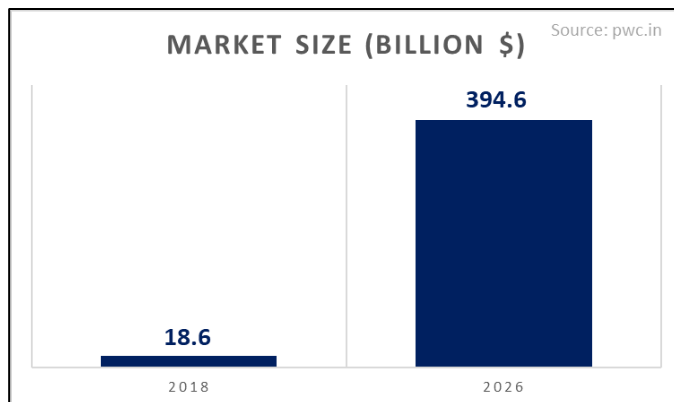
For instance, a number of players have sprung up in the alternative lending space -India has 769 startups functioning in this arena, Navi, Lendingkart, CapitalFloat, InCred, etc. being the notable few [6]. While some of these cater to both personal finance as well as loans to MSMEs, some cater exclusively to the latter. They provide solutions to MSME borrowers' lack of credit history by using machine learning and data analytics to identify alternative credit scoring metrics.



The digital lending market in India is set to witness a meteoric rise, attracting big players. Facebook announced that it would introduce a digital lending program for small businesses, with loans from Rs. 500,000 to Rs. 5 million. There have also been acquisition of Indian fintech startups through acquisitions and VC investments [7].

Neobanking

Neobanking delivers banking services via the internet and electronic media. Globally, the neobanking market is set to rise at a CAGR of 46.5% between 2019 and 2026, taking it to around $ 395 billion [8].



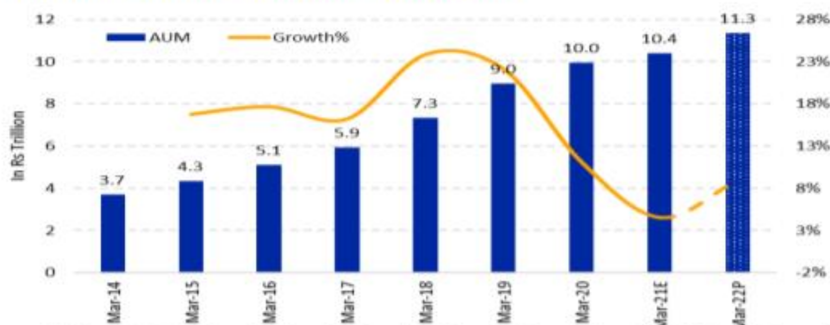
While neobanks have the same offerings as traditional banks, their processes for delivering them are more efficient and cost-effective. In India, as of now, neobanks are not issued banking licenses. Hence, there has not been significant development of neobanks in particular, it is mainly fintech players from other areas that partner with regular banks to provide non-branch banking services. On the backdrop of the revolution in fintech, some easing of regulatory restrictions would help reap the benefits of the burgeoning neobanking market.

Prospective Challenges

NBFC Crisis

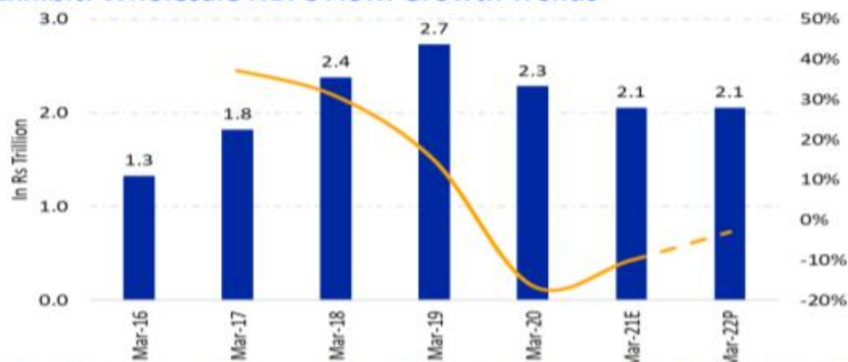
In 2017, commercial banks saw their share in credit fall from 62% (2014) to just 35%, while that of non-banking financial companies went up from 20% to 30%. During this period, due to demonetization banks also had excess liquidity and were wiling to lend to NBFCs. Mutual funds too, were a source of finance for NBFCs. Since the were after high returns, the NBFCs focused more on generating high returns rather than appropriately assessing the risk. In June 2018, IL&FS began a stream of successive defaults till its debt had piled up to Rs. 91,091 crores. This served to highlight the fundamental flaws in NBFCs model of borrowing for the short term and lending for the long term; investors became skeptical of their future and mutual funds discarded the commercial papers of NBFCs. Their cost of funding increased by around 150 basis points. Ultimately, it also hampered growth.

Exhibit: Retail NBFC AUM Growth Trends



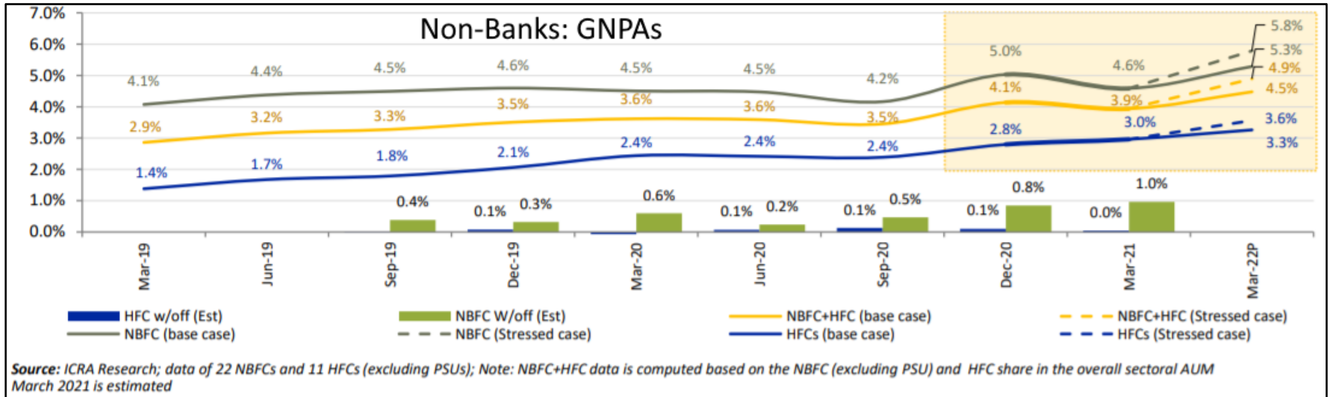
Source: ICRA Research ; Note: Data based on ICRA Sample of large entities excluding Infra NBFCs; E-Estimated ; P-Projected

Exhibit: Wholesale NBFC AUM Growth Trends



Source: ICRA Research ; Note: Data based on ICRA Sample of large entities excluding Infra NBFCs; E-Estimated ; P-Projected

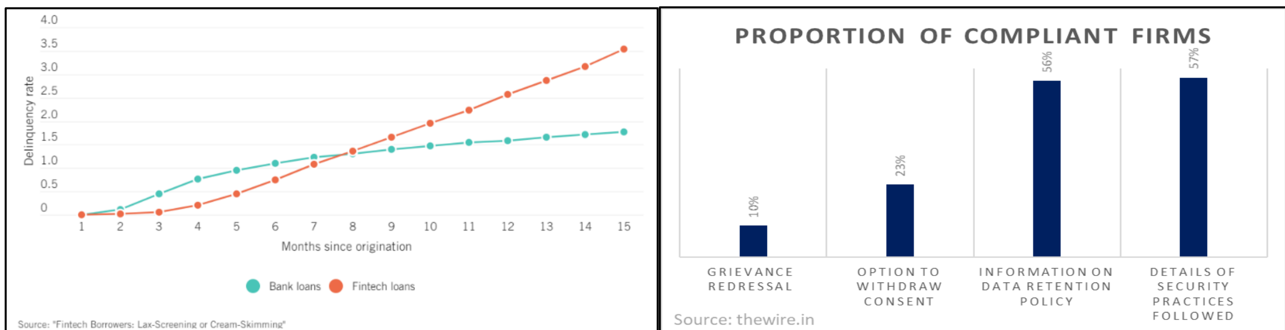
During the pandemic, apart from the risk aversion to lending, the lockdowns also affected collections of repayments; 35-40% of NBFCs' collections are on-field collections, done mostly in cash. Due to restrictions on movement, on-field collections have been difficult, leading to a rise in defaults. The effect of these issues cannot be seen in the data for 2020, mainly because about 85% of the loans they restructured during the pandemic have a moratorium of upto 12 months; a rise in NPAs is expected by Q3 2021.



Problems in Fintech

High Default Rates

More than 33% of Indian fintech borrowers today have never borrowed from a bank. Most digital lenders tend to operate in the unsecured lending markets, which exposes them even more to default risks. Research from the Harvard Business School suggests that within 15 months, default rates for fintech loans become twice as high as those of regular loans [9].



Data Protection

A survey conducted in 2019 found that most fintech firms did not adequately adhere to data security norms. There have been instances of lending apps collecting data from unauthorised sources in order to gauge borrowers' credit history.

Payment apps also require details like credit card number, account number, etc. Whether, where and in what form these data get stored needs to be appropriately regulated. Recently, the RBI put a ban on Visa and Mastercard for storing data of Indian users overseas. As digitalisation in banking becomes ubiquitous, multiple such questions will have to be tackled.

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