EMERGING TREND IN THE INDIAN BANKING SECTOR

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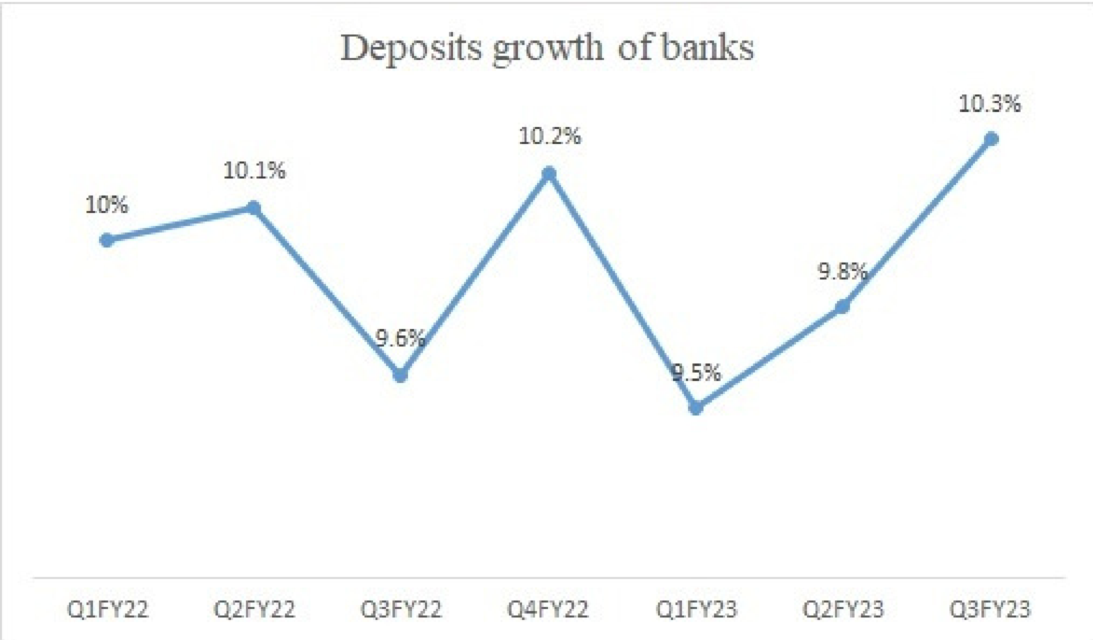
The Indian banking sector is significantly under-penetrated which provides immense opportunities for banks and other financial institutions. The Indian banking industry has recently witnessed the rollout of innovative banking models like payments and small finance banks. In recent years India has also focused on increasing its banking sector reach, through various schemes like the Pradhan Mantri Jan Dhan Yojana and Post payment banks. Schemes like these coupled with major banking sector reforms like digital payments, neo-banking, a rise of Indian NBFCs and fintech have significantly enhanced India's financial inclusion and helped fuel the credit cycle in the country. The digital payments system in India has evolved the most among 25 countries with India's Immediate Payment Service (IMPS) being the only system at level five in the Faster Payments Innovation Index (FPII). India's Unified Payments Interface (UPI) has also revolutionized real-time payments and strived to increase its global reach in recent years. The Reserve Bank of India (RBI), which is the country's central and banking authority, regulates and supervises the banking sector. Over the years, the banking sector has undergone a number of reforms aimed at promoting a diversified, efficient, and competitive financial market, besides giving operational freedom to banks.

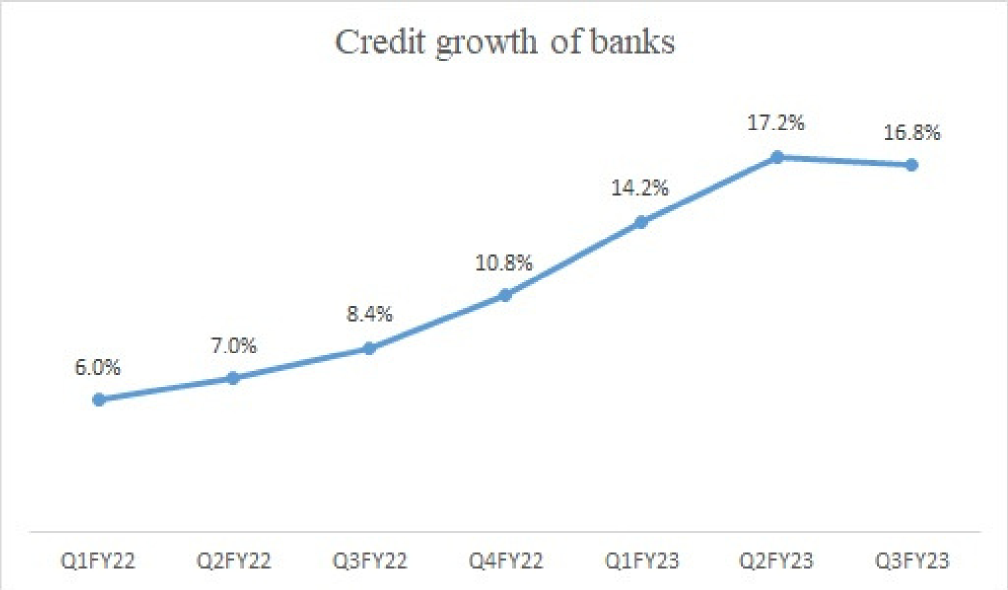
Banks' deposits growth

Banks' aggregate deposits surged by 10.30 percent year on year in the December quarter of last financial year (Q3FY23), up from 9.6 percent in the previous year's same quarter, driven by term deposit growth that rose 13.2 percent. Term deposit rose as banks have increased deposit rates after a series of rate hikes by the RBI. In the December quarter, deposits at state-run banks increased by 8.8 percent year over year, which was less than the 13.2 percent growth of deposits at private sector banks. In the December quarter, banks' credit-deposit (C-D) ratio increased further to 75.9 percent, up from 74.8 percent in the prior quarter and 71.6 percent in the quarter ending December 2021.



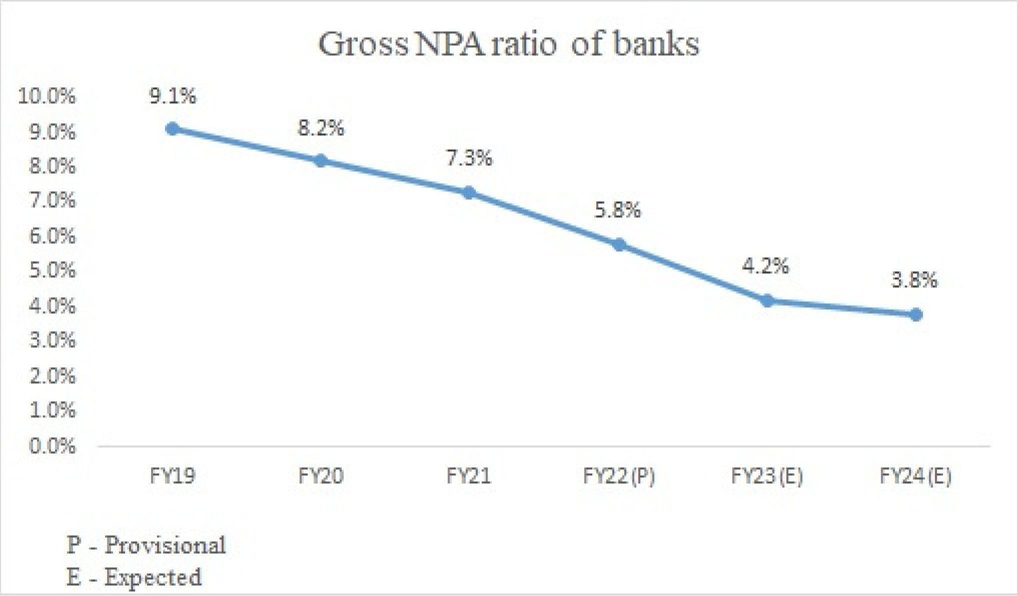
Credit growth of banks

The RBI's data has showed that banks' credit growth eased to 16.8 percent in the December quarter of last financial year from 17.2 percent in the preceding quarter. In the year-ago period, bank credit grew at 8.4 percent. Growth in credit was led by bank branches in metropolitan centers, which account for nearly 60 per cent of the total credit by all banks and recorded 17.2 percent rise (y-o-y) in lending; urban, semi-urban and rural centers also recorded double digit credit growth.



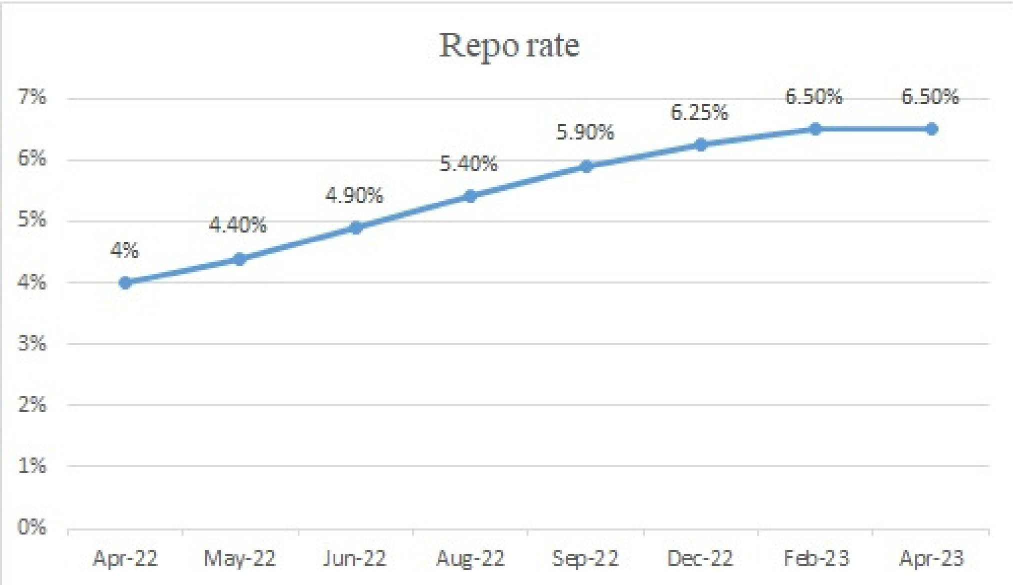
Falling grass GNPA ratio

There is expectation that the gross non-performing asset (GNPA) ratio of banks (Gross NPAs as percentage of gross advances) will reduce to 3.8 percent by the end of current financial year (FY24). Gross NPA ratio of banks had dropped sequentially to 5 percent as of September 2022 led by lower fresh slippages, strong recoveries and write-offs. The reduction in NPAs was mainly contributed by written-off loans in the case of PSBs (public sector banks), while upgradation of loans was the primary driver for asset quality improvement for PVBs (private banks). As of March 2022, gross NPAs were at 5.8 percent, lower than 7.3 percent in the year ago period.



RBI keeps repo rate unchanged at 6.5% in first Bi-monthly policy of FY24

In a surprise move, the Reserve Bank of India (RBI) has decided to keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.50 percent at its first Bi-monthly policy of the Fiscal Year 2023-24 (FY24), even as inflation is trending above its tolerance level. The rate hike has been paused after six consecutive rate increases aggregating to 250 basis points since May 2022. Consequently, the standing deposit facility (SDF) rate remains unchanged at 6.25 percent and the marginal standing facility (MSF) rate and the Bank Rate at 6.75 percent. It also decided to remain focused on withdrawal of accommodation to ensure that inflation progressively aligns with the target, while supporting growth. These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4 percent within a band of +/- 2 per cent, while supporting growth. On the inflation front, CPI inflation is projected at 5.2 percent for 2023-24, with Q1 at 5.1 percent, Q2 at 5.4 percent, Q3 at 5.4 percent and Q4 at 5.2 percent, and risks evenly balanced. On the economic growth front, real gross domestic product (GDP) growth for 2023-24 is projected at 6.5 percent with Q1:2023-24 at 7.8 percent; Q2 at 6.2 percent; Q3 at 6.1 percent; and Q4 at 5.9 percent, with risks evenly balanced.



Impact of rising interest rate

A hike in repo rate means that banks will have to pay higher interest rates to borrow funds from RBI. This could lead to higher borrowing costs for consumers, as banks may pass on the increased cost to them. For the common man, a hike in the repo rate has a direct effect on his pocket. It increases the cost of borrowing from banks and financial institutions. The loan EMIs, credit card payments and other loan payments become expensive. However, fixed deposits become appealing in a rate increase situation since banks often raise interest rates on this type of investment vehicle. A hike in the repo rate also affects inflation. It decreases the money supply in the market and reduces demand for goods and services. This acts as a deflationary pressure and can lead to lower inflation. Lower inflation means lower prices and more savings for the common man.

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Global banking crisis 2023

The 2023 global banking crisis emerged in March 2023 following a period of US central bank intermediated rising interest rates after mid-2022, which followed a previous epoch of several years with extremely-low interest rate policy since 2020. Bank capital reserves declined due to falling bond prices, decreasing the market value of the bonds, leading some banks selling bonds at steep losses as yields on new bonds were much higher. During the week ending March 12, 2023, two large banks in the United States with significant exposure to the technology sector or to cryptocurrency failed, while another entered liquidation under financial distress. The first bank to fail, cryptocurrency-focused Silver gate Bank, announced it would wind down on March 8 due to losses suffered in its loan portfolio. Two days later, upon announcement of an attempt to raise capital, a bank run occurred at Silicon Valley Bank, causing it to collapse and be seized by regulators that day. Signature Bank, a bank that frequently did business with cryptocurrency firms, was closed by regulators two days later on March 12, with regulators citing systemic risks. The collapses of Silicon Valley Bank (SVB) and Signature Bank were the second- and third-largest bank failures in the history of the United States, respectively, smaller only than the collapse of Washington Mutual during the 2007-2008 financial crisis. The US government's Federal Deposit Insurance Corporation (FDIC) took control of SVB. It was the biggest banking collapse in America since Washington Mutual in 2008. The bank took a multibillion-dollar loss cashing out US government bonds to raise money to pay depositors. It tried - unsuccessfully - to sell shares to shore up its finances. The FDIC shut down Signature Bank after a run on its deposits by customers who were spooked by the implosion of SVB. Both banks had an unusually high ratio of uninsured deposits to fund their businesses.

Recent developments

International Trade Settlement in Indian Rupees: In order to promote trade with emphasis on exports from India and to support the increasing interest of the global trading community in INR, an additional arrangement has been put in place for invoicing, payment and settlement of exports/ imports in INR. Under the Foreign Exchange Management Act, (FEMA), 1999 the broad framework for cross border trade transactions in INR is: (a) all exports and imports under this arrangement may be denominated and invoiced in INR; (b) the exchange rate between the currencies of two trading partner countries may be market determined; and (c) settlement of trade transactions under this arrangement shall take place in INR. Accordingly, subject to prior approval from the Reserve Bank, Authorised Dealer (AD) banks in India are permitted to open Special Rupee Vostro Accounts of correspondent bank/s of the partner trading country for settlement of trade transactions, and Indian exporters may receive advance payment in INR against exports from overseas importers through this channel.

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- ## Guidelines on Digital Lending:

Based on the recommendations made by the Working Group on Digital Lending, the Reserve Bank issued guidelines on digital lending applicable to all commercial banks, primary (urban) co-operative banks, state co-operative banks, district central co-operative banks and non-banking financial companies, including housing finance companies (collectively referred to as REs). The guidelines seek to achieve transparency and fairness inter alia by (a) mandating flow of funds between lenders and borrowers only through their bank accounts without any pass-through account/ pool account of any third party; (b) ensuring loan service providers do not collect any fee/charges directly from the customer; (c) transparent disclosure of the key facts of the borrowing arrangement including the all-inclusive cost to a borrower; (d) ensuring need based collection of data with audit trails backed by explicit customer consent; and (e) putting in place an appropriate privacy policy with regard to customer data. Further, it has been reiterated that the outsourcing arrangements entered by REs with a lending service provider (LSP)/ digital lending app (DLA) do not diminish the REs' obligations and they shall continue to conform to the extant guidelines on outsourcing. The REs shall ensure that the LSPs engaged by them and the DLAs (either of the RE or of the LSP engaged by them) comply with the guidelines.

- ## Liberalisation of Forex Flows:

The Reserve Bank has been continuously monitoring liquidity conditions in the forex market to ensure orderly market functioning. The following measures were announced to enhance forex inflows and to diversify the sources of forex funding, mitigate volatility and dampen global spillovers: (a) CRR and SLR exemption on incremental foreign currency non-resident (banks) accounts {FCNR(B)} and non-resident (external) account (NRE) term deposits; (b) temporary relaxation in the restrictions with respect to interest rates on FCNR(B) and NRE deposits; (c) regulatory changes to encourage FPI in debt instruments; (d) permitting authorised dealer (AD) banks' lending for a wider set of end-use purposes to facilitate foreign currency borrowing by a larger set of borrowers; and (e) doubling of limit under the automatic route of ECB and increase in the all-in cost ceiling for investment grade rating borrowers. These measures lapsed on October 31, 2022, except for the measure on ECB, which would be available till December 31, 2022.

- ## Appointment of Internal Ombudsman by the Credit Information Companies:

With a view to strengthening and improving the efficiency of the internal grievance redressal mechanism of credit information companies (CICs), it has been decided to bring the CICs under the Internal Ombudsman (IO) framework. The Directions inter alia cover the appointment/ tenure, role and responsibilities, procedural guidelines and oversight mechanism for the IO. Under the mechanism, all complaints that are partly or wholly rejected by CICs will be reviewed by the IO before the final decision of the CIC is conveyed to the complainant. The IO will not entertain any complaint directly from the members of the public. The implementation of the IO mechanism will be monitored by the CIC's internal audit system, apart from regulatory oversight by the Reserve Bank.

- ## Regulatory changes undertaken in respect of Urban Cooperative banks:

The Reserve Bank had formed an Expert Committee on UCBs in 2021. The recommendations of the Committee have since been examined for implementation duly factoring in the feedback received. The major recommendations, which have been accepted/ accepted with modification include: (a) Adoption of a simple four-tiered regulatory framework with differentiated regulatory prescriptions aimed at strengthening the financial soundness of the existing UCBs. Specifically, a minimum net worth of Rs 2 crore for Tier 1 UCBs operating in single district and Rs 5 crore for all other UCBs (of all tiers) have been stipulated. The UCBs which do not meet the requirement, have been provided with a glide path to facilitate smooth transition to revised norms. (b) Revision of minimum CRAR to 12 per cent to strengthen the capital structure of Tier 2, Tier 3 and Tier 4 UCBs. UCBs which do not meet the revised CRAR have been provided with a glide path for achieving the same in a phased manner. For Tier 1 UCBs, CRAR is retained at 9 per cent. (c) Introduction of automatic route for branch expansion to UCBs which meet the revised financially sound and well managed (FSWM) criteria and permitting them to open new branches up to 10 percent of the number of branches as at the end of the previous financial year, subject to a minimum of one branch and a maximum of five branches. Apart from the above, the branch expansion through the approval route under the existing framework will also continue. (d) Assignment of risk weights for housing loans based on Loan to Value (LTV) Ratio alone, which would result in capital savings.

Outlook

Outlook for Indian banking industry is likely to remain positive in coming times on account of stable economic growth and declining bad loans. India's economy is expected to continue to grow strongly in future, despite external challenges. India's underlying growth potential is fundamentally strong, which will support banks' credit growth and asset quality. There is expectation that non-performing loan (NPL) ratio of banks will decline modestly in FY24 because of recoveries and write-offs of legacy problem loans. Banks' profitability will stabilise after improving in the past few years as the boost from declines in loan-loss provisions wanes. Besides, there is expectation that credit demand from private corporates will stay strong as inflation increases needs for working capital and as companies turn to domestic banks to meet their financing requirements.

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