Banking Sector's Challenges in the 12th Five Year Plan

Mr. K. Kanagasabapathy*

Five year plans have lost much of their original relevance after the 1990s, but planning exercise helps providing priorities for development in India. Historically, the burden of financing development in India has increasingly fallen on the commercial banking sector, due to the failure or decreasing effectiveness of other agencies created such as cooperatives, regional rural banks, and local area banks. Since major development financing institutions also have been converted into banks, long term financing needs such as for infrastructure also are required to be met by the banking system. As insurance and pension sectors are also in nascent stages, banking services have been filling in such gaps in social security needs also. Thus, as the Trend and Progress Report of the RBI 2010-11 emphasises, 'a long term sustainability of higher growth in India will crucially depend on the ability of banking sector to mobilise savings and meet the credit needs of the growing economy through innovative financial instruments and services that foster financial inclusion and provide efficient and transparent delivery of credit'.

The challenges for the banking system during the 12th plan period may be viewed in the current context of growth scenario and the evolving global and domestic public policy environment. Overall, when we view both contractionary and expansionary elements, the contractionary forces seem to overweigh the expansionary forces that place the banking system in a very vulnerable phase during the 12th plan. But, appropriate policies within and outside the banking system can find solutions to achieve the growth target of 9% and sustain an inclusive growth as aimed by the planners.

Global context

Globally, particularly in advanced economies, banks are under great stress since the global financial turmoil in mid-2007 which got intensified after the fall of Lehman brothers in mid 2008. Several banks failed and there were unprecedented bail outs of banks by governments at huge fiscal costs. Economies are also under distress and the recovery process is slow. Currently, Euro area has another serious problem relating to public debt. Multi lateral agencies like IMF, World Bank, BIS and other international standard setting agencies are in the process of strengthening regulatory standards including those applicable to banks and financial markets.

A Financial Stability Board has been set up which in coordination with IMF will be providing early warnings of macroeconomic and financial risks and is in the process of reshaping regulatory systems. Tighter regulatory standards will become applicable to banks, systemically important institutions and financial instruments and markets and credit rating companies. In so far as banking is concerned Basel III standards will require strengthening of capital base over the medium term. Such requirements are phased for convenience, but it may have significant implications for credit growth and overall growth of economies particularly like India, where banking intermediation is significant and financial markets are less developed. The slow recovery in advanced economies will also have an adverse impact on India's export prospects.

Domestic Policy Perspectives

Banking system's progress with assets and liabilities during the 12th plan will depend upon the emerging policy scenario particularly with respect to monetary policy on interest rates. Currently banking

*Director, EPW Research Foundation, Mumbai. Inputs from Shruti Pandey and Bipin Deokar in the form of data and information are acknowledged with thanks by the author.

system experienced for the past about two years a tightening cycle which seem to have peaked (Graph A). The tightening phase had seen increase in repo rate by as much as 375 basis points to 8.5% from 4.75%. The tightening phase was also characterised by persistently high inflation and slowdown in economic and industrial activity (Graphs B and C). A clearly easing phase may begin only when there is confidence about the inflation coming down to comfortable levels. The high interest rate scenario is likely to continue for some more time, also because of the high borrowing programme of the government. The fiscal deficit target is expected to breach the budgeted level of 4.6% by a significant margin this fiscal year. The borrowing programme of the central government has been enlarged by about Rs.93, 000 crore for 2011-12. This fiscal slippage will continue to exert pressure on interest rates for several months to come and the consolidation of fiscal deficit back to around 3% is not in the near future.

Given the above situation, an easing phase of monetary policy may no doubt begin in 2012, but, in the next six months to one year, interest rates may not soften significantly. Given the past experience the softening phase of policy cycle may continue for about two years. Broadly speaking the interest rates may move southward for the first two years of the plan and from third year of the 12th plan, a tightening policy cycle may prevail. Bankers have to develop strategies for managing their liabilities and assets broadly keeping this scenario in mind.

With some of the recent changes in operating framework of monetary policy, the lending rate responses to policy rate changes are likely to be intensified. The new base rate system does not allow any lending below the base rate, unlike the previous system of bench mark prime lending rate (BPLR) which allowed sub BPLR lending. In general, the responses of short term interest rates such as on treasury bills were more elastic to policy rate changes as compared to long term government securities rates For instance, as a proportion to repo rate change, the 10 year g-sec yield response was less than 20%, whereas for treasury bills, it was proportionate or more than proportionate (Table 1). Investment and portfolio management of banks should keep these relationships also in mind.

Growth Targets and Macroeconomic Parameters

The growth targets—aggregate and sectoral as envisaged in the draft plan—along with major macroeconomic parameters are provided in Tables 2 and 3. These estimates have been provided for rate of growth at two levels namely 9% and 9.5%. But, as things stand now, the higher range of 9.5% would appear too ambitious and even the lower range of 9% would seem somewhat ambitious. But, a plan needs to be ambitious and given the track record in the12th plan, despite the intervening global financial crisis, a 9% target growth rate can be considered as potentially feasible and achievable. This will need agriculture to grow by 4%, industry by 9.6% and services by 10.0%. Based on the experience, agriculture and industry will be the thrust areas where significant fillip would be required.

In terms of macroeconomic parameters, inflation needs to be contained in the range of 4.5 to 5.0% and the current account balance of not more than 2.5% of GDP. The investment rate has to be pushed to around 33.5% and the savings rate to 36.2% of which the household savings rate should go up to 24.0% from the present level of around 23.0%. This order of investment and savings would not be realised without active involvement of the banking sector. (Tables 2 and 3)

Projections for the Commercial Banking Sector

EPWRF attempted a forecast for commercial banking sector, given the growth targets and macroeconomic parameters for the 12th plan (Tables 4 and 5). These estimates show that the bank deposits would need to grow at an average rate of 19.1% from about 18.0% currently and the credit growth should average to 22.7% from the present level of about 18.0%. The credit deposit ratio is expected to increase to around 85% from the present level of around 76%. This would call for the following: better mobilisation of deposits and larger access to non-deposit sources of funds. This would also call for better recycling of loanable funds. From this angle, the current trends in NPA levels are of serious concern (Tables 6 and 7). Improved credit risk management among other things will be crucial.

From the policy angle, this may require considerable reduction in pre-emption of bank funds in the form of cash and liquidity ratios. That in turn will depend upon how fast the fiscal consolidation takes place, and inflation rate is brought down to a comfortable range.

Plan Priorities and Strategic Interventions

Plan priorities would require expansion of credit to agriculture, MSME sector and infrastructure. Relatively the burden is likely to fall on public sector banks more compared to private sector banks. Recent trends show that the shares of bank credit to agriculture and MSME sectors have been sharply coming down which will need a reversal (Table 8).

Infra structure funding creates the problem of asset liability mismatch mainly because of short term liability structure of the banking system. One way could be to allow public sector banks to raise resources through long term bonds preferably with tax free status with implicit government guarantee. Such bonds can also be traded in the market to enhance its liquidity and long term investors such as insurance and pension funds could invest in such bonds.

Public sector banks may have to expand areas of collaboration and cooperation rather than competing among themselves leading to waste of human and financial resources. For instance, for financing MSME sector, public sector banks may identify clusters and evolve joint strategies in a planned manner to develop this sector by extending adequate credit.

Basel III and India

India at least on an average basis is comfortably placed as of now with regard to Basel norms, but with Basel III, substantial additional capital might be required. The core equity component will need to be strengthened. Added to that are counter cyclical buffer and the conservation buffer (Table 9). Liquidity requirement will be another additional requirement. While these requirements are to be met over a long phase which will extend to period beyond the 12th Plan period, the pressure will be felt during the plan. RBI is likely to come out with the related guidelines soon.

The government's ability to provide the needed additional capital in respect of public sector banks is doubtful, given the need for fiscal consolidation and the fiscal slippage being already significant. Either the government would have to further relax fiscal rules considerably which would militate against fiscal discipline, or allow dilution of its ownership to levels below 51 percent, if public sector banks have to retain their share of business over the plan period in banking business. Also, banking system as a whole would face constraints in expanding their operations particularly in increasing credit.

Credit growth might be affected for a variety of reasons: (i) short fall in capital to meet regulatory requirements; (ii) resistance from industry to borrow at higher rates of interest; (iii) rationing of credit that would not be in favour of small borrowers resulting in financial exclusion; and (iv) tighter liquidity norms may cause banks shifting towards more liquid assets and away from loan assets.

Basel III is an outcome of crisis in western countries. Though Indian banking system was not so much adversely affected, commitment to international cooperation will require implementation of global standards. An estimate recently made showed that a five percentage points increase in capital to risk weighted assets ratio for banking system could affect the growth rate in Indian economy significantly and on an annual basis, this could turn out to be a fall in growth rate by about 30 to 50 basis points. From this angle application of Basel norms would call for a flexible application in countries like India. But, international compulsions would not allow it. At least, in regard to liquidity, Indian banks are already burdened with high levels of both cash reserve (CRR) and liquidity reserve (SLR) requirements. For purposes of liquidity requirements, banks should be allowed to treat funds pre-empted under these requirements as liquid resources available in times of distress.

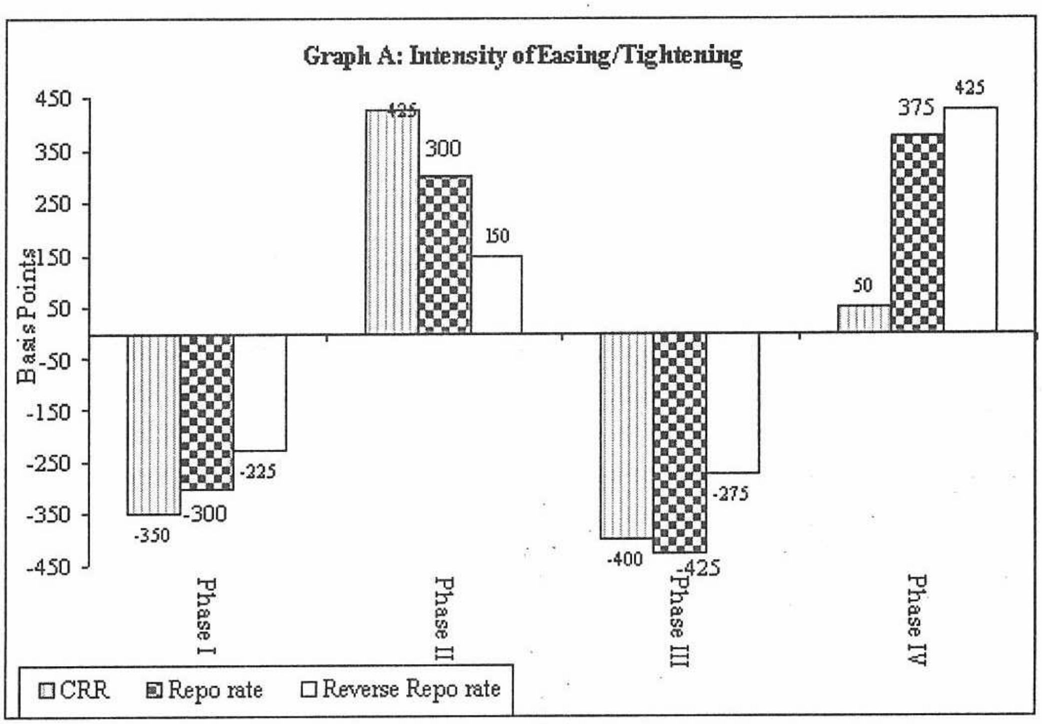
New Opportunities

There are several opportunities for banks to exploit:

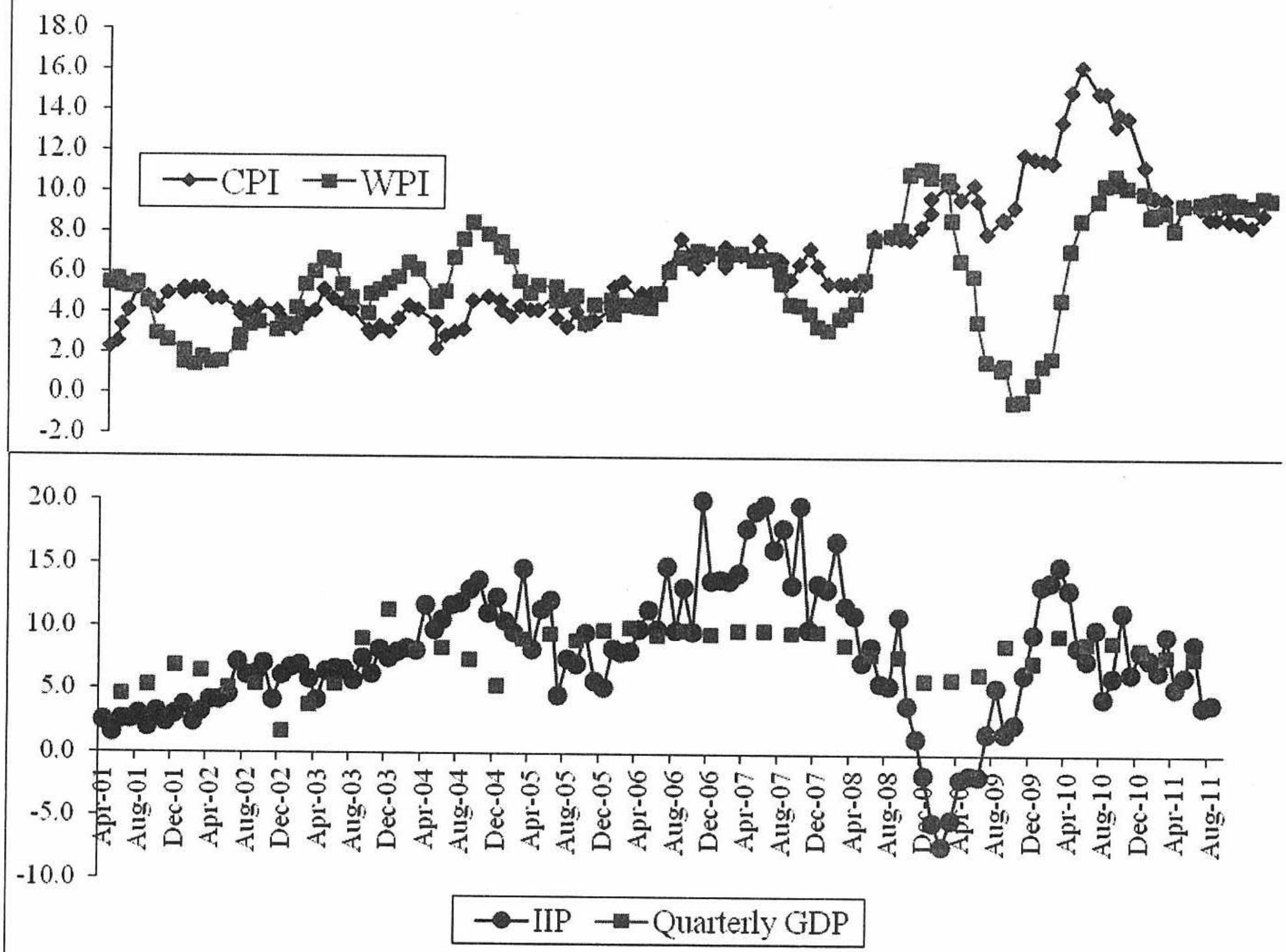
- India's demographic dividend is in favour of expanding business.
- Increasing middle and upper middle class provide opportunities for wealth management.
- Exploiting the mobile banking technology to diversify business and introduce innovative products—both on assets and liabilities sides.
- Growing MSME sector should be viewed as a profitable and viable business proposition.
- Expanding infrastructure needs would need at least half of financing requirements to come from the banking system.

Concluding Observation

Overall, there are challenges, but banks should also see the opportunities ahead. It would be very difficult to visualise achievement of plan targets in 12th plan period without active involvement of the commercial banking system. Both regulatory and public policies should be attuned in favour of helping the banking system to evolve and implement appropriate strategies in particular in meeting the growing credit needs of the economy.



Graph B : Movement in WPI, CPI, IIP and Quarterly GDP



Graph C

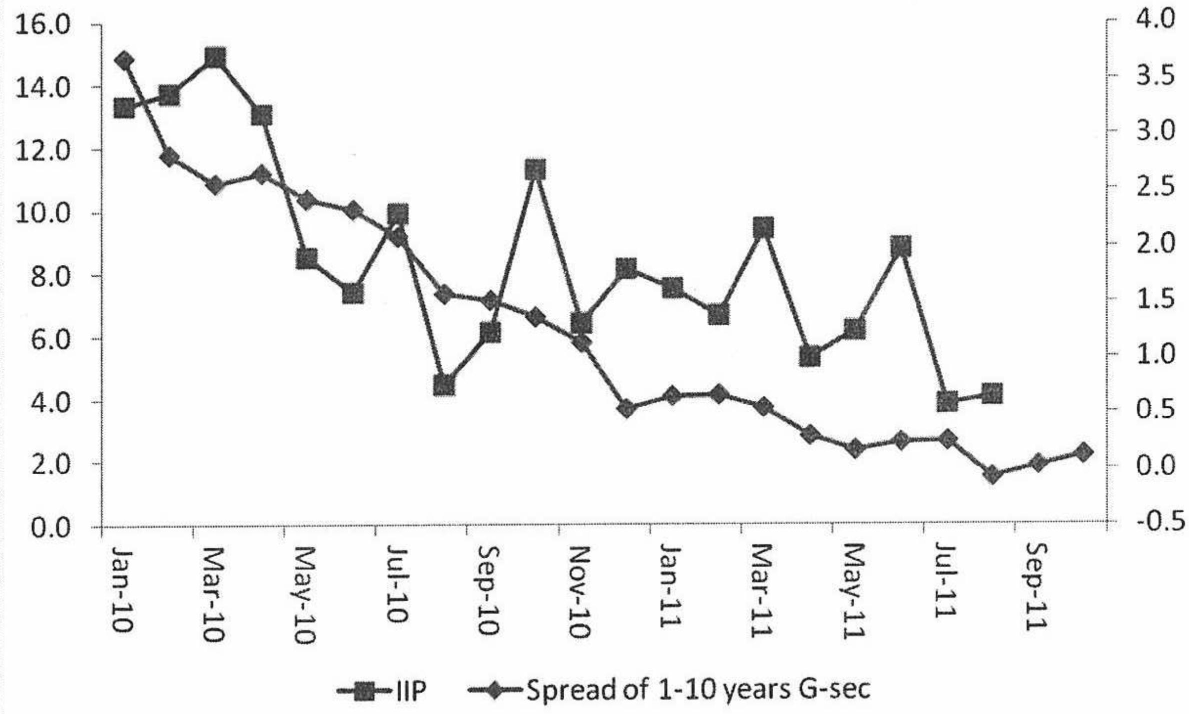


Table 1 : Changes in Policy Rates and Response - Variations in Basis Points : since April 2001

Instruments	Phase I Easing	Phase II Tightening	Phase III Easing	Phase IV Tightening
	[from April 2001 - August 2004]	[from September 2004 - September 2008]	[from October 2008 - January 2010]	[from February 2010 ……]
	[41 months]	[49 months]	[16 months]	[22 months]*
CRR	-350	425	-400	50
Repo Rate	-300	300	-425	375
Reverse Repo Rate	-225	150	-275	425
Range in Deposit Rate $	from -350 to - 450	from 375 to 450	from -275 to -300	from 175 to 250
	(117 to 150)	(125 to 150)	(64 to 71)	(67 to 47)
1 year G-Sec	-380	368	-352	366
	(127)	(123)	(83)	(98)
10 year G-Sec	-388	224	-13	73
	(129)	(75)	(3)	(19)
91 days T Bills	-348	409	-402	476
	(116)	(136)	(95)	(127)
364 days T Bills	-355	381	-358	443
	(118)	(127)	(84)	(118)

*** Till December, 2011**

Deposit rate as on December 23, 2011

Government Securities December, 2011

$ - Range - Minimum & Maximum

Figures in round brackets are as % to Repo rate Change

	Table 2: Sectoral Growth Rates - Previous Plans and Target for Twelfth Plan	IX^th^ Plan	X^th^ Plan	XI^th^ Plan	XII^th^ Plan 9.0%Target	XII^th^ Plan 9.5%Target
1	Agriculture, Forestry & Fishing	2.5	2.3	3.2*	4.0	4.2
2	Mining & Quarrying	4.0	6.0	4.7	8.0	8.5
3	Manufacturing	3.3	9.3	7.7	9.8	11.5
4	Elect. Gas & Water Supply	4.8	6.8	6.4	8.5	9.0
5	Construction	7.1	11.8	7.8	10.0	11.0
6	Trade, Hotels & Restaurant	7.5	9.6	7.0		
7	Transport, Storage & Communication	8.9	13.8	12.5		
	Trade, Hotels etc. + Transport, Communication, Storage	8.0	11.2	9.9	11.0	11.2
8	Financing, Insurance, Real Estate & Business services	8.0	9.9	10.7	10.0	10.5
9	Community, Social & Personal services	7.7	5.3	9.4	8.0	8.0
	Total GDP	**5.5**	**7.8**	**8.2**	**9.0**	**9.5**
	Industry	4.3	9.4	7.4	9.6	10.9
	Services	7.9	9.3	10.0	10.0	10.0

Note: * It is likely that on revision of farm sector GDP growth rates for the previous year and an expected good harvest in 2011-12, the average for the Eleventh Plan may be higher at 3.3–3.5 per cent.

Source: Government of India, Planning Commission

	Table 3: Macro-Economic Parameters - Previous Plans and Targets for Twelfth Plan	IX^th^ Plan	X^th^ Plan	XI^th^ Plan	XII^th^ Plan 9.0	XII^th^ Plan 9.5
1	Investment Rate (Gross Capital Formation adjusted for errors and omissions)	24.6	31.8	36.4	38.7	41.4
2	Fixed Investment	23.2	28.4	30.9	33.5	35.5
	of which					
	Household Sector	9.9	11.7	11.6	12.0	12.0
	Private Corporate Sector	6.6	9.6	11.0	12.4	13.5
	Public Sector	6.6	7.1	8.3	9.1	10.0
3	Savings Rate	23.7	31.7	34.0	36.2	38.9
	of which					
	Household Sector	20.5	23.2	23.2	24.0	24.5
	Private Corporate Sector	4.0	6.4	8.2	8.5	9.2
	Public Savings	-0.8	2.0	2.5	3.7	5.2
	of which					
	Govt. Admin.	-4.9	-2.6	-1.3	-0.5	0.8
	Public Enterprises	4.0	4.6	3.8	4.0	4.5
4	Current Account Balance	-0.6	0.0	-2.4	-2.5	-2.5
	of which					
	Trade Balance	-2.6	-2.5	-5.0	-4.5	-4.5
	Capital Account Balance	2.1	3.5	3.8	5.0	5.0
5	WPI Inflation Rate	4.9	5.0	6.0	4.5-5.0	5.0-5.5

Source: Government of India, Planning Commission

Table 4: Projection for XIIth Five Year Plan by EPWRF

	2008	2009	2010	2011	2012*	XI Plan Target	2013	2014	2015	2016	2017	XII Plan Target*
Real GDP (% Growth)	9.3	6.8	8.0	8.5	7.7	8.2	8.7	9.0	9.2	8.9	9.0	9.0
WPI (% Growth)	4.7	8.1	3.8	9.6	8.0	6.0	5.5	5.4	5.5	5.2	5.9	5.5
GDP at Market Prices (% Growth)	16.1	12.0	17.3	20.2	15.7	14.2	14.2	14.4	14.7	14.1	14.9	14.5
Household Savings Rate	22.5	23.8	23.5	24.0	23.0	23.2	23.3	24	25	23.5	25.4	24.2
Financial Savings Rate	11.7	10.8	11.8	11.4	10.7		10.9	11.2	11.5	11.0	11.7	11.3
Bank Deposits (% Growth)	22.4	19.9	17.2	15.9	16.0		18.0	19.5	19.5	19.1	19.4	19.1
Bank Credit (% Growth)	22.3	17.5	16.9	21.5	18.0		22.0	23.5	24.0	20.0	24.0	22.7
Credit to Deposit Ratio	73.9	73.9	72.4	72.2	75.7		79.6	82.3	85.4	86.0	89.3	84.5

* Projected by EPWRF

Table 5: Projection for XIIth Five Year Plan by EPWRF

	2008	2009	2010	2011	2012*	2013	2014	2015	2016	2017	XII Plan Target*
Deposits	3196939	3834110	4492826	5207969	6041244	7128668	8518758	10179916	12124280	14476390	17241381
% Growth	22.4	19.9	17.2	15.9	16.0	18.0	19.5	19.5	19.1	19.4	19.1
% to total GDP	64.1	68.7	68.6	66.1	66.3	68.5	71.6	74.6	77.8	80.9	84.1
Credit	2361914	2775549	3244788	3942083	4651658	5675023	7008653	8690730	10428876	12931806	15867326
% Growth	22.3	17.5	16.9	21.5	18.0	22.0	23.5	24.0	20.0	24.0	22.7
% to total GDP	47.4	49.7	49.5	50.1	51.0	54.5	58.9	63.6	66.9	72.2	77.4
Investments	971715	1166410	1384752	1501619	1719354	1994450	2317551	2711535	3186054	3759543	4379868
% Growth	22.8	20.0	18.7	8.4	14.5	16.0	16.2	17.0	17.5	18.0	16.5
% to total GDP	19.5	20.9	21.1	19.1	18.9	19.2	19.5	19.9	20.5	21.0	21.4
GDP at Market Prices	4986426	5582623	6550271	7875627	9112100	10406019	11904485	13654445	15579721	17901100	20496759
% Growth	16.1	12.0	17.3	20.2	15.7	14.2	14.4	14.7	14.1	14.9	14.5
% to total GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

* Projected By EPWRF

Source: RBI, Hand Book of Statistics on the Indian Economy

Table 6: Trend in Assets Quality Indicators of SCBs						
SCBs	FY06	FY07	FY08	FY09	FY10	FY11
Gross NPAs (%)	3.3	2.5	2.3	2.3	2.4	2.3
Net NPAs (%)	1.2	1.0	1.0	1.1	1.1	0.9
Fresh NPA Generation Rate (%)	2.0	1.7	1.8	2.1	2.2	2.0
Net NPAs/Net Worth (%)	10.1	9.2	7.8	8.6	9.1	10.0
PSBs	FY06	FY07	FY08	FY09	FY10	FY11
Gross NPA (%)	3.6	2.7	2.2	2.0	2.2	2.3
Net NPA (%)	1.3	1.1	1.0	0.9	1.1	1.1
Net NPAs/Net Worth (%)	13.1	12.1	11.2	11.4	13.5	13.4
Private banks	FY06	FY07	FY08	FY09	FY10	FY11
Gross NPAs (%)	2.1	2.1	2.4	2.9	2.7	2.3
Net NPAs (%)	0.9	0.9	1.1	1.3	1.0	0.6
Net NPAs/Net Worth (%)	6.3	7.8	6.1	7.5	5.3	3.2

Source: ICRA

Table 7: Projected Sectoral NPA

(% of total advances)

Sectors	Mar-12				Mar-13			
	Baseline	Low Risk	Medium Risk	Severe Risk	Baseline	Low Risk	Medium Risk	Severe Risk
Agriculture	4.06	4.11	4.2	4.32	3.7	3.89	4.24	4.72
Food Processing	5.82	6.31	7.13	8.29	6.81	8.4	12.18	15.75
Construction	2.64	2.66	2.81	3.01	3	3.09	3.63	4.35
Cement	2.57	2.57	2.57	2.57	3.27	3.78	5.12	6.95
Infrastructure	0.67	0.71	0.8	0.91	0.72	0.88	1.43	2.16
Iron and Steel	3.69	3.95	4.38	4.99	4.43	5.42	7.28	9.87
Engineering	3.36	3.63	4.09	4.73	3.8	4.82	6.65	9.13
Automobiles	1.68	1.68	1.68	1.68	2.03	2.37	3.19	3.94
Others	3.03	3.11	3.24	3.42	3.08	3.38	3.98	4.8

Source: RBI

	Table 8: Sector-wise Gross Bank Credit of Scheduled Commercial Banks	Mar-08	Mar-09	Mar-10	Mar-11	Mar-08	Mar-09	Mar-10	Mar-11
		Rs Crore				% Growth			
1	**Agriculture & Allied Activities**	**275343**	**338656**	**416133**	**460333**	**19.6**	**23.0**	**22.9**	**10.6**
		(12.5)	**(13.0)**	**(13.7)**	**(12.6)**				
2	**Industry (Micro & Small, Medium and Large)**	**858344**	**1054390**	**1311451**	**1620849**	**24.1**	**22.8**	**24.4**	**23.6**
		(38.9)	**(40.5)**	**(43.1)**	**(44.2)**				
	2.1 Micro & Small	132698	168997	206401	229101		27.4	22.1	11.0
	2.2 Medium	110800	122155	132636	184599		10.2	8.6	39.2
	2.3 Large	614846	763238	972415	1207148		24.1	27.4	24.1
3	**Services**	**549496**	**646299**	**726790**	**900801**	**31.4**	**17.6**	**12.5**	**23.9**
		(24.9)	**(24.8)**	**(23.9)**	**(24.6)**				
	of which								
	Transport Operators	36821	39302	52516	65463	39.4	6.7	33.6	24.7
	Trade	123828	144377	164497	186286	14.6	16.6	13.9	13.2
	Wholesale Trade (other than food procurement)	55749	67425	86357	103584	12.6	20.9	28.1	19.9
	Retail Trade	68079	76952	78140	82702	16.3	13.0	1.5	5.8
	Commercial Real Estate	63349	92421	92128	111836	39.8	45.9	-0.3	21.4
	Non-Banking Financial Companies (NBFCs)	78956	98853	113441	175577	62.8	25.2	14.8	54.8
	Other Services	191397	193244	219654	249376	32.5	1.0	13.7	13.5
4	**4. Personal Loans**	**521618**	**562479**	**585633**	**685372**	**14.5**	**7.8**	**4.1**	**17.0**
		(23.7)	**(21.6)**	**(19.3)**	**(18.7)**				
	of which								
	Consumer Durables	9798	8187	8294	10156	7.1	-16.4	1.3	22.4
	Housing (Including Priority Sector Housing)	260123	279366	300929	346110	12.8	7.4	7.7	15.0
	Credit Card Outstanding	26731	28000	20145	18098	100.7	4.7	-28.1	-10.2
	Education	20533	28579	36863	43710	36.7	39.2	29.0	18.6
	Vehicle Loans	58622	62095	63791	79314		5.9	2.7	24.3
	Other Personal Loans	96697	105290	104095	123847	-32.1	8.9	-1.1	19.0
	Non-food Credit (1+2+3+4)	**2204802**	**2601823**	**3040007**	**3667355**	**22.8**	**18.0**	**16.8**	**20.6**
		(100.0)	**(100.0)**	**(100.0)**	**(100.0)**				
	Priority Sector	**748074**	**932459**	**1092179**	**1239386**	**18.2**	**24.6**	**17.1**	**13.5**

ures in bracket are percentages to total

ırce: RBI, Statistical Tables Relating to India

Table 9: Capital Adequacy under Basel III vs. Existing Norms	
	Basel III Norm
Common equity (after deductions)	4.50%
Conservation buffer	2.50%
Countercyclical buffer	0-2.5%
Common equity + Conservation buffer + Countercyclical buffer	7-9.5%
Tier I (including the buffers)	8.5-11%
Total capital (including the buffers)	10.5-13%

****