ASSOCHAM
INDIA

ASSOCHAM's 1st National Bankers-Borrower's-Business Meet
(*Improving Bankers-Borrower's approach*)

Business Advances: Issues and Concerns

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MESSAGE

I am pleased to note that ASSOCHAM is organizing a "Bankers-Borrowers-Business Meet" with an aim to build a model framework and suggest measures that can be taken to strengthen the banking industry.

The Government is fully committed to strengthening and rejuvenating India's banking sector. The Gyan Sangam was an important milestone in this regard. Announcements made in the Union Budget 2015-16 reiterate our commitment to improve the governance of Public Sector Banks.

In this context, it is heartening to know that ASSOCHAM is involving several important stakeholders to come up with measures which would strengthen the banking industry.

I extend my best wishes to ASSOCHAM and hope that the meet is a grand success.

(Jayant Sinha)

New Delhi
10.03.2015

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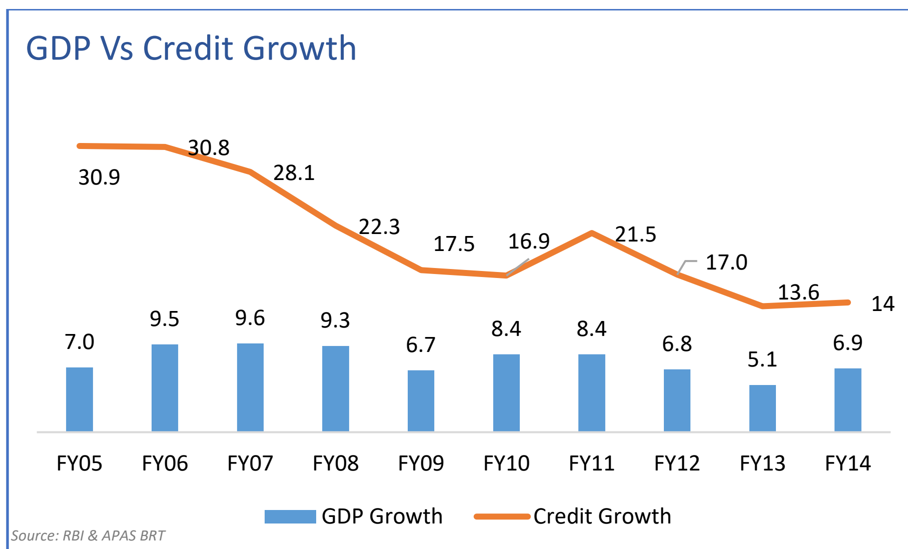
Business lending: Issues and concerns

Consistent improvement in the GDP growth of India in last three quarters has pushed demand of credit in the economy. Cooling of inflation and subsequent reduction in the repo rate has further augmented the demand. Lenders and business borrowers were waiting for such an environment to meet their business requirements. Despite of having evident demand supply gap lending is still a challenge in Indian market place.

The domestic lending of Indian Banks grew 14.0% during 2013-14, which is marginally higher than the 13.6% growth reported during 2012-13, but significantly lower than the three year (FY2010-12) average of around 18%. With long term credit growth broadly following the pattern of nominal GDP growth, it is likely to get a push at 16.5 - 18.5% during 2014-15, assuming a GDP growth rate of 6.5 - 7.5% during the current fiscal.

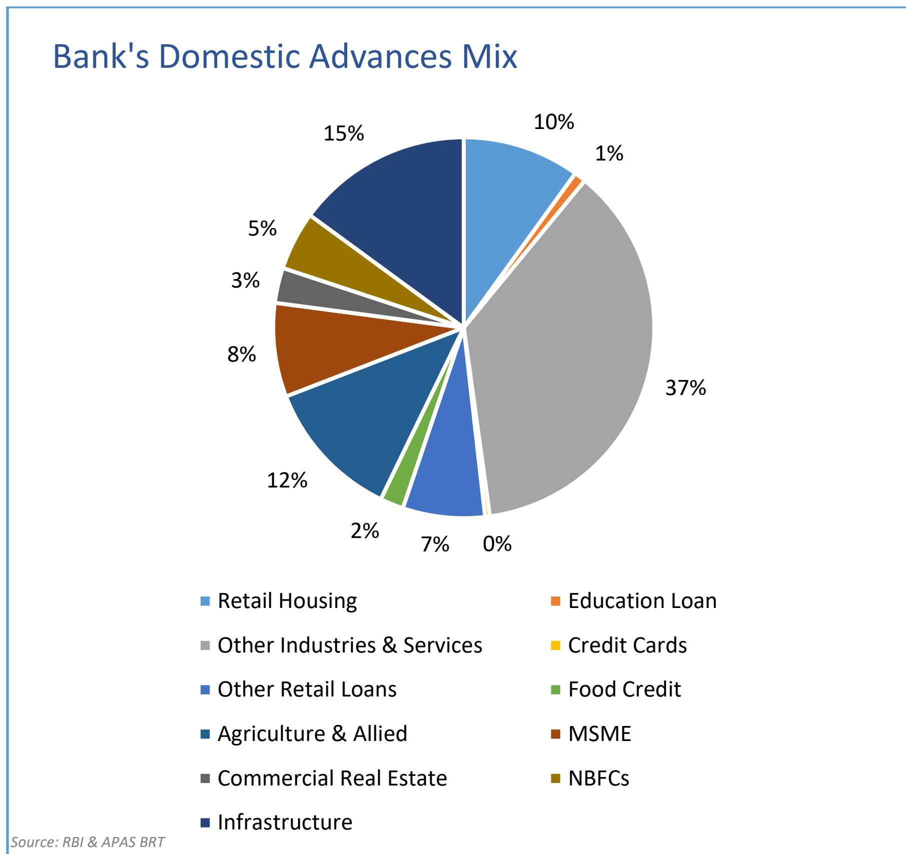
Exhibit 1



Owing to strong growth in micro enterprises loans & higher growth in agriculture loan book, banks' priority sector credit portfolio expanded by 22% vs. 8.4% during 2012-13, this may have led to reduction in priority sector deficit of several banks. The expansion in the priority sector loan book is likely to have benefited with favorable change in 'priority sector regulations' which

brought incremental credit provided to medium service enterprises under priority sector classification & increased credit limit (from Rs 5 crore to Rs 10 crore) for micro & small service enterprises. Besides, credit to the weaker sections (including loans to micro finance institutions for on - lending) reported a sharp growth in 2013-14.

Exhibit 2



In terms of sectoral distribution, overall, Indian banks have been maintaining a well-diversified credit portfolio. As of March 2014, credit to industries accounted for 45% of banks' total credit portfolio, followed by services (24%), retail (18%) and agriculture & allied activities (12%). Within industries and services too, the portfolio is well diversified across activities; while infrastructure represents the largest industry exposure for banks with a share of about ~15% of the total credit book as of March 21, 2014, no other industry or service accounts for a share exceeding 10%.

MSME CONCERNS

The micro, small and medium enterprises are the backbone of economic development in India. They are the incubators for talent, innovation and entrepreneurial spirit, which is essential for the country's development. Indian SME sector contributes 45% of the industrial output, 40% of the country's total exports, employs over 60 million people, creates 1.3 million jobs every year and produces more than 8,000 quality products for the domestic and international markets. With

approximately 30 million SMEs in India, around 12 million people are expected to join the workforce in the next three years with the sector growing at a rate of 8% a year.

SMEs are present in a variety of sectors including chemicals, plastics & polymers and pharma sectors. The burgeoning importance of SMEs in the manufacturing sector is due to their significant contribution to the key factors of the growing Indian economy. The importance of SMEs in manufacturing sector is mainly due to the quantum of units that fall in this category, forming 90% of the total industrial units in this country. Government is taking several steps to boost manufacturing sector growth as it would lead to job creation and boost the country's economy. National Manufacturing Competitiveness Council has been set up by the government to suggest ways to enhance competitiveness in the manufacturing sector. The government has already announced a National Manufacturing Policy (NMP) that aims at raising the share of manufacturing to 25% of GDP by 2022. The NMP envisages setting up of national investment and manufacturing zones, which are industrial townships, benchmarked to the best manufacturing hubs in the world.

The major hindrance in the expansion of SMEs is the unavailability of sufficient and timely funds to finance their growth plans. Banks have been making steady strides to bridge this gap. But the approach followed by banks to funding is restrictive as they create value by controlling and managing risk. In any loan application for a business, a bank has to necessarily evaluate the risks involved, gauge collateral support and the methods to mitigate those risks. There is a huge amount of paperwork involved and the process is cumbersome. Therefore, it is not always possible for an entrepreneur to satisfy all requirements and conditions the bank might pose. The above listed methods of financing are primarily debt financing, as sources of equity funding remain elusive in India.

In case of the SMEs, the access to capital markets is very limited, and they largely depend on borrowed funds from banks and financial institutions. While investment credit is provided by financial institutions, commercial banks extend working capital. In the recent past, with growing demand for universal banking services, term loans and working capital are becoming available from the same source. Besides the traditional needs of finance for asset creation and working capital, the changing global environment has generated demand for introduction of new financial and support services.

It is imperative for the RBI to issue necessary guidelines to banks on credit flow to the SME sector. Additionally, the Government should strive to create a favorable environment for SMEs that curbs the need for debt and capital. This could be achieved by setting up SME-focused banks and NBFCs that accord priority to SME sector lending. Additionally, there could be financing schemes for SMEs that might be high on risk, but promise robust returns.

Also, there is need for reduction in the interest rates. SMEs continue to pay interest rates of 19-20% for bank loans. There is an urgent need to restructure the loans for SMEs to ensure that the interest rates are lower.

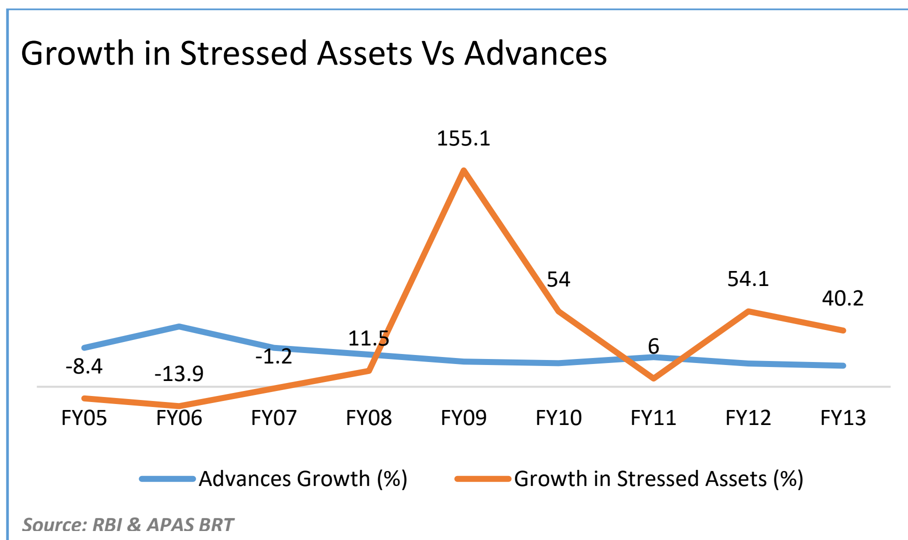
Additionally, delayed payments have always been an area of concern for SMEs that contribute to reduced working capital for SMEs. Delay in settlement of dues adversely affects the recycling of

funds and business operations of SME units. Most defaulting customers are large enterprises and SMEs are unable to report the same for fear of losing business. To address payment issues, the Government could establish an automated portal wherein SMEs provide details of customers they supply. In case of payment defaults, the Government can send automated reminders to defaulting establishments.

GROWTH IN STRESSED ASSETS

During the high growth phase of the economy from 2002 to 2008, credit growth in the Indian banking sector was in excess of 22%. A slackening in the economic growth rate has resulted in both, a lower credit demand as well as a receding appetite on the part of the banking industry, to extend credit. Stressed assets (SAs) in India have almost doubled from 5.7% in FY08 to 10.2% in FY13, which has impacted the banking industry adversely.

Exhibit 3



India is one of the fastest growing economies in the world and is set to remain on that path, backed by the growth in infrastructure, industry, services and agriculture. To support this growth, credit flow to various sectors of the economy has been increasing.

A period of downturn reverses this trend of low SA levels and asset quality concern increases as the growth in SA outpaces credit growth in the banking system. As a result, as the graph depicts, growth in SA increased by 40.2% in 2013 as against a 15.1% credit growth.

The problem is not only restricted to rising GNPA ratios. The rise in the percentage of RA and security receipts (SRs) issued by asset reconstruction companies (ARCs) are also a cause for concern. Owing to the lack of detailed data we have on SRs, we have limited our definition of SA in India to only GNPAs and RAs. The true picture of SA can be depicted by combining the GNPA and RA (as a percentage of total advances). This figure, as on March 2013 is as high as 10.2% of the total banking credit.

The corporate sector in India has shown a marked decline in asset turnover, depicting falling capacity utilizations. As a result, return on equity has taken a huge hit. The chief concern going forward is that new capacities that were added using leverage remain either underutilized or suffer delayed commercial commissioning. The additional capacity, instead of resulting in increased cash flows, is adding to the debt burden, thus creating additional stress. The number of cases referred to the CDR cell is on the rise and potential stressed corporate debt has risen from 14.3% in FY08 to 52.8% in FY13.

Large Sectors which saw a lower growth in credit offtake in 2013-14 over the previous fiscal were power (17.4% vs. 25.7%) and wholesale trade (13.3% vs.24.7%). The slowdown in credit growth to the power sector is attributable to the cautious lending stance of banks in the face of structural issues impacting the entities in the sector and the reduction in loans to State power utilities following issuance of bonds pursuant to the restructuring under FRP.

In APAS's observation, incrementally the banks are focused more towards retail loans (especially housing loans), given the significantly better asset quality profile in this segment, and towards loans to micro & small enterprises, which has provided better risk-adjusted returns and also offers part credit protection under the Credit Guarantee Trust for Micro & Small Enterprises (CGTMSE) scheme of the Government of India (GoI). Thus, retail loans and loans to micro & small enterprises are expected to outpace overall credit growth in the short to medium term.

Global technology practice and lending end to end process simplification

The lending market is recovering from the financial crisis and is expected to remain a profit driver for financial institutions into the foreseeable future. Multiple trends are reshaping the credit industry—everything from scarce funding and rising unemployment to tighter regulation. To gain greater insight on how lenders are reacting to the market pressure and the resulting more volatile business dynamics, APAS Research findings point to three main priority focuses for lenders across the Globe: credit analytics, non-performing assets (NPA) management and core credit re-platforming.

Market response to the crisis has produced various results across countries and business segments. Lending volumes are still below pre-crisis levels, instead of at segment level. Consumer finance and corporate lending have suffered more than mortgages as customers have deleveraged their assets, driven by the growing economic uncertainty. Also, banks have tightened their credit standards for corporates in an attempt to reduce their risk profile. The decrease in lending volumes has had a pronounced effect on net interest income which has been stagnate growing only 0.1 percent compounded annually from 2009 through 2013. The lack of growth is despite the support from various Central Banks which have injected a vast amount of money that banks could use as collateral in money market operations.

In addition to lower demand, lenders had to manage the increase of NPLs and related loan losses generated by a weaker economic environment. Particularly for some banks, the incidence of loan losses is higher than staff costs, eroding more than 20 percent of net interest income. Despite these negative trends, revenue generation from lending activities constitutes still half of the banking revenue pool across its three major segments (retail, small business and corporate); however, it does not necessary imply that this trend will continue in the future.

EMERGING TRENDS

Loyalty - Customers are less loyal and more eager to compare credit offers using portal aggregators, switch to a new bank or establish relationships with multiple banks. This is particularly true for the SME segment which has shifted away from a traditional single-bank model. Banks will have to work harder to restore trust and close on valuable cross-sale opportunities that have historically been possible, especially with SME customers.

Digital Technologies - Four main technologies are having a profound impact on business and consumers: Big Data: lenders already manage vast amounts of data, but many struggle to make sense of the growing volume and velocity of information. The key challenge is getting the right nuggets of information from an escalating volume of noise.

Cloud: Cloud technology is maturing and service offerings move up the technology stack from data storage and infrastructure to software, platforms, and business processes. More businesses are adopting cloud to increase flexibility, gain new capabilities and reduce costs.

Social Media: most banks have built a social presence and some of them have started to drive business through social engagement. Social and digital marketing will play an increasingly important role to engage customers, both retail and corporates, as online peer recommendation becomes a key influencer in purchase decisions especially for young consumers who are, typically, always connected to social platforms.

Mobility: smartphones are driving uptake of mobile banking, opening up a new way to interact with and serve customers; for example, enabling quick loan applications or offering assess to remote advisors.

DIGITAL LENDER

Despite the huge efforts undertaken to improve customer experience and reduce operational complexity, several issues still persist along the credit value chain that penalize efficiency and service quality:

Origination: manual data entry in sales and poor management of information.

Fulfilment: high level of manual processing, long processing times and excessive re-work. For instance, more than ten handoffs between banks and third-parties is common, and processing time is usually twenty or more days. Such metrics make the fulfilment process not only time consuming but also highly inefficient which negatively impacts the overall customer experience—particularly for SME customers.

Servicing: multiple servicing centers performing duplicate functions, multiple lending back-books services by different teams on different platforms in different locations, limited access to customer and transaction information resulting in increased customer queries and persistent overcapacity in services environments.

Digital technologies (mobile, social, cloud, analytics) can help lenders simplify and strengthen the end-to-end credit process, enabling an agile operating model to compete effectively against lending disruptors and seize market opportunities to increase loan origination volumes, despite a negative market outlook.

As demonstrated by the growing momentum of alternative lending providers (think innovative startups, technology companies and online retailers), digital technologies can play a role as key differentiators in credit services.

Long-term priorities of lenders

2014	2015
Cost reduction	1, Service Quality
Service quality	2, Cost reduction
Revenue growth	3, Revenue growth
Credit risk management	4, Credit risk management
Regulatory compliance	5, NPA management
NPA management	6, Regulatory compliance

Source: APAS BRT

Top lenders are already taking early steps to get closer to digital consumers and meet their borrowing needs. For example, some lenders now enable consumers to initiate loan discussion online but through mobile is yet to be conceived. This is why digital transformation in lending means thinking holistically about key components, including the business architecture, product systems, business processes and data/analytics architectures—and making corresponding changes in how people work and how enterprise services are provided. A complete digital transformation will greatly increase overall efficiency, reduce cost and provide a fully integrated and seamless customer experience throughout the loan lifecycle. Achieving it, however, is challenging since it may involve replacing existing legacy technology and/or infusing mobile capabilities in customers' everyday life.

Despite senior management sponsorship, the main challenges to digital technology adoption for lenders are internal collaboration, staff skills and funding.

Factors Affecting Digital Advancement

1	Poor cross functional collaboration
2	Insufficient funding
3	Skills shortage
4	Difficulties managing change
5	Lack of senior executive support
6	Insufficient customer demand for digital solutions

Source: APAS BRT

ANALYTICAL CAPABILITIES

As lending is an information-driven business, better data means better risk taking. Still, traditional lenders do very little of the information gathering. When a customer applies for a credit product, their characteristics are put into a scoring system with a score produced by a credit bureau, and the system produces a decision. Banks rely heavily on credit scoring, completing the application process with few face-to-face meetings and little additional information.

Innovators are finding new ways to create value, using data as the platform for new business models—both improving on existing models and creating new ones. They are also taking advantage of new data sources (both internal and external, social and public) and new techniques to mine data (from unconventional and unstructured sources)

Lenders pioneering a Big Data approach to improve credit scoring models in the payday lending market. Their approach combines many traditional credit metrics with a wider set of public and behavioral data and Google-like algorithms.

Some lenders are drawing on mobile phone call records and pre-paid airtime purchase data to credit score customers in the absence of credit reference data.

Both approaches use unconventional data and behavioral insights to help provision financial services to customers who were previously viewed as unmeasurable risks. In fact, data analytics is considered

first digital technology for lenders to adopt. Integrating traditional credit scoring model with broader types of data extracted by the right analytics tools can help lenders better identify high- and low-risk borrowers and thus improve net interest income, anticipate NPAs formation and monitor riskier exposures.

RECOVERY SYSTEMS

Recovery Systems should focus on maximizing the recovery rate according to the unexploited value of the NPA portfolio. Success of the Recovery Systems rests on three main pillars:

Advanced portfolio governance models to identify clusters of files based on the strategic value they have for the lender. This is accomplished by using ad hoc strategies and processes to monitor evolution of the NPL portfolio and key performance indicators (such as collection rate and litigation rate) using different levels of industrialization (from simple actions tracking to fully automated processes).

Specialized units to manage various clusters of NPLs, balancing a high level of industrialization within a pre-defined set of actions for low-value files and a bespoken approach for high-value files.

Process digitalization through end-to-end NPL tools and technology enablers, integrated with web-enabled platforms. This helps to reduce manual tasks in facilitating access to self-services and client data for all resources involved in the value chain.

CORE LENDING RE-PLATFORM

Banks can compete effectively against lending disruptors if they can take advantage of new, agile architectures that increase flexibility in supporting business requirements and enable automation of business processes to reduce time to answer and service loans.

Priority sector lending and interest subventions schemes

As per the Reserve Bank of India (RBI), “Priority Sector” refers to those sectors of the Indian economy that may not get timely and adequate credit in the absence of a special dispensation. Typically, these are small value loans to farmers and allied agricultural activities, micro and small enterprises, poor people for housing, students for education and low income groups and weaker sections. Besides, Priority Sector (PS) also includes other categories of loans as announced by the RBI from time to time.

The origins of Priority Sector Lending (PSL) can be linked to the voiced need in the late 1960s in India for “social control over banking” in line with the prevailing socialistic political mood in the country. The idea gaining currency was that credit to social sectors of the economy. Post the first round of bank nationalization in 1969, PSL was introduced in 1972 on the basis of recommendation of the informal study group constituted by RBI.

In 1974 RBI advised banks to increase PSL to one third of their overall credit by March 1979. As per currently prevailing norms, every domestic bank with greater than 20 operating branches should ensure that at least 40% of its Adjusted Net Bank Credit is lent to specific segments that qualify for PSL, of which Agricultural segments should comprise at least 18% and Advances towards Weaker sections another 10%. For foreign banks with less than 20 branches, the corresponding norms for PSL are 32% for overall exposure with no specific sub-targets for Agriculture or Weaker sections.

In response to RBI guidelines banking companies lend to priority sector as per prescribe criterion and the following table is providing details of outstanding credit during the past four years.

Outstanding Credit to Priority Sector (INR Crore)							
Year	PSBs	As % of ANBC	Pvt Bks	As % of ANBC	Foreign Bks	As % of ANBC	All banks
2011	1,028,615	41.3	248,828	46.6	66,618	39.6	1,344,061
2012	1,129,990	37.4	286,420	39.4	80,538	40.9	1,496,949
2013	1,284,880	36.4	327,317	37.5	85,011	35.2	1,697,208
2014	1,618,971	39.4	464,456	43.9	90,723	36.0	2,174,150

Source: RBI & APAS BRT

Apart from priority sector lending Government brought interest subvention schemes to penetrate and percolate certain aspect of policy decision in depth. Government has announced number of interest subvention schemes to implement its social agenda.

Reserve Bank of India has notified the banks that the interest subvention of 2% will continue to be available to banks for the first year on the restructured amount. These restructured loans may attract normal rate of interest from the second year onwards as per the policy laid down by the RBI. Farmers get loans at a concessional rate of interest on short term crop loans and banks later get the money from the government.

Government has also rolled out interest subvention schemes for exporters. Under the interest subvention scheme, exporters of items such as handicrafts, carpet, handlooms, readymade garments, a number of other textile products, processed agriculture products, sports goods, toys and certain engineering products, are entitled to an interest subsidy of 2 per cent. Interest subvention schemes are also available for self-help groups (SHG), women self-help groups and housing etc.

Abuse is also a part of such an initiative. The issue of the misuse of interest subvention scheme had come to the fore and demanding an inquiry by the Central Bureau of Investigation. Since scheme is beneficial for small and marginal farmers, there is “widespread misuse”, and many farmers have been denied the benefits of the scheme.

Most of the governments recognizes importance of financial inclusion and support such an initiative through different mechanism. Reaching out to weaker and socially disadvantaged groups through priority sector lending and interest subvention schemes are critical measures. These measures are effective and productive up-to an extant but scope to do more is still available.

Prudent lending and KYC guidelines

Regulatory pressures concerning Anti-Money Laundering (‘AML’) continued to rise during last year and this looks set to continue throughout 2015. Increased pressure surrounding compliance with AML, Know Your Customer (‘KYC’) and sanctions requirements is a key focus for banking and financial services firms need to ensure they are following appropriate compliance procedures to meet the increasing regulatory demands. Firms operating on a global basis also need to demonstrate a robust compliance framework ensuring that each territory has sufficient oversight and that AML regulatory requirements are being adhered to at both a local and global level.

RBI long back brought know your customer (KYC) guidelines into effect. The objective of KYC guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering activities. KYC procedures also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently. Banks should frame their KYC policies incorporating the following four key elements:

- Customer Acceptance Policy;
- Customer Identification Procedures;
- Monitoring of Transactions; and
- Risk management.

For the purpose of KYC policy, a 'Customer' may be defined as:

- A person or entity that maintains an account and/or has a business relationship with the bank;
- One on whose behalf the account is maintained (i.e. the beneficial owner);
- Beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors etc. as permitted under the law, and
- Any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank, say, a wire transfer or issue of a high value demand draft as a single transaction.

KYC norms seem good keeping AML challenges in mind but implementation of it has its own challenges. Close to 22 Indian banks were fined a total of Rs. 49.5 Cr. by the banking regulation authority Reserve Bank of India (RBI). These banks were found in violation of Know Your Customer (KYC) norms laid by RBI. The KYC norms that were violated were the ones aimed at preventing money laundering activities. KYC has 2 components Identity and Address, while Identity remains a constant, the address of customer might change over a period and hence banks are required to periodically update their records.

Under KYC norms, all customers of the bank are expected to submit the PAN card details, address proof details and proof of identity issued by a government authority such as Passport authority etc. From recent events it seems to appear that these KYC norms have not been implemented and followed by several banks.

Recent allegations of money laundering and breach of KYC norms brings forth few key questions. In one of the most populous nations in the world, is it possible to effectively implement KYC norms across all bank branches? How can RBI effectively implement all its KYC norms for people who don't hold pan card and other address proofs? Are banks fully equipped to trace money laundering activities if a fully KYC compliant customer engages in such dubious activities?

Few may argue that just because PAN card details were not submitted during account opening, does not testify that these accounts engaged in malicious money laundering transactions. To reduce money laundering transactions in India, RBI can direct banks to automate the transaction chain monitoring. In order to effectively monitor the entire chain of transactions and to identify suspicious transactions, a better integration among all the banks and their branches is of pivotal importance.

We are of the opinion that considering that since Indian Banking Industry is riding on Finance transformation driven by Information Technology; RBI should have a monitoring mechanism by way of periodic reports on dubious transactions submitted by banks. RBI should also encourage banks for a far deeper IT integration to share transaction chain data ensure that the chain of such suspicious transaction does not get lost because of policies or lack of integration of IT between banks.

Make in India and domestic investments

The Honorable Prime Minister Shri Narendra Modi, prior to the commencement of his maiden US visit, last year launched ‘Make in India’, a major national initiative which focuses on making India a global manufacturing hub. Key thrust of the programme would be on cutting down in delays in manufacturing projects clearance, develop adequate infrastructure and make it easier for companies to do business in India.

The 25 key sectors identified under the programme include automobiles, auto components, bio-technology, chemicals, defence manufacturing, electronic systems, food processing, leather, mining, oil & gas, ports, railways, ports and textile. The national progam aims at time-bound project clearances through a single online portal which will be further supported by the eight-member team dedicated to answering investor queries within 48 hours and addressing key issues including labor laws, skill development and infrastructure.

The objective of the mega programme is to ensure that manufacturing sector which contributes around 15% of the country’s Gross Domestic Products is increased to 25% in next few years. Speaking to more than 500 top global CEOs along with captains of Indian industry at the event in Vigyan Bhawan, New Delhi on September 25th, Prime Minister termed 'Make in India' initiative a lion step to usher in increased manufacturing in the country, which will ultimately generate more employment opportunities for the poor and give greater purchasing power in their hands.

The mega event was watched live in several cities in India and abroad through video conferencing, He urged the domestic as well as global investors not to look at India merely as a market, but instead see it as an opportunity. “When we talk of Make in India, we are not just offering a competitive situation and we give you an opportunity to create a huge market for your product. After all, handsome buyer is equally important as cost effective manufacturing.” Modi told a packed audience.

Make in India initiative has drawn adequate attention from all quarters. Key industry leaders and domestic investors has found special interest and many business groups has announced their investment.

Going by the recent media announcements big corporates – including Ambanis, Adanis and Birlas announced to investing over Rs 1.6 lakh crore and creating more than 50,000 jobs, as Prime Minister Shri Narendra Modi promised to make India the 'easiest' place to do business with a stable policy and tax regime. The following few announcements illustrates the optimism that has been prevailing in the market following the policy announcements as well as the recent annual budget.

The banking sector therefore has to reorient itself in meeting with the demand that arises out of these announcements as well as the allocation of coal and telecom spectrum.

Taking the lead, Reliance Industries would invest Rs 1 lakh crore over the next 12-18 months across businesses.

Adani group signed an MoU for setting up a solar park in Gujarat at an investment of USD four billion (about Rs 25,000 crore), while creating 20,000 jobs. Aditya Birla Group Chairman Kumar Mangalam Birla also announced Rs 20,000 crore investment in the state in cement and other businesses.

Diversified Kalyani Group also said it will invest Rs 600 crore for upgradation and overhaul of Armoured Fighting Vehicles unit at Dholera, Gujarat, while Welspun Renewables announced an investment of Rs 8,300 crore to set up about 1,000 MW solar and wind capacities in the state.

Gujarat Cooperative Milk Marketing Federation (GCMMF) is planning to invest close to Rs 5,000 crore (US$ 806.01 million) to set up ten new processing plants as well as expand the current capacity to touch 32 million litres per day (MLPD) capacity by 2020.

The Visakhapatnam Port Trust (VPT) has outlined a Rs 3,000 crore (US$ 483.61 million) expansion-cum-modernisation plan aimed at enhancing the port's capacity by nearly 50 per cent. The Rs 800 crore (US$ 128.96 million) or more than port will spend a fourth of the total planned investment, while it will seek private partners to invest the rest by way of public-private partnerships (PPP).

The Uttar Pradesh government has secured investment deals valued at Rs 5,000 crore (US$ 806.01 million) with companies like Spice Mobiles, Lava and cellular associations for setting up mobile manufacturing units in the state.

Indian smartphone maker Maxx Mobilink plans to start production of mobile handsets at its Haridwar plant, beginning with assembling devices from April at the factory where it currently manufactures accessories such as battery and charger. Maxx will invest over Rs 6 crore (US$ 967,241.29) initially in setting up the R&D lab, which will take care of device testing and software innovation such language packs, user interface (UI) and other utility-based applications.

Indostar Capital Finance Ltd and Reliance Capital Ltd have invested Rs 200 crore (US$ 32.24 million) in Alliance group, a real estate company. The investment will be deployed in two projects—one in Chennai and the other in Bengaluru. The company plans to invest close Rs 120 crore (US$ 19.34 million) in the Chennai project.

In line with Prime Minister Narendra Modi's 'Make in India' initiative to give domestic manufacturing a major push, the country's oil and gas sector is expected to see investments worth as much as Rs 5-6 lakh crore over the next five to seven years. Manufacturing opportunity is expected to be created in the near-to-medium term across the oil and gas value chain including upstream sector (oil and gas exploration and development), midstream (gas pipelines and LNG ship building) and downstream (refining and petrochemicals).

Infosys CEO met Prime Minister of India recently with a double offering aimed at aiding the government's new initiatives — a promise to allocate half its US$ 500 million venture fund as an "Innovate In India Fund" and share expertise to help smart cities. The money will be used to fund start-ups in innovative technologies and provide them an ecosystem to scale up. In return, these innovations will help Infosys climb up the value chain in the software services space.

Pune-based Suzlon Group has announced its plans to invest Rs 24,000 crore (US$ 3.86 billion) over the next 5 years on energy projects to generate 3,000 megawatt (MW) in Gujarat. This will also mark the foray of Suzlon in solar energy.

The Centre would spend around Rs 200,000 crore (US$ 32.24 billion) over the next five years for the Swachh Bharat Mission, said M Venkaiah Naidu, Union minister for urban development. The minister also said the government would set up a 'Swachh Bharat Kosh' to provide tax and fiscal incentives.

ITC Ltd will invest Rs 1,000 crore (US$ 161.2 million) for its ambitious foray into dairy and juice businesses which it plans to roll out in the January-March quarter. The Kolkata-based cigarette-to-FMCG-hospitality conglomerate will make the proposed investment in the short term on manufacturing capacity, marketing, brand building and distribution expenses.

'Make in India' initiative undertaken by the Government of India is likely to bring about positive economic reforms into the country as well as encourage more domestic investments in the next few years.

Pricing practice and discrimination

Interest rate regulation in India has travelled a long path from the days of administered regime in vogue till the early 1990s to the deregulated regime prevailing now. As part of the deregulation, banks have been permitted to set their own lending and deposit rates except for a very few segments such as DRI scheme where administered rates still prevail. To ensure that such flexibility is judiciously deployed and the borrower interests are taken care of, the BPLR system was replaced by the Base Rate system in 2010 which has largely addressed the gaps noticed in the erstwhile BPLR regime.

Despite the policy measures to steer in transparency and fairness to the credit pricing framework, there have been certain concerns from the customer service perspective. These mainly relate to the downward inclination of the interest rates, discriminatory treatment of old borrowers vis-à-vis new borrowers, and arbitrary changes in spreads, etc.

There have however been some concerns from the customer service perspective which needed a review of the pricing of credit by banks. Customer complaints essentially arose on the following:

Downward inclination of the interest rates: Banks have been quicker in increasing their interest rates in response to policy tightening than in decreasing interest rates when the policy turned more accommodative. This asymmetric response to policy rate not only impinges on the effectiveness of the monetary policy but also leads to borrower dissatisfaction.

Discriminatory treatment of old borrowers vis-à-vis new borrowers: Borrowers have represented that banks have been more generous with the new borrowers in offering them lower rates in comparison to the rates charged for the old borrowers.

A committee set up by the Reserve Bank of India (RBI) on credit pricing framework on April 2014, suggested that commercial banks, particularly those whose weighted average maturity of deposits is on the lower side, move towards computing the Base Rate on the basis of marginal cost of funds. This may result in more transparency in pricing, reduced customer complaints, better transmission of changes in the policy rate and improved asset liability management at banks, a draft report of the committee on 'Working Group on Pricing of Credit', said. If banks use weighted average cost of funds because of their deposits profile or any other methodology that may result in differentiation between old and new customers, the boards of banks should ensure that this differentiation does not lead to any discrimination amongst borrowers.

Apart from factors like specific operating cost, credit risk premium and tenor premium, broad factors, such as, competition, business strategy and customer relationship are also used to determine the spread. The RBI committee suggested that bank should have a board approved policy delineating these components. The board of a bank should ensure that any price differentiation is consistent with the bank's credit pricing policy factoring Risk Adjusted Return on Capital (RAROC). Banks should be able to demonstrate to the Reserve Bank of India the rationale of the pricing policy, the draft report of the committee stated. Banks' internal policy must spell out the rationale for, and range of, the spread in the case of a given borrower, as also, the delegation of powers in respect of loan pricing, the draft report said.

The spread charged to an existing customer cannot be increased except on account of deterioration in the credit risk profile of the customer, the committee said. The customer should be informed of this at the time of contract. Further, this information should be adequately displayed by banks through notices/website, the committee said in its draft report.

The floating rate loan covenant may have interest rate reset periodicity and the resets may be done on those dates only, irrespective of changes made to the Base Rate within the reset period, the committee said. There may be a sunset clause for Benchmark Prime Lending Rate (BPLR) contracts so that all the contracts thereafter are linked to the Base Rate. Banks may ensure that these customers who shift from BPLR linked loans to Base Rate loans are not charged any additional interest rate or any processing fee for such switch-over.

RBI has also offered freedom to banks to review the base rate calculation method once in three years, as compared with once in five years mandated earlier. The change in method should have the board’s approval. Banks are required to review the base rate at least once in a quarter with the approval of its board or asset liability management committee. At present, the review of the base rate does not have a fixed schedule.

Differentiated banking and financial inclusion

The initiative to include the financially excluded groups of the society into formal financial system in India are not new. The concept was first mooted by the Reserve Bank of India in 2005 and Branchless Banking through Banking Agents called “Bank Mitr” (Business Correspondent) was started in the year 2006. In the year 2011, the Government of India gave a serious push to the programme by undertaking the "Swabhimaan" campaign to cover over 74,000 villages, with population more than 2,000 (as per 2001 census), with banking facilities. Because of the RBI’s drive for financial inclusion, the number of bank accounts increased by about 100 million during 2011-13.

The Swabhimaan campaign, however, was limited in its approach in terms of reach and coverage. Convergence of various aspects of comprehensive Financial Inclusion like opening of bank accounts, digital access to money (receipt/credit of money through electronic payment channels), availing of micro credit, insurance and pension was lacking. The campaign focused only on the supply side by providing banking facility in villages of population greater than 2000 but the entire geography was not targeted. There was no focus on the households. Also some technology issues hampered further scalability of the campaign. Consequently the desired benefits could not be achieved and a large number of bank accounts remained dormant.

Data from Census, 2011 estimates that only 58.7 percent of the households have access to banking services. The present banking network of the country (as on 31.03.2014) comprises of a bank branch network of 1,15,082 and an ATM network of 1,60,055. Of these, 43,962 branches (38.2 percent) and 23,334 ATMs (14.58 percent) are in rural areas. According to World Bank Findex Survey (2012) only 35 percent of Indian adults had access to a formal bank account and 8 percent borrowed from a formal financial institution in last 12 months.

Access to formal financial institutions has improved gradually but thousand of villages still lack a bank branch; less than 10 percent of all commercial bank credit goes to rural areas, where around 70 per cent of the total population lives. Data from the RBI show that only 46,126 out of 640,867 villages in India were covered by banks in March 2014. Thus the need for financial inclusion is beyond question.

Financial inclusion is an important objective for the financial system for a variety of reasons including: better alignment of financial sector signals and real sector with respect to allocation of resources, allowing people to smooth consumption across time and enable diversification of risks for households. However it needs to be achieved in a manner that it does not impair the systemic stability of the financial system and its ability to offer a high degree of depositor protection.

The objective function may therefore be defined as: maximize (financial inclusion) subject to a high degree of depositor protection and systemic stability. The constraints are in turn a

function respectively of stability, transparency, neutrality and responsibility of financial institutions and alternate designs for financial inclusion would need to be evaluated using these four principals.

Keeping four principals in view differential banking model have been evolved. Under the Differentiated Bank License (DBL) model, banks will be allowed to offer products only in select verticals, like Small Financing and Payment Service etc. as indicated in the Nachiket Mor Committee report and subsequent RBI Differentiated Banking License guidelines.

The regulator is in a view to allow a wider pool of entrants into banking under DBL rather full-fledged banking license, which needs more capital, experience etc. Indian market is still untapped and there are diverse opportunities in the banking and financial landscape reflecting significant macro-economic growth potential and Differentiated Bank Licensing could enable unlocking potential of these opportunities as it encourages niche banking by facilitating specialization thereby reducing potential non-optimal use of resources. Each of the niches has the potential to be individually large to sustain significant balance sheets and specialized entities can play a major role in all of them.

First, in the current round of licensing, RBI not only recognizes diversity but encourages it. It can do so by giving licenses to applicants with diverse and specialist business models that focus on specific customer segments, products, and technology and process platforms. More importantly, it needs to show flexibility in regulation, and not ask all banks to look the same in the short run. Financial regulation is about consumer protection and micro-prudential regulation, and not homogenization.

Second, RBI needs to start thinking about Differentiated Banking Licenses. Why should we have only one type of license? Why can’t we have a utility bank – one that provides only transaction services (e.g. security related services such as custodian, trade related services, etc) and does not lend or borrow (significantly)? Why can’t we have a payment specialist bank or home loan banks (one that can take deposits but lend only in form of home loans, by far the safest lending for Indian banks)? Everyone talks about financial inclusion, so why can’t we have an inclusion bank– one that serves only the bottom of pyramid customers?

Such specialist banks will be expected to focus on their own individual niches and strengthen their capabilities in serving these niches as a bank - through access to payment systems, ability to raise deposits, regulatory oversight, etc. The presence of such banks will make the system less monolithic and hence better placed to face economic cycles.

With Differentiated Banking Licenses, we will have banks that do not face boom and bust at the same time and will address financial inclusion objectives successfully. Reduced correlations between banks will give lower systemic risk.

FEATURES OF DIFFERENTIATED BANKS:

Based on above discussion, the differentiated banks are characterized by the following features:

These are banks for serving different segments of customers

These are highly specialized banking entities focusing on target group of customers

These are driven by innovation and technology perspectives

- The products and range of services provided by these banks are also differentiated keeping in view the customized needs of the customers

- These serve the purpose of different segments of society e.g. women bank opened in Mumbai is one such example and similarly there may be banks for physically challenged people, students, younger employees and professionals

- The rates of interest charged will depend upon the nature of the clientele the banks will possess

The RBI had released Draft guidelines for both “Payment Banks” as well as “Small Finance Banks” in July, 2014 and based on the feedback received, it has issued the final guidelines on November 27, 2014. Small Finance Banks would carry out the function of accepting deposits and lending primarily to priority sector. These institutions would help in bringing the unbanked population within the ambit of regulated banking infrastructure and would help in achieving the agenda of financial inclusion. Payment banks would be providing payment & remittance services and demand deposit products to their customers. However, they won’t be allowed to undertake lending activities.

Presented below are the key features of Small Finance Banks and Payment Banks and CARE’s view on these features.

SMALL FINANCE BANKS

Small Finance Banks would provide deposit products to their customers and inculcate the culture of saving funds with a regulated institution among the unbanked population. Small finance banks will ensure that the credit needs of the unserved and underserved population are met and they don’t have to rely on informal sources of credit which charge usurious rates of interest.

Existing NBFCs, MFIs can convert themselves into Small finance banks. These entities are already serving the credit needs of the unbanked customers, now they can serve them on the deposit side also if they receive the license. Conversion of existing entities may lead to faster roll out of services.

Maintenance of CRR and SLR since inception would affect the profitability in the short term but will ensure security of depositors' money and make these banks structurally stronger. High priority sector lending target for Small Finance Banks underlines the very purpose of its incorporation. Achieving priority sector requirement won't be difficult for eligible NBFCs and MFIs if they convert into small finance banks as most of their portfolio qualifies for priority sector. The cap on single and group exposure minimizes concentration risk and the cap on loan size ensures that small borrowers are the ultimate beneficiaries.

Minimum capital requirement of Rs.100 crore will guarantee that only serious players apply for the license. Stipulation of minimum capital adequacy ratio will cut down the risk of over leveraging and ensure sufficient capital cushion to absorb various risks. Overall CAR requirement of 15% is in line with the NBFC-SI. This will help in providing basic banking services to the low income households and people in unbanked areas.

PAYMENTS BANK

Payment Banks would provide deposit products to their customers and inculcate the culture of saving funds with a regulated institution among the unbanked population. Payment and remittance services would be useful for the migrant worker population and bring them in the domain of formal banking services.

Conversion of PPIs into payment banks will address the limitations/concerns of the PPI model like inability to pay interest on balances and contagion risk. Mandatory maintenance of CRR and parking of funds in government securities and bank deposits minimize credit and liquidity risk for payment banks.

Minimum capital requirement of Rs.100 crore will guarantee that only serious players apply for the license. Stipulation of minimum leverage ratio will cut down the risk of over leveraging and ensure sufficient capital cushion to absorb various risks. Minimum promoter holding norm guarantee that the promoter's interest is involved in the entity's operation during the initial phase.

This will help in providing basic banking services to the low income households and people in unbanked areas. Focus on leveraging technology for providing the services would ensure low transaction cost for the customers.

The guidelines on Small Finance Banks and Payment Banks are aimed at setting up institutions that further the agenda of financial inclusion. These institutions shall provide the rural and unbanked population access to credit, wealth creation and contingency planning through lending and distribution of third party products such as mutual funds, insurance and pension products. Technology driven low cost model of payment and small finance banks overcome the challenge of high transaction cost faced by scheduled commercial banks in offering banking services in rural / unbanked areas. Further the regulation is a positive development for NBFCs /MFIs which already have operations in rural centres to convert into small finance banks. This would enable them to access low cost deposits to meet their funding needs and can prove to be a launching pad for becoming a universal bank. Also in the final guidelines, RBI has done away with geographical restriction, thus these entities can diversify risk arising from geographical concentration with the increase in size.

With overwhelming response of 113 applications are in place with RBI appointed two external advisory committees, financial inclusion story through differentiated banking system is yet to take off.

Product innovation to achieve customer delight

Rise of NPA to alarming level has shaken the lending market in India. Gross NPA of 4.5 percent of total advances as of the September quarter, from 4.1 per cent in March 2014, according to RBI. When the restructured assets are added, the ratio of stressed advances shoots up to 10.7 per cent from 10 per cent in March.

Experts are of the view that economy is evolving, banks have to innovate new products and explore new opportunities for lending, and specifically mentioned the farm sector which has a high requirement of capital due to increased mechanization.

The average Indian takes a loan from a money lender that he cannot return and dies. For his daughter's marriage, a poor man takes a loan from the money lender that he cannot return- this reflects the current state of affairs regarding access to bank finance. Nearly 500 million Indians today are at the mercy of money lenders who charge extortionate interest. Even though India has grown to become Asia's third-largest economy, thousands of poor farmers commit suicide every year because they cannot repay loans. While MFI’s have addressed this need for affordable financing to an extent, the search for an innovative & viable model to make available ‘credit’ to facilitate transactions continues.

HOUSING FINANCE

Financial institutions should introduce innovative products like savings-linked loans while the credit risk in case of low ticket accounts should be internalised through insurance covers. Once the customer reaches a threshold balance, the financial institutions can consider sanctioning of a loan. The balance in the account could act as collateral or the margin. The amount deposited every month would act as the base to assess the repayment capacity of the customer for the purpose of calculating the monthly repayment instalments.

Some of the common issues facing housing companies in India are:

- Lending decisions are conservative and restricted to the high income group consumers due to the lack of facilities to establish credibility, and foreclosure regulations.
- Rural and semi urban markets have remained largely untapped due to high down payment requirement and non-availability of title deeds in the absence of land records in the rural areas.

- For new construction, finance is generally offered for construction only, and not for purchase of land. This makes new housing less affordable.
- Recovery of defaults is difficult due to the lack of an effective legal framework.
- Processing of loan applications is time consuming and expensive.
- Interest rates are high because of poor recovery

AUTO FINANCE

Auto finance market is growing at 30 per cent per annum. Also, consumers are upgrading their cars by borrowing from auto financing companies. Like other lending institutions in India, auto finance companies face a high percentage of delinquencies. Some of the problems facing auto finance companies in India are:

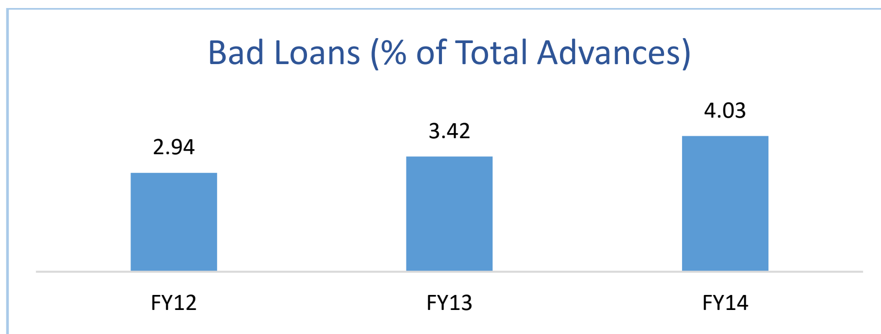
- Lending decisions are taken at the local level, and lack consistency. As local offices have to meet performance targets, they tend to lend approve marginal cases.
- Credit checks are inaccurate due to lack of information.
- Recovery from defaulters is difficult. Even repossession of automobiles limits recovery as borrowers often replace new components with used ones.
- Interest rates are high because of low recovery. This makes finance options less attractive to consumers.
- Used automobile finance and leasing of new vehicles is limited due to the difficulties in assessing consumer credibility and lack of effective recovery options.
- Automobile finance companies do not share consumer data. Consumers are often able to obtain automobile finance even after defaulting with previous such loans.

Restructuring of bad assets or ever-greening

Recent slowdown of India economy has brought number of companies/projects under stress. As a result, the Indian banking system has seen increase in Non-Performing Assets (NPAs) and restructured accounts during the recent years. Not only do financially distressed assets produce less than economically possible, they also deteriorate quickly in value. Therefore, there is a need to ensure that the banking system recognizes financial distress early, takes prompt steps to resolve it, and ensures fair recovery for lenders and investors.

Accordingly, a Framework has been developed by RBI outlining a corrective action plan that will incentivize early identification of problem account, timely restructuring of accounts which are considered to be viable, and taking prompt steps by lenders for recovery or sale of unviable accounts.

Exhibit 3



Source: RBI & APAS BRT

Bad loans in the banking system rose to 4.03% of total advances in 2013-14 from 3.42% in 2012-13 and 2.94% in 2011-12, as slower economic growth and delays in securing statutory approvals such as environmental clearances and completing land acquisition stalled many big-ticket projects, hurting companies' ability to generate cash flows and repay loans on time. The economy grew less than 5% in each of the previous two years.

This increased pace of restructuring is showing up as on Dec 31, 2014 in following data table from the RBI CDR cell.

Total References Received by CDR Cell		Total Cases Approved		Cases exited successfully	
No. of cases	Aggregate Debt (INR Cr)	No. of cases	Aggregate Debt (INR Cr)	No. of cases	Aggregate Debt (INR Cr)
647	4,52,940	520	3,80,885	77	58,682

Source: RBI & APAS BRT

Banks have resorted to innovative techniques of effectively restructuring stressed corporate standard loans which are not disclosed as restructured standard loans, but are impaired loans. Such a practice makes their asset quality appear deceptively healthy even though it has deteriorated."

Traditionally it is referred as 'evergreening of loans' wherein banks provided additional loans to corporates who were unable to repay on time. In past, Reserve Bank of India has come down heavily on such practices while inspecting banks' books.

Evergreening continues to take place. At times it is at the instance of banks themselves who are keen to save the account from becoming an NPA. Banks should restructure the account to resolve the problem instead of finding a near term solutions such as evergreening.

Indian companies had inflated the cost of acquisition of foreign entities and the banks financed these inflated acquisitions without any vigorous scrutiny. Following the slowdown many companies rushed to recast their loans. Banks which had overseas branches resorted to funding their stressed domestic corporate accounts through these branches; domestic rupee loans were replaced by loans from foreign branches as these companies used foreign subsidiaries to transfer their assets to these entities so as to receive the required funding from overseas branches of Indian banks. Such practices kept banks' stressed corporate asset exposure as "standard" without any disclosure as a restructured standard asset. A number of banks like Axis Bank, Bank of Baroda and Bank of India saw high growth in loan disbursal by their overseas branches while Canara Bank and Punjab National Bank have shown growth from a low base.

There existed a cosy relationship between banks, stressed corporates and NBFCs. Stressed corporates found it difficult to service bank loans and the banks did not classify such loans as restructured or NPAs, but instead the banks made arrangements with certain NBFCs whereby the NBFCs extended finance to stressed companies, which was used to service bank loans and the banks compensated NBFCs and further provided assurance to the NBFCs from any losses.

This scheme has been helpful for stressed corporates that lacked foreign presence and were unable to create foreign subsidiaries and shell companies through which they could get funds from banks' overseas branches.

Concluding thoughts

The rising NPAs with high credit demand has forced bankers and borrowers to brainstorm and work out ways in which cooperation between two stakeholders can be improved. Macro-economic dynamics may be a major contributor in rising NPA, however we believe that inadequate assessment and monitoring during the slowdown and revival also played a role. This compendium has attempted to understand issues and concerns associated with lending at this point in time and ways to address concerns of both the sides.

MSME segment is the huge untapped section to be explored, they even don't have easy access to capital market and they are largely dependent on borrowed funds from bank and other financial institutions. Technology, being an enabler of process simplification and improvement, has led to digitalize lending operations. As per APAS research, service quality is most demanding requirement of successful lending business entity. Digitalization must be encouraged even if it incurs marginal increment of capital expenditure.

Priority sector lending and interest subvention scheme are important initiatives to penetrate lending market and achieve financial inclusion if abuse can be avoided. Non-discrimanatory pricing is also a need of the hour, though RBI has come out with new pricing methods to avoid abuse. Bank should also ensure that any price differentiation is consistent with the bank's credit pricing policy factoring Risk Adjusted Return on Capital (RAROC). Product innovation in present context gathers significant attention in keeping with growing and evolving market place.

Expertise you need, Services you deserve

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ABOUT US

Ashvin Parekh advisory services LLP was founded in June 2013 and headquartered in Mumbai, the finance capital of India. APAS is a leading financial advisory firm that will provide a wide range of consulting services to diversified client base which will include financial conglomerates and business houses, banking companies, life general and health insurers, financial institutions, regulators and the government.

Our focus is primarily on business development through advisory services in strategy, processes, and people areas. And the strategy areas we focus on diversification, strategic alliances, mergers and acquisitions and business restructuring. We also offer services in the areas of transformation and value creation. In the operation strategy areas we also render services at product and product design, intermediation and distribution areas, business risk management and governance aspects of the management.

In keeping with the services we offer, we have experts in business and transaction advisory areas. We have teams drawn from the industry to offer services to our clients in business and operation areas in the financial services space.

We have teams focusing on the new banking reforms including the formation of the new banking companies arising out of the new licenses. We will offer operational support in the areas of financial inclusion, holding company structures and project management services. We also have focus on the new reforms in the areas of subsidarisation of foreign banks. In addition we also conduct high level diagnostic studies for public sector and private sector banks.