Challenges and Reforms Required in Financial Sector

The fast changing and evolving financial sector of the country necessitates reforms on the structural and regulatory front to ensure orderly growth. With the country's financial sector currently going through challenging times, largely due to the impact of both the prevailing domestic and global economic environment, reforms in the sector would have far reaching consequences for the sector as a whole.

It is in this context that we have undertaken a study to understand the specific challenges faced by Banks and NBFCs, the reforms they are looking forward to being initiated and the impact of these on their respective sectors.

Our study essentially involved conducting **a survey of banks and NBFCs** through a questionnaire, comprising questions pertaining to the immediate challenges (over a 1-year time horizon) faced by banks/NBFC, expectations of sector reforms from the new RBI governor and the likely impact of these reform on their business/sector. The questionnaire was answered by the heads of these institutions.

The findings of this survey have been presented here in 2 sections i.e. Section A for Banks and Section B for NBFCs.

Section A: Banks

The main **challenges** faced by banks encompass both the prevailing economic and business environment as well as evolving developments of this industry. These have been summarized below

- Deceleration in economic growth impacting banking sector growth. Quite clearly this is one factor which affects the growth and prospects of this sector. The fact that the Indian economy has slowed down in the last three years is significant here.
- Maintaining asset quality in the face of growing NPAs and restructuring of advances. There is a clear link with the overall state of the economy.
- Augmenting capital and maintaining prudential capital adequacy in view of the implementation of Basel III.
- Preserve and augment profitability of banks in a stressed environment. Banks are witnessing pressure on margins on account of capital requirement, provisioning, regulation, liquidity, volatile interest rates etc.
    - Achieving desired credit growth in a weak economy.
- Implementation of Financial Inclusion & DBT (Direct Benefit Transfer). As the RBI has been reiterating the need for focusing on financial inclusion this factor has become a challenge as it has to be addressed while keeping an eye on capital, quality of assets and profitability.
- Increased competition from both within the banking sector with various banks becoming aggressive in the existing space as well as potential competition from new entrants.
- Adopting and adapting to technological changes/ innovation to meet regulatory requirements as well as to tap alternative channels in banking
    - Dealing with technology related frauds and improving risk management systems of banks
- Improving quality of human resources for efficient working of banks in view of the latest technological developments

Banks do expect to see a series of reforms **and measures** to be implemented by the RBI in the next 1 year encompassing regulation, financial inclusion, technological focus etc. These have been elaborated upon below.

- Stringent norms pertaining to NPAs and restructured assets. The level of NPAs has gone up sharply this year which becomes more worrisome when the restructured assets are also factored in.
- Target Consolidation/mergers and entry of new players. This would involve:
  - Continuous bank licensing (as has already been voiced by the RBI),
  - Conversion of some urban co-operative banks into full-fledged commercial banks,
  - Separate licenses for niche/specific banking operations/functions such as wealth management, investment banking, wholesale banking or retail banking. This has been spoken about in some detail by a special Committee set up by RBI on financial inclusion.
- Reforms in Corporate debt market, Government Debt Market & Money Market. Activating corporate funding through alternative channels of money market and bonds by introducing benchmark spreads and transparency in the markets. (The RBI has already reintroduced IRFs and also has put up a paper on financial benchmarks).
- Focus on asset – liability management for banks.
- Increased Usage of Technology in Banking. Leveraging of technical developments on various banking activities
- Focus on Financial Inclusion/Deepening
- Introduce measures for the removal of structural bottlenecks on credit delivery and free pricing of financial assets
- Bring about transparency and improvement in clearing and settlement practices
- Reforms aimed at creating liquidity and depth for efficient price discovery of all banking products

If these expected reforms come into being, bankers expect them to have wide ranging impact**.** Some of the expected results are:

- Norms on NPAs would improve quality of assets & recovery, liquidity and the overall balance sheets of banks.
- Consolidation of banks and new players would result in competition and consequently in innovation and efficiency/productivity of banks. It would also bring about economies of scale and economics of scope for banks.
- Conversion of some urban cooperative banks into full-fledged commercial banks will help Banks to participate in main stream line of business on lower risk.
- Increased usage of technology could lead to technological upgradation and more e-products would be designed. Technology will help sustain and scale business.
- Financial deepening would make banking more inclusive, improve geographical coverage, reduce regional imbalances and credit to the unorganized sector would see an increase.

Section B: NBFCs

NBFCs too are faced with a gamut of **challenges**. Some of the key challenges have been outlined here based on responses received from them.

- Increasing NPAs and lower recovery of loans owing to economic slowdown, poor business climate and absence of special powers like SARFESI Act.
- Increased competition viz. from banks which have a competitive advantage owing to regulatory bias giving rise to an uneven playing field.
- Regulatory tightening and convergence (with banks) leading to uncertainties and reduced flexibility for NBFCs without the benefits of access to CASA like benefits.
- Funding / resource mobilization challenges given various constraints in the banking and capital markets - squeeze on flow of bank credit, regulatory tightening with respect to raising funds through NCDs under private placement, and changes in assignment rules
- Increased cost of borrowings/ funds due to economic and regulatory reasons and significant dependence on banks for borrowing
- Lower leveraging capacity due to higher risk weights and higher capital adequacy requirement
- Inadequate and unsupportive legal framework which renders recovery of dues very difficult and expensive
- Challenge of meeting 75/25 core factoring asset/income ratio by July 2014, while maintaining profitability of operations.

The **reform** expectations of the NBFC sector for the coming future are.

- Bring NBFCs under SARFESI Act to enable recovery.
- Restore priority sector lending status to eligible loans by NBFCs
- Measures to enable stable and low cost funding for NBFCs - like opening a central refinance window through agencies like NABARD and SIDBI with a cap on the spreads NBFCs can charge on such refinanced loans, daily put/call option linked to MIBOR, more access to them to public deposits (with tighter regulations) and NCDs etc.
- Availability of Refinance facilities for Systemically Important NBFCs (in case of banks almost their entire asset side can be refinanced with RBI as the lender of the last resort. RBI equates systemically important NBFCs with banks since they possess systemic risk and applies prudential regulation to them in a similar manner)
- Tightening of the Corporate Governance and disclosure norms
- Make credit insurance available so that NBFCs can also avail benefits and ameliorate credit risk
- Banking license to NBFCs
- Stringent NPA, capital adequacy and reserve norms
- Liquidity buffer for NBFCs which deploys at least 75/60 per cent of its total assets in infrastructure/asset financing to tide over short term liquidity concerns

The above expected reforms if introduced could have varied **impact** on the sector as per the NBFC participants of the survey.

- The NPA norms and introduction of SARFESI Act would aid in recovery. This along with capital adequacy norms will result in better portfolios.
- The liquidity buffer would help NBFC plan their disbursals better and lower the cost of funds, while not penalizing them for adhering to prudent measures.
- The restoration of priority sector status will significantly ease cost of borrowings for NBFCs with commensurate down-the-line benefits to borrowers from weaker sections.
- Corporate governance and disclosure norms would bring about discipline in a sector which has systemic importance.
- Refinance facility would help NBFCs derive better ratings and hence lower borrowing costs, and overdependence on banks. Diversification of funding sources will reduce dependence on banks and thereby reduce risk in the banking system. Easier access to funds will enable NBFCs to drive financial inclusion and compete against the unorganized sector.

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