



वित्तीय सेवाएं विभाग
**DEPARTMENT OF
FINANCIAL SERVICES**

सत्यमेव जयते



PSBs to take Reforms to the Branch level -
Multi-level Consultation and Ideation

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Process Guidelines for Intra/Inter-Bank Consultation/ Review/Ranking

1. Pre-populated forms from PSB to Regional and State/zonal levels

1.1 Pre-populated forms to be provided for—

- (i) Regional-level, and
- (ii) State/zonal-level,

benchmarked against the PSB's average, each region and State/zone, on each Key Performance Indicator / KPI (list attached), categorised as:

- (a) Performance significantly above average ($\geq 10\%$ above average), or
- (b) Average performance (within $\pm 10\%$ of average), or
- (c) Performed significantly below average ($\leq 10\%$ below average).

2. Stage 1 Region-level intra-PSB group consultation involving all branches

2.1 Based on the pre-filled forms and categorised performance, each branch and the region of each PSB on an appointed date collectively would—

- (a) analyse the categorised performance vis-à-vis the PSB's average for each branch and the region, on each KPI (*intra-bank branch ranking*); and
- (b) list specific suggested measures for improving performance on each KPI, while identifying whether the measure is for
 - (i) action by branch/region or consideration by
 - (ii) State/zonal or
 - (iii) National/bank level.

2.2 PSB's State/zone-level collates Region-level inputs and furnishes for the State—

- (a) consolidated and summarised list of suggestions, and
- (b) each region's/zone's categorised and ranked performance vis-à-vis the PSB's average, on each KPI (*intra-bank region and zone ranking within each State*) to the SLBC, for the Stage 2 consultation.

3. Stage 2 SLBC/State-level inter-PSB group consultation

3.1 Based on the State/zonal-level suggestions and region-wise categorised performance of each PSB, State/zonal-level heads of all PSBs in the State on an appointed date would collectively—

- (a) analyse each PSB zone's, each PSB's and the State's performance, and categorise each PSB zone's and each PSB's performance into the categories listed at 1 (a) to (c) above benchmarked against the State average, on each KPI (*intra-State bank-wise and zone-wise rankings*); and
- (b) taking into account suggested measures from the Stage 1 consultation, list specific suggested measures for improving performance on each KPI, while identifying whether the measure is for
 - (i) action by State/zonal or
 - (ii) consideration by National/bank level.

3.2 SLBC Convenor to furnish for the State—

- (a) consolidated and summarised list of suggestions, and

(b) categorised performance vis-à-vis the State average, for each PSB (intra-State bank-wise ranking) and for each PSB zone (*intra-State zone-wise ranking*), on each KPI to the HO of the SLBC Convenor PSB (SBI, in case of J&K), for the Stage 3 consultation.

3.3 State-level of each PSB to furnish for all PSBs in a State—

(a) consolidated and summarised list of suggestions, and
(b) categorised performance vis-à-vis the State average, for the PSB, both for the State as a whole (*bank's intra-State rank*) and for each zone of the PSB in the State (*bank's intra-State zone rank*), on each KPI to the PSB's HO, for the Stage 3 consultation.

4. Stage 3 National-level inter-PSB group consultation

4.1 Based on the SLBC/State-level suggestions and categorised performance of each PSB on the State level, WTDs of all PSBs on an appointed date would collectively—

(a) analyse the performance for each State as a whole, and categorise the performance of PSBs in each State into the categories listed at 1 (a) to (c) above benchmarked against the national average for PSBs, on each KPI (*State ranking*);
(b) analyse the performance for each PSB at the national level, and categorise the performance of each PSB into the categories listed at 1 (a) to (c) above benchmarked against the national average for PSBs, on each KPI (*bank ranking*);
(c) analyse the performance of all PSBs taken together at the national level, and self-assess the performance w.r.t. the potential, on each KPI (*collective PSB self-assessment*); and
(d) taking into account suggested measures from the Stage 2 consultation, identify specific action-points and decision-points for high performance on each KPI.

4.2 PSBs would present—

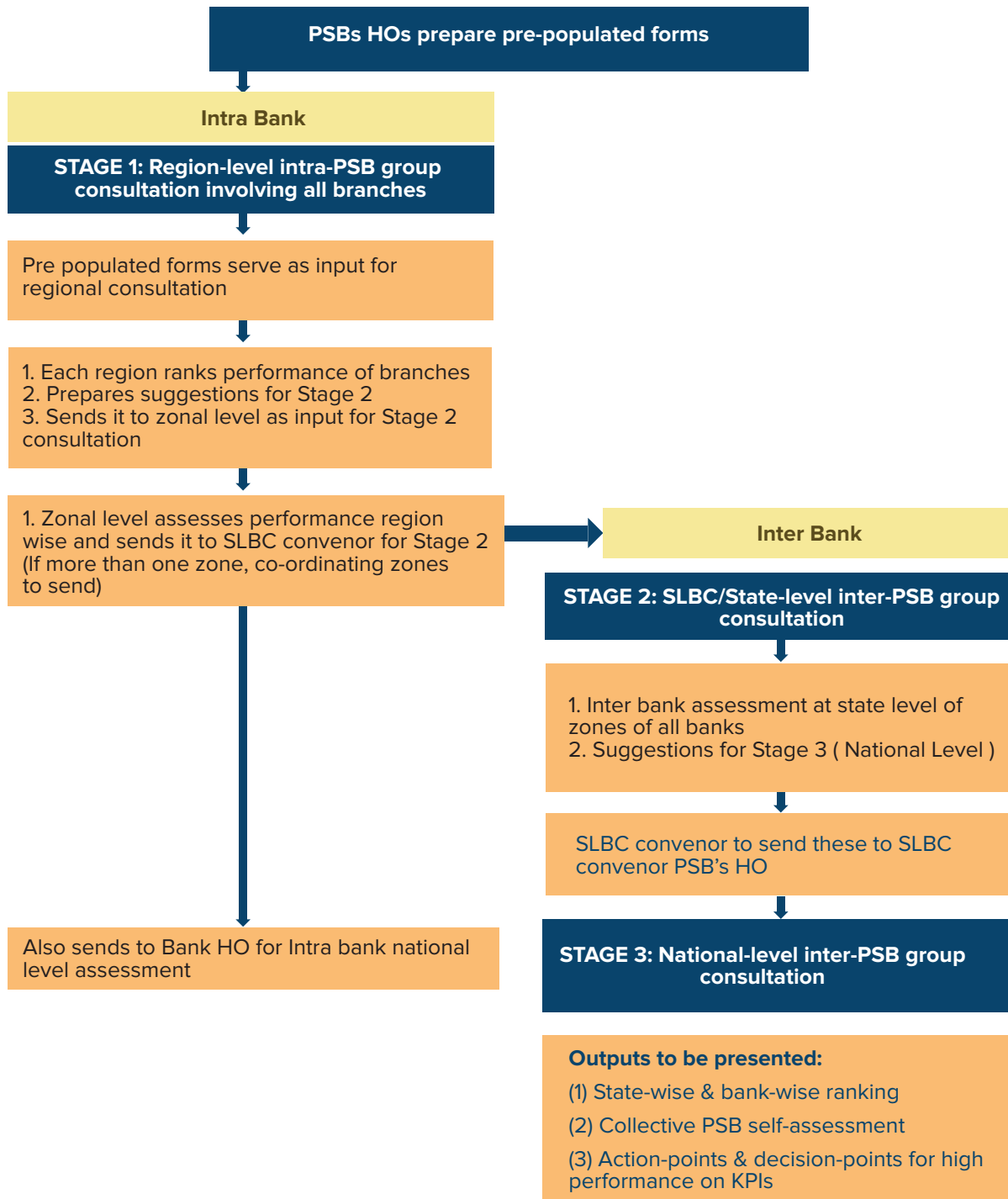
(a) their collective assessment of performance at the national level, collectively and PSB-wise, and also for each State, for each KPI (*State-wise and bank-wise ranking, and collective PSB self-assessment*); and
(b) proposed action-points and decision-points for high performance.

Appendix

Key Performance Indicators

- 1 Credit for Infrastructure/Industry (other than MSME, and Agriculture and Allied Activities)
- 2 Credit to Farm Sector and Blue Economy
- 3 Jal Shakti
- 4 Housing Loans
- 5 MSME / MUDRA / Stand-Up India
- 6 MSME: Alignment with Local Priorities
- 7 Education Loans
- 8 Export Credit
- 9 Green Economy
- 10 Swachh Credit (Credit for Swachhata Activities)
- 11 Financial Inclusion and Women's Empowerment
- 12 DBT
- 13 Less Cash / Digital Economy
- 14 ATM usage and performance
- 15 Ease of Living
- 16 Corporate Social Responsibility

Process & Output Flow for Intra/Inter-PSB Consultation/ Review/Ranking



Annexure 2

Form -4 : Housing Loans																	
Sr. No.	Particulars	2014-15		2015-16		2016-17		2017-18		2018-19		% YOY Growth		Category Weightage	Marks Scored (10/5/0)		Weighted Score
		No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt		No	Amt	
1	Total Housing Loans													10			
i	of which women																
2	Affordable Housing Loan accounts (out of total Housing Loan Accounts)																
i	of which women																
3	Priority Sector Loan accounts (out of total Housing Loans- Outstanding)																
4	PMAY accounts (out of total Housing Loans - Outstanding)																
i	PMAY accounts (of which women)																
Suggestions (If any) :																	

Form -5 : MSME /MUDRA/Stand up India																	
Sr. No.	Particulars	2014-15		2015-16		2016-17		2017-18		2018-19		% YOY Growth		Category Weightage	Marks Scored (10/5/0)		Weighted Score
		No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt		No	Amt	
1	Total MSME Advances													10			
	<i>Out of which Advances to:</i>																
i	GST Registered units																
ii	Priority Sector Lending (PSL)																
iii	Loan Sanctioned on CLP (Contactless Lending Platform)																
iv	Stand-Up India (SUI)																
	<i>Out of which</i>																
	<i>women</i>																
	<i>NPAs under SUI</i>																
v	<i>MSME Advances > Rs.10 lakh</i>																
2	Pradhan Mantri Mudra Yojana (PMMY)																
	<i>Out of which</i>																
i	<i>Women</i>																
ii	<i>SC/ST/OBC/ Minority</i>																
iii	<i>a. Shishu</i>																
	<i>b. Kishore</i>																
	<i>c. Tarun</i>																
iv	<i>No. of Unique Beneficiaries under MUDRA</i>																
v	<i>No. of new entrepreneurs under MUDRA</i>																
vi	<i>No. of borrowers, previously availed MUDRA/MSME loans</i>																
vii	<i>No. of GST Registered account holders under MUDRA</i>																
viii	<i>No. of Live Accounts under MUDRA</i>																
ix	<i>No. of renewed CC/OD under MUDRA</i>																
x	<i>NPAs under MUDRA</i>																
3	Prime Minister Employment Generation Programme (PMEGP)																
4	Export Credit																
	<i>Out of which</i>																
i.	<i>Short Term Export Credit</i>																
ii.	<i>Long Term Export Credit</i>																
Trend analysis of NPA & strategy for Wider coverage / Recovery																	
Suggestions (If any):																	

Form -5 A: MSME: Alignment with Local Priorities																										
Sr. No.	Particulars	2014-15		2015-16		GROWTH % OVER 2014-15 (Amt)		2016-17		GROWTH % OVER 2015-16 (Amt)		2017-18		GROWTH % OVER 2016-17 (Amt)		2018-19		GROWTH % OVER 2017-18 (Amt)		NPAs as on 31.03.2019	% YOY Growth		Category Weightage	Marks Scored (10/5/0)		Weighted Score
		No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt		No	Amt		No	Amt	
1	Textiles																						5			
2	Handlooms																									
3	Tiles																									
4	Leathers																									
5	Others, if any *																									
* rows can be added for additional clusters																										

Form -10 : Financial Inclusion & Women Empowerment

Sr. No.	Particulars	2014-15	2015-16	2016-17	2017-18	2018-19	% YOY Growth		Category	Marks Scored (10/5/0)		Weighted Score
							No .	Amt		No.	Amt	
1	Total BSBD Accounts								5			
2	Operative BSBD accounts											
3	No. of PMJDY customers											
	<i>of which</i>											
i.	Women											
ii.	Customers having multiple a/cs											
	<i>a) 2 Accounts</i>											
	<i>b) 3 Accounts</i>											
	<i>c) More than 3 Accounts</i>											
iii.	MUDRA Loans (other than PMJDY Overdraft)											
iv.	No. of Inoperative accounts											
4	No. of RuPay Cards issued to PMJDY											
5	No. of RuPay Cards issued to PMJDY customers (of which women)											
6	No. of Gross enrolment under PMJJBY	NA										
	<i>of which</i>											
i.	Women	NA										
ii	PMJDY account holders											
iii.	New accounts											
iv.	DBT beneficiaries											
v.	Renewal accounts											
7	No. of Gross enrolment under PMSBY	NA										
	<i>of which</i>											
i.	women	NA										
ii	PMJDY account holders											
iii.	New accounts											
iv.	Renewal accounts											
v.	DBT beneficiaries											
8	No. of PMJDY customers receiving DBT											
	<i>of which</i>											
	Enrolled under PMJJBY											
	Enrolled under PMSBY											
9	No. of enrolments under APY	NA										
10	No. of enrolments under APY (of which women)	NA										
11	No. of candidates trained in RSETIs											
	<i>of which</i>											
11.a	No. of women trained											
11.b	No. of candidates settled											
11.b.i	No. of women candidates settled											
12	No of Camps held by FLCs											
13	No of people attending the camps											
14	SHGs Outstanding											
	<i>i. Out of which Women</i>											
Suggestions (if any) :												

Form -11 : DBT

Sr. No.	Particulars	2014-15		2015-16		2016-17		2017-18		2018-19		% YOY Growth		Category	Marks Scored (10/5/0)		Weighted Score
		No	Amt	No	Amt	No	Amt	No	Amt	No	Amt	No	Amt		No.	Amt	
1	Direct Benefit Transfer (DBT)													5			
i	MNREGA																
ii	Pradhan Mantri Kisan Samaan Nidhi (PM-KISAN)																
iii	SPM RURBAN Mission (RURBAN)																
iv	LPG SUBSIDY (DBTL)																
Suggestions (if any) :																	

Form -13 : ATM usage & performance													
Sr. No.	Particulars	2014-15	2015-16	2016-17	2017-18	2018-19	GROWTH % OVER 2017-18	% YOY Growth		Category Weightage	Marks Scored (10/5/0)		Weighted Score
								No	Amt		No	Amt	
1	No. of ATMs									5			
2	Total No. of TXNS												
3	<i>Out of (2) Financial txns</i>												
4	<i>Out of (2) Non- Financial txns</i>												
5	Average Hits/per day												
6	No of ATMs with avg hits less than 100												
7	No of ATMs with avg hits between 100 to 200												
8	No of ATMs with avg hits greater than 200												
9	Amount of cash disbursed in crores												
10	Average Cash disbursed per day												
11	Uptime (%)												
Suggestions if any:													

Form -14 : Ease of Living										
Sr. No.	Particulars	2014-15	2015-16	2016-17	2017-18	2018-19	% YOY Growth	Category Weightage	Marks Scored (10/5/0)	Weighted Score
							No .		No.	
1	Savings Bank Accounts opened for Senior Citizens							5		
2	A/cs opened under Senior Citizen Savings Scheme, 2004									
3	ATM / Debit Cards Issued to Senior Citizens									
4	INB facility to Senior Citizens									
5	No of customers availed Door Step Banking*									

Note: for 5th point: * Above 70 years

Form -15 : Corporate Social Responsibility										
Sr. No.	Particulars	2014-15	2015-16	2016-17	2017-18	2018-19	% YOY Growth	Category Weightage	Marks Scored (10/5/0)	Weighted Score
							Amt		Amt	
1	Expenditure on Corporate Social Responsibility							5		
	<i>of which</i>									
	i. <i>Providing Amenities in Schools</i>									
	ii. <i>Women empowerment and Hygiene</i>									
	iii. <i>Skill Development Training</i>									
	iv. <i>Swachha Bharat Abhiyan</i>									

Annexure 3

Format for Ranking					
Scoring Parameter					
1. Maximum score for each category, as under:-					Score
a) Higher than Region Average					10
b) At Par with Region Average					5
c) Below Region Average					0
2. The Regional Manager may alter the weightage in each category based on the business profile of the Branch					
3. Weighted Score= [Total marks scored in the category / Maximum eligible marks in the category] X Category Weightage					
Weightage for self-assessment by PSBs					
Key performance Indicator	Weightage				
Credit for Infrastructure/Industry (Other than MSME/Agri & Allied)	5				
Credit to Farm Sector & Blue Economy	10				
Jal Shakti	5				
Housing loans	10				
MSME/MUDRA/Stand up India	10				
MSME: Alignment with Local Priorities	5				
Education Loans	5				
Export Credit	5				
Green Economy	5				
Swachh Credit (Credit for Swachhata Activities)	5				
Financial Inclusion & Women Empowerment	5				
DBT	5				
Less Cash/ Digital Economy	10				
ATM usage & performance	5				
Ease of Living	5				
Coporate Social Responsibility	5				
Total	100				

Annexure 4

Questionnaire

The consultation process is aimed at conducting self-assessment on various parameters to understand whether banks have been able to act as active partners in the growth of the country and their success in meeting aspirational demands of citizens. Banks may add any other point that they consider appropriate.

The following sets of broad and indicative questions/ observations are required to be captured while preparing the intra-bank and inter-bank reports at State and National level :

Banking Landscape

1. The share of PSBs in overall banking in India has continued to decline. Private banks today command a substantive share of the market. NBFCs are borrowing from banks and are able to attract customers inspite of higher interest rates.
2. What should PSBs be doing differently to address this situation?

Credit

3. Of the total lending what was the percentage of lending by your bank to
 - (a) Corporate
 - (b) MSMEs
 - (c) Retail from 2013- 2014 to 2018- 2019 year wise.
4. What were the reasons for decline if any, in loans to Corporates?
5. Why did credit to manufacturing drop, if so, between FY 2015 and FY 2019 when the IIP was rising from 2.8% in 2014-15 to 4.6% in 2017-18?
6. Did lending to NBFCs rise significantly in 2016-17 and 2017-18 in your banks while direct lending to business (Corporate + MSME – NBFC) fell or did not rise much? Give yearwise analysis of your Bank from 2014 onwards.
7. How many loan applications did your bank receive between April 2014 and March 2019. How many were accepted and how many rejected? – Please give information separately for retail, MSME and Corporate categories.

NPA

8. What was the reason for the steep rise in NPA during 2015-19? How many of these were stressed assets and which were not recognised earlier?
9. What was the percentage of long term loans (tenor above 5 years) in the total lending of the bank in FYs 2013- 2014 and 2018-2019?
10. Was the mix of commercial banking and long term loans for project finance a cause for higher NPA?
11. Of the total NPAs, default in long term loans constitutes how much?

MUDRA

12. Please indicate percentage of Mudra loans year-wise as percentage of total loans advanced during the year.

13. Has any region/zone level assessment of performance been done and if so, when was it presented to MD/Board?
14. Which region or zone of the Bank were found to be below 25% of the average of a Bank and how many in top 20?
15. Is there any region/zone-wise target and if so, year-wise how many completed it?
16. What is your view on Mudra Yojana? How is it working in your bank? What is the level of risk and NPAs in Mudra in your bank?
17. Are you satisfied with performance vis a vis the existing entrepreneurial potential? What are your ideas to improve and expand the Mudra model?
18. Should the bank co-originate Mudra lending so that the collection responsibility is of the originator or an aggregator which can be the upside to them from the bank plus the spread which the banks can give them?
19. Can Mudra model be expanded to loans of higher denominations?
20. Has the bank identified dark States/dark Districts in respect of PMMY performance?
21. Was any analytical agenda brought to Bank Board in respect of performance under PMMY, including on NPAs under the Scheme?
22. How many branches have been inspected by the ED/ZM/RM in respect of PMMY performance?
23. Has the bank identified industrial areas/clusters/locations with high foot fall where the bank has presence and could do much on PMMY. Examples in this regard could be Agra, Gorakhpur, Gaya, Deoghar, Rajgir, Puri, Madurai, Kanyakumari, etc.?

Agriculture Credit

24. What proportion of agriculture credit is provided to individual farmers?
25. What part is renewal?
26. In how many accounts the dues are deposited and renewal given on the same day (to take advantage of interest subvention)?

STANDUP INDIA

27. Each branch was to identify and advance loans to 2 SC/ST entrepreneurs.
28. On aggregate basis how many were to be advanced in region/zone of a Bank and how many have actually been advanced loan.
29. What are the challenges being faced while serving SC/ST/Women entrepreneurs under Stand Up India loans?
30. What changes should be made in the Stand up India Scheme to benefit many more SC/ST entrepreneurs?

PRADHAN MANTRI JAN DHAN YOJANA (PMJDY)

31. How many savings account/BSBD/Jan Dhan account were operative and out of them how many are enrolled under PMSBY/PMJJBY?

32. How many PMJDY account holders have been given loans under MUDRA (other than PMJDY-OD)?
33. How many PMJDY account holders are having multiple savings accounts in the same bank?
34. How many are enrolled under PMSBY/PMJJBY?
35. How many savings account/BSBD/Jan Dhan accounts are receiving DBT?

DIGITAL BANKING

36. Every branch was to onboard 100 merchants. On aggregate basis how many were to be onboarded in each region/zone and how many have already been onboarded?
37. What is the number of operative current accounts and how many of them have been digitally onboarded?

RUPAY CARD

38. How many Jandhan accounts have been provided with Rupey cards and
39. How many are active

SELF HELP GROUPS (SHGs)

40. How many self help groups have been provided credit by banks

EXPORT CREDIT

41. How much export credit was given by the Bank as percentage in absolute terms and as percentage of total loans advanced year-wise from 2014 onwards?
42. If share of export credit has fallen in last five years, what are the reasons and what should be done to improve?

Annexure 5.1

Increasing **Digital Payments**

By: Nandan Nilekani
Infosys

Introduction

1. India is home to almost a fifth of the world's population. Its scale and diversity rival those of continents, not countries. India has 22 official languages and there are many more languages with over 10,000 speakers or more. There is incredible diversity, but also incredible disparity. A large number of people still live in poverty, and less than 4% of people have paid any income tax.

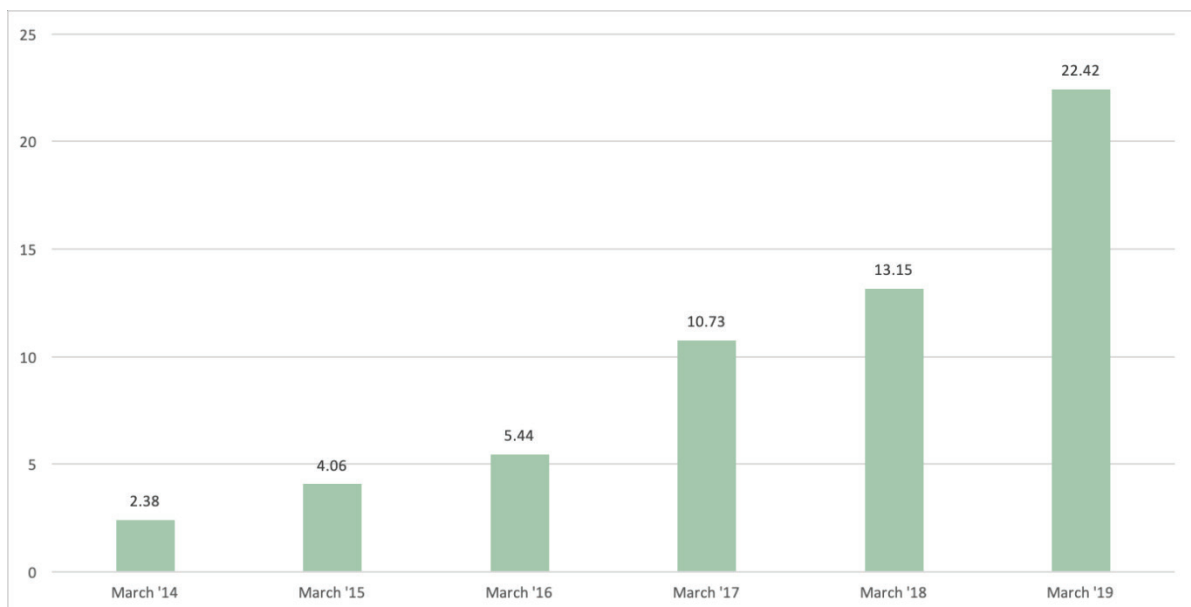
2. At the same time, digital inclusion in India has taken off in a significant way in the last few years due to the JAM trinity. 36 Crore bank accounts have been opened under the Pradhan Mantri Jan Dhan Yojana; 124 Crore residents have been enrolled in Aadhaar; and there are 120 Crore mobile connections and over 50 Crore internet users. Considerable savings have been brought about through the direct benefit transfer schemes to the government, along with convenience for the user.

3. India is incredibly young - about 50% of its population is below 25, and about 65% below 35. India expects to have 10 crore people entering the workforce over the next ten years. In short the country is young, ambitious and connected.

4. This has proved to be a fertile ground for digital payments, and India is now emerging as a global leader in innovative population scale payment systems. The Government and the Reserve Bank of India have articulated a vision of a less cash society and guided its evolution.

5. The banking network is the spine for all financial services through the country. As a consequence, banks continue to drive the growth of financial services. This backbone continues to be the best way of bringing the benefits of digital transactions to the entire country.

6. There has been a significant growth in the use of digital payments over the past 5 years, with the number of digital payments growing by a factor of 10, from 2.2 per capita per annum in March 2014 to 22.4 in March 2019. The following chart shows this growth.



Digital Payments Per Capita

7. Recently, with a view to further the digitization of payments and enhance financial inclusion through digitization, the Reserve Bank of India had constituted a High-Level Committee on Deepening of Digital Payments.

8. The committee estimated that there are about 10 Crore users, who are using digital modes of payment, and set a target of increasing it to 30 Crore users in 3 years.

9. The committee noted that digital payments have steadily become a significant mode for the inflow to the Indian consumer via Government benefit payments and salaries in the organized sector. In 2018-19, over Rs 2,00,000 Crore was transferred through the direct benefit transfer schemes. However, cash is still the dominant mode for the outflow for this Indian consumer because of the underdeveloped nature of the acceptance ecosystem for digital payments.

10. Digital transactions hold many benefits for the users. They no longer have to maintain significant amounts of cash in their homes, or on their person. This improves safety, and does away with the risk of loss due to calamities, etc. It further improves their ability to make transactions at will. The digital trail is further useful to help them avail loans, etc. in times of need.

11. Likewise, for banks the benefits are manifold; the money remains in the banking system increasing float for the banks. Digital transactions are self-service, reducing costs and improving convenience for the users. This lets the existing infrastructure to serve many more customers.

12. The committee suggested a target of increasing per-capita digital payments by 10X to 220 per year by 2022. Along with a growth of 3X in the user base, this will ensure that people benefit from digital payments. The committee adopted a framework of

a. Accelerating Acceptance: Bringing in more players, so that digital payments are accepted, removing the need for a user to carry cash.

b. Preparing for Scale: Improving the capability of the system to scale with growth in transactions, increasing user confidence in digital transactions and providing a safety net in the form of a cash-in cash-out network.

c. Changing User Behaviour: Enabling high volume use cases, including recurring payments, bill payments, transportation and small merchant payments.

d. Removing Friction: Addressing any specific problems that come in the way of digital payments.

e. Enabling Innovation: Allowing the market to grow to its full potential.

13. This paper expands on this framework, specifying steps for the banks and the regulator to implement and support this vision.

Branch View

14. The branch is the front-line of servicing the customer. It has a significant role to play in the successful implementation of various policies. Further, it can provide the feedback to the corporate team on issues that may need to be addressed.

15. Given the vast size and diversity of the country, the local bank branch is in the best position to address the issues faced by the customer in making digital payments.

16. To increase digital payments at the bank level, the branch staff must

a. Enhance internal capacity at the branch – bank employees must themselves use digital banking, so that they can better educate customers on the use and benefits of digital banking.

b. Map the customers of the bank, the service points (ATMs, Business Correspondents, Points of Sale, Aadhaar Pay), and usage patterns.

i. Use this mapping to decide on the setting up of additional access points (BCs, ATMs), and increase merchant acceptance.

ii. Increase number of digital payment acceptance points by increasing the number of merchants that have accounts with the bank.

iii. Identify local markets that can be digitized, and use them to introduce the benefits of digitization to customers.

c. Measure current usage of banking, and digital banking; identify any bottlenecks; and work towards moving accounts to increase usage, and digital usage.

d. Encourage front-line staff to increase linking of mobile numbers to accounts, and to use digital options.

e. Cash In / Cash Out networks are important service points for customers. They give users the confidence that they have a backup for digital transactions, and do not need to carry cash. The branch can help in the creation of this network for their customers!

f. Given the significant digital inflows into the bank accounts, this network will also help support users with their needs for cash.

g. For financial inclusion, a coordinated approach of working with the SLBC / DLCC / BLCC is important to ensure that customers are serviced by cooperating banks, at a reasonable cost, and that systemic hurdles (such as digital connectivity) are addressed.

h. Monitor the turnaround time of transactions, such as the setting up of NACH mandates, which require manual action, but enable future digital transactions. This also includes monitoring of transaction failures, and addressing the cause of these failures.

i. Ensuring that educational resources are deployed to educate customers on digital banking – at the branch, ATMs, BC points, as well as at the markets.

17. A better understanding of the behaviour of the branch's customers, and the goals of the bank will help the branch staff achieve these goals for the bank.

18. Any structural obstacles can be reported to the corporate staff to improve these outcomes.

19. The benefits of this approach are clear – a bank branch will be able to serve more customers, improve customer satisfaction levels, and increase the amount held in the bank. The digital trails will also allow the bank to improve its ability to identify good candidates for loans, and increase the amount of retail lending, with potentially lower NPAs.

Bank - Corporate / Board View

20. Bank officials in the corporate offices have the role to support the local branch officials in making these changes, and becoming successful. They must support these efforts through:

- a. Creating products that make the usage of digital options more attractive.
- b. Bringing in a focus on capacity building and problem solving.
- c. Training the branch staff on digital options, so that they can guide customers appropriately.
- d. Working with the branch staff to map users, access points, and usage.
 - i. Measure the status of banking usage, and digital banking usage – by branch and by PIN codes.
 - ii. Providing reports and other information to the local branches so that they can take the appropriate decisions.
- e. Improving fraud detection and prevention practices.
- f. Improving technology infrastructure; monitoring transactions, usage, and failure rates;
 - i. Reporting key metrics (Users, Usage, Failure Rates) to the board.
- g. Ensuring that business continuity options are in place for various eventualities – natural calamities, etc.
- h. Finding partnership opportunities to bring in more innovation, so that the branch network and customer base can be utilised to its true potential.
- i. Bringing in internal competition, to encourage branches and regions to improve on all these metrics.

21. The bank board must monitor the journey of the bank, and help guide it along as required to improve customer satisfaction, capacity utilisation, and innovation.

Govt / Regulator View

22. While the individual branches and banks focus on the tangible aspects of implementing the plans, the regulator and the government must support them through appropriate policies. They must make the necessary changes to enable these operations.

23. In particular, they must focus on:

- a. Building capacity for digitization
- b. Improving financial literacy across the country, with customized programs for each region and user groups.
- c. Tracking the various metrics that relate to these changes.
- d. Promoting the use of recurring payments – bill payments, etc.
- e. Promoting the use of digital payments for transit. This includes transit, as well as the National Common Mobility Card.
- f. Simplifying regulations to improve the ease of customer onboarding, and simplifying the KYC requirements for low value transactions and accounts.
- g. Encouraging government payments to be completely digital.
- h. Encouraging innovation through the sandbox, and various innovation challenges.
- i. Encouraging light touch, agile regulation through Self Regulatory Organizations.

Summary

24. The banking system provides the backbone for delivery of financial services through the country, and must serve as the way to transform the country into using digital transactions for the benefits of the people.

25. Local branches must take the lead in taking their customers along on the path to participating in a digital economy, by identifying and solving local issues, and hindrances in the usage of digital transactions.

26. Building capacity in the banking system, the extension of various touch points, and strengthening the internal systems will enable the country to achieve the vision set out by the government of a digital economy.

Annexure 5.2

Corporate Governance in **Public Sector Banks**

By: Uday Kotak
Kotak Mahindra Bank

Background

With an objective of creating a level playing field, the OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 (the “**OECD Guidelines**”) state that “consistent with the rationale for state ownership, the legal and regulatory framework for SOEs should ensure a level playing field and fair competition in the marketplace when SOEs undertake economic activities.”

Due to lacunae in the governance framework for SOEs, the OECD Guidelines have advocated that ‘as a guiding principle, SOEs undertaking economic activities should not be exempt from the application of general laws, tax codes and regulations’ and ‘laws and regulations should not unduly discriminate between SOEs and their market competitors’.

The J. J. Irani Committee Report (2005) (“**Irani Report**”) in relation to exemptions provided to government companies under company law, states as under:

“In general, there is little justification for Government companies being provided relaxations in compliance with company law. It is even less if such companies are listed. Not only should such Government companies be able to compete in the market economy with other companies on equal terms, it would not be fair to the investors or creditors if such entities are allowed to present their performance on the basis of dissimilar parameters.”

International organizations such as the OECD and the World Bank have produced many policy prescriptions for best practices in SOE corporate governance. Typical examples are the OECD Guidelines for State-Owned Enterprises, originally adopted in 2005 and revised in 2015, and the World Bank Toolkit for State-Owned Enterprises, published in 2014. Although the policy recommendations of the various organizations are numerous, they exhibit a high degree of uniformity around the following basic principles:

(Source: Curtis J. Milhaupt, Mariana Pargendler - Governance Challenges of Listed State-Owned Enterprises Around the World: National Experiences and a Framework for Reform)

1. The state should act as an informed and active owner;
2. The state should not intervene in management and should respect the independence of SOE boards of directors;
3. The legal and regulatory framework for SOEs should ensure a “level playing field” for SOEs and private enterprises;
4. Non-state shareholders should be treated equitably and granted full rights as investors; and
5. SOEs should observe high standards of transparency and should adhere to the same disclosure, accounting and compliance standards as private listed companies.

RECOMMENDATIONS

Keeping the above principles in mind, we believe the PSBs in India can come up the curve in terms of corporate governance in phases. The recommendations are therefore analysed in 3 buckets:



Framework for Corporate Governance Reform

1) Disclosures and Transparency

a. Compliance of existing applicable SEBI regulations:

Cases of lapses in compliance with SEBI regulations by listed PSBs have been observed. Some of them pertain to Board of Directors composition, limit on number of directorships etc.

Recommendation: Listed PSBs should fully comply with the existing provisions of SEBI regulations including LODR and the same must be effectively enforced.

b. Relook at statutory exemptions to PSBs:

It's a well-established fact that PSBs in India are provided with certain statutory exemptions primarily from The Banking Regulation Act, 1949, SEBI Regulations, Companies Act etc. thereby giving rise to unique corporate governance challenges, unlike their private sector counterparts. Thus, if the goal of better corporate governance needs to be achieved, there is a need to address these statutory exemptions provided to PSBs in India.

Recommendation: PSBs must abide by the same governance, reporting, control, and audit frameworks as other significant corporate or public interest entities since they have raised public monies and the investors have a right to information which is at par with those they receive from listed entities.

c. Establish a transparent mandate for PSBs and disclose its objectives and obligations:

Globally, the state-owned banks are run with dual objectives which may from time to time appear to be discording i.e.

- 1) Furthering the state policy
- 2) Furthering commercial objectives.

Recommendation: *To enhance transparency, the government must set clear objectives and mandates for the PSBs, and, where there are non-commercial objectives, these should be clearly articulated, quantified and transparently disclosed to the shareholders on a regular basis so that investors can take informed investment decisions.*

II. Management & Accountability

a. Longer tenure of management:

The management in PSBs is subject to change every 3 years which may not be in the best interest of a commercial enterprise. This leads to a lack in vision and long-term strategy of the PSB and often leads to decision-making which is short term in nature. Presently, bankers get appointed to top management positions a little too late in their careers for them to have adequately long tenures.

Recommendation: *Accordingly, the retirement age must also be relooked at, in line with the private sector bank Whole-Time Directors. The need of the hour is to appoint them for longer tenure which can then achieve the objective of continuity leading to long-term focus without disrupting the strategic objectives.*

b. Specialists:

The PSBs have a culture of transferring people into different roles, every 2-3 years. While it creates comprehensive managerial skills in an employee it may also deter individuals with specialized skills in working with PSBs who are focused on building a career as a specialist and would prefer banks offering long-term careers in their area of expertise.

Recommendation: *This again can be addressed by creating 'specialist' roles where the individual is not transferred out and is able to make a long-term career in his/her area of skills.*

c. Senior Management Compensation:

It has been observed that the senior management in private sector banks earn compensation packages which are multiple times that of their peers in PSBs. This kind of dichotomy in compensation may act as a limitation to attract talent.

Recommendation: *Have compensation benchmarked against the industry with some transparent adjustments. This will ensure quality talent is attracted and is well compensated for. For senior management, can also have long-term ESOPs as part of incentives which can also incentivize the employees to think for the long-term. Also, the selection to leadership roles must not just be based on seniority but due consideration should be given to expertise, skill sets and other factors.*

d. Simplify disciplinary action process:

All the disciplinary cases in the PSBs are dealt under a detailed structured legal mechanism consisting of long procedural measures. The same process is extremely time consuming and most of the times it loses focus and results in disproportionate higher or lower punishments.

Recommendation: *In order to ensure that the action against errant employees is exemplary and deters others from making such mistakes, it needs to be faster, meaningful and proportionate. The disciplinary proceedings of PSBs should be revamped for quicker actions.*

e. Performance monitoring to enhance accountability:

In many countries, reforms of state-owned enterprises (SOEs) show that effective performance monitoring—a key ownership function of the state as owner—can drive both financial and non-financial improvements.

Recommendation: *As per the recommendations of World Bank Tool Kit on Corporate Governance of State-owned enterprises, developing such a framework requires common and clearly understood principles of accountability and governance based on several factors:*

i. Obtaining baseline information - to create the necessary building blocks for developing a performance-monitoring system

ii. Setting mandates, strategies, and objectives - to reflect the overall policy goals of government in its ownership of each company

iii. Structuring performance agreements - to facilitate periodic performance monitoring of the SOE by an ownership unit

iv. Identifying and developing key performance indicators - to measure and evaluate results

f. Road to innovation:

In the last few years, the banking sector has been dogged with issues pertaining to NPAs and frauds. While the management focus of PSBs has been on resolving them, many of them have missed the innovations led by technology.

Recommendation: We recommend appropriate steps must be taken that may enable PSBs to tap on the extended ecosystem brought in by technology and digital innovations.

g. Risk Management culture:

The recent rise in incidence of frauds have reiterated the burgeoning need of corporate governance, especially in PSBs. An IAS study revealed that in FY17, the Indian banking sector reported 12,533 frauds amounting to Rs. 181.7 billion, of which PSBs reported frauds worth Rs. 162.3 billion. As much as this whopping amount calls for an urgency in strengthening risk management culture.

Recommendation: *The PSBs need to inculcate a culture embodying robust processes and risk management practices. This would help foster growth while also ensuring a culture without fear.*

h. Carrot and stick approach:

In PSBs the main dagger is punishment for bad decisions but not enough incentives for good decisions. Hence there is no motivation to take decisions. This needs to be changed.

Recommendation: *Link incentives to long-term performance.*

III. Governance

a. It is critical that the Board of Directors of PSBs should function independently. There are different ways of achieving this independence.

i. Constitution and composition of board of directors of PSBs should be brought under the Banking Regulation Act in line with the SEBI regulations.

ii. Evaluate the current structure of ownership vs. the holding company structure

b. Professionalizing PSB boards:

Boards play a critical role in corporate governance thereby affecting the performance of companies. The board is assigned a fiduciary duty to develop strategies and oversee the performance of the company. The board of a bank must be a think tank for the organization giving strategic directions, ensuring oversight, and not delve into operational management.

Recommendation: It is important that the government attracts independent directors on the board with varied skill sets that can add value to the organization. This will require persuasion at the highest levels to attract talent. Having an expert on the board would bring in wider depth in thinking and developing strategies thereby leading to a more professionally run bank. Also, the board should be adequately compensated in line with the market practices. With this backdrop, steps must be taken to improve board composition by designing a robust policy framework and clear processes for board nominations and appointments.

c. Regulator

PSBs are regulated by the government under The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970; the Bank Nationalisation Act, 1980; and the State Bank of India Act, 1955. Also, the RBI has certain powers which are largely operational in nature. Hence there exists a system of dual regulation.

Recommendation: The Government must cease issuing any regulatory instructions applicable only to PSBs, as dual regulation is discriminatory. RBI should be the sole regulator for banks, ensuring that the regulations are uniformly applicable to all commercial banks. In this direction it is important to define the accountability of the regulator not only to the deposit holders but also to the shareholders, in this case primarily the government. This may require amendment of The Banking Regulation Act, 1949.

Out of the Box

Public Private Partnership

The Government may explore a public-private partnership where the Government in a transparent manner inducts a private sector bank as a strategic partner with holding of 26% and the Government capping its holding at below 40%, with aggregate being below 65%. This is similar to SBI with SBI subsidiaries which was a model that remained for many years.

Deployment of talent from private sector at arm's length into the above joint venture, combined with best of the governance practices, should be a part of the conditions. This PPP model has the opportunity of bringing the best of processes of public sector with enterprise of the private sector and can lead to dramatic re-rating of the value of Government ownership going forward.

Annexure 5.3

Credit for India's **Micro, Small and Medium Enterprises**

By: U.K. Sinha
Ex. Chairman SEBI

Theme Paper

Micro, Small, and Medium-sized enterprises (MSMEs), variously estimated to be between 5.5 Cr to 6.5 Cr., of which over 90% are micro units, are crucial to India's economic landscape. Estimates also suggest that MSMEs employ over 11 crore, more Indians than any other sector except agriculture and contribute to almost one third of India's GDP.

2. Although MSMEs in India are highly heterogeneous, they face similar, myriad challenges— those of physical infrastructural bottlenecks, informal nature of operations, technology adoption, capacity building, backward and forward linkages, lack of risk capital, delayed payments, rent seeking by enforcement machinery, etc These perhaps explain why the contribution of the MSME sector to India's GDP has remained stagnant, around 30%, in recent years.

3. Amidst all the challenges that MSMEs face, the single biggest challenge and arguably the most common, is uneven access to formal credit. This needs to be understood at a granular level with credit to micro enterprises and small enterprises at the lower end being analysed as distinct from credit to relatively bigger SMEs.

4. At an aggregate level, the banking sector had credit outstanding to MSMEs of approximately 17.4 trillion as on March 31, 2019. Scheduled Commercial Banks (SCBs) accounted for 90% of the share of this, although Non-Banking Finance Companies (NBFCs) have grown at a healthy rate in recent years.

Credit Flow to MSME sector (Amount in Rs. Billion)					
Year ended	Public Sector Bank	Private Sector Bank	Foreign Banks	Scheduled Commercial Banks	Non-Banking Finance Companies
	Amount O/s	Amount O/s	Amount O/s	Amount O/s	Amount O/s
March 2014	7583.78	2471.22	344.30	10399.30	85.76
March 2015	8526.89 (12.44%)	2815.48 (13.93%)	367.87 (6.85%)	11710.26 (12.61%)	286.48 (234.05%)
March 2016	8205.48 (-3.77%)	3590.85 (27.54%)	363.73 (-1.13%)	12160.07 (3.84%)	880.13 (207.22%)
March 2017	8289.33 (1.02%)	4309.62 (20.02%)	365.02 (0.35%)	12963.98 (6.61%)	1113.10 (26.47%)
March 2018	8645.98 (4.30%)	4107.60 (-4.69%)	488.81 (33.91%)	13242.39 (2.15%)	1441.40 (29.49%)
March 2019	9367.24 (8.34%)	5717.04 (39.18%)	691.37 (41.44%)	15775.66 (19.13%)	1622.17 (12.54%)

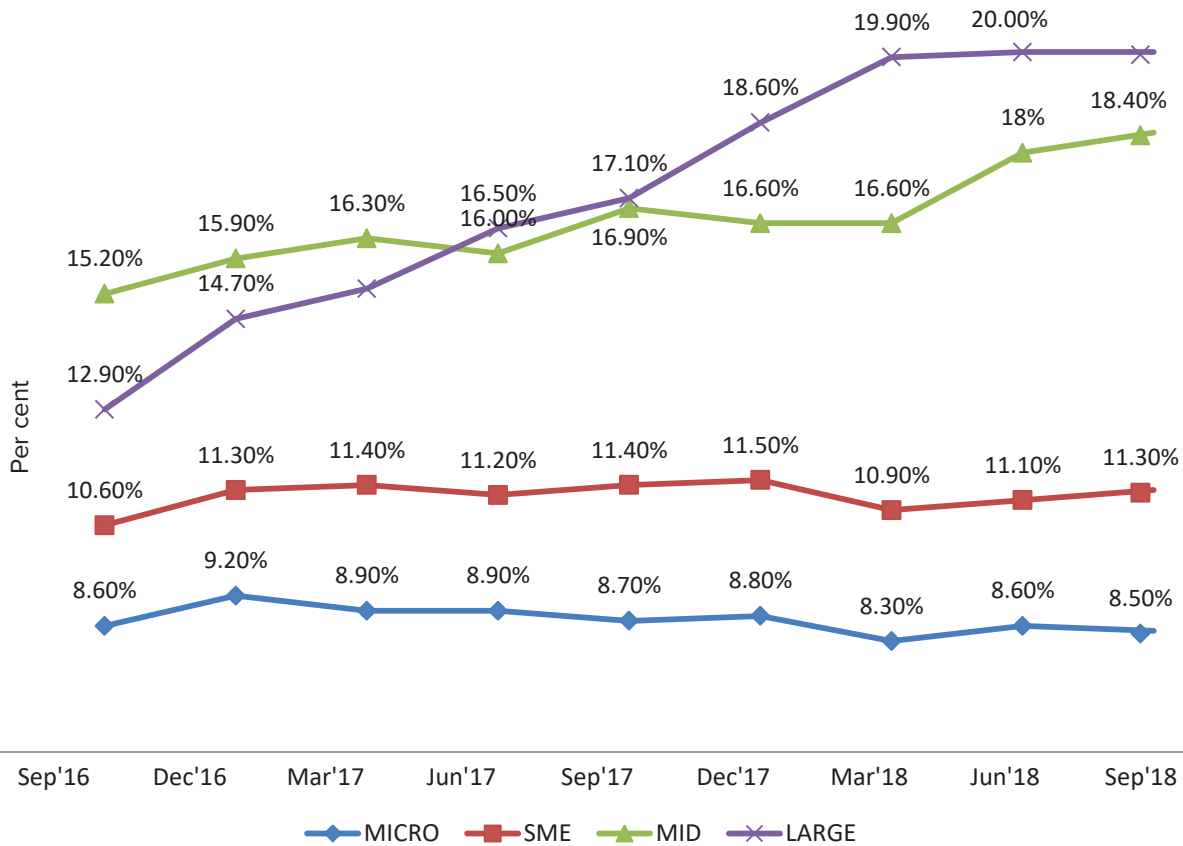
Source: As reported by Scheduled Commercial Banks to RBI
 Note: Figures in parenthesis indicate Y-o-Y growth/decline
 Data for March 2019 is provisional

5. This can be cross referenced with credit bureau data on exposure by size and Non Performing Assets (NPA) trends indicated below. Three inferences emerge from RBI and credit bureau data. First, the micro segment (<₹ 1 crore) is the fastest growing segment and accounts for ₹4.3 lakh crore out of the total of ₹14.3 lakh crore outstanding MSME credit. This segment grew at 22% y-o-y in 2018. This segment also exhibits the lowest NPAs, although in absolute terms still high at 8.5%. Second, the share of NBFCs in outstanding credit to MSME was 9.3% in March 2019. This trend may accelerate with the emergence of FinTech (typically registered as NBFCs) focused on this segment but faces headwinds in terms of liquidity and solvency constraints being encountered by NBFCs as a category. Third, the share of NBFCs in outstanding credit to Medium enterprises has become significant. As of March 2018, credit from NBFCs was 17% of the total credit extended by SCBs and NBFCs to Medium enterprises.

Overall Credit Exposure (in ₹ lakh crore)					
	Micro <1 ₹ Cr	SME ₹ 1 Cr- 25 Cr	MID ₹25 Cr- 100 C	Large >₹ 100 Cr	Overall
Sep'16	3.0	7.5	4.8	34.1	49.4
Dec'16	2.9	7.5	4.9	34.3	49.6
Mar'	3.1	7.8	4.9	34.1	50.0
Jun'17	3.3	8.1	5.0	34.4	50.8
Sep'17	3.5	8.5	5.2	34.7	51.8
Dec'17	3.7	8.9	5.4	36.4	54.5
Mar'18	4.0	9.6	5.5	37.8	57.0
Jun'18	4.2	10.0	5.5	38.3	58.1
Sep'18	4.3	10.0	5.5	38.9	58.7
Y-o-Y growth (From Sep'17 – Sep'18)	22.3%	18.4%	7.2%	12.0%	13.5%

Source: SIDBI Pulse -CIBIL Transunion

Segment Wise NPA



Source: SIDBI Pulse-CIBIL Transunion

6. In spite of these positives, there is unmet demand for credit, a point repeatedly made by MSME associations and businesses. For 2018, for instance, MSME credit demand was estimated by BCG, a consulting firm, to be Rs. 45 Lakh Cr. with roughly 40 percent of that demand served by informal credit. 25 percent of MSME borrowing was through personal proprietor loans from formal sources. Credit bureau data suggests that on an overall basis, 41% of MSME credit is by way of loans to individuals and not as loans to MSME entities.

This includes products such as Loans Against Property and gold loans. MSME loans to individuals have a distinctly better NPA record (~ 2.2%) than loans to entities.

7. Why is this happening? Most micro units and many small units lack the proper documentation needed to secure a formal loan. Many cannot offer meaningful collateral or have incomplete or under-reported financials. Ignorance levels are high. As a result, the formal loan process can be laborious and costly for them and for their lenders. It is no surprise that the majority of Micro and Small Enterprises (MSEs) have historically turned to informal financing to address their credit needs—whether through family, friends or through moneylenders.

8. Government and RBI's response to the problem has evolved over time – bank nationalisation, priority sector lending, differential rate of interest, various subsidy linked schemes such as Integrated Rural Development Programme (IRDP), Prime Minister Rozgar Yojana (PMRY), Prime Minister's Employment Guarantee Programme (PMEGP), credit guarantee scheme, interest subvention, refinance from shortfall of priority sector lending etc.

Interventions for micro enterprises

9. In 2015, Government launched the Prime Minister's Mudra Yojana (PMMY) as a programme to fund the unfunded (and the underfunded). This programme involved collateral free business loans by banks and financial institutions upto Rs. 10 lakh with support from Government by way of a refinance window and a portfolio credit guarantee scheme. PMMY was designed as a straight forward, simple to understand scheme with borrower selection and appraisal exclusively by the lender.

10. Over the last four years, PMMY has made a significant impact in increasing the volume of credit at the Bottom of the Pyramid (BoP), in making available credit to New to Credit (NTC) customers and to disadvantaged groups. Credit under PMMY has expanded considerably. The sanction of Rs. 1,32,954 Cr in 2015-16 by 177 Member Lending Institutions (MLIs) increased to Rs. 3,21,723 Cr in 2018-19 by 196 MLIs. 76% of borrowers have been women and 55% of borrowers were SC/ST/OBCs.

11. Yet, much more remains to be done. Demand for credit at the BoP is still being met by informal sources or not being met at all. What changes should be made in the PMMY scheme so that more MSEs are able to access it, informal lending is substituted by formal lending and credit needs of those MSEs which are growing, continue to be met?

Interventions for SMEs

12. Despite an ongoing policy focus, growth of MSME credit has been weak. Interest subvention, capital subsidy, sectoral support programmes such as in Textile and Food Processing sectors, credit guarantee etc. have been rolled out with varying degree of success. New approaches are needed. Some of the issues are examined later in detail.

13. At an overall level, India's banking system is still small relative to the needs of the real sector. While many urban areas have sufficient lender coverage, there is very poor credit depth in large parts of the country. This remoteness translates into weaker access to formal credit. Against this backdrop, MSMEs find it challenging to access adequate credit.

14. The risks in lending to MSME sector are high as is evident from the NPA data above. The risks in turn can often be traced to inability to pay. This can be attributed to poor understanding of business, lax or inadequate appraisal, catastrophe or business risk factors such as delayed buyer payments for transactions embedded in supply chains or supplying to Government entities and also other business risks, including changes in consumer demand or extraneous events that create a slow-down in the market. MSMEs often have little to no equity buffers which would otherwise have provided resilience. Risk mitigation mechanisms are available neither to the MSMEs nor to their lenders, and inevitably this translates into significant credit losses.

15. Another barrier is cost-to-serve. Assessing the creditworthiness of an MSME can be difficult due to information asymmetry, particularly with respect to financial performance of the business. In the absence of collateral, under-writing the customer often entails a "high-touch" approach which translates into higher operating cost. This can be addressed by bringing greater innovation in how small business loans are evaluated, underwritten, and managed. Electronic KYC, paperless (digital) applications, rapid loan underwriting and a greater emphasis on customer service can redefine the lending to MSME sector. PSB loans in 59 minutes (See Box) is one such endeavour.

16. Finally, and perhaps most crucially, there is the issue of perception and behaviour of frontline staff of the bank/ lender. A banker's motivation and understanding matters in the interface with the borrower. MSME borrowers often complain of long delays, lack of information sharing, difficulties in traceability of loan applications, insistence on collaterals even where not required as per the scheme etc. For first time borrowers such as those seeking PMMY loans, it can be a bewildering experience.

17. Significant improvement can be brought about if there is senior level monitoring and accountability coupled with online information sharing about the fate of applications. While there has been good progress through the PSB loans in 59 minutes initiative, the mechanism to track delay between in-principle approval and actual sanction needs to be strengthened. This has to be constantly monitored and reported with visible top management commitment. Further, without easy rules for portability (elaborated later), there will remain an institutional bias to delay and discourage. Portability has to be ensured like that available in the housing finance sector.

18. Capacity building of bank staff has been supported by RBI through its National Mission for Capacity Building of Bankers for Financing MSME sector (NAMCABS) programme but the scale of the task is daunting. Spatial distribution of MSMEs means that every branch needs staff who understands MSMEs. Handholding support for NTC borrowers and those from outside the banking system is equally important.

19. Competition from NBFCs created a pressure point for banks to look at the small and medium sector as a business opportunity. Some private banks have started doing so. The track record of PSBs has yet to improve. As such, measures like aligning IRAC and other norms for banks and non-banks, allowing NBFCs with minimum credit rating to be covered under co-origination guidelines and enabling these NBFCs to initiate recovery through SARFAESI should be allowed. The recommendations of the Sinha Committee regarding enhancing the collateral free loan limit and on credit guarantee should be implemented expeditiously.

20. It is evident that a long-term strategy to increase debt to MSMEs must take into consideration the cost-to-serve and risk related issues so that it is not at odds with stability of the banking sector. It also needs to leverage upon developments such as the availability of GST data, thrust on formalisation, alternative data, learnings from other sectors and emergence of new kinds of lenders as well as support entities to evolve newer methods of MSME lending.

TAT and PSB loans in 59 minutes

Traditional credit appraisal system results in high Turnaround Time (TAT). As per MSME Pulse Report by SIDBI-Trans Union CIBIL, TAT for MSME proposals is as under:

Turnaround Time for lending to MSME			
Lenders	2016	2017	2018
NBFCs	24	19	18
PSBs	41	35	31
Private Sector Banks	32	29	29

While reduction in TAT has been steady, it is still work in progress. One recent initiative to reduce TAT and promote choice has been PSBLoans in 59 minutes. PSBLoansIn59Minutes.com is an online marketplace, which enables in-principle approval for MSME loans up to ₹1 crore in 59 minutes from Public Sector Banks. On this platform, MSME borrower is not required to submit any physical document for in-principle approval. The solution uses algorithms to analyse data points from various sources such as IT returns, GST data, Bank Statements, etc. After receiving the in-principle approval letter, the beneficiary is expected to contact the concerned branch to get the in-principle approval into regular sanction to obtain disbursement of the loan. However, feedback received from entrepreneurs indicated that obtaining regular sanctions from the banks post in-principle approval has not been smooth in all cases. Delays in sanctions or high rejection rate have been reported for some lenders. As the portal relies on data, it currently caters primarily to existing entrepreneurs with a track record. The performance of the portal at a glance is given below. The data is given in Table.

PSBLoansIn59Minutes data			
Particulars	As on November 2, 2018	As on June 7, 2019	% increase
New Loans			
Preliminary approval (No.)	4,964	62,680	1163
Final sanctions (No.)	748	45,265	5951
Amount sanctioned (₹ crore)	209	12663	5959
Renewals			
Preliminary approvals (No.)	67077	102731	53
Final sanctions (No.)	1239	82619	6568
Amount sanctioned (₹ crore)	428	27493	6324
Total			
Preliminary approvals (No.)	72041	165411	130
Final sanctions (No.)	1987	127884	6336
Amount sanctioned (₹ crore)	637	40156	6204

Cash Flow-based Lending

21. Once access to credit happens, the focus shifts to its adequacy and as seen above, the time taken for delivery. Presently, banks assess working capital and term loan requirement of MSME units based on various methods viz., Cash Budget Method, Nayak Committee or minimum 20% of Turnover Method, Traditional or Operating Cycle Method. Out of these methods, assessment based on projected turnover based method prescribed by Nayak Committee, is generally used. The movement from Balance Sheet or turnover based Working Capital financing to cash flow based, or supply chain/ cluster based financing needs to be accelerated.

22. Cash Flow-based Lending (CFL) envisages a shift in bank's appraisal system from traditional balance sheet based funding to a more objective appraisal system of leveraging cash flows of the unit. In CFL, loan requirement is based on actual revenue generation and capacity to repay. Furthermore, the repayment schedule is based on the timing of the MSME's cash inflows. The advantages of CFL are that loan amount and repayment are based on the MSME's actual cash generation, reduction in credit risk, reduced monitoring costs for banks, reduction in TAT and ability to serve entities that don't have adequate collaterals. This is within the remit of individual banks and requires no regulatory intervention. CFL can be done in various ways such as GST based turnover ascertained by the bank, invoice based lending to truckers based on each trip, lending to hospitality industry through aggregator models, funding E-Commerce transactions (to registered sellers engaged in selling products through online portals), turnover ascertained from digital sales on Point of Sale (PoS) machine, Supply Chain Finance (dealer financing and vendor financing) etc.

23. Banks need to build their ability to capture cash flows of MSME borrowers on a regular basis, for which tie-ups with Industry Majors / Aggregators / Online platforms will have to be done by the Banks. As Account Aggregators (AA) get operationalized, lenders will have access to more information on borrowers' transactions at a single point which would further facilitate cash flow based lending. They should also monitor on ongoing basis data input from partners for early warning indicators. For instance, in case of e-commerce sellers, any change in seller rating, velocity of sales, etc. To be sure, some Public Sector Banks (PSBs) have been doing this for some time. However, adoption of this mode as predominant way of extending working capital credit needs more intensive effort.

MSEs in Services

24. With the increasing contribution of the Services Sector to India's GDP, the number of MSEs in the sector have increased significantly. These MSEs are a part of supply chain/inputs to large corporations. Banking sector historically has had fewer loan products suitable for MSEs in services. For instance a working capital (WC) limit requires collateral in terms of stocks etc.

25. For service sector MSEs, the requirement is not as much of funding a bills receivables problem as it is of funding current operational expenses e.g. salaries, rent, utility bills etc. These MSEs need products designed for them to service the interest on cash credit limit till such time that their bills receivables and business cycles would kick in. Startups and new age service enterprises do not have inventory but need working capital to pay daily / monthly expenses before revenues start coming in. They may need some working capital which may have to be part of the term loan itself.

Lender coverage

26. Online presence of lenders has enabled greater convenience and improved reach. Yet, the cohort of MSME customers is spread out across the country with varying levels of education, IT skills and broadband connectivity. Online needs to be supplemented through offline presence particularly in underserved (or aspirational) districts.

27. The answer to this is not more brick and mortar branches. Instead outreach has to be smarter through realignment of incentives building of partnerships (discussed below) and better use of existing channels such as Business Correspondents. Suggestions have been made for an Adjusted PSL mechanism to encourage MSME lending whereby a particular bank could, if it chooses to do so, sign up for a much higher target for PSL in lieu of lending to other sectors where it lacks a competitive advantage. Alternatively, weightage under PSL could be increased for MSME lending by banks in such identified districts.

Partnerships

28. Guidelines on co-origination announced by RBI open up new possibilities for marrying strengths of the feet on the street model/ alternate data model with low cost of funds of commercial banks. This however is just one mode of partnerships. Other partnerships need to be leveraged to improve the quality of origination and generating better loan proposals. This would involve working more closely with Rural Self Employment Training Institutes (RSETIs) and Financial Literacy Centres (FLCs) as well as nurturing Certified Credit Counsellors.

Loan Portability

29. Loan portability enables the borrower to switch, from existing lender to a new lender who offers favourable terms of credit. The need for loan portability could arise from various factors including inadequate credit limits, service deficiencies, potential for lower rates and need for value-added services such as trade finance and forex.

30. Small enterprises that grow into Medium enterprises often outpace their lender's willingness or ability to extend credit to them. A mechanism is needed to allow borrowers to shift their loan book to a new lender. Housing loans have become portable in this way and have improved the competitiveness of the sector. This needs to be now extended to business loans. Loan portability in a hassle-free manner will help promote competition amongst lenders, improve service quality, drive innovation through customised solutions for different sectors and reduce costs for the borrowers

Changes to PMMY

31. The Pradhan Mantri Mudra Yojana has become the default option for ensuring credit to micro enterprises. With four years of implementation, there is perhaps a need to go further. Initial apprehensions of “loan melas” and adverse selection have not materialised. The increase in number of MLIs, year on year increase in number of borrowers, increase in ticket size of loans along with banker led selection and appraisal of borrowers are evidence for this assertion. The number of smaller loans (below Rs. 2 lakh) made by SCBs rose significantly since 2015 (when PMMY was announced) as well as the total credit disbursed on the largest loans i.e. between Rs. 5 -10 lakh.

32. Yet the challenge of reaching many more persists. Potential solutions for these need to be assessed. Option one is to increase the limit for PMMY loans to Rs. 20 lakh. The increase in ticket size along with the overall increase in credit disbursed in the loan segment from Rs. 5 lakh to Rs. 10 lakh would suggest that debt requirements of MSMEs are increasing as their business grows. Rs. 10 lakh operates as a glass ceiling since these MSMEs will be required to produce collateral above Rs. 10 lakh and they still lack collateral. Option two is to retain the basic limit of Rs. 10 lakh, the three categories etc. and set sub targets for underserved districts such as aspirational districts and for new to credit customers. Option three is to use the leverage afforded by refinance and credit guarantees to encourage lenders to themselves increase their activities and outreach in underserved districts and new to credit customers. Each option has advantages and disadvantages.

Conclusion

33. Enhanced availability of credit helps in growth of enterprises. From an Indian policy perspective, what also matters is that this credit should be from formal sources rather than informal sources such as money lenders or family/ friends. Formalisation of the economy and financial inclusion have been overarching policy objectives.

Changes made now must be designed to encourage lenders to reach out to a larger and more dispersed set of MSMEs and simultaneously encourage enterprise by signalling that the “system” is entrepreneur friendly. This is an imperative for growth, for jobs and for a higher level of economic activity.

Annexure 5.4

Note on the Use of **Technology in PSBs**

By: K Subramanian
CEA

Context

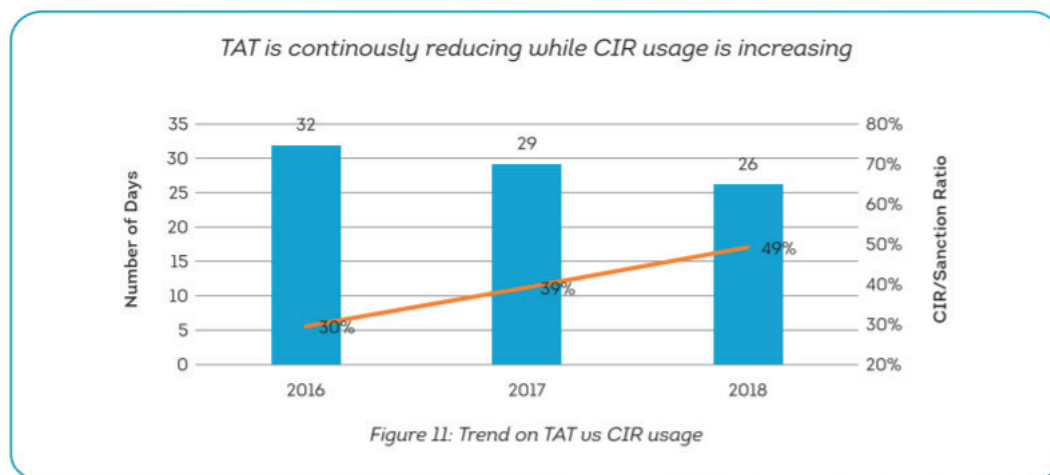
There have been significant advances in technology and Fintech (Financial Technology) is being increasingly used in banks all over the world. We are in the era of Digital Lending i.e., lending using digitised processes from customer acquisition to credit underwriting till disbursement & collections. These data driven technologies have enhanced efficiency in the banking sector.

However, Public Sector Banks (PSBs) in India still employ technology only for MIS and reporting, not for screening borrowers and monitoring them carefully. PSBs are facing many challenges, some of which are

1. Increasing NPAs with PSBs & NBFCs.
2. Cumbersome process of customer on-boarding and longer TAT (turnaround time) in PSBs.
3. High operating costs, manual operations, disjointed process flows and manual decision making.
4. Shortage of capital to extend loans.
5. Increasing competition with number of FinTech players in the lending space.

Data Driven Solutions Offer a Window

A study conducted by Ispirit¹ shows that with increased usage of credit information and digitalisation, significant improvement in TAT on lending to MSMEs across credit institutions has been witnessed. TAT has continuously improved for MSME segment underwriting- from an average of 32 days in 2016 to less than 26 days in 2018. This finding signals a definite positive correlation between enhanced use of data and increase in efficiency of the commercial lending market.

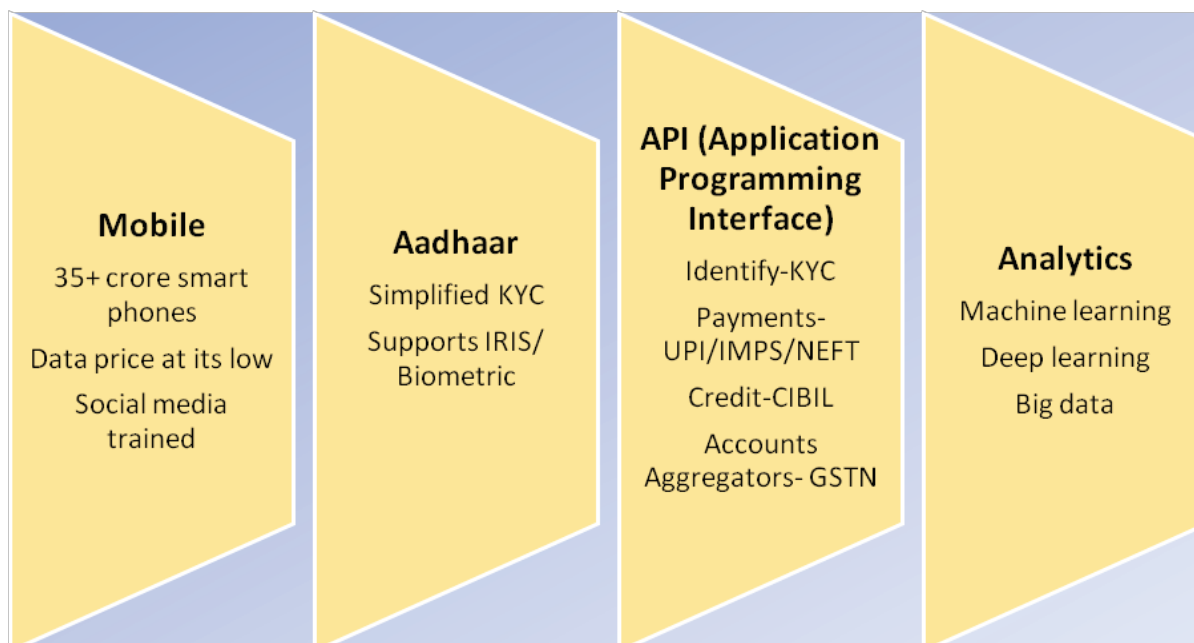


Note: CIR is Credit information report records of individuals' and companies' loans and credit cards.

A report by Economic Times² shows that two years of fin-tech driven reach has helped banks grow about 15 to 20 per cent. A 2015 report from McKinsey & Company³ revealed that a dozen European banks have already moved from traditional statistical analysis modelling to machine learning, with many citing increased new product sales of 10% and capital expenditure down by 20% as a result. With an increasing focus on retail customers, Yes Bank⁴ is now churning data to understand customer behaviour and offer a right mix of products based on a predictability model, citing that it has helped them offer right products and reduce cost.

¹<https://www.transunioncibil.com/resources/tucibil/doc/insights/reports/report-msme-pulse-september.pdf>

Existing Enablers for a Data Driven Solution



Proposed Solution

With so much happening on evolution of digital lending, PSBs are in a better position to have single solution interface to exploit market positioning & provide credit to a growing market.

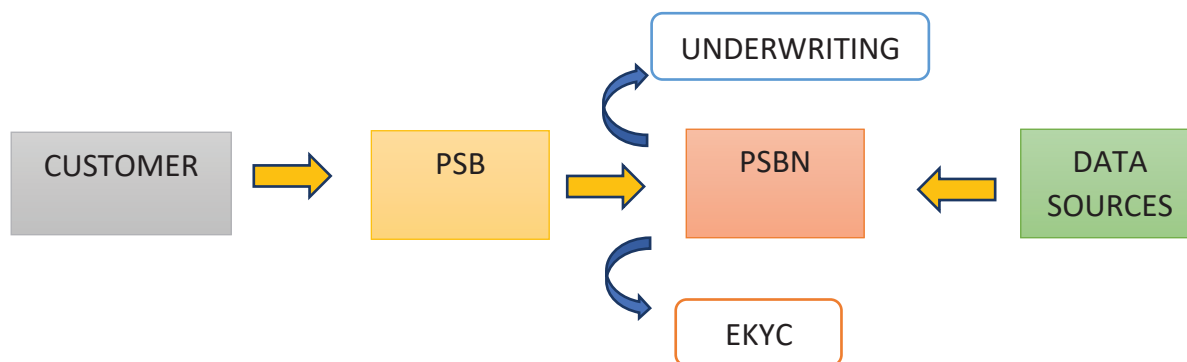
The idea is to establish a GSTN like entity (say PSBN) to use technology for screening borrowers and monitoring them carefully. The entity would utilize data from all PSBs, other Government sources, other service providers etc., to develop ratings models for rating corporates, especially those that are repeated defaulters. The ratings models would not only be employed when screening the borrower for a fresh loan but also for constantly monitoring the borrower. As the Government is the owner of all the PSBs, it can mandate the PSBs to share this data so that economies of scale can be utilized to make the necessary investments in undertaking analytics using Artificial Intelligence and Machine Learning.

²<https://economictimes.indiatimes.com/markets/stocks/news/fintech-helps-banks-disburse-more-loans/articleshow/60356665.cms>

³<https://www.mckinsey.com/~/media/mckinsey/Industries/financial%20services/our%20insights/bracing%20for%20seven%20critical%20changes%20as%20fintech%20matures/fintechcolor-the-new-picture-in-finance.ashx>

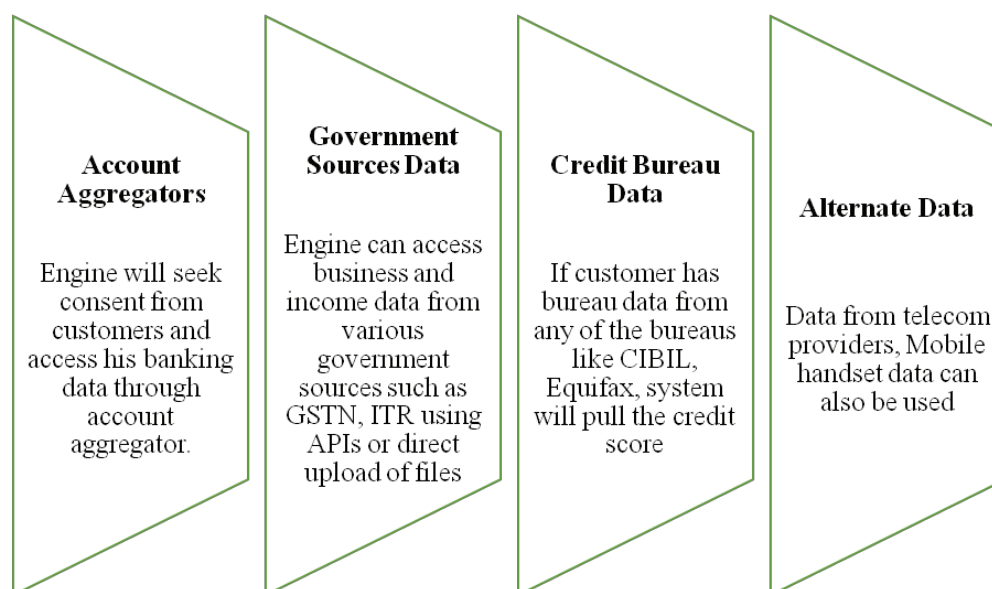
⁴<https://www.firstpost.com/business/yes-bank-to-use-data-analytics-to-understand-customer-behaviour-offer-right-mix-of-products-5790721.html>

Solution Architecture



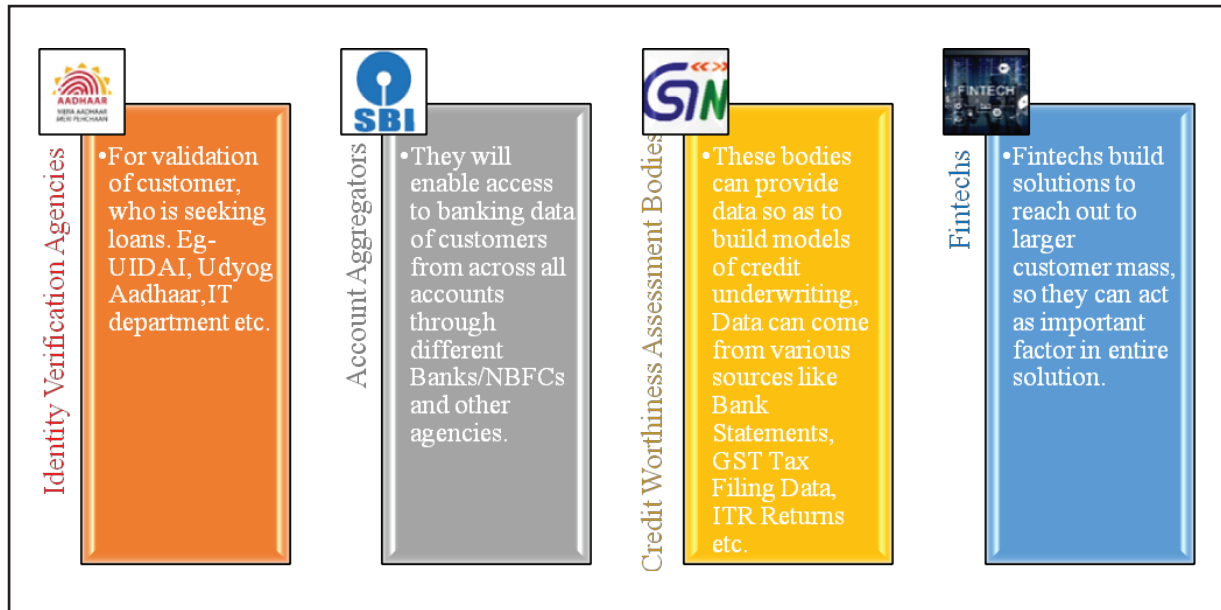
Solution Flow

- 1. Customer contact:** Customer will approach the bank and indicate the amount and type of loan he wishes to take.
- 2. KYC verification:** Bank will transfer the above information to the entity. The entity will complete KYC process for customers based on data provided by identity verification agencies e.g., Aadhaar based EKYC. As per norms, KYC has to be confirmed by Banks for loan provision through Banks. So, engine will collate data and pass on to Banks for KYC confirmation.
- 3. Data Collections:** Engine will further collate data from various data sources based on customer profile. Data will be collected from:



System will have complete credit underwriting (refers to generating credit profile of the customer after analysing all available data) based on the model built into it. Different underwriting models will be built for different types of customers (SMEs, individuals, large corporations etc.).

4. Loan provision: Based on KYC & underwriting, system will assess customer eligibility of loans and transfer all the information to the banks. On the basis of the information provided, banks can take decision on the amount and the rate at which the loan is to be given.



A Detailed list is provided in the Appendix.

Benefits to be Reaped

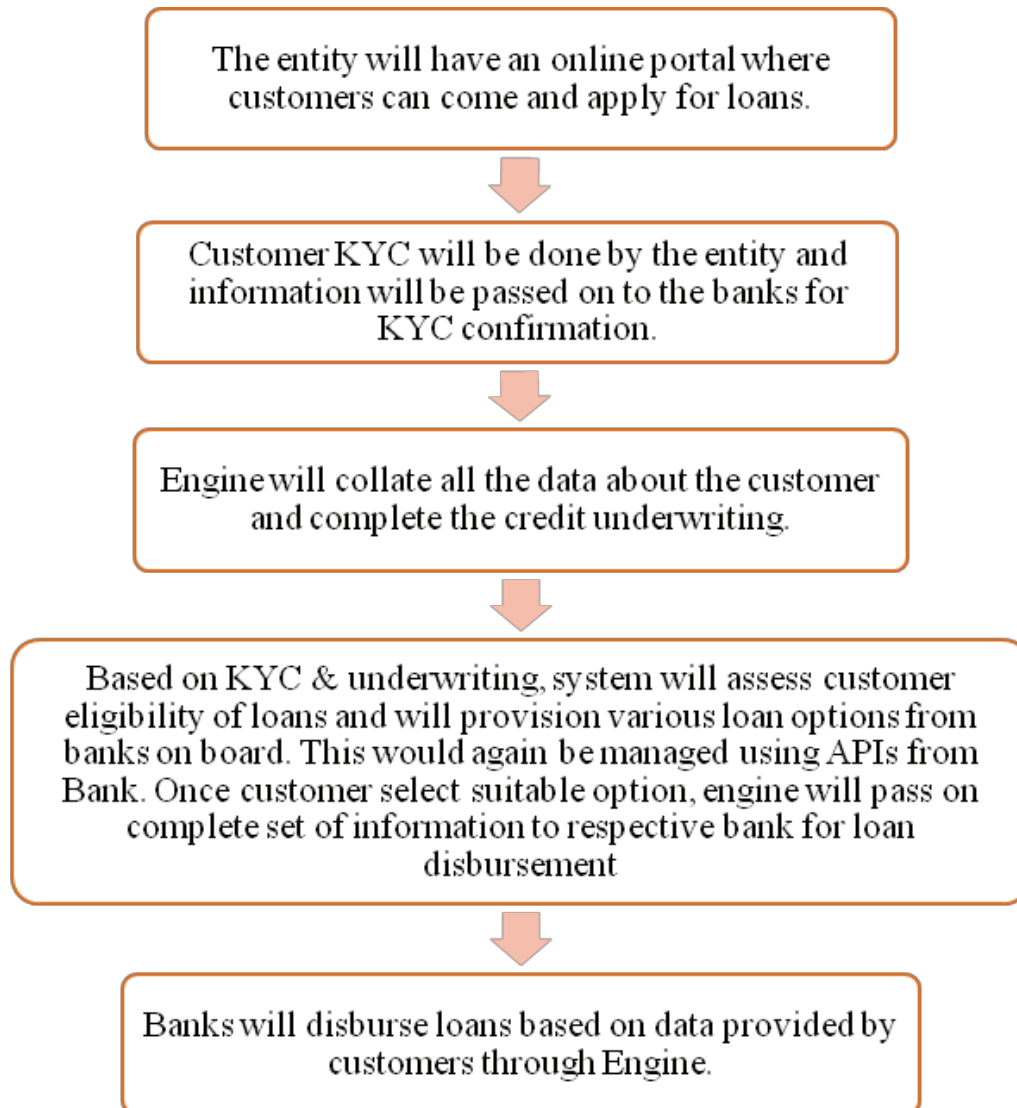
- The Solution may act as an accelerator for PSBs to:
- Take advantage of their reach & extend their reach further.
- Provide loans to retail individuals like small retailers, shopkeepers etc as well as large customer base in SME & MSME space.
- Enable better decision making on credit underwriting and hence can reduce the burden of NPAs.
- It can also help in Fraud prevention.
- Quick decisions can be taken, faster processing of loan applications and hence reducing TAT.
- Manage costs by automating the end-to-end process.
- Openness of Data leading to better collaboration.
- Creation of better loan product variants. Splitting the customers into segments according to their profiles.

Need for a Separate Independent Entity

1. Many traditional banks have been stymied in their efforts to boost business strategies by leveraging big data and analytics because they must deal with multiple databases that have not been integrated, and also because they have limited skills (data scientist expertise) to bring to bear
2. Many banks' scoring models are not tailored for specific products or segments; what's more, these models are primarily designed for (and focused on) the retail/private sectors, leaving desirable markets such as students and micro-, small, and medium-sized enterprises (SMEs), underserved. In addition, many banks have yet to apply adaptive technologies such as machine learning to credit scoring.
3. Banks' IT solutions often lack continuity, and few banks have undertaken deep, enterprise-wide IT transformation programs. Thus, few banks currently offer customers an integrated digital experience offering comprehensive, end-to-end online solutions.
4. Banks still focus on asset-based lending than cash flow-based lending.
5. Additional evaluations required in case of sensitive sectors such as funding of capital market securities or real estate proposals or commodity markets.
6. A single entity will improve overall utilisation of scarce resources. It will help in setting standard procedures, driving common governance standards and improving ease of accessibility.
7. Using data at bank level can be beneficial but a move to network-based model, where fraud detection algorithms from different banks can work together can be more beneficial.

Vision for the Future

So far, we have addressed the information asymmetry issues faced by the banks and tried to address this by collating additional information. But still we have not looked at the issues faced by customers. Most of the customers don't know about the different products available at different banks that might actually suit their needs better. So, we need a platform that not only informs banks about the credit worthiness of the applicant but also gives information to the customers on different loan products that different banks might be willing to offer to her based on her KYC information and credit underwriting.



This system will remove information asymmetry on sides of both customers and banks and will encourage competition among banks.

Appendix

PARTICIPANTS FOR SOLUTION – DETAILED LIST

For proposed solution, below participants will be part of ecosystem.

1. Identity Verification Agencies: Validation of customer, who is seeking loans, is the most critical component for any digital solution to work -Known as KYC (Know your customer). Currently, below are the bodies which could enable verification of customer identity and verification of address of home, shop or company. This would include:

For retail customers:

- NSDL: for PAN verification
- UIDAI: verification of customer identity and address through Aadhaar
- Passport
- Election Commission: Voter ID Verification

For SME/MSME (any business segment)

- Ministry of company affairs
- GST Network
- Udyog Aadhaar
- Income Tax Department
- Shop & Establishment / Gumasta License
- Utilities companies such as Telecom, Gas, Electricity Boards

2. Account Aggregators: with government already putting up framework for account aggregators, these bodies will enable access to banking data of customers from across all accounts through different Banks/NBFCs and other agencies.

3. Credit Worthiness Assessment Bodies: Credit bureau provides view on customer ability of pay loans and Credit score acts as key component in lending decision making process. But, many of large customer segments may not have formal credit score. So, it becomes more critical to build model to enable provision of various data around which credit underwriting model can be built to make decision. These data can be categorised in two modes:

Direct Data Sources such as

- Bank Statements
- GST Tax Filing Data
- ITR Returns
- Company's accounts
- Credit Bureau

Alternate Data sources such as

- Telecom Data
- Mobile/Internet Usage Data
- Location Data

4. Fintechs: Fintechs build solutions to reach out to larger customer mass, so they can act as important factor in entire solution.

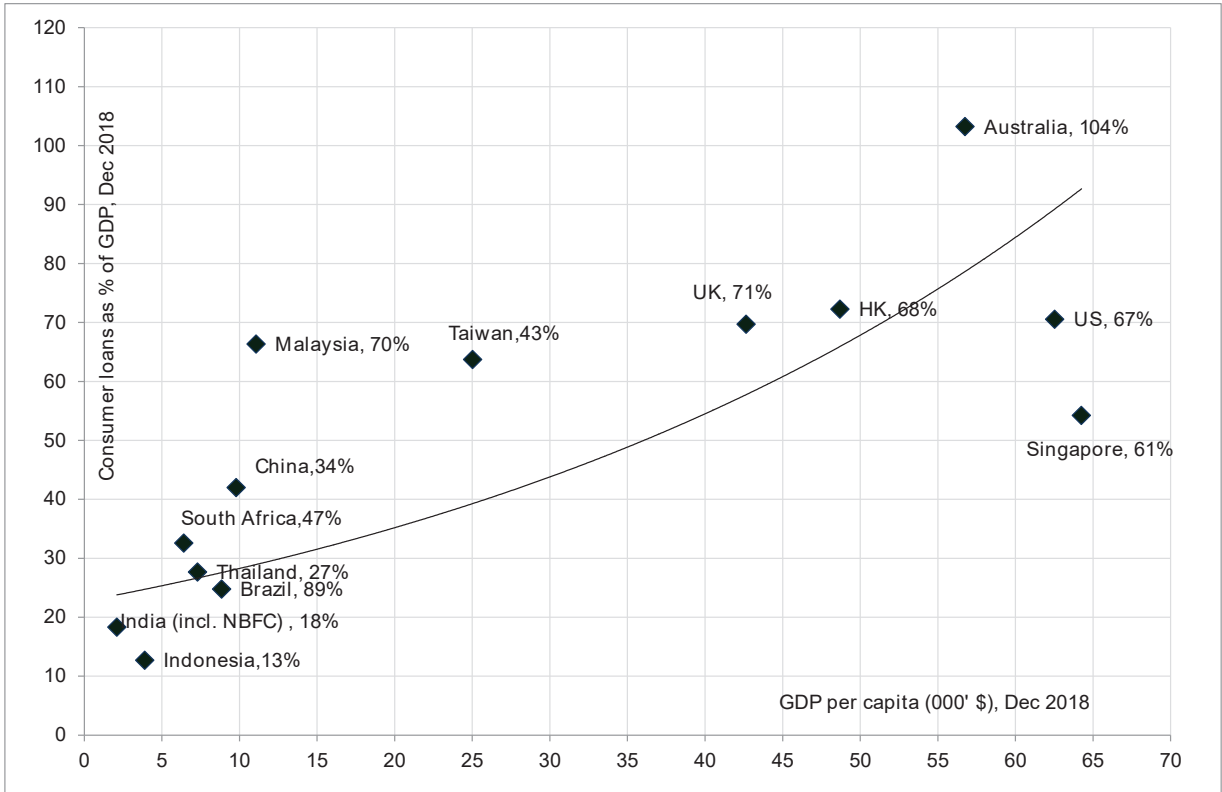
Annexure 5.5

Retail Lending – **A Great Opportunity**

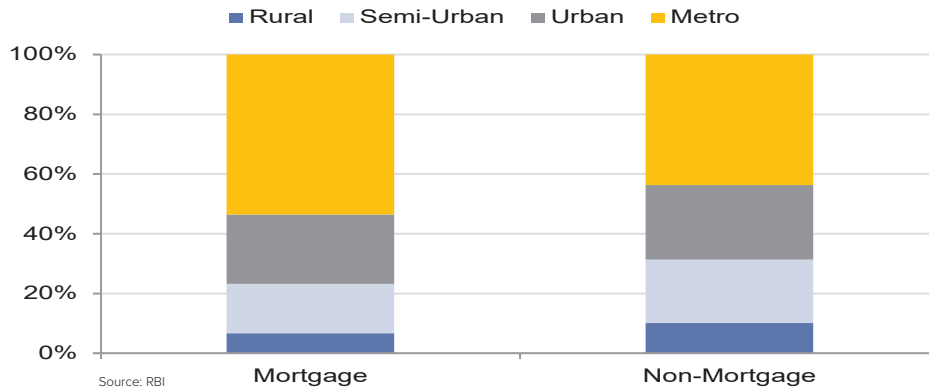
By: Aditya Puri
HDFC

Retail Lending – A Great Opportunity

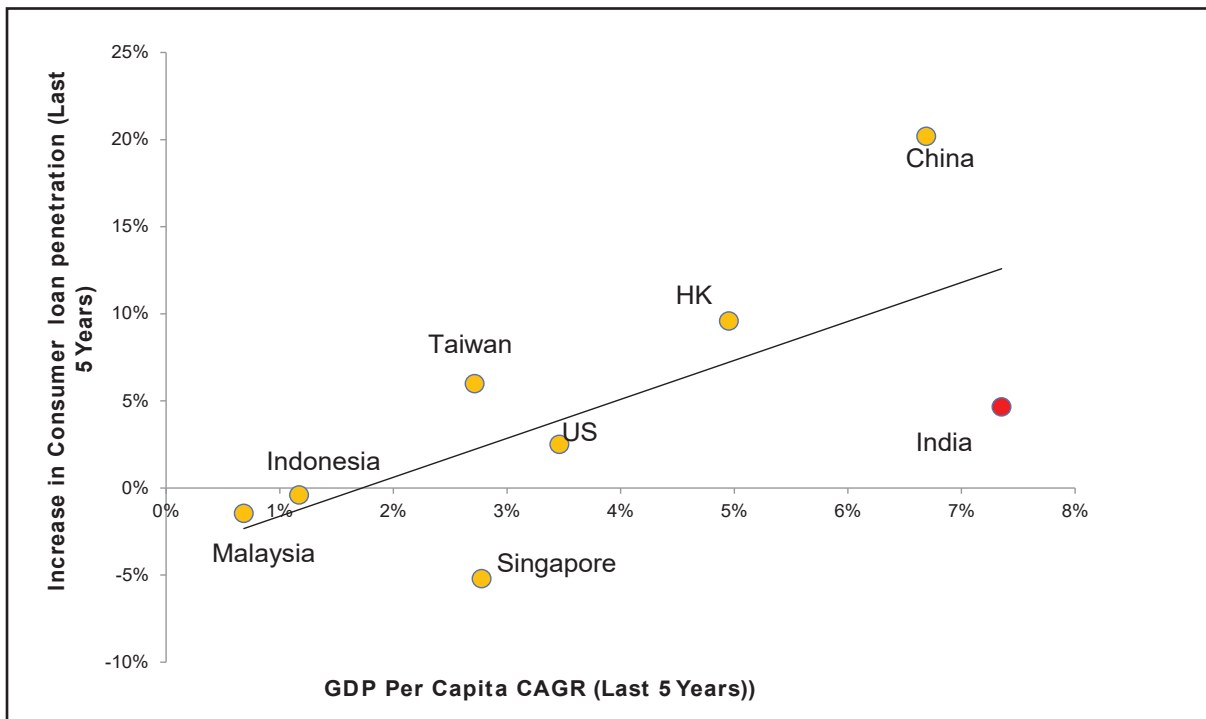
India is an underpenetrated market for retail lending. A comparison of India’s Retail Loan versus the world shows a huge opportunity. Countries with a higher consumer loan penetration have grown faster.



While consumer loans as a percentage of GDP in India are 18% this goes up to 104% in Australia. We must recognize that India’s consumer loan penetration of 18% is mainly in urban India. The penetration of organized finance in semi-urban and rural India, where 60% of India lives, is dismal.



The increase in consumer loan penetration versus increase in income is slower than in other countries. This suggests a lack or limited availability of finance.



Source: RBI, Euromonitor, FDIC, CEIC, Haver

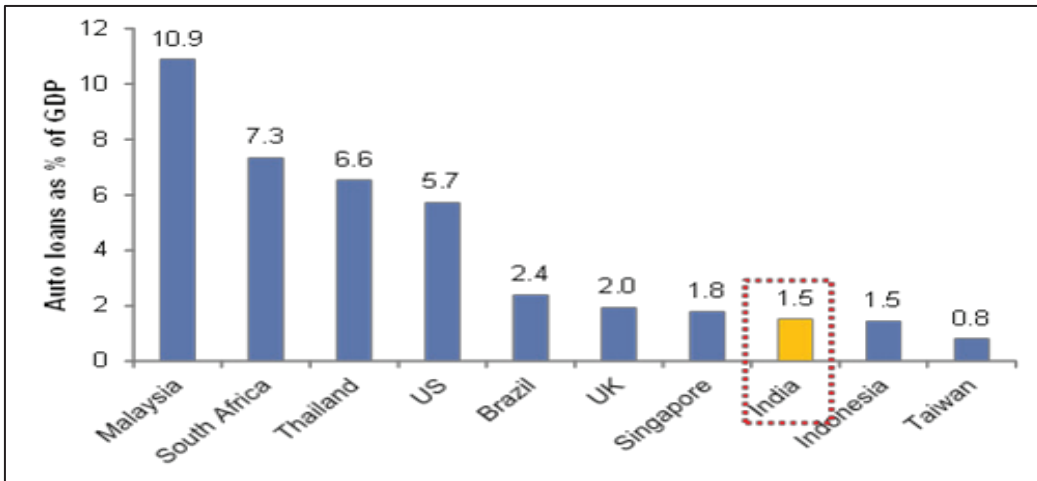
Also, most of the consumer lending of financial institutions is for housing loans.

Retail Loans (% of GDP)	FY15	FY16	FY17	FY18	FY19
Housing	7.6	8.3	8.8	9.5	10.0
Auto + CV	3.0	3.3	3.4	3.6	3.6
PL & CC	0.87	1.14	1.40	1.80	2.10
Others	2.35	2.41	2.53	2.73	2.64
Total Retail Loans	13.9	15.1	16.1	17.6	18.3

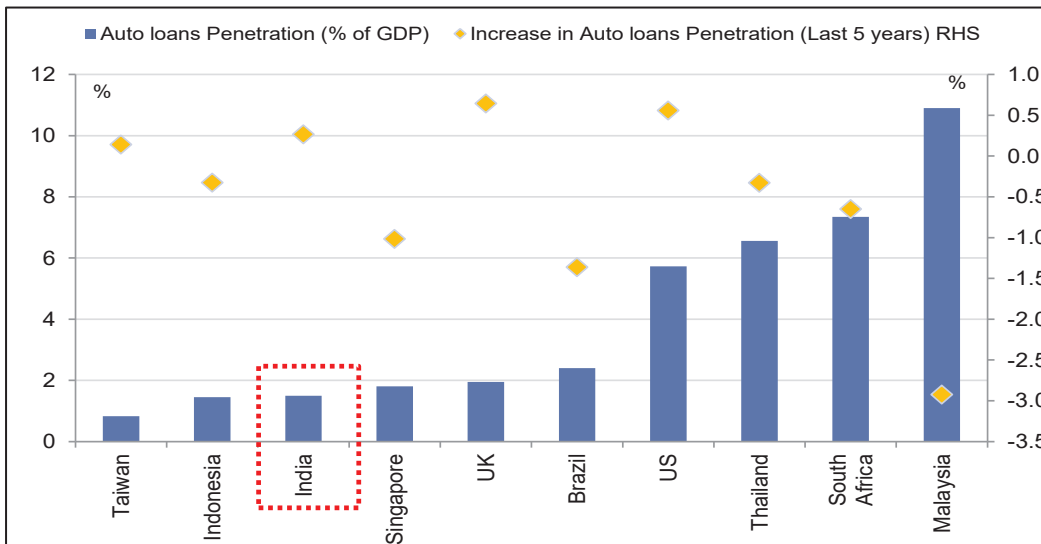
Source: RBI, TransUnion CIBIL, Company data, Euromonitor, CEIC

The unsecured retail market in India (personal loans and credit cards) is 2 per cent of GDP. Increase in unsecured loan penetration with rising GDP per capita suggests of an inflexion point of unsecured loan penetration is at per capita GDP of US\$ 8,000. We are almost there.

With better road infrastructure, auto loan market will be a huge market opportunity in India. The penetration of auto loans is low.

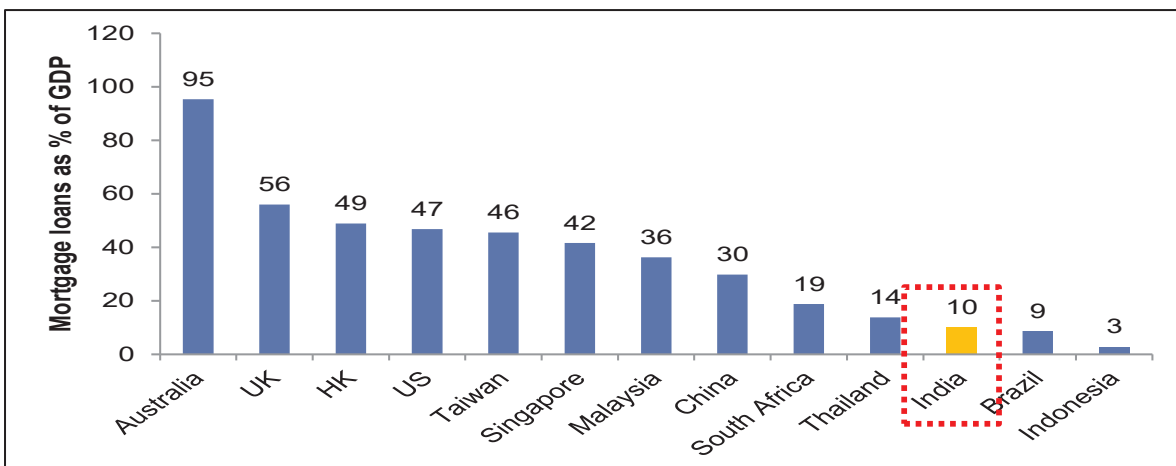


Increase in Auto loans Penetration, Last 5 Years



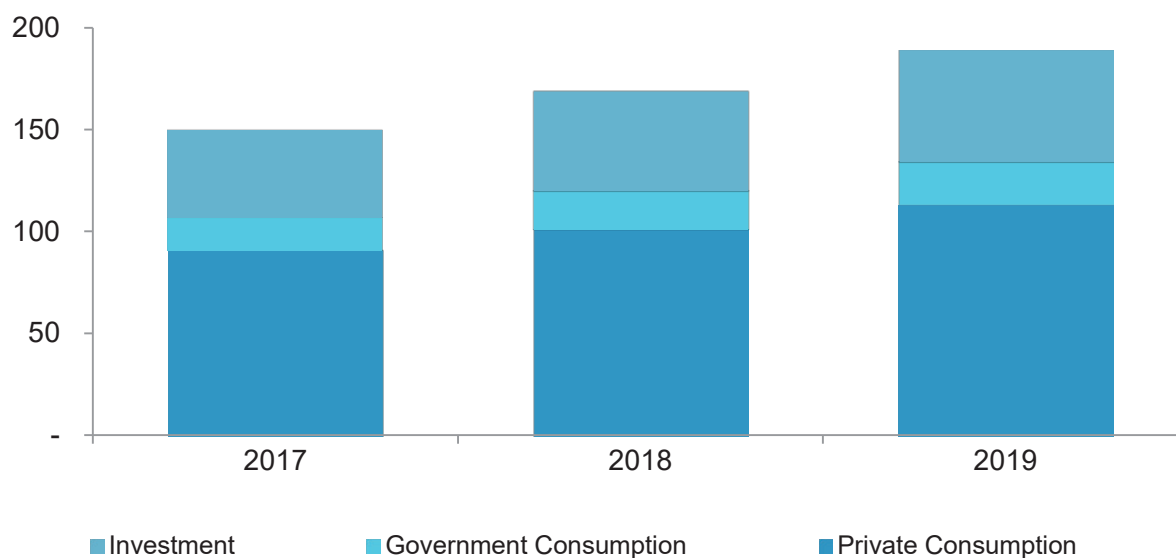
Source: RBI, CEIC, Euromonitor

Increase in Auto loans Penetration, Last 5 Years



Conclusion:

Credit is the lifeline of the Economy and must be available to all sections in all geographies. To meet the credit needs of a growing economy it is important that BANKS have a portfolio that mirrors the GDP of the country. India's GDP as measured in the traditional sense i.e. C + I + G has a consumption share of between 55% and 60%.



Banks, if they need to grow at the same pace as the Economy, need to be represented in all sectors of the Economy. In India, most banks do not have sufficient consumer lending as well as lending to small scale businesses. Also most banks have not extended credit products to Semi-urban and Rural areas.

HDFC Bank's portfolio mirrors that of India's GDP. Its portfolio is spread as follows:

1. Large corporates - 19%
2. Medium size corporates - 15%
3. Small corporates - 16%
4. Microfinance - 1%
5. Retail lending is comprised of the following:
 - a. Auto loan - both new and second hand - 10%
 - b. Two Wheeler Loans - 1%
 - c. Three Wheeler Loans - 0.02%
 - d. Tractor Loans - 1%
 - e. Gold Loans - 1%
 - f. Loans to small shopkeepers & traders - 4%
 - g. Light Commercial Vehicles - 3%
 - h. Credit Cards - 6%
 - i. Personal Loans - 10%
 - j. Home Loans - 7%
 - k. Farm Loans - 5%
 - l. Other Retail Loans - 1%

The above retail composition is despite the Regulator requiring banks to maintain a risk weight of 125% on Retail Loans for the purposes of capital adequacy. The high risk weight requirement in the Indian jurisdiction discourages retail lending. A comparison of the risk weight requirements of the Indian regulator vis-à-vis the Basel requirements is given in Annexure 1.

We, through appropriate use of technology, provide our products to the length and breadth of the country in a profitable manner. The diversification of portfolios leads to a better asset liability dispersion of risk and better margins.

There is a growing need for the banking sector to provide Retail and Small Scale Finance. Properly managed, risk in retail is low. Please refer to Annexure 2 for the detailed process.

The world is changing and continues to change rapidly. Given good old Dicken's advice that change depending on how it is managed could be the best of times or worst. We at HDFC Bank strongly believe in the Dicken's view on the best.

The secular shift in Technology, mobility, social computing and analytics is changing the way we work and live. A few companies, especially in financial services, leveraged the changing Technology landscape and in the process transformed customer expectations, created new operating models and blew a few mature companies out of the water.

When the noise level of banks being disrupted reached a crescendo, I decided to meet the people in Silicon Valley who would create the disruption. My discussions brought up the fact that no one was planning to set up a banking infrastructure but were planning to use technology to ride on top of this infrastructure and create new highly personalized customer experience coupled with frictionless user interface and a delightful journey.

I came back and discussed with my Team why we should not disrupt ourselves because we were having the most knowledge across products and customer needs and technology was available to everyone. We have now completed our transformation from a Bank to a financial experience. Today, you think money, you think HDFC BANK. We provide frictionless user interface leading to an enjoyable customer journey through access device of your choice where at the click of a button you do your – banking, pay bills, get financial advice and execution, third party products, pay your taxes and get key alerts – 10 second loans, DIY – Do It Yourself – loan against shares and mutual funds, cheapest place to buy your mobile grocery, durables, hotels, air tickets etc. Please refer Annexure 3 on Digital Transformation – a foreword by Nandan Nilekani.

To summarize,

- ✓ the market opportunity for retail lending in India is huge
- ✓ there is a significant demand in semiurban and rural geographies
- ✓ risk weights for retail lending in India need to converge to those as per Basel norms
- ✓ banks need to invest in retail processes and adopt digital technology

Appendix- 1

Risk weights on retail loans

Currently, the following variance in risk weight rules exists between the Basel Committee standards and that made applicable by the RBI. Should the RBI regulations be aligned with the Basel standards, the same will enable better capital usage for facilitating credit growth in the economy.

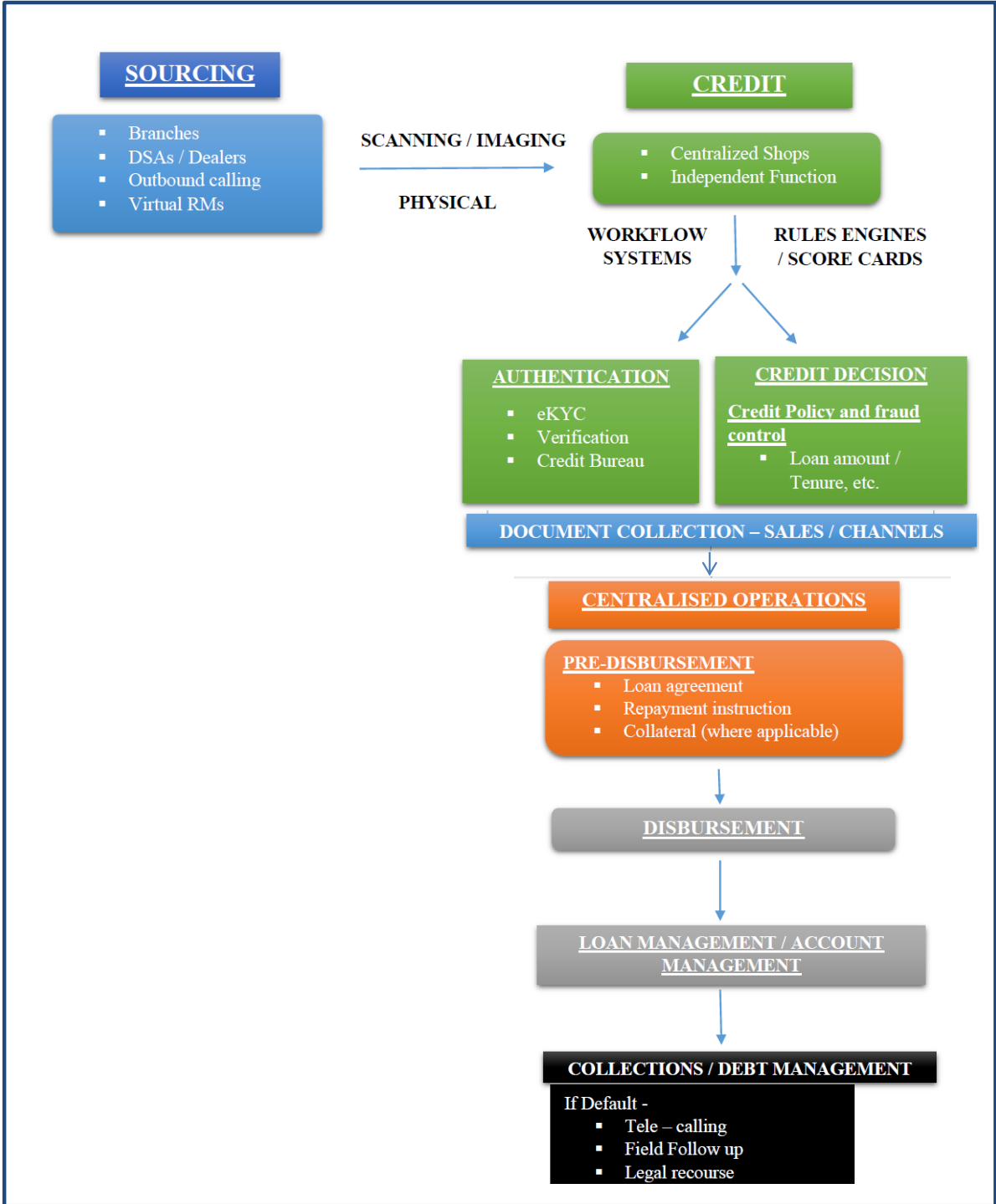
Sr. No.	Item	BCBS Standards	RBI's Basel III Regulations	Remarks
1	Minimum capital requirements	The BCBS minimum capital and CET requirement are 8% and 4.5%	RBI requires banks in India to have a minimum ratio of 9% and 5.5% respectively	
2	Leverage ratio	The Basel committee will test a minimum tier I leverage ratio of 3% during the parallel run period from January 1, 2013 to January 1, 2017.	As mentioned in the RBI guidelines on Basel III, banks should strive to maintain their existing leverage ratio above 4.5%.	
3	Claims secured by Residential Property	Risk weight is 35%, however, national discretion of supervisory authority available. No restriction on purpose of loan	Risk Weight ranges from 35% to 50% based on exposure amount and LTV ratio for Individual Housing Loans All other claims (Non Housing loans) secured by residential property attract the higher of the risk weight applicable to the counterparty or to the purpose for which the bank has extended finance.	As per both the Basel standardised and IRB norms, the lower risk weights for loans secured by residential mortgage reflect the higher recovery rates expected from such collateral. By shifting focus to loan purpose, the risk weights under the RBI norms move up substantially and may not reflect the lower loss arising

Sr. No.	Item	BCBS Standards	RBI's Basel III Regulations	Remarks
				due to this collateral.
4	Claims on Corporates, AFC, IFC and HFCs	100% RW for unrated borrowers	<p>1. Unrated claims on corporates, AFCs, and NBFC-IFCs having aggregate exposure from banking system of more than INR 200 cr. will attract a risk weight of 150%.</p> <p>2. Claims on corporates, AFCs, and NBFC-IFCs having aggregate exposure from banking system of more than INR 100 cr. which were rated earlier and subsequently have become unrated will attract a risk weight of 150%</p>	Significantly higher (from 100% RW to 150% RW) capital charge on large unrated borrowers, which could be of better quality than that reflected by a 150% risk weight.
5	Market Risk Capital Charge on Units of Mutual Funds	<p>No specific instructions on capital charge for units of Mutual Fund.</p> <p>Basel regulations suggest computing the charge of an instrument basis the risk associated with the instrument. Thus, an instrument impacted by interest rate risk is required to carry the charge basis</p>	<p>The RBI regulations mention that capital charge on Units of Mutual Funds shall be based on risk weights applicable for Equity Instruments.</p> <p>Consequently, even Units of Debt/Liquid Mutual Funds, which invest exclusively in debt/money market instruments which are exposed to only interest rate risk are treated as Equity and applied a factor of 9%</p>	<p>Treating debt mutual funds at par with Equity Mutual fund increases the General Market Risk and Specific Risk Charge significantly, as is evident in the figures provided.</p> <p>Thus, Equity Mutual funds and Debt/Liquid Mutual Funds should be given separate treatment.</p> <p>In-absence of clarity the factors applied</p>

Sr. No.	Item	BCBS Standards	RBI's Basel III Regulations	Remarks
		interest rate risk weight while equity instruments are exposed to equity risk weights.	for General Market Risk (GMR) instead of a factor of around 0.05% under Debt classification. Similarly, the Specific Risk factor of 11.25% applied under Equity classification shall get revised to around 4.5% corresponding to Interest Rate Risk when treated as Debt. (Note: The charge as per the proposed approach is computed considering the underlying instruments in debt/liquid mutual funds have weighted modified duration of 0.5 and comprises of papers rated A or better. Further, the SR factor applied is on conservative basis).	by the banks on debt/liquid mutual funds is not uniform/consistent leading to capital arbitrage.

Appendix- 2

Retail Lending Process



To set up a strong and stable retail lending franchise, key building blocks are strong and cohesive business, sales, credit, operations and remedial/ collection functions, each with their individual roles clearly defined, yet complementing each other in order to build a healthy book.

The business units would undertake the task of origination of retail loan applications and are responsible for achievement of business targets. These applications are underwritten by credit teams and disbursed by an operations unit. The credit and risk team, which include the underwriting, policy and collections teams operate completely independent of the business team and do not carry any business targets. The same is true for the operations team.

Product Program Approach

The backbone for a strong retail lending business are Product Programs that clearly define the target market and segment, portfolio mix, concentration limits, delinquency related caps based on estimated defaulted and loss characteristics and other credit parameters based on which loan proposals should be sourced by the business units and underwritten by the credit teams.

Customer Segmentation and Risk Diversification

In order to build a high quality loan book, it is necessary to have a thorough segmentation of the customer base and adequate portfolio risk diversification. The following three drivers help achieve the segmentation:

a) Product and Geographical Diversity – Product diversity is achieved through multiple offerings which could be installment or revolving loans, either for consumption or asset purchase. Within each of these products, it is imperative to operate across geographies and this diversification ensures minimal concentration to any particular segment of the market and provides protection in case there are any localized credit events.

b) Extensive Segmentation - Segmentation drivers across customers (like income, employer or employment type, channel etc.) are needed for close monitoring, both for new originations and at a portfolio level to determine changes in risk levels. This manner of extensive monitoring at a highly granular level enables early identification of any incipient issues and necessary remedial tightening.

c) Focus on Internal Customers - These are customers about whom a bank already has adequate demographic and account behavior information, either on the liability side or asset side or both. This information enables a bank to have access to critical information about its customers which can lower the risk profile.

Risk Management and Architecture

The Loan approval process must ideally incorporate the following steps:

- Loan proposals should be appraised based on detailed due diligence establishing customer contactability, credit history and financial repayment capability. Given the high volumes in retail, the underwriting should be through a loan origination system with robust controls.

- To prevent frauds, loan applications should be screened by a Fraud Control unit which reviews applications for identity theft, forged documents etc.

- Proposals should be appraised by an independent credit team. The credit underwriters should undergo an on-the-job assessment during an initial training period and then be given approval authorities post passing the respective credit tests. In case applications deviate from the set policy, there needs to be pre-defined risk based approvals which define the level and authority to appraise the same.

- Detailed post approval reviews should be in place to aid in ensuring credit underwriters adhere to laid down policies and procedures for retail loans. Adequate re-training should be provided to avoid recurrence of errors or exceptions, if any.

- Given the large volumes in retail, risk acceptance is augmented and enhanced through the usage of various scoring models. These models, built on historical data, help to differentiate customers based on risk levels, and estimate critical risk components like the Probability of Default (PD) for each borrower.

- Proposals should go through assessment by operations with respect to the valuation of the security and other legal/title search reports as required.

Data Storage and Analytics

All customer and transaction data should ideally not be purged but stored in a data warehouse which makes it amenable for the lender to mine the data for insights. This can be leveraged to build robust credit risk models by the Data Science units which enable risk appraisal and monitoring. Typically data needs to be collated for at least 7-10 years in order to complete a credit cycle.

Portfolio Monitoring

Given the high volumes in the retail lending business, automated tracking and reporting mechanisms need to be put in place to identify trends in portfolio behavior early and to initiate timely adjustments. These MIS should cover a granular analysis of the product performance as well as significant developments in the external markets which can be developed through information from the bureaus thus enabling the lender to watch for emerging trends even in the market.

Remedial Management

The framework above needs to be complemented with a strong remedial structure. In retail, large lending books afford a proportionally high volume of delinquent customers who need to be managed optimally through a variety of strategies ranging from self-cure to extensive follow up. A robust collections architecture typically entails:

- An effective telecalling channel (with comprehensive recording capabilities) –to manage large volume early delinquency portfolios

- Strong field presence– to manage late cycle delinquencies and recoveries from written off books

- Effective legal intervention to aid overall portfolio control

- Supplementary interventions through non voice channels including SMS, e-Mail etc.,

Summary

A. Lending through product programme ensures uniform portfolio quality which will result in earnings cost and default dynamics matching with the product programme.

B. Clear distinction has to be made between the origination credit, operations and collection teams to ensure efficiency and risk control.

C. Customer segmentation and risk diversification results in quality loan book.

D. It is a must that we have a collection system. 90% of collections happens through soft calling i.e., polite reminder on the payment due.

Clearly, if the basic structure in terms of pricing, defaults, cost of operations, cost of funding is not followed by the Bank, it will have problems in creating appropriate provisions and providing return on equity

If banks and pricing are in line with the market leader with varied default rates, cost of funding and operations, we are moving towards a potential problem.

KEY: In retail lending, constant monitoring is a must because once a portfolio is built, rectifying is not possible.

Appendix- 3

Digital Transformation – foreword by Nandan Nilekani

In early 2015, I was noticing the dramatic changes that were happening in financial services. This was due to many simultaneous trends in technology, regulation and markets. The rise of the smartphone, India's Unique ID, Aadhaar, and payment innovations from the National Payments Corporation of India, like IMPS and UPI, were creating a new branchless distribution channel.

The RBI's decision to license many new banks, dedicated to payments, was to bring in fresh, technology-savvy competition. And, the rise of platforms like Uber, fuelled by vast amounts of capital, were creating new data-based business models, which did not face the traditional pressures of making profits.

I connected all these dots in a presentation I made at a TiE 'Leapfrog' Conference in Bangalore on August 21, 2015, on the imminent disruption of institutions like banks. It was called as 'Are we at a WhatsApp moment in Finance?'

In the 'start-up' city of Bangalore the dominant narrative then was that these rapid and diverse changes in the environment would move too fast for incumbents, creating opportunities for agile challengers. I took a straw poll of the delegates, and the overwhelming vote was that the digital newcomers would overcome staid incumbents in the financial sector. Our young audience, however, had not taken into account HDFC Bank and Aditya Puri!

Unbeknown to the delegates of the Bangalore conference, HDFC Bank MD and CEO had already made a visit to Silicon Valley, almost a year earlier in September 2014, to see the developments and innovations in technology and understand their impact on the banking sector.

He came back convinced that HDFC Bank had to move fast and take advantage of this digital disruption. Aditya and HDFC Bank had always been known to spot trends, and then do relentless execution at speed, scale and with proper risk controls. From being a start-up in 1994, in a little over two decades the bank was striding like a colossus across the Indian banking sector.

This book narrates this transformation. Tamal Bandyopadhyay is one of India's most respected writers and columnists on finance. He tells the exciting tale of how HDFC Bank has transformed itself, especially in the last five years with its digital journey. Tamal combines his financial knowledge, eye for details, and an excellent storytelling style to create a vivid portrait of India's most valued bank and its path to the future.

It chronicled how India's most valued lender faced its most profound challenge -- turning itself into a digital bank, and not in a superficial manner but by driving fundamental change. And, all this took place at an electrifying speed—by 2018 around 85% of all its transactions were digital.

During his Silicon Valley visit, Aditya saw how the fintech companies—the new kids on the tech block—were getting into fund transfers, mobile banking, shopping. They could build products that could give quick loans, and provide a lot of convenience and a slick user interface to the customer on their phones.

But Aditya realized that most of the fintech players were OTT (Over the Top) applications that sat on top of the traditional banks network, and their customer base and merchant relationships. They were sitting on top of the banks by using APIs – Application Programming Interfaces. A similar phenomenon had happened in the telecom sector where OTT applications like WhatsApp had sat on top of the telecom network and taken away the messaging traffic.

Aditya and HDFC Bank decided that they would rather disrupt themselves than be disrupted. And while they could provide far more convenience to their customers, they also realized that by full digitization they could reduce costs in their operations. It was truly a win-win situation.

Their strategy was to provide speed, use technology to do credit and risk management at scale, improve the consumer experience and apply artificial intelligence (AI) to massive amounts of data for prediction and decision making.

It was also important that the bank combines global trends in technology like smartphones, AI, the cloud, etc. with the state-of-the-art infrastructure that India had built as digital public goods -- Aadhaar, EKYC, UPI and other elements of the India Stack.

Before the digital leap, by November 2013, the bank had come up with 'missed call banking'. This was a simple way for customers to reassure themselves that their balance in the bank was safe. Customers keep checking their balances every now and then. Providing this as a free service on a phone was the first item on the bank's agenda. While it had been done in India before, HDFC Bank was the first to implement it at such a scale.

The early innovations at HDFC Bank included sending money over the phone with an app called 'Chillr'. The app had started with the Payment platform from NPCI called Immediate Payment Service (IMPS) service, which provides instant electronic bank transfers through mobile phones and Internet banking. Subsequently with the launch of UPI from NPCI, HDFC Bank pivoted to this next generation interoperable payment platforms and provided payment services to platforms like Google Pay.

The bank has also used AI for many applications like chatbots, commerce bots and humanoid robots. Its chatbot, the Electronic Virtual Assistant now handles 600,000 queries a month; it has completed 6.5 million interactions since its launch. AI is now being used in very part of the bank.

It has also moved to make its internal 'systems of record' as 'platforms' so that any application or user could get access to a common set of capabilities through APIs. This has enabled them to launch new products quickly that could be targeted across the country, at both urban and rural customers.

For example, the 10-second loan is a genuine innovation that has enabled the bank to reach both existing and new customers, anytime and anywhere. This product, based on the principle of 'paperless, presence less and cashless', is a great example of combining the traditional strength of the bank in credit underwriting and risk management with the latest in technology. Today more than 15% of HDFC Bank's personal loan portfolio come from this product, with no increase in delinquency.

HDFC Bank has taken this innovative approach to car loans, loans against securities and loans against mutual funds.

With the increased data about small business coming from the implementation of the GST, and its technology backbone the GST Network (GSTN), similar products could well be rolled out for small business lending as well.

As a part of digitisation, in 2015, the bank introduced a marketplace platform called SmartBuy, where everything would be available at one place. This functions as an aggregator, hosting links to various sites catering to shopping, travelling, etc. Customers have the advantage of discounts and reward points. Besides, they do not need to take the trouble of going to multiple sites for different products and services. Over a period of time, the platform has been integrated to allow the customers to compare prices as well.

They can also purchase online and take delivery from a physical store, showing an e-voucher. There are approximately 5,000 to 6,000 merchants providing these services. The first bank in India to do so, HDFC Bank clocked Rs 6,000 crore from this in 2018. The technology is simple and can be replicated but it is able to leverage its huge merchant base.

The bank has also moved quickly into digital payments. Traditional POS devices are being replaced with digital POS machines that combine card payments with new generation payment systems like UPI and use QR codes. This flexible architecture also enables HDFC Bank to target new markets for digital payments beyond merchants, like schools, colleges and hospitals.

HDFC Bank's transaction volumes are astonishing. On average, more than 20 million cheques are processed by the bank every month for a value of Rs. 1.5 trillion to Rs. 2 trillion. The electronic payment numbers are much bigger. The bank processes more than 50 million transactions in a month through the RTGS, NEFT and ECH/NACH avenues combined, valued at Rs. 45 trillion to Rs. 50 trillion.

The value of transactions in trade finance is almost Rs 0.8 trillion a month and transactions in the capital markets have reach Rs0.5 trillion per month – almost 50% market share. The retail asset installment loans issued during an average month reaches Rs. 11,000 crore.

Moreover, the digitization drive has meant that the movement of documents has been slashed dramatically and this has saved around 2 million sheets of paper every month. The cost to earnings ratio shrank by approximately to 41% from 46% between 2014 and 2018. Expenses have grown at a slower pace compared with the revenue earned.

HDFC Bank is not the only bank in India which has understood the significance of digitalization. There are others such as ICICI Bank, Axis Bank, Kotak Mahindra Bank and a few other private banks and even India's largest lender, the government-owned State Bank of India are also making rapid strides in this space but to HDFC Bank's credit, it has been a leader, and moving at a faster pace and with efficient implementation. Unlike in traditional banking products where HDFC Bank learns at the cost of others and does not play the role of a pioneer, in digital banking, it has been the pioneer. For instance, even as the Reserve Bank of India gave licence to 11 payments banks, HDFC Bank has taken a leadership position in payments.

From 44% of overall transactions in March 2013, digital transactions grew to 55% in March 2014, 63% in March 2015, 71% in March 2016, 80% in March 2017 and 85% in March 2018. Transactions via phone banking have been reduced to 1%, while the share of branch banking is at 8% and ATM transactions are at 6% in 2018. HDFC Bank has navigated the difficult transition from being a brick and mortar bank to one which offers banking through both physical and digital channels, for a seamless experience for the customer.

The future will, of course, be fraught with competition. With, UPI we are seeing many players in the payments space like Google, PhonePe and Paytm. E-commerce has seen the arrival of global giants like Walmart and Amazon. There will be no 'winner take all' markets, and every victory will be hard fought. Only the paranoid will survive.

The gale of digital disruption has impacted every industry. The print media's revenues have been decimated by the rise of digital advertising. Physical retail is dealing with the onslaught of online retail, which in turn is using its data to provide automated retailing in the physical world. The entertainment industry is seeing their customers 'cut the cord' to go to new direct to consumer internet-based channels. The automobile industry is facing the simultaneous challenge of electric vehicles, autonomous vehicles and ride-hailingplatforms. In the memorable words of the Internet pioneer and VC , Marc Andreessen, 'software is eating the world'.

But HDFC Bank has shown that with an agile leadership which has foresight, and flawless execution at speed and scale, even a giant bank can take on the nimblest of start-ups and become a market leader and pioneer. It is an object lesson on how incumbents in many industries can respond to the digital disruption that is staring at them!

Nandan Nilekani

Co-founder and Chairman of Infosys and Founding Chairman UIDAI (Aadhaar)

Annexure 5.6

Note on **Agriculture Credit**

By: Prof. Ramesh Chand, NITI Aayog &
Dr. Harsh Kumar Bhanwala, NABARD

Importance of Agriculture Sector in Indian Economy

The criticality of agriculture in India stems from the fact that it sustains food security of large and growing population of India and is a source of livelihood for 44 per cent of population directly engaged in agriculture. Our large Industrial segment depends upon Agriculture sector for raw material. Agriculture has experienced two profound changes which need to be fully understood and taken note of if we want to address various issues facing agriculture and to take the sector forward. One, agriculture is becoming increasingly commercial activity dependent on external inputs. This has raised the dependence of farmers on external borrowings to meet the working capital requirements and to make investments in farm machinery, irrigation and buildings. Two, India has moved from shortage of agri-food to surplus at aggregate level. These two developments have strong implication for capital and resource requirement of farmers and post harvest agri-business activities. As agriculture sector does not have access to equity capital, its requirement need to be met by institutional finance. Mainly due to this reason, timely and adequate flow of institutional credit to agriculture has always been the goal of successive governments and was primarily the one reason for Bank nationalization. Further, access and provision of institutional agriculture credit has partially enabled farmers to move from the clutches of moneylenders who charge usurious interest rates from farmers. Credit requirement of farmer is witnessing steep increase as they are diversifying their economic activities and modernizing farm activities.

Overall Growth and Outreach of Agriculture Credit

2. During 2010-11 to 2017-18, compound annual growth rate (CAGR) of agriculture credit was around 15 per cent in nominal terms. The outreach to households, measured as number of loan accounts, grew by 10.67 per cent per annum between 2007-08 to 2017-18 reaching to around 11.39 crore agricultural accounts by 2017-18. This augurs well with 14.6 crore (Agri. Census, 2015-16) agricultural holdings in the country, though one has to duly reckon with multiple accounts per household. However, there are issues that need to be addressed with respect to inequality in distribution of credit across states, credit delivery and the expectations from banks in this area. This note attempts to address the same.

Regional Disparities' in Agricultural Credit – How to Overcome it?

3. The skewed distribution of agriculture credit across regions has persisted over the years. Kerala, Andhra Pradesh and Tamil Nadu receive 7%, 10% & 15% of total credit disbursed during 2017-18 as against their share of 1%, 3% & 4% respectively in the gross cropped area. On the other hand, Assam, Bihar, West Bengal, MP & UP have a share of 2%, 4%, 5%, 12% & 13% respectively in GCA whereas their share in credit is 1%, 3%, 4%, 7% & 5% respectively. Region-wise, the Southern region received 39.31 per cent of total institutional agricultural credit supplied during 2010-11 which further increased to 42.53 per cent in 2017-18. Central, Eastern and North East Regions with 43% of the Gross Cropped Area (GCA) of the country received only 22% of agricultural credit.

4. As per existing Priority Sector Lending (PSL) guidelines targets for credit are set and monitored Bank wise (not state/ region wise) and shortfall also determined accordingly. **There is no reckoning of achievement of these targets, state wise. Therefore, banks continue to advance more and more loans in areas already saturated and regional disparities in supply of credit continues to remain high. It is suggested that target for agriculture credit needs to be fixed State wise for large states and region wise for small states. The shortfall in PSL should also be dealt with at state level This requires modification in Priority Sector Lending (PSL) norms.**

5. Higher credit flow to some states may be due to higher productivity in their respective agriculture emanating from higher investments which is reflected in their Agriculture GVA. Alternatively, share of each state in the all India Gross value of Agriculture Output can be used as a criterion for fixing the state wise target for agriculture credit.

6. This change shall not only lead to reducing regional imbalance but will also bridge the growing disconnect between the real sector parameters and agriculture credit and enhance productivity of credit.

State wise assessment of Crop loan adequacy - Under financing and Over financing

7. Based on the assessment of Value of Output (GVO), Gross Value Added (GVA) and Value of Inputs (VOI) State wise demand for working capital for agriculture sector (Crop sector and livestock) can be estimated. Ideally, crop loan should be a fraction of the cost of inputs including hired labour because a part of the input cost is met by farmers from their own resources. However, it is difficult to determine this fraction. Therefore, the ratio of crop loan to cost of input should not exceed 100% which implies that entire cost of production is financed. The ratio for various states has been estimated in the Annexure. As may be noted the ratio in respect of Kerala, Himachal Pradesh, Tamil Nadu, Punjab, Telangana, Andhra Pradesh and Haryana is 274%, 186%, 166%, 159%, 143%, 140% and 118% respectively.

8. Based on this ratio the States /UTs are grouped in three categories

Sr. No	Category Of State	Ratio of Crop Loan to VOI	Name of the States
1	Highly Crop loan Starved States	Ratio is less than 50%	A&N, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Gujarat, Jharkhand, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, UP, West Bengal
2	Slightly Deficit to Adequate crop loan	Ratio is between 50% to 100%	Goa, J&K, Karnataka, Odisha, Rajasthan, Uttarakhand
3	Excess Credit	Ratio greater than 100%	Andhra Pradesh, Chandigarh, Delhi, Haryana, HP, Kerala, Puducherry, Punjab, Tamil Nadu, Telangana

Source: Data furnished by the Office of Member (RC), NITI Aayog, GoI

Surely, the fact that in many states/UTs the ratio is greater than 100% indicates that agriculture credit is not used for the stated purpose and this needs to be rationalized.

An assessment based on the latest available figures undertaken for the year 2017-18, reveals that at aggregate (All India) level, the Crop loan disbursed covered 72% of VOI (see Table in Annexure). Thus the additional demand for crop loan to fully cover the Cost of Production (100%) would require an additional Rs 03 lakh crore. In 07 States and 3 UTs the Crop loan disbursed is more than the VOI - Andhra Pradesh, Tamil Nadu, Telangana, Kerala, Haryana, Punjab and Himachal Pradesh crop loan disbursed was higher than VOI thereby indicating over financing. In the three UTs, namely Chandigarh, Delhi and Pudhucherry also crop loan disbursed was higher than VOI. In Bihar, Chhattisgarh, Gujarat, Jharkhand, Madhya Pradesh, Maharashtra and Uttar Pradesh Crop loan disbursed could cover less than 50% of the VOI. Thus, there exists a strong case for rationalization of crop loans across states and regions

Credit Distribution – Land Size wise

9. Generally there is a perception that institutional credit is cornered mainly by big farmers and small and marginal farmers are not adequately covered by it. In the last few years coverage of smallholders and their share in total flow of institutional credit has significantly increased. The share of small and marginal farmers in the credit disbursed was 44% in 2013-14 which increased to 50% in 2017-18. As per the latest Agriculture Census (2015-16) their share in the operated area stands at 47.34%.

Issues and Suggestion for Branch Level

- Insufficient workforce to handle the regular work and to bring the newness in the approach for the agriculture financing.
- Recruitment in specialized cadres will lead to quality project based lending in newer and fast emerging areas in Agriculture viz. precision farming, poly houses, commercial dairy, fisheries etc. which hold promise in the years to come.
- Less expansion of Branches specializing in Agriculture financing
- Credit Culture taking a beating due to announcement of Loan waivers -Issues such as irregular repayments, tend to lower credit flow at branch level.
- Non availability of clear Land records, unclear land title

Extensive application of technology is needed to overcome some of the issues faced at branch level. Credit processing Centre (CPC) manned by personnel having expertise (and qualification) need to be setup by all banks which can cater to a certain number of branches. CPC should have sanctioning powers and this would also lessen the load at the branch level. Presently, some banks have introduced the concept of CPC but it is not adequate as in large States where even one CPC per district may not suffice the requirements of the district. This model needs to be adopted and coverage increased.

Issues related to Kisan Credit Cards (KCC) as an effective delivery instruments

- KCC is still one of most effective products to bring farmers into institutional credit dispensation
- Lower usage of IT enabled system (Credit information, CERSAI etc.) for appraisal and sanctioning of KCCs. Cumbersome land record system. Due to defective land title, non-availability of clear land ownership etc. bankers are reluctant to finance farmers.
- No clear laws have been established for tenant farmers/oral lessees.
- Digitization of Land records and online charge creation.
- Campaign undertaken by Ministry of Agriculture & Farmers Welfare, GoI as well as by other agencies, for coverage of 1 crore farmers in underserved regions needs to be regularly monitored at foras viz. SLBC, DLCC and BLBC.
- Responsibilities should be fixed for the Regional Managers and Zonal Heads in terms of their performances and linked to increase in credit flow to rural areas in states receiving less credit, presently.

There are concerns that Banks have been using KCC (specifically the renewal part of it) for meeting targets and the product needs modification. As per existing prudential norms, in the case of nonagricultural loans especially 'cash credit', an account is not considered 'out of order' if the interest amount is serviced. However, in the case of KCC, each drawal is akin to cash credit, however the same does not apply to repayments. It is mandatory that repayment of the principal amount is done before its renewal. There exists a case to examine if norms which are applicable for cash credit of non-agricultural loans can also be extended to KCC and only servicing of interest portion allowed for renewal.

Data on KCC shows that in some states number of KCC is many times the number of farm households. On the other hand, NSSO survey says that institutional credit is not received even by 50% of farm households. One reason for this discrepancy could be multiple KCC taken from different branches/institution. In such cases official figures indicate 100% coverage but actual coverage is much less. There is a need for putting check on multiple loans for same purpose. This could be done by Aadhar linking of KCC and other crop loan agriculture accounts and transferring the interest subvention amount in the farmers account through Direct Benefit Transfer(DBT).

Dry land areas and agriculture undertaken therein, is prone to regular droughts and follow a cyclical pattern. The regular KCC product requires almost yearly renewal and repayment may not be suitable as a financing instrument for dryland areas. There is a need to develop suitable financing products which take into account dryland agriculture requirements.

Requirement of Rural Infrastructure for Credit Absorption

There is a direct correlation between improved rural infrastructure and the advantages it brings about in terms of improved productivity, easy access to market, increase in farm income, availability of spare money for investments other than in agriculture or in allied activities etc., besides augmenting their credit absorption capacity. Independent evaluation studies post implementation of the rural infrastructure projects by the respective State governments under RIDF, have revealed that the farm household equipped themselves with LPG stoves for cooking, constructed toilets, acquired assets viz. tractors, two-wheelers, TV refrigerators and other FMCGs. Banks also witnessed deepening of Financial inclusion as a result of increase in the credit absorption capacity of the farm household, post implementation of RIDF projects. In Odisha, the primary survey revealed that about 79 percent of beneficiaries had opened new bank accounts while in West Bengal it was 73 percent. There was also an increase in banking transactions including ATM drawals (42% Odisha, 66% WB). Further in Odisha 43 & 37 percent of the households reported an increase in their bank savings and fresh loans from the banks, while in West Bengal, Karnataka and Meghalaya it was 62 and 21 percent; 151 and 117 percent and 129 and 467 percent respectively (Source: Impact Evaluation Study of RIDF assisted Projects, 2017, NABARD).

Building a robust system of Monitoring of Agri Credit

- No uniform data monitoring system exists; hence MIS are not standardized across agencies.
- Activity wise monitoring based on Core Banking Solutions (CBS) should be undertaken. There exists divergence between Control returns submitted by controlling offices of banks and the data generated through CBS. MIS reporting should be generated henceforth only through CBS.
- The share of indirect credit in the agriculture credit (outstandings) in Schedule commercial Banks stood at 16% in 2014 which has subsequently reduced to 9% in 2018 which is a healthy development. However, reporting of Direct and Indirect agriculture credit for Banks have also undergone changes hence not strictly comparable. Moreover, similar classification at the state level is not in public domain.
- Data on number of farmers brought under Institutional finance dispensation needs to be monitored at the district level.
- No mechanism is available at the branch level to monitor the diversion of sub-vented agri. loan to non-agri purpose.

Diversion of Agriculture Priority Sector lending and Denial of Credit

It has been pointed out by some researchers that lot of lending shown as priority sector lending end up going for non agri purposes. As purpose wise distribution of credit is not in public domain it is really not easy to ascertain the deviation and its extent. RBI should ask all financial Institutions to report purpose wise advance and outstanding to appropriately track priority sector lending.

Annexure				
Value of Production(VOP), Gross Value Added(GVA), Value of Input(VOI), Crop Loan at current prices 2017-18 (Rs. Lakhs)				
State	VOI which includes hired labour (crop sector +livestock sector)	Crop Loan Disbursed	% loan to VOI	Gap between VOI and Crop loan disbursed (Rs. Lakh)
Andaman & Nicobar Islands	23548	4205	18	19343
Andhra Pradesh	5636431	7869068	140	-2232637
Arunachal Pradesh	137023	2674	2	134349
Assam	1892815	150692	8	1742123
Bihar	4351287	1443514	33	2907773
Chandigarh	6477	129325	1997	-122848
Chhattisgarh	2563480	1083966	42	1479514
Delhi	55752	653926	1173	-598175
Goa	40510	33918	84	6592
Gujarat	8261079	3965038	48	4296041
Haryana	3300121	3883484	118	-583364
Himachal Pradesh	585448	1090565	186	-505117
Jammu & Kashmir	980251	924882	94	55369
Jharkhand	1992977	210040	11	1782937
Karnataka	5223648	4414577	85	809070
Kerala	1996277	5475925	274	-3479648
Madhya Pradesh	9881078	4591769	46	5289309
Maharashtra	8425329	2737137	32	5688192
Manipur	213128	3677	2	209451
Meghalaya	87962	28663	33	59299
Mizoram	70440	2325	3	68115
Nagaland	157504	8263	5	149241
Odisha	2830797	1565002	55	1265795
Puducherry	22616	184597	816	-161981
Punjab	3324213	5297748	159	-1973535
Rajasthan	9667653	6358255	66	3309399
Sikkim	89273	6575	7	82698
Tamil Nadu	6348748	10527616	166	-4178868
Telangana	3152654	4496082	143	-1343428
Tripura	417838	70475	17	347363
Uttar Pradesh	14497605	6151245	42	8346360
Uttarakhand	532277	469268	88	63010
West Bengal	8564657	1484358	17	7080299
Total	105330896	75318853	72	30012043

Source: Calculations based on data furnished by o/o Member (RC) NITI Aayog.
(-) Indicate excess of credit over cost of production.

Annexure 5.7

Export Credit in India: **Challenges and Policy Options**

Background

Indian exports have witnessed a prolonged period of decline and stagnation, although there have been encouraging signs of a pick-up in recent times, at the back of resurgence in global growth and improvement in oil prices. Sustainability of the recent resurgence in exports and achievement of the ambitious US\$ 1 trillion target for exports would entail a holistic framework to enhance trade competitiveness, promote innovation, alleviate structural bottlenecks, bolster availability of export finance, and strengthen the institutional capacity for exports. An important facet (but certainly not the only one) for the growth continuum would be a robust ecosystem for export financing.

Current Export Financing Framework

Export financing framework refers to the policies, practices, and procedures employed in financing export business. It covers all aspects of arranging finance for export, and securing payments from the overseas buyers. An efficient financing framework must ensure that exporters are able to meet the demands of overseas buyers in a competitive global market place.

Financing facilities are available to exporters even before the shipment of goods (e.g. at order stage), as also after the shipment. As export credit is predominantly for short tenors, commercial banks are the key players for providing export finance facilities, at both pre-shipment and post shipment stage. Pre-shipment financing is needed to support pre-export activities prior to the shipment of goods, and is used for procuring raw materials, meeting wages and other overhead costs during this period. Post-shipment financing provides adequate liquidity to the exporter until the time the purchaser receives the product and initiates payment. This stage of financing is essential for international competitiveness of exporters as it allows exporters to offer better terms of payment to buyers. Commercial banks also provide other financing products such as working capital loans, letters of credit, bills of exchange, etc. which help firms in fulfilling their export orders.

Besides these, export credit insurance may also be available to exporters which helps mitigate political and commercial risks in exports. In this context, the ECGC Ltd. (erstwhile Export Credit Guarantee Corporation of India Limited) provides the necessary institutional framework for minimizing the risks involved in international trade. It provides various insurance policies and guarantees to both exporters and banks, for supporting both short term and medium to long term (MLT) exports.

India also has a specialized institution for supporting term export finance — the Export-Import Bank of India (Exim Bank), established with the objective of financing, facilitating and promoting international trade. While commercial banks meet the short-term export finance requirement, Exim Bank plays an instrumental role in providing M/LT loans to exporters.

Decline in Export Credit

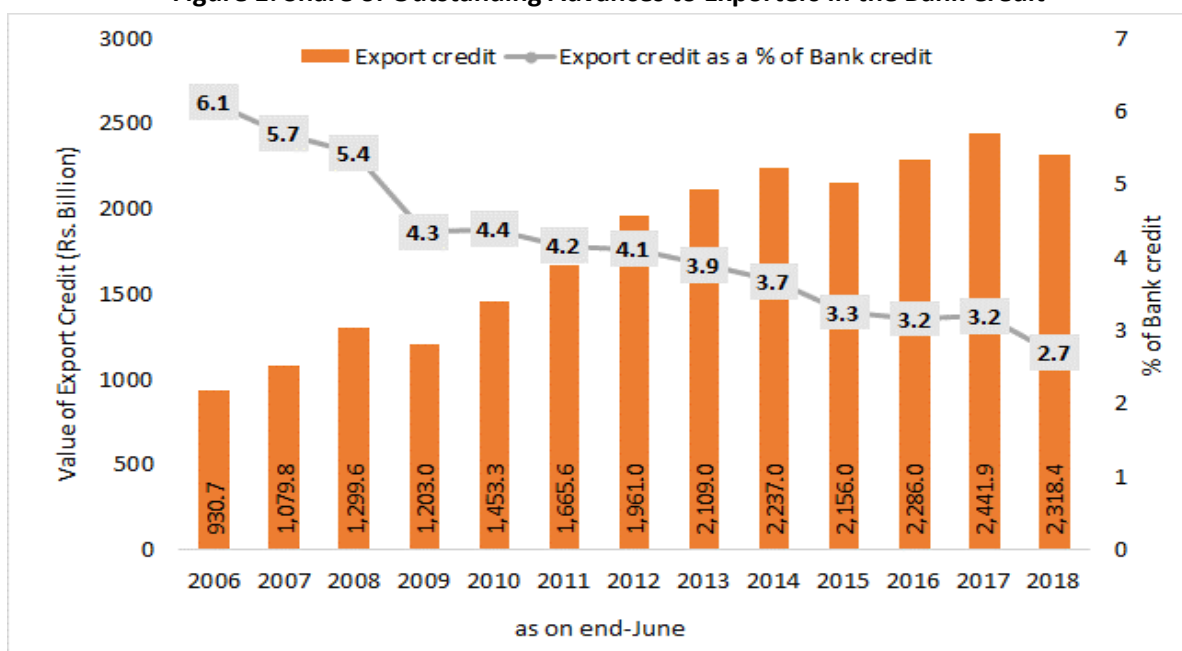
Traditionally, the Indian economy has been a bank-dominated system and banks are the primary source of pre-shipment and post shipment export finance. It is therefore a matter of concern that bank credit to the exports sector has been declining. As on end-March 2018, outstanding advances of scheduled commercial banks to exporters stood at Rs. 2388 billion, registering a y-o-y decline of (-) 4.1 percent. Outstanding advances to exporters further registered a y-o-y decline of (-) 5.1 percent as on end-June 2018. The share of outstanding credit extended by scheduled commercial banks to exporters in total bank credit has also more than halved – from 6.1 percent as on end-June 2006 to 2.7 percent as on end-June 2018 (Figure 1). It may be noted that the figures are for outstanding advances of export credit (short term), which would be revolved at least twice, maybe four times, within a year, and thus could be greater when calculated as flows. The Reserve Bank of India (RBI) however does not publish the data on actual export credit.

Table 1: Outstanding Advances of Scheduled Commercial Banks to Exporters

As on		Value of Outstanding Advances (Rs. Billion)	Y-o-Y Growth
End-March	2012	1915	14.1%
	2013	2097	9.5%
	2014	2382	13.6%
	2015	2291	-3.8%
	2016	2248	-1.9%
	2017	2489	10.7%
End-June	2018	2388	-4.1%
		2318	-5.1%

Notes :1) Data pertain to select scheduled commercial banks (excluding RRBs) which are availing export credit refinance (ECR) facility from the RBI. Since April 1, 2004, data for export credit also include five co-operative banks, viz. (i) Bombay Mercantile Co-operative Bank, (ii) Maharashtra State Co-operative Bank, (iii) Saraswat Co-operative Bank, (iv) Thane Janata Sahakari Bank and (v) The Cosmos Co-operative Bank which are availing ECR facility from RBI. 2) Export credit Refinance (ECR) Facility has been withdrawn in February 2015 and merged with the system level liquidity provision.
Source: RBI

Figure 1: Share of Outstanding Advances to Exporters in the Bank Credit



Source: RBI

The apparent decline (absolute as well as relative) in export credit has repercussion for the exports sector. The challenge of export finance is even more severe in case of MSMEs, which reportedly account for about 45 percent of manufacturing output and around 40 percent of total exports of the country, and are beset with financing bottlenecks. According to the International Finance Corporation estimates, the potential demand for India's MSME finance is about US\$ 370 billion as against the current credit supply of US\$ 140 billion, resulting in a finance gap of US\$ 230 billion (equivalent to 11 percent of GDP)¹.

¹ International Finance Corporation (2017), MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets.

Incentives for Export Credit

Low cost export credit has the potential to augment the international competitiveness of countries. Recognizing this, the Government of India has undertaken several steps to reduce the cost of export credit through the interest equalisation scheme (IES). Large sector exporters and merchant exporters of 416 four-digit tariff lines receive an interest equalisation support of 3 percent per annum. MSMEs currently receive a higher interest equalisation support of 5 percent on pre and post shipment export finance (Table 2).

Table 2: Benefits under the Interest Equalisation Scheme

Export Items	Eligible Category	Rate of Equalisation
416 four digit tariff lines	Large sector manufacturers, Merchant exporters	3% p.a.
All tariff lines	MSME sector manufacturers	5% p.a. w.e.f. 02.11.2018
Source: DGFT		

Bank lending to exports sector is further encouraged through the priority sector lending norms. Incremental export credit up to 2 percent of the Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure (OBE) is eligible for meeting the priority sector lending target of 40 percent of ANBC/ Credit Equivalent Amount of OBE (Table 3). While incremental export credit is thus “rewarded” within limits, no corresponding penalty applies to the converse.

Table 3: Priority Sector Lending: Norms for Export Credit

Domestic banks	Incremental export credit over corresponding date of the preceding year, up to 2 percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure (OBE), whichever is higher, effective from April 1, 2015 subject to a sanctioned limit of ₹25 crore per borrower to units having turnover of up to ₹100 crore.
Foreign banks with 20 branches and above	Incremental export credit over corresponding date of the preceding year, up to 2 percent of ANBC or Credit Equivalent Amount of OBE, whichever is higher, effective from April 1, 2017 (As per their approved plans, foreign banks with 20 branches and above are allowed to count certain

1 International Finance Corporation (2017), MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets.

	percentage of export credit limit as priority sector till March 2016).
Foreign banks with less than 20 branches	Export credit will be allowed up to 32 percent of ANBC or Credit Equivalent Amount of OBE, whichever is higher.

Source: Master Circular on Priority Sector Lending – Targets and Classification, Reserve Bank of India

Challenges to Export Finance & Policy Options

While there is a robust incentive structure for export promotion, the faltering trend in export credit is disconcerting. Bolstering the availability of export finance, especially in key sectors such as MSMEs, will be critical for improving the competitiveness of India's exports and propelling exports on a higher growth trajectory. Based on discussions with exporters, financial institutions, and other industry experts, some of the major challenges in export finance have been identified, and policy options have been recommended for alleviating these challenges.

Resolving Data Issues

An essential first step for assessment of the challenges to export finance would be bridging the gaps in data on export credit. As highlighted earlier, the current data on export credit is a stock variable, which does not provide information on the actual quantum of export credit disbursed by the banking system. The actual credit disbursement may be two-three times larger than the outstanding advances as export credit is short term in nature, and the same quantum of finance may be revolved several times during a year. The data is also not available at a granular level, making it difficult to undertake sector-wise analysis of export credit, as also to map whether the shortage is Rupee Export Credit or Foreign Currency Export Credit.

A systemic compilation and release of data on disbursements of export credit by the RBI would be essential for analysing the reasons for decline in export credit. Analysis of the data on disbursements can provide insights on whether the decline has been due to demand side or supply side reasons. For supply side challenges, the necessary interventions need to be in terms of improving the framework for export financing, and incentivizing supply of export finance at cost-effective rates. As the exports sector has witnessed a stagnation in the recent period, the observed decline in stock of export credit could partly be attributed to the lower levels of demand for short-term export finance. For such demand side challenges, greater focus should be on financing export capability creation rather than pre-shipment and post shipment export finance, which facilitates international trade.

The timeliness of the data by RBI also remains a concern. The latest available data on financing to exporters is available for end-June 2018, making an up-to-date assessment of the scenario of export credit difficult. In the absence of reliable data, there is a danger that policy prescriptions may go awry.

Recommendation: Data on export credit disbursements (pre and post shipment credit, currency-wise and tenor-wise) by banks and financial institutions should be recorded and regularly disseminated by the RBI. This will be essential for analysing the demand side and supply side challenges to export credit.

Lowering Cost of Credit

The IES has enhanced the competitiveness of Indian exporters vis-à-vis their counterparts in regions such as South East Asia. For continued usage of the IES, compatibility of the scheme with the WTO guidelines needs to be assessed. Several export promotion schemes have faced headwinds upon graduation of India from the Annex VII list of countries under the Agreement on Subsidies and Countervailing Measures. However, the IES has not yet been challenged, though this could easily change.

Cost of Credit in Domestic Currency

Our interactions with the exporters revealed mixed response. A section of exporters (mainly large exporters) found the interest subvention scheme reducing the cost of credit significantly. However, MSMEs, despite receiving an interest subvention of 5%, perceive the cost of credit as a challenge. According to the data from the RBI, the maximum median interest rate on pre-shipment and post shipment Rupee export credit was higher for both public sector banks and private sector banks than

their weighted average lending rates. In fact, as per the RBI data on lending rates, the maximum interest rate on Rupee pre-shipment credit (upto 180 days) was as high as 17.75 percent. At the same time, it needs to be emphasised that when export credit is availed in Rupees, the exporter has the leeway to sell forward his export receivables and benefit from the forward exchange premium, thus cutting his Rupee finance cost appreciably.

The interest rate on all bank credit, including Rupee export credit remains high in spite of the series of cuts in the repo rate by the RBI. A possible solution to the cost of export credit is to lower the funding cost via refinance, which addresses both cost and liquidity. Interest rates could be rationalized by reinstatement of the RBI's Export Credit Refinance (ECR) facility. Under the ECR, banks were provided with refinance facility to the extent of 50 percent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight. The facility was available at the Repo Rate, and was helpful in providing credit to exporters at reasonable cost. The impact of the removal of ECR facility is evident from the fact that the period immediately after the withdrawal of ECR facility was accompanied by a rise in the maximum rate of Rupee export credit by public sector banks, even though the repo continued to decline during this period. Clearly, the ECR facility played an important role in keeping the interest rate on export credit at moderate levels. The ECR facility can therefore be reinstated and a mechanism should be devised to better link the interest rates on rupee export credit to the repo rate. The ECR facility can be further complemented with a credit guarantee scheme, as highlighted later in the Note, to ensure that Rupee export credit is in the range of 7-7.5 percent.

Cost of Credit in Foreign Currency

Cost of credit is also a challenge for export finance in foreign currency. Typically, while pre-shipment credit is both in domestic currency as well as foreign currency, post shipment credit is largely in foreign currency. The IES is available for export credit in domestic currency only, and there are no concessions on export credit in foreign currency. In recent months, the USD Libor has gone up appreciably and naturally the benefit of a forward premium is negated in the case of foreign currency credit. In the absence of such support, interest rates on foreign currency export credit are prohibitive for MSME exporters. According to estimates by FIEO, the foreign currency export credit is generally available to micro and small exporters at LIBOR+ 400-600 basis points. This necessitates interest equalisation support in foreign currency as well.

For more established exporters, foreign currency export credit is available at favourable rates, and in fact the rates in foreign currency are better than the interest rates on export credit in domestic currency. However, even in case of larger players, availability of interest equalisation support can be provided to further boost their export competitiveness.

Banks have also raised concerns in relation to foreign currency lending. Their ability to access dollar funds for providing funding at pre-shipment stage is constrained. Banks are able to access dollar funds for post shipment financing under the scheme of 'Rediscounting of Export Bills Abroad' (EBR), but at the pre-shipment stage the dollar funding remains scarce and expensive.

For reduction of interest rates on foreign currency export credit, the RBI could consider extending a special window facility to commercial banks. It should be noted that the foreign exchange reserves held by the RBI at USD 430 billion as of July 05, 2019, are over seven times the Current Account Deficit for 2018-19 (USD 57 billion); as such a part of the reserves can comfortably be placed with Indian banks at rates that are lower than market borrowing costs while still earning the RBI a better deployment yield than US treasury securities, and without in any way impairing the country's external position. Under this special window facility, RBI can lend foreign currency resources to banks at lower rates for on-lending to exporters. On the foreign currency funding provided by banks through this special window, an interest subvention of 1-1.5 percent can be provided. This will substantially reduce the cost of foreign currency export finance.

Recommendation: Reinstatement of the ECR facility and linking this with the repo rate can help moderate the interest rate on rupee export credit. A special window facility could be launched by the RBI for providing dollar funds to banks for foreign currency financing, especially at the pre-shipment stage. This could be complemented by interest subvention of 1-1.5 percent on the foreign currency pre-shipment and post shipment credit. The special window facility and interest subvention on foreign currency export credit can significantly reduce the cost of credit.

Credit Insurance/ Guarantee Scheme

The role of insurance and guarantee facilities in enhancing competitiveness of exports cannot be over-emphasized. Currently, cover from ECGC Ltd. and the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) is instrumental in mitigating the risks associated with export finance. The role of ECGC Ltd. is evident from the fact that the 34 banks that enjoy cover from ECGC Ltd. extend more than 60 percent of export credit advances of the country. The maximum cover available from ECGC under any policy for export credit is 90 percent, but the effective cover is typically lower than this. The extent of guarantee cover under CGTMSE is 80 percent.

Both CGTMSE and ECGC do not provide insurance for the entire amount on account of the principle of risk sharing in insurance business. The credit insurer does not indemnify 100 percent of the losses incurred by the insured, but a certain mutually agreed percentage of the losses, thus envisaging that the insured has a reasonable stake in the export transactions.

The cover provided by CGTMSE and ECGC is often insufficient to provide necessary comfort to the banks who are extra-wary of bad loans. This entails higher collateral requirement by the banks, and compliance cost also accordingly increases. The export financing framework needs to ensure that short term export credit is extended against insurance/ guarantee cover, along with hypothecation of the stocks of the exporter only. For this, the insurance/ guarantee cover needs to be strengthened.

Further, the insurance/ guarantee cover should also be available in foreign currency. ECGC, as per IRDA norms, cannot extend cover in foreign currency. This entails additional hedging cost for exporters. Insurance cover in foreign currency can significantly reduce the transaction costs for exporters.

It may be noted that in the past, the Government had launched a fund, namely the National Export Insurance Account, for providing cover for MLT exports from the country. A need is felt for a similar fund for short term export credit in foreign currency. The focus of the fund can be on MSME exporters only. Special dispensation needs to be accorded by IRDA to ECGC Ltd. for providing cover in foreign currency under this fund. Regulatory supervision for this particular foreign currency cover can be provided by the RBI, which is also the regulator for export credit in the country. It is further proposed that cover to the extent of 90-95%, or even 100% percent can be provided on principal and interest payments through this fund. Such high coverage ratio, along with the ECR facility, can bring down the cost of export credit. As a measure of credit discipline, and to encourage better credit risk appraisal, banks whose claim ratio exceeds the industry average by (say) 10% may be levied a premium surcharge.

Recommendation: *Special credit guarantee scheme can be launched for providing cover in foreign currency to the extent of 90 percent to MSME exporters. The scheme, along with reinstatement of the ECR facility, could lower the cost of export credit.*

Establishment of Trade Credit Facility

A Trade Credit Facility (TCF) can be established to support short-term exports, something similar to the lines of credit (LOCs) extended by the Export-Import Bank of India (Exim Bank). Under the proposed facility, Exim Bank could extend LOCs to overseas banks and financial institutions to enable overseas buyers to import from India. A Sinking Fund can be set up by the Government and administered by Exim Bank to absorb the credit default risk in such transactions. Alongside, interest subvention can be provided to Exim Bank to support concessional financing provided under the TCF.

The TCF can be extended to financial institutions in key markets such as Africa, South Asia, South-East Asia, CIS and Latin America to facilitate diversification of exports to these countries. It is envisaged that the cost of export transaction (due to LC reconfirmation by another foreign bank) would get reduced, thereby increasing the competitiveness of Indian exporters.

Recommendation: *Short-term lines of credit can be extended to overseas banks and financial institutions under TCF to enable overseas buyers to import from India.*

Encouraging Factoring Business

Export factoring is a package of financial products consisting of working capital finance, credit risk protection, maintenance of sales ledger and collection of export receivables from the buyer located in overseas country. Factoring provides adequate, collateral free, and easy finance, coupled with full credit protection to exporters on undisputed export bills. In spite of its advantages and its quotidian use in many countries like the USA, factoring has failed to take off in India, and in fact export factoring accounts for only 10 percent of the factoring volumes in India.

Large exporters route their business through their overseas subsidiaries whereby they can avail non-recourse factoring at better rates. The inability of MSME exporters to adopt a similar model affects their access to transaction oriented financing offered by factoring companies. In this context, the Trade Receivable Discounting System (TreDS), an online bill discounting platform, has helped MSME in raising funds by selling their receivables to corporates. However, TreDS has a rigid structure and does not provide the full benefits of a non-recourse factoring service.

Factoring business in India suffers on account of several regulatory challenges, which are explained in the subsequent section. These regulatory challenges, coupled with low volumes, lead to high cost of factoring services in India. Experts attribute the high factoring services cost in India to the low volume of business and regulatory hurdles.

Exporters are considering the high factoring services fee as major deterrent to avail the services. In order to promote the non-recourse factoring business, a subsidy of 1.5-2 percent may be provided to the exporters for availing the factoring services. Such subsidy can be provided at least till the time regulatory hurdles are addressed, and substantial volumes are generated, which leads to reduction in the cost of international factoring.

Recommendation: *Subsidy on the factoring services fee can be provided to select exporters for availing export factoring services.*

Regulatory Issues

Insurance

As highlighted earlier, ECGC is not permitted to provide cover in foreign currency, under the existing IRDA norms. In contrast, globally, Export Credit Agencies provide cover in foreign currency, which reduces the hedging cost incurred by exporters, and improves their export competitiveness. In line with the international practices, ECGC may be allowed to provide cover in foreign currency. A special dispensation could be provided by IRDA for providing such cover. Further, since ECGC is solely in the business of export credit insurance, it may be considered for being regulated by RBI instead of IRDA.

Factoring

Several regulatory issues also plague the factoring business in India. Some of the recommendations based on the global best practices are mentioned below. Adoption of these best practices could lower the cost of factoring business in India.

- **Capital Adequacy:** There are no specific capital adequacy norms for NBFC- Factors, and therefore Systemically Important Non-Banking Financial (Non-Deposit Accepting or Holding) Companies Prudential Norms (Reserve Bank) Directions, 2015 are being followed by these companies. It is recommended that receivables purchased on a non-recourse basis should carry a lower risk weightage if the receivable is assumed by the overseas counterparty. Currently, such receivables entail a risk weight of 100 percent, but as per international practice, this may be lowered to 50 percent or even lower if the counterparty is an investment grade bank/ factoring company/ financial institution.

- **NPA Classification:** Currently, receivable acquired by an NBFC- Factor which is not paid within 90 days of its due date is treated as a Non-Performing Asset (NPA) irrespective of when the receivable was acquired by the NBFC- Factor or whether the factoring was carried out on “with recourse” basis or “non-recourse” basis.

- In recourse factoring, the NBFC- Factor purchases the receivables on a recourse basis. Here, the Factor fixes a recourse period, which is a grace period after the due date of the receivable during which time the NBFC-Factor attempts to collect the receivable from the buyer. In case money is not forthcoming from the buyer, the NBFC- Factor raises a demand on the Client to pay back the funded amount at the end of the grace period. Since the demand is made to the Client on the Recourse Period, NPA provisioning norms for the Client should start from that day, and if money is not paid by the Client within 90 days from this demand, Client should be classified as an NPA. To prevent misuse of this demand period, it is recommended to cap the grace days to a maximum of 60 days.

- In non-recourse factoring, if the NBFC- Factor takes the buyer credit risk on themselves, provisioning norms should start from the due date of the receivables, but if the NBFC- Factor covers the buyer through an overseas correspondent factor or an insurance company, NPA norms should be applicable from the date on which demand is made on the Correspondent Factor or Credit Insurance. To prevent misuse, maximum period for such demand should be within 180 days from the due date of the receivable.

- For interest, fees and charges payable by the client, there should not be any grace days.

- **Declaration of Wilful Defaulters:** NBFC-Factors regulated by RBI should be considered as eligible institutions to declare a borrower as a wilful defaulter.

- **Provisioning Norms:** NBFCs are required to make a provision for standards assets at 0.40 percent. There should be different guidelines for NBFC-Factor for non-recourse factoring where an overseas correspondent factor or a credit insurer covers the credit risk. The credit cover obtained by NBFC-Factor and given to the clients, is similar to the cover obtained by exporters under ECGC Guarantee. Furthermore, credit risk is insured and loss of default is low as the correspondents or credit insurers are reputed institutes. Hence, lower provisioning norms may be considered for non-recourse factoring.

Regulations pertaining to Exporters

- **Self-extension Clause:** As per RBI Circular no 40 dated December 03 2003, all exporters were allowed (including Status Holder) to write-off (including reduction in invoice value) outstanding export dues, and extend the prescribed period of realization beyond 180 days or further period as applicable, provided, the aggregate value of such export bills written-off (including reduction in invoice value) and bills extended for realization does not exceed 10 percent of the export proceeds due during the calendar year, and such export bills are not a subject of investigation by Enforcement Directorate / Central Bureau of Investigation or any other Investigating Agencies. But self-extension of outstanding invoices has now been discontinued and exporters have to apply to the AD bank for extension of period of realization beyond 180 days. RBI could consider reinstating the self-extension clause.

- **Outstanding Extension:** Currently exporters have to make an application to the AD Bank for extension of time period by 6 months for payments which are outstanding for more than 9 months in EDPMS. The realization period may be extended to 1 year in line with GST requirements and further extension could be allowed for another 9 months.

- **Change in normal transit period for shipments to North and South America:** While the transit period is not related to the arrival of goods at the destination, the general tendency of buyers is to make payment only when goods arrive in their country. The voyage time for export of goods from India to Latin American countries or to Mexico/Canada is generally between 45 to 60 days. It is, therefore, suggested that FEDAI guideline for the transit period may be changed from 25 days to 60 days.

Recommendation: Streamlining the regulatory issues as above.

Digitization of the Export Credit Process

Digitization has truly transformed the Indian banking sector. Fintech revolution has been seen across various verticals including payments, lending, security/ biometrics and wealth management. Technology has the capability to significantly reduce the cost of credit delivery for banks and thereby lead to a reduction in the overall cost of credit. A time bound, digitized process flow needs to be developed for processes relating to export finance. Not only will this accelerate the credit delivery process, but the export related service charges at various stages such as bill negotiation, inward remittance, etc. will be rationalized through such an approach.

Several steps have been taken in this direction, including the introduction of the Export Data Processing and Monitoring System (EDPMS). However, there are several challenges in the system. For example, the AD code in shipping bill may be different from the AD code of the bank to which documents have been submitted, and in the current system, the shipping bills remain pending for the banks which have not handled the document. Moreover, for uploading corrections, the exporters have to depend on Customs only. Failure to record export proceeds with banks not only creates problems in terms of getting refunds like drawbacks, but also entails possibility of action from the Enforcement Directorate. The issues pertaining to EDPMS need to be addressed for greater digitization of trade transactions, and concomitantly easier export financing processes. Exporters need to be provided access to the EDPMS system. A single integrated system can also be established which integrates the customs e-filing system with the export data processing system (i.e. EDPMS). This will help in digitizing the entire supply chain of exports and export financing. Various stakeholders could also jointly work on development of technology such as block chain/ distributed ledger technology in order to remove inefficiencies from the process.

Alongside, the GST refund process also needs to be streamlined. According to exporters, there are several months of delays in GST refund, which is affecting their working capital cycle. Streamlining the GST refund process can improve the liquidity position of exporters. Currently, the facility of automatic refund is available to those exporters who have paid Integrated Goods and Services Tax (IGST) while exporting goods. Since the GST Network (GSTN) systems are integrated with Customs, hence, refunds are generally transferred to the bank accounts of such exporters in relatively less time. However, manufacturing exporters and suppliers to SEZ, who want to claim a refund of Input Tax Credit, have to file an application in Form GST RFD-01A on the common portal and thereafter manually submit a print out of the form along with other documents to the jurisdictional officer. Automation of these processes can improve the process flows.

Recommendation: Digitization of processes relating to export credit / realisation of export proceeds can help rationalize the associated service charges. The Government can also encourage integration of the customs e-filing system and EDPMS. Alongside, automatic GST refund system is also needed for exporters and suppliers to SEZs.

Amendments in the Priority Sector Lending Norms

As outlined earlier, incremental export credit is currently eligible for inclusion in the priority sector lending (PSL) targets of banks. However, there is no mandatory sub-target for export credit. The Government has set up four All India Financial Institutions, viz. Exim Bank, National Bank for Agriculture and Rural Development, National Housing Bank, and Small Industries Development Bank of India, in key developmental areas of exports, agriculture, housing and micro and small enterprises, respectively. Of these critical developmental areas, agriculture and micro and small enterprises have mandatory lending targets under the priority sector lending norms.

Exports were also part of the mandatory PSL target for foreign banks but as per the new guidelines, the export book of foreign banks with more than 20 branches lost its PSL status in December 2017. It is important to note that export financing by the three large foreign banks constituted 61 percent of total PSL eligible export credit of Rs. 424 Billion² in Mar'16. After the new guidelines, nearly Rs. 261 Billion³ of export credit gradually became available at a higher price to Indian exporters thereby reducing their competitiveness vis-a-vis their global peers. Most of this export credit was extended in foreign currency. The interest cost differential between PSL eligible export book vis-à-vis ineligible export book was in the

range of 1.50-2.00 percent (depending on the prevailing hedging cost). The impacted foreign banks have a significant presence in India's major trade corridors, i.e. India-China/Hong Kong, India-Europe/ the UK and India- the USA. The disallowance of exports from PSL has impacted availability of low cost financing for these trade corridors.

The outstanding exports book under PSL started declining after December 17. According to the report on 'Impact of Banking Misappropriation on Trade and Industry' presented to the Rajya Sabha on August 6, 2018⁴, export credit which is part of the priority sector lending registered a decline of 24.4 percent at the end of fiscal 2017-18.

Given a consistent decline in credit to exporters in the recent time, as also the importance accorded to finance in driving export growth, the RBI could consider prescribing a sub-target for export credit within the existing 40 percent target for priority sector lending (PSL).

Export credit is perhaps a more lucrative business proposition than other priority sector lending areas, and a flexibility in PSL norms can help commercial banks perform potentially better in terms of meeting the targets. According to the RBI, public sector banks have been continuously underperforming on the overall lending target of 40 percent for priority sectors, while private banks have lent more than the mandatory PSL target in the recent years. Specifically in context of export credit, while incremental export credit up to 2 percent of ANBC or credit equivalent amount of balance sheet exposure is eligible for meeting the PSL targets, it accounted for only 1.74 percent of the priority sector lending.

In order to improve the credit flow for exports, the RBI could consider prescribing a target – 5 percent of the ANBC/OBE of commercial banks as export credit (Table 4). As access to export credit might especially be a constraint in the agriculture and allied activities and MSME segments, a sub-target can be defined for export credit to these sectors within the existing PSL targets for these sectors. The target for agriculture sector currently stands at 18 percent of the ANBC/OBE, while the target for micro enterprises is 7.5 percent. Within this, a sub-target of 2 percent in case of agriculture, and 1 percent in case of micro enterprises could be set by the RBI for export transactions. Another 2 percent of mandatory priority sector lending could be prescribed for export credit under other categories.

Table 4: Recommended Priority Sector Lending Targets for Export Credit

Segment	Priority Sector Lending Target (% of ANBC/OBE)
Agriculture	2% [within the existing 18% target for the sector]
Micro Enterprises	1% [within the existing 7.5% target for the sector]
Export Credit to all other sectors	2%
Total	5%

Inability to meet the PSL targets could necessitate contribution by respective commercial banks to a fund, to the extent of the shortfall in stipulated priority sector lending towards export credit. As a measure for disincentive for non-achievement of the target for priority sector lending to exports, the rate of interest for the contribution made by banks to this fund could be in inverse proportion to the extent of shortfall in the lending vis-à-vis the target. This structure is similar to the structure of the RIDF currently maintained by NABARD. The amounts so collected in the fund could be used for meeting the requirements of the proposed special guarantee scheme for short to medium term export credit, or for extending short-term lines of credit under the proposed TCF.

Recommendation: *The RBI can set priority sector lending target of 5 percent for export credit. Shortfall in meeting the target can entail contribution to a fund which could be used for meeting the requirements of the aforementioned special guarantee scheme or for the proposed Trade Credit Facility.*

² RBI website

³ Citi: INR 104Bn; SCB: INR 85Bn; HSBC: INR 72Bn

⁴ http://164.100.47.5/committee_web/ReportFile/13/97/146_2018_8_11.pdf

Countertrade Arrangements for OFAC Countries

The embargo/ OFAC sanction countries also present considerable opportunities for Indian exporters. However, banks and financial institutions are reluctant to deal with export documents or issue e-BRC pertaining to sanctioned countries, as this could lead to secondary sanctions. Secondary sanctions penalize third-country individuals and companies for dealing with sanctioned countries.

As banks are wary of facilitating such transactions, the possibility of countertrade arrangements can also be explored with embargo/ sanction countries. Countertrade refers to the exchange of goods and services in whole or part, with other goods and services as payment, rather than with money. Such a system can alleviate currency and/or payment risks for exporters. Several of the countries facing embargo/ sanctions are resource-rich and a countertrade arrangement with these countries can bridge the yawning chasm in India's energy demand and supply. The arrangement can also be extended to high risk countries, wherein exchange rate fluctuations can adversely impact export realizations.

A countertrade arrangement policy needs to be formulated, which defines the list of goods which can be traded under the arrangement with a pre-defined set of countries. Different barter channels can be identified in existing ports for the products traded under these arrangements.

Recommendation: *Definition of countertrade arrangement policy and systems, and identification of barter channels in existing ports, can alleviate the need of banking channels for trade with sanction/ embargo countries.*

Gold Card Scheme

Creditworthy exporters with good track record are eligible for benefits under the Gold Card Scheme. Under the scheme, banks can provide in-principle limit for export credit to exporters for a period of three years with a provision for automatic renewal subject to fulfilment of applicable terms and conditions. Gold Card holders are given preference in granting of packing credit in foreign currency, and the cost and time for availing export credit is reduced significantly.

The Gold Card Scheme can be further revamped with easier norms. Further, processing fee/ services charges/ ECGC premium should not be levied for customers under the Gold Card Scheme. Provisions can also be made for not charging overdue interest rate upto 60 days from Gold Card holders.

Recommendation: *Benefits under the Gold Card Scheme should be enhanced. Easier qualification norms can be recommended.*

Caveats:

A couple of caveats may be entertained in the context of the above.

- First, challenges at the WTO, on the ground of India's graduation from Annex VII status of the ASCM may be anticipated with high degree of confidence. While India has been arguing for a phase-out period, there is no clarity on how long (if at all) such phase-out period may be permitted. In any case, newly introduced subsidy measures would be the first target. Work needs to be done urgently on suitably substitution of the IES and related measures with alternative measures that yield similar benefit but do not contravene the WTO norms. For instance, the funds budgeted for IES could actually be deployed to cover the premium on (say) 95-100% risk cover by ECGC of export credit. This would cease a fund transfer to the exporter but would appreciably reduce the cost and enhance the availability of export credit. Since the premium for export credit insurance is materially lower than the IES, the same fund outlay could lead to a multiplier effect of over three times in efficacy of fund use.

- Second, while the paper focuses on export credit, it needs to be understood that this is only a symptom rather than the disease. Illustratively, for an export order of Rs. 100, pre-shipment credit would typically be for 60% of the order value for (say) 90 days and post-shipment credit would typically be for 100% of the order value for (say) 90 days. Thus the average credit would typically be 80% of the order value for (say) 180 days. Assuming an interest rate as high as 12%, the finance cost of the export order of Rs.100 would be just Rs.4.80. Thus finance cost as a percentage of the export value would be just 4.5%. Even if it were somehow possible to cut the cost of export credit by half, the impact on invoice pricing would be minor. While the paper addresses this 4.5%, it is necessary to also examine the balance 95.5%, comprising raw materials, technology, labour, marketing etc.

Annexure 5.8

Need to Establish
Financial Grid

Taking forward PMJDY

Charan Singh

Introduction

Financial inclusion is a process that enables improved and sustainable economic and social development of the country. It focuses on raising the standard of living of the underprivileged people in society with the objective of making them self-sufficient and well informed to take better financial decisions. Also, it acknowledges the participation of low income groups based on the extent of their access to financial services in economic growth.

The aim of financial inclusion is delivery of financial services to low income groups with the provision of equal opportunities. This effort is just not for altruistic purposes but in national interest. In this context, it would be useful to visit the basics of banking. A bank is a financial intermediary collecting money from depositors and lending to borrowers to invest in productive activities. In the process of investment, jobs are created, growth occurs and the nation progresses. More importantly, while granting loans, bank not only scrutinizes loan proposal but also guides the investors in relevant areas for undertaking a successful venture, as after all, banks money, collected through millions of depositors, is at stake. Thus, a bank plays an important role in helping realize the personal ambition of the investor, in a safe and sustainable manner.

In an emerging country like India, national priorities focused on development and growth, could differ from personal ambitions. Therefore, it is in national interest that while individual citizen progresses, national priorities are also achieved. Hence, convergence of personal and national priorities could help in achieving faster growth. The banking system, given the army of trained and dedicated bankers, can help in this endeavor, by identifying commercially viable projects at individual level that also will help fulfil the macro economy requirements of India.

To lend money for productive purposes there has to be deposits in the bank. So, deposits and loans are co-related and banks make profits from this intermediation. It has been observed that a large amount of financial resources are outside the banking system, sometimes in the informal sector, and gets wasted in fruitless activities, given that national priorities are waiting to be completed for want of finances. In fact, many people keep cash which does not earn interest while others, due to lack of awareness invest in risky avenues and lose their savings, sometimes hard earned and life time savings.

It is in this context that the Government of India has been making efforts to provide safe and robust avenues for savings of the people. On August 15, 2014, the Prime Minister placed the extension of banking facilities across the country, irrespective of income status, as a top priority while making his maiden speech from ramparts of Red Fort. The opening of 36 crore of accounts, of which 80 percent were opened by public sector banks, under the PM's Jan Dhan Yojana (PMJDY), is an effort in that direction. There are 60 percent of Jan Dhan Accounts (JDAs) in rural areas while females account of 53 percent of JDAs. The Prime Minister has also announced a number of financial schemes which can benefit the weak and financially excluded (Annex - 1).

The bank accounts, Jan Dhan and others, are like pillars on which a financial grid can be established to provide great opportunity for individuals, bankers, and the nation, and that potential has to be tapped. *Financial Grid would imply establishing a network of banking services and products, integrated with bank accounts so as to serve as a conduit for collection of deposits and disbursement of loans, in pursuit of national priorities.*

Tapping the Potential of bank accounts, especially under PMJDY

To tap the potential of accounts, especially under PMJDY it would be helpful to understand the challenges being faced by the depositors. Amongst many, few need consideration –

- a) Low penetration of banks -There is lower percentage of new bank branches opened in the unbanked areas and lower percentage of accounts with overdraft facility. Illustratively, there are only about 90,000 bank branches in rural areas while there are 6,00,000 villages.
- b) Need for greater use of technology –The hand-held devices lose connectivity and deter the customers as well as BCs. On the operational side, despite the convenience offered by ATMs in providing banking services, the debit card penetration continued to be low with only 30 per cent of deposit account holders having a debit card.
- c) Demand Side Factor - Factors such as lack of awareness about financial products, perceivably unaffordable products, high transaction costs, products which are not convenient, inflexible and not customized; and of low quality are the major barrier for gaining access to the financial system.
- d) Differently abled and Senior Citizens -There is need to address lack of financial inclusion among differently abled and senior citizens of the country.
- e) Convenience of availability of money, when required, especially during emergencies. As money is not readily available, people still depend on money lenders.

The Road map to Establish Financial Grid

The commercial viability of PMJDY has been established with Rs.1 trillion collected in the accounts. In the next few years, rural economy, where most of accounts have been opened, financial revolution is expected with doubling of farmer's income. Also, the country is heading for US\$ 5 trillion and hence banking has to play a more prominent role, both in urban and rural areas. Hence, the banks need to prepare for it. The detailed road map is in Annex 2 while broad policy recommendations to be considered to improve the extent of financial inclusion are –

Commercial Viability through instruments by bankers

Success of financial inclusion depends upon commercial sustainability of operations and not on subsidies and incentives. Therefore, to achieve sustainability, generating volumes through suitable instruments is necessary. Hence the following can be considered in general, and with special focus on PMJDY -

- a. Jan Dhan accounts should be leveraged for furthering Mudra loans, stand-up and start-up schemes
- b. The insurance and pension schemes, especially those announced by the Central Government like Jeevan Jyoti, Jeevan Suraksha, Atal Pension, etc, should be linked to each of Jan Dhan accounts.
- c. Create a credit card, with upper limit of Rs. 5,000 only, given that direct transfer by the Government is Rs.6,000 annually.
- d. MSME loans, especially for micro industry, should be linked to Jan Dhan Yojana
- e. SHGs and MFIs have extensive presence across the country and should be linked to Jan Dhan accounts
- f. Banks should create demand-oriented savings, credit and remittance products that are customized to lifestyle pattern and income streams of the population they are aiming to serve. Illustratively, girl child fixed deposit schemes can be offered to tap money under DBT.

Financial Literacy

- a. There is a need for expansion of counseling and advisory services on financial literacy in order to enhance banking activities, especially amongst vulnerable sections.
- b. There is a requirement to tailor different literacy and counseling mechanisms, including entertainment, depending upon the need of different segments of society. In this context, literature in different languages and different medium, including print and electronic, needs to be considered.

Differently abled and Senior Citizens

- a) Audio guide and Braille support in ATMs/ Banks for Instructions
- b) Reverse Mortgage Schemes can be considered

Technology and ATMs

- a. Incentivizing usage of Plastic cards and e-commerce in the economy.
- b. Mobile banking has tremendous potential, and benefits of mobile-commerce need to be explored to enhance banking penetration. The JAM framework needs to be strengthened
- c. TV can be helpful in spreading banking culture and financial literacy.
- d. There is a need to focus on synergy between post-offices and ATMs. ATMs could be opened in post offices, numbering nearly 1,40,000 in rural areas.
- e. Provision of electronic card reading machines could also be considered in post offices and business premises, especially in rural areas to facilitate transactions.

Regulation and Supervision

There is a need for regulating the formal and informal financial institutions who are competing for collecting savings of rural people and offering credit.

Conclusion

The banking system with wide-spread reach should increasingly serve as conduit to channel resources for investment purposes. The spreading of financial network across the country, right up to the door-step of beneficiaries, either through BCs or through internet, should help tap resources for meeting national priorities. The proposals in the Note aim at changing the behavioral pattern of people in general, and those covered under PMJDY. By offering them basic instruments of banking like credit cards and also ATMs and POS, where such cards can be used, the customers can appreciate the ease of banking facilities. The extension of social security schemes would help in building confidence and credibility of banking in minds of accountholders to motivate them to deposit their savings in bank accounts.

The creation and laying of a national financial grid, especially in the rural areas, and for people with Jan Dhan accounts can be expected to unleash the creative potential in the economy and provide easy finance to convert ideas into manufactured products for the markets. This will benefit the banks with more business and profits. The objective of "Make in India" is expected to be strengthened by inclusive growth yielding higher employment and output for the economy. This will be in the true spirit of *Sabka Sath, Sabka Vikas, and Sabka Vishwas*.

Appendix- 1

Select Schemes of the Government of India

Pradhan Mantri Mudra Yojana

Pradhan Mantri Mudra Yojana (PMMY) is a scheme launched by the Prime Minister along with the launch of Micro Units Development and Refinance Agency Limited (MUDRA), on April 8, 2015 for providing loans up to 10 lakh to the non-corporate, non-farm small/micro enterprises. These loans are classified as MUDRA loans under PMMY. These loans are given by Commercial Banks, RRBs, Small Finance Banks, Cooperative Banks, MFIs and NBFCs. MUDRA loans are extended in three categories based on the size of the loans. They are:

1. Shishu loan (Loan up to Rs.50,000)
2. Kishor loan (Loans from Rs.50,000 to Rs.5 lakh)
3. Tarun (Loan from Rs.5 lakh to Rs.10 lakh)

Stand up India

The Prime Minister launched Stand up India in his Independence Day address on August 15,2015 to promote entrepreneurship at grassroot level for economic empowerment and job creation. The scheme facilitates bank loans between Rs.10 lakh and Rs.1 crore to at least one Scheduled caste and scheduled tribe borrower and at least one woman borrower per bank branch for setting up a green-field enterprise. This enterprise maybe in manufacturing, services or trading sector. In case of non-individual enterprise at least 51 percent of shareholding and controlling stake should be held by either an SC/ST or women entrepreneur.

Social Security Schemes

The flagship scheme, Atal Pension Yojana (APY) will provide old age income security to working poor in unorganized sector while addressing longevity risks amongst workers constituting nearly 88 per cent of total labor force of 47 crore. The APY would provide fixed monthly pension of Rs.1, 000, 2,000, 3,000, 4,000 and Rs.5,000 respectively from the age of 60 years depending on contribution. The amount of monthly contribution would have to be paid through a bank account.

The Prime Minister had also announced the Jeevan Jyothi Bima Yojana (PMJJBY) in May 2015 providing a one year cover, renewable annually, while offering life insurance for death. The scheme again envisages a savings bank account and will be administered through life insurance companies in arrangement with banks.

The third scheme is the Pradhan Mantri Jeevan Suraksha Bima Yojana or accident insurance scheme, renewable annually, providing insurance to cover death or disability on account of an accident. The scheme will be operated through general insurance in arrangement with banks. All savings bank account holders are eligible to join and the premium of Rs.12 per annum will be shared between insurance company, agent and bank.

The Pradhan Mantri Jan Arogya Yojana

The Pradhan Mantri Jan Arogya Yojana (PMJAY) scheme was rolled out on September 23, 2018. It aims to provide financial protection to 10.74 crore deprived rural families and select occupational categories of urban workers as per the latest Socio-Economic Caste Census (SECC). It will offer a benefit cover of Rs.500,000 per family, annually. To ensure that nobody is left out (especially girl child, women, children and elderly), there will be no cap on family size and age in the Mission. The scheme is envisaged to be cashless and paperless at public hospitals and empanelled private hospitals.

Scheme for MSMEs

On November 2, 2018, the Prime Minister announced special scheme for Micro, Small and Medium Enterprises (MSMEs). The scheme allows easy access of credit to MSMEs who have a GST account. Further, the Prime Minister announced that the MSMEs should have social security as a fall-back mechanism through opening of Jan Dhan accounts and insurance products. The Prime Minister's efforts to help MSME sector will enhance financial inclusion in country as there are 6 crore MSMEs employing nearly 12 crore workers.

Appendix- 2

Roadmap to achieve Financial Grid to tap benefits from PMJDY

Branch Manager - *Monthly Statement, IT enabled, to the HQs* (Tabulated in Annex - 3)

To link Jan Dhan accounts and general accounts with the following schemes –

a) Insurance Schemes

- PMs Jeevan Jyoti
- PMs Jeevan Suraksha
- PMs Jan Arogya

b) Mudra Loans

- Shishu loans
- Kishor loan
- Tarun Loan

c) Atal Pension Yojana

d) MSME Loan

e) SHGs

f) MFIs

g) Rupay Cards

h) Other Schemes announced by the Bank or the Government

Bank Management – *To monitor the progress of Financial Grid*

a) Fix and Monitor Quarterly Targets to achieve progress of Financial Grid

b) Annual data in Financial Grid to be presented in the Annual Report

c) Achievements in Financial Grid to be part of Annual Review of the Employee

d) Contribution in Financial Grid as a criteria in Promotion especially from AGM onwards

e) To strengthen BC system

- f) To tap FinTech companies to promote digital transactions
- g) To explore possibilities of spreading the network of ATMs, especially in rural areas
- h) Issue of Credit Cards with Jan Dhan accounts or extension of credit facility in Rupay Cards
- i) Consider, operationalizing and monitor OD facility in Jan Dhan accounts
- j) Financial Literacy Campaign in terms of vernacular media – print and electronic, street plays, theatre and dramas, and other entertainment
- k) Training of people, branch and zonal managers, in soft skills to handle Jan Dhan accounts and weak customers

Bank's Board– *To monitor the Progress*

- a) Quarterly Statement to be submitted to Board
- b) Monitor policies on BCs, FinTech companies
- c) Progress to be part of annual evaluation of ED and MD by the Board

Reserve Bank of India

- a) Progress of Financial Grid to be part of the Inspection Reports of each respective bank
- b) Annual data on Progress of Financial Grid to be analysed in Report on Trend and Progress of Banking in India – Statutory Report
- c) Circular to all Banks that progress of Financial Grid to be facilitated and taken up on Mission Mode
- d) To permit issue of Credit Card with outstanding limit upto Rs.5,000.
- e) To advise IDRBT, Hyderabad to help develop Hand Held devices to retain connectivity
- f) To seek advice from IDRBT, Hyderabad and engage FinTech companies to develop appropriate tools for domestic banks to monitor development in Financial Grid
- g) Exploring possibilities of having ATMs in premises of Post Offices
- h) Ensuring availability and sale of POS machines in large numbers across the country
- i) Financial Literacy Campaigns in national dailies and electronic media

DFS, GOI

- a) Quarterly Monitoring of each bank on progress of Financial Grid
- b) Financial Grid as an Important Criteria in selection from GM to ED and from ED to MD

Appendix- 3

Monthly Statement to be filled by each branch

	Jan Dhan Accounts		General Accounts		Total	
	No.	Amount	No.	Amount	No.	Amount
<i>Insurance</i>						
Jeevan Jyoti						
Jeevan Suraksha						
Jan Arogya						
<i>Mudra</i>						
Shishu						
Kishor						
Tarun						
Atal Pension						
MSME						
SHG						
MFI						
RuPay Card						
Other Schemes <i>(announced by the Government or the respective bank)</i>						

Annexure 5.9

Enabling Bank Credit
Towards a
\$5 Trillion Economy

Soumya Kanti Ghosh
SBI

Contents

Section 1: Credit Requirement for \$5 trillion Economy

Section 2: Issues to be tackled to reach \$5 Trillion Economy

2.1: Asset Quality and Infrastructure Financing

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2.3: Capital Requirement

2.4: Corporate Governance and Risk Management

2.5: HR issues

2.6: NBFC sector

2.7: MSME

Section 3: Reinvigorating Private Sector Investment

Section 4: Summary of Key Recommendations

Section 1:

Credit Requirement for \$5 trillion Economy

- India is now the 6th largest economy in the world and is on its way to become \$5 trillion economy by FY25, based on an assumed 12% nominal GDP growth and 5% depreciation in Rupee. India remains a promising story of growth at scale – taking continuously shorter spans to add each subsequent trillion dollars of GDP.

- China doubled its GDP in 4 years and quadrupled it in 8 years! Chinese economy's structural transformation initially began in rural China, propelled by massive thrust to infrastructure. India is poised to spend a massive Rs 100 lakh crore on infrastructure over the next 5 years!

Towards a \$5 Trillion Economy			
Year	Nominal GDP (Rs Lakh Crore)	Exchange Rate	GDP in \$ Trillion
FY19	190.1	69.9	2.7
FY25	375.2	73.3	5.1
Growth (%)	12.0	4.9	-

Source: SBI Research

Based on the trend growth, to support the \$5 trillion economy, we estimate that outstanding bank credit needs to grow to Rs 188 lakh crore in FY25 from Rs 97.7 lakh crore in FY19, with an increase in incremental credit of Rs 90 lakh crore during FY20-FY25. PSBs could potentially supply at least Rs 55 lakh crore of credit and Rs 75 lakh crore of deposits mobilization in this period. For this banks need to drive credit growth in agriculture, MSME, exports, retail, infrastructure and construction.

Sector-wise Incremental Credit Requirement	
Sector	Incremental Credit
Agriculture	Rs 8-10 lakh crore
MSME and Exports	Rs 18-20 lakh crore
Infrastructure & construction	Rs 10-12 lakh crore
Retail	Rs 25-28 lakh crore

Section 2:

Issues to be tackled to reach \$5 Trillion Economy

2.1: Asset Quality

- During 2008-14, banks in general and PSBs in particular had financed infrastructure projects in a big way. During this period, the All Scheduled Commercial Banks (ASCBs) credit increased by a CAGR of 17%, while credit to infrastructure grew by 26%.

- Owing to the optimistic growth projections made during boom years, inadequate appreciation of inherent risks, delay in environmental and other clearances etc, several infrastructure projects funded by the banks got delayed resulting in cost and time overruns. These factors coupled with the RBI's Asset Quality Review (AQR) exercise led to the elevated levels of Gross NPAs in the banking system.

- The enactment of the Insolvency and Bankruptcy Code, 2016 (IBC) and the amendment to the Banking Regulation Act, 1949 empowering the RBI to leverage the IBC mechanism for resolving specific stressed accounts, have helped in turning around the deteriorating asset quality cycle. We believe that the NPA cycle has peaked and GNPA's have started to decline and it stands at 9.3% as on Mar'19 as against 11.5% as on Mar'18. Provision Coverage Ratio (PCR) in the banking system improved to 60.9% at end-March 2019 from 48.3% at end-March 2018 with number of PCA banks now at 5 (from 11).

Way forward

- Going forward, RBI's Macro-stress tests for credit risk indicate that under the baseline scenario, SCBs' GNPA ratio may decline further to 9.0% in March 2020.

- Further, the proposed amendments to the IBC bringing more clarity on the issues relating to financial creditors and operational creditors, time bound resolution and distribution of resolution amount etc will give further impetus to the orderly resolutions under IBC and will sustain the interest of investor community in the stressed assets.

- Enabling regulations allowing Foreign Portfolio Investors (FPI) to acquire stressed rupee loans directly instead of present system of going through an asset reconstruction company (ARC) and allowing eligible ECB investors to fund acquisition of stressed companies both under IBC and outside IBC will augment the capital needed for resolution of stressed assets.

Inherent asset-liability mismatches of commercial banks in funding the infrastructure projects is an issue. Dedicated Developmental Financial Institutions (DFIs) with robust capital structure will be helpful.

- Mandatory consortium arrangement for large Corporates lending (> Rs. 200 crs.) will instill financial discipline among the borrowers and facilitate effective monitoring of such loans.

2.2 Transmission and Cost of Borrowing

- One of the critical enablers for ensuring a \$5 trillion economy is adequate supply of loanable funds at affordable interest rates. In India, the banks often face hurdles in ensuring a lower term structure of interest rates in terms of an effective transmission.

- Banks currently follow Marginal Cost of Funds based Lending Rate / MCLR in determining their lending rates as regulated by RBI. The Marginal Cost of Funds (MCF) in turn depends on the current interest rate offered on the deposits due to the structure of the PSB's Balance sheets. CASA deposits, which are largely interest rate agnostic, constitute almost 40% of the total deposits and the remaining are Term deposits, where pricing is dynamic depending upon market conditions. Therefore, reduction in MCLR may be possible only if there is a subsequent downward revision in deposit rates, i.e. Term Deposit rates.

- Furthermore, repo linked funding is not more than 1-2%.

- Preemptive regulatory requirements also act as a constraining factor. Though SLR has been reduced, still India has the highest preemptive ratios like CRR and SLR (currently at 18.75%) across BRICS and Asian economies. If we add to this, the priority sector lending commitments also, India has the highest stipulated norms across all such countries. And if the stipulated LCR ratios as mandated by Basel III is also considered it legitimately raises the pertinent question of whether uniform global financial regulation is desirable and appropriate.

Pre-emptive regulation in India and abroad			
Country	CRR (in %)	SLR (in %)	Priority sector lending (%)
BRICS			
Brazil	Multilayered structure: Basic 20% on time deposits	0	Agriculture & Housing
Russia	4	0	Not well defined
India	4	18.75	40% of lending portfolio (18% for Agriculture, 10% for weaker sections & MSME based on investment in plant & machinery)
China	17.5	0	None
South Africa	2.5	0	None
ASEAN			
Indonesia	12	0	20% of lending portfolio to SME only
Thailand	6	0	20% of deposits (Agriculture:14%, SME:6%)
Malaysia	4	0	Interest rates capped at 200 basis points above base lending rate for SME
Philippines	20	0	8% of lending portfolio to SME only

Way forward

- To improve transmission in MCLR, both asset and liability side of Bank balance sheet need to move simultaneously.

- Real interest rate has turned positive and is around 4%, which was negative before FY15. Thus there is room for reduction in interest rates on deposits that can translate into lower lending rates.

- A potential CRR cut will lead to better transmission.

2.3: Capital Requirement

- In the last five years (FY15-19), PSBs have been recapitalised to the extent of Rs 3.19 lakh crore, with infusion of Rs 2.5 lakh crore by the Government and mobilisation of over Rs 0.66 lakh crore by PSBs themselves. Further, in the budget FY20 Government has made additional provision of Rs 70,000 crore of capital for the recapitalization of PSBs. With the recapitalization, SCBs' capital to risk-weighted assets ratio (CRAR) has improved from 13.0% in FY15 to 14.3% in FY19. PSBs' CRAR has also improved from 11.3% to 12.2% during the period. Such recapitalization also improved incremental C/D ratio for PSBs in FY19 (to 75% from -6% in FY18).

Way forward

- Banks need adequate capital and liquidity to ensure credit growth. Around Rs 3-4 lakh crore of incremental capital is needed to enable Rs 50-60 lakh crore of incremental lending to manufacturing and services (excluding retail) for attaining a \$5 trillion economy in the next 5 years.
- PSBs also need to explore multiple sources of capital – government, domestic and foreign lending.

2.4: Corporate Governance and Risk Management

Corporate Governance

- Recently, the Bank Board Bureau (BBB) has advised the Government to improve the operative environment and selection process for filling up post of directors on PSB boards to “attract the best board-level talent”. The BBB has asked the Government to give “complete autonomy” to bank boards to decide the organisation structure.

- The BBB has asked the government to introduce a performance-based compensation through Employee Stock Option Scheme, which is different from Employee Share Purchase Scheme, and Performance-Linked Incentives in a bid to “incentivise maximisation of risk adjusted income” and discourage “operational inefficiencies by aligning compensation with right performance metrics”.

Way forward

- Matters pertaining to corporate governance in PSBs require attention. During the last tenure of NDA, the BBB was established to minimize government interference in PSBs appointments. However, past efforts need to be taken further so that open issues such as appointment of top management, stability and expertise of management team, and skilling of manpower to address the missing middle are tackled.

- Only when these measures are taken that PSBs will have the will to compete and merger consolidation proposition of PSBs will have any meaning.

Risk Aversion

- Risk aversion among PSBs officials stemming out of fear of investigating authorities

Way forward

All internal and external enquiries should be transparent, and time-specific. Any banking decisions that are bonafide should be respected by regulators and judiciary. Investigative agencies have to take a more balanced approach.

2.5: HR issues

- The mainstay of any successful bank is talented and knowledgeable workforce. Public-sector banks are witnessing large chunk of retirements resulting in skilled manpower at middle management levels. The absence of middle management could lead to adverse impact on banks' decision making process as this segment of officers played a critical role in translating the top management's strategy into workable action plans. Workload coupled with lack of suitable incentive system also hampers the morale.

Way forward

Keeping in view today's banking scenario of intense competition, PSBs should be given:

- (i) operational flexibility in terms of recruitment on a regular basis for permanent vacancies
- (ii) independent incentive structure at all level
- (iii) independence / more autonomy in areas of employee compensation as per performance and increase in quantum of fund to meet staff welfare activities
- (iv) an effective skill upgradation systems through robust training infrastructure.

2.6: NBFC sector

- NBFCs are important growth engines for Indian economy and it is imperative that we address the issues that the sector is currently facing.

- The revival of NBFC is a two-step process, i.e., Short Term and Long Term. The recent measures announced by Regulators – RBI, SEBI, NHB are mostly for long term strengthening of NBFC Sector. The steps taken in Union Budget 2019-20 (like regulatory control of Housing Finance Companies will shift from NHB to RBI) are also commendable.

Way forward

- However, some more confidence building measures needed
 - Regulatory review of portfolio of NBFCs (AQR/ Stress test)
 - Government Sponsored Entities buying out quality assets
 - Credit Enhancement- first loss cover for securities (initiated in Budget)
 -
- Medium to Long Term measures:
 - NBFCs' audit system to strengthen.
 - Alternative sources of Long Term Funding for infrastructure / projects.
 - When NBFC reaches level of "Too Big To Fail" – Takeover by Banks under Holding Company
 - structure.

2.7: MSME

- The sector is struggling due to the growing incidence of sickness of the sector. Besides, non-availability of authentic financial data, vulnerability on account of delayed payments by buyers, technological challenges due to low awareness, absence of single MSME data repository, low awareness about various govt. initiatives and lack of compliance to statutory/legal/environmental norms are some of the challenges the sector is currently going through.

Way forward

- Need for appropriate public policy that would accord high priority to this sector to achieve balanced, sustainable, more equitable and inclusive growth in the country.
- Further, change in definition of Micro, Small and Medium enterprises from 'investment in plant & machinery/equipment' to 'annual turnover' will make it transparent, progressive, easier to implement and improved ease of doing business.
- Delayed Payments of receivables is the major stress factor for MSMEs. So, need for a centralised authority to monitor and take action for delayed payments.
- Creation of Unique Enterprise Id (UEI) for fetching all details viz. financial & non-financial pertaining to any MSME. This would be useful in supplementing the current initiatives of the Government like the loan disbursement within 59 minutes through a dedicated online portal that has been largely successful.

Section 3:

Reinvigorating Private Sector Investment

- Currently, private investment is a significant laggard in total investment. The share of private sector has declined from 50% during 2007-14 period to 30% during 2015-19 period in new projects investments (in value-terms).

New Investment Projects Announcements				
OwnerShip	2007-14		2015-19	
	Project	Rs trillion	Project	Rs trillion
Government	26,020	44.3	37,719	54.2
Central Government	6,483	22.6	8,247	29.3
State Government	19,537	21.8	29,472	24.9
Private Sector	25,009	45.0	13,551	28.9
Foreign Private Sector	706	3.4	896	4.4
Indian Private Sector	24,303	41.7	12,655	24.5
All Sectors	51,030	89.4	51,270	83.1

Source: Projects Today; SBI Research

- The current capacity utilization at 74% - will need demand to scale up before further investments are expected.

Way forward

- A possible increase in capacity utilization can happen if we simultaneously address the sector-specific issues in order to boost demand of bank credit.

Sector Specific Suggestions to Boost Credit Growth	
Sector	Suggestions
Construction	Real estate sector should be classified under infrastructure
	<ul style="list-style-type: none"> • ECB may be allowed for all real estate projects based on their solvency and external credit rating • Risk Weightage may be rationalised • Clarity of project loan repayment under RERA norms
Infrastructure	<p>Power</p> <ul style="list-style-type: none"> • Ensure steady coal supply to Power plants • DISCOMs may be discouraged from amending agreed upon PPAs / Agreements <p>Renewable</p> <ul style="list-style-type: none"> • Payment discipline of the DISCOMS • Clarity on GST due to differential rates (Solar System is treated as Goods & charged at 5%, Work Contract at 18%) • Cap on Power tariffs may be removed for bidding by Developers <p>Telecom</p> <ul style="list-style-type: none"> • Waiver of past liabilities for purchaser of spectrum, either within IBC or outside IBC • Rationalization of Spectrum Usage Charges to support M&As within telecom industry • Rationalizing the GST rate from the existing 18% <p>Roads & Highways</p> <ul style="list-style-type: none"> • Timely payment of dues - minimise litigation post arbitration • Relevant clause for claim period of one year may be taken care of/ amended • There can be a separate dispute resolving mechanism like NCLT for faster resolution of disputes
Fertilizer	<ul style="list-style-type: none"> • Lower import duty on raw material to encourage more urea production • Expediting release of subsidies to enable companies achieve efficient working capital management and economization of finance costs
Cement	<ul style="list-style-type: none"> • Increased budget outlays for infrastructure sector mainly roads • Initiatives to promote real estate could uplift demand for cement sector
Steel	<ul style="list-style-type: none"> • Reduction in customs duty for pet coke, anthracite coal, met coke and coking coal and increase in basic customs duty for specific steel products
Aluminium	<ul style="list-style-type: none"> • Increasing import duty on primary aluminium and aluminium to support domestic players • Consider imposing minimum import price and quota system on the imports for the user industry
Capital Goods	<ul style="list-style-type: none"> • Addressing issues like inverted duty structure and the unintended consequences of export promotion policies like zero duty on import of capital goods and import of second-hand machinery impacting the competitiveness • Reworking the tie-ups and FTAs with different trading countries to reduce imports and increase exports
Automotive	<ul style="list-style-type: none"> • Subsidizing the battery and lithium imports or incentivizing companies to set up this business in India • Incentive programme for scrapping more than 15 year old commercial vehicles • In line with Make in India programme, the Government should promote localization, especially in the Commercial vehicle segment • Priority lending by banks for purchase of EV vehicles

Section 4:

Summary of Key Recommendations

To fulfill the Vision of the Government, PSBs will continue their role in the transformation of the economy. However, certain issues including asset quality, capital adequacy, HR, governance, transmission etc., as described above need to be addressed so that the banks are able to disburse advances to the tune of Rs 90 lakh crore required during FY20-FY25 to reach the \$5 trillion economy.

The summary of key recommendations are as follows:

1. Banks need adequate capital and liquidity to ensure credit growth. Around Rs 3-4 lakh crore of incremental capital is needed to enable Rs 50-60 lakh crore of incremental lending to manufacturing and services (excluding retail) for attaining a \$5 trillion economy in the next 5 years.
2. To instill confidence in foreign investors, IBC might be tweaked to give clarity for various asset classes/creditors.
3. To improve transmission in MCLR, both asset and liability side of Bank balance sheet need to move simultaneously. A potential CRR cut will lead to better transmission.
4. Matters pertaining to Corporate Governance in PSBs require attention. Past efforts need to be taken further so that open issues such as appointment of top management, stability and expertise of management team, and skilling of manpower to address the missing middle are tackled.
5. All internal and external enquiries should be transparent, and time-specific. Allegations should be quickly enquired into and closed within a manner of weeks. Any banking decisions that are bonafide should be respected by regulators and judiciary. Investigative agencies have to take a more balanced approach. Every decision should not lead to criminality.
6. In NBFC sector more confidence building measures are needed.
7. Keeping in view today's banking scenario of intense competition, HR policies of PSBs need to be changed to align them with the private sector banks giving more autonomy to PSBs in hiring and moving to a performance based incentive structure.



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Department of Financial Services
Ministry of Finance
Government of India