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A Study on Development of Non Banking Financial Services in India

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ABSTRACT
Banks play a key role in India's financial system and underpin economic growth. However, during the 2010s, the health of Indian banks deteriorated significantly and a subsequent decline in credit growth contributed to a slowdown in economic activity. Although Indian authorities have taken a number of steps to strengthen the banking system, progress has been difficult and has been further curtailed by the COVID-19 pandemic. While financial linkages between Australia and India remain limited, India is an increasingly important trading partner for Australia, and continued weakness in its banking system is likely to weigh on India's demand for Australia's exports.

Banks are the main providers of credit within India's financial system, and account for around half of India's financial assets (Graph 1). Since the 1970s, government-controlled banks have been central to India's development strategy by extending credit to sectors prioritised by governments, such as agriculture and infrastructure (RBI 2005). While Indian authorities have sought to develop a domestic corporate bond market, this remains relatively small and is mostly used by larger firms and financial institutions (Ganguly 2019). Non-bank financial corporations (NBFCs) have grown in recent years as alternative intermediaries of finance; however, a substantial share of funding for NBFCs is ultimately provided by banks. Beyond financing private and state-owned firms, banks are also a significant funding source for governments, through direct loans and buying bonds issued by the central and state governments. More generally, India's capital account has remained relatively closed, and so India remains more reliant on domestic financing sources than comparable emerging market economies.

I. INTRODUCTION

Banking System in India or Indian Banking System or Banking Sector in India refers to a network of financial institutions, such as banks and credit unions, that handle financial transactions and provide financial services to individuals, businesses, and governments. These institutions, primarily, act as intermediaries between people with money i.e. savers, and those who need money i.e. borrowers. The types of services offered by the banking institutions, usually, include accepting deposits, lending money, facilitating transactions, and offering various financial products like savings accounts, loans, and credit cards. The banking system in India is significantly different from that of other Asian nations because of the country's unique geographic, social, and economic characteristics. India has a large population and land size, a diverse culture, and extreme disparities in income, which are marked among its regions. There are high levels of illiteracy among a large percentage of its population but, at the same time, the country has a large reservoir of managerial and technologically advanced talents. Between about 30 and 35 percent of the population resides in metro and urban cities and the rest is spread in several semi-urban and rural centers.

II. OBJECTIVES OF THE STUDY

The main aim of this research work is to analyze critically and examine the concept of globalization and its impact on the Indian banking services along with and challenges which arise as a result of globalization. The researcher also aims to find out the adverse effect of these challenges and what measures can be taken to reduce them.The main objectives of this research are as follows:-

• To study the challenges faced by the Indian public sector banks with regards to technology, human resource, customer service and other services.

• To study and analyze customer's perception towards banking services of Public sector banks.
• To study and understand corporate sector's approach towards banking services of Public sector banks.
• To study and analyze impact of globalization on banking services of public sector banks.
• Toanalyze the growth, performance and improvement in banking services due to globalization.

The country where I operate just before the outbreak of the global financial crisis of 2008, commercial banks were extensively issuing mortgages denominated in foreign currency, mainly in Swiss franc, i.e. CHF. Mortgage offers offered in CHF were deliberately structured very attractively for customers, which resulted in a strong increase in lending actions on this type of loans. In 2006-2007, lending actions carried out within the framework of mortgages denominated in CHF grew so strongly that they significantly exceeded lending actions carried out within the framework of mortgages granted in the domestic currency, i.e. in PLN. However, in reality, the offers of these loans were not as attractive as initially presented to customers by the banks. At that time, in the context of high stock valuations on stock exchanges, rising prices of raw materials on wholesale commodity markets, high economic growth rates, rapidly rising real estate prices, good economic conditions, Poland's plans to join the euro zone, the PLN domestic currency exchange rate was in an upward trend. The banks, based on their macroeconomic analysis, knew what was going on, they knew about the overvalued assets, the overvalued PLN against other currencies, etc. The average customer, the potential borrower, did not have this knowledge. Banks took advantage of the asymmetry of information regarding the aforementioned issues of the macroeconomic situation of the economy, the valuation of assets on the capital markets, the level of exchange rates.

Within the framework of their CHF-denominated mortgages, they passed the currency risk arising from changes in exchange rates and the risk of changes in interest rates by the central bank in Switzerland onto the borrowers. Soon after the global financial crisis erupted in mid-September 2008, the exchange rate of the currency of a relatively non-large developing economy with higher investment risk, i.e. the PLN exchange rate against other currencies, instead of continuing to rise it began to fall sharply. The CHF exchange rate, on the other hand, rose rapidly, resulting in a significant increase in the size of the amounts paid to the bank by borrowers with the aforementioned loans in CHF in installments as part of their loan repayments. Before the global financial crisis of 2008, mortgage installments denominated in CHF were significantly lower compared to the situation if the same loan had been taken on analogous terms but in the domestic currency of PLN. On the other hand, after the outbreak of the aforementioned financial crisis, the situation reversed dramatically, as the amount of money paid to the bank in installments of repaid CHF loans increased significantly, and there were later situations that it exceeded the situation if the same loan had been taken on analogous terms but in the domestic currency of PLN. In addition, the loan agreements contained provisions that were prohibited from the point of view of good standards and guidelines of regulatory and supervisory institutions, abusive clauses. The abusive clauses in question were included in these agreements as part of the asymmetry of information used by the banks, occurring in their relations with customers.

In view of the above, the granting of mortgage loans in foreign currency is a deliberate exploitation by commercial banks of the information asymmetry occurring in relations with borrowers, is the transfer of currency risk by the bank to customers, and is an activity that is contrary to the principles of business ethics, corporate social responsibility of banking and, consequently, leads to a decline in the level of public confidence of citizens in relation to banks. Thus, the issue of CHF-denominated mortgages has become one of the significant factors deteriorating the image of commercial banks from the point of view of customers. The granting of mortgage loans denominated in CHF has caused a deterioration in the reputation of commercial banks operating in Poland, a decrease in the level of social responsibility of the banking business and, consequently, also a deterioration in the image of banks as institutions of social trust.
In view of the above, I address the following question to the esteemed community of scientists and researchers:

III. RESEARCH METHODOLOGY

The main objective of this research is to propose a methodology for forecasting NPAs which can thereby be used to forecast NPA of an Indian bank and gauge the crisis which Indian banking system is facing. There are many forecasting methods which can be used to predict the variable of interest. They are broadly divided into two categories: 1) Regression models: Simple

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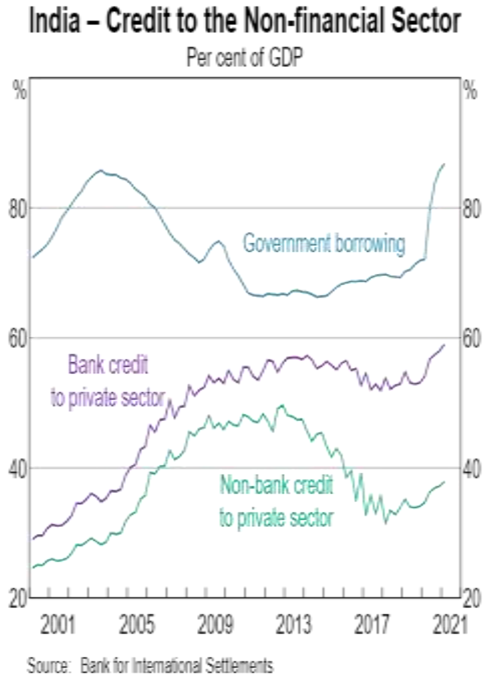
Linear Regression (SLR), Multiple Linear Regression, 2) Time series-based methods: Moving Average, Simple Exponential Smoothing, Holt, and Holt-winter method. Regression models are used for prediction purposes. Based on the trend of independent variables, they predict the trend for the dependent variable. Since we will be predicting the NPA's in 2020 based on external factors, regression models are the best fit in this particular situation. SLR could not be used because it gives the value of dependent variable (Gross NPA's) in terms of only one independent variable. NPA is often dependent on various factors so this method will never give satisfactory results. We finally conducted the analysis by MLR method . The first stage included the introduction of Indian Banks and how they work in India. Ichoose five criteria Growth, Credit quality, Strength, Profitability, Eff iciency Profitability. The next stage involved determining the objectives of the study, drafting a questionnaire will be designed keeping in mind the target audience and objectives of the study. It will non-disguised in nature and will include a few open-ended questions

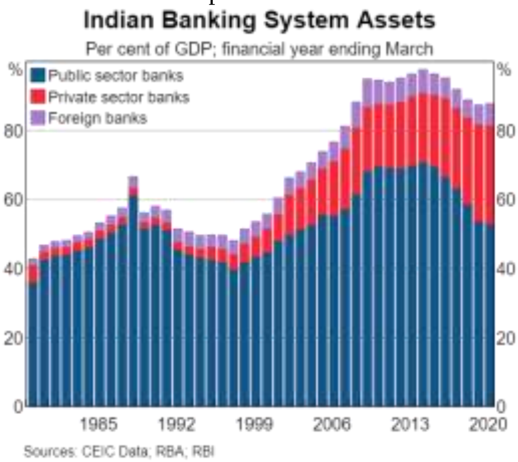
IV. DATA ANALYSIS AND INTERPRETATION

Graph 1



India's banking system is dominated by government-owned 'public sector banks' (PSBs), which account for around 60 per cent of commercial banking system assets. Since the mid-2010s, these banks have been beset by problems with non-performing loans (NPLs) and low capital levels (Graph 2) (RBA 2019). Over the past two decades, private sector banks have become more prominent and generally have healthier balance sheets with lower NPL ratios, although some private banks have failed in recent years. Foreign banks are in the strongest financial position but comprise only 7 per cent of commercial banking system assets. Outside the commercial banking system, there are a number of smaller banks that serve the needs of narrower groups of borrowers, including rural cooperative banks, small finance banks, local area banks and payment banks.

Graph 2



Credit to the non-financial sector in India is equivalent to around 165 per cent of GDP, which is high relative to many other emerging market economies. India's high level of debt and reliance on bank credit magnify the effect of stress in the banking system on economic growth. While direct financial links between Australia and India are limited, potential vulnerabilities in the Indian financial system are important for Australia through the trade channel. India accounts for only 0.6 per cent of Australian investment abroad, and 0.05 per cent of foreign investment in Australia. A few Australian banks have subsidiaries in India; however, their operations are very small. In contrast, India was the destination for around 4 per cent of Australia's exports in 2020. This trade channel was apparent in 2018/19, when weaknesses in India's banking system contributed to a slowdown in Indian economic activity, and weighed on India's demand for Australia's exports (Fairweather and Sutton 2020).

This article examines four factors that are affecting the ability of India's banking system to

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allocate credit efficiently and support long-term growth: banks' high NPL ratios and low capital levels; high levels of government borrowing from banks; Indian authorities' influence on credit allocation; and the interaction of banks and NBFCs (the shadow banking system).

Non-performing loans and low capital levels

Since the mid-2010s, the Indian banking system has experienced NPL ratios far higher than other Asian banking systems, and Indian banks have had far lower levels of capital (Graph 3). This has weighed on banks' ability to extend credit because NPLs have reduced banks' profitability and risk depleting already low capital buffers. Low capital levels have also contributed to low Basel III leverage ratios, which have further limited banks' capacity to extend credit.[1] While Indian authorities had previously introduced measures to help banks address their weak balance sheets, the COVID-19 pandemic has hindered progress and in some cases exacerbated existing issues.

Graph 3

The rise in NPLs has its origins in the mid-2000s. At this time, PSBs began to play a key role in financing a decade-long infrastructure investment boom and expansions in India's mining and steel sectors (RBA 2019). India's Priority Sector Lending (PSL) policy (discussed below) influenced this credit allocation and hindered banks' development of strong risk management practices (Loukoianova and Yang 2018; IMF 2018). During this decade, lending standards weakened, the projects that had been funded faced bottlenecks and cost-overruns, and corporations' capacity to repay debt declined (IMF 2018). This drove a significant deterioration in PSBs' asset quality, which was for a time masked by delays in asset reclassification. However, in 2015, the Reserve Bank of India (RBI) tightened rules on asset classification and provisioning, which prompted banks to reclassify a large share of loans as 'non-performing' (RBI 2015a).

In the mid-2010s, as NPL ratios began to increase significantly, authorities began to introduce a number of measures to address weaknesses in Indian bank balance sheets. The RBI imposed lending restrictions on some banks to reduce pressures from poor asset quality (Acharya 2018). The RBI also introduced restructuring and resolution frameworks to help banks address their high NPL levels and prevent the 'evergreening' of distressed loans by replacing them with new loans (RBI 2019a). Furthermore, banks needed additional capital to meet the increasing requirements of the Basel III reforms, which were implemented to improve banks' ability to absorb future losses (RBI 2015b). The government injected INR3.16 trillion (US$42 billion) of capital into banks from 2015 to 2020, primarily funded by government bonds. Ten PSBs were merged into four to address the capital levels of the weaker PSBs (RBI 2020a). In mid-2019, the RBI lowered the minimum leverage ratio by 0.5 percentage points to ease pressure on banks' balance sheets (RBI 2019b). Despite this and an improvement in equity levels (helped by capital injections from the government), at the end of 2019 many banks' leverage ratios were close to regulatory minimums, and in some cases below them.

While bank balance sheets were beginning to improve into 2020, the onset of the COVID-19 pandemic and resultant activity restrictions severely disrupted Indian economic activity, and weakened the balance sheets of households and businesses.

In response, like many other countries, Indian authorities introduced a number of measures to support households, businesses and financial institutions. Between March 2020 and March 2021, borrowers were allowed to pause repayments on their loans.[2] New restructuring and resolution frameworks were introduced that enabled banks to delay recognising NPLs and smooth their provisioning against losses. Further capital injections have been required, totalling INR200 billion in the year to March 2021, with a further INR200 billion budgeted for the year to March 2022. Since the onset of the COVID-

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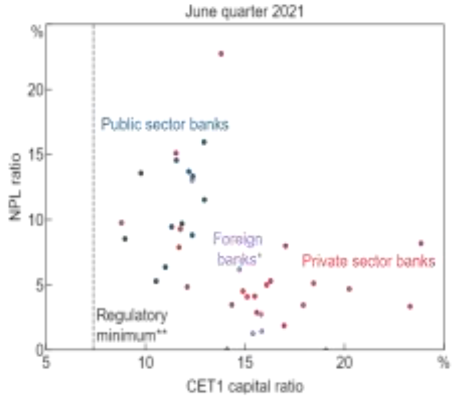
19 pandemic, the RBI has also delayed the final stage of implementing the capital conservation buffer multiple times and kept the countercyclical capital buffer at zero per cent, such that banks' minimum Common Equity Tier 1 (CET1) capital ratios remained at 7.375 per cent, to reduce pressures on bank balance sheets.[3] Despite these measures, some banks have still faced stresses, and in some cases the RBI has had to intervene to resolve them.[4]

Significant risks remain for India's banking system. While headline NPLs have declined, this is partly the result of recent support measures that have delayed banks recognising loans as non-performing.[5] NPLs are likely to rise as these measures are unwound – in July, RBI analysis found that under a scenario where GDP grew by 9.5 per cent in the year to March 2022, banks' NPLs would increase to 10 per cent (RBI 2021b). To help banks address this, in September 2021 the Indian Government announced that it would establish the National Asset
Reconstruction Company Limited (NARCL), which will acquire up to INR2 trillion of distressed debt (Press Information Bureau 2021). Nevertheless, some banks will need to raise more capital. In October 2021, the capital conservation buffer was increased to 2.5 per cent, raising the minimum CET1 capital ratio to 8 per cent. The RBI may also begin gradually raising the countercyclical capital buffer, which would further raise capital requirements. PSBs remain most at risk, given their high levels of NPLs and lower capital levels; however, some private banks are also under significant stress (Graph 4).

Graph 4
Health of Indian Bank Balance Sheets
June quarter 2021



* March quarter 2021 data for most foreign banks
** 7.375 per cent as of June 2021, including capital conservation buffer; does not include additional CET1 capital required for domestically systemically important banks
Source: S&P Global Market Intelligence

As it stands, some banks may face constraints on how much additional credit they can provide without needing to raise additional capital. A tightening in Indian financial conditions could make it more difficult or costly for banks to raise capital, while a slower-than-expected recovery, possibly because of further lockdowns or a delayed vaccine rollout, could drive NPLs even higher.

Government borrowing from banks

At the same time as Indian banks have been addressing their weak balance sheets, they have continued to be an important source of funding for the Indian Government. Banks' demand for government debt is partly a result of regulation; banks in India are subject to the Statutory Liquidity Ratio, which requires them to hold a significant share of their assets as government bonds. While helping to protect the system against liquidity shocks, this has made borrowing by governments cheaper at the expense of banks' profitability and has crowded out bank credit to the private sector (IMF 2019). Banks' purchases of government bonds also lower their Basel III leverage ratios, exacerbating the pressures that Indian banks were already facing. While foreign investors are a potential alternative source of funding for the Indian Government, India has maintained strict limits on foreign ownership of government bonds – currently making up only 6 per cent of outstanding bonds – in part to limit risks associated with capital flow volatility (RBI 2021c).

Since the onset of the COVID-19 pandemic, the Indian Government has significantly increased its bond issuance to fund response measures. This increase in issuance has been largely absorbed by banks and other domestic financial institutions, which increased their government bond holdings by 19 per cent and 17 per cent (Graph 5). Authorities' efforts to improve banks' capital levels through the crisis have helped to improve the leverage ratios of some banks; however, many banks remain close to regulatory minimums (Graph 6).

In July, the RBI also raised concerns that banks' profits were becoming more sensitive to changes in government bond yields. Many of the government bonds that PSBs purchased in the year to March 2021 had not been classified as 'held-to-maturity' (RBI 2021b). This means that banks must include changes in the values of those bonds in their profit calculations – higher yields mean lower values and lower profits. A decline in profitability will make it harder for banks to raise equity

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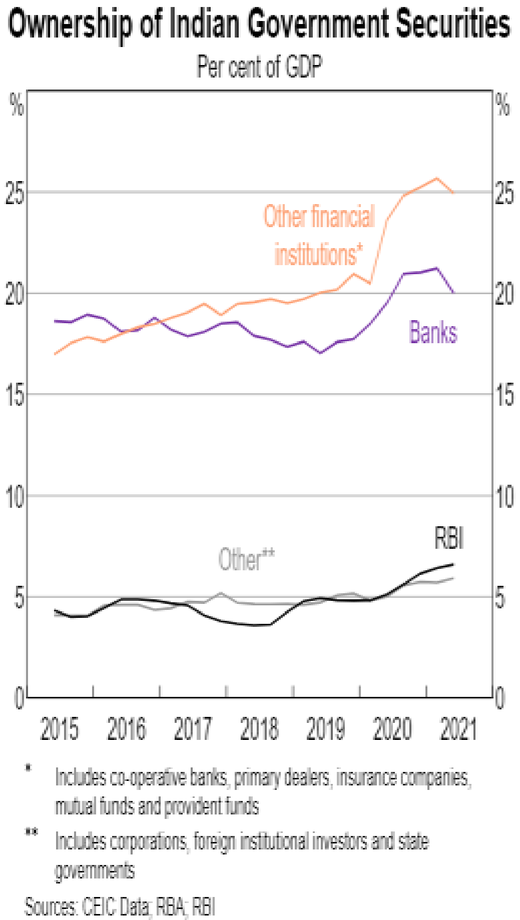
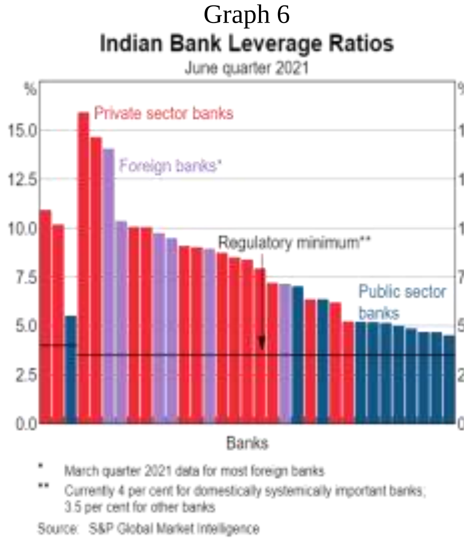
themselves, by either issuing stocks or through retained earnings.

Graph 5



Graph 6



In the near term, Indian banks are likely to need to continue to purchase significant amounts of government bonds. In its 2021 budget, the Indian Government announced plans to increase its bonds outstanding by INR9.7 trillion (4½ per cent of GDP) in the year to March 2022 (RBI 2021d). Between April and October 2021, the RBI purchased INR2.4 trillion of government bonds to anchor yield expectations as part of its government bond purchase program (RBI 2021e). In October, the RBI announced a pause on additional purchases. For the current financial year, this leaves over INR7 trillion of bonds to be absorbed largely by banks and other domestic financial institutions.

This will present a challenge for banks. If they do not purchase sufficient government bonds, the lower demand could cause government bond yields to rise, which would generate losses for banks on their current government bond holdings. However, additional purchases will put downward pressure on their Basel III leverage ratios and their profitability, and could limit their ability to extend credit (RBI 2021b).

As discussed above, Indian authorities are taking measures to help the financial markets absorb these bonds and are slowly increasing access for foreign investors. Authorities are also seeking inclusion in global government bond indices, which would increase foreign participation in India's bond markets in the medium term.

Government measures to increase and influence credit allocation

Historically, the Indian Government has played a key role in directing and influencing credit allocation. Beyond its majority ownership of PSBs, one of the ways the government has directed credit has been through its PSL policy. In India, domestic banks are required to extend at least 40 per cent of their credit to sectors selected by the RBI (32 per cent for foreign banks). This is not unique to India – many other Asian economies have used these policies to improve access to credit and support economic development (Creehan 2014). While PSL has boosted access to credit in India, it has led to higher NPLs and has compromised banks' development of strong risk management practices (Loukoianova and Yang 2018; IMF 2018). Perceptions of implicit guarantees also influence credit towards firms backed by government-related entities.

Despite a significant increase in government borrowing since the onset of the COVID-19 pandemic, India's direct fiscal stimulus has been small relative to other economies; instead, the government has placed

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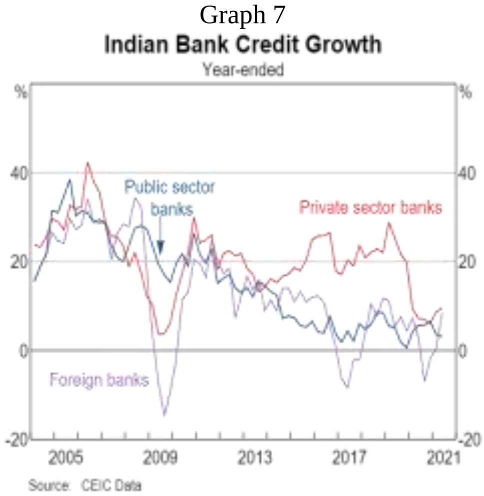
more emphasis on loans and loan guarantees (Hudson et al 2021). Like in many economies during this period, Indian authorities took a number of measures to encourage banks to extend credit, particularly to micro, small and medium enterprises (MSMEs). These measures have included an INR3 trillion loan guarantee scheme and an INR1 trillion targeted long-term repo operation (TLTRO) to provide funding for financial institutions to invest in corporate bonds (Press Information Bureau 2020; RBI 2020e). The government has also continued to direct PSBs to conduct loan fairs to increase outreach to borrowers (Anand and Ahmed 2021).

Credit to MSMEs is providing much needed support to those businesses; however, these loans are also riskier and are likely to contribute to a further rise in NPLs. In the longer term, India faces a difficult task of balancing its development needs with the health of its banking system.

More broadly, continued subdued credit growth remains a significant risk to India's recovery, particularly given the government's emphasis on credit in its support measures. Credit growth at private banks remains well below pre-COVID-19 levels, and PSB credit growth remains historically weak (Graph 7). While banks have attributed this to subdued demand for credit, their net interest margins remain slightly higher than before the pandemic (RBI 2021b). This is consistent with banks' other competing needs, including improving their profitability and capital levels, disposing of NPLs and purchasing government bonds. These issues are likely to continue to weigh on credit growth.

Graph 7

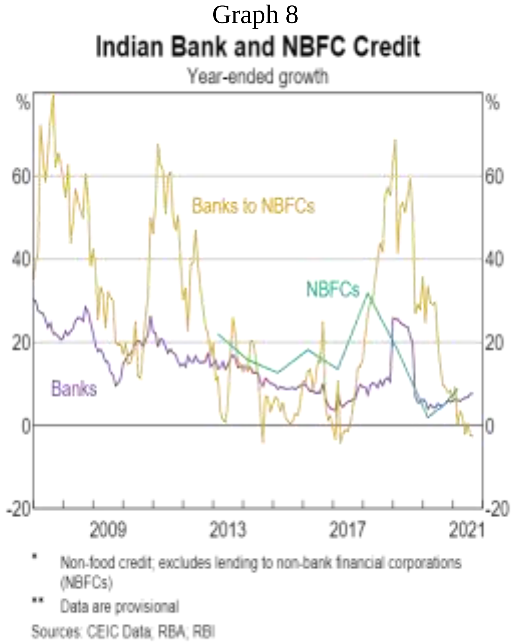


Non-bank financial corporations

NBFCs have grown in recent years as an alternative source of credit for businesses and households. NBFCs currently provide around one-fifth the credit of banks.[6] These 'shadow banks' have been deliberately subject to less rigorous regulation than banks to allow them flexibility to innovate and provide new financial services and increase access to financing (including to those without bank accounts) (RBI 2021f). This was based on the assumption that their activity would remain significantly lower than bank lending and so present a low level of risk. However, less stringent regulation can result in weaker lending standards, facilitate an excessive build-up of leverage, and reduce capital and liquidity buffers within the financial system. NBFCs also receive a significant share of their funding from banks, increasing the risk that stress in NBFCs can spill over to the banking system.

From 2015, NBFCs expanded credit at around twice the pace of banks, with an associated increase in risk (Graph 8).[7] This rapid expansion occurred at the same time that lending by PSBs was constrained (RBA 2019). The demonetisation of India's highest denomination banknotes contributed to an inflow of funds to mutual funds, which in turn purchased NBFC debentures and commercial paper. However, investor sentiment deteriorated following the default of a high-profile NBFC in 2018, which significantly tightened funding conditions for NBFCs.

Graph 8



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NBFC credit growth has since slowed dramatically and NBFCs have required continued support from banks. To avoid broader financial distress following the default, authorities introduced a number of measures to stabilise funding conditions. One focus of these measures was to support and incentivise banks to provide more funding to NBFCs – as such, limits on bank lending to individual NBFCs were relaxed, banks were allowed to classify lending to NBFCs for on-lending as priority sector lending, and a partial credit guarantee scheme for credit from PSBs to NBFCs was introduced. In response to the pandemic, authorities have extended and expanded these programs, and introduced further measures – in April 2020, the RBI conducted another TLTRO program worth INR500 billion with at least 25 per cent of the funds earmarked for banks to purchase bonds issued by NBFCs.

These measures have helped to stabilise NBFCs; however, they have also increased both the size of linkages and the risk of spillovers from NBFCs to banks (IMF 2021). Eight per cent of bank loans are currently extended to NBFCs. Banks also purchase NBFCs' debentures and commercial paper, although these exposures are smaller. While data on NBFCs' NPLs are limited, provisional data for the March 2021 financial year indicate an average NPL ratio of 6.4 per cent, which is similar to those of Indian banks (RBI 2021b). NBFCs are generally less diversified than banks and so a deterioration in conditions of some sectors of India's economy is likely to weigh on NBFCs (IMF 2021).

V. CONCLUSION

Addressing the health issues of the Indian banking system has been a slow and difficult task – and one that has been significantly curtailed by the pandemic. However, the progress made prior to early 2020 has allowed the banking system to weather the COVID-19 storm, despite significant outbreaks and stringent lockdowns. Despite some improvements, the health of the Indian banking system is likely to constrain its ability to extend credit and support the economic recovery. Efforts are underway to strengthen bank balance sheets further, although banks will need to continue to absorb additional government bond issuance as they do this. Spillover risks from NBFCs also remain elevated. This weak outlook is likely to weigh on India's development and growth, which presents a downside risk to the demand for Australia's exports. The main aim of this research work is to analyze critically and examine the concept of globalization and its impact on the Indian banking services along with and challenges which arise as a result of globalization. The researcher also aims to find out the adverse effect of these challenges and what measures can be taken to reduce them.The main objectives of this research are as follows To study the challenges faced by the Indian public sector banks with regards to technology, human resource, customer service and other services. To study and analyze customer's perception towards banking services of Public sector banks. To study and understand corporate sector's approach towards banking services of Public sector banks. To study and analyze impact of globalization on banking services of public sector banks. Toanalyze the growth, performance and improvement in banking services due to globalization.

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