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Analysing the Banking Sector of 2023: Challenges and Way Forward

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Abstract

This paper provides a concise overview of the most significant challenges the banking sector faced in 2023 and proposes strategic pathways for sustainable growth and resilience. As the industry grapples with technological disruptions, evolving customer expectations, regulatory complexities, and global economic uncertainties, financial institutions must strategically adapt to ensure their continued relevance. This paper explores key challenges faced by the banking sector in 2023 like privatisation of banks, increasing inflation, challenges in liquidity management, the failure of small private banks in India, and the often-neglected expansion of the banking sector into rural and tribal regions. After analysing these issues this paper puts forward solutions like emphasizing the integration of advanced technologies, regulatory compliance frameworks, and customer-centric approaches. The research emphasises the necessity for a holistic approach to monetary policy, including qualitative tools, while emphasizing effective asset-liability management, financial inclusion through digital banking,

and promoting sustainable finance to ensure economic prosperity and stability in India. By adopting a forward-looking mindset, the banking sector can not only overcome challenges but also thrive in the dynamic landscape of 2024.

Introduction

After almost a decade of struggling with bad loan challenges, there has been an evident resurgence in India's banking system recently. However Indian banks remain susceptible to the impact of monetary policies and external uncertainties like geopolitical issues.

The first generation of banking in India began with the establishment of the Bank of Hindustan in 1770 and the General Bank of India in 1786. These early banks primarily served the needs of British colonial interests and trade. The banking landscape evolved with the establishment of the Bank of Calcutta, Bank of Bombay, and Bank of Madras in 1806, which later merged in 1921 to form the Imperial Bank of India. This laid the foundation for modern banking in the country. The Reserve Bank of India was also established during this period in 1935. However, most of the small or local banks established during this period faced failure due to internal frauds, interconnected lending, and the amalgamation of trading and banking activities.

The second-generation banking took place from 1947-1967. During this time, the three banks which were merged in 1921 to form the Imperial Bank of India, became the State Bank of India. The State Bank of India was given control of eight state-associated banks in 1960, under the State Bank of India (Subsidiary Banks) Act, 1959 (RBI, 2015). By mobilizing retail deposits and consolidating resources Indian banks were able to offer loans to a limited number of business families. Credits were offered to the agriculture sector as well.

The third-generation banking began in 1967. In this period, the Indian government successfully linked industries and banks by nationalizing 20 major private banks. Priority sector lending was also introduced by the government during this period (1972).

Fourth-generation banking took place between 1991 and 2014. Some of the most significant reforms in the history of the Indian banking sector like issuing new licenses to private and foreign banks took place in this period. This step taken by the government played a significant role in bringing competition among the banks thereby improving productivity and efficiency. By the international banking regulations issued by the Basel Committee on banking supervision, the Indian government brought in changes like the introduction of prudential norms. Narsimham Committee I (1991), which was headed by M. Narasimham, former RBI

Governor suggested several measures to strengthen the banking system, including reducing government interference, increasing the role of the RBI in supervising banks, and enhancing transparency. It recommended the reduction of statutory liquidity ratio (SLR) and cash reserve ratio (CRR), which were high reserve requirements for banks, to improve their liquidity. The committee also suggested the recapitalization of weak banks, the strengthening of bank management, and the introduction of prudential norms. R. H. Khan Committee (1997), which was headed by R. H. Khan, former Deputy Governor of the Reserve Bank of India (RBI), examined the financial system's effectiveness for the small-scale sector and the role of primary dealers. The committee put forward recommendations to improve credit delivery to the small-scale sector and enhance the functioning of primary dealers. Narsimham Committee II (1998) was a follow-up to Narsimham Committee I and aimed to review the progress of reforms. The committee emphasized the need for structural reforms, consolidation of the banking sector, and the establishment of strong and autonomous regulatory bodies. It recommended reducing the government's stake in public sector banks (PSBs) to less than 33% and enhancing corporate governance standards in PSBs. The committee also suggested the adoption of international accounting standards and the introduction of risk-based supervision. Raghuram Rajan Committee (2008), which was chaired by Raghuram Rajan, former Chief Economist of the International Monetary Fund (IMF), this committee was appointed to examine the financial sector reforms in India. The committee provided recommendations to strengthen the banking system and enhance stability. Financial Sector Legislative Reforms Commission (FSLRC) (2011), which was headed by Justice B. N. Srikrishna was tasked with reviewing and restructuring the legal and regulatory framework of the financial sector in India. It aimed to consolidate and streamline the laws governing the financial sector, including banking, insurance, securities, and pensions. PJ Nayak Committee (2014) which was led by P. J. Nayak, this committee was constituted to examine the governance of PSBs. The committee highlighted the need for reforms in the governance structure, such as strengthening the board's role, empowering bank management, and professionalizing the appointment process of top executives. It suggested reducing government interference and advocated for a greater role of the board in key decisions, including appointments and capital allocation. Nachiket Mor Committee (2014) which was headed by Nachiket Mor, was formed to examine the Comprehensive Financial Services for Small Businesses and Low-Income Households. The committee recommended measures to increase financial inclusion, such as the establishment of payment banks, small finance banks, and the creation of a universal electronic bank account (Jan Dhan Yojana). It proposed the concept of "payment banks" to provide basic banking services, including payments and remittances, to underserved sections of society. The well-known JAM trinity which includes Jan-Dhan, Aadhaar, and Mobile came into effect in 2014. Payments Banks and Small finance banks (SFBs) also received their licenses during this period.

The Indradhanush framework was introduced in 2015 by the Government of India to rejuvenate and reform public sector banks (PSBs) in the country. The Indradhanush framework aimed to improve the efficiency, transparency, and governance of PSBs and strengthen their ability to support economic growth. The framework aimed to address key areas of banking sector reforms, encapsulated by the seven pillars of Indradhanush, which were regarding the appointment of skilled professionals in banks, and the setting up of the Bank Board Bureau (BBB) as an autonomous body to provide guidance and enhance governance in PSBs, injecting capital into PSBs to strengthen their balance sheets and enable them to meet Basel III capital adequacy norms Implementing measures to address the issue of non-performing assets (NPAs) and stressed assets in PSBs, granting more autonomy to bank boards and empowering them with greater decision-making authority, introducing a framework to hold the management of PSBs accountable for their performance and enhancing transparency, risk management, and governance practices in PSBs.

HR Khan Committee (2015) which was led by H. R. Khan, former Deputy Governor of RBI, was formed to examine the existing framework for monetary policy in India. The committee made recommendations on issues such as inflation targeting, monetary policy transmission, and improving the decision-making process of the RBI's Monetary Policy Committee (MPC). The 4R framework was introduced in 2017 as part of the government's policy to address the issue of mounting bad loans in the banking system.

The framework focused on four key elements: Recognition: Prompt identification and classification of stressed assets as NPAs to accurately assess the extent of the problem, Recapitalization: Injecting capital into banks to improve their financial health and enhance their lending capacity, Resolution: Establishing mechanisms for the timely resolution of stressed assets through processes like the Insolvency and Bankruptcy Code (IBC) and other resolution frameworks and Reforms: Undertaking structural reforms to improve the governance, risk management, and operational efficiency of banks.The 4R framework aimed to address the issue of stressed assets, promote transparency and accountability, and strengthen the banking sector's resilience.

EASE (Enhanced Access and Service Excellence) Framework is an initiative launched in 2018 to improve public sector banks (PSBs) in India. Key features of the EASE framework include governance reforms like strengthening the governance structure of public sector banks (PSBs), enhancing the effectiveness of boards, improving transparency, and bolstering risk management practices. It also addresses the importance of responsible banking by encouraging PSBs to align their activities with national development goals and promoting social objectives and environmental sustainability. This also includes credit offtake improvement in credit processes streamlining lending procedures and promoting digital lending platforms. This framework also included enhancement of credit access for small and medium-sized enterprises agriculture, and retail borrowers(SMEs), deepening financial inclusion, and expanding banking services in unbanked and underbanked areas.

This framework also outlines leveraging technology for wider accessibility, offering affordable banking services to all, prioritizing customer responsiveness through a customer-focused approach and streamlined processes, and introducing a Responsible Banking Index to assess and rank Public Sector Banks (PSBs) based on governance, credit, and customer service parameters, fostering healthy competition and improvement.

Bimal Jalan Committee (2019) which was chaired by Bimal Jalan, was established to review the economic capital framework of the Reserve Bank of India (RBI). The committee recommended transferring a portion of RBI's surplus reserves to the government and revising the framework for determining RBI's capital requirements. It aimed to strike a balance between the central bank's need for capital buffers and the government's fiscal requirements.

The banking sector in India plays a pivotal role in the nation's economic landscape, serving as a cornerstone for financial stability and growth. Characterized by a diverse mix of public, private, and foreign banks, this sector is regulated and supervised by the Reserve Bank of India (RBI). Over the years, the banking industry has undergone significant transformations, adapting to technological advancements and regulatory changes.

Literature Review

1. Non-performing assets and profitability: Case of the Indian banking sector

-Dolly Gaur, Dipti Ranjan Mohapatra

The current state of the Indian banking sector faces a challenging period marked by a rising trend in non-performing assets (NPAs), posing a significant test to its resilience. This study investigates the relationship between NPAs and profitability in the Indian banking sector, aiming to gauge the gravity of NPAs' impact on bank profitability. The analysis considers various bank-specific, industry-specific, and macroeconomic factors over 14 years (2005–2018) using a balanced panel data set of 37 scheduled commercial banks. Employing fixed effect and random effect panel regression models, the study reveals a highly negative correlation between NPAs and profitability measures, specifically return on assets (ROA) and return on equity (ROE). The findings identify NPAs as a major impediment to banking industry profits, emphasizing that deteriorating credit quality adversely affects banks' performance and can lead to their collapse. The research gap in this study could be the lack of exploration into potential strategies or interventions that could help mitigate the impact of NPAs on bank profitability. While the study effectively identifies the negative correlation between NPAs and profitability, it would be beneficial to delve deeper into possible solutions or risk management practices that banks could implement to address this issue and improve their resilience in the face of rising NPAs.

2. An Overview of Measures to Recover NPA Concerning 4R Strategy

-Greeshma Francis

This paper emphasizes the crucial role of commercial banks as the lifeline of the economy, focusing on their primary function of providing credit facilities and the challenges posed by Non-Performing Assets (NPAs). NPAs, defined in India as assets with unpaid interest or principal for over 90 days, present a significant concern for banks. This paper traces the evolution of NPA resolution mechanisms, highlighting the shift from a lengthy legal process pre-1993 to contemporary strategies such as Debt Recovery Tribunals, Corporate Debt Restructuring, SARFAESI Act, Credit Information Bureau, Asset Reconstruction Companies, Lok Adalats, and compromise settlements. Emphasizing the time-consuming nature of the judicial process, the paper explores the impact of the government's 4R strategy to expedite NPA recovery in the Indian banking sector. While the paper provides an overview of these mechanisms and acknowledges the government's efforts to expedite NPA recovery through the 4R strategy, it would be valuable to delve deeper into the empirical evidence of their success or failure. This could involve assessing the efficiency, transparency, and overall impact of each mechanism on reducing NPAs and restoring the health of the banking sector.

3. Technology Adoption in Indian Banking Sectors – 2023

- D. Murugun

(School of Business Studies, Hindustan College of Arts and Science, Padur)

This paper discusses the impact of recent technological advancements on the banking sector, particularly emphasizing the transformative influence of phone, online, and mobile banking. It highlights how these innovations have revolutionized financial management, eliminating excuses for overdrawing or missing credit card payments. The paper also traces the evolution from traditional log books and branch visits to the convenience of ATMs and, more recently, mobile banking apps. Notably, this research addresses the advantages of technology, enabling real-time balance checks, quick bill payments, and financial management flexibility. Through this paper, the author aims to explore the adoption of technology in the Indian banking sector, by performing a comprehensive analysis of its implications and benefits. Assessing the readiness and accessibility of technology infrastructure in rural or underserved areas of India, along with potential strategies to address any disparities in technological adoption, could provide a more comprehensive understanding of the implications of technology in the Indian banking sector.

4. Impact of FDI on Productivity of Public Sector Banking Industry, India

-Pushpalata Mahapatra & Arpan Mahapatra

(Srusti Academy of Management)

This paper highlights the technological advancement of Indian banks, emphasizing the crucial role of the banking sector in a country's economic development. It views Foreign Direct Investment (FDI) as a tool for economic growth, promoting domestic capital, productivity, and employment. The focus is on FDI in the service sector in India, exploring its impact on technology, skills, and managerial capabilities. The paper also discusses top countries investing in India's service sector through FDI and analyzes the inflows and impacts specifically in the banking sector. The research gap would be the lack of exploring the effectiveness of existing regulatory frameworks in managing FDI inflows in the banking sector and mitigating associated risks which could have provided valuable insights for policymakers and stakeholders.

5. Customer’s Satisfaction Towards Sustainable Banking Services of Public Sector Banks in India: A Study on SBI in the District of Hooghly, West Bengal

-Jyotirmoy Koley

This paper highlights the significant role of the banking industry in India's financial system, particularly post-1991 reforms. It emphasizes the shift where customer satisfaction is crucial for banking business success, as it is a key factor for profitability and sustainability. It also suggests that Indian public sector banks, like the State Bank of India (SBI), must offer innovative products and services to private and foreign banks. This research focuses on analyzing customer satisfaction with sustainable financial services provided by SBI in West Bengal's Hooghly district, revealing associations between satisfaction levels and demographic factors such as gender, age, education, occupation, and annual income. While the paper effectively analyzes the associations between satisfaction levels and demographic factors such as gender, age, education, occupation, and annual income, it would be valuable to also consider other factors such as accessibility of banking services, quality of customer service, perception of product offerings, and awareness of sustainable banking practices. Also, examining the impact of cultural or regional differences, technological innovations, and competitive landscape on customer satisfaction could provide a more comprehensive understanding of the dynamics influencing banking business success in these regions.

Current Status of the Indian Banking Sector

Indian banking system finds itself in an enviable position in 2023, after going through seething government and bad loan issues for nearly a decade. From suffering a loss of Rs 85,390 crore in FY18 to gaining an outstanding profit of Rs1,04,649 crore in FY23, Indian public sector banks have come a long way. According to a PTI analysis, these 12 PSBs have attained a 57% increase in total profit compared with Rs 66,539.98 crore earned in 2021-22. The gross and net NPAs of PSBs are 14.6% and 8.5% respectively. To reduce the Non-Performing Assets (NPAs) faced by PSBs the Prime Minister Narendra Modi-led government and RBI implemented some policies like the 4R strategy. The government implemented a comprehensive strategy encompassing transparent recognition of Non-Performing Assets (NPAs), resolution and recovery efforts, recapitalization of Public Sector Banks (PSBs), and financial ecosystem reforms. During the last five financial years (2016-17 to 2020-21), an unprecedented Rs

3,10,997 crore was infused to recapitalize PSBs, preventing defaults and providing crucial support. Over the past eight years, reforms focused on enhancing credit discipline, promoting responsible lending, improving governance, adopting technology, bank amalgamation, and maintaining overall banker confidence (Economic Times, 2023).

Housing Development Finance Corporation (HDFC) merged with its subsidiary HDFC Bank on July 1, 2023. The HDFC, HDFC Bank merger created the world's fourth largest bank of the world after JP Morgan Chase & Co., Industrial and Commercial Bank of China Ltd (ICBC) and Bank of America Corp. According to an analysis by Abhilash Pagaria, Head of Nuvama Alternative & Quantitative Research, the revised weight of HDFC Bank will be 14.43 percent in the Nifty50 index which will be the highest weight of any single constituent in the index Shrey Jain, Founder and CEO of SAS Online - India's Deep Discount Broker pointed out that following its merger of HDFC and HDFC Bank, the latter's weightage in the Nifty50 has surged to an impressive 14.43 percent. This elevation has propelled HDFC Bank ahead of Reliance Industries in terms of weightage, securing its position as the anchor for the benchmark index. This will also lead to an upward weight revision to 29 percent from 27 percent in the Nifty Bank index. Now, HDFC Bank has the highest weight in Nifty which means its movement will significantly influence the performance of both Nifty and Bank Nifty. The stock, along with the stock of Reliance Industries, will have a heavy impact on how these indices move. The overall market capitalisation (mcap) of HDFC Bank will now be over 14 lakh crore which will make it the second largest firm, after Reliance Industries, in terms of mcap in India. TCS, which was at the second spot, will now slip to the third place with a mcap of nearly 12 lakh crore.

The net interest margins (NIM) which is the difference between interest earned on loans and paid on deposits shrunk by another 30 basis points (bps) over the next few quarters. After hitting a peak of 3.3 percent in the third quarter (Q3) of the financial year which ended on March 31, 2023 (FY23), NIMs have been on a downward trajectory, touching 3.13 percent in Q2FY24 on the higher cost of funds, according to capital markets firm CARE Ratings.

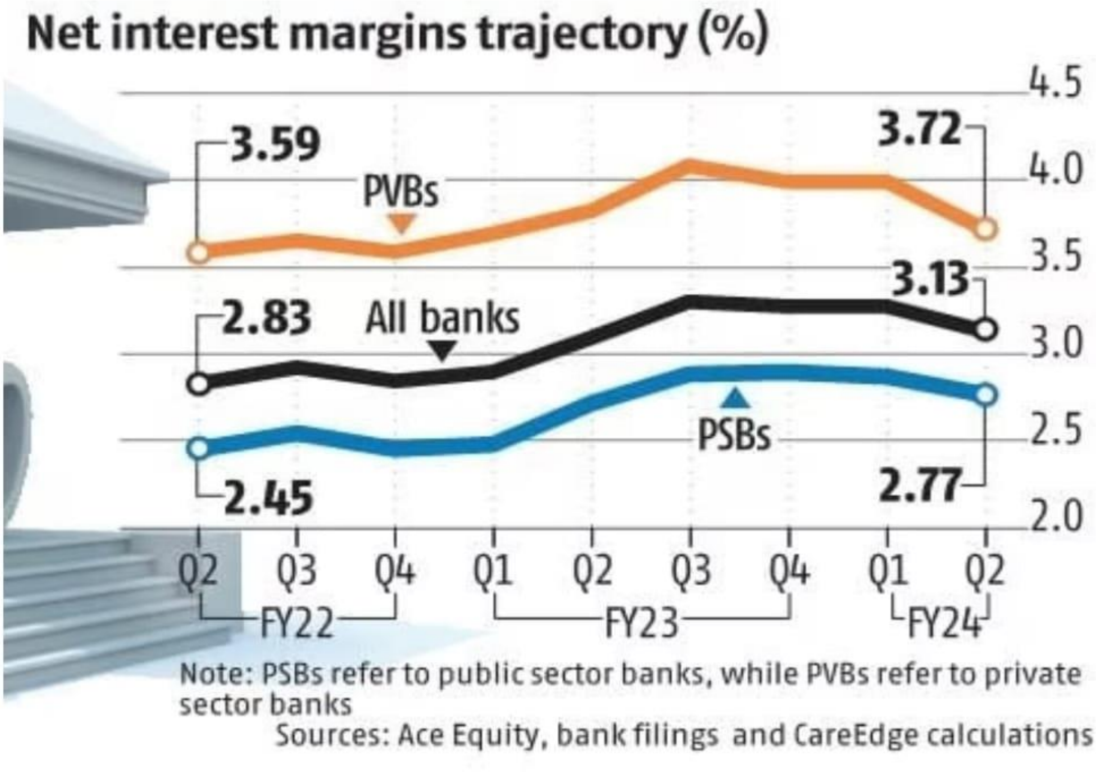
Banks are still struggling with the Reserve Bank of India's policy rate increases which have made deposits costlier as the interest payable to customers has increased and the regulatory actions on unsecured lending added to the issues.

NIMs of banks stood at 2.83 percent in Q2FY22. Public and private sector banks reported NIMs of 2.45 percent and 3.59 percent, respectively, in the quarter.

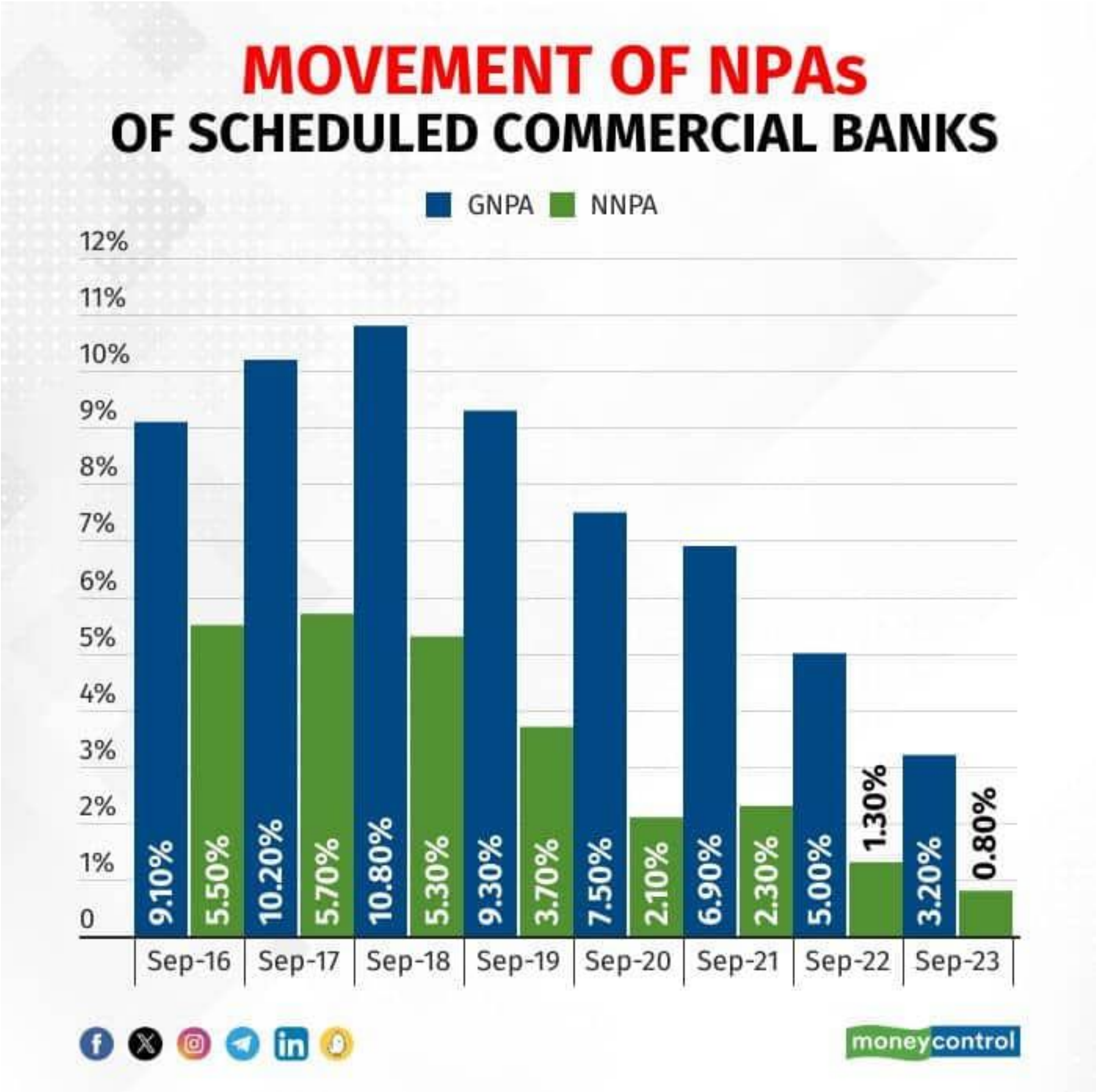
In terms of sequential performance, margins of scheduled commercial banks (SCBs) declined 14 bps to 3.13 percent, and, private and public sector banks recorded a decline of 27 bps and 10 bps, respectively.

The rising interest rates have pushed the cost of deposits. For public sector banks, the cost of deposits, which refers to the rate of interest the bank pays on deposits, rose to 4.93 percent in Q2FY24, from 4.68 percent in Q1FY24 and 3.93 percent in Q2FY23. For private banks, the rise in cost of deposits has been much sharper at 5.73 percent in Q2FY24 from 4.99 percent in Q1FY24 and 4.13 percent in Q2FY22.

The rising yield due to the repricing of loans and fresh credit disbursal at higher rates helped boost NIMs. The yields on PSB advances rose to 8.59 percent in Q2FY24 from 8.48 percent in Q1FY24 and 7.44 percent in Q2FY23. For private sector lenders, yield on loans rose to 10.7 percent in Q2FY24, up from 10.08 percent in Q1FY24, and 9.06 percent in Q2FY23, rating agency analysis showed.



The capital-to-risk-weighted assets ratio (CRAR) stands at 16.8%, which indicates the strong financial position of scheduled commercial banks (FSR,2021). Indian banks exhibit strong financial health, which is indicated by their capacity to absorb risks and uphold stability in the financial system. Indian banks uphold strong liquidity levels, exceeding the RBI's minimum requirements, and major institutions like SBI, PNB, and Union Bank demonstrate a capability for extended lending, as reflected in their Credit-Deposit ratios which are below 72%. Despite the overall robustness of the banking sector in 2023, it still encountered a few challenges.



Source: Moneycontrol

Obstacles Faced by the Indian Banking Sector in the year 2023

1) Privatization of banks

Finance Minister, Nirmala Sitharaman while presenting the 2021-22 budget announced the privatization of public sector banks (PSBs) as part of the disinvestment drive to accumulate Rs, 1.75 trillion. Since then, two Union Budgets have been presented and nine regular Parliament sessions have taken place but none of them have passed a bill facilitating privatization of public sector banks. The government has not given any information regarding the timeline of privatization even after facing questions regarding this in every other parliament session. During the last winter session of parliament, Minister of State for Finance, Bhagawad Karad stated that the policy regarding the privatization of banks included objectives like enablement of growth of public sector enterprises through the infusion of private capital, which can, in turn, contribute to economic growth by creating new jobs, financing social sectors and developing government programs (Business Standard, 2024).

According to Dr. Panagariya, who headed the NITI Aayog earlier for two and half years as its first vice chairman, when the PSU banks were in bad condition due to heightened levels of non-performing assets (NPAs), the crises were tackled by the government by rescuing them through funding. This has removed the risk of them being undervalued, which could have postponed the decision to sell the government's stake in them. As per his vision, the right time to privatize PSU banks is after the general election of 2024 (Dutta, 2024)

2) Rising Inflation

As per the Ministry of Statistics and Programme Implementation (MOSPI), the inflation rate in India was 5.69% in December 2023. This means that the prices of goods and services in India have increased by 5.02% since 2022. Here, is a snapshot of the inflation rate in India for the last 10 years, as measured by the Consumer Price Index (CPI).

Year	Inflation rate (%)
2013	9.84
2014	6.39
2015	5.42
2016	4.55
2017	3.56
2018	5.08
2019	3.73

2020	6.62
2021	5.13
2022	6.70

The continuation of rising food prices was the major reason for inflation, potentially leading to a destabilization of inflation expectations and widespread price pressures. These risks are increased by emerging geopolitical tensions and supply chain disruptions. In light of these persistent uncertainties, monetary policy is necessary to guide us through the final stages of disinflation effectively. After all, maintaining stable and low inflation at 4% is essential for ensuring sustainable economic growth (The Hindu, 2024).

According to a study conducted by Minnu Baby Maria and Farah Hussain titled “Does inflation expectation affect banks' performances? Evidence from the Indian banking sector”, inflation expectation is instrumental in deciding the banking sector's performance. Inflation expectation has been found to have a significant and positive impact on accounting-based measures of banking performance. At the same time, it shows a negative impact on the marketing-based measure.

Inflation can have several positive impacts on the banking sector including increased lending activity, higher interest margins, asset appreciation, and wealth effect (As asset values increase, individuals may feel wealthier and be more inclined to invest or spend, which can stimulate economic activity and increase demand for banking services such as investment management and wealth advisory).

Inflation can also have negative impacts on the banking sector including interest rate risk, credit risk, asset quality deterioration, regulatory challenges which may further increase compliance costs and operational burdens for banks, reducing consumer confidence and reducing demand for banking products and services, such as loans and investments, which can impact banks' revenue streams and growth prospects.

Overall, while moderate inflation can stimulate economic activity and benefit banks, high or unpredictable inflation can pose significant challenges to the banking sector, affecting profitability, asset quality, and regulatory compliance.

3) Liquidity Management

According to World Bank data, the gross domestic savings (GDS) has dropped from 34.3 percent in 2010 to 29.1 percent in 2022. Household savings in physical assets have increased from Rs. 22.52 trillion in 2018-19 to Rs. 27.69 trillion. In contrast, financial savings have increased from Rs. 22.63 trillion to Rs.25.97 trillion during the same period with an obvious bias towards physical assets.

The recent data from RBI shows that the demand deposits are falling from 44.4 percent in March 2019 to 41.55 percent in March 2023. Even deposits of up to one year fell from 44.4 percent to 36.7 percent during the same period. As a result, the deposits beyond one year duration are rising pushing up the cost of funds. Many banks are even allowing premature withdrawal of term deposits through net banking services making liquidity more vulnerable.

However, in an evolving stressed liquidity environment where the banking system is on interoperable technology, it is necessary to understand the behavioral shift of young consumers. Their savings pattern is fast shifting the gears exposing liquidity flows to new forms of risks. The inability to factor these granular nuances in managing liquidity risks may increase vulnerability (Rao, 2024).

Why do small private banks in India fail?

In the year 1969, the government of India nationalized the prominent 14 commercial banks then were monitored and controlled by the Government sector. Even after taking massive measures and policies, few banks are unable to pay back the money for their depositors which is a huge risk for India’s economy.

The most popular bank failures in India were that of Punjab and Maharashtra Co-Operative Bank Limited (PMC Bank), Global Trust Bank, and Lakshmi Vilas Bank.

On September 23, 2019, the Reserve Bank of India (RBI) imposed stringent restrictions on Punjab and Maharashtra Cooperative Bank (PMC Bank) due to major financial irregularities, failure of internal controls and systems, and misreporting of exposures to RBI. The PMC bank granted a loan of Rs. 2,500 crores to a real-estate company named Housing Development and Infrastructure Limited (HDIL). To give out such a huge amount of loan the bank gave out 70% of its depositors' investments, to do this fraud twenty-one thousand new fake bank accounts were created to show that the loans had been granted to different individuals. Later, the director of the bank, Mr. Waryam Singh had to accept and confess to this fraud as the liquid money in the bank was given out as a loan and people wanted to withdraw their deposits which the bank lacked in giving. The promoters of Housing Development and Infrastructure Limited (HDIL), Rakesh Wadhawan, and Sarang Wadhawan were arrested and the director of PMC Bank was convicted of cheating.

Global Trust Bank had high exposure to capital markets, more than the regulator's prescribed limit, and gave away loans to speculators in the 2000s. When the market crashed, the bank suffered heavy losses. The RBI review found that the bank's net worth turned negative and forced it to shut shop.RBI issued a Moratorium Order on 24 July 2004. Before GTB's winding up, Goldman Sachs owned 4% of the bank and the International Finance Corporation owned 5%. GTBL filed financial lawsuits against Goldman Sachs on 24 July 2004.

For a long time, the Lakshmi Vilas Bank has been consistently facing problems such as bad governance, no profit, and an increase in non-performing assets (NPAs). In the year 2017, this bank started facing huge problems when they granted a loan of Rs. 720 crores to then the promoters of Ranbaxy, Shivinder Singh, and Malvinder Singh, and this loan transfer was investigated.

Later, the information that came forward was that the Lakshmi Vilas Bank gave away the deposits of Religare Finvest Limited to the promoters of Ranbaxy, Shivinder Singh, and Malvinder Singh in their capacity. Moreover, the bank also misused the public funds deposited into the bank. After the case was filed, RBI put LVB under prompt corrective action (PCA) in September 2019 due to which the bank was not able to issue fresh loans or open a new branch anywhere.

Due to these issues, the Reserve Bank of India (RBI) merged this bank with a foreign bank named DBS and placed a moratorium which means that the bank cannot give out any loans for 30 days and no depositor can withdraw more than Rs. 25,000/-.

Reasons for Bank failures are reckless lending, focusing on the big corporate entities without targeting the local men and retail customers, and high NPA.

Why banks are not expanding to rural and tribal areas?

The research paper titled "Do Rural Banks Matter? Evidence from the Indian Social Banking Experiment" written by Robin Burgess and Rohini Pande clearly states the benefits of expanding banks to rural areas. The study examines the impact of branch expansion on the composition of output, employment, wages, poverty, and inequality in Indian states from 1970 to 1992. The most important findings indicate that branch expansion into unbanked areas positively affects non-agricultural output and diversification, contributing to the growth of small manufacturing units and improving rural welfare. Expansion into unbanked areas reduces rural poverty and inequality, while expansion into banked areas has a limited impact. The study suggests that the social banking experiment has helped poor people transition into non-farm employment and production activities, thereby reducing rural poverty and inequality. These findings challenge the idea that bank expansion mainly benefits the rich elites in India.

The study titled "Rural Financial Intermediation: A Study in Tribal Areas of Jharkhand" sheds light on how tribal regions like that of Jharkhand can increase their banking potential. Rural tribal areas of Jharkhand were isolated from the external financial systems until five decades ago. Even now, these areas are so underdeveloped that the barter system is still prevalent.

The tribes have their own system of trading land and are not very familiar with the concept of paper money. Thus, they do not possess adequate skills to use the money received as compensation from the land. The tribes of Jharkhand usually borrow small sums of money at regular time intervals which are often too small to obtain through mainstream banks. Therefore, instead of monetization of land, emphasis should be put on capitalization of land. In this case, the tribal land can be used for the generation of a steady stream of revenue under a suitable lease contract over some time.

They also designed a financial model and suggested that the financial system should be made end-exogenous instead of an endogenous form of management as suggested by the National Forest Policy in 1988. According to this model, tribal financial systems gain precedence over the state financial machinery and the role of the state is only to facilitate these systems. The original structure of the system can be seen in the figure given below, where the government interventions are primarily through NABARD, and the money is channeled through banks and NGOs. This system also has minimal cooperation among the participating organizations. SHGs and co-operative banks still need to avail funds at a higher rate from the nationalized banks and NABARD.

The modified tribal financial system

Here, the organizations that are nearer to the people get a greater role to play. These institutions have a better understanding of the varying credit needs of tribal people and hence can structure their products to suit their needs. The government can set up funding agencies and regulatory authorities to monitor these institutions.

This modified version of the financial system can be implemented in other rural and tribal areas with some changes.

Small-scale farmers, landless agricultural laborers, artisans, and economically disadvantaged castes and groups in India have been exploited by informal lenders, resulting in a cycle of indebtedness. Initially, there were 196 regional rural banks (RRBs) across 28 states, with around 14,700 branches. By June 1996, these RRBs were disbursing approximately Rs 1500 crore annually, with over 90% of loans targeted towards weaker sections.

Substantial growth was observed in 2007-08 and 2008-09, with agriculture receiving the highest share of loans compared to non-agricultural activities. However, there's a need for banks to ensure sufficient funding for non-priority sectors and minimize the gap between short-term crop loans and long-term loans for agricultural activities. Increasing the availability of term loans for agriculture and diversifying loan allocation to non-agricultural sectors could benefit the rural economy. This insight is crucial for rural banking institutions and policymakers in shaping a robust credit structure for the future.

Obstacles that Lie Ahead for the Indian Banking Sector

1. Challenges of Investing in Infracture

The Union Budget 2023 reveals a significant 33% boost in capital expenditure, signaling a substantial government commitment to infrastructure projects. This increased investment aims to foster economic growth and development. Notably, the shift in banks' stance, from reluctance to lending in the infrastructure financing segment, indicates a positive alignment with the government's vision for robust national development. According to Bank of Baroda’s MD and CEO, Mr. Sanjiv Chadha, the hybrid annuity model in the road sector ensures government funding to NHAI for viability gap funding, while requiring 90% land acquisition before project initiation. This intervention minimizes market risk for banks post-completion, contributing to a significant impact, especially with the recent 33% growth in capital expenditure. Investing in infrastructure also helps in developing core industries like steel and cement (Menon, 2023). Bank lending for infrastructure and capital investments tied to State government entities carries default risks amid strained State finances. To mitigate this, banks should establish internal exposure limits grounded in fiscal and financial evaluations of each State.

2. Issues Caused by Surging Stock Market

The surging stock market, fostering a facade of prosperity, poses a potential threat to retail investments. The spike in demat accounts and elevated PE ratios across sectors signals a looming risk. To mitigate this, integrated supervision and robust stress tests on retail portfolios are advised for proactive risk management. This issue regarding stock market and retail exposure risk presents a huge threat to the smooth functioning of banks.

3. Challenges faced by SMEs and Liquidity Coverage issues

The resurgence of global interconnectedness and geopolitical changes could pose challenges for Small and Medium-sized Enterprises (SMEs), particularly with Free Trade Agreements (FTAs) and regional ambitions. Banks must meticulously evaluate and ready themselves for potential risks to SMEs, taking into account possible disruptions to cash flows.

Banks with higher credit-deposit ratios may need help in liquidity coverage. A structural shift in Indian savings requires caution and prudence from bankers.

4. Downward Trajectory of GNP Ratio

India has been seeing a high digital adoption level across banks. UPI continues to drive significant volumes in payment, the share of which has improved from 71% to 78% YoY. In a contrasting scenario, the volumes of debit card usage have dropped by 33% YoY. Strong asset quality metrics have bolstered confidence in the Indian banking industry. Gross NPA continues to improve across banks with an industry GNPA of 3.3%. By bringing down the amount of NPA's in the last few years, Indian banks have quite succeeded in generating consistent profits. Still, robust risk management practices are necessary to curtail the operational risks.

RBI expects the downward trajectory of the GNP ratio to continue in the same manner. As per CRISIL, GNPA might well hit a decadal low of around 3.8% to 4% in FY-24 due to underlying recoveries and upgradations through the National Asset Reconstruction Company Ltd (NARCL).

Measures to protect the Indian Banking Sector

If executed well some measures like establishing big banks, blockchain banking, ESG integration, enabling corporate bond market growth, and improving risk management models can enhance the potential of the banking sector.

The Narasimham Committee Report in 1991 emphasized the significance of establishing three or four major commercial banks in India with a global presence, alongside foreign banks. This recommendation aimed to strengthen the country's banking sector both domestically and internationally.

The integration of enhanced risk management through technology, particularly by neo-banks, can contribute to advancing digital financial inclusion and supporting the growth of an emerging India. In the context of Indian banking, the adoption of technologies like Blockchain has the potential to streamline prudential supervision, enhancing control over banks.

Distinctive Banks tend to benefit by listing on a reputable stock exchange and embracing the ESG framework, aiming to enhance long-term value for stakeholders through a focus on Environmental, Social Responsibility, and Governance principles.

To foster a responsive banking system aligned with the dynamic real economy, promoting corporate bond market growth is crucial, signaling a shift from a bank-centric economic model. Additionally, enhancing risk management involves creating and implementing tailored internal risk models for individual States, such as the Bank Exposure Risk Index, to assess risks tied to lending for State government entities and infrastructure projects.

These measures if implemented can help the banking sector to improve significantly in the future.

Policy Recommendations

1. Limited Political Intervention

Based on the research done by economists Belavadi Nikhil and Shivakumar Deene, considering the monetary policy rates alone as an instrument will not be effective in generating and simulating the economic activity level desired in the banking sector. They have strongly emphasized the need for proper planning and timing regarding policymaking, which is based on the economic conditions of the economy. They have also suggested the need for using qualitative tools that help in regulating the flow/fluctuation of money supply and inflation in the economy. The combination of both quantitative, as well as qualitative tools will give positive results to the banks as well as to the Indian economy. It is the duty of policymakers (monetary policy committee) to govern the monetary tools to ensure that they are effective in producing and stimulating the level of economic activities desired in the banking sector. According to them political intervention in the banking sector is unfavourable to the growth and well-being of the banking sector and should be minimised for its growth. (Belavadi & Deene, 2021).

2. Effective Management of Asset-Liability Mismatch

The effective management of asset-liability mismatch should be one of the key focus areas for banks. For the same, RBI can enforce strict guidelines concerning the maturity profiles of assets and liabilities, thereby ensuring that these two are aligned. Conducting regular stress tests to assess the impact of adverse scenarios on their balance sheets can help banks in finding potential mismatches. Banks can also try to establish ALCOs (Asset Liability Committees) by appointing members from the treasury, risk management, and finance which can be helpful in monitoring and managing asset- liability-related issues. Ensuring that the banks maintain a sufficient capital buffer can help in tackling losses due to asset-liability mismatches. Singapore has effectively managed asset-liability mismatch by establishing institutions like the Monetary Authority of Singapore (MAS) which has played a key role in ensuring that banks maintain adequate liquidity. Another method that helped the country is diversifying its investment strategies across various asset classes globally. They focus mainly on a long-term investment approach by creating sustainable returns over the long term. This method has helped them withstand short-term market volatility.

3. Financial Inclusion

Another issue is financial inclusion, India, with a population of 1.3 billion, an enormous number of individuals are still out of the formal financial net. Despite our concerted efforts toward financial inclusion over decades, the nation has had limited accomplishment in bringing its underprivileged into utilizing banks' services. Some practices that are prevalent even today are borrowing at a high cost, accepting risky arrangements from loan sharks, dependence on cash-only transactions, etc. If the rural masses, who comprise the majority of the unbanked segment can gain access to digital banking may develop a habit of saving, thereby expanding capital formation in the country. It will guarantee satisfactory and straightforward credit accessibility from the banks, thereby fostering the entrepreneurial spirit, which in turn will add to the overall prosperity of the nation.

Most importantly, it will help plug the holes in administering public subsidies and government welfare programs. The majority of the population avoids financial reach due to the costs involved in electronic transactions, for instance, charges levied on NEFT, RTGS, mobile wallets, and so on. Another concern is that most banks have a minimum balance requirement on accounts that are hard to maintain for individuals on low pay. These aspects need to be addressed if financial inclusion is to be achieved. Banks must also focus on adopting a mobile-first strategy by using applications to gain access to account data as well as different functionalities, for example, cash flow. There is also a lack of trust among consumers concerning the security and reliability of the newly established platforms. To help them come out of this fear, authorities must issue clear rules and guidelines shielding customers and allowing them to make informed decisions (Vishal Pradhan, Tata Consultancy Services). Kenya's mobile money service, M- Pesa has significantly increased financial inclusion by making banking services available to the unbanked population.

4. Sustainable Finance Policies

As inclusive and sustainable development was part of the strategies for 'Amrit Kaal' put forward by the finance minister, more policies focusing on sustainable finance will be promoted. As of now, India is one of the leading countries concerning policy intervention in the field of sustainable finance.

Conclusion

This paper explored key challenges faced by the banking sector in 2023 like privatisation of banks, increasing inflation, challenges in liquidity management, the failure of small private banks in India, and the often neglected expansion of the banking sector into rural and tribal regions. After analysing these issues this paper put forward solutions like emphasizing the integration of advanced technologies, regulatory compliance frameworks, and customer-centric approaches. Key findings included the challenges of a surging stock market, liquidity coverage issues, and the downward trajectory of the GNP Ratio. Policy recommendations are put forward to address the necessity for reducing political intervention in the banking sector, measures for financial inclusion, and the need for more sustainable finance policies.

Despite facing challenges such as non-performing assets (NPAs) and occasional economic uncertainties, the Indian banking sector continues to demonstrate resilience. The government's initiatives, regulatory reforms, and the pursuit of financial inclusion contribute to shaping the sector's dynamics. As India progresses on its path of economic development, the banking sector remains a key driver, fostering financial stability and supporting the aspirations of businesses and individuals alike.

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