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Emerging threats to the Indian Banking Sector

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Abstract

Recent developments in financial products and services have proved to be game changers in how banks conduct their day to day operations. Alongside innovations, a slew of new threats have also emerged, making the banking environment potentially riskier and unpredictable. As the Indian financial sector is largely bank-centric, the performance of the banking sector is crucial in the development process of the economy. This paper highlights the rise of NPAs, cyber threats and systemic inertia as the major threats faced by the banking sector in India and how these may reflect on the general financial climate.

Keywords: NPA, Banking, RBI, Financial Stability Report, cyber threats.

Since the turn of the millennium, the mantra of ‘economic growth’ has become the embodiment of the hopes and dreams of India. As an aspiring economic superpower with unmatched human resources there is no denying the fact that India represents tremendous potential for growth. With so much depending on it, matters concerning the growth of the economy are no longer the purvey of economists or statisticians alone. Every dip or spike in growth is closely monitored by the government, subjected to intense media scrutiny and public debate. At the centre of this debate is the banking system which is the fulcrum on which the economy turns. There is great pressure on the Indian banking system to rise up to the challenge and facilitate growth. It is in this context that the question whether Indian banks are prepared to rise up to future threats gains importance.

The Reserve Bank of India (RBI), as the central regulatory authority of Indian banking, is one of the agencies best poised to anticipate and formulate plans of action to deal with emerging threats. The RBI’s bi-annual publication of the Financial Stability Report (FSR) outlines current awareness and preparedness for emerging threats to the banking industry. The latest edition of the FSR published on June 30, 2017 indicates that the banking system may have to cope with an increase bad loans and contingent problems with capital adequacy in the near future. Further threats from cyber-attacks, bank fraud and systemic inertia against the new accounting standards Ind-AS (Indian Accounting Standards - scheduled to roll out in 2018) may beset banks. This article will examine some of the key threats outlined by the FSR, the corrective measures that may be adopted and how they may be implemented.

1.1 Rising NPA's: Since liberalisation, public sector banks have posted a steady increase in the bad loans in the portfolios. These Non-Performing Assets (NPAs) are loans which have failed to bring in returns to the bank either through non-repayment of interest or have resulted in loss by way of the capital amount not being repaid. As of March 2017, total amount of NPA's in Indian Banks is almost Rs 10 lakh crore, which represents about 9.6 percent of all loans. The RBI expects this to rise to 10.2% by March 2018.

This is particularly troubling to public-sector banks where almost 75 percent of their net worth is tied up in Non-Performing Assets. With more bad loans on their books, public-sector banks will be forced to set aside more money to ensure capital adequacy, thus limiting their ability to lend. This sets up a vicious cycle where banks earn less and less due to non-repayment of loans and also inability to sanction new loans. Eventually, the non-availability of loans could affect economic growth itself, further complicating the problem. There is some relief on this front as the Capital to Risk-weighted assets Ratio (CRAR) has marginally improved from 13.4 per cent to 13.6 percent between September 2016 and March 2017. If the current situation does not continue to improve, banks may not be able to meet the minimum requirement for capital adequacy set by the RBI. New norms like the Ind-AS will also require more money to be set aside against future bad loans.

The most common reason why viable loans turn into NPA's is because borrowers are not able to generate enough profit from their investments to repay the loan. In an economy experience a slowdown in growth, this might become commonplace. The annual growth rate for the first quarter of 2017 has been 5.7 percent, down from around 7 percent last year. The current growth rate is also the lowest since 2014. This fall has been attributed to the twin shocks of demonetisation and the roll-out of Goods and Service Tax (GST) within months of each other. Both of these put the economy under stress and severely affected borrower's ability to pay interest on their loans. In the event of any more unforeseen stress on the economy, the situation might become even worse. However, the RBI has continued to remain optimistic about India's growth potential.

Another hidden aspect of the problem of NPAs is restructured loans, which are NPAs that have been technically reclassified as viable loans, so that it does not appear as NPAs on the bank books. This is done in the hope that such loans will eventually be repaid and until that time, they will not negatively affect the balance sheet of the bank. Such loans are at risk of becoming full-fledged NPAs if the economic situation worsens. Restructured loans are only a temporary solution to the problem of NPAs and may in fact, do more harm than good.

1.2 Systemic Inertia: In any complex system operating according to its own rules, there is a great deal of inertia against change or innovation. This inertia often delays or denies much needed improvements and could pose as a threat to the whole system. The Indian Banking system has historically shown complacency in adopting the latest developments in banking in a timely fashion and this trend could prove costly in the future. The current hiring trends in banking is indicative of an upcoming vacuum in middle management. With most of recruitment happening at the entry level and with the retirement of senior staff, the essential decision implementing level of management may fall vacant. This could lead to further delay in effectively carrying out policy decisions.

According to the FSR, the upcoming transition to a new auditing system, Ind-AS (Indian Accounting Standard) could be challenging without capable manpower. Additionally, under Ind-AS, banks will be required to devote more funds for provisioning against future bad loans and this could severely affect their ability to lend.

Economic acceleration has ushered in an age of fierce competition in the Indian banking sector. Domestic and foreign operators have entered the arena in a big way and banks have taken to keeping themselves updated to operate in the competitive environment. While Indian banks have woken up to the need to adopt international standards and procedures, the delay often experienced and the inadequacies in the implementation often prove to be challenges. Despite the many innovations of late, India remains far away from the cutting edge of banking reforms.

Banks exhibit a high degree of management inertia, whereby the management does not do what is best for the institution in the long run. Balance sheet management is one of the practices in Indian banks which reflect the desire to defer accountability. This is done so that losses or stressed assets are temporarily kept out of the bank balance sheet. Managers who are about to retire often do this so that they can appear to have brought more rewards to their investors, while the losses are hidden. One way of doing this is by deferring the provisioning of capital to cover future bad loans. Although this might seem acceptable in the short term, it is a risky practice. As a corrective measure, it is necessary to introduce more transparency into banking practices; including the regular publication of the balance sheets.

1.3 Cyber Threats and Bank Fraud: Apart from NPA’s and systemic deficiencies, the most apparent threat to the banking industry is by way of cyber-attacks. The FSR notes that a cyber-threat can affect the financial system in three ways: a) by directly affecting the operations of a critical firm or service provider, b) by reducing the confidence in firms and markets and c) by damaging the credibility of key data. Although India has been a cash centric economy for long, the ready availability to smart devices and network connectivity is spurring on online transactions. However, the level of awareness is low among customers on how to conduct online transactions securely. The current digital literacy among Indian citizens is about 15 percent and the government aims to raise this to 50 percent by 2019. This has created a window of opportunity for hackers and cyber criminals to exploit loopholes in banking technologies.

Recently, targeted attacks on banking institutions have come to light. The attack on Union Bank of India in July 2016 started after an employee inadvertently infected the bank’s computers after opening an email attachment. It has also been reported that seventy percent of ATM's used in India are vulnerable to attack by ransomware like Wanna Cry. These are malicious computer programs that encrypt the contents of computers they infect and threaten to withhold information unless a ransom is paid. It is difficult for law enforcement agencies to take action against those who create this software because they are almost exclusively based abroad and they demand to paid through crypto currencies like Bitcoin which are virtually untraceable. It is also worrying that several of these cyber-attacks originate from Central Asia and Europe and could also be state sponsored instances of cyber terrorism.

Indian banks are also lagging behind in ensuring the security of the data that they have on their computers. In October 2016, it was revealed that data connected to over 3.2 million debit and credit cards was leaked through a malware attack on an ATM. This lead to several customers losing money through fraudulent transaction and forced the banks to block the compromised cards.

As a preventive measure against cyber threats, the RBI has set up an Inter-Disciplinary Standing Committee on Cyber Security to advise it on the topic. Various sub groups under the Standing Committee will oversee the security aspects of using mobile banking and credit and debit cards. One way in which banks have started to defend themselves against attack is by setting up 'honeypots', which are parallel virtual systems which are open to attack. By setting these up, banks hope to lure hackers into attacking them instead of their actual online resources. Honeypots also help to track the attackers and understand their methods, which can help strengthen the bank's actual systems.

Additionally, the RBI's tech arm Institute for Development and Research in Banking Technology (IDRBT) has set up a group of cyber experts to assess the preparedness of Indian Banks against cyber-attacks. The group called IB-CART (Indian Banks - Center for Analysis of Risks and Threats) consists of cyber security firms which deliberately attack dummy sites of banks to find vulnerabilities. Yet another step taken to enhance preparedness is the setting up of a forum for Chief Information Security Officers of banks to discuss security related issues.

Apart from cyber threats, traditional bank fraud continues to be a threat to the banking sector. The FSR points out that instances of fraud have also been on the rise. During the last five years the volume of losses caused due to fraud has increased by 72 per cent to 167.7 billion rupees. Unlike the threat of unstable markets or dips in industrial production, bank fraud can be directly brought under control through effective countermeasures. Most cases of bank fraud are related to corporate loans. According to the RBI, the reason for most of them are "serious gaps in credit underwriting standards...liberal cash flow projection at the proposal stage, lack of continuous monitoring of cash flows and cash profits, lack of security perfection and over valuation, gold plating of projects, diversion of funds, double financing and general credit governance issues in banks". These corporate debts often place enormous strains on the exchequer in the form of bailouts necessary to save banks. They have proven to be highly detrimental to the overall development of the nation and the credibility of its banking institutions. It is clear that most of these can be avoided through careful scrutiny on the part of the bank.

1.4 Conclusion: As India is well on its way to occupying one of the top slots in the world economy, the presence of robust banking infrastructure becomes crucial. India is already the third largest economic power in the world in terms of purchasing power parity GDP (according to the IMF forecasted estimates for 2017). The IMF estimates Indian economy to grow by 7.4% in 2018. In a way, the demonetisation of high value currencies in 2016 demonstrated the capability of Indian banks to deal with unforeseen economic shocks.

However, as we have seen above, the banking sector is not without its fair share of hurdles to overcome. The rise of NPAs, systemic inertia and cyber threats are the most significant among them. Despite these threats looming on the horizon, the FSR remains optimistic about the robustness of the Indian banks. The fact that India's is a 'banking centric' economy rather than a 'market centric' one, is testament to the faith that we have in our banking institutions. When compared to its global counterparts, the Indian banking system was late to capitalize on many of the breakthroughs in modern banking. Being under the protectionist regime of the government from 1969 and until the liberalisation drive of the 1990s, kept Indian banks away from the cutting edge of banking. It came to the table late on technologies and practices like networked and automated banking, ATMs and online banking. Even with these setbacks, it is commendable that Indian banking is set to grow to become the world's fifth largest by 2020. Hopefully, the threats outlined above will not keep it from reaching this goal.

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