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Dear Comrades,

6th October, 2016

News of Interest 6th Oct

QUOTE OF THE DAY

“PRESS FORWARD. DO NOT STOP, DO NOT LINGER IN YOUR JOURNEY, BUT STRIVE FOR THE MARK SET BEFORE YOU.”

GEORGE WHITEFIELD

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Business Standard

1. Split verdict on bad bank

The idea, which was mooted earlier, had been shot down by former RBI governor Raguram Rajan

Ishan Bakshi

With a change in guard at the Reserve Bank of India (RBI), rumours of creating a bad bank to deal with the issue of bad loans have once again cropped up.

The idea, which was mooted earlier, had been shot down by former RBI governor Raghuram Rajan. The renewed interest in the idea could perhaps be construed as acceptance of the severity of the bad loan problem plaguing the system, which continues to persist.

Theoretically, a bad bank or an asset management company could be set up with government money to buy non-performing assets from banks. By selling souring loans to the bad bank, banks would be free of providing for these loans. This would also free up precious capital which could then be used to boost credit flow to industry. To resolve these soured loans, the bad bank could explore various options such as closing down plants, selling them off or going to court to

resolve pestering issues. But, such a proposal raises many troubling questions. First, who will pay for the potential losses?

For the sake of argument, let's assume that a bad bank is set up with a capital base of Rs 10,000 crore. It can then issue Rs 40,000 crore worth of government-backed bonds, totalling up to Rs 50,000 crore. These funds will then be used to buy loans from banks. But, as only a fraction of these loans are likely to be recovered, the government will end up bearing the costs (the difference between Rs 50,000 crore and the amount actually recovered). For example, take the case of IDBI.

The Stressed Asset Stabilization Fund to which the loans were hived off was only able to recover 45 per cent over nine years. Second, at what prices will these loans be bought from banks? Will the loans be bought at the book value — in which case banks don't bear costs — or will they be bought at discounted rates, in which case banks do bear a portion of the loss. "Some structure could be worked out where banks are paid a portion as upfront cash and the balance is paid depending on recovery," says Vibha Batra, former head of financial sector ratings at Icra.

If banks are willing to sell loans at a haircut, wouldn't it make more sense to allow asset reconstruction firms, which have the required expertise in this area, to be major players?

"Given the scale of the problem in India, a bad bank may not be needed. You can resolve this through asset reconstruction companies. But, the question is of the haircut — how much banks are willing to take," says Pronab Sen, former chairman, National Statistical Commission.

The third issue is of moral hazard. If the government indeed sets up a bad bank, the fear is banks would continue with their reckless lending.

While Ajay Shah of the National Institute of Public Finance and Policy disagrees on the creation of bad bank on account of moral hazard, other economists contend that at the current juncture, concerns of growth override that of moral hazard.

"It (bad bank) does create the problem of moral hazard as it creates incentives for banks to be reckless. But today, the banking system is in a bad shape. It's a good idea," says Madan Sabnavis, chief economist, CARE. "But, it depends on how it is structured," he adds.

Batra concurs. "Yes, moral hazard is a problem. But, at the present juncture, the gains outweigh the costs. It could free up precious management bandwidth and capital that can be used to boost credit to industry," she says. "The success of the bad bank depends on its governance structure, incentives for staff as well as quality of staff." Lastly, the issue of how much capital is required and from where it will come needs to be addressed.

On the issue of capital required, the first step entails getting firm estimates of the scale of the problem. While currently, gross non-performing loans stand at 8.5 per cent of total advances, analysts contend that even stressed assets should be included to arrive at the final figure.

While this will cause the figure of capital required to blow up, analysts believe that only big loan accounts should be transferred to the bad bank, leaving banks to deal with only the small loan accounts. "The focus should be on large accounts while leaving banks to deal with smaller accounts," says Batra.

On the issue of funds, while a cash-strapped government may find it difficult to cough up the entire amount, simply providing Rs 20,000 crore as the capital base could be a start. This amount could be leveraged up to arrange funds totalling to Rs 1 lakh crore.

2. Cheaper credit only after deposit rate cut

The banking regulator expects banks to make loans cheaper over the coming quarters

Abhijit Lele

Announcing a 25-basis point cut in the repo rate on Tuesday, Reserve Bank of India (RBI) Governor Urjit Patel voiced displeasure at banks not doing enough to pass on the benefit. The banking regulator expects banks to make loans cheaper over the coming quarters.

Bankers say the plans are in line with RBI's expectations but with a twist. The central bank would bite the bullet (that is, reduce rates further on loans) after slashing interest rates on deposits.

Banks have been reviewing rates each month under the marginal cost of funds-based lending rates (MCLR) regime since April. Much of the revision has been downward, though the quantum of reduction has been only 5-10 basis points (bps). The MCLR regime was designed taking into account limitations of both the benchmark prime lending rate (BPLR) and the base rate regimes.

WHY BANKS DON'T CUT RATES

- Fixed interest rates on savings deposits stifle transmission
- No or small reduction in small savings rates
- Piling stress loans and pricing of risk premium
- Sluggish demand for bank loans
Source - RBI monetary report

B Sriram, managing director, State Bank of India, said those benefitting from the Seventh Pay Commission will place money with banks. The government has also cut the small savings deposit rates by 10 bps. This would give room to reduce deposit rates and cost of funds, and further the revision in lending rates would follow.

Sriram said banks would need six more months to adjust to the MCLR system, which would complete one year in March 2017. After this there would be scope for more transmission.

Ravindra P Marathe, chief executive officer and managing director, Bank of Maharashtra, said monetary policy transmission was already structured into the MCLR methodology and was largely dependent upon the cost of deposits.

The rate cut is indicative of the softening of the interest rate regime in the economy. This was expected to pump-prime the fresh investment cycle. Interest rates were bound to come down, bankers said.

The RBI governor, in his remarks at the press meet after the policy said, there were two parts to transmission. One, the transmission through the money markets had been swift and decisive and corporates were using those parts of the financial system more compared to plain-vanilla bank credit.

The transmission to bank lending and to bank borrowers had been less than what the regulator would have wanted, the governor said.

The MCLR calculation itself would now throw up more transmission, Patel said, adding that for new lending, the transmission had been much more in terms of the rates coming down.

During the first half of 2016-17, the median one-year MCLR of public sector banks and private banks declined by 15 bps and 25 bps, respectively.

Banks have, however, increased the spread and term premia over the same period, effectively leaving the weighted average lending rate (WALR) on outstanding rupee loans unchanged. For fresh rupee loans, the WALR declined by 5 bps (April-August 2016). Rupee loans that are being disbursed since April 1, 2016, are priced at the MCLR, and therefore, the base rate continues to account for a substantial share in the pricing of outstanding credit.

The transmission of monetary policy is marked by long and variable time lags with asymmetric market responses to policy impulses - generally higher during a tightening phase and lower during an easing phase, irrespective of the prevailing regime for pricing of credit.

3. Delinquencies in loan against property to rise: India ratings

According to the Ind-Ra report, early signs of stress are already visible and especially amongst the NBFCs

Nupur Anand

Loan against property, one of the segments that has been witnessing high double digit lending growth may begin to see higher levels of stress, as per a report by rating agency India Ratings and Research (Ind-Ra).

As per the report, early signs of stress are already visible and especially amongst the Non Banking Financial companies (NBFCs). "Delinquencies may even exceed 5 per cent on a static basis for a few NBFCs, about three times of those in FY14. The signs of early stress are clearly visible in the LAP business loan pools assessed by Ind-Ra, indicated by a sharp rise in 90 days past due delinquencies for some of the large players," said the report.

As per the analysts, stagnant property prices especially in metros and large cities which are the primary markets for medium and large ticket LAP and squeeze on refinancing due to risk aversion is leading to the stress.

Even though this is a secured lending segment some banks had begun to get cautious in this segment in the last few months due to excess competition. "Several players especially the NBFCs had started getting very aggressive in this space and that was leading to unnecessary competition and at times lending to some profiles that we may not otherwise be very comfortable with so we had started going slow in it," said one of the retail heads of a private sector bank.

"Intense competition has pulled the yields significantly which have shrunk to about 300 basis points over State Bank of India's base rate. After adjusting for yield reversals on NPLs and operating costs, yields may not, at least for few players with uncompetitive funding costs, leave enough buffers to absorb spikes in credit costs," said the report.

The analysts also added that in a majority of cases, property valuation is outsourced to third-party valuation companies and therefore the methodologies followed are not standardised yet that may lead to stress.

In a bid to garner market share in this segment, lenders are believed to have diluted the use of risk mitigation practices. Apart from Non-residential properties (including industrial, commercial, freehold land, unoccupied residential property, among others) are increasingly being accepted as collaterals. This proportion could go as high as 30 per cent of the portfolio for some players and the realization on liquidation of these properties is low, said the report.

Financial Express

4. Debt management: Fin min starts process of shifting from RBI

After successfully setting up the Monetary Policy Committee (MPC) recently to set policy interest rates, the finance ministry on Wednesday initiated steps to set up an independent Public Debt Management Agency (PDMA) to take over the government debt management functions from the Reserve Bank in two years.

By: [FE Bureau](#)

After successfully setting up the Monetary Policy Committee (MPC) recently to set policy interest rates, the finance ministry on Wednesday initiated steps to set up an independent Public Debt Management Agency (PDMA) to take over the government debt management functions from the Reserve Bank in two years.

In an office memorandum, the ministry said a decision has been taken to set up a Public Debt Management Cell (PDMC) in the Budget division of the Department of Economic Affairs, as an interim arrangement before setting up an independent and statutory PDMA, in due course.

"This interim arrangement will allow separation of debt management functions from RBI to PDMA in a gradual and seamless manner, without causing market disruptions. The PDMC shall be upgraded to a statutory PDMA, in about 2 years," the memorandum said. Till such time, the PDMC will have only advisory functions to avoid any conflict with the statutory functions of RBI, it added.

The PDMC advisory functions would include planning and management of central government borrowings, monitor cash balances, improve cash forecasting and promote efficient cash management practices. Other functions included foster a liquid and efficient market for government securities, develop an Integrated Debt Database System (IDMS) as a Centralised data base for all liabilities of government and undertake requisite preparatory work for PDMA.

The joint secretary (budget) would be the overall in-charge of the PDMC, which will be housed at the RBI's Delhi office. The transition process from PDMC to PDMA would be implemented by a joint implementation committee (JIC).

JIC would operate under the supervision of the Monitoring Group on Cash and debt management with economic affairs secretary and RBI deputy governor as co-chairpersons. The PDMC would be staffed by 15 debt managers from Budget

division, RBI, current middle office and other government units. The extant middle office of the Budget division in the ministry will be subsumed into PDMC with immediate effect.

Originally, the government had proposed in Budget 2015 to set up MPC as well as PDMA. However, these proposals were withdrawn from the finance Bill 2015 after differences cropped up with the RBI over the structuring of the two bodies. After consultation with RBI, the government amended the RBI Act through finance Bill 2016 and now a six-member MPC has been set up with equal representation from RBI and government-appointed members.

The PDMA proposal was hanging fire as RBI opposed the transfer of the back office to the PDMA. The latest announcement indicate that differences between the government and RBI have been narrowed down on the PDMA front.

The creation of the PDMA, it is reckoned, would enable RBI to focus on its core function of monetary policy (flexible inflation-targeting) and regulating banks. Such an agency is also expected to lower the government's borrowing costs eventually and foster a liquid and efficient G-Secs market.

The idea is also to resolve the conflict of interest involved in RBI, simultaneously targeting inflation by calibrating interest rates and regulating as well as managing government debt.

5. RBI to continue with easing; next cut in February: Analysts

A day after the monetary policy committee (MPC) debuted with a surprise 0.25 per cent cut in rates, analysts today said the Reserve Bank will continue with the accommodative stance but the next action can come only in the February review.

By: PTI

A day after the monetary policy committee (MPC) debuted with a surprise 0.25 per cent cut in rates, analysts today said the Reserve Bank will continue with the accommodative stance but the next action can come only in the February review.

In a note, domestic rating agency Icria said it expects the rate easing cycle to continue.

"With the indication that real interest rates (the differential between the key lending rate and inflation) may need to be lower than 1.50 per cent given prevailing global scenario of negative rates, further easing by the Monetary Policy Committee (MPC) can't be ruled out," its senior vice president Karthik Srinivasan said, adding that he is uncertain over the timing.

Economists at foreign brokerage Bank of America Merrill Lynch said however that it doesn't expect any rate cut in the upcoming review of the bi-monthly policy in December.

"We expect a final 0.25 per cent cut on February 7," it said in a note.

Concurring with this view, Singaporean brokerage DBS also said the next rate cut can happen only in the first quarter of 2017 and not at the next policy review.

Newly appointed Governor Urjit Patel had a conference call with analysts after the announcement of the policy yesterday in which the media was not allowed.

DBS also attributed the cut to the change in the real rates framework.

Even though the policy document did not have a formal guidance, DBS added, the stance indicates lower inflation print continuing into the December quarter.

All the brokerages and analysts said that having committed to keeping the liquidity deficit at neutral, the RBI will continue its liquidity injection through the open market operations or buyback of G-Secs.

DBS said there can be Open Market Operations of up to Rs 70,000 crore over the already done Rs 1.1 lakh crore in the remainder of the fiscal till March 2017, while Bof AML put the figure at Rs 90,000 crore by March.

Icra said the OMOs will be between Rs 50,000-60,000 crore till December alone. In a surprise move, the Patel-led MPC cut its key lending rates by 0.25 per cent to 6-year low of 6.25 per cent on ebbing inflation and to push the growth.

6. Cash is costly, digital payments could mean big 'savings'

KR SRIVATS

It is common knowledge that 'cash' rules the roost in the Indian economy, but putting a number to the cash dominance issue has never been attempted till now.

Now, a new report from global payments company, Visa, has done just that.

It has estimated the net cost of cash in the Indian economy at 1.7 per cent of real gross domestic product in 2014-15. The report offers to policy-makers a perspective of "how costly cash is" and the "savings" that could be harnessed by accelerating growth of digital payments in India.

If the calculations in the report titled 'Accelerating the growth of digital payments in India: A five-year outlook,' is an indicator, then by 2025 the total savings could be as much as \$70 billion (□4.7-lakh crore) if the adoption of digital payments is accelerated.

"The idea of this report is to be a dialogue opener. It's not a panacea. It certainly shows how large the problem is and also how large the opportunity is. At 1.7 per cent of GDP, this is a problem that is worth debating at the senior-most policy levels of this nation," TR Ramachandran, Group Country Manager, India and South Asia, Visa, told *BusinessLine*.

The report, released in the presence of NITI Aayog CEO Amitabh Kant, also suggests a three-pronged strategy for India to accelerate growth of digital payments. These are: expand acceptance, energise innovation, and bolster financial participation.

Focusing on the three pillars could help India accelerate its shift to a less-cash society, it says.

Shadow economy

Besides, putting an estimate on the net cost of cash, the report also quantifies the size of the 'shadow economy' and estimates that foregone tax revenues from the 'shadow' economy account for 3.2 per cent of GDP.

Today, less than 5 per cent of India's ₹75-lakh crore consumption expenditure is made using digital payments. The measures, outlined in the report, together with a series of other policy levers, could result in increasing digital consumption expenditure to around 36 per cent in the next five years.

"If the government is serious about less cash and cashless, then charity needs to begin at home. They need to digitise government-to-government, citizen-to-government, government-to-business payments," Ramachandran said.

To expand acceptance infrastructure, the report calls for establishing an India Acceptance Development Fund to incentivise banks to expand acceptance in under-penetrated merchant segments and geographies.

It also suggests incentivising the use of digital payments by providing a tax rebate of ₹2,000 per capita per annum, and for incentivising merchants, it suggests acceptance of digital payments by providing them a 50 per cent tax rebate on 50 per cent of turnover.

The report also makes a case for lowering the existing countervailing duties and levies on POS machines to 5 per cent and promoting domestic manufacturing.

For energizing innovation, it has, among other things, suggested adoption of open loop payment systems for mass transit.

In fact, the RBI had, in its monetary policy review on Tuesday, announced steps towards setting up an acceptance development fund by end of this year.

7. Karnataka Bank launches campaign for home, car loans

OUR BUREAU

Karnataka Bank Ltd has reduced interest rates on home loans and car loans by 20 basis points as part of a special campaign.

A press release by the bank said here that the loans extended during the campaign period from October 1 to March 31 will have the benefit of lower interest rate, longer loan period, lower EMIs and quick sanction.

During the campaign, housing loans up to ₹3 crore will attract an interest rate of 9.5 per cent, and loans up to ₹5 crore will attract 9.7 per cent.

The bank will offer car loans at 10.25 per cent interest during the campaign period, the release said.

8. Services sector too slows down in September

SURABHI

The services sector grew at a slower pace in September with a modest increase in new business orders. The Nikkei India Services Business Activity Index eased to 52 in September from 54.7 in August.

"The health of the Indian private sector economy improved in September, but to a lesser extent than in August...The level of new business placed with Indian services firms increased moderately in September," said Nikkei in a release on Wednesday.

Composite PMI dips

Similarly, the seasonally adjusted Nikkei India Composite PMI Output Index fell from August's 42-month high of 54.6 to 52.4 in September. Factory output also grew at a muted pace in the month and the Nikkei India Manufacturing Purchasing Managers' Index (PMI) the rate of growth eased to 52.1 in September as against 52.6 in August.

Despite the sluggish trend, this was the 15th consecutive month of growth on the index. A reading above 50 indicates expansion while that less than 50 denotes contraction.

Meanwhile, in a boost to domestic industry, the Reserve Bank of India on Tuesday cut the repo rate by 25 basis points to 6.25 per cent.

"Over the second quarter of 2016-17, however, the PMI Composite Output Index posted its highest reading since the January to March 2015 quarter, thereby suggesting a pick-up in GDP growth. This would be welcome by policy-makers after the below-expectations figure of 7.1 per cent recorded in the first quarter," said Pollyanna de Lima, economist at IHS Markit, and author of the report.

Meanwhile, according to the survey, despite the challenging market conditions and competitive pressures that reportedly hampered growth, activity rose in each of the six monitored categories.

"New business declined at 11 per cent of companies (surveyed), which they blamed on unfavourable weather and an increasingly competitive environment," it said.

The survey also pointed to a slight increase in inflation though it remained below the long-run series average.

"Food and petrol prices continued to climb in September, which placed pressure on operating costs. In response, private sector companies raised their own prices for the second straight month, although inflation remained relatively soft," said de Lima.

It further said that both services and manufacturing firms reported stagnant staffing levels so far this year. However, given the higher backlog of work across the private sector, businesses may be more willing to take on additional workers.

With kind regards,

Yours Comradely,



(N. GOVINDRAJULU)
GENERAL SECRETARY