Mr Reddy gives a valedictory address with concluding remarks on flexibility, autonomy and the regulatory refocus in banking

Valedictory address by Dr Y V Reddy, Deputy Governor of the Reserve Bank of India, at the Conference of Chairmen of Banks at NIBM, Pune, on 7 January 2000.

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At the outset, I am thankful to the Institute for giving me an opportunity to be here and share the experiences and be a witness to the variety of sentiments and ideas. There is no prepared valedictory address; and I deliberately decided not to have one, so that I can share with you my perception of what happened in this Conference and incidentally make a few comments. This is a somewhat risky path for a central banker, especially with the press being here. But, by and large, the press has been fair and, I, therefore, continue to trust them. This is not a Machiavellian comment where "gratitude is only hope of benefits to come". It is a pretty straightforward and genuine comment.

The background papers have been excellent, and they really provide an overview of both the theory and practice, as of today.

Inaugural session

For convenience, in this valedictory address, I will go session by session. Mr Bhide, in his broad overview, referred to the Bhagwad Geeta and how Arjuna was confused and sought Krishna's advice. Perhaps Krishna is the most ancient consultant that we have. He never fought a war, but he always advised. In fact, he offered his advice to both the parties and as some say, even managed to see that they quarrel. Anyway, certainly the type of problems that we have are complicated and it does require substantial input of expertise and international experience to solve them. From the Reserve Bank of India, we are also in a similar search as Arjuna, and I can almost visualise that Arjuna who fought the war must have known how difficult it is to operationalise an advice. That there could be problems in actual implementation was evident from the response of the Chairmen present here, to various ideas.

Dr Ganti Subrahmanyam noted that this conference is being held after 10 years. As you are aware, substantial reform has occurred in the financial sector in the last 9 to 10 years. Obviously we have had to undertake a lot of day to day fire-fighting as we moved ahead in the reform process. Perhaps now, it is about time we really looked at the reform process more carefully.

Dr Jalan, in his inaugural address, put forward three important issues. Firstly, he said that banks are one part of the financial sector and, therein lies a hint of the hard days ahead for banks. He hinted that financial stability requires multiple financial intermediaries and not merely banks. He also indicated that the development of financial markets is an extremely important element and that the focus on development of debt markets will continue. This implies that many of the corporates who approach banks now for loans, may directly go to the debt market more than ever before. Consequently, banks will have to contend with non-banks as well as developments in financial markets, apart from competition among banks themselves.

The second message, which Dr Jalan gave, is that the supervisory/regulatory aspects are no longer matters of domestic interest alone since they are now evaluated internationally. This means that our supervisory and regulatory standards will have to get aligned to global standards. This again is not a very soft message from the Governor to the banking community.

The third message, which was more in the nature of a clarification, was that this new reality would require banks to pay enormous attention to their internal management. And in internal management, he did recognise that an important input that banks really have is that of human resources. Thus, as it became evident in the discussion here with the Chairmen also, the crux of the problem and indeed the crux of the solution, boils down to human resources coupled with technology.

Basically my submission is that, in the Governor's statement, behind his very pleasant, smiling and affectionate appearance, you could see that there are three hard messages which ought to be noted by the banking community.

Technology

In the first session, the eminent scientist, Dr Vijay Bhatkar talked about the impact of digitalisation. Normally, we have to have three sets of action plans; immediate or short-term, medium-term and long-term. Traditionally for us, short-term meant one year, medium-term five years, and long-term perspective planning meant 10-15 years. But after listening to Dr Bhatkar, the feeling is that short-term is one year or less, medium-term is one-and-a-half years and long-term is two to two-and-a-half years. And this is not said in a flippant sense, because the way things have happened, and the speed with which change is occurring, compression of time to change is the major message that we should take from the discussions in the session.

The other critical point in the session that Mr Narayana Murthy of INFOSYS made is that technology people in India are already prepared for the change. He made a point that "hardware, yes; software, yes; we are available for both; we are already supplying these to the rest of the world". All it means is that our financial sector should learn how to use it, and use it sooner than later for its own survival. Another important point that came out was that the technology is not anti-poor. Technology is at best neutral and more probably pro-poor. Though unsaid, what came out from Mr Murthy's exposition is that the banks in future may have to be a lot more oriented to customer needs and not just paternalistic in behaviour in the guise of assisting the poor. From the Reserve Bank of India, what I would like to add to what Mr Narayana Murthy has said, is that we in the RBI are getting ready with technology and we are already going ahead with computerisation of the Public Debt Office. In about 18 months, we will be ready with a Real Time Gross Settlement System (RTGS). Thus, the central bank is providing whatever technological infrastructure is required, particularly in terms of externalities for banks, and so the ball will squarely be in the court of the commercial banking sector.

Human resources

In the second session, Dr Sushil Chandra, a management expert, made an excellent presentation. Among the most important points he made are, that trade unions are less aggressive now and that changes should be consensus oriented. In my view, consensus will be productive under two conditions. One, when we share a common perception with regard to where we want to go and second, those who are involved have reasonable symmetry in their negotiating strengths. So if there is an asymmetry and one party has no stake in consensus, and, in fact, has a stake in status quo than in change, then it is very difficult to achieve a consensus. A situation may, therefore, have to be created where every party crucial for consensus suffers losses if consensus is not arrived at. Two, in this context it becomes necessary to address some of the basic issues, basic building blocks of an environment, whether they are legal or attitudinal, that would facilitate consensus building.

In this regard, there are some broader public policy aspects. One is that as a dominant owner, the conduct of the Government will play an important part in these changes. Second, and more important, the type of signals that are required to build a consensus with the trade unions will arise out of public policy in general and public policy not necessarily restricted only to banks. In this context, how the public policy aligns itself towards efficiency and incentive/disincentive measures becomes relevant. There is a need for a clear signal from public policy and we have to actively seek such an appropriate policy. We must not hope that we will be in a position to fix things in an isolated manner for too long. In a way fixing things in banking, especially restricted to a few banks, in an isolated manner may limit or even jeopardise the extent to which we can move forward in the future.

A reference was also made by Dr Sushil Chandra to work practices. Once we accept the work force as "given" in Indian conditions, I do not see a very practical way of telling a large work force that they should simply "go home". I strongly believe that the quality of human resource is very high in public sector banks. There is hardly any banking system in the world which is so highly involved in retail banking and which has such high quality manpower as the Indian public sector banks. In a way, the tragedy is that the work atmosphere, especially work-practices, have not been very conducive to efficiency. Between reduction in manpower and expansion of business, the latter is a better option; and banks have to create an environment in which they will be able to ensure expansion of business through more redeployment, more training and better incentives. If labour force is given, there is an imperative need to find business to afford their wages, and so public sector banks may have to diversify, namely, sell insurance policies, or sell private mutual fund certificates or do any permissible non-fund based business. Since banks have the manpower, they have to learn to treat it as a resource and ensure that it pays for itself. The whole issue again reverts to work practices and unless restrictive practices are addressed to impart flexibility to enable rapid expansion of business through diversification, there may be a threat of decay.

The flexibility and autonomy for each bank to find unique solutions is important because there is no "fixed solution" for all institutions and all problems. For instance, I hear that there are opportunities for increased deposit mobilisation activities in East India, where agriculture is developing fast and in fact this could be an extremely important strength for the Calcutta based banks. These banks have both the manpower and the branch network. In fact, there are very few organisations in the country which have the reach or the presence in rural India and agriculture comparable to public sector banks. So one goes back to the issue of flexibility and autonomy that is required in managing the banks and in managing the change.

Rural-banking

In the third session on rural banking, several important issues came up. One, that rural banking is actually more than credit to agriculture; second, there was a consensus that the approach to subsidise weaker sections has been expensive; and third, priority sector lending, by and large, has not been effective in its present form.

In my view, it may not be appropriate to state that directed lending in terms of a particular sector or in terms of a particular area would necessarily be harmful to the banking sector. There are many countries and there are many systems where directed lending is found to be possible and useful. But here, perhaps we are doing what we cannot afford to, which is to subsidise on a large scale. Further, we cannot afford to separate the origination, assessment and recovery aspects since these are integrated functions of a banker and need to be fully exercised by bankers even in directed lending. One could readily agree with the unanimous demand in this Conference to make the priority sector lending more sustainable, more responsive, more efficient and more cost effective. That's the message we got and that is what Mr Guptaji, my predecessor, eloquently presented.

But, in addition, I would like to reiterate the point I made recently in my lecture on the Future of Rural Banking. Banks have great advantage in delivering or handling financial services and so in future we do not necessarily look at somehow delivering credit to a rural area but really look at providing financial services to a rural area. This could be big business for banks; business in which banks have comparative advantage, and business that will make public sector banking sustainable, since many rural areas are ready for it. It is quite possible that, in some areas, banks may have to reach through NBFCs and reach input suppliers who give credit for commercial agriculture and also output purchasers financing commercial agriculture. There are also districts which are prosperous and where the agricultural labour may require consumption credit for four months when it gets into a seasonal unemployment situation. There is no reason why banks should not provide such credit to creditworthy agricultural labour if it can be done to credit card holders. With agricultural prosperity, many villages are growing into semi-urban centres. Many studies have shown that the semi-urban areas are full of commercial potential. One has to recognise the increasing rural-urban continuum rather than persist with the old rural-urban divide and accordingly reorient the whole banking strategy.

Regulation and supervision

On the next theme of regulation and supervision, my colleague, Mr Muniappan had apparently very frank discussions. I would like to comment briefly on the issue of size and diversification. The worldwide trends are clearly towards large size but overall, it is extremely contextual, especially in our country. It really depends on how a bank is able to transform the advantage or disadvantage of size. In an economy which is aiming a 7% growth rate in GDP, there is enough room and enough maneuverability for all institutions including banking institutions to reposition themselves. So again, it goes back to the issue of the type of flexibility and autonomy that is accorded to the various players in the financial system including the banks, not only in operation but also in structural or organisational transformation.

Corporate governance

In the session on Corporate Governance, Dr Y R K Reddy, an invited expert covered a number of very important issues in the backdrop of both international and Indian experiences. There is only one basic issue I would refer to: is there a separate pattern of corporate governance for banks compared to non-banks in the financial sector? One is not sure whether there should be a separate corporate governance approach according to types of financial institutions or merely adaptation of general principles to specific types would suffice. No doubt, the Bank for International Settlements has recently come out with a paper on corporate governance in banks.

In my view, however, there is a more serious issue, and that is, whether the existing legal institutional framework in respect of our public sector banks is consistent with the accepted principles of good corporate governance. Mr Narasimham wanted that public sector banks be genuinely board-run-companies so that the corporate governance related to the constitution and conduct of the board. The alignment of the existing institutional and legal structures and practices with good corporate governance, especially in the public sector, should really be an area of attention. This may warrant radical legislative changes.

Restructuring

This morning we had a very interesting session with Mr Leo Puri, who gave us a sort of peep into the future. Unlike Thailand or Korea, our bank restructuring will be a lot more domestically led and the enabling environment will have to be created by the Government and the RBI. In the presentation on bank restructuring in India in terms of tables and graphs, one finds both banks and financial institutions participating together. In other words, when we talk of restructuring in the banking system, perhaps it is necessary to focus on restructuring in the financial sector and the financial system as a whole and not look at the banking industry alone internally. Almost all the illustrations, which have been presented, except the two cases of mergers, have such a mix and in future perhaps the coverage would include the insurance sector, also to which a reference was indeed made.

Chairmen’s session

During the session, discussion of the Chairmen of banks, two major points or themes came up very openly and one more not so openly. One, there was virtual unanimity on the need for flexibility in dealing with the staff, in dealing with issues, in dealing with operational procedures such as signing of drafts, etc. The second theme was on the need for autonomy, especially in areas such as recruitment of personnel. The most critical issue obviously is to ensure the necessary operational flexibility and autonomy, which are imperative if banks are to be in a position to face the future confidently. More importantly, the implied suggestion was that in a very broad sense, both the Government and the RBI as regulators, should attempt some sort of regulatory refocusing in the direction of greater flexibility and autonomy.

Concluding remarks

I will conclude by commenting a little more on these three aspects, namely flexibility, autonomy and regulatory refocus. As you have discussed, be it the use of IT or HR, bank managements require flexibility. The more one listens to the various discussions, the more one is convinced that most of the suggestions fall under the category of flexibility.

Second, is the autonomy; and, one question here is how does a business executive operate with a small degree of autonomy and compete with others in the non-public sector. This is operational autonomy, which could be accorded by making the public sector banks genuinely board-run companies. The other question, and a more important one, relates to autonomy to ensure some organisational transformations.

For instance, there was a hint in the discussion that in rural areas, existence of bank branches, cooperatives, RRBs and local players results in avoidable duplication. In my view, these changes should be allowed to evolve rather than prescribed from a centralised governmental or RBI decisions. From being instruments of planning, if we have to transform them into business entities, necessary maneuverability with regard to the ownership and the accountability will have to be allowed. In this framework, the rehabilitation or restructuring should evolve with initiatives at the Board level and not done with a preconceived notion by the bureaucracy. It needs to be recognised that there are basic structural impediments in public sector banks and RRBs in exercising flexibility and autonomy in bringing about rehabilitation or restructuring. And these impediments will have to be sooner or later removed.

I will now move on quickly to the regulatory refocus issue. We have, from the RBI, indicated from time to time, the direction of regulation in that its basic long-term purpose is only to protect depositors' interests and ward off systemic threats; though in the interest of development, the RBI has accepted responsibility for provision of necessary infrastructure in the financial sector, both technological and institutional. As Governor Jalan mentioned, the Regulatory Review Authority is reviewing on a "zero regulation" basis like "zero budgeting". We welcome specific suggestions indicating that a particular framework of regulation is justifiable or another one is not justifiable.

In the context of the future of the financial system, several issues have been raised in the document on universal banking, which had been circulated to you. These relate to ownership and clear demarcation of regulation vis-à-vis ownership. A view on these will have to be taken soon without which possibly further progress in restructuring of the financial system will be rather difficult.

There has been a demand that there is a need to revisit policies such as the priority sector lending. Given the objectives, say of priority sector, the issue is with regard to the instruments that we have been using so far and the achievements. It is quite possible that the achievements did not entirely correspond with what was intended. Since the total socioeconomic and financial environment has changed while the objectives of priority sector have not changed thorough re-examination of policies relating to priority sector lending would be worthwhile. Earlier, the deposit mobilisation function was virtually a monopoly of banks, while allocation of resources was through an administered regime. Today the banks are being asked to evaluate risk and price their product. It means that the allocation function has been shifted from the government to the banks. Now we have to see how we can create an environment, which will give incentive for banks to maximise the allocative efficiency while ensuring that some of the social objectives continue to be served. This is a complex area and it will be better for people who are in the field to suggest an operationally feasible framework to us. That is what Mr Jagdish Capoor, Deputy Governor was hinting at when he sought your views on subsidy. On all these aspects, some more concrete thinking is necessary, and in any case it is necessary to accept that there are some objectives which must be met, that there is a new paradigm and that it is necessary to redesign the instruments to meet such objectives in a changed situation.

Before concluding, I would like to mention an aspect relating to privatisation of the public sector banks. I will only repeat what I had said in another gathering last year. The idea that "there is a possible fiscal demand on the government to recapitalise banks and, therefore, you privatize and then the whole world is happy", is somewhat simplistic, because the health of the banking system is critical for both macro-economic and fiscal stability. If the banking system, public or private is unhealthy and weak, the hit is on the fisc since the bail-out has to be publicly funded. We have seen it in East Asia, we have seen it in many other countries, and, therefore, the contention that merely shifting of the ownership from the public sector to the private sector will immunize the possible impact on the fisc is not correct. Irrespective of the ownership, public authorities and the society at large have a stake in ensuring that we have a very healthy financial system and in particular banking system. As Governor Jalan mentioned, banking system collects non-collaterilized deposits, is highly leveraged and is very critical for payment systems.

Perhaps I have made all this sound more complicated than necessary, but thank you very much for your patient listening.