Kishori J Udeshi: Bank supervision - challenges ahead

NA Palkhivala Memorial Oration lecture by Ms Kishori J Udeshi, Deputy Governor of the Reserve Bank of India, Jaipur, 28 August 2004.

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I deem it an honour and a privilege to speak before this august gathering on the occasion of the Nani Palkhivala Memorial Oration. While conferring on him the Honorary degree of Doctor of Laws, Shri Nani Palkhivala was described by Princeton University, USA, as a "defender of constitutional liberties, champion of human rights, teacher, author and economic developer". This description, however, does not capture the brilliance of the man's mind, the eloquence of his speech and the goodness of his heart. While I do not have even an iota of his ability to speak without notes for hours and keep his audience in rapt attention there is one small thing that we two have in common and that is our alma mater; St. Xavier's College, Mumbai. Shri Palkhivala was a Director of the Central Board of the Reserve Bank of India from 1963 till 1970 and it is befitting that the subject of today's talk is on the challenges ahead for banking.

For a better appreciation of the future challenges let me begin by giving a brief glimpse of how we reached where we are today.

The financial sector witnessed a radical shift with the introduction of the reform process in 1992. The focus of the reforms was on deregulation and liberalisation especially of the Banking sector which is the major component of the financial sector of the country. The banking sector reforms were guided primarily by the recommendations of the Committee on Financial System (Narasimham Committee, 1991) which related, among others, to (a) reduction in the levels of statutory pre-emptions, (b) dismantling the complex structure of administered interest rates, (c) laying down of capital adequacy requirements; (d) introduction of prudential norms and (e) liberalisation of entry norms for domestic and foreign banks.

At the macro level, firstly there has been a reduction in the level of preemption of banks' resources. The statutory liquidity ratio (SLR) has been reduced from 38.5 percent in 1991-92 to 25 percent. The average cash reserve ratio (CRR) has been reduced from 15 percent in 1991-92 to 4.5 percent now. Secondly, interest rates have been deregulated. The number of administered interest rates on bank advances has been reduced from 20 in 1989-90 to just 2 by 1994-95. Interest rates on loans above Rs. 2 lakh are fully deregulated. Prime lending rates have declined from 19 percent in 1991-92 and the benchmark PLR now, in respect of five major banks, is in the range of 10.5 to 11.5 percent currently. Interest rates on domestic term deposits have also been deregulated. Thirdly, directed credit schemes have been streamlined to avoid inefficient use of credit. Fourthly, a Board for Financial Supervision has been set up with an Advisory Council to strengthen the supervisory system of banks and financial institutions and an independent Department of Banking Supervision has been set up in the RBI to assist the Board.

At the micro level, the less strong banks, which suffered capital erosion due to rising levels of non-performing assets were recapitalised. Secondly, capital to risk-weighted assets ratio of 8 percent was introduced. This is now at 9 percent. Thirdly, prudential norms for income recognition, classification of assets and provisioning for bad debts were introduced. The management of NPAs has been fortified by the enactment of the Securitisation & Reconstruction of Financial Assets and Enforcement of Securities Interest (SARFAESI) Act, 2002 which provides statutory support for the enforcement of creditors' rights and inter alia, paved the way for the establishment of Asset Reconstruction Companies. Fourthly, Debt Recovery Tribunals were set up to assist the banks in the recovery of loans. Fifthly, the Scheme of Ombudsman was introduced in 1995, to look into and resolve customer grievances. Sixthly, the State Bank of India Act, 1955 and the Bank Nationalisation Act of 1970 were amended to enable the banks to access the capital market for debt and equity. Lastly, reforms were also introduced in respect of Regional Rural Banks (RRBs) and non-bank finance companies (NBFCs).

The above measures together with the strengthening of prudential norms and market discipline and the adoption of international benchmarks to suit India specific needs have served to make the Indian financial sector competitive, viable and resilient.

Financial crises the world over have revealed that weak financial systems and their supervision are the most important factors contributing to macro instability. As East Asia discovered so painfully, the health of the banking system underpins that of the economy as a whole. Financial markets are different from product markets and therefore, greater liberalisation goes along with deeper supervision and higher degree of regulation. Any destablisation in financial markets affects even those who are not in financial markets. On the other hand, financial markets can drive the real economy. Therefore, transparency, disclosures, prudential norms and capitalisation are a must. This is essential because bank depositors have no other security except that banks are well regulated.

Increasing deregulation and globalisation, greater competition from within the country and cross-border dealings have exposed banks to even greater risk. Diversification into non-traditional products like insurance, derivatives etc., has added to the complexity of banking business. Further, internet banking, e-commerce, e-money and other information technology related innovations are adding new dimensions to risks faced by the banking sector. Mergers and acquisitions as well as outsourcing of some non-core activities are undertaken by the banks with some strategic objectives - they also enhance the risks in banking. Considering the speed with which banking is changing, it is recognised that there is a need to enlarge the focus and thrust of Risk-Based Supervision (RBS) so as to be able to improve the risk sensitivity of the supervisory approach.

In view of the relevance of improved risk management systems under the changing circumstances and the larger emphasis placed on risk management systems in banks under Basel II, it is essential that RBS stabilises at an early date and serves as an important feedback to not only the managements but also the supervisors. However, taking into account the diversity in the Indian banking system, stabilising the RBS as an effective supervisory mechanism will be a daunting task.

Consolidation and move towards universal banking

We are slowly but surely moving from a regime of “large number of small banks” to “small number of large banks”. The new era is going to be one of consolidation around identified core competencies. Mergers and acquisitions in the banking sector are going to be the order of the day. Successful merger of HDFC Bank and Times Bank earlier and Stanchart and ANZ Grindlays has demonstrated that the trend towards consolidation is almost an accepted fact. We are also looking for such signs in respect of a number of old private sector banks, many of which are not able to cushion their NPAs, expand their business and induct technology due to limited capital base.

Coming times may usher in large banking institutions, if the development financial institutions opt for conversion into commercial banking in line with the recommendation of the Second Report of the Narsimhan Committee. In India, one of the largest financial institutions, ICICI, took the lead towards universal banking with its reverse merger with ICICI Bank. IDBI is also well on its way to transform itself into a universal bank. This may lead logically to promoting the concept of financial super market chain, making available all types of credit and non-funded facilities under one roof or specialised subsidiaries under one umbrella organisation. The setting up of banks by financial institutions and non-banking financial companies and setting up of insurance, merchant banking, mutual funds, housing finance and investment companies either as subsidiaries or as joint ventures has brought into focus the need for consolidated supervision. Consolidated accounting and supervisory techniques would have to evolve and appropriate firewalls need to be built to address the risks underlying such large organisations and banking conglomerates.

Supervision/regulation of financial conglomerates

The financial landscape is increasingly witnessing entry of some of the bigger banks into other financial segments like merchant banking, insurance etc., which has made them financial conglomerates. Emergence of several new players with diversified presence across major segments and possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have systemic impact make it imperative for supervision to be spread across various segments of the financial sector. In this direction, an inter-regulatory Working Group was constituted with members from RBI, SEBI and IRDA. The framework proposed by the Group will be complementary to the existing regulatory structure wherein the individual entities are regulated by the respective regulators and the identified financial conglomerates would be subjected to focused regulatory oversight through a mechanism of inter-regulatory exchange of information.

Risk management and capital adequacy

Financial sector reforms in the current millennium are going to focus on setting the rules of the game for financial intermediaries in such a way that risks are taken with an adequate level of capital. In other words, financial intermediaries should be free to engage in asset liability management that allows them to diversify their risk so long as they are supported by a level of capital sufficient to cushion them against their risk profile.

The first Capital Accord of 1988 evolved by Basel Committee provided a framework for a fair and reasonable degree of consistency in the application of capital standards. However, the methods used to determine the capital charge for credit risk in the accord were not sufficiently sophisticated and not perceived to be risk sensitive. Keeping in view the financial innovation and growing complexity of financial transactions, a need was felt for a more broad based and flexible framework for capital adequacy. Towards this end the Basel Committee has formulated a new framework, popularly called "Basel II" which attempts to formulate more precisely than before the levels of regulatory capital that banks must hold as a cushion against the credit and other risks that banks take.

Cross-border supervision

This would involve a greater focus on overseas operations of Indian banks and in having information sharing arrangements with overseas supervisors on a firmer and more formal footing. In the context of money laundering concerns raised by some of the supervisors, it needs to be ensured that some of the branches, especially those which are not compliant with the anti-money laundering principles of the Financial Action Task Force (FATF), are not causes of serious operational and reputational risks to their parent banks in India.

Money laundering

Although I touched upon this issue in brief earlier while discussing cross border supervision, I would like to dwell a little bit more on this issue as it has been engaging the attention of governments, regulators and international financial community for quite some time. And there will be no exaggeration if I call it the biggest challenge before the supervisors today.

Post September 11, the issue that bank supervisors the world over are grappling with is "How to root out the menace of money laundering?" Until recently, the governments talked tough about the problem, but did little about it. All that changed three years ago. The FATF was conceived by G-7 countries as a helpful mechanism to persuade governments to combat money laundering and offer them technical assistance to do so. The laws being enacted typically require a bank to "know the customer" to be confident that his money is obtained by legitimate means, and to report any suspicious activity. This involves a Herculean effort, thanks in part, to the growth of "Correspondent banking relationships." In effect, this means banks must know their customers' customers as well.

Banking supervision all over the world has to achieve the delicate balance between respect for customer privacy and making banks report suspicious transactions. This raised the toughest question: What exactly are efforts against money laundering trying to achieve? So far, countries have been free to define what they regard as illegal sources of money. Some include drugs, racketeering and other dark crimes in their definition of illegal money. Some, such as France, consider tax evasion to be money laundering. Others like Switzerland have more flexible laws. However, as recently as last week, Switzerland has agreed in principle to dismantle the veil of secrecy governing its banking activity in order to comply with anti-money laundering requirements. This is a landmark development.

Corporate governance

I would also like to touch upon an area, which is going to be the focus of the next generation financial sector reforms. One of the latest initiatives of RBI aims at enhancing the level of corporate governance in banks.

In view of the special status enjoyed by banks whereby they freely accept deposits from the public and leverage on such funds through credit creation, legal prescription for ownership and governance of banks have been laid down in the Banking Regulation Act, 1949. These have been supplemented by

regulatory prescriptions issued by the Reserve Bank from time to time. These cover the following aspects:

- Composition of the Board of Directors
- Approval of the Reserve bank for the appointment of CEO
- Powers for the removal of managerial personnel, CEO and Directors
- Guidelines on criteria for appointment, role and responsibilities of Directors
- Guidelines for acknowledgement of transfer/allotment of shares in private sector banks
- Foreign investment in the banking sector

We have recently placed in public domain a draft paper on ‘A comprehensive policy framework for ownership and governance in private sector banks’. The objective of the draft guidelines issued by the Reserve Bank in July 2004 is to have a regulatory road map for ownership and governance in private sector banks in the interests of the depositors and financial stability. The underlying thread of the draft guidelines is to ensure that the ultimate ownership and control of banks is well diversified, banks are owned and managed by ‘fit and proper’ persons/entities and well capitalised and that the processes are transparent and fair. Several countries, both developed and developing, have regulatory stipulations and clearance for significant shareholding and control. The threshold level may vary from country to country and can also involve more stringent conditions for higher thresholds.

The draft guidelines allow for a level of shareholding of a single entity or a group of related entities beyond 10 per cent with the prior approval of the Reserve Bank. Such approval will be governed by the principles enunciated in the February 2004 guidelines. Apart from more intensive due diligence at higher levels of shareholding, the February 2004 guidelines require public interest objectives to be served for shareholding beyond 30 percent. In case where the ownership of a bank is that by a corporate entity, diversified ownership of that corporate entity will be considered among other factors. The draft guidelines do not cover foreign bank investment in Indian banks, which will be released separately consistent with the policy in the Government press note of March 2004 to allow only one form of operational presence for foreign banks in India.

In order to minimise vulnerability due to small size, the guidelines provide for increase in the net owned funds to Rs.300 crore for all private sector banks within a reasonable period. Cross holding beyond five percent is sought to be discouraged and where such holding exceeds five percent, the objective is to reduce it to five percent. Promoters with existing shareholding beyond ten percent will be required to indicate the time table for reduction - the requests will be considered on the basis of the underlying principles of ‘fit and proper’, governance and public interest. As a matter of desirable practice, not more than one member of a family or close relative or associate should be on the board. Based on the feedback received, a second draft of the guidelines would be prepared and put in public domain. The broad principles underlying the proposed framework is intended to ensure the following:

- Well-diversified ownership and control
- ‘fit and proper’ status of important shareholders, Directors and CEO
- Minimum capital/net worth for optimal operations and systemic stability
- Transparency and fairness of policy and process.

A consultative group headed by Dr. Ashok Ganguli was set up to review the supervisory role of board of banks. The recommendations included due diligence procedures for appointment of directors, the role and responsibilities of independent non-executive directors, qualification and other eligibility criteria for appointment of non-executive directors, providing training to the non-executive directors so that they are in touch with the latest developments, etc.

In the midst of all these initiatives and challenges, a major challenge for the Reserve Bank has been to ensure that the overarching banking regulatory framework facilitates banking services reaching the common man. The Reserve Bank has appointed an External Committee on Procedures and Performance Audit on Public Services headed by Dr. S.S. Tarapore and this committee has in one of its reports focused on depositor’s accounts and other banking facilities relating to individuals - the common man. Subsequently, Governor, Dr. Y.V. Reddy has addressed all the Chairmen of banks reminding them of the trust reposed by the common person in the nature and quality of customer

service rendered by banks. Banks must recognise that if there is disenfranchisement of the depositor they may wake up to find slippages on the liability side of their balance sheet.

In the ultimate analysis, however, it is the human resource which will have to respond to these challenges and in the words of our previous Governor, Dr. Bimal Jalan, “In the years to come this ‘human’ bias is likely to get stronger and the quality of human resources would become the cutting edge of competitiveness. A forward looking approach to our long term vision must focus on building human resources in a continuous cycle of competency and development”. To drive the change and meet the challenges we need bankers with not only requisite leadership and technical skills but also ethical standards of the highest order and in this we need look no further than the late Shri Nani Palkhivala for a role model - a man about whom it can be truly said that he walked with Kings yet lost not the common touch.