V Leeladhar: Contemporary and future issues in Indian banking

Speech by Mr V Leeladhar, Deputy Governor of the Reserve Bank of India, to Kanara Chamber of Commerce and Industry, Mangalore, 11 March 2005.

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Banking scenario has changed rapidly since 1990s. The decade of 90s has witnessed a sea change in the way banking is done in India. Technology has made tremendous impact in banking. ‘Anywhere banking’ and ‘Anytime banking’ have become a reality. The financial sector now operates in a more competitive environment than before and intermediates relatively large volume of international financial flows. In the wake of greater financial deregulation and global financial integration, the biggest challenge before the regulators is of avoiding instability in the financial system.

Economic outlook and banking sector’s performance

Keeping in mind the impact of real sector shocks on financial stability, any assessment of the banking sector needs to be done in the backdrop of national as well as international economic outlook. During the last couple of years, global growth has been above the forecast in almost every region stimulated by strong monetary and fiscal measures. The domestic economic outlook is also bright with the real GDP growth rate surpassing 8% last year and estimated to be around 7% in the current year. Industrial performance also improved considerably with a strong manufacturing growth for the second consecutive year. Inflation rate has been under control, barring some hiccup for a short period.

Aided by a good macro economic environment, banks’ bottom line has improved significantly over the last two years. However, let us not forget that a major contributor to the windfall gains has been treasury profits fuelled by a secular decline in interest rates during the three years period from 2001 to 2004 and consequent profit booking on sale of government securities. From the current year, with the hardening of interest rates, this trading component of profits is no longer going to shore up banks’ profitability. On the contrary, most banks have been required to provide for the decline in the market value of their investments portfolio. Thankfully, one offsetting factor has been the strong pick up in the credit off-take due to buoyant demand in the economy and revival of industrial activity, which have resulted in substantial increase in banks’ core interest income.

High capital inflows: an opportunity as well as a challenge

As you all know, liquidity position in the financial sector has been quite comfortable in the recent times. The buoyant capital market coupled with an appreciating rupee vis-à-vis US dollar has been attracting large foreign institutional inflows during the last two years. While we have an all time high foreign exchange reserves of more than $130 billion, high capital inflows pose a big challenge to monetary and exchange rate management. In this context, operationalisation of Market Stabilisation Scheme (MSS) has given an additional instrument for liquidity and monetary management. To sum up the challenge, I would like to quote a statement of Dr. Y.V. Reddy, Governor, Reserve Bank of India, which he made at the annual meeting of Bank for International Settlement (BIS) on June 28, 2004. And I quote, “…..Special defences need to be put in place for ensuring financial stability in the case of countries like India that are faced with the prospect of volatile capital flows. The issues relating to cross-border supervision of financial intermediaries in the context of greater capital flows are just emerging and need to be addressed.”

Technology is the key

As I mentioned in the beginning of my speech, technology has thrown new challenges in the banking sector and new issues have started cropping up which is going to pose certain problems in the near future. The new entrants in the banking are with computer background. However, over a period of time they would acquire banking experience. Whereas the middle and senior level people have rich banking experience but their computer literacy is at a low level. Therefore, they feel the handicap in this regard since technology has become an indispensable tool in banking.

Foreign banks and the new private sector banks have embraced technology right from the inception of their operations and therefore, they have adapted themselves to the changes in the technology easily. Whereas the Public Sector Banks (PSBs) and the old private sector banks (barring a very few of them) have not been able to keep pace with these developments. In this regard, one can cite historical, political and other factors like work culture and working relations (which are mainly governed by bipartite settlements between the managements and the staff members) as the main constraints. Added to these woes, the PSBs were also saddled with some non-viable and loss making branches, thanks to the social banking concept thrust upon them by the regulatory authorities in 1960s.

Globalisation of financial services

Growing integration of economies and the markets around the world is making global banking a reality. The surge in globalization of finance has also gained momentum with the technological advancements which have effectively overcome the national borders in the financial services business. Widespread use of internet banking has widened frontiers of global banking, and it is now possible to market financial products and services on a global basis. In the coming years globalization would spread further on account of the likely opening up of financial services under WTO. India, as you know, is one of the 104 signatories of Financial Services Agreement (FSA) of 1997. This gives India's financial sector including banks an opportunity to expand their business on a quid pro quo basis.

Indian Banks at the global stage: A Reality check

As per Indian Banks' Association report 'Banking Industry Vision 2010', there would be greater presence of international players in Indian financial system and some of the Indian banks would become global players in the coming years. So, the new mantra for Indian banks is to go global in search of new markets, customers and profits. Let us not forget that the competition is not only on foreign turf but also in the domestic field as well from foreign banks operating in India.

Now against these lofty objectives of Indian banks going global, let us see where we stand. Although, Indian banks have also made their presence overseas, yet it is limited. Only twenty Indian banks including private sector banks appear in the list of "Top 1000 World Banks" as listed by the London based magazine "The Banker". What is even more revealing is that State Bank of India, India's largest bank, ranks 82^{nd} amongst the top global banks. Size is increasingly becoming important for the global banks as it is crucial to improved efficiency. However, India's largest bank, SBI is not even a 10^{th} in size of the 9^{th} largest bank, Sumitomo Mitsui, which has assets of $950 billion as against SBI's assets of $91 billion. Therefore, the notion that SBI or ICICI Bank can compete in the international arena seems far fetched at the moment.

Is size the only constraint for Indian banks?

The problem is not just one of lacking the necessary size; few Indian banks have the necessary products or human resource capabilities. If anything, the implementation of Basel II norms has raised the bar for Indian banks seeking an international presence. The top international banks can lower their capital requirements through the use of sophisticated risk management techniques and thus compete more aggressively than before.

What is being done to prepare Indian banks to meet global challenge?

Indian banking sector has already implemented internationally followed prudential accounting norms for classification of assets, income recognition and loan loss provisioning. The scope of disclosure and transparency has also been raised in accordance with international practices. India has complied with almost all the Core Principles of Effective Banking Supervision of the Basel Committee. Some of the Indian banks are also presenting their accounts as per the U.S. GAAP. The roadmap for adoption of Basel II is also under formulation. All these factors give Indian banks much needed confidence for overseas operations. But as I said earlier overseas operations is one thing and competing against the global players in the international market is quite another. And Indian banks have a lot of catching up to do before they can emerge as truly global players.

Supporting Regulatory Framework

Supporting institutional and regulatory framework at home is vital for domestic banks aspiring for global operations. RBI has suitably changed the country's regulatory framework from time to time to support Indian financial institutions to withstand the competitive pressures placed on them by increasing globalization.

Proper steps have been taken to guide the banking sector to see that the banks pass through this transition phase by and large successfully. The reforms initiated in the banking sector have now reached a crucial stage. Government's stake in some PSBs is reduced and as a consequence public equity in these PSBs is enlarged. This led to greater responsibility on the bank managements since the level of accountability has increased. Pressures of performance and profitability will keep them on their toes all the time as the public shareholders expect good performance along with good returns on their equity. Many PSBs have already started the exercise of cleaning up of their balance sheets by shedding the excess baggage. The VRS scheme in the recent past in some of the banks was aimed not only at downsizing the manpower but also at cutting down the staff costs and increasing the performance levels of the staff in the long run. Some of these banks are able to run the show to certain extent by low cost funds that are available thanks to the branch network spread over the length and breadth of the country.

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 three years ago has demonstrated that 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 Narasimhan (II). In India, one of the largest financial institutions, ICICI, took the lead towards universal banking with its reverse merger with ICICI Bank coming through a couple of years ago. Another mega financial institution, IDBI has also adopted the same strategy, and has already transformed itself into a universal bank. Now the process of its progeny IDBI Bank merging itself with the parent IDBI is underway, and is likely to be completed soon. This trend may lead logically to promoting the concept of financial super market chain, making available all types of credit and non-fund facilities under one roof or specialised subsidiaries under one umbrella organisation. Consolidated accounting and supervisory techniques would have to evolve and appropriate fire walls built to address the risks underlying such large organisations and banking conglomerates.

Will the stable conditions continue for the banks?

The big question we have to ponder is whether these stable conditions marked by all round improvement in banks' performance can continue into 2005 onward in the light of potentially dramatic changes that include, among others, a sliding dollar, rising interest rates, introduction of Basel II accord and international accounting standards, and the possible flattening of consumer lending boom. Hopefully, the banking industry in tandem with the regulatory authorities will rise to the occasion, and collectively face the challenges and opportunities that lie ahead.

Thank you.