# Kishori J Udeshi: In quest of new cheese

Speech by Ms Kishori J Udeshi, Deputy Governor of the Reserve Bank of India, at the Indian Banks' Association Seminar, Mumbai, 26 April 2005.

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IBA deserves to be complimented for having organised this Seminar on the subject of "In search of new cheese – Towards Newer Profit Avenues". The subject holds considerable contemporary relevance coming as it does at a time of intense competition, thinning margins, rising yields, and dwindling trading profits. As we look back we can see that the declining interest rate scenario during the last three to four years coupled with prudent regulation, in alignment with international standards and effective supervision has strengthened the balance sheets of banks. It's a different matter that had the asset quality been as it should have been, the profits could have been more gainfully utilised. What is of concern however, is whether the reduced NPA levels reported are sustainable through stronger credit appraisal processes built up over the years or are they only a result of massive provisioning which will be difficult to sustain in a scenario of rising bond yields. Only time will tell.

Before I talk of cheese let me begin by chalking out two issues on the expenditure side in the future scenario. This chalk may serve to highlight the quest for cheese.

First and foremost, banks would need to invest heavily in technically qualified professionally skilled staff. For this you recognise to invest in ARMS i.e. Attract, Retain and Motivate Staff. Turnover of such staff in banks is going to be as volatile as it is for the BPO firms and compensation structures would need heavy revamping. This should necessarily be accompanied by good HRM system which can measure performances.

Secondly, although technology deployment in banks has increased remarkably, this has not been leveraged to the maximum extent essential to achieve and maintain high service and efficiency standards. In effect, managing technology, is still a key challenge for Indian banks. We have, therefore, had to settle for just the standardised approach under Basle II. We need to move to advanced approaches under Basle II in order to achieve greater efficiency of capital and be competitive in India as also globally. For this, banks not all but certainly the large and significant banks need to invest heavily in advanced technology which is another item of expenditure that cannot be avoided in the near future.

Given this backdrop, can banks make profits by the same old 3-6-3 rule ? i.e.

Pay 3% interest on deposits

Charge 6% interest on loans and

Head for the golf course at 3.

Because there is grain of truth in this, I would say that perhaps they may manage to earn some profits but they would certainly not remain competitive.

Banks would need to think of partnerships and strategies that were previously unthinkable – and perhaps still so – but these would need to be tackled. For example, investment banking may have been thought of as being unreasonably volatile but it may now be the need of the corporate customer.

- Banks need to develop more efficient credit delivery mechanisms and this should form part of its repositioning strategy.
- Banking data reveals concentration of banking business in urban / metro areas, with the top ten centres accounting for roughly 70% of banking business i.e. potential of rural / semi-urban areas remain relatively untapped. I may be naïve, but what beats me is the high spreads between the formal and informal sector lending rates in the rural areas. Is cheese for the money lender not cheese for a bank ?
- Banking can forge and nurture appropriate public-private partnerships for development of micro finance activities.
- SMEs have been a neglected segment of bank lending – year on year growth in the SSI segment has been barely 5% as compared to 19% growth in total lending. It may interest you to know that in its search for improving profitability, a large Japanese Bank introduced a

product called “Uncollateralised Business Select Loan” aimed at small businesses in 2002. It has been stated that this business generated net margins of 2% -2.5% compared with the net corporate lending margins of 0.8%-1.1%. For this, instead of relying on collateral, the bank developed a new credit scoring system and new methods of measuring default and counterparty risk as also new marketing methods.

- Securitisation will enable banks to target profit growth from asset turnover based business rather than the Balance Sheet.
- It is stated that non interest income accounts for nearly half of all operating income generated by US commercial banks. In India, it is less than one-fifth. While there is scope for increasing fee based income through non-traditional services, studies in the US suggest that increased reliance on fee based activities tends to increase rather than decrease the volatility of banks’ earnings stream.

I am aware that the issues raised are neither new nor profound but if something is oft repeated, there is a likelihood of it being acted upon. I am optimistic in that sense. I would sum up by saying that improved profitability can come through :

(i) Improved asset quality through a more risk-management based banking culture and

(ii) Improved cost and revenue efficiency through use of advanced information technology and financial processes.

And in concluding, I would remind banks that the societal concerns of banking, which assume relevance in an emerging economy like India, where a significant proportion of the population resides in rural areas, should not lose its prominence, in their quest for new “cheese”.