V Leeladhar: Emerging challenges before the Indian banks - the road ahead

First Annual Dena Bank Foundation Day address by Mr V Leeladhar, Deputy Governor of the Reserve Bank of India, to commemorate its founder, the Late Pranlal Devkaran Nanjee, Mumbai, 26 May 2005.

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It is indeed an honour to be invited to commence the Dena Bank Foundation Day Lecture Series. Today, as we remember the founders, we essentially pay homage to their vision and drive that led to the establishment of the Dena Bank. Shri Pranlalbhai Nanjee, inspired by his late father Shri Devkaran Nanjee's dream to start a bank and play a seminal role in the development of the Indian banking industry, started the Devkaran Nanjee Banking Company in January 1938, about three years after the Reserve Bank was established. It was then incorporated as a private limited company under the Indian Companies' Act on 26 May 1938. In a span of twenty five years, the bank grew in size and stature to rank amongst the top 14 banks in India and was converted into a public limited company and renamed as Dena Bank Limited in December 1966. It was nationalized in July 1969 along with 13 other banks in the first phase of bank nationalization in India. Today, as the bank is gearing itself to enter the fast changing, turbulent and uncertain environment that characterises the banking terrain, we trust it will pick up the momentum of its first twenty five years.

Founding days are always very special. They are one of the few 'possessions' which are owned by each and every one of the institution's fraternity alike. It is not only a day to feel proud, it is a day to reflect, a day to share, and a day to celebrate. It is also an opportunity to re-emphasise what the institution stands for, to renew its symbols, its imagery and its values. These symbols and imagery not only help project its corporate culture and identity, but they also constitute an integral part of the institutions' brand building exercise. Founding days constitute one of the few opportunities for collective sharing in an institution. The coming together and the camaraderie that this day evokes is perhaps the appropriate moment to reinstate an emotive content into the work place.

The emotive content, team building, the ownership in work, how to inspire, how to draw out from the staff the very best, are perhaps new issues in the boardroom agenda in the world of Indian banking. Strategy sessions are increasingly focusing on the ways of unleashing the tremendous power of emotions that has been hidden in organizations and using it in a constructive manner to energise people and to maximise motivation. The desired outcome is to get individuals cognitively, physically, affectively and personally engaged in their work in the pursuit of institutional excellence. The common theme underlying these perspectives is that leaders may persuade with logic but they motivate through emotion and that a strong motivation and psychological involvement is not possible without an emotional attachment to the work or the work context. What has brought about this change? For a few decades preceding the onset of banking and financial sector reforms in India, banking operated in an environment that was heavily regulated and had a certain security of expectations built into it. Banks, the institutions which evoked notions of 'fortune, probity and prudence', charted their way slowly but surely, secure in the belief that the regulatory environment protected their margins, their territories and their branch network. This also posed sufficient barriers to entry and protected them against too much competition and a relationship based on the loyalty contract bound their customers irrevocably to them. This environment of complacent certainties has now changed bringing with it profound implications for the manner in which banks operate, their responses to customer needs, their agility, the never-ending quest towards efficiency and the continuous search for ever newer pastures – 'hunting for cheese' and the more serious concern for the need to continuously reassess and reposition themselves in their business plans.

The last decade has witnessed major changes in the financial sector: New banks, new financial institutions, new instruments, new windows, and new opportunities and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment revenues, it has entailed greater competition and consequently greater risks. Cross-border flows and entry of new products, particularly derivative instruments, have impacted significantly on the domestic banking sector, forcing banks to adjust the product mix, as also to effect rapid changes in their processes and operations in order to remain competitive in the globalised environment. These developments have facilitated greater choice for consumers, who have become more discerning and demanding compelling banks to offer a broader range of products through diverse distribution channels. The traditional face of banks as mere financial intermediaries has since altered and risk management has emerged as their defining attribute.

It is clear that we are at the beginning of this new phase in the Indian banking. The recent measures announced by the Government and the Reserve Bank of India for opening up India's banking sector to international investors will further increase the pressure of competition. At the same time there is renewed emphasis by the Government on the social sector together with thrust on rural and agricultural lending. Caught between the competitive pressure, both domestic and external, and the politics of development, banks will have to be on their toes, become even more efficient in managing funds and in meeting the needs and demands of customers.

Economic outlook and banking sector's performance

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 three 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.

Globalisation – a challenge as well as an opportunity

Currently, the most important factor shaping the world is globalisation. The benefits of globalisation have been well documented and are being increasingly recognised. Integration of domestic markets with international financial markets has been facilitated by tremendous advancement in information and communications technology. But, such an environment has also meant that a problem in one country can sometimes adversely impact one or more countries instantaneously, even if they are fundamentally strong.

There is a growing realisation that the ability of countries to conduct business across national borders and the ability to cope with the possible downside risks would depend, *inter alia,* on the soundness of the financial system. This has consequently meant the adoption of a strong and transparent, prudential, regulatory, supervisory, technological and institutional framework in the financial sector on par with international best practices. All this necessitates a transformation: a transformation in the mindset, a transformation in the business processes and finally, a transformation in knowledge management. This process is not a one shot affair; it needs to be appropriately phased in the least disruptive manner.

High capital inflows: not an unmixed blessing

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 $140 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."

Interest rate risk for Indian banks – profits under pressure

The rapid and relatively substantial rise in rupee interest rates in recent months has brought into focus the market risk faced by Indian banks. Your own bank's current years profits have been badly affected due to increased provisioning requirement on the investment portfolio. Your fourth quarter results have shown massive losses due to Mark to Market (MTM) losses on your G-Sec portfolio. The story is not much different for most of the public sector banks. The benchmark 10-year yield on government securities has risen from 5.2% in May last year to around 7.2% at this point. The spike in interest rates has affected the trading profits of banks. We in Reserve Bank have been regularly carrying out quantitative impact studies of rising yields on banks' economic value. While, financial media, and some academic circles have been portraying an overly alarming and pessimistic picture regarding banks' potential interest rate risk, our analyses reveal that gradually increasing interest rate regime is unlike to erode banks' equity, given the likely increase in net interest income (NII), some residual unrealized gain on the portfolio (though, I must confess, most of it has evaporated), and the recent forbearance by RBI permitting banks to hold a larger proportion of securities under the 'held to maturity' (HTM) category that need not be marked to market. Of course, as I cited your own bank's example, banks had to take a one time hit before shifting the securities from trading to banking book.

Different banks, however, vary in their levels of vulnerability, with some new private banks being less susceptible to market risk compared with most old private banks and some government banks. In the medium term, however, most banks are likely to need to increase their equity to meet growing regulatory capital allocation for market risk.

Technology is the key

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. This 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 nonviable and loss making branches, thanks to the social banking concept thrust upon them by the regulatory authorities in 1960s.

Basel II accord, capital and market discipline

The most prominent on our minds in the context of banking these days, perhaps, are the implications arising out of the Basel II accord. Two deserve special mention – one relates to capital and the other to market discipline. Where capital is concerned, the prescriptions have ushered in a transition from the traditional regulatory and market measures of capital adequacy to an evaluation of whether a bank has found the most efficient use of its capital to support its new business mix, i.e., from capital adequacy to capital efficiency. In this transition, how effectively capital is used will determine returns on equity and a consequent enhancement of shareholder value. In effect, future plans may, therefore, include the fluid use of capital, an approach that has been called the "just-in-time balance sheet" management, in which capital flows quickly to its most efficient use. This transition in how capital is used and how much capital is needed will become a significant factor in return-on-equity strategy for years ahead and banks' strategic plans may be required to execute this kind of approach.

The accord also has, as an underlying principle, the reliance on the market to assess the riskiness of banks. This translates into an increased focus on transparency and market disclosure, critical information describing the risk profile, capital structure and capital adequacy. Besides making banks more accountable and responsive to better-informed investors, these processes enable banks to strike the right balance between risks and rewards and to improve the access to markets. Improvements in market discipline also call for greater coordination between banks and regulators.

India has been a participant in the international initiatives to ensure improved processes of market discipline that are being worked out in several fora, such as, the multilateral organisations, the BIS, the Financial Stability Forum, and the Core Principles Liaison Group. Concurrent efforts are underway to refine and upgrade financial information monitoring and flow, data dissemination and data warehousing. Banks are currently required to disclose in their balance sheets information on maturity profiles of assets and liabilities, lending to sensitive sectors, movements in NPAs, besides providing information on capital, provisions, shareholdings of the government, value of investments in India and abroad, and other operating and profitability indicators. Financial institutions are also required to meet these disclosure norms. Banks also have to disclose their total investments made in equity shares, units of mutual funds, bonds and debentures, and aggregate advances against shares in their notes to balance sheets.

The critical regulatory initiatives taken by the Reserve Bank of India to prepare the banking sector for these changes are : (i) the Reserve Bank's endeavour to ensure that the banks have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital; (ii) The introduction of Risk Based Supervision (RBS) in 23 banks on a pilot basis; (iii) the drive to encourage banks to formalize their capital adequacy assessment process (CAAP) in alignment with their business plan and performance budgeting system; (iv) Ensuring better disclosure so as to have greater transparency in the financial position and risk profile of banks and (v) finally, the Reserve Bank at its end is in the process of building capacity to ensure it can vet models for banks who will be adopting the IRB / Advanced Measurement approaches.

As banks have two years lead-time to prepare themselves for Basel II, they are encouraged to focus on capacity building and undertake impact analyses. On the basis of the impact studies, banks would be required to put in place appropriate strategies and plans for raising fresh capital or augment capital through internal resources. Banks may also need to redefine their business strategy with a view to altering their profile of risk exposures or adopt a combination of both these approaches to meet the capital requirement.

Organizations all over are rushing to implement the latest ideas on management, sometimes to the point of overuse. Most of these ideas are about doing things better, about improving operational effectiveness. If everybody however is competing on the same set of variables, then the standard gets higher but no one gets ahead. And getting ahead – then staying ahead - is the basis of strategy and creating a competitive advantage. Strategy is about setting yourself apart from the competition. Its therefore not just a matter of being *better* at what you do, its rather a matter of being *different* at what you do. The major challenge now for banks as well as any other organisation is therefore how to develop their social architecture that generates intellectual capital as the quintessential driver of change. Developing the individual or human capacity is an integral element of building capacity and, in fact, capacity building initiatives are now increasingly becoming almost an index of institutional quality. Capacity building would in the days to come not only influence the structure of institutions, it would also determine how they are run.

Taking the banking industry to the heights of excellence, especially in the face of the afore-detailed emerging realities, will require a combination of new technologies, better processes of credit and risk appraisal, treasury management, product diversification, internal control and external regulations and, not the least, human resources. Standing as we do at this critical juncture, I trust innovative, illuminating ideas, fresh insights and alternative ways of thinking about the competitive yet cooperative combat that the world of banking and finance is readying itself for will mark Dena Bank's business strategies and institutional development plans and will give you the emotive content to carry forth Shri Nanjee's legacy of financial entrepreneurship and set the lead to position your institution not just as a national but as a global player. I wish you every success in your all future endeavours.

Thank You.