Duvvuri Subbarao: Should banking be made boring? – an Indian perspective

Keynote address by Mr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the International Finance and Banking Conference on “Banking – Crisis and Beyond”, organised by the Indian Merchants’ Chamber, Mumbai, 25 November 2009.

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I. Introduction

First of all, my grateful thanks to the Indian Merchants’ Chamber and the Institute of Chartered Accountants of India for inviting me to be the Chief Guest at this year’s International Finance and Banking Conference. The theme of this conference, “Banking – Crisis and Beyond” is relevant and timely. The global financial system has been engulfed in possibly the deepest crisis of our time shaking our world view of the financial sector to its roots. As attention both around the world and here in India shifts from managing the crisis to managing the recovery, the importance of consolidating the lessons of the crisis and reflecting them in our forward plans can hardly be overemphasized. Being at this conference and sharing some thoughts and ideas with you is therefore an opportunity to which I attach a lot of value.

II. Calls for making banking boring

2. Banks have been at the heart of the global financial crisis and bankers are widely seen as being responsible for the crisis. Quite understandably, there is a deluge of ideas and suggestions on reforming banks, banking and bankers. One of the more influential ideas, one that has generated a vigorous debate, has been the thesis put forward by the noted economist and Nobel Laureate Paul Krugman that the way to reform banking is to once again make it boring.

3. Taking a long term historical view, Krugman argues that there is a negative correlation between the “business model” of banking and economic stability. Whenever banking got exciting and interesting, paid well and attracted intellectual talent, it got way out of hand and jeopardized the stability of the real sector. Conversely, periods when banking was dull and boring were also periods of economic progress.

4. To support his thesis, Krugman divides American banking over the past century into three phases. The first phase is the period before 1930, before the Great Depression, when banking was an exciting and expanding industry. Bankers were paid better than in other sectors and therefore banking attracted talent, nurtured ingenuity and promoted innovation. The second phase was the period following the Great Depression when banking was tightly regulated, far less adventurous and decidedly less lucrative – in other words banking became boring. Curiously, this period of boring banking coincided with a period of spectacular progress. The third phase, beginning the 1980s, saw the loosening of regulation yielding space for innovation and expansion. Banking became, once again, exciting and high paying. Much of the seeming success during this period, according to Krugman, was an illusion; and the business model of banking of this period had actually threatened the stability of the real sector. Krugman’s surmise accordingly is that the bank street should be kept dull in order to keep the main street safe.

5. The boring banking thesis found an echo in other influential voices. In a speech last month that attracted wide notice, Mervyn King, Governor of the Bank of England addressed the moral hazard issue: why were banks willing to take risks that proved so damaging to themselves and the rest of the economy? The problem, according to Governor King, was that financial institutions became too important to be allowed to fail. His solution: restrict banking

to its traditional “utility” function – performing basic retail financial intermediation of deposit taking and lending, and providing payment and settlement services; and hive off the riskier financial services such as proprietary trading into a separate entity. In what has come quickly to be known as the “utility and casino” model, the “utility” will be heavily regulated and will enjoy implicit government guarantee while the “casino” will be left to the discipline of market forces.

6. Closer home, another equally influential voice – Dr. Y.V. Reddy, former Governor of the Reserve Bank of India – weighed in on the issue. In his Guhan Memorial Lecture last month, Dr. Reddy called for “back to basics” in banking and urged that banks must curb the tendency towards further financialization of deposits they mobilize and must focus instead on lending to real sectors of the economy, particularly agriculture and the small and medium industries, that have limited ability to tap the capital markets.

7. Although neither Governor King nor former Governor Reddy mentioned “boring banking”, in a sense both of them were calling for what can stylistically be interpreted as boring banking.

8. Krugman’s thesis of “boring banking” is interesting, but also debatable. It raises several important questions. What were the ills of the banking system that caused the crisis? Is making banking “boring” a necessary and sufficient cure to those ills? How do the several proposals on the table at the international level for reforming banking measure up to the test of making banking boring? And, how relevant is the “boring banking” perspective in India? I want to use the platform of this conference that you have so kindly provided me to address these questions.

III. Ills of the banking system that caused the crisis

9. Let me turn first to the ills of the banking system that caused the crisis. I will not go into an extensive analysis of the causes. I will attempt something much more limited – just give a brief synopsis to provide a backdrop for the “boring banking” discussion.

Glass-Steagall Act, financial innovation and risk transmission

10. Many believe that the genesis of the crisis can be traced to the repeal in the United States in 1999 of the Glass-Steagall Act which mandated the separation of commercial and investment banking to protect depositors from the hazards of risky investment and speculation. The repeal opened up opportunities for commercial banks, investment banks, securities companies and insurance companies to consolidate, setting off a wave of innovation. Complex financial products were created by slicing and dicing, structuring and hedging, originating and distributing, all under the belief that real value could be created by sheer financial engineering. The system was characterized by opacity and dissipation of information with no one having a full picture of the extent of risk, how it was getting transmitted across the system and where it resided.

Globalization of financial institutions and services

11. A very striking feature of the financial crisis was its global scope with no country escaping unscathed. This should not surprise us. The progressive globalisation of financial institutions and services over the last two decades has led to a complex web of interconnected markets, institutions, services and products. Institutions transcended borders; markets became accessible in real time and financial services were available from everywhere. In short financial markets and institutions declared “death of distance” and “conquest of location”. And when the crisis came, it showed that globalization meant that no country can really be an island.

Proliferation of quasi banks beyond regulatory purview

12. As the pace of globalisation and financial innovation gained momentum, and encouraged by an extended period of monetary accommodation, banks entered into areas of activity that had earlier been the preserve of non-bank institutions. Banks looked for, and exploited, opportunities to shift profitable but risky businesses to entities outside the regulatory purview. To economize on capital requirements, banks developed new structured products to distribute the credit risk, they also found new special purpose entities and vehicles to handle them. The structured investment vehicles quickly spawned a vast "shadow banking" network that operated and thrived outside the perimeter of bank regulation. With few regulatory restrictions and no coordinated oversight, they were able to take on risks that they did not fully comprehend. And when the Minsky moment arrived turning the financial mania into panic, the risks reverted to the parent banks causing financial turmoil and economic down turn.

The moral hazard of "too big, too important to fail" institutions

13. The lure of profits encouraged financial institutions to expand, transcending borders and business segments, to exploit economies of scale and scope. And this was facilitated by the implicit faith of the authorities in "light touch" regulation. Consequently, what we ended up with was large financial conglomerates with footprints across the system. These institutions knew that their failure would result in a systemic collapse, and that they would therefore be rescued at public cost. This acted as a perverse incentive for them to take on risks that we now know were imprudent if not reckless. The moral hazard of "too big to fail" is therefore reckoned as one of the prime causes of the crisis.

Compensation and perverse incentives

14. Finally, the asymmetric compensation structures in many financial institutions encouraged risky behaviour. The variable components of compensations were anchored to short-term profits, were one sided (high in good times and at worst zero in bad times) and had little or no risk adjustment. This myopic attitude towards long term risk provided perverse incentives to bank managements to maximise their current compensations at the cost of shareholders, and to maximise leverage without regard to the tail risks to the institution.

IV. Is "boring" banking a necessary and sufficient solution?

15. The ills of the banking system listed above raise two follow-on questions. Is making banking boring in the sense that Krugman indicated a necessary and sufficient solution to curing those ills and preventing their recurrence? And what will be the cost of making boring? Both questions cause much confusion, the first because it has too many answers and the second because it has too few. Abstracting from these answers, I will argue that it is neither possible nor desirable to make banking boring.

16. The narrow banking of the 1950s and 1960s was presumably safe and boring. But that was in a far simpler world when economies were largely national, competition was sparse, pressure for innovation was low, and reward for it even lower. Bankers of the time, it is said, worked on a 3-6-3 formula: pay depositors 3 per cent interest, lend money at 6 per cent and head off to the golf course at 3 pm. From the 24/7/365 perspective of today, that may appear romantic but is hardly practical.

17. The boring banking concept does not appear persuasive even going by more recent evidence and on several counts. First, recall that during the crisis, we saw the failure of not only complex and risky financial institutions like Lehman Brothers but also of traditional banks like Northern Rock. What this demonstrates is that a business model distinction cannot be drawn between a utility and a casino; and if it can, it does not coincide with the

distinction between what has to be safe and what need not be. Second, in an interconnected financial sector, how can a "boring" bank realistically ring-fence itself from what is happening all around? Let us say a large investment bank, a casino if you will, fails. Because of the inevitable interconnectedness, that will cause a break down of trust not just in that particular bank but in the entire financial sector. So utilities cannot expect to insulate themselves against the risks being taken by the casinos. Third, the co-existence of utilities and casinos can also open up arbitrage opportunities. During "tranquil" periods, financial institutions with higher risk and reward business models will wean away deposits from narrow banks. But when problems surface and stresses develop in the financial sector, the position will reverse with the deposits flowing back into the so called "boring banks" triggering procyclicality. Finally and most importantly, what will be the cost of boring banking in economic terms? Does restraining banking to its core function just to keep it safe not mean forgoing opportunities for growth and development?

18. There have of course been problems in the way banking evolved around the world – problems that were at the heart of the crisis. But clearly the answer is not to adopt Luddite solutions that take us back decades. The solution is to look ahead to what we need. We need to build institutions that go beyond narrow banking and provide the whole gamut of financial services to meet the needs of customers, markets and economies. We need to build on the innovations of the last few decades but in doing so build in also correctives based on the lessons of experience. We need to build a safe and enterprising banking sector that supports growth while preserving financial stability. We need to nurture financial markets and institutions within clearly defined and effectively supervised boundaries. Doing all of this is the basic thrust of the international reform agenda currently under discussion to which I now turn.

V. International reform initiatives – will they make banking boring?

19. The reform initiatives in the wake of the crisis are intended to rein in the "irrational exuberance" of the banking sector, keep it safe and healthy, and make banking an aid for growth and macroeconomic stability. What is relevant to our discussion here is that none of these measures is aimed at making banking boring; on the contrary, several of them will likely make banking more challenging and thereby spur innovation of a more value adding and sustainable variety. In order to enable an appreciation of this, let me provide a brief synopsis of the various initiatives under discussion from the macro and micro perspectives.

The macro perspective

20. One clear lesson of the crisis is that regulation and supervision at the institution level is necessary, but not sufficient. Even if each institution is healthy and safe on a stand-alone basis, systemic risk can build up because of procyclical, herd behaviour – what economists call the fallacy of composition. It is therefore necessary to supplement micro-prudential regulation with macro prudential oversight.

21. At a macro level, to address procyclicality and contain leverage, three important initiatives are underway: (i) development of capital buffers that banks would be required to maintain to counter cyclical effects; (ii) requirement for institutions to set provisions on a dynamic basis, i.e. building up buffers in good times to be drawn down in bad times; and (iii) developing a metric to contain excessive leverage in banks to supplement the risk based capital ratio.

22. A somewhat original idea proposed by Prof. Raghuram Rajan, currently under discussion, is to require institutions to maintain "contingent capital" to tide over systemic crisis or idiosyncratic problems. This proposal will potentially require banks to issue long-term debt instruments that would automatically covert to equity under specific triggers. This contingent arrangement will accordingly enable banks coming under stress to quickly buffer

their capital without imposing any cost on tax payers. All this will not, of course, be costless. The challenge is to design the contingent capital provisions in a way that optimally manages the trade off between higher cost and lower moral hazard.

23. An important proposal aimed at mitigating systemic risk is to impose a systemic risk capital surcharge on institutions that pose a higher risk to the system because of their size, complexity or interconnectedness. There is increasing support for such a measure. In fact, Lord Turner, Chairman of the UK Financial Services Authority, went further and argued that should such a capital charge prove insufficient, there should be no hesitation in levying a tax on specific financial transactions. The Turner proposal is based on the premise that regulation should ensure that the financial sector remains within its "socially useful" size.

24. Large, interconnected and complex institutions will be subject to additional regulatory obligations in other dimensions as well. Importantly, such institutions will be required to institute more sophisticated risk management systems, have robust contingency plans and put in place "living wills" that can steer the course of their orderly exit should problems in these institutions become unmanageable. The Basel Committee on Banking Supervision (BCBS) is working on resolution mechanisms for cross border financial institutions with an aim to containing risk.

25. There is a proposal to move OTC derivatives to central counterparties and charge differentiated capital for OTC derivatives that are cleared on a bilateral basis. This will contain systemic risk to some extent.

26. Another lacuna that came into sharp focus during the crisis is that while financial activity is increasingly getting international, regulation remains fiercely national. The growing cross border nature of banking and banking services underscores the need for a coordinated oversight of banking entities, particularly of large and complex institutions. In an ideal world, we would have global regulation; because we are in a less than ideal world, we are having to settle for a "global framework" that will mandate minimum consistency across jurisdictions in regulatory principles that would apply to similar markets, institutions, activities and products.

27. Finally, the emergence of a large shadow banking system, typically with higher than average leverage, has underscored the need for their regulation and the importance of mandating disclosure and reporting requirements. This is coming in the form of expanding the perimeter of regulation to those institutions that are "near banks" which are currently unregulated or under-regulated.

The micro perspective

28. Let me now turn to the micro perspective which focuses on ensuring the safety and soundness of individual institutions.

29. First, to ensure that bank exposures are adequately and sufficiently covered by capital, various enhancements to the Basel II capital framework have been finalised. These specifically relate to higher capital requirements for trading book to minimize the opportunity for regulatory arbitrage between the trading and banking books. There are also proposals on the table for improving the quality of capital to ensure that regulatory capital is comprised largely of elements having a true loss absorbing capacity in a going concern scenario.

30. Second, recognising that solvency of banks can be threatened by illiquidity as much as by inadequate capital, work is currently under way to develop a global standard for liquidity risk regulation of cross-border banks, and strengthening information sharing on liquidity risk among home and host country supervisors.

31. Other initiatives under way include promoting compensation structures that reflect the underlying risks taken over a longer term horizon and enhanced oversight of credit rating agencies, particularly where ratings are being used for aligning bank risk to regulatory capital requirements.

32. Collectively, the measures initiated both at the macro and micro levels to reform the financial sector aim to impart a balanced perspective to banking. The intention is to ensure that the stability of the system is preserved, the integrity of core banking is not violated, retail customers' savings and deposits are not jeopardized and that the costs of riskier business products and practices are internalized to prevent, or at any rate minimize, externalities.

VI. Boring banking – an Indian perspective

33. Let me now turn to Indian banking. The decade of the 80s and 90s and the first decade of this century saw several financial crises around the world, many of them centred in banks. These crises were sometimes country specific, often regional, and in the case of the current crisis, global in scope. And in each case, the banking sector became a drag on the real economy, jeopardized public finances and hurt economic growth. What is noteworthy though is that even as other countries and other regions went through banking upheavals, Indian banking remained safe. This is a reflection, in part of our cautious and prudent regulation, and in part of the relatively lower globalization of our banking sector.

34. All this does not mean that the lessons of the crisis are irrelevant for us. Going forward, our banking sector too will acquire an increasingly international character – Indian banks will increase their presence abroad while foreign banks will have larger presence in India. The task for the Indian banks is to learn to compete abroad and to set the terms of competition at home. It is imperative therefore for Indian banks to learn from the successes and failures around the world, study international best practices and adapt them to the Indian conditions. Just as banking around the world is not going to revert to being boring, neither will Indian banking get boring.

35. In fact, I will go further and argue that boring banking is an oxymoron in the Indian case. Here my intent is to argue not so much from the perspective of a banking model – narrow or full service – but from the perspective of the challenges that Indian banks will have to meet. Meeting these challenges is going to demand lateral thinking, entrepreneurship and management calibre – all a far cry from anything like boring. In order to illustrate this, I will list and explain what in my view are four big challenges that Indian banks will need to address.

First challenge: financial inclusion

36. Despite its impressive progress, commercial banking in India has not penetrated sufficiently to serve the large mass of rural, illiterate and poor people in any meaningful way. Rough estimates indicate that of the 600,000 habitation centres in the country, only about 30,000 centres are covered by commercial banks. Even this big picture, stark as it is, does not fully convey the true extent of exclusion. Furthermore, even where 100 per cent financial inclusion is claimed, oftentimes it is inclusion only in a nominal sense. Households have bank accounts that remain dormant; few conduct any banking transactions and even fewer receive any credit. What we should attempt is quality financial inclusion which aims not at chasing a target but instead focuses on giving access to at least minimal financial services to the currently excluded.

37. The Reserve Bank has taken several steps over the last few years to further financial inclusion – encouraging "no frills" accounts to allow access to basic financial services, initiating and then expanding the Business Correspondent (BC) model and the use of mobile phones for extending banking outreach. More recently, we have expanded the categories of entities that can be appointed as BCs and also allowed banks to charge a commission for services rendered by BCs. There are of course formidable challenges to the BC model that we need to address – high maintenance costs, small size of transactions, expanding awareness, improving communication skills and techniques for dealing with semi-literate people in local languages, enlisting the cooperation of the village administrations and

overcoming the constraints posed by lack of electricity and sometimes telecommunication access.

38. What is clear though is that it is not possible to cover a country of a billion plus people, spread over 600,000 habitations, covering vast distances, with poor infrastructure and sometimes inhospitable terrain by traditional brick and mortar branches.

39. We need to think laterally, harness technology, adopt effective dissemination practices and reach out to all the people across the country to provide at least minimal banking services. Financial inclusion is especially valuable as it will at once promote both growth and equity. I can hardly overemphasize how big a challenge financial inclusion is for banks, for the banking regulator and for the government. Working to meet this challenge can hardly be a boring proposition.

Second challenge: financing infrastructure

40. Distinct from other large emerging market economies which are typically demand constrained, India has been, and will remain in the foreseeable future, a supply constrained economy. The biggest supply constraint is of infrastructure – physical, social and urban. It is widely recognized that poor and inadequate infrastructure is adding to production costs, denting productivity of capital and eroding the competitiveness of our productive sectors.

41. The Eleventh Five Year Plan targets increase in infrastructure investment from around 5 per cent of GDP in 2006/07 to 9 per cent by 2011/12. This translates to cumulative infrastructure investment over the Plan period of over Rs. 20 trillion (US$ 520 billion). Almost one half of this investment is to be funded through debt, and as much as 43 per cent of this total debt requirement (21 per cent of overall planned investment) is planned to be financed by banks. We have to await the mid-term appraisal of the Eleventh Plan for an update of the above numbers. Regardless of any revision the numbers may undergo, what is clear is that the financing needs of our infrastructure are huge.

42. A big issue in bank financing of infrastructure is the asset-liability mismatch. While infrastructure typically requires long term funding, the deposits of banks, their main source of funds, are relatively short-term. The problem of asset-liability mismatch in long term financing is not unique to India; banks elsewhere too face the same problem. But in advanced economies, the long term finance space is filled by insurance companies and pension and provident funds. If some of the pending legislation gets through, in India too we can expect new sources of long-term financing to open up. But until that happens, the burden of infrastructure financing will have to be met largely by the banks. In order to partly offset this problem, the Reserve Bank has, since 2000, allowed banks to enter into take out financing arrangements with other financial institutions.

43. To facilitate financing for infrastructure, the Reserve Bank has also relaxed the exposure norms. To avoid concentration risk, banks are mandated to restrict their exposures to a maximum of 15 per cent of the banks' capital funds in case of a single borrower and 40 per cent in case of a borrower group. These norms are relaxed in the case of financing for infrastructure by up to 5 per cent in the case of a single borrower and 10 per cent in the case of a borrower group.

44. A number of recent measures and several in the pipeline should facilitate greater flow of credit to the infrastructure sector. Let me recount a few important ones. First, interest rate futures have been reintroduced recently and these should aid banks in managing their interest risk more efficiently. Second, repos in corporate bonds are slated to start soon; we expect to issue final guidelines by end-November 2009. Third, in the second quarter policy review last month, we announced the introduction of plain vanilla OTC single-name credit default swaps (CDS) for corporate bonds for resident entities. Fourth, a separate category of NBFCs – infrastructure NBFCs – is being introduced. Fifth, banks will be permitted to build up capital for "take-out" exposures in a phased manner. Finally, refinancing through the

special purpose vehicle, India Infrastructure Finance Company Ltd. (IIFCL), is expected to leverage bank financing for Public Private Partnership (PPP) projects. These measures, along with existing ones, can be expected to enhance banks' ability to fund infrastructure projects.

45. Going forward, financing infrastructure is going to be a big challenge for the banking sector. This huge and growing demand of infrastructure finance will have to be met even as banks wrestle with expanding their traditional banking services. Apart from finding the resources, banks will also need to hone their skills in appraisal and management of risks inherent in infrastructure financing. This is a daunting challenge, and hardly fits the description of a "boring" prospect.

Third challenge: risk management

46. Let me now turn to the third challenge – the challenge of risk management. In the years ahead, two big forces will define the environment in which Indian banks will be called upon to operate – a rapidly globalizing India and a fiercely competitive banking industry. This means in the main that Indian banks will have to upgrade their risk management architectures. In this regard, an important lesson thrown up by the crisis is that in addition to managing more effectively the traditional risks such as credit risk, operational risk and market risk, banks also need to manage some new risks that have proven to be significant such as reputation risk, counterparty credit risk, liquidity risk, interest rate risk in the banking book and incremental risks in the trading book. Expertise in risk management needs to be complemented by strengthening stress testing techniques. Evidently this calls for substantially broadening and sharpening the skill endowment at the institutional level. However, this cannot stop at getting a new toolbox and learning how to use it; it has to extend to changing the mindset. Banks need to develop a culture of risk management at the institutional level. What the crisis has shown is that risk management cannot be done in silos; it demands a more integrated approach with risks and their interconnections across the entire organization recognized and managed synergistically.

47. Buffering the capital base of banks is obviously a standard and much needed response to risk management. In this regard, countries around the world are in the process of migrating to the Basel II capital standard. In its current form, the standard provides a menu of approaches from simple to advanced to assess credit, market and operational risks and to calibrate the capital requirement to the assessed risk. Importantly, the standard provides a framework for assessing the new risks that I talked about earlier.

48. India is committed to adopting the international best practices though with the sequencing and pacing determined by our domestic conditions. As of March 2009, all Indian banks have migrated to the simpler approaches of the Basel II standard. The task on the way forward is to graduate to more advanced approaches. Towards this end, in consultation with banks, the Reserve Bank has now finalized a four-year time frame starting in April 2010 and ending with March 2014. Moving to advanced approaches is both skill and technology intensive. In the first instance, it will therefore necessarily have to be confined to the larger banks. While the Reserve Bank will actively facilitate the transition of such larger banks to advanced approaches, it is expected that the banks themselves will be proactive in preparing themselves to meet the preconditions for the transition in view of the competitive advantages it will offer.

49. All in all, going forward, risk management is going to involve pushing the frontiers of knowledge and transforming that knowledge to practical policy. That can hardly fit the description of boring.

Fourth challenge: further improvements in efficiency

50. Let me now turn to the fourth and final challenge on my list which is the challenge of further improving the efficiency of banking. But before I look ahead, I need to look back a little. The growth acceleration of the Indian economy during 2003–08 is attributable to a host of factors. Some of these are tangible such as the deregulation of the industrial sector, liberalization of external trade and external finance, reform of direct and indirect taxation and elimination of controls on doing business. Some of the factors that contributed to growth are intangible such as improved productivity, higher efficiency and growing entrepreneurism. We often forget to add to this list the contribution made by the financial sector by way of larger and better quality financial intermediation that raised the level of aggregate savings and channelled them to investment. Just one statistic will evidence this – bank credit as a proportion of GDP nearly doubled from 29 per cent in end-March 2000 to 56 per cent at end-March 2009. Even more notable, this rapid expansion of credit has been accompanied by a significant improvement in asset quality which is now close to international norms.

51. The analysis in the Reserve Bank's Report on Currency and Finance 2006–08 shows that the Indian banking sector has recorded an impressive improvement in productivity over the last 15 years; many of the productivity/efficiency indicators have moved closer to the global levels. The Report also shows that the performance of public sector banks has converged with that of new private sector and foreign banks. More interestingly, contrary to popular perception, there is also no significant relationship between ownership and efficiency – the most efficient banks straddle all three segments – public sector banks, private sector banks and foreign banks.

52. Improvement is a never ending business, and there are several tasks on the way forward. The intermediation cost in India is still high, largely due to high operating costs. Non-interest sources of income constitute a very small share in total income of banks in India. Although overall efficiency and productivity have improved, resources are not being utilised in the most efficient manner. There is a degree of stickiness and non-transparency in bank lending rates.

53. The challenge for Indian banks, therefore, is to reduce costs and pass on the benefits to both depositors and lenders. This will involve constantly reinventing business models and designing products and services demanded by a rapidly growing and diversifying economy. As we noted earlier, in the wake of the crisis, there are proposals at the global level to mandate higher capital standards, stricter liquidity and leverage ratios and a more cautious approach to risk. Admittedly, all these safeguards are necessary, but they will also raise the banks' funding costs. What this means is that Indian banks will need to improve efficiency even as their costs of doing business go up. This is a challenge that will test ingenuity, perseverance, ability to learn and adapt and management skills. And this is going to be anything but boring.

VII. Conclusion

54. Let me now conclude by summarizing the issues that I have addressed today. I have referred to the debate generated by Prof. Krugman's thesis that "exciting" banking will make for an unsafe and unstable financial system and that an important preventive against future crises is to restore boring banking.

55. I have argued that making banking boring is neither a cure to the ills that the banking system was plagued with before the crisis nor an appropriate path for the future of banking. Banking has to evolve, grow and innovate in response to the developments in financial markets and institutions. The excitement lies in responding to the challenges that this growth brings.

56. From an Indian perspective, what banks do and how well they do it is going to be central to accelerating and sustaining our growth momentum. In particular, I have referred to

four challenges that the banking sector has to meet head on – deepening financial inclusion, financing infrastructure, strengthening risk management and improving efficiency. These are formidable challenges, and meeting them is going to be an exciting, rewarding and fulfilling opportunity. Perish the thought of Indian banking ever getting boring.