K C Chakrabarty: Indian banking sector – towards the next orbit

Inaugural address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the 9th Advanced Management Programme at IMI, Delhi, 13 February 2012.

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It gives me great pleasure to be before you today as you embark on this journey of learning here at IMI and later across Paris, Berlin and Milan to imbibe the culture of these countries and the best practices. The Advanced Management Programme is the ninth in the series and includes study visits to central bank/leading commercial banks of these countries and interacting with their senior management, the objective being to enable the participants to see world class banking systems, understand the strengths and weaknesses of the European banking system and develop awareness and appreciation of the emerging business environment. Lectures and interactions with some leading academicians and management experts of the European business schools will give rare insights to the participants on present status of the Eurozone economies. Apart from the structured classroom learning, these kind of programmes offer a unique opportunity to the participants for learning from each other and also understand the best management practices across organizations. It is expected that the participants will try to develop further on these best practices and implement them in their organizations in their own way. All these and more are required as each one of you have a role to play in taking Indian banking to the next orbit.

Having said that, I have been asked to speak on "The Indian Banking Sector: Towards the Next Orbit". I would like to begin with an analogy. A spacecraft needs to achieve a certain momentum before it breaks free from the earth's gravitational pull, leaves behind the familiar and comfortable and enters into the unchartered vastness of a new orbit. The success of the mission and certainty of reaching its goals would lie in how effectively it has made its preparation, the skills of its crew and its ability to manage the risk of turbulence and overcome the snags and obstacles in its flight path. The banking system is no different. To move into the next orbit, it is vital to understand the environment we are in, the inefficiencies, the pitfalls that limit growth and build on synergies and innovation for catapulting it into the future.

The outlook for the global economy remains uncertain with green shoots of optimism in the US as fresh jobs were added, but the Eurozone remains embroiled in uncertainty of decision making and lack of consensus with the battered economies unwilling to commit bailout funds to the troubled nations. India has been more fortunate in that it has emerged virtually unscathed from the global crisis. A combination of strong regulation and supervision and a will to evolve policies that lean against the wind helped insulate the Indian financial system from the crisis. It helped too that the Indian banks were not very sophisticated and excessively leveraged. However, in a world where financial systems recognize no boundaries and the fortunes of nations are intertwined, no nation can consider itself an island and remain immune to the changes in the tides of the world economy for a prolonged period. If the envisaged growth rate of 9 per cent per annum during the Twelfth Plan is to be achieved and banks have to remain competitive and continue to improve their margins, they would need to look at the new drivers of growth.

I. Key drivers for propelling Indian banking sector

A recent IBA-FICCI-BCG report, titled "Being five-star in productivity-Roadmap for excellence in Indian banking" has projected that the domestic banking industry is set for an exponential growth in the coming years with its asset size poised to touch USD 28,500 billion by the turn of the 2025 from the current asset size of USD 1,350 billion (2010). It is fairly obvious to presume that scope for such growth rates would inevitably usher in more competition for the Indian banks aided in part by regulatory impulses and increased openness of the Indian economy. Simultaneously, the reach and penetration of banking is going to increase tremendously due to the policy spotlight on inclusive growth and financial inclusion. Aiding the transition would be another fortuitous transformation in human resources area. Public sector banks which account for nearly three fourths of the one million people working in Indian banks face the prospect of retirement of nearly 55 per cent of their people in the next decade. Thus, if ever there was a time for right sizing the organisation, hire the right talent, the right skilling of the workforce and bring about a cultural transformation, the time is now. We are, therefore, on the cusp of a defining decade in banking history. What are the key drivers that would propel the Indian banking sector into the next orbit? To answer this, I would draw upon extensively from an address I delivered at BANCON 2011 where I have identified three sets of drivers – external, regulatory and internal which will define banking in the next decade.

i. External drivers

A. Financial inclusion

The overriding and most transformative driver would be the policy imperative to extend the reach of banking services and to provide fair, transparent and affordable products and services. To borrow from the spacecraft analogy given previously, the momentum to escape to the next orbit will come from universal financial access. Apart from the potential to expand banks' business manifold besides acquiring new customers for other value added services, they would have the satisfaction of contributing immensely to higher inclusive growth. This is an opportunity which will not present itself again. With the Government of India and the Reserve Bank prioritising financial inclusion, banks have been encouraged to expand the network through setting up of new branches and also through the Business Correspondent Model. Resultantly, the population per bank branch improved from 14000 in 2009–10 to 13466 in 2010–11 while population per ATM from 19,700 to 16243 during the same period. In June 2011, banks were advised to allocate at least 25 per cent of the total new branches to un-banked rural centres. The number of branches opened in hitherto un-banked centres has increased from 281 in 2009–10 to 470 in 2010–11, but the population per bank branch is significantly higher than the national average in the North East, Eastern and Central Regions. To strengthen the outreach of banking services, banks were advised to cover all villages with more than 2000 population with at least one banking outlet by March 2012 and also encouraged to cover peripheral villages with population less than 2000. Banks were also required to put in place Board approved Financial Inclusion Plan (FIP) and the Reserve Bank is monitoring the implementation of these plans. Significantly, the number of villages covered by at least one banking outlet grew by 82 per cent in 2010–11 over the previous year, besides 47 per cent of the villages covered under FIPs were villages with population less than 2000. Almost 77 per cent of the villages covered were through business correspondent model. The number of no frills accounts also grew by 50 per cent. While considerable progress has been made, a lot more needs to be done to garner the savings of households. The moderating of financial savings of households from 12.1 per cent of GDP in 2009–10 to 9.7 per cent in 20010–11 is an area of concern. Banks need to tap into the untapped business opportunities for resources to power the growth engine. A GDP growth target of 9 per cent requires harnessing resources and fortune at the bottom of the pyramid. The small customers are the key to big business opportunities waiting to be tapped. Improving the quality of life of the people of our country by enabling them to have access to banking

services could be the next big game changer as it could unlock the vast potential of rural India.

B. Competition, consolidation and globalisation

The past decade has virtually been a sellers' market in so far as the Indian banking sector is concerned. The ability of the customers to choose the banking products and services were severely restricted since they could hardly differentiate between the product and service offerings of banks. The design of products and services was more bank-centric than customer-centric. A bank would now need to convince a customer as to why he should bank with them rather than another bank. While the lack of innovations by the banks could partially be attributed to the extant regulatory regime, the banks on their part have also remained largely unimaginative and lacked inspiration to experiment even after freeing of interest rates. The recent regulatory initiatives like deregulation of savings bank interest rates, opening of government business to more banks, etc. and some imminent steps such as licensing of new banks and subsidiarisation of the foreign bank branches, on the one hand, and the changing profile and simultaneously rising aspirations and expectations of the customers on the other, should make the turf more competitive and increasingly, a buyers' market.

In view of the impending competition, banks would be forced to take a hard look at their existing bouquet of product and service offerings and customer base so that they may reposition themselves as "differentiated and niche" players. The increased competition could also drive a spate of mergers among existing players and lead to consequent consolidation within the sector. The entry of new players will also spur efficiency and productivity in the system. While, at the moment, financial inclusion takes precedence, once financial inclusion is substantially achieved, the banks may focus on consolidation. As the Indian banking sector is propelled forward to a higher orbit, the banks would have to strive to remain "relevant" in the changed economic environment by reworking their business strategy, designing products with the customer in mind, focussing on improving the efficiency of their services and having global ambitions. The mantra would be to "Innovate or perish".

Globalisation of Indian banks could be a consequence of their customers becoming global once increased competition and consolidation set in. Apart from banks' own global ambitions, as Indian businesses turn global, their need for financial products and services would be reason enough for banks to go global to service them. However, banking is a business of size and more so for those that harbour global aspirations. Hence, consolidation is one way to achieve the needed scale. Thus, the second set of external drivers that could propel the Indian banking to the next orbit would be increased competition, consolidation and globalisation.

ii. Regulatory drivers

The next set of drivers which would also be essentially external in nature would be those provided by the regulator. Across the globe there is an increased convergence and realisation that regulations would become more stringent especially in the areas of providing fair treatment to customers, KYC norms and risk management.

A. Fair treatment to customers

In recent times, the provision of fair treatment to customers has gained prominence globally. The writing is firmly on the wall that regulations in this area are likely to become stricter in years to come. Banking/ financial services industry being a highly regulated industry with stiff entry norms, regulators have a critical role in ensuring fair treatment to customers and it cannot be left to the market forces alone. Banks need to price their products and services fairly and competitively and ensure higher transparency in their products and pricing. Lack of transparency in designing and pricing of products and services and selling them to inappropriate customers could expose banks to litigation, reputational risks besides making

them liable for supervisory action. There should be no unreasonable post sale barriers if the customers wish to change product or bank. Customer education is also critical to providing appropriate and need based products and services and Indian Banks' Association may have a critical role to play in this regard. The banking business would thus have to turn customer centric in all its true dimensions.

B. Knowing your customer

A customer-centric business needs to know its customer, the nature of his business and the inflows/ outflows into the accounts, if it is to provide customised business products and solutions. But, banks need to understand the risks associated with customer's business to manage risks arising from potential delinquency, fraud and consequent losses as also legal and reputational risks arising from exposure to customers having links to Multi level Marketing (MLM) business/terrorist activities/hawala transactions, etc. Know Your Customer (KYC), Know Your Customers' Business (KYB) and Know Your Customers' Business Risks (KYCBR) should be ingrained in the DNA of the bank's business. It should be understood that it is not just procedural compliance, but that good KYC and KYCBR compliance are good for the bank's business.

The banking system runs on information and data. Although financial data are made up of innumerable complex components, one of the fundamental building blocks is reference data about companies, organizations, firms and individuals customer. Reference data might include a number of things, but an essential component is a systematic structure or code that uniquely identifies each entity. Essentially a bank should have a Unique Customer Identification (UCI) Code which helps it to identify a customer, track facilities availed, monitor financial transactions in various accounts for compliance with KYC/AML regulations. A key factor in ensuring KYC compliance is having a Unique Customer Identification Code which may serve as a lynchpin for financial data and assist in improving regulation, risk management and business processes. It would help the bank identify the customer, track facilities availed, monitor financial transactions across accounts for compliance with KYC/AML regulations. The UCI should eventually graduate to a Legal Entity Identifier (LEI) which is a unique ID associated with a single corporate entity which assists in easy identification of the same party across multiple financial market utilities and aids in tracking settlement activity and exposures. The financial crisis clearly demonstrated the extreme "complexity of interrelationships" and dependencies that exist between parties, counterparties, issuers, guarantees, and guarantors and the domino effect that takes place should one or more of the nodes within these horizontal or vertical relationships come under pressure. Unique identification of each and every entity would be critical to unravelling these linkages and (inter)relationships.

Some of the Indian banks have developed UCI numbers which enables them to track the transactions of customers across the bank and monitor customer wise exposure limits, account status and generate AML alerts/reports for FIU-IND filings etc. However, there is no unique number to identify a single customer across the banking system based on a shared database which provides an avenue for the customers to circumvent the risk profiling guidelines and obtain multiple facilities across banks by opening several accounts. Even for banks that have some form of unique customer identification, there is no guarantee that a single customer does not hold multiple IDs.

The principles behind the Legal Entity Identifier (one entity – one identifier) could be borrowed for shaping the KYC/ AML framework for the Indian banks. Towards this end, the UIDAI initiative, Aadhaar, launched by the Government of India, which is envisaged to issue a unique identification number to individuals that can be verified and authenticated in an online, cost-effective manner for eliminating duplicate and fake identities, could be leveraged upon by the banking system. It is heartening to note that UIDAI uses a state of the art biometric technology (combining both – 10 Finger Prints and 2 Iris) and has achieved a high degree of accuracy (99.96 per cent) in duplication detection.

Presently the Reserve Bank guidelines permit the use of Aadhaar as a KYC document for small accounts. Since the coverage of the entire set of bank customers/potential customers under Aadhaar would take time, in the interim, the banks should consider putting in place unique identification numbers for each of their customers and filter out multiple banking facilities availed by them through a de-duplication exercise. The banks could also work jointly to set up a shared database which would enable them to securely see information on a customer (KYC information and facilities availed from various banks etc.) based on a unique identifier i.e. his Aadhaar ID. In the process, banks would be able to leverage upon the KYC exercise already carried out by the previous bank and also benefit from consequent lower customer acquisition costs, simplified account opening processes without repeated burdensome procedures for the customers and also promote financial inclusion.

C. Risk management

The road ahead demands that banks further refine their risk management skills for enterprise wide risk management. Globally, there is an inexorable move towards more advanced approaches to risk management. However, we are still at a very rudimentary stage. As capital comes always at a cost, banks need to have in place a fair and differentiated risk pricing of products and services. This involves costing, a quantitative assessment of revenue streams from each product and service and an efficient Transfer Pricing Mechanism which would determine capital allocation. Each business unit in the enterprise would have to aim at being a profit centre within the overall risk –return framework. In essence, it would mean accountability for profit tempered by the discipline of risk–return within a deeply embedded culture of good governance, the tone of which is set by the bank’s Top Management. As an illustration, the base rate is intended to serve as a benchmark for interest rates. Our past experience has been of poor customers subsidising the rich borrowers. Also, there are incidences of rampant mis-pricing of risks. From a business perspective, pricing of assets should be non-discriminatory and in line with risk rating of the customer. A lower rated customer should not get a better price than a higher rated customer. Once these basic issues are addressed, other issues such as migration to advanced approaches etc. would gain importance.

Migration to advanced approaches under Basel II

All the Indian banks have adopted the standardised approaches under the Basel II framework in 2009, however, the pace of migration to the advanced approaches has naturally been very slow. Though the Reserve Bank has set an indicative time schedule for implementation of the Advanced Approaches, banks’ response has been less than encouraging so far. Migration to the Advanced Approaches is important for larger banks because it involves adoption of more sophisticated risk management systems. Moreover, there are reputational issues too if large banks continue with standardised approaches. Apart from the fundamental issues mentioned above, much of this sluggishness could be attributed to issues relating to development of human resource skills, technology upgradation, branch interconnectivity, availability and management of historical data, robustness of risk management systems, etc. within the banks. Even within the Reserve Bank, the supervisors would have to make rapid strides to be able to appreciate the nuances associated with the quantitative techniques and modelling.

Journey to Basel III regime

(a) Capital

An assessment of Indian banks’ capital requirements under Basel III has revealed that, notwithstanding some issues with a few individual banks, the system as a whole, is very well capitalised and the transition to the revised capital norms of overall capital adequacy, Tier I component or equity component would be smooth. The stress, however, could however arise from a need for the banks to adjust the unamortized portion of Pension and Gratuity liabilities in the opening balance sheet on April 1, 2013 on transition to IFRS.

(b) Addressing too-big to fail

The negative externalities associated with the large and complex financial institutions forced the Central Banks/Governments the world over to bail them out during the financial crisis by committing taxpayers' money. With an eye on reducing the probability and impact of failure of such global systemically important banks (G-SIBs) as also to reduce the inherent competitive advantages they enjoy in the funding markets, the standard setters have agreed on a combination of capital surcharges, better resolution regimes, living wills, more robust financial market infrastructures and a more intense supervision for these systemically important financial institutions since then. Large size, excessive interconnectedness, reliance on a single or few firms for the provision of key financial infrastructure, and complexity of operations and cross-border activity have been identified as key indicators of systemic importance of internationally active banks by the Basel Committee on Banking Supervision (BCBS). Financial Stability Board (FSB) has since released the names of the 29 banks which have been reckoned as G-SIBs based on the criteria laid down by BCBS.

While none of the Indian banks feature in this list of 29 G-SIBs, the BCBS and FSB are already working towards laying down a criterion for identification of domestic SIBs which would need to be subjected to additional capital and liquidity requirements on the lines of that applicable to the G-SIBs. The industry may argue that the Indian banks are very well capitalised and no additional capital may be necessary on account of the SIFI-ness of the banks. As part of the superequivalence to Basel III banking reforms, under which the national regulators prescribe a much higher regulatory capital ratios as compared to the Basel norms,, the Swiss banking regulator has already set much more stringent capital requirements for the largest Swiss banks and the United Kingdom is expected to follow suit based on the report of the Independent Banking Commission.. The readiness of banks to these evolving regulatory requirements would very critically determine whether they can successfully transit to the next orbit.

iii. Internal drivers

A. Managing human resources

An organisation can only be as good as its people. They are the force behind innovation, business process re-engineering and making the difference between success and failure. A committed and highly motivated work force can make the difference in winning and retaining customers as banking is a people oriented business. Banks have to be knowledge organisations, able to attract and retain talent. HR policies should look at right size, right fit and career growth with market related compensation. Increasingly, there is a going to be an intense competition for the right kind of talent as they are likely to be in short supply. The demand will not only stem from domestic institutions but it will also be from foreign institutions and countries. The challenge before Indian banks is therefore to revitalise themselves by hiring the right talent, investing in training and bringing about a vibrant transformation in their DNA, in effect doing what Sumantra Ghoshal, the management guru and Founding Dean of the Indian School of Business, called changing the "Smell of the Workplace". Successful organizations, he felt, exude a vibrancy which uniquely defines the "Smell of the Workplace". Ghoshal describes the smell of the air in the forest of Fontainebleau, 40 miles south of Paris, the vibrancy which spurs the casual walker to run, jog or do something, and is in essence revitalising. He compares it to downtown Kolkata in summer which is hot and drains energy and vitality. Most large companies in India and abroad, he felt end up creating downtown Kolkata in summer inside themselves. The smell of the workplace then becomes encapsulated in an environment of *constraints,* where jobs/relationships are only *contracts* and actions are defined by *control* and *compliance*. As opposed to it, successful companies promote *stretch*, which means doing more with *self discipline*, as opposed to control there is *support* and enhancing *collaboration* across the organisation through combination of support on the one hand and *trust* on the other. The real

source of competitive advantage in organizations is not merely in technology but in the behaviour of individuals in the organisation where each one of them takes initiative, collaborates, has self confidence, has commitment to himself, to their teams, to their units, and to their organisation. The challenge before management is to use the vast unused potential in people and make ordinary people produce extraordinary results thereby changing the smell of the workplace.

B. Leveraging technology

A recent article in the Economic Times dated December 27, 2011 detailed how e-governance initiative helped check grass root pension fraud. In Keregodu village in Karnataka's Mandya district, senior citizens, all 65-plus, face an endless wait in front of the local post office for their pension money orders. Hours later they are told by a post office official – "the money had already been collected by someone". In this south-eastern district of Karnataka, thousands of pensioners haven't received their pension and entitlements for months – it is siphoned off in transit. Even worse, out of the 2,95,525 pensioners in the district – whose allowances get released from the state treasury every month – names of 37,000 are missing – causing a monthly loss of nearly Rs 1.48 crore to the exchequer (or Rs 17.76 crore a year). The state also suffers on account of distribution and delivery losses for pensioners whose name exists but still do not get their money. But the situation in Mandya, a thriving agricultural town till the late 1980s, is set to change with the state government along with an IT services firm digitising the entire pension records and issuing smart cards to pensioners to plug the leakage. It is perhaps one of the biggest financial inclusion projects where technology can come to the aid of thousands of old and poor farmers, widows and other rural pensioners. But that's only the first part. For the last-mile authentication and financial transaction, the state government has tied up with a Karnataka-based bank. A bank correspondent will now be sent to each pensioner's house with a card-reader where the pensioner would swipe his smart card and give his thumb impression. Once the bank receives the data at its central server, the amount would be credited to the pensioner's bank account. The system is expected to fight ground-level corruption by cross-checking the pensioner's identity against multiple databases, making it difficult for any single agency or person to log false information. This would make a huge difference to the lives of the pensioners. Technology, the will and desire to make a difference to the lives of the rural poor living on the fringes of financial exclusion are the change agents.

Most banks are already on Core Banking Systems (CBS) which covers banking operations pertaining to deposits, withdrawals, credit delivery, back-office operations etc. Banks need to look beyond Core Banking to harness the benefits of technology. CBS could provide inputs for developing customised products based on customer data base. It would help in planning product delivery and service at multiple/selected delivery points and better Customer Relationship Management and building lasting customer relationships which will translate into higher revenues. Technology needs to be more customer focussed than employee or vendor focussed. The costs of banking transactions need to be dramatically reduced just as in so many other fields such as telecom after the advent of technology. In case of glitches, the rectification must be swift to instil faith and confidence in the system. It is only the more agile and innovative players who will stay ahead in the game. Along with IT solutions arise allied issues such as IT security, governance and audits. Gaps in IT security could make banks vulnerable to data piracy, fraud and operational risk leading to reputation risk and erosion of customer confidence.

C. Improving managing information systems

MIS is an inseparable part of bank's decision making process. The integrity and timeliness of data is critical in formulating the bank's capital planning, business strategies, reviewing achievements vis-a-vis targets, formulating course correction exercises where required, feeding data into stress tests and importantly taking action on the outcomes. This brings us to technology support for decision making. Banks have made huge investments in

technology, which should be translated into better MIS as decision support systems and yield returns on investment by providing economical, affordable and customised customer centric banking solutions. The use of technology should not be seen as an end in itself but as a means to an end.

D. Business plan, strategy and vision

The role of banks' Boards would become increasingly crucial in the next decade in view of the looming competition. The Board would need to have a clear vision for the bank, a strategy to achieve its objectives, both medium and long-term and a well laid out long-term plan. The banks would need to look beyond their existing customer base and large corporates and reach out to rope in the vast number of small, retail and the SME clients which are presently deprived of bank credit. Alongside extending the reach of their banking services there would be a need to improve the products offered to customers and the quality of services. They need to have proper business model and delivery model.

II. Managing change in the emerging regulatory and supervisory landscape

It has become fashionable to attribute any adverse feature to the economic downturn. Perhaps, we need to draw the right lessons, learn from it and move ahead so as not to repeat it in future. As an example, the 2011 financial results of most banks show a growing increase in NPAs. While some slippage in an economic downturn is inevitable ,it does not absolve banks from quick mortality/slippage due to adverse credit selection, lack of critical credit appraisal and due diligence, laxity in monitoring end use of funds and performance of the account. I am reminded of a story in the times of the Great Depression.

A man stood at the street corner every day selling hamburgers. He was cheerful and whistled a tune as he sold his tasty hamburgers. His cheerful demeanour and modestly priced hamburgers had a brisk sale. He had through his trade managed not only to do well but also put his son through University. One day when the son came home on a holiday and saw his father plying his trade as usual he was surprised. "Dad", he said, "You shouldn't be making so many hamburgers as we are going through the Great Depression". And then the boy proceeded to educate his father on the finer details of the Depression. The father thought over what his son said and made fewer hamburgers. At work he was preoccupied and less cheerful each day. Soon sales dwindled. Returning home one day with his products unsold, he said to his son: "Son, you were right about the Great Depression. That's the advantage of a university education!"

The stable funding profile of commercial banks – strong retail franchise and relatively less dependence on wholesale funding is a comforting factor. Even under a worst case scenario wherein the quarterly growth rate of September 2011 in gross NPAs and gross advances continues for the next two quarters and GNPA ratio reaches 3.74 per cent; the system would remain resilient as per the results of the credit risk tests mentioned in the latest Financial Stability Report (FSR). The report goes on to predict that even under a worse case scenario when NPAs are assumed to grow by 150 per cent and the NPA ratio reaches 7 per cent, the system as a whole would remain resilient inasmuch as its CRAR would remain at 11 per cent, though some of the banks may come under duress. But, pressures are building up in certain infrastructure sectors especially power sector, aviation, telecom, which could further increase the NPAs. Increase in interest rate and slowing economic growth may adversely impinge on repayment capacity of all categories of borrowers especially those from SSI, MSE, etc. There could be renewed requests for further restructuring from several sectors. Banks, however, need to strengthen their credit appraisal and monitoring system as also recovery efforts. Recovery through compromise settlements/under OTS should be a transparent and analytical process after assessing all the options and ensuring that the net present value of the settlement amount is not less than the net present value of the realisable value of the available securities.

The idea behind this digression was to illustrate that for banks to move to the next orbit, they have to realise their true strengths and weaknesses. They need to build on their strengths and rectify their weaknesses to prepare and adapt themselves for the challenges which these external, regulatory and internal drivers are going to entail. In this, a very relevant and critical issue which emerges is whether the regulatory and supervisory processes are also geared up for the next orbit.

III. How equipped are the supervisors?

The existing supervisory framework for commercial banks in India has fared rather well over the years and drawn praise from peer supervisory agencies, global standard setters and the FSAP assessors for the regulatory and supervisory regime as the Indian banking system remained largely stable during the global financial crisis.

However, as supervisors, we face challenges. The growing complexities of the banking business coupled with significant cross-border and cross-sector expansion has rendered the system increasingly vulnerable to the threat of “contagion”. The paradigm shift in the banks’ business processes, products and systems with an ever-growing reliance on ICT, as delivery channels pose immense challenges before the banking supervisor. While on the one hand, the banking landscape has witnessed considerable changes, the supervisory processes within the Reserve Bank have remained more or less static. This has necessitated a review of the supervisory processes and rationalisation of the organisational structure for bank supervision. Additionally, lessons from the financial crisis which have manifested in form of new regulatory and supervisory benchmarks like Basel III, revisions to the Core Principles for Effective Bank Supervision, increased focus on systemically important banks also have to be factored in for making the supervisory processes and mechanism at the Reserve Bank more robust and capable of addressing emerging issues.

The present supervisory processes followed by the Reserve Bank are focused on elaborate transaction testing and compliance monitoring and do not provide a forward looking measure of risk that the supervised entities pose to the supervisory objectives. We need to move away from transaction based to risk based and from incidence based to theme based supervision. The on-site assessment and the off-site surveillance processes also need rationalization so that efforts made by the external /internal auditors of banks could be effectively utilised and duplication avoided. Supervision has to be intrusive and decisive. The basic underlying theme should be that supervision must facilitate good business and must obstruct bad business. Another issue worth pondering is whether the Reserve Bank’s supervision adds value for the supervised entity or is it an “unnecessary evil” that they have to endure. With a view to addressing some of the above mentioned shortcomings, the Board for Financial Supervision has constituted a High Level Steering Committee which is conducting a thorough assessment of the adequacy of the Reserve Bank’s supervisory policies, procedures and processes and would recommend measures to make the Reserve Bank’s supervisory policies comparable to the global standards and be more value-adding to the supervised entities.

The approach to supervision world over is undergoing a change with the financial system under increased public scrutiny and movements such as the Occupy Wall Street movement gaining traction. Both the Central Bank and supervised entities are increasingly accountable for their actions. The challenge for the supervisors is to be nimble footed and attuned to the changes and nuances in the way banks do their business, identify emerging areas of risk for the bank and the banking system and intervene swiftly where required. Financial stability is on top of every Central Bank’s agenda and the Reserve Bank is no exception. Besides changes in the way it supervises and inspects banks, it is looking at closer collaboration with other supervisors both at home and overseas. MoUs with other supervisors overseas is part of our ongoing effort for sharing supervisory information. The Bank is also working to bring in legislative changes in the statues to give it greater autonomy in entering into MoUs,

collaborating with overseas /other supervisors and strengthen powers of supervision over entities in a conglomerate, among others.

The changes in the way banks do business, increased sophistication of products and services calls for capacity building not only in banks but also for the supervisor. the Reserve Bank is investing in human resources through focused skill building and collaborative efforts with other supervisory agencies, the World Bank and top training institutes both at home and abroad to be on top of the learning curve.

Conclusion: Prepare to move into the next orbit

We are at the cusp of a defining decade in the banking system. The Indian banking system has come a long way in terms of technology, business systems and processes. It has weathered the global economic crisis, but going forward it needs to focus on the key drivers of growth to be globally competitive. The lodestone of external impulses would be financial inclusion and the other key stones would be competition, consolidation and globalisation. The regulatory drivers would be more stringent regulations, essentially in fair treatment to customers, know your customer norms and risk management. The internal impetus would be provided by the unique human resources opportunities created by impending retirements, leveraging technology to increase reach, lower costs and provide improved customer service and to re-orient the organisation to be customer centric in all its manifestation. It would require the complete involvement of the top management and board of banks. Each one of you has a role to play in this agenda and *stretch* to achieve the objectives that would make your organisations from good to great and take it to the next orbit.

I wish you all success in this endeavour.

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