K C Chakrabarty: Supporting explosive growth – effective linkages between the banking sector and real sector

Keynote address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the Inaugural Session of the 8th Annual Banking Summit, organised by the Associated Chambers of Commerce and Industry of India (ASSOCHAM), New Delhi, 21 November 2012.

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Introduction

Shri Rajkumar Dhoot, Hon'ble Member of Parliament and President, ASSOCHAM, Shri M. Narendra, Chairperson, ASSOCHAM National Council for Banking & Finance and CMD, Indian Overseas Bank, Shri Sunil Kanoria, Vice President, ASSOCHAM and Vice Chairman, SREI Infrastructure Finance Ltd.; Mrs. Shubhada Rao, Senior President and Chief Economist, Yes Bank Ltd.; Mr. Subhash C Aggarwal, CMD, SMC Group; Ms. Sudha Ravi, Co-Chairperson, ASSOCHAM National Council for Banking & Finance and CEO, PHL Finance Ltd., Shri D. S. Rawat, Secretary General, ASSOCHAM, distinguished guests, ladies and gentlemen. It is a pleasure and privilege to be here at the 8th Annual Banking Summit organized by the ASSOCHAM on the theme "Poised for Explosive Growth".

Present scenario

Post the wide ranging structural reforms of the 90s, the Indian economy has, until recently, been churning out impressive growth rates and is now firmly ensconced in the exclusive club of countries with GDP in excess of one trillion US dollars. However, as the dark clouds of economic gloom hover above the horizon with doomsayers painting a dismal picture for the future of the world economy, time is ripe for taking a hard look at the economic outlook for India at the present juncture and examine what we need to do in order to keep the Indian growth juggernaut rolling.

The pundits of doom are having a field day as the global scenario remains bleak with the Eurozone slipping into recession once again and the debt crisis continuing to batter southern Europe and gnawing at the economic performance of export driven Germany. An ebullient America had seen some green shoots of recovery, but the unemployment numbers, since, have not been encouraging and it is now facing a fiscal cliff. On the domestic front, though it is not all clear skies and sunshine with the growth engine slowing down, the growth is still way above that of the developed countries. India has been largely protected from the global economic crisis through a combination of strong regulation and supervision and policies which leaned against the wind and best suited our country, society and culture. Having said that, we cannot claim to have remained totally immune from global headwinds. The Indian economy, which had accelerated since the reforms, recording a growth of more than 9% before the crisis, has slumped to 5.5% in the first quarter of 2012–13, with sequential downward revisions in estimated growth rate, which is now expected to clock around 5.8% in 2012–13. This, however, is a far cry from our actual potential.

With economic liberalization, we have moved away significantly from the "Hindu rate of growth" which had stagnated around 3.5% during 1950–80. According to Dun & Bradstreet report titled "India 2020", India is poised to become a $ 5.6 trillion economy by the year 2020. The report adds that Maharashtra, Gujarat and Andhra Pradesh will be amongst the most developed states in the country by 2020 and would, together, contribute 32 per cent of the overall GDP. The states which were, hitherto, lagging behind such as Madhya Pradesh,

Bihar, Orissa, Rajasthan and Uttar Pradesh, are also expected to contribute significantly to India's growth story during the current decade.

The 11th Five Year Plan carried the objective of faster and more inclusive growth. Rapid GDP growth, targeted at 9.0 per cent per annum, was regarded necessary to generate income and employment opportunities for improving living standards of the masses and to generate the requisite resources for financing social sector programmes aimed at reducing poverty and enabling inclusiveness. The economy performed well on the growth front, averaging 8.2 per cent in the first four years. Growth in 2011–12, the final year of the Eleventh Plan, which was originally projected at around 9.0 per cent, continuing the strong rebound from the crisis, was eventually recorded at 6.5 per cent. The slowdown of the economy in 2011–12 compared to the previous year was a phenomenon common to all major economies.

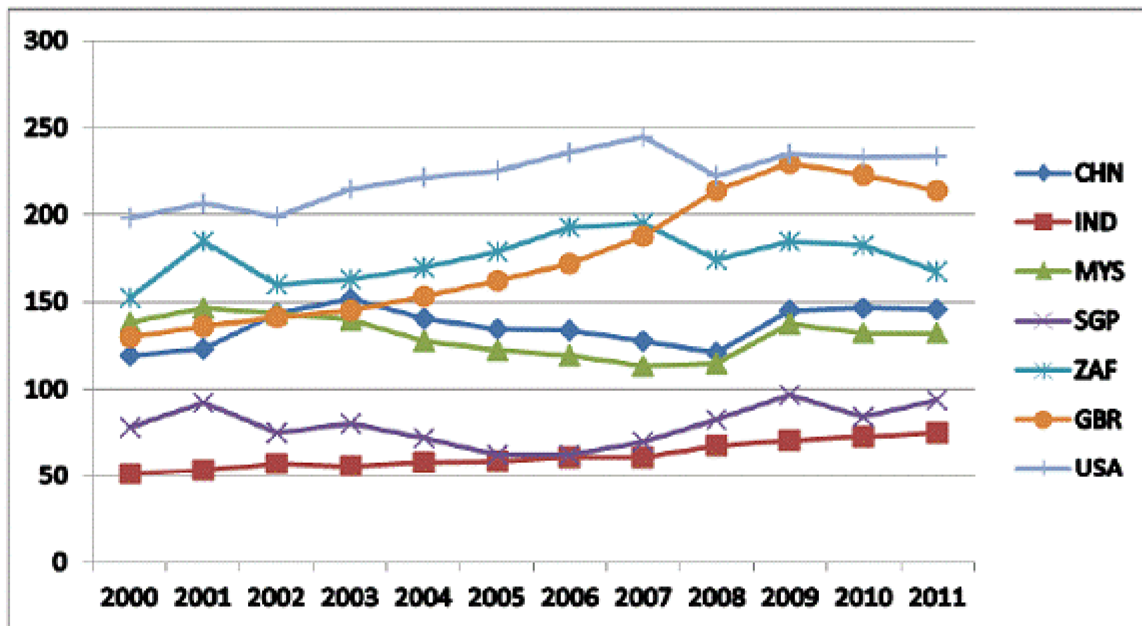
Undoubtedly, there has been a decline in growth, which cannot be solely attributed to the global slowdown. A part of it can be traced to domestic infrastructural and governance issues. The twin deficits, inflation and the supply side bottlenecks are some concerns that need to be quickly tackled to spur growth. The poser before India at this juncture is whether we can afford to relapse to the Hindu rate of growth and be content with being considered an emerging nation forever, or should we make efforts to take our due position among the leaders in the world arena? We cannot and must not revert to the Hindu rate of growth.

In order to overcome these challenges, we need to focus on the key areas of productivity, innovation and reforms, both at the level of the macro economy and at the individual firm / enterprise level. These will help us overcome the various bottlenecks currently shackling our growth and put us firmly on the path of sustained high economic growth. It will ensure that we are able to leverage our strengths, some of which I would be alluding to subsequently, in order to create a conducive growth environment. These reforms need to involve all stakeholders and should, necessarily, leverage on technology, which has the potential to act as a force multiplier in our efforts towards productivity, innovation and reforms. I see that some of these topics would be the focus of the technical sessions slated for later in the day. I am sure these sessions will deliberate on how the various measures could be implemented in an effective and time bound manner.

The role of the financial sector in any economy is to subserve the needs of the real economy. Consequently, if the Indian economy has to fully realize its optimum potential, the financial sector would have to play a pivotal part. As we all know, our financial sector is predominantly bank-centric and therefore, the performance of the banking sector is crucial to the fate of the economy. The Indian banking system has come a long way since the Financial Sector Reforms, with the banks having served the economy remarkably well over the last two decades. Liberalization has resulted in greater autonomy for banks in business decisions, but with the concomitant responsibility of conducting business in line with the highest standards of corporate governance, customer service and a commitment to nation building, which encompasses financial inclusion.

There is no doubt in my mind that if the economic growth engine has to churn out a powerful performance, banks would, necessarily, have to be the prime mover. The domestic credit provided by the banking sector in India stands at an abysmally low level compared to many of our emerging Asian peers, let alone the advanced economies. There is enormous scope for the banks to expand their business to areas/sectors hitherto lacking formal credit.

Domestic Credit of the Banking Sector to GDP (in %)



Source: World Bank Data

10. Banks have to develop the ability to maintain high growth levels over a sustained period of time. They also need to develop strong linkages with the real sector. These linkages should critically determine all aspects of banking operations including the kind of products and services offered, the pricing strategies, delivery channels adopted, sectors/ sub-sectors receiving focused attention, technology platforms adopted, etc. This linkage with the real sector will ensure relevance of banks as a key pillar in the economic system and enable them to fully meet their crucial role in nation building. Besides, by ensuring that the financial system grows in tandem with the real sector, build up of systemic risk through creation of asset price bubbles can be avoided. This lack of linkage between the financial system and the real sector was one of the critical factors contributing to the global financial crisis and hence, the importance of this linkage has been one of our important learnings from the crisis.

What are our strengths?

Demographic dividend

Sometimes, like the mythological Hanuman, we need to be reminded of our strengths, first and foremost of which is the great demographic dividend that the country enjoys. India has a young population not only in comparison to advanced economies but also in relation to the large developing countries. According to the Approach Document to the Twelfth Five Year Plan, the labour force in India is expected to increase by 32 per cent over the next 20 years, while it will decline by 4 per cent in industrialized countries and by nearly 5 per cent in China. This "demographic dividend" can lead to sustainable long term growth, provided two conditions are fulfilled. One, higher levels of health, education and skill development must be achieved. Two, an environment must be created in which the economy not just grows rapidly, but also promotes inclusion by generating good quality employment/ livelihood opportunities to meet the needs and aspirations of the youth. The demographic dividend has payoffs in creating a skilled, technology savvy work force, strong customer base and higher savings rates, thereby increasing the resources available for productive investments. The progress made in the field of education and literacy is leading our transformation from being the world's back office to being a knowledge partner.

Potential for inclusive growth

A recent internal study conducted by the Reserve Bank on the profile of customers of banks has heartening indicators. With increasing number of bank branches, the average population per bank branch has improved from 15,583 in 2001 to 12601 in 2012. As per latest census, 58.7 percent households were availing of banking services in 2011 as compared to 35.5 percent in 2001. With liberalization of the branch licensing policy and drive towards financial inclusion, the share of rural and semi urban branches in total new branches opened reached 69.8 percent during 2011–12 from a mere 23.2 percent in 2004–05.The share of hitherto unbanked centres in newly opened branches has been around 20 percent during 2011–12. Further efforts are required and are being made in view of the large number of unbanked centres in the country. The Reserve Bank has been encouraging banks to improve banking penetration through the Business Correspondent (BC) model, allowing "for-profit organizations" to work as BCs, leveraging technology, including mobile technology, to deliver banking services as part of the drive to enhance financial inclusion. While there has been some progress, more ground needs to be covered before we achieve the goal of meaningful financial inclusion. The extent of financial exclusion is high when compared to some of the advanced as well as developing countries. In a cross country analysis of financial inclusion, we compare poorly at 10.64 branches and 8.90 ATMs per 0.1 million adults, say, as against Brazil, which has 46.15 branches and 119.63 ATMs per 0.1 million of the population. In this vast financially excluded populace lies our opportunity!

Growth, merely in terms of numbers, would not carry any meaning unless it reaches every section of society – the vulnerable, underprivileged and the marginalized. Public sector banks as well as RRBs have played a key role in expanding the branch network to rural India. However, since it has been observed that the benefits of Government schemes often do not reach the intended beneficiaries, Reserve Bank has been encouraging banks to implement Electronic Benefits Transfer (EBT). Since many such social security beneficiaries reside in villages with population of less than 2000, RBI has been giving thrust on expanding the benefits of EBT to all villages. SLBC convenor banks have, therefore, been advised to prepare a roadmap covering all unbanked villages with population of less than 2000 and allocate these villages to various banks for providing banking services in a time bound manner. Besides, banks also need to provide a BC touch point in each village, where brick and mortar branches are not available, for extending the provision of EBT services at the earliest. BCs could also provide door step services to EBT beneficiaries through regular visits to villages, thereby ensuring that all kinds of banking facilities are available in the long run through a mix of brick and mortar branches and BC networks. We have also recommended the one district-many banks-one leader bank model in our "Operational Guidelines for Implementation of EBT and its Convergence with Financial Inclusion Plan", which would expedite implementation of EBT in a simple and scalable manner. Banks need to wholeheartedly work towards achieving these goals, not as a CSR activity, but rather by seeing this as a viable and profitable business opportunity. Likewise, banks should also pursue extending banking services like opening of Basic Savings Bank Deposit Accounts, etc. as a potential business proposition and not as a regulatory burden. It is in banks' own interest to realize early that the population mass concentrated in financially excluded centers has the potential to drive their future growth and profitability and help place the economy in the fast track mode!

Infrastructure financing – huge potential

Stimulating growth puts the spotlight on developing infrastructure – an efficient public transport system, roads, public utility services, housing, educational institutions, locomotive plants, ports, container terminals, etc. – the entire gamut, which forms the backbone of any developing country. The increasing infrastructure requirements to support a growing economy call for enormous investment. A McKinsey estimate suggests that each year we may have to build about 700 – 900 million square meters of residential and commercial

space, 350–400 km of metros and subways and 19000–25000 km of roads – a massive task and an equally massive opportunity for banks. The Approach Paper to the 12th Plan estimates that infrastructure investment will need to increase from about 8.0 per cent of GDP in the base year (2011–12) of the Plan to about 10.0 per cent of GDP in 2016–17. The total investment in infrastructure would have to be over Rs. 45 lakh crore or $ 1 trillion during the Twelfth Plan period.

Financing this level of investment will require larger outlays from the public sector, but this has to be coupled with a more than proportionate rise in private investment. Private and PPP investments are estimated to have accounted for a little over 30.0 per cent of total investment in infrastructure in the Eleventh Plan. Their share may have to rise to 50.0 per cent in the Twelfth Plan. Government's proposal for modification in investment norms for pension and provident funds to channelize their large cash inflows into Infrastructure Debt Funds would also provide infrastructure projects with reliable sources of long term funding. The funding for infrastructure has not been a major constraint thus far and credit to infrastructure has continued to account for almost one third of bank credit to industry. There have, however, been other conspicuous stumbling blocks, viz. delay in policy promulgations, environmental clearances, land acquisitions, permissions, etc. which have contributed to delays and project over-runs. While Central and State Governments would have to deliver on easing these roadblocks and facilitating investments in the infrastructure sector, banks would also need to hone their credit appraisal, monitoring and risk management skills, keeping in view the long gestation period of infrastructure projects. This would ensure that the sector's funding needs are met, while keeping the position of NPAs under stringent control.

Challenges for banks

Need for enhancing productivity

The performance of banks in 2011 and 2012 have been somewhat muted due to the general slowdown in the economy and the higher interest rate environment. The balance sheet of Scheduled Commercial Banks (SCBs) reflected slower growth at 15.5 percent in 2011–12 as compared to 19.2 percent in 2010–11, with deceleration in credit growth. The increased cost of deposits impacted net profit of banks, which increased at a slower rate of 16.1 percent as compared to 23.2 percent during the previous year. Interest expended on deposits, along with increase in proportion of high cost term deposits, led to acceleration in the interest cost of banks. Net Interest Margins of banks dipped marginally compared to the previous year. An analysis of profitability of banks, however, reveals that profitability of foreign banks is higher than that of other bank groups. Though their share of total assets of the banking system stands around 7 percent, foreign banks account for close to 12 percent of profits of SCBs. A Du Pont analysis showed that foreign banks registered highest Return on Assets amongst bank groups due to better asset utilization, although their operating expenses to assets ratio was higher compared to other bank groups. Their higher profitability could be attributed to better fund management practices. This is an area where Indian banks would need to improve.

The profitability of SCBs would be under increased strain during 2012–13 due to higher level of NPAs. The gross NPAs of the banking system has increased from 2.36 percent in March 2011 to 3.25 percent in June 2012. Restructured standard accounts as a percent of gross advances have doubled from 2.7 percent in 2009 to 5.4 percent as at June 2012 with substantial increase in restructuring in certain sectors. Data indicates that restructuring is largely resorted to in case of industrial sector accounts, particularly, large industries, as against smaller borrowal accounts such as agriculture, micro and small enterprises. The persistently high level of NPAs and increase in restructured accounts continues to pose a significant constraint on banks' abilities to reduce lending rates, thereby, in a sense, penalizing the honest borrowers. Corporates need to innovate and embrace technology to improve their productivity and efficiency so that their costs can come down, they remain

competitive and continue to service their obligation as borrowers. Banks on their part must look to arrest the deterioration in asset quality by adopting better risk management practices like better credit appraisal, closer monitoring of borrowal accounts, greater information sharing among banks and by carrying out elaborate viability studies before restructuring. While NPAs/ restructuring of assets cannot be wished away, they need to be effectively curtailed so as to ensure that the lendable resources of banks are maximized. On its part, RBI has mandated banks to put in place an effective mechanism for information sharing by December 2012 and to sanction ad hoc loans/renewal of loans to new or existing borrowers only after obtaining/ sharing the information.

Lack of enabling environment

According to the Doing Business Rankings 2013, India ranks way down at 132 out of 185 countries in the global index of countries in "Ease of doing business"; 41 places below China, 51 places below Sri Lanka and 116 places below Taiwan. Explosive growth can only be achieved if there is an enabling economic environment. This requires Governmental policies for quicker clearances, which encourage business and long term investment. Recently, some steps have also been announced to stabilize the Government finances and contain fiscal deficits within manageable levels.

Government has also taken steps to encourage public investment as well as public private partnerships in infrastructure and to tap into available technology and capital from around the world. I firmly believe that for achieving explosive growth, it is imperative that macroeconomic environment stabilizes, inflation and inflation expectations come down to comfortable levels and the twin deficits are contained. The steps initiated by the Government need to fructify into effective change.

Opportunities galore

Customer centricity

Every challenge is also an opportunity. A Boston Consulting Group study "*Indian Banking 2020 – Making the Decade's Promise Come True"* estimates that the income group below the middle class with annual household income of Rs 90000 to Rs 2.00 lakh per annum will constitute the largest group of customers, increasing from an estimated 75 million households in 2010 to 120 million in 2020, constituting the "Next Billion". This customer segment would increasingly demand affordable, low cost banking services. The challenge for banks is to extend the reach of banking services through bank branches/ATMs/BC model to tap the potential of this customer segment. Banks need to develop customer centric products and services. The pricing has to be right and affordable. Greater use of technology, including mobile services, could revolutionize banking. The potential of mobile banking is immense. The BCG study estimates that even if 25–30 percent of mobile users have GPRS / 3G activated, there would be 250 million to 300 million customers who would access banking services over the mobile. The Indian banking industry would have to innovate and build an efficient and low-cost framework for transaction banking. Going forward, customer satisfaction would be the buzzword for success and would set the winners apart from the laggards.

Dream big, think small

If we are to achieve explosive growth, banks would need to increasingly focus on the SME, agriculture and retail sectors. It is a fact of life that large corporates have easy access to huge loans across the banking sector, but they also account for a major segment of NPA/restructured accounts. On the contrary, the small borrowers/MSMEs continue to face difficulties in accessing bank finance due to perceived higher risk and lower ticket size. It needs to be appreciated in this context that the delinquencies in this segment are largely attributable to the inadequacy of finance and lack of support from the banks to the viable

units at an appropriate stage. Banks must realize that through adequate appraisal, fair pricing and by extending proper handholding support to the MSMEs, the sector can be a potential game changer in terms of accretions to the banks' bottom line.

Banks need to evolve business models and delivery channels which would bring down the cost of providing credit to the agriculture/ retail/ SME segments. We can achieve explosive growth if banks are able to customize and deliver cost effective products and services to this customer segment while simultaneously guiding and providing handholding support to these sectors. The fear of increase in NPAs cannot be a ground for depriving these sectors of timely and adequate credit. Besides translating into increased business opportunities for banks, these sectors can significantly contribute to employment generation and growth in savings, and would support GDP growth.

There is also a need to encourage incubation and development of new business ideas and providing funds to translate these into reality. Facebook would not have been a reality if angel investors Reid Garrett Hoffman and Peter Thiel had not funded Mark Zuckerberg. According to a BCG India study, India has 190,000 millionaires but only about 500 angel investors. The HNIs in India prefer to invest in real estate. While Venture capital funds, to some extent, do provide funding to start ups, much more needs to be done to develop a viable ecosystem where new ideas with potential for employment and wealth generation can flourish. Banks could consider providing funding to such innovations.

Attitudinal changes

Success demands change in the way banks do business, harness the power of innovation, recognize the huge potential at the bottom of the pyramid and reach out to them. Banks need to go the extra mile in financial literacy by educating the customers and understanding the ecosystem in which small businesses and agricultural operations grow and thrive. They need to learn to work in a partnership to finance sustainable business.

Success is not about financing seemingly safe large corporates by following the herd in a "me too" manner. It is about changing mindsets, looking at untreaded paths, putting the customer above all and tapping the power of technology. This demands a committed workforce with the requisite technology, HR and risk management skills. It calls for re-skilling the existing workforce and hiring and retaining talent in the public sector, particularly, in view of the large scale retirements over the next few years. PSBs would have to increasingly look at performance management, changing mindsets and empowering employees for fast and effective decision making. It requires a cultural revolution in the banking sector, particularly for public sector banks if they wish to retain the competitive advantage of size over the smaller but more nimble footed private sector/ foreign banks.

Regulatory / supervisory environment

One of the essential pre-requisites for attaining sustained growth is financial stability, which in turn requires a combination of strong regulation and supervision. The regulators and supervisors need to be abreast of the changing contours of the financial system, be aware of the changes in the way banks do business, new products and services, the risks and the mitigants. They need to have their ears to the ground, so to speak, so that they are not caught unawares by the undercurrents in the financial system, which could turn into a financial tsunami. Given the tremendous financial and human cost of the recent sub-prime crisis, we cannot afford a relapse. Hence, the emphasis has to be on developing a strong supervisory infrastructure for creating a robust financial system and an environment conducive to growth. We at the RBI have been looking at the supervisory system and the way we supervise banks. Based on the recommendations of the High Level Steering Committee set up for the purpose, we have initiated the transition from a CAMELS transaction based approach to a Risk based approach in supervision of banks. Based on the interactions that I had as the Chairman of the HLSC and other periodic dialogues that I have

with the bank management, my assessment is that most of the banks do not have a clear perception of their activity wise costs and profits. It is, indeed, perplexing how these banks have been managing their risks when they do not have an idea of which activity/business line has a positive risk-reward skew?

Against this backdrop, as a first step, we have advised banks to re-assess their risk management architecture, culture, practices and such other related processes and to benchmark them against certain essential requirements which have been identified as prerequisites to introduction of risk based supervision. Banks have also been advised to upgrade their HR capabilities with regard to skill sets required for handling risk management systems, MIS, etc. to facilitate the switch over to risk based supervision. RBI would also conduct training programmes/ workshops for banks once the Risk Profile Templates and guidelines on RBS are finalized. Meanwhile, the challenges for banks would remain in terms of upgrading their MIS capabilities, fine tuning their transfer pricing policies, measuring transaction/ activity wise costing, evaluating the risk-return trade off, putting in place an effective and transparent framework for risk based pricing of products and services and non-discriminatory pricing of liabilities.

Conclusion

To sum up, let me recapitulate the key ponderables:

- The first and foremost requirement is to improve the Governance standards in all spheres – at the centre, state, institutions, individuals, etc. Probity in public life and in our dealings are key ingredients that can unshackle the chains that bind us. We need to build public opinion/ awareness about the need for rapid growth as it would prove to be the main driver for the changes that we seek. Agitation is not and cannot be a solution.
- The banking sector has to develop strong linkages with the real sector in order to ensure stable and sustainable growth. This should govern all aspects of banking operations which would help avoid build up of systemic risk through asset price bubbles.
- We have recounted some of our inherent strengths earlier. All we need is to refocus on our key strengths and to concentrate our energies on overcoming the bottlenecks currently shackling our growth. Collectively, we need to work hard and improve our productivity and efficiency. There is no reason why we cannot realize our potential of being a high growth economy. As stakeholders, let us strive towards attaining a sustainable high economic growth trajectory and making India a vibrant economy where the gains of inclusive growth disseminate wide and deep and touch all lives, especially those at the bottom of the pyramid. Together we can make this happen.

I once again thank ASSOCHAM for inviting me to this Summit and giving me an opportunity to share my thoughts on the theme of the Summit. I note that the technical sessions to follow will be focusing on related sub-themes such as financial inclusion, reforms and the emerging regulatory framework. I am sure that the imperatives of productivity, innovation and reforms, along with the need for linkages between financial sector and real sector, which I alluded to earlier, would find resonance in the session discussions.

I hope that today's deliberations would generate new ideas on how to realize the potential of Indian banking and achieve the explosive growth required to support the needs of the economy, as it seeks to regain its high growth trajectory. Thank you.

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