S S Mundra: A new banking landscape for New India

Keynote address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the Mint's Annual Banking Conclave, 2015 on "A New Banking Landscape for New India", Mumbai, 29 January 2015.

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2. At the outset, let me thank Tamal and the Mint Management for inviting me to deliver the keynote address at the Mint Annual Banking Conclave. This event has become one of the most awaited events on the calendar of bankers. I last attended this event as a panelist in January 2014 when the topic for panel discussion was "Indian Banking: A New Banking Landscape" and this time it is enlarged to "A New Banking Landscape for New India."

3. When I sat down to think about the theme of the Conclave, I wondered what is new about India. Is it the new political regime and consequential policy changes? Is it the tag of being the new growth leader in the world economy? Is it a more financially included India that is being thought about or is it a 'digital' or 'connected' India that is new. I think it is a bit of all and beyond. We all know that political stability is a necessary precursor to a sustained economic development anywhere in the world and a democratically elected government with decisive mandate is capable of launching significant pro-growth reforms.

Defining contours of New India

4. What are the defining contours of the new India? What are the themes that would play out over the next decade or two? To my mind, there are seven key themes which would define the Indian economy and Indian banking sector in the days to come. These are:

- demography
- urbanization
- digitization
- industrialization
- education
- inclusion and
- global integration

Let me elaborate on a few of these in greater detail and delve upon the impact they could have on the banking system going forward.

a) Demography

5. Much has been talked about the demographic dividend that India possesses. At its current pace of growth, the Indian population is predicted to exceed China by 2025. Further, while China's working-age population may peak around 2015 and shrink for a decade and a half thereafter, 68% of India population would be within the working age range (15–64) until 2030. Life expectancy of the Indian population is also slated to increase to about 70 years by 2030. While on the one hand the numbers present sustained opportunity for the banks in terms of new stream of customers, it also presents challenges. These challenges are in the form of

diverse behavior patterns that customers in different age groups display. The banks would need to continuously foretell the customers' preferences and focus their strategies on meeting them proactively.

b) Urbanisation

6. India is also witnessing a growing trend of urbanisation. By 2030, urban population is estimated to rise to 631mn recording an annual increase of 2.6% as against an annual rise of 1.1% in the overall population. This would mean that 41.8 % of the population would be living in urban agglomerations as against 31% today. While even at that percentage, the urban population would be far lower than the global average at 50% presently; this would open up huge business opportunities for the banks for creation of public infrastructure, housing, consumption, education needs of customers and so on.

c) Digitization

7. Digitisation is another area which is being pursued relentlessly by the new Government. There is massive focus on enhancing internet penetration in the country through accelerated broadband connectivity. The internet penetration has seen a sharp growth over the last year, however, the extent of internet penetration at 20% pales in comparison to other developing countries like China (46%), Brazil (53%) and Russia (59%); let alone the developed nations like US, UK and Japan where the number is in excess of 85%. In these low numbers lie the inherent opportunities for the banking sector. As the number of internet users in the country grows, the banks would be able to better utilize this medium as a delivery channel. On the other hand, the mobile penetration in the country is significantly high at around 930.20 mn and beckons as an opportunity to be tapped.

d) Industrialization

8. The new Government's 'Make in India' pitch also touches the right cords and efforts are afoot to increase the presently stagnant share of manufacturing in GDP to around 25–30 % by 2025 from 15% at present. If that materializes, it would mean addition of 90 million domestic jobs and attendant corporate and retail business opportunities.

e) Education

9. Likewise, there is tremendous scope of improving the level of education in the country by strategic focus on the four Es i.e. Expansion, Equity and Inclusion, Excellence & Employability. It would entail significant changes in consumer awareness, needs, demands and expectations.

f) Financial inclusion

10. The launch of the PMJDY scheme with a focus on linking each household with a bank account has received extremely positive response. At last count, the number of accounts opened under the scheme had reached 12.14 crore. I don't need to emphasize the avenues that this scheme has opened for the bankers. Moreover, it is just a stepping stone. Major part of the work has to commence now.

g) Global integration

11. That brings me to the last theme of growing global integration, which I believe is already having significant repercussions on the financial sector. Be it the quantitative easing by the advanced economies and the subsequent withdrawal of it, convertibility of currency, making or breaking of regional alliance of economies and currencies etc. There could be other hitherto unforeseen developments too affecting the global structure of finance. Let me highlight two recent headlines reported in Financial Times: One, the potential exclusion of Russia from the SWIFT payment system and the other about withdrawal from correspondent

banking relationships in 30 jurisdictions by three of the world's biggest banks. Ostensibly, the motivation for these banks to sever their ties with the lenders in developing nations has been to limit the risk of being hit by regulatory sanctions on account of breaches, money laundering and terrorist finance. Events such as these, though having their origin in specific jurisdictions, have the potential to significantly impact the business and finance elsewhere in the globe.

12. Under the circumstances, it would be important for the banks to keep track of emerging trends and be prepared not only to negotiate through the imminent challenges, but simultaneously be ready to latch on to the opportunities that present themselves.

Key actors/acts in the new banking landscape

13. Let us see what would be the impact of these themes/developments on the key actors/acts in the new banking landscape.

14. ***Customers, employees, owners and regulators*** comprise the key stakeholders in the banking system. In the emerging landscape, the banks would have to contend with a set of customers who are more educated, better informed and well-networked. The banks may probably be forced to hard sell their products and services using a variety of media across the physical and the virtual world. As the complexity of the products/services demanded by the customers increases, the banks would have to not only focus on upgradation of skillsets of their employees but also on their retention. Also the new competition would potentially pull down the ROEs that the owners currently enjoy rendering it difficult to persuade future investors to put in more capital in the banks. In case of public sector banks, the ownership structure itself may change with Government bringing down its stake in these banks. They would, thus, also join the race to seek private capital.

15. As we have witnessed, the regulators across the globe have been particularly very severe on failings of the regulated entities on the consumer protection, money laundering and fair market conduct front. This regulatory activism is evident in the frequency and quantum of penalties levied on banks worldwide. Post crisis, the banks in US and Europe alone have been forced to cough up approximately $230 bn in penalties and legal cost so far.[1] Next two years are likely to see another $70 bn being forked out by the banks for the same reasons. These are staggering numbers. We have also seen some enforcement actions in our jurisdiction but these are pretty benign in comparison. Believe me; Indian regulators have been relatively more tolerant thus far. Some of you who have overseas operations are well aware of the tough stance that the host regulators adopt. Banks would need to gear up to face stricter regulatory regime.

16. The new banking landscape would impact the processes currently in vogue in the sector. Let me highlight some of these in greater detail.

Competition and consolidation

17. Competition and consolidation in the sector is an impending development that the banks would have to contend with sooner rather than later. Two new private sector banks should start operating within this calendar year. Further, the small finance banks and payments banks might mark their presence, may be, later in the year or by early next year and so. There could be consolidation and mergers between the existing market players. No doubt, the pie is big enough to accommodate new players and there is plenty of opportunity for the well-organised and mainstream regulated players to wean away the customers from unregulated shadow banking entities. But, the existing players can afford to stay in denial at

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[1] http://www.irishtimes.com/business/financial-services/us-european-banks-have-paid-230bn-in-legal-costs-since-2009–1.2064163.

their own peril. We have seen competition giving a tough run to the monopoly players. It has happened in the aviation sector, the telecom sector and there is no reason why it would not happen in the banking sector. And believe me, this is not the end of new competition for you. RBI has been indicating about the possibilities of the bank licensing process being put on tap or introducing more varieties of differentiated banks. Also, there is a healthy appetite from the foreign banks to enter this country.

18. The entry of new competitors alone would not mean dramatic changes soon. Banking is a business of scale which the new players cannot build overnight. New banks would start small and scale up over a period of time. Not only would there be a competition for business but also for talent. The processes would be forced to be more efficient.

Technology

19. I have already talked about a paradigm shift being brought about by technology in the way the social interactions are taking place. Growing mobile and internet penetration has opened new avenues for the entrepreneurs. This is reflected in the way the new age customer transacts her business. If all traditional businesses have been impacted by technology, banking could not have remained unaffected. As a flip-side to its well-documented advantages in terms of efficiency and effectiveness of service delivery, technology has also fast tracked the process of customer alienation- first in the form of ATMs and then in the form of internet and mobile banking. In this sense, banks have become faceless entities. This transition calls for a change in the way the banks interact with and retain their customers. I will shortly return to the expectations built around the integration of technology in the banking services and its impact on the banks.

Risk Management

20. Risk Management in banks is of the same vintage as the banks themselves. The banks are in the business of taking risks and hence they need to have a risk management framework in place. It’s been more than a decade and a half since RBI first released the risk management guidelines for banks in India. But, my own sense is that risk management has been pursued in our banking system more under compliance compulsions and has not been dovetailed in the banks’ businesses processes as much as they ought to have been. As the complexity in the financial world grows, the banks would need to carefully consider and set their risk appetite after duly evaluating their capital level as also the skillsets of the officials entrusted with the management of risks.

21. As I said before, the defining elements of the new India would have far-reaching impact on each of the actors and the acts in the new banking landscape. These elements would interplay and provide shape to the new banking order. It would be interesting for you to pick up these 7 contours, 4 actors and 3 acts and interplay them to build probable business scenarios. You may be amazed to see the range of possibilities and challenges. Let me now return to the subject of technology, which is widely perceived as the ‘be all and end all’ of the new in banking.

Technology – a great enabler

22. I would begin by quoting Brett King, the author of famous book “Bank 3.0”.

> “Customers don’t use channel or products in isolation of one another. Everyday customers would interact with banks in various ways. They might wire money to a third party, visit ATM to withdraw cash, go online to check salary credit, pay an utility bill , use their credit card to purchase some goods from a retailer, fill out a personal loan application online, ring up the call center to see what their credit card balance is or report a lost card. More sophisticated they are, they may also

trade some stocks, transfer some cash from their Euro A/c to USD a/c put up a lump sum in a Mutual Fund or sign up a home insurance policy online".

23. The above statement denotes the diverse set of banking applications which technology can support In fact, there is a need of a single channel solution to multiple product offerings. It must, however, be remembered that technology is just an enabler and not a panacea for all ills. Most, if not all, Indian banks have invested heavily in web-based and mobile-based delivery solutions. Each of these channels is supported by a different vendor and each one uses different technology which increases complexity and involves cost. Further, technology is ever evolving and adoption of new technology for staying contemporaneous is a costly proposition. Hence, unless we are able to optimally exploit all the capabilities of the technology enabled delivery solutions, we could be looking at unproductive investments.

24. While there is a lot of euphoria around the adoption of mobile banking and mobile payments, the model has been relatively less successful barring a few countries where the right environmental factors existed. I am talking here about the delivery of financial and payment services by using the mobile device rather than its use as an access channel for internet banking etc. In the Indian context, an objective analysis would reveal various reasons for slow adoption. On the other hand, there are technical issues like type of handsets, variety of operating systems, encryption requirements, inter-operable platforms or the lack of it, absence of standardised communication structures, difficulty in downloading application, time lag in activation etc. These get accentuated by the operational difficulties in on-boarding merchants and customers and customer ownership issues. The interplay of these factors has stymied the deployment and adoption of mobile banking as an effective and widely accepted delivery channel. Issues of coordination and cooperation between banks and telcos, is another aspect which acts as either a driver or a barrier to the adoption of mobile banking. These issues need to be quickly resolved if the mobile has to serve as an influential delivery channel for distributing banking products and services in India.

25. Let me also highlight some opportunities that technology throws up. Take for example the results displayed on the Google search page which is personalized. Each time an individual runs a search at Google, the website collates details of the sites visited/links clicked by that individual and loads more of those websites his/her future searches. There are more ATM transactions than searches on the Google webpage at present. However, the kind of personalisation Google has achieved in its searches has not been attempted in the area of advertisement on ATMs.. This could be an area for the banks and their software vendors to work on in future so as to generate further sales leads.

Few Qs seeking As

26. Let me leave you with some questions that the banking profession and the bankers would need to find answers to ensure their relevance in the emerging landscape.

(i) Can there be a possibility of ***account number portability*** on similar lines as mobile number portability? So, if an individual is not happy with the service received at one bank, he can possibly opt for shifting his banking relationship, lock, stock and barrel to another bank. Of course, there could be issues around loan contracts etc. but there is no reason to believe that such challenges cannot be surmounted and pave the way for a massive disruption in the way banking is conducted today.

(ii) How long can the banks continue increasing their ***retail loan portfolio***? Unless some means to pool and distribute these loans to other investors in the market is created, the retail lending pipeline can get chocked quite quickly.

(iii) How is ***crowd funding*** going to impact lending business of the banks in future? The amount of funds raised by crowd funding platforms worldwide has increased progressively from $ 1.5 bn in 2011 to $ 2.7 Bn in 2012 and further to $ 5.1 bn in 2013. I hear some of you say it is negligible in volume. The pace of growth however, is quite fast and combined with the ***peer-to-peer lending*** business this could create disruptions, at least for some of the players who operate in the same segment.

(iv) If Mobile Banking were to succeed, ***would plastic money still be needed***? Basically there are two questions rolled in one. First, whether mobile banking can succeed and if that is the case what implications would it have for the future of ATMs and the debit cards that have been issued by banks. There is justifiably a growing need for reducing the reliance placed on cash by the system and hence, if more and more people moved to mobile/internet based payments, the plastic cards and the investments made thus far, would be rendered useless unless put to more imaginative uses.

(v) What ***IFRS*** implementation would mean for the banking system? IFRS accounting could potentially overstate assets or overstate capital position. The question is how prudential regulation would exist alongside IFRS? Proposed impairment calculations under IFRS, accounting for interest income on Effective Interest Rate basis and presence of multiple systems for operations and accounting of different portfolios would mean that IT systems would have to be upgraded/realigned for IFRS migration. Banks would also need to overcome challenges around converging policies for financial accounting and tax accounting for preparation of financial statements. The banks would need to train their staff in various departments like credit, and treasury, etc. for acquiring proficiency in IFRS accounting.

(vi) Would the ***large corporates continue to borrow*** from the banks? Of late, the global markets, particularly the emerging market economies, have been flush with funds flowing in on account of variants of QEs launched by the Central Banks in the Advanced Economies. Many large corporate houses have been able to access funds at very cheap rates without needing to reach out to banks. The sustained deflationary trends in the Euro Area and Japan portend further bouts of QEs which can adversely impact the lending business of banks in the emerging markets. Further, the large corporates in developed countries normally access financial markets directly for their funding requirements rather than commercial banks. Hence, even while this time-specific event of QEs might fade away, as Indian economy and the financial markets mature, more and more large corporates could start bypassing banks for their funding requirements.

(vii) Would the pain from the ***loans restructured*** earlier return to haunt the banks? My understanding is that the prolonged global economic slowdown might have thrown off the projections made earlier at the time of restructuring the advances in the immediate aftermath of the crisis. As the moratorium period comes to a close, the banks would need to take a hard look at the techno-commercial viability of these projects and take the losses wherever the viability seems in jeopardy. Timely decisions, including for recall/recovery of the loan, wherever the financial prospects are unviable, would be critical.

Conclusion

27. Before I conclude, let me also give a perspective on the global regulatory reforms and how it might impact the Indian banks. Basel III norms have been announced and set to be implemented as per the indicated timeline, with the liquidity regime already kicking in from January 1, 2015. So you are well-versed with the new regulatory phrases- ***leverage, capital conservation buffers, counter-cyclical capital buffers*** etc. The ***D-SIBs*** guidelines have also been announced and the list of banks considered systemically important in the domestic context would be unveiled in August 2015. Besides, being subjected to stricter capital and liquidity buffers, these banks may also be nudged to prepare detailed ***'recovery and resolution plans'***. Negotiations are also on at the Financial Stability Board level for implementation of a ***TLAC*** (Total Loss Absorbency Capital) framework for the banks identified as G-SIBs. The essence of all the above discussion is that the banks would need to substantially augment their capital bases to stay in the business. The question is ***where do you find such capital?***

28. I have covered much broader landscape than I had originally intended to. I believe the elite panel gathered here today would deliberate on the issues raised and also reflect on them later. I once again thank Mint for inviting me and wish you all a fruitful deliberation.

Thank you!