S S Mundra: Indian banking sector – emerging challenges and way forward

Lecture by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, as part of the Memorial Lecture series launched by State Bank of Mysore in the memory of His Highness Sri Nalwadi Krishnaraja Wadiyar, Bangalore, 29 April 2015.

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1. Shri Sharad Sharma, Managing Director, State Bank of Mysore; Shri Karthak, Regional Director for Karnataka, RBI; senior colleagues from the banking fraternity; ladies and gentlemen! It is a privilege for me to deliver the inaugural memorial lecture in the honour of His Highness Sri Nalwadi Krishnaraja Wadiyar, former Maharaja of Mysore. It is quite apt that a memorial lecture has been instituted by State Bank of Mysore in the honour of Sri Krishnaraja Wadiyar. The prophetic Maharaja of Mysore, during his lifetime, had earned sobriquets of being a philosopher-king and a 'Rajarshi' or a "saintly king" from no less a person than the Father of the Nation. It is a glowing testimony of his popularity and prowess that Mysore in his times was regarded as "the best administered state in the world". As Lord Sankey noted "princes from other sections of India were sent to Mysore for administrative training" and hence, holding this memorial lecture at this newly opened learning Centre holds an added significance. During his reign, Maharaja Wadiyar worked towards social causes like poverty alleviation and economic regeneration by improving rural reconstruction, public health, industry and education; some of the goals that the policy makers are presently pursuing with support from the banking sector.

2. The banks are the lifelines of the economy and play a catalytic role in activating and sustaining economic growth, especially, in developing countries and India is no exception. Our banking system, at the present juncture is, however, facing significant challenges from several quarters. These challenges, if not addressed quickly and adequately, may result in loss of opportunities as and when the economic growth starts picking up momentum. In a sense, it has implications for both- the banks as well as for the economy as a whole, because as I mentioned earlier, a strong banking system is one of the essential pre-requisites in the quest for growth. In my lecture today, I intend to focus on the economic landscape and the emerging challenges for the banking system at the current juncture.

Macroeconomic landscape

3. Since the onset of the Financial Crisis in 2008, the global economy has continued to face rough weather and the Indian economy and our banking system have not remained immune. Recovery has been moderate and sometimes uneven. Different jurisdictions continue to be tormented by financial fragilities and macroeconomic imbalances. Geopolitical risks surrounding oil prices and the uneven effects of currency and commodity price movements also pose significant threat to economic stability. Sustenance of highly accommodative monetary policy in the Advanced Economies has also created monetary policy challenges in emerging markets like India.

Challenges for the banking system

4. It is against this challenging backdrop that the banking system in India has been operating for a relatively long period of time which has resulted in an adverse impact on the asset quality, capital adequacy and profitability of our banks. But the tough situation in which the banking system finds itself is also attributable in a large measure to the bankers' inexperience and aggression. Let me delve upon these challenges and the way forward in a bit of detail.

i) *Asset quality*

Though on the whole, the banking system has remained resilient, asset quality has seen sustained pressure due to continued economic slowdown. The levels of gross non-performing advances (GNPAs) and net NPAs (NNPAs) for the system have been elevated. As per preliminary data received at RBI for March 15, while the GNPAs have increased to 4.45% for the system as a whole, the NNPAs have also climbed up to 2.36%. When seen in isolation, the NPA ratios do not appear very distressing; however, if we add the portfolio of restructured assets to the GNPA numbers, this rises alarmingly. Stressed Assets Ratio (Gross NPA+ Restructured Standard Advances to Gross Advances) for the system as a whole stood at 10.9% as at the end of March 2015. The level of distress is not uniform across the bank groups and is more pronounced in respect of public sector banks. The Gross NPAs for PSBs as on March 2015 stood at 5.17% while the stressed assets ratio stood at 13.2%, which is nearly 230 bps more than that for the system.

It is pertinent here to also note the observations made in the Global Financial Stability Report released by IMF recently. Referring to the high levels of corporate leverage, the report highlights that 36.9 per cent of India's total debt is at risk, which is among the highest in the emerging economies while India's banks have only 7.9 per cent loss absorbing buffer, which is among the lowest. While these numbers might need an independent validation, regardless of that, it underscores the relative riskiness of the asset portfolio of the Indian banks.

As you all know, RBI has taken various steps to improve the system's ability to deal with corporate and financial institution distress. This includes issuance of guidelines on "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy, detailed guidelines on formation of Joint Lenders' Forum (JLF), Corrective Action Plan (CAP), 'Refinancing of Project Loans', 'Sale of NPAs by Banks' and other regulatory measures, which emphasized the need for early recognition of financial distress and for taking prompt steps for rectification, restructuring or recovery, thereby ensuring that interests of lenders and investors are protected.

Various reports that I get suggest that the implementation of JLF framework needs further improvement on the ground level. We have received representations from bigger lenders about non-cooperation from a few lenders. On the other hand, smaller lenders have voiced their concerns about being arm twisted by bigger lenders. Unless, there is proper co-ordination between the interested parties, all the revival efforts are likely to fall flat.

RBI had given a road map for ending the regulatory forbearance on asset classification of restructured accounts long back and accordingly, the forbearance has come to an end on March 31, 2015. There has been a lot of clamor from all quarters for extending this forbearance. Our stand on this issue has been absolutely clear. I wish to highlight that 'Restructuring' *per se* is not necessarily a forbidden word. It is a legitimate financial activity practiced the world over to help the borrowers tide over short term problems and to preserve economic value in the system. I don't know why restructuring a loan which is under short term stress should not be done. What we are saying is that, the banks must acknowledge the problem, admit that the account is facing stress as of now, but is expected to recover in future. Hence, make a small provision and reverse it when the account becomes satisfactory and starts paying. Staying in denial mode does not help anyone especially in an interconnected world where regulation making has become global and so has the public scrutiny. Any forbearance extended by the regulator will be discounted by the investor/ analyst community while assessing the bank's financials.

ii) *Capital adequacy of banks*

Concerns have been raised about the ability of our banks to raise additional capital to support their business and I would admit that these concerns are not entirely misplaced, especially for the public sector banks. Higher level of capital adequacy is needed due to higher provisioning requirements resulting from deterioration in asset quality, kicking in of the Basel III Capital norms, capital required to cover additional risk areas under the risk based supervision framework as also to sustain and meet the impending growth in credit demand, going forward.

Though at present, the banking system is adequately capitalized, challenges are on the horizon for some of the banks. For the system as a whole, the CRAR has been steadily declining and as at the end of March 2015, it stood at 12.70% as against 13.01% as at the end of March 2014. Our concerns are larger in respect of the PSBs where the CRAR has declined further to 11.24% from 11.40% over the last year.

The poor valuations of bank stocks, especially the PSBs, are not helping matters either, as raising equity has become difficult. When even the best performing PSBs have been hesitant to tap the markets for augmenting their capital levels, it would be difficult for the *weaker* PSBs to raise resources from the market. There is a constraint on the owners insofar as meeting the capital needs of the PSBs and hence, the underperforming banks are faced with the challenge of looking at newer ways of meeting their capital needs. A singular emphasis on profitability ratios (based on RoA and RoE) perhaps fails to capture other aspects of performance of banks and could perhaps encourage a short term profitability-oriented view by bank management. However, without getting into the merits of this approach, from a regulatory stand point, we feel that some of these poorly managed banks could slide below the minimum regulatory threshold of capital if they don't get their acts together soon enough. Of course, the pressure may lessen somewhat if, going forward, the asset quality improves on account of higher growth, resulting in higher retained earnings for banks. The need of the hour for all banks, and more specifically, in respect of the PSBs, is that capital must be conserved and utilized as efficiently as possible.

iii) LCR framework

As you are aware, the Liquidity Coverage Ratio (LCR) regime has kicked in for the banks from January 1, 2015 with a minimum requirement of 60% to be gradually increased to 100% by January 1, 2019 in a phased manner. The LCR is a ratio of High Quality Liquid Assets (HQLA) to the Total Net Cash Outflows prescribed to address the short term liquidity risk of banks and the banks would be required to maintain a stock of HQLAs on an ongoing basis equal to the Total Net Cash Outflows.

Banks have been asking for reduction in SLR citing the implementation of the LCR framework. To a certain extent their request has merit. SLR essentially serves the same purpose as the LCR. However, SLR does not assume certain outflow rates for liabilities while outflow and inflow rates under the LCR framework are based on certain assumptions of stress. Presently, apart from maintaining LCR at 60%, the banks have to maintain SLR of 21.5% of the NDTL. Going forward, as the LCR requirements gradually increase, it may be desirable to reduce the SLR progressively. Presently, there is a special dispensation wherein RBI has permitted banks to reckon up to 7% of the SLR towards LCR (2% of MSF and 5% under FALLCR[1]). Our regulatory department is seized of the issue and would take appropriate measures to address this issue going forward.

iv) Unhedged forex exposures

The wild gyrations in the forex market have the potential to inflict significant stress in the books of Indian companies who have heavily borrowed abroad. This stress, besides impacting repayment of forex liabilities, eventually hampers their debt repayment capability to the domestic lenders as well. It is precisely with this consideration that RBI has been

[1] Facility to Avail Liquidity for Liquidity Coverage Ratio.

advocating a curb on the increasing tendency of the corporates to dollarize their debts without adequate risk mitigation.

Our supervision of banks' books has highlighted the need for the banks to have more robust policies for risk mitigation on account of unhedged foreign currency exposure of their corporate borrowers. Inadequacies of data further complicate the impact assessment of such exposures across the banking system. The banks have been advised to factor in this risk into their policies/ pricing decision and also devise means for sharing of information on such exposures amongst themselves. Regulatory guidelines have also since been issued outlining the capital and provisioning requirements for exposure to entities with significant unhedged forex exposures.

v) Human resource issues

I do not need to emphasize the HR issues in banks. This is a decade of retirement for the PSBs and I am sure those working there are already feeling the pinch of the loss of experienced hands in their day to day operations. While the recruitments would be happening at the junior levels, there would be a virtual vacuum at the middle and senior level for some time to come. The absence of middle management could lead to adverse impact on banks' decision making process as this segment of officers played a critical role in translating the top management's strategy into workable action plans. Some of the major banks are also suffering on account of prolonged leadership vacuums at the top. All banks, including those in the private sector, are witnessing high attrition rates, giving rise to resource gaps. The problem is set to get accentuated further once the banks that have been newly licensed/ likely to be licensed, start hiring. Therefore, bridging resource gaps and managing employee turnover are major challenges that banks need to be prepared to address.

The banks need to continuously enhance the skill levels of their employees so as to remain viable and competitive and to take advantage of new opportunities. The banking personnel, across the cadres need to be suitably trained to acquire necessary skill sets to perform their jobs more efficiently. The biggest challenge is to build capacity at a rate which matches the loss of existing talent and skills to retirement, poaching and resignations. The training initiatives must ensure that the available talent pool in the banks is able to always keep pace with the fast changing ways in which banking is conducted. Of course, in these challenges also lie an inherent opportunity for banks to redraw their organizational profile and to create HR systems and processes best suited to the needs of the future.

vi) Revision to the priority sector lending guidelines

The revised priority sector lending guidelines have been released last week. Lending to a few new sub-sectors like renewable energy, social infrastructure and to the medium enterprises would now be treated as priority sector lending. Concept of a tradable Priority Sector Lending Certificate (PSLC) has also been introduced, which would enable the 'deficit' banks to buy these certificates from 'surplus' banks to meet their targets.

There is also readjustment in some sub-targets, whereby the banks are now required to progressively achieve 8% of lending to Small and Marginal Farmers and 7.5% to the micro enterprises among the MSEs in a phased manner. This has been brought about with an underlying objective of making available finance to the most needy and the most alienated of the borrowers. This may probably pose a bit of a challenge initially but I believe with proper planning, these targets could be achieved sooner rather than later.

vii) PMJDY and beyond

I must compliment the banking sector for wholeheartedly working for the success of the PMJDY scheme. The numbers speak for themselves. More than 14.5 crore accounts opened. That leads to the question- what next? Flow of individual savings, albeit howsoever small combined with flows from direct benefit transfer would be crucial to give an initial push to keep these accounts active while extending productive/need-based credit would be the second crucial step. The onus is upon all of us to ensure that the window of opportunity that has been presented by the opening of such a large number of accounts, is not put to waste by allowing the accounts to turn inactive.

The credit absorption capacity of the farmers can be enhanced through consolidation of fragmented landholdings by ushering in land reforms or through pooling of land holdings in a SHG format. Similarly, customers may also be trained to undertake non-farm activities. Efforts to enhance the credit absorption capacity must also be supplemented through financial literacy and vocational training initiatives. Improved financial literacy would aid the inculcation of a savings culture and investment habit amongst the customers, which can be leveraged by the banks by offering suitable small savings, investment and pension products.

A major challenge for the banks would be to manage their banking correspondent model effectively. The problems relating to their viability, governance, cash management, linkage and oversight from a base branch need to be quickly addressed. The entire financial inclusion ecosystem must progressively develop, if the momentum gathered under the PMJDY exercise has to be sustained for all-round benefit of all stakeholders.

viii) Globalization of regulation-making process

As I alluded to a little earlier, banking regulations are getting increasingly globalized, subject of course to certain national discretions. As members of the standard setting bodies like BCBS and FSB, we are committed to implement these regulations in our jurisdictions. There is a process for peer review of regulatory guidelines issued by various jurisdictions to ascertain compliance with the global standards, failure to adhere to which would render the jurisdiction non-compliant to the standards. While we do participate in the regulation making process and suggest modifications to protect the rightful interests of the domestic economy, very often, we have to abide by the larger framework. I will give just one example viz. the large exposures regime, for which a consultation paper on new SBL/GBL norms has already been released by RBI.

ix) Technology and its impact

Let me briefly touch upon an issue which is relatively much more pertinent for the PSBs, i.e. use of technology in banking. All PSBs are now on CBS platform and have developed capabilities to offer anywhere banking. Few have also started offering basic banking transactions on mobile for their customers. But this is just scrapping the surface as the technology can be leveraged for a far greater effect. PSBs must be able to leverage technology for building data warehouses and then be able to do data mining and analytics. The goal should be to use data for effective decision making at various levels, including product customization, developing business models and delivery channels, etc.

PSBs must be able to pitch suitable products for their customers through internet and mobile banking channels. Traditional businesses are slowly moving on-line and e-commerce is the preferred choice of the gen-next customer. The challenge before the PSBs is to upscale their capabilities, train their employees on the new technologies to benefit from the possibilities that adoption of technology can open up.

A good thing going for the banks is the current recruitment of youngsters in the work force. This new-generation staff is tech-savvy and can quickly connect with technology. The enterprising among them must be accorded freedom to experiment and suggest ways in which the bank could reengineer its processes for its own benefit and that of its customers. This would require a change in mind-set of the senior / Top Management and this must happen if the PSBs have to compete efficiently and effectively with the private sector counterparts in future.

x) Treating customers fairly

Protection of bank customers has been one of the thrust areas for RBI in recent times. As you may be aware, RBI has issued a Charter of Customer Rights based on the global best practices. The Charter comprises of following five rights:

- Right to Fair Treatment
- Right to Transparency, Fair and Honest Dealing
- Right to Suitability
- Right to Privacy
- Right to Grievances Redress and Compensation

A model customer rights policy jointly prepared by IBA and BCSBI incorporating these rights has been circulated to all banks by IBA. The banks have been advised to prepare a Board Approved Policy based on the model policy before July 31, 2015. RBI may review the policies framed by the banks and their implementation as part of our supervisory assessment over the next 12–18 months.

xi) KYC/AML compliance

Let me now turn to another very important issue which is equally challenging for the private sector banks as well and that is, compliance with the KYC/ AML norms. A majority of the enforcement action by the banking sector regulator in the recent past has been on account of these violations.

The instances of fake e-mails soliciting unsuspecting customers to make payments to certain bank accounts as a precursor to receiving prize or lottery winnings from abroad, have become quite rampant. It is surprising that even well-educated individuals are falling prey to such incredulous offers. While spreading financial literacy remains a huge challenge, the banks cannot be absolved of their responsibilities in the sequence of events. Most of this money is being transferred through banking channels and obviously, there is a deficiency in KYC compliance. Money muling is another common occurrence which highlights deficiencies in risk categorization of customers and monitoring of transactions.

I am emphasizing on this issue because banks need to be sensitive to the possibility of regulatory strictures / penalties for non-compliance. Consistent monitoring of transactions is necessary to prevent money muling. A few banks in the past have already been fined for deficiencies in adherence to KYC/AML norms and with our commitment to comply with the FATF norms; I can only forewarn you that the frequency and severity of such penalties would rise in future.

xii) Balance sheet management

Over the past few years we have witnessed an increasing propensity to defer or delay provisions in an apparent attempt to post higher net profits. Probably, this short term vision is also in part attributable to short term tenure which the CEOs/ CMDs get. It must be appreciated that CEOs/ CMDs would come and go but the institutions are perpetual entities. The only thing which can perpetuate their existence is a stronger and healthier balance sheet. It must be realized that the first step towards resolving a problem is to acknowledge its existence. The problems which are swept under the carpet for a quarter or two would need to be encountered thereafter, with the issue getting further complicated in the interim.

Making higher provisions would not only add strength to the balance sheet, but also lead to better control over tax out-go and the dividend pay-out, besides adding credibility to the bank's financial statements. While a lower net profit would make headlines for a day or two, believe me the savvy long-term investors / analysts do not read too much into the short term blips. If they understand that the Management is sincere about repairing the balance sheet, they would drive up the valuation of your stocks, which would help you in the long-term. With most banks in dire need of capital, the retained earnings need to increase progressively.

As a part of balance sheet management exercise, the Board/Top Management would have to proactively take a call on the likely components of their balance sheets and what shape they would like the balance sheet to take in future. The objective of optimal utilization of capital would have to be necessarily kept in mind while evolving balance sheet management strategies.

xiii) Risk management

Risk is inevitable in the banking business and hence, a sound risk management framework is the touchstone of an efficient bank. The risk management effectively aims at balancing the Risk-Return Trade-off which is “maximizing return for a given risk” and “minimizing risk for a given return”. The responsibility of setting a risk appetite for the bank as a whole is that of the Board and the Top Management. In practice, however, we seldom see the articulation of an objective risk appetite statement by the PSBs. If you haven’t set out a risk limit for each type of risk that the bank runs and an aggregate risk appetite for the bank as a whole, how do you measure and monitor risk? We must understand that risk management is integral to the success of the bank and hence, the Top Management should strive to put in place an efficient risk management framework keeping in view the changing market dynamics and the regulatory prescriptions.

Conclusion

5. In conclusion, I would once again like to invoke Krishnaraja Wadiyar in whose memory this lecture has been instituted. Maharaja was known to be a man of action, a man of deeds and a person of compassion and empathy for his subjects. The bankers present here would do a great service to the memory of the Maharaja if they could imbibe these qualities in their day to day operations, particularly while dealing with their customers.

6. As we have noted, these are challenging times for the banking sector but as the clichéd proverb goes “Every cloud has a silver lining”. The future leaders in the banking industry would be those who identify this silver lining early and initiate necessary steps to leverage the opportunity. The impending competition from new banks and the large number of new accounts opened under the PMJDY Scheme are two instances that readily come to mind of the challenges that could be turned into opportunities. Besides this, banks as the key players in the country’s financial system also carry the responsibility of supporting economic growth, once the economic cycle turns favourable. Banks have to prepare themselves for meeting this responsibility by nurturing a healthier balance sheet.

I conclude by wishing the State Bank of Mysore management the very best on this occasion and thank you all for patient hearing!