Kishori J Udeshi: Issues in bank regulation and supervision

Speech by Ms Kishori J Udeshi, Deputy Governor of the Reserve Bank of India, at a seminar on Global Banking: Paradigm Shift, organised by the Federation of Indian Chamber of Commerce and Industries, Bangalore, 16 September 2004.

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FICCI has been in the forefront of creating a platform for healthy debate and discussion leading to responsible actions. I would like to thank FICCI for inviting me to speak at this Forum especially as there are several high level functionaries who have travelled great distances to be with us on this occasion. It is a wonderful opportunity and I would certainly use it to explore a few issues at the frontiers of regulation and supervision. Some of these are unsettled issues and the raising of issues is essentially with a view to encouraging debate as it is only through debate and dissent that we can aspire to achieve meaningful progress. I would, therefore, stress that the raising of unsettled issues at the frontiers should not be perceived as a statement of an official stance of the Reserve Bank of India. While much of the issues are raised from an Indian perspective, I would also like to glean some thoughts from experience abroad.

In recent years the blurring of the distinction between financial intermediaries under the combined effect of domestic and cross-border integration, innovations in instruments and processes, advances in technology and the massive volumes of capital intermediated by the financial system has necessitated a pro-active strengthening of the regulatory and supervisory framework.

The financial landscape is increasingly witnessing entry of some of the bigger banks into other financial segments like merchant banking, insurance, etc., which has made them financial conglomerates. Emergence of several new players with diversified presence across major segments and possibility of some of the non-banking institutions in the financial sector acquiring large enough proportions to have systemic impact make it imperative for supervision to be spread across various segments of the financial sector. Banks have grown organically beyond the national frontiers and spread across the globe. With liberalisation in trade in services, banks are also able to render banking services across territories even without the need for physical presence in those territories. These aspects add other dimensions to the challenges of regulation and supervision of the banking system.

Recent measures by RBI

I would now turn to some of the issues on which the RBI has taken action in the recent period. As part of a move towards greater deregulation, banks fulfilling certain minimum criteria regarding CRAR and net NPAs have been given the discretion to pay dividend without the prior approval of the RBI. In view of the ongoing shift towards financing borrowers based on estimated cash flows rather than on collateral and in recognition of the availability of financial assistance through credit substitutes, *viz.*, commercial paper, bonds and debentures, the restriction on unsecured exposures was withdrawn and banks' boards are allowed to formulate their own policies on unsecured exposures. Banks are not required to obtain prior approval of the Reserve Bank for engaging in insurance agency business or referral arrangement without any risk participation, subject to their complying with the prescribed conditions. Banks intending to set up insurance joint ventures with equity contribution on a risk participation basis or making investments in insurance companies for providing infrastructure and services support, however, still require prior approval of the RBI.

Various issues which received regulatory attention during the recent period include ownership and governance in banks, further progress towards international best practices in prudential norms with country-specific adaptation, greater deregulation and rationalisation of banking policies, compliance with Know Your Customer (KYC) norms, strengthening the financial system for global integration in the light of the ongoing liberalisation of the capital account, greater inter-regulatory co-ordination and the drive for improving the quality of public services rendered by banks. In the evolution and implementation of policy, a consultative approach continues to be followed through formal institutional structures such as the Board for Financial Supervision, the newly-formed Standing Committee on Financial Regulation, the Technical Committee on Money and Government Securities Markets and also through specific working groups and committees as well as formal and informal consultations with the regulated entities, external experts and professionals.

Transparency and disclosure

Transparency has been the watchword in our endeavour to promote best practices. Moreover, transparency is crucial to a well functioning financial system. The RBI recognises the need to align standards adopted by the Indian banking system with global standards. The Reserve Bank has issued detailed guidelines relating to several Accounting Standards. Banks are required to ensure that there are no qualifications by the auditors in their financial statements for non-compliance with any of the accounting standards. We recognise that the banking sector will need to adjust to more exacting valuation rules. Again, rules on disclosure will need to be exacting, including disclosure on penalties or adverse action by the supervisory authority. The financial sector has to recognise that exacting standards of disclosure are necessary to strengthen the financial sector and there is a world-wide move to such disclosures.

In recognition of the importance of dissemination of credit information, the RBI requires banks/DFIs to obtain the consent of all their borrowers - not only defaulters - for dissemination of credit information to enable Credit Information Bureau of India Ltd., to compile and disseminate comprehensive credit information.

Preserving the integrity of the banking system

Prevention of frauds and implementation of anti money laundering (AML) measures are two important aspects of the efforts being made to prevent criminal misuse of the financial system which threaten the stability of financial transactions worldwide.

Supervisory initiatives

Keeping in view the emerging scenario under the Basel II accord and the need to use supervisory resources more productively, a beginning towards risk-based supervision (RBS) of banks has been made. On the basis of experience gained this will be extended to the entire banking system and will become an essential aspect of Pillar 2 compliance.

Risk management systems

I would now like to flag a few issues - some of which are purely exploratory and are raised for debate rather than as a statement of the official stance. As you are all aware, we are positioned at a crucial juncture because the current phase will be the time when risk management skills of financial entities will be put to test.

The liquidity overhang in the system coupled with the past downward movement of interest rates seems to have spurred a sense of complacency oblivious of the downside risks of an adverse interest rate movement. It is also apprehended that this attitude has led some banks to dilute their approach to credit risk. The building of the risk elements into the pricing of the credit facilities is reportedly taking a backseat in the pursuit of asset expansion. This may leave banks in a situation where some of the players are not only less prepared to face the reversal of interest rate movement, but are also left with a badly priced portfolio in relation to the credit quality. I would like this aspect to be appreciated not so much as a note of alarm but as a voice of prudence. Credit growth should be carefully calibrated with risk measurement and should not be merely seen as deployment of funds at marginal costs in the background of sluggish growth. Banks should look ahead at the expansion of credit portfolio in a healthy way, particularly in the background of higher industrial growth, new plans of corporate expansion and higher levels of infrastructure financing. Coupled with this are the regulatory requirements of management of market risks, which are becoming increasingly relevant. As we are all well aware, the adverse effects of risk exposures do not impact independently but tend to snowball into an avalanche.

These are perhaps the times when market players begin looking for some concessions in the prudential norms, regulatory forbearance and dilution of accounting principles. So what would one make of such a situation?

- That the most ill prepared players make the loudest noises or
- The weakest ones make the first noise?

What is the lesson to be learnt from this? Is it not time for banks to adopt integrated risk management systems whereby they effectively address all relevant risks in an ongoing and comprehensive manner? Should banks not think in terms of having a Chief Risk Officer who oversees all risks - credit, liquidity, operational and market risks?

Moreover, while banks may have adopted risk management systems for their various portfolios, very few, if any, have developed risk models suited to their operations. It occurs to me that India is the cradle of IT professionals who are doing wonders and are providing efficient solutions to their clients across the world. It is also a matter of pride that some Indians are at the helm of the affairs at some of the large global banks. In these circumstances, it is surprising that the banks in India are lagging behind in tapping the IT potential of the country and putting them to productive use for developing / applying risk models. As compared with the potential available in this country, the extent of application of the talents in banks is relatively low, especially when the benefits to be derived from them are tremendous.

A concurrent question that emerges is whether banks should think in terms of disclosing to the investors at large their risk management policies indicating also their risk containment practices and strategy pursued by the bank, on the same lines of statements made by Chairmen of large corporates. At present, such disclosures cannot be made mandatory considering the level of maturity of the financial sector and the levels of assimilation of information by the stake holders and the public.

Banks confident of pursuing a well defined strategy taking into account their clear strengths should articulate their philosophy of running their banks in their annual reports. Encouraging banks to do so should certainly help in improving the perception of the concerned banks in the eyes of the public and the market. It should, however, be a well thought out step, considering that the bank's major asset is the trust reposed by the public at large and nothing should be done to undermine that level of confidence.

We have recently issued guidelines to banks for maintenance of capital charge for market risks. In addition, banks will also be required to draw up their strategies for meeting the capital requirement arising out of implementation of Basel 2. Banks have been until now tapping the traditional instruments eligible for capital status, namely equity shares and subordinated debt instruments. The present legal framework does not allow all banks to raise capital through issue of preference shares. There are also certain restrictions on the maximum tenure of preference shares. This not only gives rise to an uneven playing field but also raises issues pertaining to the eligibility of redeemable preference shares for capital status, especially with regard to inclusion under Tier I or Tier II. In view of the above uncertainties this has been a largely untapped source of capital in India. With a view to enabling banks to tap this source the Reserve Bank is examining the amendment of the existing legislation. Through proper structuring, preference capital may be made attractive to meet the needs of a section of investors. We need to explore carefully this option as also the raising of capital through other hybrid instruments defined under the Basel guidelines, so as to address the requirements of capital by the banking sector in India.

This brings me to consolidation in the banking sector. As you are aware, the First Narasimham Committee had recommended consolidation in the Indian banking sector whereby we would have a few internationally active banks, a few national banks and the others would remain regional banks. It was also clarified that the mergers should be based on synergies and locational and business specific complementarities of the concerned institutions and must obviously make sound commercial sense. Mergers of public sector banks should emanate from the managements of banks with the Government as the common shareholder playing a supportive role. In this background, the implementation of Basel 2 could trigger a round of consolidation in the banking sector.

It is difficult to foresee the precise pattern of consolidation which is likely to be triggered with the implementation of Basel 2 in India. As we have seen in the past, in any merger integrating the manpower and culture of the taken over bank with the manpower and culture of the host bank proves to be a great challenge. It is only when integration in these aspects is achieved successfully that the merged entities would be able to capitalise on the synergies. Hence, while the consolidation moves would be triggered by market forces, it will be necessary to ensure that mergers are successful in all respects, including manpower and cultural aspects, which are unique in the Indian context.

Smaller localised banks might nonetheless still have a relevant role even on a standalone basis if they were to redefine their business strategy in favour of conservative growth which can be supported by internal accruals and by having an effective control on their risk exposures. This would perhaps be possible when they carve out a niche for themselves.

Self-regulation

The international experience with reference to banking sector suggests that statutory regulation by the banking regulator cannot be substituted by self-regulation. It could at best supplement the banking regulation. Having recognised that self-regulation has its relevance even when banking regulator is present we would encourage self-regulation. If self-regulation has to establish itself firmly the first and foremost prerequisite would be establishment of sound principles of corporate governance in the banking system as a whole. The supplementing factor, which is also enshrined in Pillar 3 of Basel 2, namely, transparency and disclosure should also take strong roots in the system. Transparency and disclosure under Pillar 3 is expected to facilitate active role for market discipline. A thought which occurs to me is whether Indian markets are equipped to discipline the participants. One opinion is that the markets in India lack adequate depth and width which would qualify them as efficient markets.

The above reaffirms the need for intensifying supervisory/ regulatory efforts, at least in the short term, before self-regulation and market discipline stabilise in the country. In the interregnum it would be useful for the banks to take proactive measures on both, corporate governance and transparency / disclosure aspects.

Following the Ganguly Report, issues of governance in the banking system have come to the fore. Increasingly exacting standards of Board accountability will need to be introduced and issues relating to penal action if directors fail to properly discharge their duties need to be addressed. I raise this issue not to create panic among directors or to generate media headlines but to pose the issue of wider and effective powers for bank boards commensurate with increased accountability.

Ownership issues in banks

In the recent period there has been considerable debate on the question of ownership of the banking system and the issue of restriction on ownership of a bank by a single individual, institution or group. In view of the importance of corporate governance in banks, it was considered necessary to lay down a comprehensive framework of policy in a transparent manner. Accordingly, we have recently placed in public domain a draft paper on ‘A comprehensive policy framework for ownership and governance in private sector banks’. The RBI has been openly encouraging a debate on this issue and the draft would be reviewed on the basis of the feedback received from various quarters. In this context, I would only make two brief comments. First, the banking system is central to the country’s economy irrespective of whether banks are locally or foreign owned. Some countries like Australia feel that banks are so systemically important that foreign controlled banks are precluded. Our stance in India is on the middle ground where foreign ownership of banks has been permitted on certain conditions. Secondly, we must not forget that the cost of bank failures is not limited to rescuing banks or bailing out depositors but there can be large real economy costs. Thus, a well reasoned approach of regulating ownership of banks is a necessary concomitant of a stable financial system.

Anti-tying measures

I would now refer to an issue which is at the frontiers of regulation.

Banks and financial institutions are increasingly offering a broad measure of financial services and thereby endeavoring to build customer loyalty. In some countries there are anti-tying restrictions to prevent banks from forcing customers to take unwanted products to obtain needed services. These issues are interlinked to corporate ethics, a robust internal control culture and transparent disclosures. I would submit for debate that sooner or later we in India will need to consider the feasibility of anti-tying regulations in the financial sector. I would invite attention to an interesting presentation by Ms. Susan Schmidt Bies. (BIS Review No. 42).

Further, with increasing consumer spending the data bases of the banks’ customers are also being shared with various product sellers and the cross-selling is acquiring a new dimension of invasion of the privacy of the customer. This is an area where banks need to exercise self-regulation.

Concluding observation

I would end here by saying that the rationale for financial regulation lies in the economic costs imposed on the society by financial market failure. The adverse consequences include threat to systemic stability, the potential for gridlocks due to adverse selection and moral hazard problems as well as undermining the substantial benefits which would otherwise accrue from correction of market imperfections, reduced transaction costs and providing people with a financial system they can trust. In a rapidly changing economic environment the financial system necessarily has to undergo change, however painful it may be.