Y V Reddy: Banks and corporates as partners in progress

Valedictory address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the FICCI-IBA Conference on 'Global Banking: Paradigm Shift', Mumbai, 7 October 2005.

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Friends,

I am thankful to the organisers for giving me the opportunity to be with you and deliver the valedictory address at the FICCI-IBA Conference on 'Global Banking : Paradigm Shift'. It is noteworthy that eminent persons from diverse areas of expertise and experience have participated in the Conference; and quite a few of them are from global bodies such as, BIS and central bankers or banking regulators from Mauritius, Pakistan, Saudi Arabia, Singapore, U.K. and U.S.A. It is difficult to add significantly to the erudite discussions that have already taken place. I am well aware that I will be disappointing some analysts here by not giving my views on the macro-economic front and policy leads. This is a conscious choice as the formal announcement of the Mid-Term Review of the Annual Policy is due in about a couple of weeks. Any meaningful statement by me on monetary policy would militate against the emergence of a collegiate approach to monetary policy which is our avowed objective.

I had some difficulty in choosing a subject for this address since the three Deputy Governors and one Executive Director of the Reserve Bank India (RBI) have spoken at this Conference on almost all the relevant aspects and I also happen to fully agree with them. But the uniqueness of this Conference, in being sponsored by a Chamber of commerce and industry, and the banks' association, warrants some deliberation. Perhaps, it would be appropriate to dwell on certain aspects of how the banks and the corporates can nurture and strengthen their mutually rewarding partnership while also contributing to the progress of our economy.

At the outset, let me briefly recount the strengths of our banks and our corporates, as also the challenges faced by them. The performance of and outlook for the banking sector in India, as evidenced by the movement in Bankex relative to BSE Sensex in the recent years, appear to be positive. Both, the public and the private sector banks have gained in their equity prices and market capitalisation. The interest of Foreign Institutional Investors in the Indian banking sector is considerable and it is widely believed that their exposure to this sector is at the top, amounting to about one-sixth of their total exposure to India. The study of 'India's Top 20 Banks' by the S&P/ CRISIL, released this week, documents the steady improvement as well as their operating resilience and preparedness for Basel II. The Report lists the challenges, the most important being the risk-management and consolidation. RBI expects to release the Report on Trends and Progress in Banking in a couple of months, which, I hope, will add further comfort to the analysts of our banking sector.

Indian corporates have demonstrated that some of them are world-class with noticeable overseas acquisitions; and the global as well as domestic expectations from their entrepreneurship are perhaps unprecedented. S&P / CRISIL have also published a report on "Indian Top 50 Corporates" this week, which is candid in assessing the strengths of India's corporate sector along with possible challenges. As a central banker, I was struck by a remark in the Introduction to the Report. The Report appreciates the overall financial profiles of the top 50 corporates and describes them as currently 'strong' to 'adequate' but comments that the companies choosing to debt-finance their growth could face challenges. It is in this context that the joint efforts of the banks and the corporates in India could perhaps be an imperative for meeting the challenges ahead.

The relationship of the banker and corporate borrower in India has come a long way from the days of highly regulated economy. During the last two decades, there has been a sea change in the outlook of the banks as well as the corporates towards each other. While the balance sheets of banks are now stronger and their operations far more transparent, their lending practices too are better attuned to the requirements of various categories of borrowers. The corporates, on their part, have shown a greater sense of responsibility in the use and repayment of the borrowed funds. A noteworthy aspect is that under current guidelines relating to External Commercial Borrowings, Indian corporates have been able to borrow significant amounts from overseas directly, based on their own credit standing.

In this context, it would be useful to recall some of the important policy initiatives of the RBI relevant to bank-corporate relationship. Dr. Rangarajan's monetary policy of April 1997 announced a package of measures permitting multiple banking arrangements for the corporates and providing greater operational freedom to the banks. Dr. Jalan's policy pronouncements followed through this initiative with development of the money market, move towards universal banking and above all, urging the banks and corporates to put in place sound risk-management systems – particularly for market risks. In 2003, RBI issued a Fair Practices Code to be followed by the banks which aimed at making them more responsive to the borrowers and enhancing the confidence of borrowers in the banks as a source of funds. The procedure for declaring borrowers as "wilful defaulters" has been streamlined so as to afford full opportunity to the corporates to present their viewpoint before so classifying them.

Recent developments that warrant a careful redesign of the bank-corporate relationship include financing by multiple banks, through several instruments including investments, and access to a wider choice of sources of finance for corporates such as capital markets and external financing. Since such choices nudge towards transaction-based banker-customer relationship, these could impinge on the access to the information required by the bankers for financial assessment as also on the ability of corporates to get an assured and appropriately priced financial package. Perhaps there is a need for supplementing transaction-based relationship between banks and corporates with a more active and meaningful dialogue between them. I am sure such meetings do take place even now, but it is worth exploring whether the process needs to be strengthened. In this regard, there may be an advantage in industry bodies like FICCI and IBA embarking upon a review of the existing practices of dialogues between the banks and their corporate borrowers to ensure and enhance trust, transparency and timeliness – the three "t"s of banking. Such a review could perhaps also promote healthy competition amongst banks and add to the comfort of the corporates too.

The Corporate Debt Restructuring Mechanism (CDRM), which became operational since March 2002, is another platform for banker-corporate interface. Its efficacy is evident in the fact that well over one hundred cases have been approved for restructuring under this system. The CDRM was reviewed recently by a Special Group and we expect to bring out, in a couple of weeks, the revised operational guidelines for improvements in the CDRM to make the restructuring smoother for genuine cases.

Another area of common interest to the banks and the corporates is the risk management. The lenders and investors have an obvious interest in accurately assessing a firm's risk-management performance, apart from its underlying financials, so as to understand the risks assumed by the firm and those it has hedged or transferred to others. While the banks' risk exposures and their risk-management strategy is usually an item of public disclosure, there is a corresponding need for corporates too to make adequate disclosures regarding their risk exposures, specially to derivatives and foreign exchange. This would enable the banker to assess the risk profile of the corporate accurately and to evaluate the appropriateness of various financial products on offer. While these disclosures could be made mandatory through the Accounting Standards – on which, I understand, ICAI is working – it would be desirable if the corporates adopt such disclosures voluntarily, sooner than later, in their own as well as the system's interest.

It is useful for the bankers to track the changing dynamics of the pattern of corporate financing. The equity base of the corporate sector, relative to debt, seems to have increased, and many corporates are currently cash surplus, presumably to meet their investment commitments. Besides, the corporates also have access to other funding sources, especially external commercial borrowings and domestic and global capital markets. The Development Finance Institutions have substantially got subsumed in the banking sector and banks are increasingly functioning as universal banks. Banks' lending to households, be it through consumer credit or housing loans, has been increasing in the recent past along with increases in lending to priority sectors. It may, therefore, be worthwhile for banks, especially those with long history, to review their systems and procedures for lending and extending other forms of support to the corporates. An area of concern, in terms of public perception, is that there is under-pricing of credit risk for private sector corporates while there could be overpricing of risks in lending to agriculture as well as small and medium enterprises. There is merit in reviewing the current procedures and processes of pricing of credit, perhaps through a well structured segment-wise analysis of costs at various stages of intermediation in the whole credit cycle.

We also notice that several corporates are active in treasury management. Hence, they need to be well-equipped to identify, measure, manage and control the risks especially when, often, they are counterparties to the treasury transactions of the banks.

Regulatory framework for banks is gradually encouraging banks to assess and manage the risks on their own while regulation focuses on the adequacy and robustness of the systems in vogue in the banks for the purpose. The share of corporates in the lending by the banks, however, does not reflect the full range of the banks' exposure to them as it does not capture significant exposure to corporates through investments in bonds and other instruments. More important, banks' overall exposure would also include the non-funded exposures through credit substitutes and derivatives transactions which have grown significantly over the last few years. The continuing close linkage between the balance sheet of banks and of the corporate sector is, thus, clearly evident but only the nature of bank-corporate interaction is getting diverse and wider. A regulator's comfort, therefore, lies not only in satisfaction about the quality of risk-management in the banks but also in the banks' level of understanding of risk-management by their corporate clients. In a sense, there is an element of delegated supervision to be exercised by the banks over the corporates. In this background, a closer ongoing dialogue across a wider spectrum in a spirit of partnership between the banks and the corporates adds to the comfort of the regulator.

Consistent with the theme of the conference, it is essential to ponder over the implications of the paradigm shift in global banking for the bank-corporate relationship. There are differences across countries in the role and functioning of banks vis-à-vis the corporates. For example, the Anglo-Saxon, the European and the Japanese practices do vary though there is some evidence of elements of convergence with the emerging importance of trans-national corporates, global banks as well as financial intermediaries and increasing global financial integration. In the bank-dominated financial systems, such as in India, banks support corporates not only by direct lending, but also through their positions in money, debt, equity and derivatives markets. Further, the industrial progress involves entrepreneurship, inevitably entailing some measurement and management of implicit risks. As the partners in progress, the banks are now called upon not only to manage the risks in lending but increasingly, to also assess the risks involved in the business to which they are lending. In this background, the case for a more intense dialogue, to the extent of some partnering, becomes stronger.

Let me conclude by complimenting the organisers for the excellent Conference; the participants who met me deeply appreciated the high quality deliberations at this truly global gathering.

Thank you.