Shri V Leeladhar: Indian banking – the challenges ahead

Text of the Third Natarajan Memorial Lecture delivered by Shri V Leeladhar, Deputy Governor, Reserve Bank of India, Chennai, 14 November 2005.

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I deem it an honour to have been invited to deliver this year's G Natarajan memorial lecture. I did not have the good fortune of meeting late Shri G.Natrajan but I have heard a lot about him from my friend Shri V.A. George. As a father of a mentally challenged child I had an insight into the activities of Smt. Poonam Natrajan, founder chairperson of Vidya Sagar, formerly known as Spastic Society of India, Chennai. I am grateful to her for inviting me to address this august gathering. Recently I had an opportunity to read late Natrajan's book – Rupee watch, the story of the Indian Forex Market Retold (1993 -99) which gives us an idea of the deep insight he had on the India Forex Markets during those turbulent days. To pay my homage to this great visionary, I thought nothing could have been more appropriate subject for todays address than – "Indian banking – The Challenges Ahead".

In recent years, there has been a considerable widening and deepening of the Indian financial system, of which banking is a significant component. With greater liberalisation, the financial system has come to play a much larger role in the allocation of resources than in the past and its role in future can be expected to be much larger than at present. The growing role of the financial sector in the allocation of resources has significant potential advantages for the efficiency with which our economy functions. Consequently, the adverse consequences of malfunction of the financial system are likely to be more severe than they used to be in the past. Hence, all our efforts today are focused at ensuring greater financial stability. Given the significance of the Indian banking system, one cannot afford to underplay the importance of a strong and resilient banking system.

The pre-reform period witnessed the following major regulatory constraints on the banking sector which not only distorted the efficiency of the interest rate mechanism but also adversely affected the viability and profitability of banks:

- large pre-emptions – both in terms of the statutory holding of Government securities (statutory liquidity ratio, or SLR) and cash reserve ratio (CRR); and
- complex structure of administered interest rates;

One of the major objectives of banking sector reforms in India has been to enhance efficiency and productivity, which were achieved through:

- reductions in the pre-emptions;
- de-regulation of interest rates;
- enhancement of competition through establishment of new banks in the private sector, more liberal entry of foreign banks, enhancing the role of public shareholders in nationalised banks by gradual reduction of Government shareholding in these banks and allowing foreign direct investment in the private sector banks up to 74 per cent, subject to conformity with the guidelines issued from time to time.

The cumulative effect of these measures is that banks have been accorded greater discretion in sourcing and utilisation of resources albeit in an increasingly competitive environment.

Present position and the challenges ahead

The enhanced role of the banking sector in the Indian economy, the increasing levels of deregulation and the increasing levels of competition have placed numerous demands on banks. Operating in this demanding environment has exposed banks to various challenges.

i) Customer service: It is no longer adequate for banks to provide only traditional banking services. Apart from providing the conventional banking services, banks have begun offering a bouquet of financial services to their clients, including cross selling of financial products. The ultimate aim is to offer a one-stop-shop for meeting varied customers' financial needs. Some banks have begun employing customer relationship management systems to not only retain the existing customers but also to attract new customers. The establishment of new private sector banks and foreign banks has rapidly changed the competitive landscape in the Indian consumer banking industry and placed greater demands on banks to gear themselves up to meet the increasing needs of customers. For the discerning current day bank customers, it is not only relevant to offer a wide menu of services but also provide these in an increasingly efficient manner in terms of cost, time and convenience.

While banks are focusing on the methodologies of meeting the increasing demands placed on them, there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis. Further, experience has shown that consumers' interests are at times not accorded full protection and their grievances are not properly attended to. Feedback received reveals recent trends of levying unreasonably high service/user charges and enhancement of user charges without proper and prior intimation. It is in this context that the Governor, Reserve Bank of India had mentioned in the Annual Policy Statement 2005-06 that RBI will take initiatives to encourage

- greater degree of financial inclusion in the country;
- setting up of a mechanism for ensuring fair treatment of consumers; and
- effective redressal of customer grievances.

It would, therefore, be reasonable to expect banks to focus on the above aspects while designing their products for customers.

ii) Branch banking: Traditionally banks have been looking to expansion of their branch network to increase their business. Against this background it is interesting to observe that the new private sector banks as well as the foreign banks have been able to achieve business expansion through other means. It has been realized that it might not be necessary to establish a wider brick and mortar network to reach a wider population. Banks are, therefore, examining the potential benefits that may accrue by tapping the agency arrangement route and the outsourcing route. While proceeding in this direction banks ought not to lose sight of the new risks that they might be assuming and hence put in place appropriate strategies and systems for managing these new risks.

iii) Competition: With the ever increasing pace and extent of globalisation of the Indian economy and the systematic opening up of the Indian banking system to global competition, banks need to equip themselves to operate in the increasingly competitive environment. This will make it imperative for banks to enhance their systems and procedures to international standards and also simultaneously fortify their financial positions.

iv) Technology: A few banks which have impressive branch networks have not been able to meet their customers' expectations due to inefficiencies arising out of inadequate investment in technology and consequently faced an erosion of their market shares. The beneficiaries are those banks which have invested in technology. Another distinct advantage of use of technology is the ability to effectively use quantitative techniques and models which can enhance the quality of their risk management systems. Recognising the benefits of modernising their technology infrastructure banks are taking the right initiatives. The challenge in this regard will be for banks to ensure that they derive maximum advantage out of their investments in technology and to avoid wasteful expenditure which might arise on account of

a. uncoordinated and piecemeal adoption of technology;

b. adoption of inappropriate/ inconsistent technology and

c. adoption of obsolete technology.

A case in point is the implementation of core banking solutions by some banks without assessing its scalability or adaptability to meet Basel II requirements.

v) Basel II implementation: As you are aware, Basel II is the revised framework for capital adequacy for banks. Implementation of Basel II is seen as one of the significant challenges facing the banking sector in many jurisdictions. With the introduction of capital charge for market risks with effect from the year ended March 31, 2005 banks in India are compliant with all elements of Basel I. I will now outline the approach to Basel II implementation in India. Commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills are developed, both by the banks and also by the supervisors, some banks may be allowed to migrate to the Internal Rating Based (IRB) Approach. Implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. Though last year has not been a very good year for banks, they are exploring all avenues for meeting the capital requirements under Basel II. The cushion available in the system, which has a CRAR of over 12 per cent now, is, however, comforting.

With a view to ensuring migration to Basel II in a non-disruptive manner, a consultative and participative approach has been adopted for both designing and implementing Basel II in India. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) has been constituted wherein representation from the Indian Banks' Association and the RBI has also been ensured. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework have been issued. Though Basel II implementation is considered as a challenge generally, the above approach has lightened the burden on banks in India.

Notwithstanding the above, capacity building, both in banks and the regulatory bodies is a serious challenge, especially with regard to adoption of the advanced approaches. We have initiated supervisory capacity-building measures to identify the gaps and to assess as well as quantify the extent of additional capital which may be required to be maintained by such banks. The magnitude of this task appears daunting since we have as many as 90 scheduled commercial banks in India.

vi) Improving Risk Management Systems: With the increasing degree of deregulation and exposure of banks to various types of risks, efficient risk management systems have become essential. As you are aware, as a step towards further enhancing and fine-tuning risk management systems in banks, Reserve Bank has issued guidelines on asset-liability management and risk management systems in banks in 1999 and Guidance Notes on Credit Risk Management and Market Risk Management in October 2002 and the Guidance Note on Operational risk management in 2005. Though Basel II focuses significantly on risks its implementation should not be seen as an end in itself. It should be seen as a medium whereby the risk management systems in banks are constantly upgraded to address the changing environment.

At the initial stages of development of the risk management systems, banks were managing each risk in isolation. The current business environment demands a more integrated approach to risk management. It is no longer sufficient to manage each risk independently or in functional silos. Enterprises worldwide are, therefore, now putting in place an integrated framework for risk management which is proactive, systematic and spans across the entire organisation. Banks in India are also moving from the individual silo system to an enterprise wide risk management system. This is placing greater demands on the risk management skills in banks and has brought to the forefront the need for capacity building. While the first milestone would be risk integration across the entity, banks are also aware of the desirability of risk aggregation across the group both in the specific risk areas as also across the risks. Banks would be required to allocate significant resources towards this objective over the next few years.

In the Reserve Bank, we have adopted the risk based approach to supervision since 2003 and have brought about 23 banks under the fold of risk based supervision (RBS) on a pilot basis. On the basis of the feedback received from the pilot project, the RBS framework has now been reviewed. The risk based approach to supervision is also serving as a catalyst to banks' migration to the integrated risk management systems. In view of the relevance of improved risk management systems under the changing circumstances and the larger emphasis placed on risk management systems in banks under Basel II, it is essential that the RBS stabilizes at an early date and serves as an important feedback not only to bank managements but also to RBI.

However, taking into account the diversity in the Indian banking system, stabilizing the RBS as an effective supervisory mechanism will be a challenge to the RBI.

vii) Implementation of new accounting standards: Derivative activity in banks has been increasing at a brisk pace. While the risk management framework for derivative trading, which is a relatively new area for Indian banks (particularly in the more structured products), is an essential pre-requisite, the absence of clear accounting guidelines in this area is matter of significant concern. It is widely accepted that as the volume of transactions increases, which is happening in the Indian banking system, the need to upgrade the accounting framework needs no emphasis. The World Bank's ROSC on Accounting and Auditing in India has commented on the absence of an accounting standard which deals with recognition, measurement and disclosures pertaining to financial instruments. The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) is considering issue of Accounting Standards on the above aspects pertaining to financial Instruments. These will be the Indian parallel to International Accounting Standards 32 and 39. The proposed Accounting Standards will be of considerable significance for financial entities and could therefore have implications for the financial sector. The formal introduction of these Accounting Standards by the ICAI is likely to take some time in view of the processes involved. In the meanwhile, the Reserve Bank is considering the need for banks and financial entities adopting the broad underlying principles of IAS 39. Since this is likely to give rise to some regulatory / prudential issues all relevant aspects are being comprehensively examined. The proposals in this regard would, as is normal, be discussed with the market participants before introduction. Adoption and implementation of these principles are likely to pose a great challenge to both the banks and the Reserve Bank.

viii) Transparency and Disclosures: In pursuance of the Financial Sector Reforms introduced since 1991 and in order to bring about meaningful disclosure of the true financial position of banks to enable the users of financial statements to study and have a meaningful comparison of their positions, a series of measures were initiated. The disclosure requirements broadly covered the following aspects:

- Capital adequacy
- Asset quality
- Maturity distribution of select items of assets and liabilities
- Profitability
- Country risk exposure
- Risk exposures in derivatives
- Segment reporting
- Related Party disclosures

With a view to moving closer towards international best practices including International Accounting Standards (IAS) and the disclosure requirements under Pillar 3 of Basel II, Reserve Bank has proposed enhanced disclosures which lay a greater emphasis on disclosure of certain qualitative aspects. Transparency and disclosure standards are also recognised as important constituents of a sound corporate governance mechanism. Banks are required to formulate a formal disclosure policy approved by the Board of directors that addresses the bank's approach for determining what disclosures it will make and the internal controls over the disclosure process. In addition, banks should implement a process for assessing the appropriateness of their disclosures, including validation and frequency.

ix) Supervision of financial conglomerates: In view of increased focus on empowering supervisors to undertake consolidated supervision of bank groups and since the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision have underscored consolidated supervision as an independent principle, the Reserve Bank had introduced, as an initial step, consolidated accounting and other quantitative methods to facilitate consolidated supervision. The components of consolidated supervision include, consolidated financial statements intended for public disclosure, consolidated prudential reports intended for supervisory assessment of risks and application of certain prudential regulations on group basis. In due course, consolidated supervision as introduced above would evolve to cover banks in mixed conglomerates, where the parent may be non-financial entities or parents may be financial entities coming under the jurisdiction of other regulators.

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. In this direction, an inter-regulatory Working Group was constituted with members from RBI, SEBI and IRDA. The framework proposed by the Group will be complementary to the existing regulatory structure wherein the individual entities are regulated by the respective regulators and the identified financial conglomerates would be subjected to focussed regulatory oversight through a mechanism of inter-regulatory exchange of information. As a first step in this direction, an inter-agency Working Group on Financial Conglomerates (FC) comprising the above three supervisory bodies identified 23 FCs and a pilot process for obtaining information from these conglomerates has been initiated. The complexities involved in the supervision of financial conglomerates are a challenge not only to the Reserve Bank of India but also to the other regulatory agencies, which need to have a close and continued coordination on an on-going basis.

x) 'Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards: Banks were advised in 2002 to follow certain customer identification procedure for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to appropriate authority. These 'Know Your Customer' guidelines were revisited in the context of the recommendations made by the Financial Action Task Force on Anti Money Laundering standards and on Combating Financing of Terrorism. These standards have become the international benchmark for framing Anti Money Laundering and combating financing of terrorism policies by the regulatory authorities. Compliance with these standards both by the banks/financial institutions and the country has become necessary for international financial relationships. Detailed guidelines based on the Recommendations of the Financial Action Task Force and the paper issued on Customer Due Diligence for banks by the Basel Committee on Banking Supervision, with indicative suggestions wherever considered necessary, were issued to banks in November 2004. Banks were required to ensure that a proper policy framework on 'Know Your Customer' and Anti-Money Laundering measures is formulated and put in place with the approval of the Board within three months and be fully compliant with these guidelines before December 31, 2005. Compliance with the above is a significant challenge to the entire banking industry to fortify itself against misuse by anti-social persons/ entities and thus project a picture of solidarity and financial integrity of the Indian banking system to the international community.

xi) Corporate Governance: Banks are "special" as they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but they also leverage such funds through credit creation. Banks are also important for smooth functioning of the payment system. In view of the above, legal prescriptions for ownership and governance of banks laid down in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time. In this context, one must remember that profit motive should not be the sole criterion for business decisions. Flow of bank finance for productive purposes must always take priority over the granting of credit for speculative investment no matter how profitable the latter may be. If bank finance flows increasingly to finance speculative activities, it will be to the detriment of real productive investment for research, development and the production of real goods/ services. One might conclude that such uncontrolled flow would ultimately affect economic growth. Hence, funding of speculative activities must be subject to prudential limits, even though it might yield attractive returns. This will be a significant challenge to banks where the priorities and incentives might not be well balanced by the operation of sound principles of corporate governance. If the internal imbalances are not re-balanced immediately, the correction may evolve through external forces and may be painful and costly to all stakeholders. The focus, therefore, should be on enhancing and fortifying operation of the principles of sound corporate governance.

Conclusion

Friends, it is crucial for the banking industry to meet the increasingly complex savings and financing needs of the economy by offering a wider and flexible range of financial products tailored for all types of customers. With the increasing levels of globalisation of the Indian banking industry, evolution of universal banks and bundling of financial services, competition in the banking industry will intensify further. The banking industry has the potential and the ability to rise to the occasion as demonstrated by the rapid pace of automation which has already had a profound impact on raising the standard of banking services. The financial strength of individual banks, which are major participants in the financial system, is the first line of defence against financial risks. Strong capital positions and balance sheets place banks in a better position to deal with and absorb the economic shocks. Banks need to supplement this with sophisticated and robust risk management practices and the resolve to face competition without diluting the operating standards.

Thank You

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Y V Reddy: Banking sector reforms in India - an overview, Karachi, 18 May 2005.