Y V Reddy: Global developments and Indian perspectives – some random thoughts

Valedictory address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Bankers' Conference 2007, Mumbai, 27 November 2007.

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Dr. Khandelwal, Mr. Rao and distinguished friends,

I am happy to be here with the banking fraternity to participate in the Bankers' Conference 2007. I find that there are several conference papers which are of high quality. In fact, they provoked me to think through some of the issues that emanate from the analysis and also some facets which might have escaped the attention of the authors. The result is an urge to share some consequential random thoughts on global developments and Indian perspectives as they interplay in a real world setting.

Overall approach to reforms in the financial sector

The overall approach to reforms in the financial sector in our country, in the context of global developments is worth recalling here. First, we appreciate and analyse relevant theories. Second, we study international practices which are often divergent, even among advanced economies, and are far from being static. No doubt, it is convenient for analytical purposes to offer comments or presume what constitutes a best practice, but, for practical policy purposes, divergence in international practices is no less relevant than convergence. Third, the scope for, limits to and desirability of adoption of prevalent global practices are governed by the legal, institutional and overall socio-political conditions in our country. Fourth, the adoption, in our country, of what is considered an appropriate global practice is often a process that has to be managed carefully, sometimes gradually and often in a non-disruptive manner. Fifth, the desired reforms to align with what are considered appropriate global practices, in financial sector, in terms of timing and redesigning to suit our conditions must recognise the status and developments in the real sector, especially flexibilities, fiscal health and overall governance standards. Attempts to align the financial sector with global practices without similar alignment in the related areas mentioned above may invite avoidable risks. Hence, the pace of reform in the financial sector is governed not by assumed progress in reform in the related areas mentioned above but on a realistic assessment of the substantive movement towards global standards, in those areas.

Benchmarking with global best practices

An important feature of the reform of the Indian financial system has been the intent of the authorities to align the regulatory framework with international best practices keeping in view the developmental needs of the country and domestic factors. Hence, periodic assessments of the Indian financial sector have been undertaken by the Reserve Bank of India (RBI).

The RBI had undertaken a self assessment with regard to the Core Principle for Effective Banking Supervision in 1998 which served as a basis for several regulatory initiatives towards alignment with the international best practices.

A Standing Committee on International Financial Standards and Codes was constituted in 1999 by the RBI in consultation with the Government of India to identify and monitor developments in global standards and codes being evolved in the context of international developments; consider the applicability of these standards and codes to the Indian financial system; and chalk out a roadmap for aligning India's standards and practices to the evolving international standards. The Standing Committee set up ten Advisory Groups in key areas of

the financial sector comprising non-official experts. The recommendations contained in these reports have either been implemented or are in the process of implementation.

In 2004, a review of the recommendations of the Advisory Groups was undertaken to assess the progress on the implementation of the 2002 Report, monitor new developments in the field of international financial standards and codes and provide a future agenda in this area. The Report provided an assessment of the professional staff of the RBI engaged in monitoring the implementation of recommendations and benefited from the views of several inside and outside experts.

The World Bank and the International Monetary Fund jointly brought out, in September 2005, a comprehensive *Handbook on Financial Sector Assessment*. The Handbook is designed for use in financial sector assessments, conducted by country authorities themselves and by the World Bank and IMF teams. The Handbook, available to the public, is intended to serve as an authoritative source on the objectives, analytical framework, and methodologies of financial sector assessment as well as a comprehensive reference book on the techniques of such assessments.

Following the publication of the Handbook by the IMF-World Bank, it was decided to undertake a self-assessment of financial sector stability and development using the new Handbook as the base as also any other pertinent documents for financial sector assessment. Accordingly, the Government of India decided, in consultation with the RBI, to constitute a "Committee on Financial Sector Assessment" (CFSA).

The central plank of the self-assessment by the CFSA is based on three mutually reinforcing factors, *namely*, financial stability assessment and stress testing; developmental issues and, assessment of the status and progress in implementation of international financial standards and codes. To assist in the process of assessment, the CFSA has constituted four Advisory Panels. These are on Financial Stability Assessment and Stress Testing, on Financial Regulation and Supervision, on Institutions and Market Structure and on Transparency Standards. In order to enhance the credibility of this self-assessment, the Committee has decided that the reports of the Advisory Panels would be peer reviewed by a panel of international experts. These are expected to be available for public debate by March / April 2008. I would urge all analysts to refer to the previous reports and comment extensively on the CFSA report in April to guide us on further policy initiatives.

Country context

We do recognise that the pace and context of globalisation is generally influenced by three factors, namely technological progress, inherent desire of people to be free to move and overall public policies of the relevant countries. Globalisation of financial sector is one element of this process and related public policies are one of the many elements that impact the process. RBI's policies are one, though important, part of the overall public policy relevant to financial sector. In this background, it may be useful to put before you the current dominant considerations in the RBI's policy relating to financial sector.

First, as articulated in the recent monetary policy statements of the RBI, the poor tend to reap the benefits of high growth with a time lag while rises in prices affect them instantly. In the short term, the impacts of high growth and price rises are asymmetrical between the non-poor and the poor, warranting a greater emphasis on price stability at this juncture of high growth for maintaining social accord as well as securing popular mandate for the reform process itself.

Second, to the extent there are externalities in terms of financial sector – both positive and, on occasions, negative – the weight for stability in our policies has been higher in view of limited capacity of the poor to bear risks that may occur in the real sector by virtue of developments in the financial sector. The lack of social security mechanisms and public

safety nets in India are also relevant. The design and pace of liberalisation of financial sector in India thus takes into account the due weight for stability.

Third, to enhance efficiency and stability of the financial system and thus contribute to growth and employment, several steps have been undertaken for widening, deepening and integrating financial markets although it is “work in progress”.

Fourth, the overall objective remains growth with stability, but provides for elements of selective fiscal support for ensuring inclusive and equitable growth. Currently, the aggregate annual fiscal burden of subsidisation on account of the above measures, through the financial sector, is estimated to be about a quarter of one per cent of GDP. The RBI’s recommended approach does not preclude subsidisation by the Government but, it disfavours excessive use of banking system to cross subsidise, especially if it were to favour non-poor. RBI favours a financial system that provides incentives to encourage flow of credit at justifiable terms and conditions and for purposes that ensure servicing of interest and principal, i.e., bankability of schemes.

Fifth, an important instrument for influencing allocation of credit in the banking system, keeping in view the compulsion of growth and employment, has been the stipulation regarding bank’s lending to priority sector. The definition of priority sector has been reviewed from time to time to match with the contemporary requirements.

Sixth, in the reform process that commenced in 1992, the reform of the financial sector was early in the cycle. The first stage of the process concentrated on elimination of financial repression which was followed by greater marketisation of financial sector and changes in regulatory regime, consistent with global standards. The process strengthened the financial sector, improved its efficiency, imparted stability, facilitated impressive growth and withstood several global and domestic shocks. The next phase clearly has been to ensure, what may be termed as, “democratisation” of financial sector. The process which was initiated two years ago aimed at ensuring hundred per cent financial inclusion. The process of financial inclusion consists of seeking each household and offering them options for inclusion in the banking system. A beginning has been made to enhance financial literacy and impart financial education to enable vast numbers of new entrants into employment and higher incomes, to better manage their finances in a rapidly marketising financial sector.

Seventh, the institutional reform of scheduled commercial banks reinforced governance standards and witnessed the disappearance of all who could not meet the capital adequacy standards. But, the credit needs of vast section of population, especially of unorganised sector, traders and rural areas are best met by revival, restructuring and revamping of what may be termed as community based banks. These include Urban Cooperative Banks, Regional Rural Banks and rural cooperative credit system.

Eighth, as the reform progressed, it was assumed that deregulation and competition would enhance efficiency and ensure better-than-before quality of service at reasonable, but competitive, cost to the customers. However, while many improvements have taken place, entirely as expected, several adverse features in regard to retail customers were noticed particularly in respect of a few banks. Apart from issues of appropriate pricing, instances of unequal contracts, unfair trade practices, non-transparent fees, intrusion into privacy, excessive penalties, delays in cheque-clearing, arbitrary revision of interest rates or equated monthly installments, usurious interest charges in some cases and excesses by loan recovery agents have been noticed warranting several institutional, policy and procedural interventions by RBI. A delicate balance between competing considerations is needed. To the extent banks have special privileges, the regulator, who has granted such privileges, has a responsibility to ensure financial deepening and widening in an efficient, fair and equitable manner.

Finally, our experience shows that financial sector policies and instruments need to be constantly rebalanced to respond not only to financial markets, prices and overall stability considerations but also to developments in real sector, in particular, trends in growth across

sectors, regions and sections of population. Such a comprehensive, but dynamic, approach to development of the financial sector enhances contribution of financial policies to growth and employment while maintaining stability.

Likely impact of recent global developments

Monetary policy statements and other messages from RBI have been, since 2005, drawing attention to global imbalances, under-pricing of risks, excess volatilities, dispersion of risks to unidentifiable sources etc. During this period, every effort has been made by the RBI to take advantage of favourable global financial environment, while being guarded against the evolving risks. In this background, the recent turbulence in the global financial markets was not a total surprise to us, though the manner in which it has visited was not anticipated. There was special focus on financial stability in recent Policy Statements. The Mid-Term Review of the Annual Policy for 2007-08 issued on October 30, 2007 stated, among other things, that the overall stance of the monetary policy is to be in readiness to take recourse to all possible options for maintaining stability and growth momentum in the economy in view of the unusual heightened global uncertainties and the unconventional international policy responses to the developments in those financial markets.

Subsequent developments have shown that there are continuing elements of uncertainties in the global environment which are unlikely to be clarified or resolved in the very near future. While the overall analysis, including the assessments of likely impact, made in Mid-Term Review remains valid, I would like to add a few words on what factors we are monitoring now and why we feel that extraordinary vigilance of the factors mentioned are warranted by RBI.

We are monitoring (a) the process of restoration of full normalcy in global financial markets; (b) the evolving financial contagion; and (c) the possible spill over to the real sector after accounting for the possible extent of "decoupling". The major reason for extraordinary vigilance by RBI is what I would describe as simultaneous volatilities in several globally significant markets, namely, money, credit and currency markets; asset prices; and commodity prices, especially oil and food items. The current phenomenon of simultaneous volatilities should be viewed in the context of possible repositioning of the world's dominant reserve currency, involving significant wealth, income and terms of trade effects.

Similar stresses unlikely in India

Our banks with overseas presence have confirmed that they have insignificant exposure to the US sub prime mortgage market.

Some analysts have flagged the prospect of a sort of sub prime lending problem within India also. Though there are reports of accelerated emergence of non-performing assets in regard to consumer credit, housing and real estate in a few banks, our preliminary assessment, on the basis of information provided, is that these do not have systemic implications either in terms of solvency or liquidity. There are several reasons why Indian banking system may not invite disturbances akin to sub prime. First, pre-emptive monetary policy actions have been taken to address evolving monetary, credit and inflation environment. Second, several prudential measures have been taken which include higher risk weights and higher provisioning in respect of sensitive sectors, namely capital market, housing, real estate etc. Third, the initial exposure of most banks to the sensitive sectors mentioned above has been very modest. Fourth, intensive supervisory review of select banks was undertaken when it was observed that their off balance sheet exposures appeared large or were rapidly accelerating. Finally, as part of our regulatory regime in regard to banks and financial markets, there has been what may be termed as "focus on liquidity". Recent turbulence in global financial markets was characterized by liquidity issues and there is currently a global debate on the need to focus on liquidity. Hence, a more detailed account of our regulatory focus on liquidity is appropriate.

Regulatory focus on liquidity

As you are aware, the overall liquidity in the system is actively managed by the RBI mainly through the operation of LAF on a daily basis. However, there are challenges in this regard due to volatility in capital flows and governments' balances.

In terms of the evolving global prudential framework, the emphasis has generally been more on capital, as a means of reducing vulnerability to risks, than on prudential requirements for liquidity risk. The issue of liquidity has not been generally addressed in as structured a manner as the issue of capital requirement. Aspects relating to liquidity have been largely left to each regulator to assess and prescribe a suitable framework under Pillar II of Basel II.

In the Indian context, RBI had issued broad guidelines for asset liability management and banks have flexibility in devising their own risk management strategies as per Board approved policy. However, in regard to liquidity risks at the very short-end, RBI has taken steps to mitigate risks at the systemic level and at the institution level as well.

First, RBI had, early on, recognized the risks of allowing access to the unsecured overnight market funds to all entities and therefore restricted the overnight unsecured market for funds only to banks and primary dealers (PD). To enable this phase-out of all non-bank / non-PD participants from the uncollateralized money market, the repo markets – both bilateral repos and collateralized borrowing and lending obligations (a form of tripartite repos), were developed. Since 2005, the overnight call market is a pure inter-bank market. The impact of this has been that the volumes have shifted from the overnight unsecured market to the collateralized market.

Second, greater inter-linkages and excessive reliance on call money borrowings by banks could cause systemic problems in two ways. One, if a bank is not able to repay the loan on the due date or the market perceives that the bank is having funding problems it may not be able to continue borrowing in the inter-bank market. If this results in non-payment, the bank which has lent the funds could itself face liquidity problems if it has also borrowed on an overnight basis to lend to this bank. The risk of financial contagion could also arise if other banks in the system that are similarly placed become affected by such concerns. The external costs of failure – the costs that are not borne by the bank and are, therefore, unlikely to be taken into account in its own planning – are therefore greater. The RBI has therefore introduced prudential measures to address the extent to which banks can borrow and lend in the call money market in relation to the net worth. On a fortnightly average basis, call market borrowings outstanding should not exceed 100 per cent of capital funds (i.e., sum of Tier I and Tier II capital) of latest audited balance sheet. However, banks are allowed to borrow a maximum of 125 per cent of their capital funds on any day, during a fortnight. Similarly on a fortnightly average basis, lending in the call market should not exceed 25 per cent of their capital funds; however, banks are allowed to lend a maximum of 50 per cent of their capital funds on any day, during a fortnight.

Third, recognising the potential of "purchased inter-bank liabilities" (IBL) to create systemic problems, RBI had issued guidelines in March 2007 prescribing that IBL of a bank should not exceed 200% of its net worth (300% for banks with a Capital to Risk Assets Ratio (CRAR) more than 11.25%).

Fourth, like other supervisors, RBI has issued asset liability management guidelines for dealing with overall asset-liability mismatches taking into account both on and off balance sheet items. While prudential limits were prescribed for the first two time-buckets of 1-14 days and 15-28 days, the mismatches in the other time-buckets are determined by the banks themselves. These guidelines have been recently revised to provide more granularity to measurement of liquidity risk by splitting the first time bucket (1-14 days at present) in three time buckets viz. Next day , 2-7 days and 8-14 days. The net cumulative negative mismatches in the three time buckets have been capped at 5 % ,10%, 15 % of the cumulative cash outflows.

The RBI, in its supervisory oversight of banks' activities, also monitors the incremental credit deposit ratio of banks. Although banks may implement sophisticated risk management strategies, this single ratio with a minimum lag indicates the extent to which banks are funding credit with borrowings from wholesale markets or what is now known as purchased funds. As part of supervisory review, RBI engages in a discussion with the banks which have high incremental credit deposit ratios. However, we have also raised these concerns in the monetary policy and encouraged banks to increase deposit mobilization for funding credit. As early as April 2006, the annual policy had stated that "*It is, therefore, necessary to reiterate the need for banks to review their policies in this regard (funding sources) and make sustained efforts towards mobilising stable retail deposits by providing wider access to better quality of banking services. This would sustain prudent business expansion without facing undue asset-liability mismatches*." In April 2007 it was again reiterated that "*While buoyant deposit growth has, to an extent, alleviated the financial constraints on banks, incremental non-food credit deposit ratios remain high … These developments are likely to pose challenges to banks in managing liquidity*."

The RBI guidelines on securitization of standard assets had laid down detailed policy on provision of liquidity support to Special Purpose Vehicles (SPVs). While the policy enabled a liquidity facility, by the originator or a third party, to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to investors, it was subject to certain conditions to ensure that the liquidity support was only temporary and got invoked to meet cash flow mismatches. Any commitment to provide such liquidity facility, is to be treated as an off-balance sheet item and attracts 100% credit conversion factor as well as 100% risk weight. The facility was specifically proscribed for the purposes of a) providing credit enhancement; b) covering losses of the SPV; c) serving as a permanent revolving funding; and d) covering any losses incurred in the underlying pool of exposures prior to a draw down.

Concluding remarks

Let me hasten to reiterate that India cannot be immune to global developments but we, in the RBI, are actively monitoring the global developments, articulating our assessments as well as responses in regard to impact on India and are in a state of readiness to act, as appropriate, in a timely manner. The RBI appreciates the understanding shown and cooperation extended by the banking community. In particular, I appreciate collaboration between RBI and Indian Banks' Association.

Thank you and wish the conference all success.