K C Chakrabarty: Contemporary issues in banking – reflections on viewpoints of a bank economist

Remarks by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at a book release function organised by the Indian Overseas Bank, Chennai, 30 December 2012.

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Dr. M. Narendra, Chairman and Managing Director, Indian Overseas Bank (IOB); Shri A.K. Bansal and Shri A.D.M. Chavali, Executive Directors of IOB; Shri N. Viswanathan, Regional Director, RBI; Smt. Indira Padmini and other General Managers of IOB; Shri M. Ramaswamy, Retired Secretary of Auroville; Shri S. Muthiah, Historian; Shri M.Ct.P. Chidambaram, grandson of the founder of Indian Overseas Bank; Shri B.J. Krishnan, Environmentalist; Shri Bhakther Solomon, Chief Executive Officer of Development Promotion Group; Shri Dharmalingam Venugopal, who is the reason for our assembling here today; serving and retired members of the banking fraternity, other invited dignitaries whom I have not specifically named; ladies and gentlemen. It is a matter of great pleasure for me to be present here today on the occasion of release of Shri D. Venugopal's book "Indian Banking Reforms and After: A Bank Economist's Take". Based on my interaction with Shri Venugopal and reading of his articles, my assessment of him is of an individual with an incisive mind and an ability to dispassionately analyse diverse subjects of concern to the economy.

The book being released today is an anthology of articles written by him in various national and financial dailies over a period of time. It deals with an impressive array of subjects and provides a bank economist's perspective on various issues, which certainly makes an interesting reading. I congratulate Shri Venugopal for the book, of which I had the privilege of writing the foreword, and hope the book gets all the success and accolades that it, so richly, deserves.

The first thing that strikes about the collection of articles featured in the book is the wide time horizon over which the articles were penned. The book succeeds in providing a panoramic view of issues that have confronted the economy over the last two decades, a period that has been exciting for the Indian economy with the country moving from the throes of despair at the beginning of the decade of the 90s to a period of heady growth and further, to the present, when we are facing multiple challenges. The book deftly captures several major landmark events/developments in the banking sector with the perspective of the point of time when these articles were actually written. It is noteworthy that apart from India, Shri Venugopal has also extensively covered the economic developments in China in his articles. Shri Venugopal has made a strong pitch for economic cooperation between the two major Asian markets naming China as the market of the future and stating that India should seek to get its due share of this market. It is actually a tribute to the vision of the man, as he has intensively focussed on two economies that have, since, seen a lot of economic prosperity and have become the cynosure of all in the global market place. As the Indian economy battles challenges on multiple fronts, Shri Venugopal's articles could provide valuable insights into these challenges and provide guidance for overcoming them.

The Indian banking system has seen a complete transformation during the last two decades, in sync with the progress made by the real economy. Almost every aspect of banking operation has seen significant change during this period as banks sought to reinvent themselves in an attempt to retain their preeminent position in the financial system. The period saw banks moving beyond brick and mortar branches to adopt innovative delivery channels including internet banking, ATMs, call centres, kiosks, Business Correspondents (BCs), etc. New products such as retail banking gained prominence. Banks have sought to grow, not just in terms of balance sheet size, but also in terms of greater penetration of banking services to the hitherto unbanked segments of the population. It is reasonable to say that banks have succeeded in rising up to the challenges posed by the unique needs of a transforming economy and have, in no small measure, contributed to the nation's economic progress during this period.

The growth of the banking system and its pivotal position in the country's financial architecture implies that the banks cater to a whole host of diverse stakeholders who have equally diverse expectations. The success of individual banks and of the banking system as a whole depends on how well these stakeholder expectations are met. Some of the problems currently facing the banking industry bear their genesis to banks' inability to align their business operations with stakeholder expectations. In view of the considerable debate (and sometimes noise) generated by the ills plaguing the banking sector, I thought it appropriate to briefly flag some random thoughts on steps the Indian banking industry needs to take, in order to effectively meet the diverse stakeholder expectations and overcome the present challenges. Some of these thoughts also find resonance in the articles presented in Shri Venugopal's book.

A) Productivity and efficiency

Banks play the critical role of financial intermediation by performing the task of maturity and risk transformation, besides providing payment and settlement services. In order to effectively perform these functions, banks need to ensure that they maintain high levels of productivity and efficiency in their operations. Two kinds of efficiency are essential for banks:

- ***Allocational Efficiency:*** This requires banks to ensure that the precious societal resources are allotted to the most productive activities. Besides, while taking allocation decisions, the interests of the most vulnerable sections of the society should also be taken into account.
- ***Operational Efficiency:*** Operational Efficiency requires banks to perform the financial intermediation function in a safe, secure and speedy manner while ensuring that the cost of performing the intermediation function is minimized. While profit margins are important for sustaining banking operations, the cost of operational inefficiencies of banks should not be passed on to customers by way of higher service charges and fees.

Indian banks need to improve both, allocational and operational efficiency, so that the financial intermediation function is effectively performed. This would include reengineering of all critical products and processes by leveraging on innovative technology-based solutions, while retaining a strong customer-centric focus.

B) Financial consumer protection and its linkage to risk management function

Financial Consumer Protection has emerged as a key area of supervisory focus globally. The global financial crisis has highlighted the vulnerability of the consumer class, which has been worst hit in the crisis. The key feature of the exploitation has been the discriminatory, non-transparent and illogical pricing which has affected the poor and vulnerable consumers most emphatically. The product innovations have not focused on customer requirements and have, instead, aimed at serving the interests of the service provider. The basic fact, that the well-being of the consumer is essential for the sustainability and growth of the service provider, has been lost sight of. As part of its regulatory reform agenda, G 20 Finance Ministers and Central Bank Governors have also endorsed a set of High-level Principles on Financial Consumer Protection, underlining its overall importance for financial stability. The principles enjoin upon the supervisors and oversight bodies to ensure an equitable and fair treatment of consumers, disclosure and transparency in product and service offerings along with promotion of financial education and awareness amongst the consumers.

In this context, I would like to highlight some important aspects of consumer protection and risk management that banks need to imbibe in their business processes:

- Pricing of asset and liability products should be transparent and non-discriminatory. At a minimum, it must be ensured that poor do not subsidize the provision of banking services to the rich.
- The business operations of banks should be customer-centric in nature. This should be reflected in all aspects of banking operations including creation of customized products and services, pricing of services, delivery channels, etc. Banks should, inherently, be flexible in their operations so that they have the ability to meet the evolving stakeholder expectations.
- Banks should be able to appreciate the risk-return trade-off involved in various activities. The basic premise that greater return would invariably come from assumption of higher risk, needs to be appreciated and disseminated, both within the organization and to banks' customers. Banks need to develop the ability to discern good risk from bad so that they selectively take on only those risks that are in alignment with the bank's long term strategic vision.
- The culture of efficient risk management needs to be imbibed in the organization's ethos so that everyone from the top management to frontline managers in the field shares a common vision of risk management.

A key related issue is the integrity of MIS in banks. Each bank claims to be oriented towards its customers. But, I have a simple poser. Are the banks aware of the number of customers they have? I am not referring to the number of accounts but the actual number of customers that the bank serves across all business verticals by offering different products. Moreover, most of the banks do not have a system of working out activity wise costs and returns. Unless banks know the return on each and every product, they cannot arrive at a truly risk based pricing.

C) Impaired assets

Another issue which is generating considerable concern and is likely to impact banks' ability to serve its stakeholders is the rising portfolio of non-performing assets (NPAs) and restructured loans. While the downturn in business environment globally and in India has contributed to this rise, we need to reflect on why our risk management practices during boom time were unable to anticipate future downturns and build up suitable safeguards while giving loans.

I do believe that the rising impaired assets is a "governance" issue as banks have forgotten the art of saying "no", except, may be, to small borrowers. Banks need to significantly improve their risk assessment capability and their ability to price risks, so that they take on only those risks that they understand and can effectively manage. I believe that this need is all the more pronounced in the case of public sector banks, which, at times, end up with assets that have been exited by private sector/ foreign banks on account of inherent weaknesses.

The ability to manage NPAs is important in order to preserve the strength of bank balance sheets and to retain the appetite to take on good risks. An attitude of complete risk aversion would not be appropriate as banks are in the business of taking risks, but with adequate safeguards. I note that NPAs are a recurrent theme in Shri Venugopal's articles and hope that they do provide insights into how banks can manage this problem.

Another issue that I would like to bring up before you is the element of discrimination practiced by the banks in restructuring of loans. Analysis of available data indicates that the larger borrowers have invariably received the benefit of restructuring of loans, while the restructuring in case of SME/ agriculture loans has remained abysmally low. I believe that with timely intervention and support from the banks, this sector would have definitely shown much lower levels of impaired assets than it presently does.

D) Financial inclusion

Despite several steps having been taken by the Government and the Reserve Bank of India, the extent of exclusion in the Indian financial system continues to be unacceptably high. The unbanked masses constitute a unique but important stakeholder group for banks, even though they may not be bank customers. Meeting the expectations of this group through financial inclusion efforts presents a huge business opportunity for banks.

While there is no "one-size-fits-all" approach to financial inclusion, it is important that banks recognize three important prerequisites for maximising the benefits of financial inclusion efforts. These are:

- Holistic approach to provision of financial services, not just credit or deposit alone
- Meeting the needs of small firms
- Focussing on segments of population excluded by gender or geographical remoteness

Banks need to focus on leveraging technology to create new business models and delivery channels that are customized to the needs of the targeted population. Technology has the potential to act as a force multiplier in our financial inclusion efforts, provided it is implemented in a planned manner. There is, however, an increasing realization that mere reliance on technology-enabled non-face to face channels alone would not be sufficient to meet our goal of creating an inclusive financial system. There is a need for opening more brick and mortar outlets as delivery points, both as a control mechanism for BCs and to gain the trust and acceptability of the masses.

Our assessment of the progress in financial inclusion since the introduction of Board approved Financial Inclusion Plans is that while there has been considerable progress in the number of accounts opened, the actual number of transactions per account or per BC continues to be extremely low. This reduces the viability of the financial inclusion efforts and would, ultimately, results in concerned stakeholders losing interest in the exercise. The low transaction levels indicate inadequacies on both the demand and supply sides such as deficiencies in BC operations, non-distribution of smart cards, lack of awareness on the part of the account holders, etc. Banks need to identify the causes for the low transaction rates and urgently address them. In order to be successful, sustainable and scalable, financial inclusion should necessarily be commercially viable for everybody including the bank, the BC and the technology provider. However, the pricing should not result in exploitation of the customers.

It is, indeed, very gratifying to note that besides including financial inclusion prominently in his articles, Shri Venugopal, is also working for the financial inclusion of primitive tribes of the Nilgiri district. I am also very pleased to note that he is a great friend and protector of nature, especially the Nilgiris and has been staunchly espousing the cause of the environment throughout his career. We need more such dedicated persons with a genuine passion for inclusive and sustainable growth.

Conclusion

As with the economy, the Indian banking system is also at a crossroads with multiple opportunities and challenges before it. We need to make the right choices now in order to ensure the future of the banking system as the key pillar upon which the economic prosperity of the country rests. Banks are the lifeline of any economy and it is the collective responsibility of all of us to ensure that we have a strong, resilient and inclusive banking system geared up to face all domestic and global challenges.

Opinions of thought leaders such as Shri Venugopal are important in deciding the right course of action for taking the banking system forward. The collection of articles in this book provides insights into how the economy has developed over the last two decades and provides clues to tackling the current challenges. The narratives are in a very simple language and the coverage of a diverse set of topics makes the book eminently readable and useful to most people. I hope the book is the first in a series of many more to follow. I once again congratulate Shri Venugopal for the book and wish it all success. I also thank Dr. Narendra and Indian Overseas Bank for this wonderful function.

Thank you.