K C Chakrabarty: Indian banking – the new landscape

Keynote address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the Mint's Annual Banking Conference 2014, Mumbai, 30 January 2014.

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1. Sukumar and Tamal, thank you very much, for this invite. I am happy to note that you and your paper – the Mint, have been focussing on the process of change for the Indian banking that is presently underway. I see that in many of its writings. By organizing this discussion on "Indian Banking: The New Landscape", it will further spur thoughts and debates in this area. That this discussion has drawn several doyens of the Indian banking, is a testimony to the importance of the issues we face as a banking community. I welcome all the listed speakers, Smt. Arundhati Bhattacharya, Chairman, State Bank of India; Smt. Chanda Kocchar, MD and CEO, ICICI Bank Limited; Shri Aditya Puri, MD, HDFC Bank Limited; Shri S.S. Mundra, CMD, Bank of Baroda; Shri Pramit Jhaveri, CEO, Citibank-India; Shri Sunil Kaushal, Regional Chief Executive, India & South Asia, Standard Chartered Bank as also exclusive audience here comprising of senior members of the financial services industry, members of the print and electronic media; ladies and gentlemen! Let me begin by stating that an "exclusive" audience cannot be a substitute for inclusive banking. Through this process of change, we have to move on faster to serve all in our society. The customer has to be the king and the banks have to shift their attention away from the exclusive club of corporates and High Networth Individuals (HNIs) to those who still fear to tread through the bank's glass doors and feel hesitant to sit on its sofas or approach the counters. Bankers should serve them with a smile and leave them with a feeling that they are as welcome and exclusive as any other and also that the banks can understand their needs and offer them "structured products" as per their requirements. More of this would come later. Suffice to say that "Inclusion" agenda will dominate the new landscape of the Indian banking in the coming days.

Five questions on processes amidst changing business environment

2. I know that you all will be keen to debate issues of emerging new banking structure with its building blocks in the form of new bank licenses, more liberal entry of foreign banks, mergers and acquisitions, required capital infusion to meet Basel III requirements, etc. Yes, these are important issues. But I intend to start my keynote address on the theme of "new landscape for Indian banking" with a little broader sweep. There is a need to bring about significant changes in the banking processes in this country so that the banks of today can remain relevant in the days ahead. In my talk today, I intend to focus on the key challenges in the business environment facing the Indian banking industry and five important process changes that would be needed to meet these impending challenges.

3. ***First,*** with bringing down of the barriers to entry in the banking industry, are we geared for a more competitive banking industry that is likely to emerge? ***Second***, a paradigm shift is taking place in global banking activity and its regulation with greater emphasis on managing financial risks. Are we adapting to it in right measure, without getting carried away by being overzealous in copying the regulatory changes, importing them in a CKD form or are we going to the other extreme of being obstinate and refusing to accept global norms and standards? A corollary to this is the penchant for financial innovations and financial engineering. Are we captive to it or are we using this for the benefit of the real sector that produces goods and services, consumes them, saves some and invests the surplus. ***Third***, fear is the worst substitute for courage, though some dose of it may be necessary to stimulate defences. A question I would like to ask is, in view of the current asset quality concerns, are we making efforts to improve our credit appraisal systems? An important

consideration in this regard would be to appreciate the need for sustainable development and hence, incorporating assessment of impact that the projects financed by the banks may have on the environment and the society. ***Fourth***, technological change is affecting banks as well as other industries. In fact, technology has entered all facets of our lives. It can pose threat as well as throws opportunities for banks. The key point is whether we doing enough to leverage technology to our advantage. ***Fifth***, with increasing competitiveness and information, the customer is becoming more demanding than before. So how are banks gearing up to improve customer service, commoditize products amidst more diversified demand for banking services and consequently, to offer wider menu choices.

Gearing up for competition

4. One inevitable outcome of the changing banking structure will be that the industry would have more players but simply bringing in more players would not make the banking industry more competitive. It is not as if there is lot of concentration in our banking industry. In fact, India scores over many of its peers as well as several advanced countries when it comes to concentration within the industry. Concentration measured by top three banks in total banking assets is just under 30%. This compares well with other countries. For Germany and Japan, it exceeds 75%, while that for China, Brazil, UK and France it exceeds 50% and for the United States it is just over 35%. Herfindahl index, a measure of concentration ratio, shows that concentration is low and the index normalized to a range of zero to unity reads 0.040 for March 2013, down from 0.065 in March 2000. Apart from concentration, on several other parameters the sector appears fairly competitive. Interest rates, both on deposit and lending side are essentially deregulated. Branch licensing has now been freed subject to certain well-founded interventions to ensure that under-banked rural areas are not neglected. Foreign banks can seek licenses on tap. We plan to move in similar direction for private sector banks with passage of time after seeing the outcomes of the current initiative.

5. However, even with these developments, the banking industry cannot be considered truly competitive. The reason for that is the major players have not really started competing with each other. It is only when the dominant players in any business segment start to compete against each other that the consumer truly benefits in terms of prices and quality of service. This sadly is not the case in our banking sector. In my opinion, the bigger and stronger players would not be averse to competition as the new banks are not likely to threaten their position at least in the medium term. The stronger players would rather use this opportunity to further consolidate their position by innovating and improving their internal systems and processes. As I said before, if the customer experience in terms of quality of service and charges has to improve in this country, it can only happen through competition amongst the bigger banks. Therefore, I would request the doyens of the industry present here, who represent the top public, private and foreign sector banks in the country, to begin a healthy competition amongst them.

6. It is not that the regulators support monopolistic tendencies in the Indian banking system. It must be remembered that banking is a tightly regulated sector across the globe and there are stiff entry barriers for obvious reasons. Banks do their business by using depositors' money and it is incumbent upon the regulators and supervisors to ensure their safety. But, we do need more banks in the country for more than one reason. The Net Interest Margins (NIMs) in India have not suffered much despite the pronounced downturn. At around 2.8 per cent at the system level, they suggest that banks can withstand more competition. At the system level, NIMs are closer to 1 per cent for banks in Japan, UK, France and they are even lower in the case of Germany. At the same time, NIMs in India are less than those in Brazil and Russia. Our primary motive for allowing new banks, however, is to increase banking penetration in the country. More banks are needed because we need to take banking across the geography and to all income classes of the population.

Deploying financial innovations to support growth

7. A stark trend in banking leading up to the global financial crisis was rapid financial innovation and financial engineering. The pre-crisis period witnessed efforts by financial engineers to find solutions to real sector problems in the financial sector. A very key reality was lost sight of which is, financial sector exists to subserve the real sector and it should not be allowed to run ahead of the real sector. A number of regulatory reforms have been ushered in since, which has slowed down the pace of financial innovations and the extent of financial engineering. The Dodd-Frank Act in the US and other regulatory changes in the euro zone and the UK have changed the face of banking. Through the crisis and after the crisis, Indian banking industry faced a more stable regulatory environment that allowed changes and transformation to occur with due cognisance of the international standards and codes, but India neither retracted on the financial deregulation nor did it discourage new innovations within the ambit of its regulatory system and genuine market needs. Consequently, we have seen introduction of several new financial products that include credit default swaps, new cash-settled interest rate futures, inflation indexed bonds and certificates, etc.

8. Once the global financial crisis is behind us and banking reforms in its aftermath completed, the pace of financial innovations can pick-up again. But we need to ponder if our financial innovations are growth-supportive or create mere notional financial gains and losses. Financial innovations bridge the missing markets to provide complete markets, reduce agency costs, facilitate risk sharing and improve efficiency and economic growth. However, they can lead to weaker financial and credit discipline, encourage excessive risk-taking, add to market volatility and fuel asset price-led or credit-led boom-bust cycles risks. All these evils will mitigate if we, as bankers, focus on financial innovations to support economic growth. The innovations must lead to affordability. The innovation has to be what Dr. R. A. Mashelkar calls “inclusive.” Innovations must be aimed at serving the needs of the society. The benefits of innovations must reach the masses in form of cheaper prices and accessibility. Where do we stand on this today? Have there been any efforts to provide suitable banking products to those whose access to finance is restricted? Are there products that can meet the needs of a street hawker or the seasonal needs of an agrarian labourer? Why have our efforts at financial inclusion been so supply-driven and not demand-led? As I mentioned earlier, eliminating financial exclusion in all its manifestations would have to be one of the underlying missions for the banks.

Globalisation of regulation

9. An important fallout of the Financial Crisis has been internationalization of bank regulations. More and more bank regulations are emerging out of shared understanding amongst the members of the Basel Committee on Bank Supervision, Financial Stability Board, the IMF, the World Bank etc., primarily with the objective of ensuring financial stability in a highly interconnected global financial system. As a member of the BCBS and FSB, India too is committed to implementing the regulatory, supervisory and other financial sector policies which these global standard-setting bodies decide upon. In fact, the implementation of the regulations would be reviewed by peer regulators. Therefore, the Indian banks have to be ready to “expect the unexpected” and prepare to live with more and more stringent regulations. It is high time our banks start adopting the international best practices in their operations and stopped seeking regulatory forbearance at the earliest sign of distress.

Strengthening credit appraisal system to address asset quality issues

10. With each quarterly corporate results season, we see some market nervousness surrounding asset quality for the banks. Some of the concerns are genuine responses to the deterioration in the asset quality. However, there also needs to be a recognition that NPA cycles do take a turn with changing business cycle conditions. With the economy slowing

down, gross NPAs of the public sector banks have increased from 2.3 per cent in March 2011 to 4.8 per cent in September 2013. In net term, their ratio went up from 1.0 per cent to 2.8 per cent over the same period.

Moreover restructured standard advances to gross advances rose to 6.6 per cent by September 2013. Undeniably, these are signs of deterioration. Yet one needs to consider that restructuring is a legitimate banking activity so long as it is practiced with due diligence and does not become a conduit to financial indiscipline. There are silver linings too. Slippage ratio of public sector banks has improved, coming down from 3.1 per cent at end-March 2013 to 2.1 per cent at end-September 2013. There is some hope that the NPA cycle might bottom out ahead, especially if economic recovery sets in and investment activity picks up.

11. However, the question we need to ask ourselves is whether the fall in slippages comes out of good luck or good policies by the bank boards. Have banks learned some lessons from this cycle of asset quality deterioration? The cycle has certain distinctive features in that apart from cyclical slowdown, structural and sector-specific issues have worsened the asset quality of the banks. Several investment projects, especially in infrastructure space, have got stuck for want of environmental or forest clearances or due to constraints on the resources front. Banks clearly lacked expertise in evaluating these projects. There was no contingency planning. No exit route was thought of. Going forward, a key consideration for the banks and more specifically for public sector banks, would be to make a demonstrable improvement in their credit appraisal system. Some of you might have gone through my presentation in BANCON 2013 titled "Two Decades of Credit Management in Indian Banks: Looking Back and Moving Ahead". A very disturbing fact which hits us is the quality of equity that has been brought in by the promoters. The banks, to put it mildly, have been very lackadaisical in the credit appraisals. Most of the time it is debt raised elsewhere by the promoter, either in the holding company or in a SPV, which is used to fund their portion of the equity. Effectively, promoters do not have any "skin" in the game and they are least bothered whether or not the projects see the light of the day. The "source" and "quality" of equity brought in by the promoters is a major element which the banks would have to carefully examine in their credit appraisal going forward.

12. Let me now come to another common lacuna in the banks' credit appraisal process. We know that banks and financial institutions are leveraged entities but the leverage witnessed in some of the corporate groups dramatically overshadow the leverage of the banks. Evidence suggests that the banks were not taking adequate cognisance of the build-up of leverage while sanctioning or renewing limits. In fact, banks' credit appraisal processes failed to differentiate between promoter's debt and equity and over time, promoters' equity contribution significantly declined and leverage increased. In particular, there has been a significant increase in the indebtedness of large business groups in recent years. A study of ten large corporate groups has revealed that the share of these groups in total banking sector credit more than doubled between 2007 and 2013 even while, the overall debt of these groups rose six times (from under Rs. one trillion to over Rs. six trillion). Hence, this is an area where the banks need to focus more closely in future.

13. At the same time, banks cannot ignore their own capital requirement for supporting the projected growth of their balance sheet. They must closely look at the state of the economy, expected credit expansion, requirements of provision for loan losses and other present and future liabilities and model them into their capital requirement.

14. As I mentioned earlier, another area where the banks need to be sensitive about in their appraisal is the environment. Banks as the financing agent of the economic and developmental activities have an important role in promoting overall sustainable development. It is in this respect that the concept of green banking has emerged and is recognized as an important strategy to address sustainable development concerns and creating awareness among people about environmental responsibility. Promoting Green banking has to be the way forward for banks across the globe. Green Banking entails banks

to encourage environment friendly investments and give lending priority to those industries which have already turned green or are trying to go green and, thereby, help to restore the natural environment.

15. As a part of the Corporate Social Responsibility, the companies are required to integrate social and environmental concerns in their business operations and in their interactions with their stakeholders on a voluntary basis. The banks /financial institutions would also need to keep themselves abreast of the latest developments in this area and help build a sustainable environment through good banking practices. This is important for ensuring that the banks remain socially relevant.

16. The banks need to beef up their market intelligence and economic analysis, so that they can catch demand-supply gaps, such as those in minerals and mining space, better than they have. Only then can the deterioration in asset quality be turned around. Have the banks sufficiently moved in this direction? I would rather wait for your introspection rather than the answer.

Know your customer, his business and business risks

17. Let me now turn to a related issue, which is KYC. This is to my mind one of the most misunderstood concepts in banking parlance. KYC to a certain extent can be considered as a necessary evil. But, KYC goes much more beyond a simple proof of identify and proof of address for the banks. KYC is a critical component of a bank's risk management framework. A customer-centric business needs to know its customer, the nature of his business and the inflows/ outflows into the accounts, if it is to provide customised business products and solutions. This, I call as KYC-B. The banks further need to understand the risks associated with customer's business to manage risks arising from potential delinquency, fraud and consequent losses as also legal and reputational risks arising from exposure to customers having links to Multi level Marketing (MLM) business/terrorist activities/ hawala transactions, etc., which is another manifestation of KYC and may be termed as KYC BR. The Know Your Customer (KYC), Know Your Customers' Business (KYC-B) and Know Your Customers' Business Risks (KYC-BR) should be ingrained in the DNA of the bank's business. It should be understood that it is not just procedural compliance, but that good KYC and KYC-BR compliance are important for the bank's business.

Leveraging technology and making technical progress

18. A wave of technology change has already occurred as banks adopted core baking technology to enhance customer relationships and expand the market for banking services. These technologies could enable banks to "go-to-customers" and enable door-step banking through virtual banking. For instance, cloud computing and big data technologies can reap both scale and scope economies. What is important is not the name of the technologies, but what they do eventually. Banking technology is poised to make a big leap in the near term towards integrating customer data across banking platforms, facilitating trading in a more secure manner, developing virtual desktops and private clouds to centralize information across desktops by making them available to different employees on need-basis, enable speedier transaction processing and faster settlements.

19. Technology should not, however, be acquired for the sake of it. Unless, it is employed gainfully and helps enhance procedural and cost efficiency, technology adoption cannot be considered meaningful. The technology ought to help the banks achieve cost-effective scalability in the services they render. Such technology should contribute to enhancing productivity, especially through total factor productivity growth in the banking industry. I, however, see statements suggesting that the cost of service delivery has escalated post adoption of technology and bankers are contemplating levying charges on their own customers for using their ATMs. I find the position quite amusing actually. Have we made a comparative assessment of the expenses of delivering services at the branch and

the ATM? I urge my banker friends to take a holistic view of things and harness the technology to its optimum rather than blaming the technology itself.

Commoditizing banking products amidst wider menu choices

20. Two emerging trends in the banking space are greater competition and a more discerning customer, who is aided by less information asymmetry and more knowledge in the world where ICT revolution has occurred and where media and internet penetration has empowered him. In this world, what strategy could work best for the banks? Actually they need to realize that customer wants wider menu choice and more tailored products to meet their needs. At a time when banks are facing increasing competition amongst themselves, as also from non-banking intermediaries, they are left with little choice but to adapt themselves to meeting the customer needs or else risk losing their clients. At the same time, more competition also means that they need to reap economies of scale and scope more fully. For reaping these, banks need to commoditize their products and produce them in large scale so as to bring down the average and the marginal cost of producing them. The banking in that sense has to traverse from being “class” to “mass”. This is quite a challenging job.

21. The solution perhaps lies in banks turning themselves into mega stores, with a wide array of services that it can offer, leveraging on technology. They can then offer customized web pages for individuals based on their profile and the need. This alone can ensure cost-effective delivery of products and services right at customers’ door steps.

22. Talking of customers let me remind you that consumer protection and fair market conduct are two themes which are at the forefront of regulators’ agenda and would continue to engage their attention going forward. The growing regularly activism is evident in the frequency and quantum of penalties being levied on banks worldwide. Whether, it is the European Commission slapping record fines on major banks and financial institutions for making undue profits or masking their problems by fraudulently rigging the rates or whether it is the US Fed putting fines on the banks in America for selling bad loans to government-controlled companies Fannie Mae and Freddie Mac, the trend of activism has emerged. An outcome of these developments has been creation of new regulatory bodies to focus exclusively on consumer protection and financial market conduct. We are also witnessing a lot of mis-selling by the banks, not only of the banking products but also the non-banking financial products that they sell at their braches, especially insurance. The purpose of allowing banks to sell the non-financial products is not to create an avenue for generating non-interest income and to facilitate customers’ diverse needs. So the banks must not aim only at the former and they should, in fact, link their sales to the needs of their banking customers. The insurance products that the banks sell must be low premium with the income for banks staggered over the entire life of the product. Believe me, unless we mend our ways quickly, we must be prepared for more intrusive regulation in this area with a significant bearing on your compliance cost.

23. I would conclude by saying that rather than worrying about the new landscape that the banks would have to encounter, the brilliant minds assembled here must deliberate on the actions that they need to take to prepare the banking sector to face the upcoming challenges. I believe that the panel discussion would throw up some actionable ideas. These are some of my thoughts that I want to leave with you in the twilight of my career as a banker and bank regulator. However, as I see the tectonic shifts occurring in the banking space ahead, I cannot afford to rest. As they say, age wrinkles the body, quitting wrinkles the soul. So I can go on and on, but in the interest of time, let me close by wishing you all a fruitful deliberation.

Thank you!