R Gandhi: Designing banking regulation in aspiring economies – the challenges

Keynote address by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the 41st Annual Convention of the Department of Business Economics, University of Delhi, New Delhi, 29 September 2014.

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1. Prof. Suresh Aggarwal, Head of the Department of Business Economics, University of Delhi, delegates to this flagship 41st Annual Convention of the Department and students participating in the convention – very good morning! It is an honour for me to be here today to deliver the inaugural address of the convention. The convention provides a valuable platform for interaction between the industry and academia on various current issues relevant to creating conducive business and growth environment. Banking is the backbone to the development of trade, investments and business in any country and provides crucial credit and payment infrastructure and services to an economy. In this backdrop, I thought that it may be appropriate for me to dwell on the main features of the Indian banking regulatory firmament, specifically, on how the Reserve Bank has tailored its regulatory stance and the banking regulation framework to suit the evolving needs of the economy and disparate stages of economic development. My address today, therefore, traces the evolution of banking regulation in India since independence to highlight the main thought process behind it as well as the challenges ahead in banking policy formulation.

What and why of banking regulation

2. Banks are special and therefore, exposed to special risks and challenges. In the course of fulfilling their primary function of financial intermediation they are intricately connected with various other drivers propelling growth and stability in the real sector. Banks are conduits for monetary policy transmission and serve as the backbone for credit creation and payments and settlement systems. Also, banks are highly leveraged institutions and function in fiduciary capacity. Therefore, the more immediate motivations for banking regulation are the protection of the depositors' interest and maintaining public confidence in the banking system. Banking regulations also aim at building efficiency and resilience of the banking system on the one hand and address the concerns that arise from the functioning of the financial system. Financial risks are more dynamic than static and assume more intrepid forms with the evolution of the banking functions, products and financial innovation, increased functional integration and decentralisation. Contagion and systemic risk, moral hazard, too big to fail phenomenon, public bailouts of banks are some of the issues that came under sharp scrutiny following the global financial crisis that erupted in 2008. As such banking regulation assumes critical significance to retain the resilience and soundness of the banking entities on the one hand and the macro-prudential stability of the financial system as a whole on the other and thereby also prevents volatility and disruptions in the real sector and the overall economy. Then, there are, of course, the structural and developmental issues relevant to a particular economy and the financial system which, in a large part, provide the backdrop for the regulatory measures.

3. Banking regulation can take the form of formalised legislation and statutory provisions, regulatory directions and guidelines, moral suasion, etc. Different times, evolutionary stages in banking and the various financial and banking crisis have all influenced the regulatory form and substance from time to time. World over, regulation for the banking sector has gone through cycles which range from prescriptive to principle based to a less pervasive format allowing the market mechanism to take precedence (market oriented form of regulation), from structural restrictions to micro and macro-prudential regulation, etc. As the effectiveness of traditional control based rules diminishes with increasing competition, liberalization,

globalization and innovation, ongoing regulatory reform assumes great significance. The recent global financial crisis demonstrated the overwhelming need for evolving commensurate banking regulation as also the need for the regulatory reform process to remain ahead of the developments in the banking functions, products and services.

4. I intend to give you a peep into the contextual circumstances that led to the regulatory measures in the Indian banking sector, as also the rationale for considering these important reforms and / or changes. While one of the prime thought in this context has always been the need to align the Indian policy measures and regulatory guidelines with the international best practices, the different stages of economic growth in the country have had an important bearing on the regulatory process in the banking sector.

Banking regulation in Emerging Market Economies (EMEs)

5. An emerging market economy (EME) is an economy that has some characteristics of a developed economy but is not yet a developed economy; it has aspirations to be a developed economy one day; it has certain distinct characteristics and differs from developed economies in multifarious ways. An EME is as an economy with low to middle per capita income with dominance of the proportion of the global population. EMEs are typically classified as emerging because of the relatively recent initiatives at development and reforms and beginning to open up their markets and "emerge" on to the global scene. EMEs are expected to be fast-growing economies; the need for, as also the level of savings, investments, both domestic and foreign, consumptions and rate of growth are all expected to be higher and much faster due to the smaller base effect.

6. Accordingly, the EMEs have their specific economic and developmental needs and agenda. The global banking regulatory standards, or for that matter, the regulatory framework for any other financial sector segment is designed more to suit the needs and the level of development in the advanced economies. The fundamental reason for this is their dominant presence and role in the global standard setting fora as also the more advanced stages of their financial sector development including the higher level of complexity, variety and sophistication of financial products and services innovated /offered in these economies. However, the existing financial intermediaries and the available financial products and services in the EMEs often fall grossly short of meeting the requirements of higher and faster growth, savings, investments etc. Moreover, the requirements of funding infrastructure and social sectors, as also the real sector, are unprecedented, particularly in view of the serious constraints on funding, muted investor and international confidence, under developed condition of the social and public institutions, lower levels of appropriate skills, specialisation and expertise, etc. The risks and volatility emerging from the foregoing are equally large and often alien to the EME milieu. That is why the regulatory standards, often designed keeping in view the ground realities in the advanced economies, may not also always be a perfect fit for the emerging economies and the EMEs use national discretion in this respect while at the same time making sincere attempts at aligning their regulatory framework with the global best practices.

Evolution of banking regulation in India

7. Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the RBI Act, 1934 (the Act). This marked the culmination of the prolonged efforts, to set up a central bank in the country. The principle of aligning the regulatory structure to the specific needs of the country and for that matter to even go beyond the prevalent wisdom and ethos were distinctly visible at that time itself. Despite the Reserve Bank being constituted as a central bank, it was thought fit to prescribe in the statute itself a development role for the Reserve Bank. Accordingly, the Act has a provision that the Reserve Bank will develop and maintain expertise in agricultural development (later expanded as rural development) and

related subjects and thus began the role of the central bank being sensitive to the need of the economy.

8. Private banks were then on the scene, though the money lenders were the major source of funding. A usurious and exploitative system prevailed. As such, after independence in the year 1947, the Indian banking industry was brought under the regulatory ambit of the Reserve Bank of India with the passing of the Banking Companies Act in the year 1949. Later, in March 1966, certain co-operative societies were brought within its fold and this act was renamed as the Banking Regulation Act, 1949 (BR Act). This enactment brought significant powers to the Reserve Bank of India (RBI) over the banks. Though anointed as the regulator, the Reserve Bank was, is and will be conscious of its responsibility to be alive to the aspirations of the economy.

Promotional and developmental role of the Central Bank in India

9.The basic function of the Reserve Bank, according to the preamble of the Reserve Bank of India Act, is to regulate the issue of Bank notes and the keeping of the reserves with a view to maintaining monetary stability in India and generally to operate the currency and credit system of the country to its advantage. This function imposes on the Reserve Bank the responsibility for:

- Operating the monetary policy for maintaining price stability and ensuring adequate financial resources for developmental purposes;
- Promotion of the efficient financial system; and
- Meeting the currency requirement of the public.

10. In the process of discharging these responsibilities, the Reserve Bank over the years acquired a wide range of promotional and developmental roles. The Government's efforts to accelerate and sustain growth of the economy through planned development process and to realize its socio-economic goals also warranted a complimentary role from the Reserve Bank. The First Five Year Plan emphatically stated, that "central banking in a planned economy can hardly be confined to the regulation of the overall supply of credit or to a somewhat negative regulation of the flow of bank credit. It would have to take on a direct active role of, firstly, in creating or helping to create the machinery needed for financing developmental activities all over the country and secondly, ensuring that the finance available flows in the directions intended".

Establishment of specialized institutions

11. In order to meet this mandate that devolved outside the objectives defined in the RBI Act, 1934, in the years of the Five Year plans beginning from 1950–51, the Reserve Bank embarked upon a number of specialized initiatives. These included establishment of a well defined structure of credit institutions to promote savings and capital formation and to widen and deepen flow of agricultural and industrial credit.

12. Apart from furthering the development of cooperatives to provide short-term credit to agriculture, the Reserve Bank established a separate institution, viz., the National Bank for Agriculture and Rural Development (NABARD) for provision of medium-term and long-term refinance for agriculture and rural development as also for providing consultative service to the Government and banks and generally coordinate its activities in area of agricultural credit with those of the agencies engaged in purveying such credit. Further, in the absence of an active capital market, the Reserve Bank actively assisted in setting up of several specialized financial institutions at all India and also regional level, to widen the facilities for term-finance to industry and for institutionalization of savings. This included establishment of Industrial Finance Corporation of India (IFCI), State Financial Corporations, Industrial Development Bank of India (IDBI) and Unit Trust of India (UTI). In order to provide a safety net for the small depositors and to encourage commercial banks and other financial institutions to grant

loans to various categories for small borrowers, the Reserve Bank promoted the Deposit Insurance and Credit Guarantee Corporation of India Limited (DICGC) for providing insurance and guarantees against the risk of default in payment by the banks or to the banks.

13. Further, the Reserve Bank also helped establish specialized institutions for specific type of financing, like National Housing Bank (NHB) and Export Import Bank of India (EXIM Bank). For ushering in market making in government securities and treasury bills, the Reserve Bank established the Discount Finance House of India (DFHI) and the Securities Trading Corporation of India (STCI). The Reserve Bank also helped promote market infrastructure institutions like the Clearing Corporation of India Ltd (CCIL) and the National Payment Corporation of India Ltd (NPCI).

Expansion of the scope and reach of the Indian banking system

14. Even though, up to the late 1960's the Indian banking system made reasonable progress, there were still many rural and semi-urban areas which were not served by banks. The large industries and the big and established business houses tended to enjoy a major portion of the credit facilities, to the detriment of the priority sectors such as agriculture, small-scale industries and exports. Thus, with the primary objective of achieving efficient distribution of resources in conformity with the requirements of the economy and in order to meet the needs of the priority sectors, the Government decided to introduce social control over banks by amending the banking laws. Accordingly, on July 19, 1969 and April 15, 1980 respectively, 14 and six major Indian scheduled commercial banks in the private sector were nationalised. Social control marked a transitory stage in the evolution of banking policy and in this process; a system of credit planning and the Lead Bank Scheme were operationalized by the Reserve Bank to make the banking system function as an instrument of economic and social development.

15. In conformity with these desired objectives of social control, the banking policy was reoriented in the seventies for securing a progressive reduction in poverty, concentration of economic power and regional disparities in the banking facilities. The promotional aspects of the banking policy came into greater prominence. In this direction, the branch expansion policy was designed, among other things, as a tool for reducing inter-regional disparities in banking development, deployment of credit and urban-rural pattern of credit distribution. Administered interest rate policy emerged as an important instrument for directing the flow of funds and for augmenting the pace of deposit mobilisation. The Reserve Bank opted for selective extension of credit under the Selective Credit Control scheme to those sectors that were accorded priority in conformity with the national objectives. The objective was to correct undue price fluctuations in respect of certain commodities such as food grains and agricultural raw materials arising from speculative activities. The main instruments of Selective Credit Control were a) minimum margins for lending and b) ceilings on the level of credit against stocks of selected commodities to control the quantum of credit given.

16. The period since 1985 was a process of consolidation which involved, i) comprehensive action plans by banks covering organization, structure, training, house-keeping, customer service, credit management and recovery of bank dues, productivity and profitability, ii) phased introduction of modern technology in banking operations with emphasis on financial viability by easing some of the policy related constraints on profitability, iii) strengthening capital base of banks and iv) allowing them flexibility in several areas.

17. By the end of eighties, the Indian economy had developed an extensive financial superstructure consisting of a vast network of institutions, deploying varied instruments and facilitating the mobilisation and channelling of funds for working capital and production credit purposes as well and for long term investment. The Reserve Bank thus helped promote and nurture a functionally varied and spatially diversified financial system.

Financial sector reforms of 1990s – new economic policy regime

18. In the economic planning phase initiated in April 1951, which postulated financial and physical controls for rapid economic and social developments, the financial system was increasingly called on to meet the financial needs of the economy. Commercial banks were subjected to interest rate controls and regulations such as the pre-emptions in forms of cash reserves ratio (CRR) and statutory liquidity ratio (SLR), directed lending, prescription of norms governing credit dispensation. The CRR and SLR that together imposed a marginal pre-emption of around 28% of bank deposits in 1951, increased to 63.5% in 1991. In addition, credit allocation at concessional rates at designated priority sectors constituted a major portion of bank credit and over time, this rose up to 40%.

19. Though the steps initiated post 1951 propelled development of resource mobilisation and deployment relative to the pre 1951 period, several distortions, rigidities and weaknesses crept into the financial system which hindered it from playing its role in ushering in a more efficient and competitive economy. The efficiency, productivity and profitability of the banking system were severely challenged. Banks became saddled with a large volume of non-performing assets. The acceleration in economic growth witnessed in the eighties was also associated with macro – economic imbalances and persistence of structural rigidities. By 1990, against the background of the weak macro-economic situation with rising inflation, high fiscal deficit, low economic growth and unsustainable current account deficit, the Gulf war precipitated the balance of payments crisis. This led to loss of international confidence and as a consequence international commercial borrowing dried up and non-resident Indian deposits recorded net capital outflows. The foreign exchange reserves touched a low of US $1 billion (roughly equal to two week's imports) in June 1991. Besides, by August 1991, inflation had reached a peak of 17% on annualised basis. These factors coupled together put pressure on India in meeting its international commitments.

20. The situation called for strong measures towards macro-economic stabilization and removal of structural rigidities. As a response, an intensive reform programme for developing a competitive environment as a means of improving productivity and efficiency of both the economic and financial system was initiated. Deregulation of the real sector and removal of the license and permit system that was prevalent in and constrained almost all spheres of production and domestic trade were a part of these initiatives. It was, however, recognized that the financial sector reform was a necessary concomitant to the trade and industrial policy liberalization.

21. An overhaul of the Indian financial system was initiated as part of the structural reforms. In August 1991, the GOI set up a high-powered Committee on the Financial System (CFS) under the Chairmanship of Shri M. Narasimham, to examine all aspects relating to the structure, organization, functions and procedures of the financial system and made wide-ranging recommendations which formed the basis of financial sector reforms relating to banks, development financial institutions (DFIs) and the capital market in the years to come. The Committee's recommendations aimed at improving the allocative and functional efficiency of the banking sector while putting in place a vibrant, diversified, competitive and efficient system.

22. During the first phase (1991–92 to 1997–98) of reforms, several mutually reinforcing measures were initiated with focus on strengthening the commercial banking sector by applying prudential norms, providing operational flexibility and functional autonomy as also strengthening of the supervisory practices. The important measures undertaken during this period covered adoption of capital adequacy norms to strengthen the capital base of the banks, strengthening the IRAC (Income Recognition and Asset Classification) norms to enable realistic assessment of the asset quality of banks; phased reduction in the SLR and CRR to augment the lendable resources of banks; rationalization and gradual deregulation of interest rates for inducing competitiveness; permitting new players in the banking sector to enhance competition and granting greater flexibility in branch expansion. Another important

aspect of the reforms in this phase was new institutional arrangements like setting up of the Board for Financial Supervision (BFS) within the Reserve Bank in 1994 for strengthening the arrangements for monitoring and supervision of banks, especially in view of the increased risks faced by banks in the liberalized environment; instituting a state of-the-art Off-site Monitoring and Surveillance (OSMOS) system for banks in 1995 as part of crisis management framework for Early Warning System (EWS) and as a trigger for on-site inspections of vulnerable institutions; operationalisation of the Banking Ombudsman Scheme for expeditious and inexpensive resolution of customer complaints against deficiency in banking services and compilation and dissemination of credit information so as to contain incidence of fresh NPAs. Several other channels of NPA management were also instituted including Lok Adalats, Debt Recovery Tribunals (DRTs), Corporate Debt Restructuring Mechanism and Asset Reconstruction Companies (ARCs) for strengthening credit appraisal and recovery framework.

23. The focus in the second phase (1998–99 and beyond) was on further strengthening of the prudential norms in line with the international best practices, improving credit delivery, strengthening corporate governance practices, promoting financial inclusion, strengthening the urban co-operative banking sector and improving the customer service. The experience of banks facing asset-liability mismatches in the South East Asian countries during 1997, underlined the need for putting in place sound asset liability management (ALM) practices. The ALM framework was, therefore, complemented with guidelines on risk management. One of the significant achievement of this phase was the introduction of comprehensive policy framework of ownership and governance in private sector banks in February 2005 to ensure that (i) ultimate ownership and control was well diversified; (ii) directors and CEO and the important shareholders were 'fit and proper' and observed sound corporate governance principles; (iii) private sector banks maintained minimum net worth of Rs.300 crore for optimal operations and for systemic stability; and (iv) policy and processes were transparent and fair.

Impact of the financial sector reforms

24. The reforms had the desired outcome of strengthening the banking sector; providing more operational flexibility to banks, enhancing the competitive efficiency, and strengthening the legal framework governing operations of banks. In addition, the reform measures had a major impact on the overall efficiency and stability of the banking system in India. The outreach of the banks increased in terms of branch / ATM presence. The balance sheets and overall banking business also grew in size. The financial performance of Indian banks improved, as reflected in their profitability. Following the 1st phase of reforms, the performance of nationalised banks particularly, showed significant improvement. In the second phase, the capital position improved significantly and banks were able to bring down their non-performing assets sharply. As the asset quality began to improve, banks also started expanding their credit portfolio which included increase in the flow of credit to the agriculture and SME sectors. Intensified competition however, narrowed down the margins. But despite this, banks improved their profitability among others, due to increased volumes and improvement in asset quality. Return on assets improved from 0.39 at the beginning of reforms in 1991–92 to 0.50 in 2001 –2002. The reform phase also witnessed increased use of technology which in turn, helped improve the customer service in banks.

25. During the period of reforms, conforming to international standards and best practices was the primary driver. It is equally true that the economy's difficult situation in the beginning and the liberalizing, globalising and growing economy also dictated such an approach.

Shift towards macro prudential regulation

26. The reform process did not cease with the second phase of reforms but remained a progressive ongoing practice in the Indian banking system. The most significant among these and much applauded in the aftermath of the financial crisis have been the macro

prudential policies. Globally, the financial crisis brought to the fore, only recently, the concept of macro prudential regulation of the financial system. However, in India along with the measures detailed in the foregoing paras, there was a gradual shift towards macro prudential financial regulation as early as 2004 itself. The Reserve Bank made use of the countercyclical policies since 2004 as a toolkit for addressing systemic risk and ensuring financial stability though it had used them sporadically even earlier.

27. The instruments used to address the time dimension of the systemic risk have been time varying risk weights and provisioning norms on standard assets for certain specific sectors wherein excessive credit growth, in conjunction with sharp rise in asset prices, has caused apprehension of potential build-up of systemic risk and asset bubbles. In the process, the policies have “leaned” against the wind and have had the desired effect of moderating the credit boom in the specified sectors both through signaling effect and affecting the cost of credit.

28. As regards the cross sectional dimension of the systemic risk which deals with the interconnectedness issues, various measures have been undertaken such as, prudential limits on aggregate interbank liabilities; restricting the access of uncollateralized funding markets only to banks and PDs and stipulating caps on lending and borrowing; restricting the banks’ investments in the capital instruments of other banks; stipulation on banks’ exposure to NBFCs and MFs and close monitoring of systemically important NBFCs and financial conglomerates; restrictions on unbridled innovation in financial products; enhancing transparency and addressing risks in OTC transactions by operationalizing reporting platforms and CCP arrangements.

Current approach to banking regulation and reforms and the challenges involved

29. Given these realities, the needs for the financial sector reforms and regulatory development in India do not necessarily converge with those felt in the developed nations. Risks emanating from the EME financial sector are also diametrically different from those emerging from those in the advanced economies. In the emerging economies, it is the limited spread of the financial sector as well as the constrained and or underdeveloped / lower capacity in terms of the products, services and institutions that subject these economies to various financial risks, as against the advanced economies where the risks emanate from the sheer scale and volumes of financial transactions, size, connectivity and systemic importance of the financial institutions, sophistication and complexity of the financial products and services etc.

30. The need for the financial development and regulatory reform remains as strong as ever in emerging markets. Instead of innovating complex and sophisticated products and instruments or setting up financial behemoths, the EMEs require to focus more on the fundamental financial sector elements such as financial stability, strengthening and creating sound banking systems, widening the scope and reach of the formal financial system and services, expanding financial inclusion and enhancing financial literacy, improving monetary policy transmission as also developing and deepening the financial markets (such as corporate bond markets and basic currency derivatives) and making them more liquid, etc. As such the financial development and regulation has to be aligned to these specific needs of the emerging market economy financial system.

31. One of the most critical aspects of reforms in the Indian financial sector, was the deliberate strategy of ‘cautious gradualism’ so that the pace of reforms remained specific to the nature of the Indian financial system in terms of its maturity, absorptive capacity and the stage of development and was neither too fast or abrupt to disrupt the very structure of the financial system nor too slow as not to have a meaningful impact This approach encompassed small and steady doses of reform push, coupled with a close and continuous monitoring of impact and preparedness for taking mid-course correction, if required. The reform measures in the banking sector were coordinated with those in other areas and even

within the banking sector, the measures were well sequenced, with an unwavering focus on stability.

32. On the one hand, while, since the early years of 2000, the Reserve Bank has embarked on a dedicated effort at reconciling its guidelines with the Basel Accords and chosen to be more conservative on many of the prudential norms in comparison to the global standards, it has also retained its national discretion on some of the regulatory aspects so as not to disrupt and instead encourage the flow of credit to sectors crucial for growth. Some such divergences, whether sub-equivalent or super-equivalent, are discussed below:

Capital requirement and leverage ratio

33. RBI implemented Basel III requirements w.e.f. April 1, 2013. Under Basel III too in India, the minimum capital requirements has been retained at 9% of Risk Weighted Assets as against Basel III requirements of 8%. Leverage Ratio requirement is proposed to be at 4.5 % as against Basel III proposal of 3%. In India, the real sector is predominantly dependent on the banking sector for credit needs. Any disruption in provision of credit supply from banks may be catastrophic for the economy. Further, the extant external credit ratings provided by the credit rating agencies to bank loans which determine the risk weight and capital for those exposures under the Basel II Standardised Approach for credit risk, suffer from various gaps and weaknesses. In view of the forgoing, it is desirable to reduce probability of bank failures by having additional capital. The Basel Committee for Banking Supervision (BCBS) provides flexibility to national regulators to prescribe higher minimum capital requirements. Several other jurisdictions (e.g. Singapore, China, South Africa, Brazil, Australia etc.) have also prescribed higher capital requirements than 8% of the risk weighted assets. Incidentally, the Reserve Bank has prescribed higher capital requirements even under Basle II.

34. However, capital and leverage ratio prescriptions at levels higher than the global standards can have constraining effect on the supply of adequate credit from banks to the productive sectors which in turn, can adversely impact growth to some extent raising questions of trade-off between growth and banking stability. Further, questions have been raised about requiring banks to mobilise additional capital, given the huge capital needs and a lackluster capital market. This compels us to take a balanced view about continuing with the additional requirements to ensure banking resilience by having adequate cushion towards identified weaknesses and the practical difficulties the banks face.

Exposure norms – the group borrower limits

35. Exposure norms for banks in India are as follows: for a single borrower, it is 15 per cent of the bank's capital funds and for borrowers belonging to a group, 40 per cent of the bank's capital funds. The present guidelines also allow banks to exceed the norm with respect to a single borrower and group borrower by an additional 10 per cent and 15 per cent respectively, for extension of credit to infrastructure projects and in exceptional circumstances. Apart from this, there are specific prudential norms for bank finance to NBFCs, call money / notice money borrowing and lending and inter-bank liabilities, etc. BCBS in the Standards published on Supervisory framework for measuring and controlling large exposures' (the BCBS Standards) in April 2014 have stipulated that the sum of all the exposure values of a bank to a single counterparty or to a group of connected counterparties must, at all times, not be higher than 25% of the bank's available eligible capital base. As per the Standards, the eligible capital base is also revised to the effective amount of Tier 1 capital only.

36. In India, our effort has been to harmonise our guidelines with the international best practices and converge the same with the global prudential norms/standards. However, India, being an emerging economy with limited sources of funds to finance the growth process, relatively smaller capital base of the Indian banks as also fewer number of corporate groups which can take up big ticket infrastructure and manufacturing projects and sudden growth in their size, has certain typical compulsions to meet. Funding requirement for

development of the infrastructure sector in India is huge. During the 12th five year plan, starting in the current year, this requirement is estimated to be approximately $1 trillion or Rs 61 lakh crore. Currently, a huge chunk of this financing responsibility is borne by the banks. The banking sector exposure to the infrastructure sector has grown from 3.61% of total bank credit as on March 2003 to approx 15.09 percent of the total bank advances as on March 2014.[1] The group borrower limit in India is substantially larger in our country than the international norms due to the developmental needs of the country. Keeping the group borrower limit at the level of single borrower limit, that too related to Tier I than the total capital will severely constrain the availability of bank finance (which is the major source of finance in India) to these corporate groups and the infrastructure sector and thus hamper the growth of the economy. Stricter group exposure limits would also leave surplus lendable resources with banks which may result in adverse selection. At the same time, high exposures to specific businesses or business groups impairs stability and results in excessive concentration of credit. Thus, while we are aware of the need to reduce the group borrower limit, we have to take a considered view as to what extent and how smoothly this can be brought down going forward without adversely impacting the growth prospects of the economy.

Liquidity standards – treatment of the SLR holdings

37. During the early "liquidity phase" of the financial crisis that began in 2007, globally many banks faced unprecedented difficulties despite adequate capital levels. The Basel Committee on Banking Supervision (BCBS) recognized that such difficulties were due to lapses in basic principles of liquidity risk management. In response, as the foundation of its liquidity framework, the BCBS in 2008 published Principles for Sound Liquidity Risk Management and Supervision ("Sound Principles"), which provide detailed guidance on the risk management and supervision of funding liquidity risk. To complement these principles, the BCBS further strengthened its liquidity framework by developing two minimum standards for funding liquidity, viz., the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) to achieve two separate but complementary objectives. While the LCR's objective is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month, the NSFR is aimed at promoting resilience over a relatively longer time horizon (one year) by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis.

38. Following the issue of final standards by BCBS, the Reserve Bank of India issued its final guidelines on 'Liquidity Coverage Ratio (LCR), Liquidity Risk Monitoring Tools and LCR Disclosure Standards' on June 9, 2014. The RBI's guidelines have taken into account the range of HQLAs available in Indian financial markets and their liquidity vis-à-vis the liquidity instruments prescribed in the BCBS standard. The balance sheets of Indian banks have adequate liquid assets due to the CRR and SLR requirements of 4% and 22% respectively of a bank's NDTL. Any additional HQLA requirement on banks over and above CRR and SLR may reduce banks' capacity to meet the growing credit needs of the economy. It also reduces competitiveness of banks in India vis-a-vis their international counterparts. Keeping this aspect in view, Government securities to the extent of 2 per cent of NDTL i.e. those currently allowed under marginal standing facility (MSF), have been allowed to be included as Level 1 HQLAs in India. Further, eligible common equity shares with 50% haircut have been allowed to be included as a Level 2B HQLAs in RBI guidelines.

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[1] Source: *Handbook of Statistics on Indian Economy – 2013–14*.

Counter cyclical capital buffer

39. In the aftermath of the financial crisis in 2008, BCBS published *Guidance for national authorities operating countercyclical capital buffer* (CCCB) to propose a framework for dampening excess cyclicality of minimum regulatory capital requirements with the aim of maintaining the flow of credit from banks to the real sector in economic downturns with the capital accumulated in good times. Moreover, in good times, while the banks will be required to shore up capital, they may be restrained from extending indiscriminate credit. In Indian context, its implementation may have to be well calibrated by recognising structural changes in banking system due to financial deepening and the need for separating the structural factors from cyclical factors. Accordingly, it has been envisaged that while the credit-to-GDP gap shall be used for empirical analysis to facilitate CCCB decision, other indicators like Gross Non-Performing Assets' (GNPA) growth, Industrial Outlook Survey, Credit to Deposit Ratio, etc., will also be considered in India.

Accounting norms and IFRS implementation

40. Some of our prudential guidelines on key areas such as investment classification and valuation norms, impairment recognition and loan loss provisioning as well as securitisation are indeed at variance with international accounting norms. However, these guidelines were framed keeping the Indian financial system in perspective. Some of them are more conservative than international practices. For instance, we do not allow the recognition of unrealized gains in investment portfolios while requiring that unrealized losses be provided for. Similarly, we require banks to provide for standard assets even where there are no signs of impairment. While these have served us well, as our financial system develops we may have to harmonise our guidelines with international requirements.

41. At their summit in London in 2009, the G 20 leaders called on "the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards". The International Accounting Standards Board (IASB) has now replaced IAS 39 with IFRS 9 with a view to reduce complexity and improve convergence.

42. With India having made a commitment to converge to IFRS and the Finance Minister's Budget announcement of the mandatory preparation of financial statements by companies (other than banks, insurance and NBFCs) on the basis of IFRS converged Indian Accounting Standards (Ind AS) from FY 2016–17 onwards, the RBI is in advanced stages of finalization of a roadmap for banks and NBFCs in consultation with various stakeholders. The main challenges for Indian banks would be system changes, implementation of an expected loss impairment model and skilling human resources. Issues also arise on account of the interaction of the regulatory and accounting frameworks. For instance, apart from the complexities of an expected loss model, transitioning from an incurred loss to an expected loss model may also potentially adversely affect capital adequacy. Similarly, the introduction of a fair value through other comprehensive income (FVOCI) category coupled with the removal of the regulatory filters under Basel III may also potentially introduce volatility in the capital. In order to address implementation issues and facilitate a smoother transition, the RBI has set up a Working Group comprising professionals with experience in IFRS implementation, bankers and RBI staff engaged in regulation and supervision."

KYC and AML standards

43. The international standards for KYC/AML/CFT are set by the Financial Action Task Force (FATF) and the Reserve Bank issues KYC/AML/CFT guidelines mainly on the lines of FATF recommendations. However, irrespective of the FATF recommendations covering many areas, the Reserve Bank issues instructions to banks only if there are enabling provisions in Prevention of Money Laundering Act/Rules 2002. Thus, for example, Recommendation 17 of FATF provides for third party verification of KYC, subject to certain conditions. In India, we had not allowed it until enabling provisions were brought in the PML Rules by the

Government in August 2013. Similarly, in terms of Recommendation 12 of FATF, banks/FIs are required to take reasonable measures to determine whether a customer or beneficial owner is a domestic Politically Exposed Person (PEP) and if so are required to take certain enhanced customer due diligence procedures, etc. Since the Government has not taken a decision in this regard/incorporated this in PML/Rules, RBI has not instructed banks/FIs to follow the FATF recommendation.

Conclusion

44. To conclude, designing banking regulations for an aspiring economy has to carefully factor difficult realities and calibrate its policies. While on some the regulations have to conform to international standards, norms and best practices, on certain other issues the regulations will have to be designed using national discretion and consciously be different from such standards and norms. Enlightened self interest will have to be the guide post. In the Indian context, our past experience of and learnings from such deviations are our additional guide posts. Reserve Bank is ever conscious of this position.

45. Thank you.

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