S S Mundra: Emerging contours of regulation and supervision in the Indian banking sector

Special address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the Investors' Conference, organized by Axis Capital Limited, Mumbai, 13 November 2014.

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1. Delegates to the conference, ladies and gentlemen! It is a pleasure to be here this morning to interact with you all. At the outset, I would like to thank Axis Capital Limited and especially Mr. Nilesh Shah, for inviting me to address the participants.

2. During 2013–14, amid slow growth and high inflation, the Indian economy had to contend with serious challenges to external stability emanating from an unsustainably high current account deficit (CAD), capital outflows and consequent exchange rate pressures. Joint efforts by the Reserve Bank and the Government helped stabilize the economy. With greater political stability, commitment to fiscal consolidation, strengthening of the monetary policy framework and better policy implementation, GDP growth is expected to be around 5.5 per cent in 2014–15 from the sub-5 per cent growth in the preceding two years.

3. As you are aware, based on the recommendations of the Expert Committee to Revise and Strengthen the Monetary Policy Framework (Chairman: Dr. Urjit R. Patel) in January 2014, Reserve Bank of India formally adopted a glide path for disinflation in terms of headline consumer prices, with target milestones of 8 per cent by January 2015 and 6 per cent by January 2016. The Reserve Bank anchored this change by tightening monetary policy in the January 2014 policy review and maintained this tight stance in subsequent policy reviews so as to set the economy firmly on a disinflationary path. Since then, inflationary pressures have fallen in a broad-based manner. This has been aided in part by measures taken by the Government to control the fiscal deficit and to augment food supply, disincentivise agricultural exports and reform agricultural marketing policies.

4. I have been asked to speak on a subject of my choice. Let me take this opportunity to dwell on some current as well as emerging themes in the regulatory/supervisory landscape for the Indian Banking Sector and the financial sector in general. But before I get into the subject proper, let me give a broad overview of RBI's current areas of focus for strengthening the Indian financial system.

Five pillars of RBI's developmental measures

5. Those of you closely following Reserve Bank of India's policies would have noticed that over the past few quarters our developmental measures have been focused on five key areas. These are:

- Strengthening the monetary policy framework
- Strengthening banking structure through new entrants, branch expansion, encouraging new varieties of banks and moving foreign banks into better regulated organisational forms
- Broadening and deepening financial markets and increasing their liquidity and resilience so that they can help allocate and absorb the risks entailed in financing India's growth
- Expanding access to finance to small and medium enterprises, the unorganised sector, the poor and underserved areas of the country through technology, new business practices, and new organisational structures
- Improving the system's ability to deal with corporate distress and financial institution distress by strengthening real and financial restructuring as well as debt recovery

6. While RBI's developmental and regulatory policies continue to evolve around this five pillared approach, current efforts, in specific, are directed at certain important initiatives. These include strengthening and harmonisation of regulatory guidelines for non-bank finance companies, rationalising the priority sector lending guidelines, measures for strengthening the fraud risk management system and resolution of fraud cases in commercial banks, designing a charter of customers' rights, developing a framework for resolution of financial firms under distress and catalysing the state level coordination committee structure for better regulation, supervision and monitoring of the activities of firms indulging in promoting Ponzi schemes. Thus, on the whole, RBI's regulatory and supervisory resources are directed at fostering a competitive, vibrant and sound financial system for meeting the financing needs of a growing economy.

A. Issues in regulation/supervision

7. Let me now turn to the issues and challenges in the regulation /supervision of banks in India. As finance professionals, you are well aware that the performance of banks is inextricably linked to the performance of the economy, more so in India where the financial sector is heavily dominated by the banks. Following the Global Financial Crisis, the standard setters have been working overtime on fixing the regulatory loopholes which allowed the financial sector to underestimate and underprice risks. Regulatory reforms agenda in the banking sector, also called the "Basel III" reforms are aimed at improving the banking sector's ability to absorb shocks arising from financial and economic stress; improving the risk management and governance framework and on strengthening the banks' transparency and disclosure standards. Steps have also been taken to address the concerns around macro-prudential or system wide risks that can build up across the banking sector as well as the pro-cyclical amplification of these risks over time.

8. Efforts have been initiated to end the moral hazards associated with "Too-Big-to-Fail" by requiring the global systemically important banks (G-SIBs) to hold higher loss absorbency capital and to improve resolvability upon failure. Focus has also been on strengthening the supervisory effectiveness and disclosure standards. Reserve Bank is committed to carry forward banking sector reforms by adapting the best international practices to country-specific requirements while being mindful that growth dynamics in Emerging Market Economies (EMEs) are different and there is a thin line between prudent regulation and excessive regulation.

Risk based supervision

9. In the domestic context, a significant shift has happened in the approach to supervision of commercial banks in the form of risk based supervision. At the core of supervisory monitoring under RBS is an assessment of the quality of a bank's procedures for evaluating, monitoring and managing risk, and of the bank's internal models for determining economic capital. The success of the risk based supervision approach is incumbent upon quality and integrity of data, skill levels and competency across the banks and regulators and above all, an orientation of the top management of the bank towards risk-oriented business activities and oversight function. I will touch upon some of these issues in the course of my address. Let me now turn specifically to some of the recent regulatory/supervisory measures initiated by the RBI:

10. No discussion on the Indian banking system these days is complete without a discussion on the asset quality of the banking sector as well as the capital requirement of the public sector banks. Hence these are the first two issues which I would dwell upon.

i) Asset quality

11. The slowdown of the Indian economy in recent times has had its impact on the asset quality of the banks. The overall banking system in India is, however, quite stable and

resilient though there are some specific areas which pose challenge to the regulators and supervisors and need continuous monitoring. The level of gross non-performing advances (GNPAs) as a percentage of total gross advances for the entire banking system is at an elevated level of around 4 per cent while the net non-performing advances (NNPAs) as a percentage of total net advances is around 2.2 per cent. The level of distressed assets is not uniform across bank groups. PSBs as a group, exhibit much larger GNPA and NNPA levels. While on an isolated basis, the asset quality is not very distressing, if we were to add the portfolio of restructured assets to the GNPA numbers this surely raises concerns.

12. In line with the fifth pillar mentioned above, various steps have been taken by RBI to ensure improvement in the system's ability to deal with corporate and financial institution distress. For effective NPA Management and to enable speedier and prompt recovery, RBI has set out Guidelines on "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalising Distressed Assets in the Economy. Detailed Guidelines on formation of Joint Lenders' Forum (JLF), Corrective Action Plan (CAP), "Refinancing of Project Loans", "Sale of NPAs by Banks" and other regulatory measures were issued to banks, emphasizing inter-alia, the need to ensure that the banking system recognises financial distress early, takes prompt steps to resolve it through rectification, restructuring or recovery thereby ensuring that interests of lenders and investors are protected by setting in motion a corrective action plan which incentivizes early identification of problem cases, timely restructuring of accounts considered to be viable, and taking prompt steps for recovery or sale of unviable accounts. At the same time, the guidelines provide for punitive actions on lenders in the form of accelerated provisioning norms if they fail to report the status of distressed accounts to Central Repository of Information on Large Credits (CRILC) or if JLFs are not convened within the stipulated timeframe etc.

13. The CRILC has been created within RBI to collect, store and disseminate data on all borrowers' credit exposures including Special Mention Accounts (SMA 0, 1 & 2) having aggregate fund-based and non-fund based exposure of Rs. 50 million and above. The repository is expected to help in tracking and reviewing exposures/impairment of such large borrowers more effectively across banking institutions as also NBFCs so that timely remedial measures can be taken.

14. A point that I wish to highlight here is that "Restructuring" *per se* is not necessarily a forbidden word. It is a legitimate financial activity practiced the world over to help the borrowers tide over short term problems. Policy and administrative reforms would establish that such forbearance was appropriate to preserve economic value in the system. It may get further help from easing commodity prices and growth returning in some parts of the globe. Our concern on restructuring is more around the fairness of the process. It should address the problem, not merely postpone it. Hence, RBI has set out clear guidelines that a second round of restructuring would lead to automatic classification of the asset as non-performing and call for a higher provisioning requirement.

ii) Capital adequacy of banks

15. There have been numerous discussions on the need and ability of the Indian banks to raise additional capital to support their business, going forward. I would not say that the concerns raised in this regard are entirely misplaced, especially for the public sector banks. The need to shore up capital adequacy would arise on account of pulls from several directions. These include need for higher provisioning requirements due to deterioration in asset quality, phased implementation of Basel III Capital norms, capital required to cover additional risk areas under the risk based supervision framework as also the need to expand the business and meet the likelihood of higher credit demand going forward. Let me tell you that at present, the capital position of Indian banks is comfortable with all of them meeting the extant regulatory requirement comfortably. The capital to risk weighted assets ratio (CRAR) for Indian banks under Basel III as at end March 2014 stood at a comfortable level of

12.9 per cent. While the ratio for the PSBs was lower at around 11.38 per cent, the ratio in case of private sector and the foreign banks was in excess of 16 per cent. Going ahead, the capital position of the banks, especially the PSBs, is likely to come under some strain, both in terms of quantity and quality. To meet minimum capital requirements, capital buffers, domestically systemically important banks (DSIBs) surcharge and impact of increased stressed assets, the Government's contribution to the equity up to March 31, 2019, would have to be to the tune of two lakh forty thousand crore rupees at the existing level of its shareholding in respective public sector banks. This requirement is independent of the risk based capital requirements which the banks might need under the RBS process. It is, however, important to note that this requirement may come down if, going forward, the asset quality improves on account of higher growth and consequently, higher internal retention. Notwithstanding the room available to the banks to meet the Basel III timeline, the banks have to look to generate more internal capital. With the emphasis on fiscal consolidation by the GOI, the leeway earlier available to the PSBs to approach the Govt. for additional capital will be limited and hence, one of the options for the Government could be to reduce its stake in some of the PSBs which presently ranges from 56.26 per cent to 88.63 per cent.

iii) Total loss-absorbing capacity (TLAC) for global systemic banks

16. Let me now come to a related issue which is being debated by the standard setting bodies. You might have already read in the newspapers a couple of days back about the proposals being set out by the Financial Stability Board (FSB) to lay down a new minimum standard for "total loss-absorbing capacity" (TLAC) for the G-SIBs. The TLAC standards are meant to provide confidence to home and host authorities that the G-SIBs do have sufficient capacity to absorb losses, both before and during resolution and simultaneously enable resolution authorities to implement a resolution strategy which would minimise any impact on financial stability and ensure the continuity of critical economic functions.

17. While the TLAC regulations are meant to be applicable to G-SIBs, we would surely see such regulations find their way into the domestic regulations across jurisdictions over time. We have already seen regulations on the higher loss absorbency capital requirement and resolution regime for G-SIBs slowly being made applicable for the D-SIBs and hence, it can well be assumed that the international community would want the TLAC regulations to be made applicable to the D-SIBs in all jurisdictions as well as banks with overseas presence. We have expressed our reservations on the likely spillover impact of the TLAC proposals on the banks in the emerging markets economies (EMEs) with delirious impact for economic growth in EMEs and emphasised the need for *ab initio* addressing of the concerns of the EMEs during the consultation process. We have also emphasised that ownership of the banks should also have a bearing upon such requirements.

iv) Unhedged forex exposures

18. You would all probably recall the significant volatility experienced in currency markets around the globe, and more so, in the EMEs, at the mere mention of an exit from accommodative monetary policy by the FED Chairman, during May last year. Actual tapering of asset purchase programme by the FED and the recent announcement of a complete exit from the quantitative easing programme that has been in existence since 2008 has not had a very adverse impact on the rupee. However, notwithstanding the recent measures and policy buffers created since last year, it is highly likely that any reversal in the interest rate trend in the US would lead to flight of capital to the so-called "source" countries, in the process, putting pressure on the domestic currency of the EMEs.

19. The wild gyrations in the forex market has the potential to inflict significant stress in the books of Indian companies who have borrowed abroad as was evident during the financial crisis. This stress eventually hampers their debt repayment capability to the domestic lenders as well. It is precisely with this consideration that RBI has been advocating

a curb on the increasing tendency of the corporates to dollarize their debts without adequate mitigation.

20. Our inspection of banks' books has highlighted need for the banks to have more robust policies for risk mitigation on account of un-hedged foreign currency exposure of corporate entities. Inadequacies of data further complicate the impact assessment of such exposures across the banking system. The banks have been advised to factor in this risk into their policies/ pricing decision and also devise means for sharing of information on such exposures amongst themselves. Regulatory guidelines have also been since issued outlining the capital and provisioning requirements for exposure to entities with significant unhedged forex exposures.

v) Corporate governance

21. Another area which is a major challenge, especially in the PSBs, is corporate governance. Some of the recent headline events have shown the PSBs in poor light. As a regulator and supervisor of banks, RBI has been putting a lot of emphasis on this aspect. The P J Nayak Committee appointed by RBI to review "Governance of Boards of Banks in India" has made certain significant recommendations like splitting the post of Chairman and Managing Director at PSBs, giving fixed five-year tenures for these posts, professionalising the Boards of PSBs, etc. RBI is constantly engaging with the Government for the early implementation of the Committee's recommendations. A related concern is the impending vacuum likely to be created in the public sector banks, especially in the middle management level, due to large-scale retirement of officers in next 2–3 years. On our part, we have been sensitizing the bank managements to address the likely talent deficit that they would have to encounter more so on account of entry of new banks in the private sector space in the near term.

B. Positives for the banking sector

22. Let me now dwell upon several positives that hold out for the Indian banking sector. As I mentioned earlier, the performance of the Indian banks pretty much mirrors the performance of the Indian economy. The piling up of distressed assets and consequent drop in profitability is, thus, largely a fallout of poor macroeconomic environment- both domestic and global. Going forward, a sharp uptick in "investment" led as also "consumption" led demand is expected in the economy. The banking sector, the corporates and the administration have to cater to the diverse needs of two broader constituencies in the country i.e. "India" and "Bharat". Towards this end, they might have to adopt different strategies. However, there is no denying the fact that a whole host of opportunities are likely to emerge for the Indian banks in future.

i) Economic recovery

23. The Indian economy is poised for a gradual recovery. As growth picks up, domestic supply bottlenecks ease and the stalled projects come back on stream again, the outlook for both manufacturing and services sectors would brighten. With a stable Government at the Centre, pace of economic reforms in the areas of industry, services, international trade, labour markets, public sector management, financial markets and competition are likely to improve further, which would help improve commercial activity levels and productivity, thereby help enhance the growth potential. As the economy recovers, investment demand and the need for credit will pick up which would boost banks' performance and, to a great extent, address the issues of asset quality and internal generation of capital.

ii) Government's focus on infrastructure

24. Attempts to de-clog the infrastructural bottlenecks through accelerated clearances and setting up of smart cities are likely to open up new avenues for banks. *In order to make it*

easier for the banks to extend long term loans to infrastructure sector with flexible structuring to absorb potential adverse impacts, RBI has already issued enabling guidelines. This will mitigate the asset-liability management (ALM) problems faced by banks in extending project loans to infrastructure and core industry sectors, and also ease the process of raising long-term resources for project loans to infrastructure and affordable housing sectors.

iii) Retail demand

25. The impending turnaround in the Indian economy has the potential to provide a big leg-up to the domestic demand. India's demographic pattern suggests that the domestic consumption demand would continue to grow for a foreseeable future. In the absence of corporate demand, many of the banks have been crowding in the retail space trying to capitalise on demand for housing, two-wheelers and four-wheelers, white goods and so on. This, however, raises concerns on credit absorption level in the sector. Though, the segment has until now experienced moderate levels of impairment, going forward, the banks would need to put in place systems and processes to ensure adequate origination & monitoring standards and stand guard against formation of asset bubbles. Here again, the big potential would lie in the "greater India" where banking penetration has hitherto been inadequate. Meeting the funding needs for the life-cycle demand of this segment would be a sustainable business avenue for banks in the coming years.

iv) MSME sector

26. MSME sector plays a pivotal role in generating employment, increasing cross-border trade and fostering the spirit of entrepreneurship. In fact, it is being increasingly recognized by the policy makers that if India has to regain its high growth trajectory, it needs a vibrant MSME sector.

27. Quite often, the sector complains about not having to only contend with higher cost of borrowing but also a lack of availability of timely credit. In this context, let me make a couple of points. The interest rate on lending are no longer administered and are left to market forces, the only caveat being that the lending has to happen above the base rate. Second and more importantly, it needs to be realised that the alternate cost of borrowing for the sector would be much higher than the median rate of 12–14 % which the MSME borrowers currently pay. On our part, we have advised the banks to take into account the incentives available to them under the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) scheme and assign zero risk weight for capital adequacy purpose for the portion of the loan guaranteed by the CGTMSE for such MSE borrowers.

28. There are also issues around the unavailability of credit rating for first time MSME borrowers. In this context, the banks have been advised to formulate Board approved policy and start using credit scoring models in their evaluation of the loan proposals of MSE borrowers which works on the principles of attributes of similar borrowers rather than on past or future financials.

29. Further, the underlying objective of the proposed issuance of small finance banks licenses is to facilitate provision of credit to small and hitherto credit starved sections of the society, which has been relying on informal finance channels.

v) Differential licensing of banks

30. RBI has announced licensing of two new banks in the private sector. Simultaneously, issuance of guidelines for differentiated licences for small finance banks and payment banks are in the final stages. Possibility of continuous or "on-tap" licensing, setting up of wholesale banks and conversion of large urban co-operative banks into commercial banks were detailed in our consultation paper issued earlier. Discussions on these ideas are currently underway and a detailed road map of the necessary reforms and regulations for freeing entry and making the licensing process more frequent will be issued in due course.

While these possibilities encourage much optimism, they are simultaneously likely to place strain on our supervisory resources, which we are internally trying to strengthen and optimize. As these banks are likely to cater to small and relatively uninformed borrowers, protection of consumer interest would also pose a big challenge.

31. In conclusion, I would like to say that while challenges remain for the sector, a host of opportunities also await the Indian banks and they have to be geared up to seize these opportunities. RBI's regulatory and supervisory stance is oriented towards facilitating strengthening of the sector in terms of best practices, processes and structure. Neither over-indulgence nor over caution are on our policy menu card.

I once again thank the organizers for inviting me here today and wish the deliberations all success.

Thank you.