Mr. G.P. Muniappan, Deputy Governor's Remarks –FICCI Seminar on September 11, 2002 at Mumbai

I. Introduction to the theme and the speakers

The theme for this session is a very broad one, encompassing the entire framework of regulation. However, it is very relevant in today's times given the focus on the regulation and supervision of the institutions in the financial sector. This focus has emerged in the context of the large number of financial sector crises and bank failures, which have plagued almost all the economies in the world over the last two decades. These crises can have severe implications not only for depositors who find their savings evaporating overnight, but also for the taxpayers, and the resolution costs of some of these episodes have been as high as 40% of the GDP in some countries.

There have been two main dimensions of the issues relating to governance and regulation of the financial sector –

(i) the rationale, contents and sequencing of the process of regulation and regulatory reform and
(ii) the appropriate institutional framework of regulation.

I am glad that the two speakers we have today will be covering both these major dimensions.

First, Shri Dalbir Singh, CMD of Central Bank of India, who represents the banking community in India as the Chairman of the Indian Banks Association, will speak on the broader issues relating to regulation in the Indian context. He is a familiar figure to all of you and needs no introduction.

While he represents the institutions, i.e the demand side of regulation, he will be followed by Mr. Michael Ainley, who represents the supply side, i.e. the regulators. He will deliver the keynote address for this session and in his talk, he will take us through the issues of appropriate institutional framework of regulation, drawing from the experience of the Financial Services Authority of the UK. The FSA, and its precursor, the Bank of England both hold a position of eminence in the pantheon of national supervisors and their systems and processes have provided the blueprint for supervisors all over the world.

We are very fortunate to have Michael here with us – he is one of the most respected members of the international supervisory fraternity and it has been my pleasure to have had his professional acquaintance over the last few years both in his capacity as the host supervisor of our banks in UK and as the member of several international groups and committees where we have served together.

I will now request Shri Dalbir Singh to give his comments, after which I will invite Michael Ainley and his associate Anna Heynes to familiarize us with the UK experience.

II. Comments on Dalbir Singh's presentation:

As has been rightly pointed out by Mr. Singh, protection of the **depositor's interest** remains the cornerstone of bank regulation here in India, and this objective is enjoined upon us by the Banking Regulation Act. This has become even more critical these days in the wake of the

failure of several urban cooperative banks, and has been the guiding pillar for supervisory policy with regard to the resolution of weak and failed banks. In fact, even in cases where the concerned state governments have asked us to facilitate their bailout packages for weak urban banks, we have insisted that they first provide explicit safety nets for existing depositors in any resolution strategy.

However, there is a growing awareness of the objective of **preserving the systemic stability** and preventing contagion effects from seeping across institutions. In the light of this supplementary objective, deposit insurance takes on an important role in fulfilling the depositor protection mandate, and we are in the process of introducing major reforms in the DICGC.

Mr. Singh has also touched bravely on a very sensitive point – that of the **sensitivity** of the institutions in the financial sector to any **adverse development**. This is due to the highly leveraged characteristics of the balance sheets of banks, which makes them prone to runs in the event of depositor panic. We have witnessed several situations where such circumstances have built up without any fundamental deterioration in either liquidity or solvency. In some cases this has been caused by overzealous competitive practices by the new marketing savvy banks and in some cases by media reports of financial problems.

Mr. Singh has also mentioned about the **fungible nature of finance** being another reason for the tight regulation of finance. Banks have often argued that the fungible nature of funds makes it difficult for them to keep track of the flow of funds, but our view always has been that banks should have enough information on their borrowers to gauge when their clients indulge in such unethical practices. In fact, this aspect has been the focus of our recent efforts to provide guidance on the issue of diversion of bank funds and subsequent willful default.

A level playing field is no longer the issue since all banks, whether in the public or private sector or in the foreign or domestic sector, are subject to broadly the same set of rules. It is more a question of how the game is played, and if all players agree to be fair while being competitive at the same time. In fact, our analysis of the performance of banks shows that the banks which have continuously out-performed their competitors have not done so because they have a regulatory advantage in any way. Their success has been due to operational efficiency brought about by the use of information technology, risk management systems, reduced operating costs and good corporate governance practices.

On the issue of **accounting standards**, I may mention that consequent to the announcement made in the Mid-Term Review of Monetary and Credit Policy for the year 2001-2002, a Working Group has been constituted under the Chairmanship President of the ICAI, with representatives, of IBA, banks and RBI, in order to identify the compliance as also gaps in compliance with Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) and to recommend steps to eliminate/reduce the gaps.

The issue Mr. Singh has raised regarding **universal banking** being the order of the day is not as straight as it seems. This is a path which should be tread carefully, and all the participants have to take into account the interests of all the stakeholders including the investors. This term normally refers to a bank undertaking all types of business – retail, wholesale, merchant, private etc under one organizational roof. This is already possible for banks in India. However, this term has taken on an extended meaning after the Khan Committee report was released a few years ago, and is now associated with the harmonization of business of banks

and development financial institutions and their possible merger. However desirable mergers may seem to the market, there are a host of issues which have to be taken into account while dealing with merger proposals. For instance, in the absence of the private sector's willingness to risk absorbing the losses of weak institutions, their merger with public sector banks is often presented as a fait accompli. However, the question that this raises is whether this would tantamount to fiscal profligacy given that the taxpayers funds are being committed to the revival of a weak institution where there is no guarantee of success.

Mr. Singh has commented on the **gradual process** followed by us in opening up the banking sector first to private sector then to international participation. Gradualism has been the hallmark of our financial sector policy, as it allows for the participants to absorb major changes incrementally without there being any major turbulence. We had begun by permitting the entry of the new banks in the private sector, and have now sought to strengthen them by enhancing the level of foreign participation. This is expected to strengthen the corporate governance, risk management and technological competence of these banks. Some banks have successfully managed to attract **foreign capital** and this is a route which other capital banks could also explore. We are encouraging such foreign capital participation and have written to the Government to relax the ceiling on voting rights in such cases in view of the importance of this source of capital.

Finally, I am happy that Mr. Singh has commended the process of consultation that we are now following with regard to the formulation of regulatory policy. I would like to assure him and all the bankers here that we intend to continue this process forward.

III. Comments on Michael Ainley's presentation:

Michael's presentation has been very informative and we are grateful to him for this experience sharing exercise which he has shared with us.

As has been pointed out by him, after the UK's move to a single regulator, many other countries have also followed the same path. However, the reasons for doing so have been different – in some cases a major loss event or crisis has been the trigger, in some cases it is the expansion of financial conglomerates has led to this decision, while in some cases it has simply been the case of "follow the leader."

In India, too, this topic has been the subject of some discussion. There are two aspects to this issue –

(i) unification of regulation under one authority and
(ii) segregation of the unified authority from the central bank.

While Michael has pointed out the advantages of unification, there are several well-documented disadvantages –

(i) unification makes it difficult to strike balance between different regulatory objectives
(ii) it results in diseconomies of scale
(iii) synergy gains from unification may not be more than the costs of unification
(iv) The same model may not work in different jurisdictions given the different legislative and political framework.
(v) Bank supervisory capacity may get compromised by unification of agencies

(vi) Finally, the most significant disadvantage of the decision to create a unified regulator is the unpredictability of the change process itself together with the concomitant danger that the discussion itself may gain momentum to such a stage that change becomes inevitable, whether it is appropriate or not.

The debate on the appropriate form of institutional framework for regulation is likely to continue for some more time. As it stands, a study of a sample of 73 countries in 2000 by Abrams and Taylor showed that only 13 of these followed a model of unified supervision (out of which 3 had unified supervision within the central bank, 10 outside it). Further, due to a host of issues, most of which are to do with the limited availability of financial and human resources, developing countries prefer to keep bank supervision with the central banks as had been reflected in data from a sample of 123 countries studied by Hawkesby in 2000 which shows that banking supervision was located within the central bank in as many as 78% of the developing countries while this was so in only 35% of the industrial countries.

Unification has not yet found favour in India because the markets and the institutions remain largely segmented and financial conglomerates are a rarity in the Indian context. Further, though the linkages between banking, securities and insurance has grown in the past few years with DFI's having set up banks, and banks dealing in insurance and securities products and participating directly in the capital market. However, these linkages have not grown to an extent that the overlaps or grey areas in their regulation have become significant.

The markets also still deal largely in vanilla products and sophisticated instruments which straddle all there sectors have not been in evidence. Most of the products which are being offered are stand alone and do not combine the features of all three types. What will probably work best in such an environment are mechanisms to enhance coordination and cooperation between the existing regulators. In fact, one coordinating arrangement which has been proposed earlier by Dr. Y V Reddy, and which is known as the Reddy formula, suggested an umbrella regulatory legislation which creates an apex regulatory authority without disturbing the existing jurisdictions.

However, there is a lot which we have taken from the re-engineering process being followed in the FSA. We have been looking closely at their rating models and framework and have also sent several of our officers to FSA to interact with them. In the past some of our officers have even been seconded to the FSA for several months and have come back enriched by the experience. The FSA supervisory process has been studied by us in the course of formulating our Risk Based Approach to supervision.

This is an opportune moment for me to dwell upon the recent developments in the area of bank supervision and regulation. As I have mentioned , we are embarking on the path to Risk Based Supervision, which would be introduced in phases beginning from 2003. A dedicated Project Implementation Group set up in the Reserve Bank is addressing the transitional and change management issues for facilitating a smooth switchover to RBS based on the recommendations of PricewaterhouseCoopers, London.

The RBS model consists of

(i) development of a risk profile for each bank,

(ii) designing a customised supervisory action plan for each bank based on the risk profile,

(iii) delineating the scope and extent of supervision to target high risk areas and areas of supervisory concern, and

(iv) strengthening quality assurance and enforcement functions to maintain objectivity and neutrality in application of supervisory standards.

The RBS approach will involve allocation of supervisory resources in accordance with the risk profile of a bank. A high-risk bank will be subjected to enhanced supervisory focus through a shorter supervisory cycle and greater use of various supervisory tools like targeted inspections, intensive off-site surveillance, structured meetings with bank management, commissioned audits, etc. On the other hand a low risk bank will be subjected to a longer supervisory cycle and use of fewer supervisory tools.

Thus, the RBS approach will lead to an optimum use of supervisory resources through focus on the targeted banks and the specific areas within the banks that pose the greatest risk to the system and to the supervisory objectives.

The implementation of RBS calls for certain preparedness on the part of commercial banks like setting up comprehensive risk management systems, adopting a risk-focused internal audit system, upgrading the management information and Information Technology-based systems, setting up dedicated compliance units and addressing issues related to HRD and skill development. A discussion paper on RBS giving a background of the approach, its objectives, the processes involved and the specific bank level preparedness required for successful implementation has been circulated among banks. They have also been involved in a consultative process through high-level meetings to identify areas requiring assistance/guidance.

The designing of the templates for risk profiling of banks, preparation of a new manual applicable to the new supervisory approach as well as upgradation of technical skills of both commercial bank staff and RBI supervisory staff is currently engaging the attention of the Reserve Bank. RBS is intended to be implemented in phases with a target to commission it during the next year. We have already begun imparting training on this area to both supervisors and bankers, and would have trained a critical mass of both by the time RBS is introduced.

We have also prepared a scheme for Prompt Corrective Action or PCA, which lays out the remedial actions to be taken by banks and the supervisors in the case of banks breaching certain specified trigger points of capital adequacy, return on assets and NPAs.

The Reserve Bank is committed to the implementation of the “Core Principles for Effective Banking Supervision” drawn up by BCBS. It is a matter of satisfaction that the banking system in India is largely compliant with most of the Core Principles. We have already initiated measures to achieve full compliance with these principles. We have already circulated draft guidelines to banks on country risk management and provisioning therefore and expect to finalise them shortly. With regard to consolidated supervision of banks and bank groups we have taken several initiatives to move towards a system of consolidated supervision such as voluntarily building-in the risk-weighted components of their subsidiaries into their own balance sheet on a notional basis and to annexe the balance sheet, profit and loss account, report of the board of directors and the report of the auditors in respect of each of their subsidiaries to their own balance sheets beginning from the year ended March 2001.

Subsequently, a multi-disciplinary Working Group was set up in November 2000 by Reserve Bank of India (RBI) to look into the introduction of consolidated accounting and other related quantitative techniques of consolidated supervision and to make recommendations accordingly. The recommendations of this group, which are centered around consolidation of accounts and its reporting and disclosure through Consolidated Financial Statements and Consolidated Prudential reports, will be implemented shortly.

We have devoted significant resources to the prevention of Money Laundering in tune with the international supervisory community and commercial banks in India are mandated to adhere to "Know Your Customer" (KYC) procedures for prevention of misuse of the banking system for money laundering and financing of terrorist activity. Further, systemic improvements in monitoring the implementation and enhanced due-diligence procedures on correspondent relationship are under introduction. The passage of the "Prevention of Terrorism Act" has strengthened the legal; framework towards countering financing of terrorist activity. The enactment of "Prevention of Money Laundering Bill: should further strengthen AML initiatives and compliance with FATF recommendations. Govt. of India in consultation with RBI, would initiate further steps for compliance of FATF recommendations.

Our initiatives have not been confined to the area of regulation and supervision alone. We continue to foster institutional structures and mechanisms which would strengthen the existing financial infrastructure. Some of these recent initiatives have been the facilitation of the setting up of a Credit Information Bureau, which would provide banks with a mechanism to access credit information and a mechanism for Corporate Debt Restructuring. .

The banks and the markets have responded well to our regulatory initiatives and there has been considerable improvement as reflected in certain key performance parameters. This has also helped in containing NPAs in the banking system over the years and maintaining the desired level of capital adequacy. The gross NPA ratio has continuously declined from 12.7% to 10.7% between March 31, 2000 and March 31, 2002 while the net NPA ratio has fallen from 6.8% to 5.8% in the same period. The Capital Adequacy Ratio, too, has increased from 11.1% to 11.8% over the same period. [1]

In conclusion, I would like to briefly point to some of the changes that we may expect in the regulation of banks in the coming years. The agenda will be dominated by the implementation of the proposals of the New Capital Accord, which through its three pillar approach, would have a far reaching impact on the systems and processes in banks and supervisory agencies. It will provide a fillip to risk management systems, and banks which have good internal ratings systems based on sound risk management practices, can expect to get some relief in capital through the implementation of the IRB approach. We would be expecting all Indian banks which are operating internationally or those which are significant in the domestic system, to gradually implement this approach over the coming few years.

At the same time, the Pillar II proposals for supervisory review would strengthen the implementation of RBS and PCA, while the increased disclosure through the Pillar III will strengthen market discipline. However, the implementation of these proposals would require a significant strengthening by both bankers and their supervisors, and I would enjoin upon all

[1] 2002 figures are provisional

of you present here to embark upon a major exercise in skill development so that you are ready for the challenges and sophistication that this will require.