Challenges Before The Indian Banking Industry

I am honoured to speak at the 55th Annual General Meeting of the Indian Banks' Association. The Indian Banks' Association started as a voluntary service Organisation in 1946 has played a very important and pivotal role for more than 50 years in the banking industry and has made commendable efforts as a facilitator in ensuring an efficient and sound banking system which is committed to excellence in operations and customer service. The Association strives to meet the diverse requirements of its members comprising public sector, private sector and foreign banks. With the growing complexity in finance, IBA's role has expanded from merely assisting member banks in their activities to functioning as a Self Regulatory Organisation, functioning as an effective liaisoning agency between the banking Industry, the regulators & the Government and preparing the members for the changing times.

The second phase of financial sector reforms has provided the necessary architecture for strengthening the Indian banking system and the banks have a vital role to play as the repository of liquidity, as an important channel for flow of funds from the surplus sectors to the deficit sectors and as the backbone of the payment and settlement systems. However, in the era of globalisation, financial sector conglomorisation and ‘bundling’ in the provision of financial services, there is a need for further strengthening of the regulatory and supervisory regime to ensure stability of the financial system.

The Reserve Bank of India has recognised this need and the fact that it cannot remain insulated from the international developments while crafting these regulatory and supervisory standards. I will take this opportunity to speak on the recent developments and challenges before the banking sector and the strategies and initiatives undertaken to meet them.

Competition and Consolidation

The deregulation in interest rates, grant of functional autonomy to banks in the area of credit, entry of foreign banks and emergence of new private banks has made the banking environment more competitive. While the total share in bank credit continues to be dominated by public sector banks, the share of foreign banks is showing an increasing trend. As announced in the Union Budget for 2002-2003, it has been decided to give an option to foreign banks to either operate as branches of their parent banks or to set up subsidiaries. As per the recent RBI guidelines, the overall ceiling for foreign direct investment in private sector banks has also been enhanced. In the changed scenario, it has now become extremely important for Indian banks to remain competitive for surviving. Universally there is a move towards consolidation and convergence. It has been our contention that the Government and supervisory authorities should only provide a conducive environment for consolidation and convergence through appropriate fiscal and monetary policies supported by a sound regulatory and supervisory framework. Hence, bank consolidation/ merger process should be primarily market driven and such proposals should come voluntarily from the banks themselves depending on the organizational synergy and the market share.

Management of NPAs

Management of NPAs continue to be the foremost challenge of the Indian banking system. In the recent past there has been a conscious and persistent effort through the prescription of strict objective norms for the identification and classification of NPAs. This was also supplemented by the sustained efforts both by the Government and the RBI for setting up the requisite infrastructure as also systems/ procedures for effecting recoveries/ reduction of NPAs. The result has been encouraging. However, realising the rigidities in the legal system, Govt. of India/ RBI have taken several special steps to ensure that legal inadequacies do not thwart the resolve to reduce the NPAs of banks. In addition, banks have been advised to strengthen their credit administration machinery and put in place effective credit risk management systems to reduce the fresh incidence of NPAs.

Tightening of Prudential Standards

The prudential standards need to be enhanced to fall in line with the international best practices. In this direction, Reserve Bank of India has introduced the 90 days delinquency norm for identification of NPAs with effect from the year ending March 2004 and reduced the timeframe for classification of a sub-standard asset as a doubtful asset from 18 months to 12 months with effect from the year ending March 2005. In some countries, doubtful assets, irrespective of their status i.e. secured or unsecured, are required to be classified as loss assets and fully provided for. However, in India, doubtful assets backed by collateral, are provided for only upto 50% of the outstanding balances, irrespective of the number of years in which the accounts remain in this category. Given the delay in recovery of dues through the legal process, the current provisioning norms followed in India do not entirely cover the latent losses inherent in such advances. The existing provisioning requirements would have to be enhanced in line with the international best practices.

The Proposed Basel Capital Accord

The Basel Committee recognises that the New Accord is more extensive and complex than the 1988 Accord. The New Accord is more risk sensitive and it contains a range of new options for measuring both credit and operational risks. The New Accord is likely to be finalised next year and would be implemented in member jurisdictions in 2006.

The adoption of the New Basel Capital Adequacy Framework, relating to assigning capital on a consolidated basis, use of external credit assessments as a means for assigning preferential risk weights, sophisticated techniques for estimating economic capital, etc., may need suitable modifications to adequately reflect the institutional realities and macro-economic factors specific to emerging market economies including India. Recognising these implications, RBI has been impressing on the Basel Committee that some of these proposals may require modification / flexibility to fully reflect the concerns of the emerging market economies. Notwithstanding the above, it is imperative that the banks in India study the proposed Capital adequacy framework, identify their transition path and initiate steps to be fully prepared for adoption of the new standards when introduced.

Risk Management Systems

In view of the diverse financial and non financial risks confronted by banks in the wake of the financial sector deregulation, the risk management practices of banks have to be upgraded by adopting sophisticated techniques like VaR, Duration and Simulation and adopting internal model-based approaches as also credit risk modelling techniques, at least by top banks. Banks need to evolve an integrated risk management system depending on their size, complexity and the risk appetite. As a step towards enhancing and fine-tuning the existing risk management practices in banks RBI has recently issued the draft guidance notes on credit and market risks.

Risk Based Supervision

Financial sector supervision is expected to become increasingly risk oriented and concerned more with validation of systems. Bank managements will have to develop internal capital assessment processes in accordance with their risk profile and control environment. These internal processes would then be subjected to review and supervisory intervention if necessary. The emphasis will be on evaluating the quality of risk management and the adequacy of risk containment. The transaction based internal / external audit would have to give way to risk based audit system. As banks are computerising more areas of their operations, they would be required to introduce information system audit also.

Corporate Governance

An adequate institutional and legal framework is in place in India for effectively implementing a code of sound corporate governance in banks. The statutes have built-in legal provisions that prohibit or strongly limit activities and relationships that diminish the quality of corporate governance in banks. As a major step towards strengthening corporate governance in banks, they have been advised to place before their Board of Directors the Report of the Consultative Group of Directors of banks and FIs (Dr. Ganguly Group) set up to review the supervisory role of Boards of banks. The recommendations include the responsibility of the Board of Directors, role and responsibility of independent and non-executive directors, fit and proper norms for nomination of directors in private sector banks, etc. The banks were advised to adopt and implement the recommendations on the basis of the decision taken by their Board.

Transparency and disclosure standards are also important constituents of a sound corporate governance mechanism. Transparency and accounting standards in India have been enhanced to align with international best practices. However, there are many gaps in the disclosures in India vis-à-vis the international standards, particularly in the areas of risk management strategies and practices, risk parameters, risk concentrations, performance measures, components of capital structure, etc. Hence, the disclosure standards need to be further broad-based in consonance with improvements in the capability of market players to analyse the information objectively.

Technology Issues

The delivery of products and services need extensive use of information technology necessitating high magnitude of investment. However, with a view to enhance the quality of customer service as also to enhance the quality of control, one of the prime thrust areas for the future would be completion of branch computerisation and networking of banks. This would also necessitate putting in place of appropriate legal and security systems.

Sum up

The above challenges confronting the banking sector make a demand on the Indian Banks' Association to play a pivotal role in the collective interest of the banking industry. The Association should continue to align the efforts of the regulatory authorities and the banking industry to meet these challenges. The Association can also play an active role in identifying the gaps in India vis-à-vis the international best practices in prudential standards and chart out necessary strategies to take the Indian banking system to higher levels. But most of all, I would like to make an appeal to the banking fraternity from this forum that they should give their utmost attention to improving the customer service and ameliorating the public grievances. The common man, as a bank customer, should get the respect and convenience he deserves and customer complaints, if any, should be attended to seriously and sympathetically. My heart goes out to those small means customers who are turned away rudely from the bank branches and sometimes even application forms are not given to them. This apathy of bank officials hurts me. This has to be changed. This change has to flow from the top of the bank management. If the senior management has the interest of common customers in heart, other officials will have to fall in line. After all, in a service industry, customer has to be given his due. Basically it calls for attitudinal change. We shall be failing in our duties if we ignore this change. Let us all make all out efforts to bring about the much required attitudinal change and I am confident that IBA can contribute significantly in this direction.

Address by Shri Vepa Kamesam, Deputy Governor, Reserve Bank of India on August 31, 2002 at the Annual General Meeting of the Indian Banks' Association at Mumbai