Inaugural Session on Technical Session I – Reorienting Structure

Introduction

It gives me great pleasure to address this gathering of professionals from the financial sector. I have been impressed by the arrangements which have been made for the conduct of the program, and hope that the proceedings will also match the organisation in grandeur.

I have had the opportunity to go through the papers which are being presented at this session and I am very happy to note that they are of a high quality and raise very pertinent issues. In fact, I find that the papers presented at BECON have been improving in quality every year and this trend should be nurtured. The provision of incentives in the form of awards for outstanding papers this year is a good innovation and should be continued. After all, an important goal of this conference is to stimulate thinking on financial sector issues and to strengthen the linkage between research and policy. I look forward to this event being elevated to the level of an international conference where meaningful interaction and experience sharing can take place on issues of common concern.

In my address for today, I would like to dwell upon the issues raised in the papers being presented in this session and present the regulatory perspective on these issues as relevant to the Indian context. As you are aware, this session broadly covers the area of "Reorienting Structure" and is more specifically intended to cover topics on Corporate Governance, Reforming Capital Structure, Universal Banking and the New Capital Accord.

Corporate Governance

The fact that many papers have been received on the subject of Corporate Governance in banks, is an indication of the interest that this issue continues to generate. The papers have dwelt on crucial issues such as the professionalisation of Boards through selection of competent independent directors, role of the audit function, conflict of interest of having regulators on the Boards and the role of the CEO. Some suggestions have also been made regarding expanding the role of the Board for Financial Supervision (BFS) to oversee the bank audit function. I would like to clarify here that the role of the BFS is to provide expert advice and guidance to the Reserve Bank on matters relating to oversight of banks, financial institutions and NBFCs and it cannot directly undertake audit/inspection of the entities mentioned above.

The papers have highlighted the relentless march in the corporate world towards better corporate governance standards and adoption of uniform accounting standards

and disclosure requirements. The appropriateness of these twin requirements is much more to banking sector where depositors' funds are many times higher than promoters' equity.

Corporate governance is no longer a concept to be discussed endlessly; rather it should be an action point to be addressed at the earliest with all the seriousness it deserves. In my view, this should be so even without any regulatory or other pressures but as an inevitable adjunct in a highly competitive market. It is also true that the obligations of corporate governance are becoming more and more mandatory through listing and other requirements with the capital markets placing greater demand on corporates including banks for information flow. The obligations of directors to furnish corporate governance reports to shareholders under the listing agreement with SEBI is a clear pointer in this regard.

The lines of responsibility in the banks' Board therefore need to be clearly drawn to ensure that :

(a) the policy initiatives to keep the wealth of the bank growing are clearly drawn
(b) action plans towards their implementation are conceived realistically consistent with available human and other resources and
(c) there is a constant review mechanism to get a feed back on the implementation efficiencies for course correction.

The demands on the Board of banks are therefore going to be truly onerous.

We have come across instances of members of certain bank Boards showing reluctance to ratify and adopt the covenants circulated by the Reserve Bank containing the recommendations of Dr. Ganguly Committee on the professionalisation of the bank Boards. I truly hope that the bank Boards will rise to the occasion and discharge their fiduciary duties to the fullest in all respects. After all, good corporate governance can not be enforced by regulatory dictates but is a larger issue of ethical standards.

Role of the Chief Executive Officer (CEO)

It is the CEO who is the most important instrumentality for implementing corporate governance in banks and who has the duty of carrying all the stakeholders with him, including the Board and the bank. There are some areas where the CEOs have to particularly focus their energies in the coming year. First and foremost is the effort to build a team of performers and motivate the organisation as a whole. CEO's job should not always be aimed to improve the bottom line of the bank. Efforts should be made to go into the staff psyche and HRD issues to create a vibrant structure. No organisation can ever stand on a disjointed and non motivated personnel structure, however efficient and high performing the CEO is. We have shining examples of two

weak public sector banks having been turned around where the CEOs have proved how much an institution could achieve with the same set of staff by identification of talent and proper motivation.

Another area is that of **induction of new talent** – many banks, particularly public sector banks and a few private sector banks, have successfully implemented VRS schemes, but how many of them have taken steps to put in place special talent scouting plans. Similarly, while banks often announce new products, sometimes only as a matter of competition, I am not sure whether issues like strategic planning, mobilization and recruitment of appropriate talent and provision of required training facility to the staff to handle such new products are adequately addressed by them. Successful banks have invariably spent a lot of time in product planning and marketing which has provided them the cutting edge in this area.

Then there is the issue of **education of non official directors on the Boards of banks.** Non-official nominees play an important role in the deliberations of the Board and it is essential that the CEO carries them along with him. This applies in the case of all banks cutting across ownership pattern. Whether it involves promoter directors, or government nominated independent directors, I will exhort the CEOs to spend significant time in briefing the new entrants on organizational structure, strengths and weakness of the institution, gray areas of internal control and regulatory gaps observed in the past audit/inspections, business plans both near term and long term, and seek their suggestions for addressing the issues in these areas.

This brings us to the crucial issue of the **interaction of the CEO with the Board**. When we talk of disclosure, what is also included is proper disclosure to the Board by the CEO. There have been instances in banks and financial institutions where the Board has not been kept properly informed but has been held responsible for the actions taken by these institutions. The blame for this often falls upon the Directors nominated by the Government or RBI, as they are seen to be more responsible than the others for safeguarding the institution. There is of course a larger issue in this which has been mentioned in the papers being presented, and that is of the conflict of interest in the role of the RBI as a regulator and as a director on the Board of a bank/financial institutions. I must clarify here that we too are more than aware of this conflict and are reluctant to take on this role, and do so only in cases where we have no option – either where it is a legal requirement or where a bank's condition financial or otherwise, warrants presence of RBI nominee. Even in these situations, to minimise the conflict, officials from the areas of supervision or regulation are not nominated on the Boards of these institutions.

There are certain other areas in which the CEOs should bestow their personal attention. I shall mention three important ones: **housekeeping, fraud prevention and NPA management.**

(a) In the area of **housekeeping**, there must be a concerted effort to clear backlog in balancing of books especially in large branches, tighten control to ward off clearing differences which are fraud prone and streamline inter-branch and nostro accounts reconciliation. Systems should be put in place for control over unusual build up of outstanding entities in suspense and sundry deposit accounts, a fertile field for perpetration of frauds. Strict observance of Know Your Customer (KYC) procedures is essential to prevent reputation risks emerging in the area.

(b) Coming to **fraud prevention**, CEOs should ensure that there is follow-up and quick disposal of cases relating to large value frauds of say Rs.1 crore and above within the time limit of 4 months as prescribed by CVC. They should also implement **fraud control procedures** by the early implementation of Mitra Committee recommendations and adopt best practices, strengthen internal audit and control systems and put in place accountability process for audit and inspection staff. They should also establish systems and procedures for immediate reporting of large value frauds to RBI/CBI/CVC, co-operate with investigation agencies for tracking down the culprits and complete the disciplinary proceedings as quickly as possible.

(c) A lot has been said about **NPA management** in different forums, but given the magnitude of this ailment, I do not have any hesitation in reiterating some important points in this forum. CEOs should adopt dynamic approach in going for compromise settlements. Fear of CVC/CBI need not exist as long as banks follow a transparent system through constitution of Settlement Advisory Committees, adoption of committee approach, obtention of Board approvals whenever needed etc. Banks should also make effective use of DRT / Lok Adalats, and the CDR mechanism to further the cause of NPA resolution. Finally, now that the SRFAESI Act has been passed by the Parliament, banks must set up task forces to make judicial use of the Act's provisions with appropriate back up framework to take over, manage and dispose of assets of the defaulting borrowers.

I am happy to note that the issue of a regime of corporate governance in urban co-operative banks has also been raised in some papers. Whatever I have mentioned earlier regarding corporate governance in commercial banks holds equally true for co-operative banks. In fact, it takes on an even greater meaning in the urban co-operative structure because of the influence of political personalities, the regulatory gray areas on account of dual control and the weak regime of audit to which they are subject. I would, therefore, exhort all stakeholders of urban co-operative banks to work towards strengthening corporate governance structure in this sector also.

Universal Banking

The presentations on Universal Banking have appropriately flagged the burning issues in a very topical area. It has been mentioned that the speed of consolidation in banking has begun to slacken, and the model of universal banking which was earlier

being hotly pursued by the big banks is now considered as flawed. It is also pointed out that recent events have brought to the fore the inherent conflicts of interest between commercial banking and investment banking being conducted within one bank. Further, despite the theoretical arguments in support of cross-selling of products such as insurance, there are few success stories possibly because this requires team building and selling skills, which all banks do not have.

Extending the above arguments to the Indian context, it is mentioned that the **merger** strategy to create size is likely to be witnessed here and is likely to result in the take over of the old private banks by public sector banks.

I would first like to comment on **the issue of mergers**. Let me very clearly state that the regulators are interested in seeing a banking sector which has a diverse array of well-capitalized and sound banks which have the skill and appetite to serve different segments of the population. However, we do not prefer any particular method by which this should be achieved and certainly do not promote mergers between public and private sector banks as the best solution.

Mergers, especially those between banks, are not easy. First, finding suitable partners is not an easy task and once this is done, getting agreement on a suitable swap ratio is equally difficult. Finally, all this requires the blessing of the regulators and is also subject to scrutiny at a later stage. If the merger is approved, then there is the vexatious issue of management control, which is always a bone of contention whether it is a merger or an acquisition. Compulsory mergers are not always a good solution because they invariably involve one weak bank and lead to a loss for the shareholders and the depositors and also has the potential to create a systemic problem.

It is our view that mergers are best left to the markets to decide and regulators should only create an environment which can facilitate consolidation among willing institutions. However, regulators may have to step in where a weak bank can no more exist and compulsory merger is the only option in the interests of both the depositors and the system.

However, in the Indian context, mergers have raised another type of policy issue. I refer here to the **reverse mergers** between the DFIs and banks. With the DFI model increasingly becoming unviable, one DFI has already merged with the bank floated by it; another is contemplating converting itself into a bank while a third is likely to be reduced to a narrow bank. The main incentive for this is of course the access to the cheap and stable bank deposit base, but the consequence of this is the drying up of sources of long term finance for the economy. Banks, therefore, have to fill this gap by funding long term projects which are viable. At the same time, they have to find suitable ways to mange their ALM mismatches which would arise from using the lower duration deposits to fund the higher duration projects.

On the issue of **diversification and universal banking**, I share some of the concerns expressed here, given that many banks have not made significant gains in allied activities handled through subsidiaries. The reasons for this may have been indiscriminate entry into different lines of business. It is heartening to note that banks have taken stock of the situation and begun to exit from businesses in which they did not have either skill or scope.

Capital Structure

From the presentations on capital structure of banks, it would appear that this is the right time for banks to begin planning for their capital needs for the coming years, since their performance has been better and since the markets are receptive. Although the average capital adequacy of the banking system is over 11%, this is not enough. The need for capital can go up in the coming years on account of two events. **First**, if there is a pick up in credit demand, then banks would need to re-align their risk weighted portfolio to meet this. Currently, they have invested 10-15% over the SLR requirements in Government Securities, which attract 0% credit risk-weight and 2.5% market risk weight. If this quantum is required to be redeployed in the loan book of banks then this loanable surplus will attract 100% risk-weight and warrant allocation of additional capital.

The **second reason** why banks will need to augment their capital in the coming years brings us to a key topic that was listed for this session but on which no papers have been received – the **New Capital Accord**, which is also termed as Basel II.

The Accord represents the ultimate convergence of research and practice in supervision as it attempts to apply state of the art financial modelling techniques to the prescription of capital adequacy. I will briefly mention the progress being made in the consultative process, what will be the likely shape of the final proposals and how these would impact our banks.

Basel II: The New Capital Accord

We have been actively participating in the international discussions on the proposals and have also been in the forefront of an initiative with other non G-10 supervisors to promote the recognition of a feasible approach which could be adopted by less complex banks without imposing significant costs. We support the move towards enhanced risk sensitivity in the capital allocation process. However, our basic concerns regarding the proposed framework, have been that the Standardized Approach (SA), which the majority of the banks in the world are expected to apply, is based on the ratings of bank borrowers by external agencies. This approach is deficient because penetration of such ratings is very low and not expected to increase significantly in the near future. Besides, such ratings are not seen as reliable in view

of the track record of some of the agencies. Further, wherever ratings are available, these are more issue ratings than issuer ratings, and culture of rating issuers has not yet developed. Finally, there is the important issue as to the cost that this rating would impose upon the system.

In view of the above constraints, such an approach essentially does not enhance risk sensitivity significantly in developing economies and hence is not favoured over the existing approach. Further, such an approach could put banks in jurisdictions where an external rating culture was not widespread at a relative disadvantage to banks in other jurisdictions and simply lead to an increase in capital requirements.

On the other hand, the **internal rating based (IRB) approach** is a more risk sensitive option and is also theoretically sound as banks are in the best position to evaluate their borrowers. In fact, the installation of this approach will lead to better risk management practices in banks and the output of these systems can be used for purposes other than pure capital allocation. However, only banks that have the necessary wherewithal in terms of data, MIS and skills can apply this approach in the timeframe contemplated i.e. by 2006.

Given that many countries have only recently implemented the 1988 Accord and given the different stages of sophistication at which the emerging economy banking systems are at present, **it may be necessary to phase in the New Accord in country specific time schedules**. The Basel Committee has taken note of the concerns expressed by India and other non-G10 supervisors and recognized that non-member countries would need more time beyond 2006 to implement the new framework and that they should not be considered as non-compliant till they are ready to move to the New Accord. The Committee is also working with a group of national supervisors, including India, to develop an option within the standardized approach that will not be based on external ratings but will be an extension of the current risk-weighting system.

This does not mean that our banks should take it easy as far as implementing the Accord is concerned. On the contrary, it should be the endeavour of our banks, which have international presence and also those, which are technologically capable to install IRB systems as early as possible.

You will be interested to know that the Reserve Bank has already taken steps to implement two main components of the second pillar of Basel II, viz., **Risk Based Supervision (RBS) and Prompt Corrective Action (PCA).** PCA framework has already been put into operation by the Reserve Bank and banks have been advised to initiate necessary steps to prevent them from attracting the provisions of this framework. Risk-based supervision will come into force from the first quarter of next year.

Conclusion

RBI has been putting in place various regulatory requirements to bring up the banking system on par with international requirements. The measures have been introduced gradually considering the over all ability of the banks to adopt them and after due prior consultation. This process is irreversible and all banks and financial institutions have to necessarily find the wherewithal to comply with them sooner rather than later.

Simultaneously, RBI has also been consistently moving away from "micro regulation". The combination of the above has resulted in considerable pressure on the banks to reorient them and to function in a market driven environment. This would evidently need a very pro-active management which is alive to the competition and the emerging scenario of the "low cost high efficiency "needs of operation in order to survive in the short to medium term. Needless to say, unless the governance process at the corporate and Board level is fully attuned to this requirement and is supplemented by advice and strategies from professionals, risks of slippage would emerge gradually.

You would see that the developments in the banking system mentioned by me, though seemingly independent, have a common connecting thread. Strong capitalization, sound performance, corporate governance, meeting challenges of competition, consolidation and providing market information are all inter woven. Non performance or under performance in any one of these areas would attract immediate notice of the stake holders and action from the regulators. In this situation, efficient and alert leadership needs as also quality governance and management could no longer be wished away.

I conclude by once again complimenting the organisers of BECON for doing an excellent job, and the authors of the papers for having raised some very important issues. I wish them success in their professional careers and expect them to continue to improve the quality of their research and analysis so that they can make a difference for their organisations.

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Address by Shri G P Muniappan, Deputy Governor, Reserve Bank of India at the Bank Economists' Conference, Bangalore.