Management Challenges in Banking*

Introduction

It gives me great pleasure in participating in the Annual Day function of NIBM where I have spent two years as a student of BMP in 1980s. NIBM has been playing a vital role in providing a platform to bankers and at times to Regulators also for exchange of views and thoughts to meet the emerging requirements of banking sector.

Recent developments have underscored the urgency to sensitise the banking industry on emerging issues and quickly adapt to the change. The theme chosen for discussion i.e. "Management Challenges in Banking" is most appropriate as it provides an opportunity to deliberate on the challenges that lie ahead of every one of us in the light of transformations taking place in the financial sector. There are two ways in which this topic can be interpreted – firstly, as challenges faced by bank management and secondly as the management of challenges faced by banks. Both these issues are of concern to us and although there is a common thread between the two topics, the focus of the two would be different. I have chosen to interpret today's topic as an amalgam of both these issues and have accordingly covered both in my address.

Before the onset of the reform process, Indian banking was operating in a relatively comfortable and protected environment. The reform process has brought the Indian banking system into the era of intense competition even though it paved the way for achieving remarkable improvement in various parameters. Every aspect of functioning of the banking industry, be it profitability, NPA management, customer service, risk management, human resource development, etc. has to undergo the process of transformation to align with the international best practices. Managing the challenges effectively becomes the most urgent task for the banks' management.

Against this backdrop, I would like to highlight some of the challenges confronting the banks which would require them to build up effective and well coordinated long term strategies to keep pace with the reform process.

Profitability

An important indicator of the strength of any system is its profitability level. The financial sector reform process brought in its wake measures like tightening of prudential norms, which affected the profitability of banks in the initial years. However, banks had responded well to the reform process. This has been possible due to careful sequencing of introduction of various prudential norms by the Regulator as also proper planning by the banks in adopting these norms.

Except for the year ended March 31, 2001, when public sector banks introduced Voluntary Retirement Scheme (VRS), resulting in huge charge to their profit and loss account and affecting their profitability, the operating and net profit of all bank groups for the last three years ended March 31, 2000 to 2002, as I see from the table below, had shown remarkable improvement.

Bank Group	Operating profit (Rs crore)*			Net profit (Rs. crore)		
	2000	2001	2002	2000	2001	2002
Public	13,042	13,801	21,672	5,116	4,316	8,301

sector banks	(1.46)	(1.34)	(1.88)	(0.57)	(0.42)	(0.72)
Private sector banks	2,576 (1.95)	2,843 (1.74)	4,628 (1.73)	1,160 (0.88)	1,141 (0.70)	1,778 (0.66)
Foreign banks	2,687 (3.24)	5,739 (3.05)	8,719 (3.13)	967 (1.17)	2,221 (0.93)	3,449 (1.33)
Total	18,305 (1.66)	22,383 (1.53)	35,019 (1.94)	8,243 (0.66)	7,678 (0.49	13,528 (0.75)

*Figures given in parenthesis are operating profit and net profit as a percentage to total assets

As compared to March 2000, the operating and net profit of banks had almost doubled by March, 2002.

However, you will agree that there are still some factors/constraints, which affect profitability levels in banks. One of them is NPAs, particularly in the public sector banks and old private sector banks. Other factors are the large number of unremunerative branches, low staff productivity and archaic methods of operations. With increasing competition, margins will come under further pressure and therefore banks have to build long-term strategies for increasing their profitability levels by:

- rationalization of branch network
- rationalization of manpower deployment
- use of latest technology in banking for further reduction in cost of operations and
- well concerted efforts to minimize the NPAs to the lowest possible level

NPA Management

The issue of NPA management continues to be the biggest challenge before the banking sector. One of the major constraints of the competitive efficiency of banks is the tendency to accumulate poor quality of assets. Nothing is more true indicator of the quality of assets than the incidence and quantum of NPAs in relation to the total portfolio. The level of gross NPAs of all groups of banks for the last three years from the table below, is on the rise, though the rate of growth has decelerated.

(Rs. Crore)

Bank Group	**Gross NPAs ***		
	2000	**2001**	**2002**
Public sector banks	53,033 (14.0)	54,773 (12.4)	56,507 (11.1)
Private sector banks	4,761 (8.2)	6,039 (8.4)	11,672 (9.7)
Foreign banks	2,614 (7.0)	3,071 (6.8)	2,726 (5.4)
Total	**60,408 (12.7)**	**63,883 (11.4)**	**70,905 (10.4)**

*Figures given in parenthesis are gross NPAs as percentage of gross advances

While we appreciate the steps taken by banks in reducing the level of NPAs, it still continues to be high by international standards. RBI / Government of India have taken several steps to arrest the NPA levels. The steps taken have been preventive, remedial and legal in nature.

For instance, the Corporate Debt Restructuring (CDR) mechanism has been introduced which is aimed at restructuring the debt of viable corporate entities outside the purview of BIFR, DRT, etc. Further, efforts are being made to make CDR mechanism more efficient. However, some banks have not joined the CDR mechanism and those who have joined have not referred many cases to CDR Cell.

Another major step in this direction has been the introduction of One Time Settlement Schemes (OTS). The success of the OTS has been modest. Under both the OTS schemes, i.e. upto Rs.5 crore and upto Rs.25,000 banks could recover only around Rs.3000 crore. I hope banks would make effective use of the forthcoming OTS guidelines for NPAs upto Rs. 10 crore.

The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, 2002 has been another major initiative from the legal side. This legislation would provide a comfort level to banks in tackling the problem of NPAs.

While the steps taken by RBI / Government of India will go a long way in reducing the level of NPAs, banks' Boards, on their part should also formulate clear cut guidelines for monitoring NPA level, refine their own appraisal systems and strengthen the loan review mechanism to prevent incidence of fresh NPAs.

Capital Adequacy

Ability of a bank to absorb unexpected shocks and losses is solely dependant upon its capital base. Basle Capital Accord of 1988 played a positive role in strengthening the soundness and stability of banks and enhanced the competitive equality among international banks. While on the one hand ongoing refinement in the capital adequacy norms had increased the capital requirements of our banks, there was increased pressure on the bottom lines of banks in view of the demand for setting aside profits for meeting the increased provisioning requirements. However, as indicated in the table below, the system as a whole has managed to maintain capital adequacy ratio of more than 11% over the last few years. However, there are still a few banks in the system, which operate with a capital adequacy below the stipulated level.

Year	**98-99**	**99-00**	**2000-01**	**2001-02**
Nationalised Banks	10.63	10.11	10.2	10.91
SBI Group	12.34	11.57	12.7	13.26
Public Sector Banks	11.25	10.66	11.15	11.76
Old Private Sector Banks	12.07	12.35	11.93	12.52
New Private Sector Banks	11.76	13.44	11.51	11.69
Foreign Banks	10.78	11.93	12.57	12.97
All Banks	11.27	11.1	11.39	11.92

The introduction of 90 days delinquency norm for recognition of loan impairment effective from March 31, 2004, reduction in the transition period for migration of a sub-standard asset

into doubtful category from 18 months at present to 12 months effective from March 31, 2005, making adequate provision to cover country risk, etc. would put increased pressure on the capital adequacy and bottom lines of banks.

Indian banking industry is playing a significant role in the financial intermediation process and as the pace of economic development is accelerated, the ratio of the bank credit to GDP is likely to be doubled from the existing ratio of about 25% to 50% within next 5 years which implies that the bank credit would increase two fold. Added to this, the big thrust being accorded to infrastructure sector requires substantial support from the banking system in the form of long-term loans. Hence, banks would be required to increasingly explore avenues to raise capital from the market.

Banks have, in recent years, placed greater reliance on subordinated debt to meet the increased capital requirements. However, scope for raising capital through subordinated debt is also limited in view of the prudential limit that subordinated debt cannot exceed 50% of Tier I capital.
Added to this, there is a constraint for public sector banks to raise capital from the market. As you are aware, the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) has high-lighted the fact that recapitalisation of public sector banks is costly and in the long run, is not a sustainable option. The Committee has therefore, suggested that no further recapitalisation of banks be undertaken from the Government budget and public sector banks should be encouraged to go to the market. Sixteen public sector banks have accessed the capital market so far, reducing the share of Government holding in these banks. The head room available to raise further capital by these banks is limited. In this context, there is an imperative need to expedite the proposed amendment to the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/80, enabling the nationalised banks to bring down the Government shareholding from 51% to 33%.

The New Capital Accord (Basel II) has already generated wide debate among the various sections of the banking industry. This shows that the Indian banking system is gearing itself to study, analyse and adopt the New Accord. RBI has been actively involved in the international discussions and is bargaining for national discretion to promote recognition of a feasible approach which could be adopted by less complex banks without imposing significant costs.

It was emphasised in the Monetary and Credit Policy of April 2002 that banks should constitute an expert internal team to study the methodology of the new Basel Committee proposals and its likely impact and the difficulties that would be experienced in implementing the proposals on account of their complexity and costs. Banks can share with us the results of such a study as and when completed by them.

A Quantitative Impact Study (QIS) has been conducted by the Reserve Bank of India in seven banks and the impact assessment is being evaluated. In the meanwhile, the banks have to refine their existing systems with a view to ensuring smooth transition to the New Accord.

Management

Recent developments in the country have brought to the fore the need for banks' management to exercise proper vigilance and supervision over the functioning of their respective banks.

Corporate governance, which represents the value framework, the ethical framework and the moral framework under which business decisions are taken, calls for transparency in decision-making and accountability to stakeholders.

In the context of the Indian banking system, though much greater autonomy and powers have been entrusted to the Boards of banks and financial institutions to lay down effective internal guidelines and procedures for transparency, disclosure, risk management, etc. Boards of some banks have not lived up to the expectation. You will appreciate that the role of banks' Boards becomes crucial in the deregulated regime.

Reserve Bank of India had set-up a Consultative Group under the Chairmanship of Dr. A.S. Ganguly to review the supervisory role of Boards of banks and financial institutions and obtain feed back on the functioning of the Boards vis-à-vis compliance, transparency, disclosures, audit committees etc. and give recommendations for making the role of Board of Directors more effective with a view to minimising risks and over exposure. The recommendations of the Group have been benchmarked with international best practices as enunciated by the Basel Committee on Banking Supervision, as well as of other committees and advisory bodies, to the extent applicable to the Indian environment. I would urge upon the banks to place the report and the list of recommendations before the Board of Directors and based on the decisions taken by the Board, to adopt and implement them. Banks should imbibe in the bank the highest level of corporate governance in larger spheres in the bank in due course.

Corporate Governance not only calls for greater responsibility of the Board. In fact, the role of the CEO also becomes equally crucial in sensitising not only the Board but the institution as a whole to appreciate the importance of corporate governance and supplement it. CEOs should therefore pay importance to building a team of performers and motivate the organisation as a whole.

Systems and Control

In recent years, size of operation of banks has increased manifold. Besides, banks are entering into various other activities in the financial services sector. Due to increased exposure of banks to various activities, the risks associated with them have also increased. Here I would like to emphasise upon the importance of managing operational risk which arises out of deficiencies in internal systems and controls, systems failures and non-adherence to prescribed procedures.

Operational risk covers a broad range of risks that are internal to the bank and have received less attention in the past than other kinds of risks. However, attention is increasingly being focused on the issue because of the scale of losses that banks have suffered as a result of breakdown in internal controls. Banks, particularly those operating in international markets, are beginning to apply the same quality of management attention to operational risk, which has traditionally been a back office concern as against the more well developed areas of credit and market risks.

Internal control and internal audit are the primary means to mitigate operational risk. A well established internal control system, which includes segregation of duties, clear management reporting lines and operating procedure coupled with sound internal audit system mitigate operational risk to a large extent.

Internationally, as well as in India, banks have not been able to evolve any scientific method for quantifying operational risk. This may be due to lack of historical data. Therefore, RBI has advised banks in its guidelines on "Risk Management Systems in banks" to evolve simple benchmark based on business activity such as gross revenue, fee income, operating costs etc., in the absence of any sophisticated models. Banks should devote the necessary resources to quantify the level of operational risks and incorporate them into the assessment of their overall capital adequacy as envisaged in the New Capital Accord.

Fraud

The reason why I wish to stress upon bank frauds is that banks in recent times have not adhered to the laid down systems and procedures thus giving rise to incidence of fraud. Practices in some banks like release of funds by lower level functionaries on oral instructions of the top management with no record maintained on such instructions, had contributed to the perpetration of frauds. In many cases the Board of Directors had in a routine manner ratified, post facto, the credit decisions of CMDs or other functionaries taken in excess of their delegated authorities. In many such cases, the loans had turned into NPAs later on.

We have been mentioning in all the interactions with the CMDs of banks that considerable delay has been noticed in reporting of the frauds to RBI/CBI/CVC. In as many as 23 cases of large value frauds for Rs.10 crore and above, cases filed for more than 5 years ago are yet to reach their logical end. This is the reason for our urging the banks, particularly CEOs to ensure that laid down systems and procedures are followed and there should be 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.

I agree that there is justification in the demand being made by banks that appropriate legislative amendment to Public Servants Act should be brought out to provide for dismissal of a public servant, through a focused enquiry lasting not more than a week in case of large frauds. This would, besides serving as a deterrent, would also ensure that fraudulent officials are not allowed to stay around to commit further mischief and tamper records.

Customer service

The reform process has resulted in shift from highly regulated banking to deregulation and liberalisation of the banking sector. The objective was to evolve a level of banking services which is efficient, effective and customer-oriented and which should seek to emulate the "best practices" in the industry the world over. Indian banking, realizing the challenges thrown by global competition is undergoing significant developments and improvements in the field of customer service. This has by and large been possible due to increased use of technology in banking resulting in branch computerization, growth of retail banking and automation of banking processes. Extension of reach of customer service and rationalisation of costs of operations were the by-products of this process.

For instance, ATM has emerged as an alternative banking channel which facilitates low-cost transactions vis-a vis traditional branch banking. The increased use of modern technology by foreign banks and new private sector banks has helped them to increase their market share vis-a-vis public sector banks. Modern clearing operations, electronic funds transfer system and centralized funds management system are some projects receiving priority of RBI to enhance customer service in the banking sector.

Banks should not be satisfied only with introducing latest technology towards providing better customer service. The level of service still needs improvement. Complaints about delay in crediting proceeds of outstation instruments by banks and fraudulent encashment of instruments by unscrupulous persons after opening deposit accounts in the name/s similar to already established concern/s resulting in erroneous and unauthorised debit of drawers' accounts continue to be received. In such cases, there have been instances where banks have also not restored funds promptly to customers even in bona-fide cases but deferred action till completion of either departmental action or police interrogation. I would reiterate that once banks are convinced that an irregularity / fraud had been committed by its staff towards any constituent, it should at once acknowledge its liability and pay the just claim.

There is a lot more to be done to enhance customer service in banks. Best way to come up to the customers' expectations would be to obtain regular feedback from them especially from rural and non-metro branches, and filling the gaps wherever exist. Banks' Boards should, in particular, review the policies regarding customer service at periodical intervals to fine tune them in line with customer needs. Complaints redressal mechanism should be quick, responsive and prompt.

Future road map

For a diverse and vast banking system like the one in India, it is important to build a future road map for the banking system. The future of Indian banking system needs a long term strategy which would broadly cover areas like structural aspects, business strategies, prudential standards, control systems, integration of markets, technology issues, credit delivery mechanism, information sharing, etc.

With increasing competition and globalisation the need for specialised one window service concept will grow. Banks would, therefore be required to draw business strategies keeping in view their risk bearing capacity and need for additional capital. Banks would also have to explore new markets and strive to achieve consolidation of their operations taking into account the client profile, business opportunities, etc.

In recent times, RBI has taken a number of initiatives keeping in mind the future road map of the banking system. Introduction of Prompt Corrective Action framework is one among them.

Under the PCA framework, RBI can initiate certain structured actions in respect of banks which have hit the trigger points in terms of CRAR, net NPA and ROA. RBI, at its discretion, will resort to additional actions (discretionary actions) as indicated under each of the trigger points. It would be better for banks to avoid coming under PCA framework. The CEO and the banks' Board have to work together to ensure that banks business is not conducted in such a way that trigger points under PCA framework are attracted by it. As the saying goes, "prevention is better than cure".

RBI is in the process of evolving fair practices code on lenders liability. The same has been put on the RBI website for comments from the public. Under the proposed guidelines, banks would be required to follow proper procedures with respect to loan application, such as acknowledging receipt of all loan applications, conveying reasons for rejection of loans, timely disbursement of loans etc. Banks would be given the freedom to draft fair practices

code. However, it should be ensured that RBI guidelines are not diluted. For this, Board of banks should lay down clear policy on all loan sanction and loan disbursement matters.

I conclude my address by thanking NIBM for giving me this opportunity to interact with you all.

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* Address by Shri G. P. Muniappan, Deputy Governor, Reserve Bank of India at the NIBM Annual Day Celebrations January 6, 2003