Conference of Chairman of Private Sector Banks
at NIBM Pune, on 15th February 1999.
(Address by S.P.Talwar, Deputy Governor, Reserve Bank of India)

Way forward for Private Banks in India

It is a Pleasure to be in the midst of my banker friends whom I had a privilege to meet individually on many occasions in the Past.

2. It is indeed nice on the part of NIBM to have organised such a Conference which I am sure would in the normal course deliberate on the role and initiatives of the private banking community. I shall at the same time consider it worthwhile if you would also take into account the responsibilities cast on the private sector banks in the present times when the Indian banking system is trying to reorient itself to meet the challenges arising out of the competitive environment in the context of ongoing financial sector reforms by way of deregulation of interest rates and prudential self governance, besides the pressures of globalisation bringing in their wake not only extensive use of technology and also application of transparency standards in published accounts. For a Conference of this kind, it is therefore very appropriate for NIBM to have made this congregation a mix of traditional bankers together with the technology driven new breed of Indian banks.

3. Of course, I am also aware that for around 3 decades NIBM has been playing this catalyst role in bringing together the Professional bankers and providing an opportunity for them to have an interface with the central bank of the country on the various aspects of their immediate concern. I am informed that this session is essentially meant for an interaction between us. But in the background of what I stated earlier, I seek your kind permission to convert this into a session of introspection on some of the vital issues before the Indian banking system and particularly those which I perceive are crucial for the very survival of Private banks in our country. I would like to highlight some of the more important ones to serve as a backdrop for the fruitful discussions that are bound to follow later.

4. On the positive front, I would be failing in my duty if I do not acknowledge the fact that the new banks have brought in the latest technologies in transaction processing, innovated on banking products and excelled in customer service almost giving a run to even well established foreign banks in the matter. Their operating costs, particularly staff costs to total income are at much lower levels than that of the foreign banks due to extensive use of technology and absence of restrictive practices in an officer oriented staff set up. It also makes me proud to note that some of the old private banks maintain high standards of operational efficiency and won accolades from the market and rated at top by leading financial dailies and journals.

5. The focus of the statutory regulation of commercial banks in India till the early 1990s was mainly on licensing, administration of minimum capital requirements, pricing of services including administration of interest rates on deposits as well as credit, reserves and liquid asset requirements. After evolution of BIS prudential norms in 1988, RBI has

taken a series of measures to realign its regulatory standards almost on par with the international best practices. At the same time it also took care to keep in view the socio-economic conditions of the country, the business practices, payment systems prevalent in the country and the predominantly agrarian nature of the economy and ensured that the prudential norms were applied over the period and across different segments of the financial sector in a phased manner.

6. Some of the regulatory and prudential norms suggested by the Narasimham Committee (2) though essential for the transformation process of the Indian banking system to reach global standards also cast heavy responsibility on banks in strengthening their financials which may not be feasible unless there is also a simultaneous structural realignment on the lines suggested by the Committee. I would like to discuss a few such recommendations of the Committee which do have a bearing on the course the private sector banks should follow in the days to come.

Capital Adequacy standards

7. Main thrust of the committee in this regard is on the following direction:

- increase of CRAR from 8 to 10% by 2002 and authority for RBI to raise this further for individual banks taking into account the risk profile
- capital adequacy requirements should take into account market risks in addition to credit risks
- 5% risk weight for market risk for government and approved securities
- risk weighting of government guaranteed advances

100% risk weight for foreign exchange open position

Implementation of the aforesaid recommendations require a great deal of efforts on the part of not only public sector banks but also old private banks many of them being substantially under capitalised.

8. In fact I would like to mention in this forum that the public sector banks despite their largeness would need to mobilise externally only around Rs 5400 crores, that too by only 13 nationalised banks and 5 associate banks of SBI, as additional capital funds to meet the proposed CRAR requirement of 10% by year 2002. This is despite assuming an average annual growth at 15% in their risk weighted assets, conservative estimate on return on assets at 0.8% and 12% increase by way of retained earnings based on past trends over this period. Again, a large proportion (Rs. 3350 crores) of the above capital funds are meant for the strong banks and easily mobilisable from the capital market either through equity or sub ordinated debt. Further, the needs of associated banks would easily be met by a cash rich SBI. I thought that we should provide aforesaid correct picture to the market and public in general and show how the assessment, in some cases pitched upto Rs.13500 crores, by various international agencies on the additional capital funds need of our public sector banks falls wide off the mark.

9. All said, it has to be accepted that the old private banks in the country need

large infusion of capital funds to make their operations viable and enable them to reach a level playing field. Additional capitalisation is essential for them for business growth and match the capital prescriptions for dealing with various emerging risk weighted products in Indian banking system. They need to make these efforts to reach the capital level standards of, if not the public sector banks, at least their immediate cousins viz. New private banks.

10. It is to be acknowledged that many of the old private banks suffer from low capital base. Although many banks have been in existence for considerably long period and 12 banks have in fact completed more than 50 years of existence , they have not taken steps to adequately strengthen their capital base. This is perhaps due to apprehensions of the management groups of losing controls over the banks on an enhanced capital base.

11. As many as 14 old private banks had capital funds which ranged from Rs.2.04 crore to Rs.95.12 crore as on 31st March 1998. Seven banks had capital funds of less than Rs.50 crore and have been advised to increase the position beyond Rs.50 crore within a period of 3 years. Five banks had CRAR at levels less than 8 per cent as on 31stMarch 1998 which continued to be so even as on 30th September 1998. Only 18 of the 26 banks enjoyed CRAR level of more than 10% as on 30th September 1998. I expect that these facts would engage your attention and trigger the coming together by the regional groupings and those with symmetry in business and operational profiles towards consolidation and restructuring to provide the much needed thrust for synergising the functioning of private banks in the country.

Prudential norms

12. Implementation of financial sector reforms in their second phase requires entire portfolio of government securities should be marked to market in the next 3 years. While this is already in vogue for new banks, old banks have to gradually move towards this regime from the existing level of 70% in respect of current assets. It is a matter of satisfaction that the old private banks together have reached a level of 87.31% in respect of current investments by end of September 1998, with many of them already switching over to marking their entire investment to market As already indicated in the RBI’s Mid term review in October 1998, marking investments upto 100% to market would be put in place over the next three years and I expect the remaining banks also to move in this direction on their own as done already by many of their counterparts and foreign banks.

13. While dwelling on the subject of investments, I would like to mention an emerging issue of supervisory concern in this area. In the light of substantial growth in the Non SLR investments by banks during the last 18 months, there is a need for proper assessment of underlying risks in equities and corporate bonds and debentures acquired by banks. This is all the more important in the context of the quoted non SLR investments to total non SLR investments reaching a level of as low as 39.59% in respect of new

banks and 35.28% in old private banks as on 30th September 1998.

Non performing advances

14. The following are some of important norms of asset classification and income recognition norms commended for adoption by the central bank as outlined by the Narasimham Committee (2) over the next few years.

- classification of assets as doubtful if it had remained in the substandard category for 18 months in the first instance and to be brought down to 12 months later

- non performing government guaranteed advances should also be brought under NPA classification norms

- evergreening of irregular advances by making fresh advances should be avoided and suggestions for relaxation of the definition of NPAs and the classification norms should be resisted by the central bank

- average level of net NPAs for all banks should be reduced to below 5% by 2000 and to 3% by 2002

- banks with international presence (Bharat Overseas Bank has international presence at present amongst private banks and new banks may aspire in the times to come) should reduce gross NPAs to 5 and 3% and net NPAs to 3 and 0%by 2000 and 2002

- international practice of income recognition norm of 90 days as against the present practice of 180 days should be introduced by 2002

- general provision for standard assets at 1 %

As you are already aware, RBI has already moved ahead in implementing many of the above recommendations except in regard to adoption of 12 months for classification of doubtful debts and reduction of past due tenure to a period of 90 days for income recognition asset classification. At the same time we have taken care to phase them for adoption, as in the past, over a gradual spread of time to ensure that the burden of absorption remains at bearable level for the institutions.

15. While it is normally expected that the banks in private sector will be more concerned in credit management and ensure faster recovery and recycling of loan portfolio, it is surprising to note that their NPA level, including that of new banks has been increasing at alarming levels over the last few years. The gross NPAs of old private sector banks have been rising in absolute terms during the last 3 years, from Rs.1474.34 crore in March 96 to Rs.2794.13 crore in March 98 and forming 7.99 % and 10.92% to the gross advances as on the respective dates. As many as 17 old private banks has gross NPAs level exceeding 10% as on 31st March 1998. The level of gross NPAs of these banks has shot up to 13.84% (net NPAs at 8.58%) as on 30th September 1998.

16. It is more a matter of concern to note that New private sector banks though have started their operations in the real sense only from 1995 have accumulated non-performing advances within short period. The gross NPAs of these banks had increased from 218.90 crore in March 97 to 405.63 crore in 31 March 98 with the percentage also raising from 2.30 % to 3.21 % at the end of respective periods. The gross NPAs were estimated at 5.40% (net NPAs at 3.98%) at the end of September 1998.

17. The increase of NPA in private sector banks is indicative of an alarming trend in this area viewed in the light of a rise of as much as 71.68% in gross NPAs in respect of new banks followed by 22.95% by old private banks as against 5.49 per cent increase registered by the Indian Banking System during the half year ended September 1998. It is unfortunate that 2 of the 9 new banks have reported gross NPAs above 5% and 19 old banks reporting gross NPAs above 10%. I would like all of you seriously look at the factors which led to such a sorry state of affairs in the area of credit management. You should initiate immediate steps for a relook into the credit appraisal techniques followed by your banks and institute or activate loan review mechanism especially for large borrowal accounts and systems to identify potential NPAs.

Credit and fund Management

18. The private banks and particularly the new banks continued to depend heavily upon bill market as a part of their lending operations with bills purchased constituting more than 30% of their loans and advances (13% for old banks) as on 30th September 1998. The banks were found on many occasions dealing with such a portfolio in a rather casual manner leaving aside time tested evaluation standards relating to appraisal of customer's capabilities to retire the bills in time. They had instead rested on the availability of other bank's comfort letters, which at times proved forged and violated maximum permissible level of finance a customer can obtain from banking system by way of funded and non funded exposures.

The new banks are particularly taking recourse to market borrowings as a regular source of funding their operations and also for arbitrage reasons. There should be clearly defined limits beyond which banks should not rely on the call money market. Access to call market should be only for meeting unforeseen swings and not as regular means of financing bank's lendings.

Risk Management and ALM techniques

19. The ratio of off balance sheet items as a percentage of total assets was high at 85.41% in respect of new banks (30.17% for old banks, 55.36 % for all banks, 321.69% for foreign banks) as at the end of September 98. The banks should pay greater attention to ALM and avoid mismatches and cover liquidity and interest rate risks. They should also adopt statistical risk management techniques like value at risk in respect of balance sheet items which are susceptible to market price fluctuations, forex rate volatility and interest rate changes

Credit Deposit Ratio

The Credit Deposit Ratio of the new banks was 46.58% followed by 49.55% registered for old private banks as against 48.68% for the Indian Banking System as on 30th September 1998. The banks should make extra efforts to optimise their credit portfolio without sacrificing credit discipline.

Profitability

20. The proportion of high cost inter bank deposits is high in the case of new private sector banks like in the case of foreign banks. In fact, largest proportion of high cost deposits is held by new banks followed by old private sector banks. This may lead to lower profitability particularly in the context of these banks already having a thin margin of interest spread in their operations.

21. The new banks have recorded the lowest interest spread at 0.89 per cent followed by 1.24 % in respect of old private banks which was less than industry average of 1.48% recorded for the half year ended September 98. They were still be able to maintain profits perhaps on account of low operating costs. The staff expenses as percentage of total income constituted only 2.82 per cent in respect of new banks and even less than foreign banks at 7.62%. This is indeed a commendable aspect of their working. The proportion was 11.46 per cent for old private banks for half year ended September 98.

22. It is worthmentioning that barring 4 banks all other banks reported profits during 1997-98 and declared dividends ranging from 9% to 75% for that year.

Transparency and Disclosure norms

23. There is a growing demand world over for introduction of better transparency and disclosure norms. As you all know, RBI has already introduced such norms over the last 3 years requiring banks to include in their published accounts various critical ratios relating to their operations, state of health of their provisioning and loan and investment portfolio and staff productivity levels. Narasimham Committee(2) has particularly recommended following disclosure parameters for adoption by the industry.

- need for disclosure of maturity pattern of assets and liabilities, foreign currency assets and liabilities, and movements in provision account and NPAs

- direction by RBI to banks for publishing consolidate group balance sheet

- full disclosure relating to connected lending and exposure to sensitive sectors

- disclosure of loans to related companies in bank's balance sheet

RBI is already working out the modalities for introduction of the aforesaid standards and banks are being advised shortly in the matter.

Systems and methods

24. There is increase in the number of frauds reported by the private banks including new banks during the last 3 years. The total number of frauds reported had increased from 182 (Rs.14.51 crore) in 1995 to 270 (Rs.95.92 crore) in 1997. Number of frauds reported during 1998 (upto September 1998) were 170 for Rs 76.06 crores. The banks should therefore make internal control systems as core of their business operations with particular focus on internal inspection and audit, concurrent audit, submission of control returns by branches and controlling offices, visits by controlling officials to field level offices. The banks should also introduce computer audit on a regular basis.

Technology upgradation

25. With globalising, financial systems have undergone fundamental changes because of the ongoing revolution in IT and EFT and payment system areas, these two emerging as pillars of modern banking developments. There is immediate need for introduction of information and control systems particularly in many of the old private sector banks towards

- better tracking of spreads, costs and NPAs for higher profitability,

- accurate and timely information for strategic decisions

- to identify and promote profitable products and quality customers

- risks and assets liability management and

- efficient treasury management

26. The banks should explore the feasibility of collaborative arrangements with universities and other institutions in India and abroad offering specialised training to the financial services industry to facilitate inflow of emerging training packages and methodologies.

Structural Issues

27. As already mentioned by me, capital adequacy levels would have to go undergo rapid changes flexible with emerging risk trends in the banking system. The question of minimum threshold capital for old private sector banks deserves attention and mergers could be one of the options available for reaching the required capital threshold. I would like to emphasise that mergers need not necessarily be between weak and strong banks but can happen even between strong banks as is happening around the world. The latter type of mergers would make greater economic and commercial sense and have a

'force multiplier' effect.

Connected Lendings

28. I would like to mention another disturbing trend emerging of late in the management of banks. As all of you are aware, Section 20 of the Banking Regulation Act prohibits loans to directors or to any firm or company in which directors are interested. The banks should maintain arms-length relationship in respect of own subsidiaries or joint ventures; all loans to such companies have to be made at commercial rates and are subject to limits which apply to similar companies. But in many cases the aforesaid discipline has not been adhered and violated in spirit and ultimately resulted in the loan facilities turning as NPAs. Such instances which have come to light during the course of inspections and through off-site reporting by banks are viewed seriously by the central bank. I would like to stress again that we resort to extreme supervisory action in such cases and in fact two chief executives of private banks have been removed by the central bank for gross violation of the above norms of connected lendings. Though it is not my intention to scare the bank managements, I still thought that I can leave a word of caution to the private banking community in this area.

Millennium (Year 2000) Issues

29. I would like draw your attention to one of the current IT related issues viz. Y2k problem which is pursued by RBI more as a business continuity risk than a technology problem. Initiation of Supervisory measures by RBI is in synchronisation with the standards set by BIS. RBI has an enlarged role of monitoring and enforcing the compliance by the entire financial sector and co-ordinates its efforts with the National level Task Force set up by the Prime Minister of India.

30. A target date of 31st December 1998 was fixed for ensuring Y2K compliance and banks may be subject to penal measures in case of persisting non compliance beyond March 1999. Institutions have also been advised to put in place appropriate contingency plans to take care of possible system failures. A High Powered Working Group in RBI under the chairmanship of Deputy Governor and with representatives drawn also from banking industry reviews the progress made in compliance at regular intervals.

Issues to be addressed

31. To conclude , I would like to reiterate the following issues for introspection by the banking community.

- In order to bring in synergy to their operations and bring in economies of scale, the private banks should go if necessary for voluntary mergers among themselves. The mergers need not necessarily be between a weak and strong bank. It can also be between two strong banks as proven by recent global experiments.

- There is an ever increasing pressure on banks' profits and business portfolio due to globalisation. The banks should therefore go in for an appropriate training packages and collaborative arrangements with specialists in technology and new product areas.

- The future trend of private banks should be not by mere expansion but more by way of consolidation.

- The performance ratios of both old private banks in comparison to other segments of the Indian banking system should make them vulnerable. Unless the banks wake up and redraw their business targets and operational strategies towards optimum earnings some of them will land in serious problems of even survival in the near future. Any apathy on the part of private banks will cast poor reflection on the investors' interest besides proving themselves as a drag on the Indian Banking System.

I take this opportunity to thank the Director, Shri Subramaniam for providing me an opportunity to share my views and concerns in this august forum of professional and dynamic bankers. I wish the Conference all success.