Banking and Trade Finance*

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I am indeed privileged to be invited to inaugurate this conference and especially so, as this is the first time that the International Chamber of Commerce Banking Commission Meeting is taking place in India. The contribution made by ICC in standardisation is well-known but perhaps what is not so well-known is that the ICC also contributes to making business policy by publishing policy statements and reports and laying down guidelines, goals and rules. This conference would, therefore, provide a forum for interaction between Indian bankers and corporates and their counterparts from other parts of the world. It is also an excellent opportunity to project India's potential in the banking and financial sector. Kudos to Mr. Kanwar for having arranged this conference in India.

The Indian financial sector reforms launched a decade ago have transformed the operating environment of the financial sector from an administered regime to a competitive market based system. The reforms are an on-going process. There is increasing evidence of strong inter-linkages between markets. In the macro economic and financial spheres, inflation has been contained, external debt indicators have vastly improved, the exchange rate is flexible and the country is free of financial repression. The trade account is open and India has become much more integrated with the world economy. The economy has also become more resilient to shocks, both domestic and external.

The Indian economy has emerged as one of the fastest growing emerging market economies and the Indian banking sector is perceived, as being the best performer in Asia. The robustness of the banking sector is witnessed by a consistent rise in Return on Equity, strong earnings momentum, improved loan book quality and unrealised gains on treasury portfolios. There are some structural factors that could drive credit growth, namely, the emergence of consumer loans, the shrinking of spreads on alternate assets and a higher risk appetite because of stronger foreclosure norms and statutory support for enforcement of creditor rights.

The Reserve Bank has initiated a host of measures to liberalise the financial system. The movement has been on four broad parameters – reducing if not eliminating price controls, reducing quantity prescriptions, reducing barriers to entry and increasing competition and moving to international standards of income recognition and accounts.

It may be of interest to the ICC Banking Commission that India has been closely

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associated with various standard setting bodies and has been taking active part in the work of several key international institutions devoted to the task of developing and promoting implementation of financial standards and codes. Although we are not a member of the Financial Stability Forum (FSF), we were one of the countries specially requested to help its Task Force on the Implementation of Standards and subsequently, the Follow Up Group on Incentives for Implementation of Standards.

The Reserve Bank's Standing Committee on International Financial Standards and Codes (Chairman: Dr. Y.V. Reddy) has assessed Indian regulations against international best practices in order to facilitate positioning of international financial standards and codes in relevant areas of the financial system in India and to guide the overall process of implementation of appropriate changes in respect of various segments of the financial system. India is one of the countries that has sought participation in the joint IMF-World Bank Financial Sector Assessment Programme (FSAP). As part of the Reports on Observances of Standards and Codes (ROSCs), India's compliance in respect of standards and codes has already been assessed in respect of six codes, *viz.*, Monetary and Financial Policy Transparency, Fiscal Transparency, Banking Supervision, Securities Market Regulation, Payment and Settlement System and Corporate Governance. Currently, assessment is being undertaken with regard to Special Data Dissemination Standards.

The Narasimham Committee on Banking Sector Reforms (1998) had observed that a legal framework that clearly defines the rights and liabilities of parties to contracts and provides for speedy resolution of dispute is a *sine qua non* for efficient trade and commerce, especially for financial intermediation. Several legislative initiatives have been undertaken in the banking and financial sector.

The bills introduced in Parliament for amendment of the Banking Regulation Act will encourage foreign banks to set up subsidiaries and attract foreign investors. Historically, foreign banks have always been allowed to operate in India and have enjoyed national treatment and a level-playing field. With a view to developing trade and payment relationship, we have encouraged foreign banks from other countries which did not have historic links to establish branches in India. I may add that the WTO commitment on banking services has been fulfilled.

A critical issue of increasing international concern is the question of money laundering. The impact of money laundering is now beginning to extend from economic crimes to international terrorism. As financial transactions grow more complex, it becomes more difficult for banks to maintain a customer profile. The challenge, therefore, is to ensure that banks know their customers without hindering the smooth flow of financial transactions.

The Reserve Bank has issued several guidelines to banks and non-banking financial companies to implement the 'Know Your

Customer' principle. The basic aim is to prevent banks being unwittingly used as the channel of funds derived from criminal activity or financing terrorism. The guidelines relate to identification of depositors and institution of systems and procedures to control financial frauds, identify money laundering and suspicious activities and scrutinise / monitor large-value cash transactions.

In India, recognising the paramount role of exports in the overall growth process of the economy, the Government of India and the Reserve Bank of India have, over time, taken several measures to ensure adequate flow of credit towards export related activities. The important measures include rationalisation and liberalisation of export credit interest rates, flexibility in repayment/pre-payment of pre-shipment credit, simplification of procedures relating to exports (like direct despatch of shipping documents and enhancement in normal period for realisation of export proceeds), flexibility to banks to source foreign currency funds for granting pre-shipment credit in foreign currency (PCFC) and export bill rediscounting (EBR) scheme and introduction of a transparent reporting system for export credit interest rates.

At present, exporters have the option to avail of pre-shipment and post-shipment credit in foreign currency from banks in India. In order to encourage competition among banks and also to increase flow of credit to the export sector, the Reserve Bank of India has liberalised interest rates on local currency export credit effective May 1, 2003 for pre-shipment credit above 180 days and post-shipment credit above 90 days. In the context of globalisation, however, what one needs to keep in mind is that even though finance is a critical ingredient of production, what matters even more is the demand for the product and its competitiveness on quality considerations. Finance can only act as a facilitator when these two preconditions are satisfied. This is vindicated by the recent surge in growth of exports of automotive components and C.D. Roms.

The initiative with regard to the setting up of an Electronic Data Interchange (EDI) in the banking sector for the benefit of the exporters and importers bears mentioning. EDI provides several benefits to the corporates such as operational efficiencies and cost savings by elimination of paperwork, logistical benefits by better scheduling and reduced stockholding *etc.*, and strategic benefits through competitive advantage and access to new markets. Under the EDI project, one of the major benefits for the exporters is that the RBI has abolished GR forms for export transactions. The exporters can now fill up a common Statutory Declaration Form (SDF) for the customs from where the data relevant to the banks and the RBI can be extracted. Presently, EDI is working at 23 ports covering 80 per cent of exports. Under the EDI project, bank branches at 114 export intensive centers identified by the Ministry of Commerce are to be provided connectivity with the customs authorities.

The Reserve Bank has provided the enabling conditions for promotion of trade and investment, both domestic and international, by ensuring adequate liquidity, a competitive interest rate regime measures to encourage decentralised decision making and ease procedures in the credit delivery systems and most importantly financial stability in the midst of a world economy beset by uncertainty and recessionary trends. It is now necessary for market participants to have enough confidence to make investment decisions.

And what would banks need to do ? Banks need to continue to adequately finance activities that are of crucial importance to growth. The fostering of entrepreneurship in new industrial activities, in the emerging services sector and other non-traditional activities, will all require proactive financing.

Banks need to bear in mind that risk is not merely compliance with regulatory guidelines. The regulatory guidelines can at best represent the minimum requirements which the Supervisor expects each bank to achieve. Through efficient risk management systems they can create value for themselves by making the best use of their capital which would by itself be a source of competitive advantage to them besides generating positive externalities for a sound and stable banking system. The sophisticated banks have to set their own standards for risk management depending on their risk appetite, the products, the portfolios and the markets in which they operate. While Reserve Bank would like banks to optimally manage credit and market risks, operational risks should be eliminated totally. As Walter Wristan said "Banking is the business of accepting, managing and transforming risk".

As the Indian economy opens up, there is general need for better risk management through proactive building of investment fluctuation reserve (IFR), provisioning in respect of problem assets, putting in place systems that monitor unhedged external liabilities along with measures to contain such risks, active use of available derivatives and the development of markets for risk management products.

Along with the risk-based internal audit, the banks must also put in place proper risk management architecture, strengthen the MIS and Information Technology, address HRD issues and set up compliance units. These steps will enable a smooth transition to the risk-based supervision which is currently being implemented in India. The risk-based supervision provides incentives to the banks for adoption of more sophisticated risk management techniques and this together with sound corporate governance should lead to the creation of a banking system which is world class.

The Reserve Bank, on its part, would continue to ensure financial stability, strengthening of prudential norms with the strategy of convergence of international best practice, consistent with our specific needs, as also progressive strengthening of the supervisory framework. Accordingly, the focus of our policy initiatives would be on streamlining banking operations in order to reduce transaction costs, infusing flexibility into the system, upgrading risk management systems, enhancing the level of compliance by banks with accounting standards, operationalising consolidated accounting practices and last and most important of all, providing the public with a financial system they can trust.

While there is substantial progress in the financial sector reforms initiated in 1991, the accent at the present time is on implementation of the reforms at the grass roots level. In this context, the endeavour is to facilitate ease of transactions by the common person, further broadening of the consultative process and continued emphasis on the institutional capacity to support growth consistent with stability. Furthermore, the credit delivery system is being strengthened to ensure that financing gaps do not constrain the acceleration of growth.

In line with the philosophy underpinning the Basel Accord, it is our attempt to move banks to a risk-based supervisory system where we enforce a certain discipline on market players with strong self governance standards which are transparent to the market, their investors and customers.

To face the increasing challenges and complexities in the context of globalisation and risk management, a *Standing Technical Advisory Committee on Financial Regulation* has been set up by Governor Dr. Y.V.Reddy which, through a consultative process, will endeavour to simplify and rationalise the regulatory regime to move towards a clear and unambiguous framework.

In another initiative, *Standing Committee on Procedures and Performance Audit on Public Services* provided by the Reserve Bank is being set up to bench mark the current level of services and to enhance the timeliness and quality of these services. The Committee will also coordinate with the Ad hoc Committee on Customer Services being set up by each bank. These initiatives would, it is expected, bring about a significant improvement in customer service in the financial sector.

The central objective of financial reforms is to attain a significant improvement in the efficiency of financial intermediaries and the endeavour of the Reserve Bank would be to provide a regulatory framework in which economic agents can perform their activities in an optimal manner. In this endeavour, the Reserve Bank would approach issues in a collaborative manner, and in this, seek the hand of market participants.