BANKING SECTOR IN GLOBAL PERSPECTIVE

Inaugural Address by

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at

Bankers' Conference, 2004

Distinguished guests, Ladies and Gentlemen,

It is indeed a pleasure and privilege to be amidst this august gathering of eminent bankers, experts and policymakers. Over the years, the Conference has evolved as an important forum for structured information sharing among not only delegates from the banking sector, but also experts from research institutions, credit rating agencies, international institutions and other financial sector bodies. The *Bankers' Conference,* 2004 is a great advancement over the previous years. The most notable feature is that Respected President Dr. A.P.J. Abdul Kalam is addressing this gathering. In addition, we also have here today, globally renowned policy makers amidst us who will give us the benefit of their views. These include, Ms. Anne Krueger, First Managing Director of the IMF, a dear friend of mine, and a distinguished Central Banker, Governor Caruana of Bank of Spain who is also Chairman of the Basel Committee on Banking Supervision.

The subjects selected for the Conference are of great importance and we, in RBI, look forward to the benefit of your deliberations. My inaugural address today will be brief and in the nature of a few comments on the status of Indian banking industry and challenges ahead in a global perspective.

I. Status of Indian Banking Industry

It is useful to note some telling facts about the status of the Indian banking industry juxtaposed with other countries, recognising the differences between the developed and the emerging economies.

First, **the structure of the industry** : In the world's top 1000 banks, there are many more large and medium-sized domestic banks from the developed countries than from the emerging economies. Illustratively, according to *The Banker 2004*, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan, over 80 in Germany, over 40 in Spain and around 40 in the UK. Even China has as many as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. India, on the other hand, had 20 banks within the top 1000 out of which only 6 were within the top 500 banks. This is perhaps reflective of differences in size of economies and of the financial sectors.

Second, the **share of bank assets** in the aggregate financial sector assets : In most emerging markets, banking sector assets comprise well over 80 per cent of total financial sector assets, whereas these figures are much lower in the developed economies. Furthermore, deposits as a share of total bank liabilities have declined since 1990 in many developed countries, while in developing countries public deposits continue to be dominant in banks. In India, the share of banking assets in total financial sector assets is around 75 per cent, as of end-March 2004. There is, no doubt, merit in recognising the importance of diversification in the institutional and instrument-specific aspects of financial intermediation in the interests of wider choice, competition and stability. However, the dominant role of banks in financial intermediation in emerging economies and particularly in India, will continue in the medium-term; and the banks will continue to be "special" for a long time. In this regard, it is useful to emphasise the dominance of banks in the developing countries in promoting non-bank financial intermediaries and services including in development of debt-markets. Even where role of banks is apparently diminishing in emerging markets, substantively, they continue to play a leading role in non-banking financing activities, including the development of financial markets.

Third, **internationalisation** of banking operations : The foreign controlled banking assets, as a proportion of total domestic banking assets, increased significantly in several European countries (Austria, Ireland, Spain, Germany and Nordic countries), but increases have been fairly small in some others (UK and Switzerland). Amongst the emerging economies, while there was marked increase of foreign-controlled ownership in several Latin American economies, the increase has, at best, been modest in the Asian economies. Available evidence seems to indicate some correlation between the extent of liberalisation of capital account in the emerging markets and the share of assets controlled by foreign banks. As per the evidence available, the foreign banks in India, which are present in the form of branches, seem to enjoy greater freedom in their operations, including retail banking, in the country on par with domestic banks, as compared with most of the other developing countries. Furthermore, the profitability of their operations in India is considerably higher than that of the domestically-owned banks and, in fact, is higher than the foreign banks' operations in most other developing countries. India continues to grant branch licences more liberally than the commitments made to the WTO.

Fourth, the **share of state-owned banks** in total banking sector assets : Emerging economies, with predominantly Government-owned banks, tend to have much higher state-ownership of banks compared to their developed counterparts. While many emerging countries chose to privatise their public sector banking industry after a process of absorption of the overhang problems by the Government, we have encouraged state-run banks to diversify ownership by inducting private share capital through public offerings rather than by strategic sales and still absorb the overhang problems. The process has helped reduce the burden on the Government, enhance transparency, encourage market discipline and improve efficiency as reflected in stock market valuation, promote efficient new private sector banks, while drastically reducing the share of the wholly government owned public sector banks in a rapidly growing industry. Our successful reform of public sector banks is a good example of a dynamic mix of public and private ownership in banks.

A noteworthy feature of banking reforms in India is the growth of newly licensed private sector banks, some of which have attained globally best standards in terms of technology, services and sophistication. In many respects related to performance, these domestically promoted banks have surpassed branches of foreign banks in India, and could be a role model for other banks.

II. Challenges Ahead

Let me highlight some thoughts on certain areas which have a key bearing on the ability of Indian banks to remain competitive and enhance soundness. Needless to state, these are more in the nature of random thoughts, rather than any structured thinking, and are meant to invite discussion.

First, **cost management**. Cost containment is a key to sustainability of bank profits as well as their long-term viability. To highlight this point, let me, take recourse to some figures. In 2003, operating costs of banks as a proportion of total average assets[1] in the UK were 2.12 per cent, for those in Switzerland they were 2.03 per cent, and less than 2 per cent in major European economies like Sweden, Austria, Germany and France. In India, however, in 2003, operating costs as proportion of total assets of scheduled commercial banks stood at 2.24 per cent. The tasks ahead are thus clear and within reach.

Second, **recovery management**. This is a key to the stability of the banking sector. There should be no hesitation in stating that Indian banks have done a remarkable job in containment of non-performing loans (NPL) considering the overhang issues and overall difficult environment. Let me add that for 2004, the net NPL ratio for the Indian scheduled commercial banks at 2.9 per cent is ample testimony to the impressive efforts being made by our banking system. In fact, recovery management is also linked to the banks' interest margins. We must recognise that cost and recovery management supported by enabling legal framework hold the key to future health and competitiveness of the Indian banks. No doubt, improving

[1] Average assets defined as total assets at the beginning of the year plus total assets at the beginning of the subsequent year divided by 2

recovery-management in India is an area requiring expeditious and effective actions in legal, institutional and judicial processes.

Third, **technological intensity of banking:** This is one area where perhaps India needs to do significant ‘catching up’, notwithstanding the rapid strides made over the last few years, though data on this score are difficult to come by. Some available figures indicate that in late 1999, the percentage of customers using online banking was less than 1 per cent in India, compared with anywhere between 6-30 per cent in developed economies like US, UK, Germany, Finland and Sweden. Even in Latin America, these figures are much higher than for India. While admittedly the numbers for India are likely to be much higher at present than these figures suggest, so would be the case for these other economies as well. The issue, therefore, remains what has been the extent of ‘catching up’ by India on this score? In fact, this seems somewhat intriguing: India happens to be a world leader in information technology, but its usage by our banking system is somewhat muted. It is wise for Indian banks to exploit this globally state-of-art expertise, domestically available, to their fullest advantage.

Fourth, **risk management**. Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II Accord is likely to lead to an even sharper focus on the risk measurement and risk management at the institutional level. Thankfully, the Basel Committee has, through its various publications, provided useful guidelines on managing the various facets of risk. The institution of sound risk management practices would be an important pillar for staying ahead of the competition. Banks can, on their part, formulate ‘early warning indicators’ suited to their own requirements, business profile and risk appetite in order to better monitor and manage risks.

Fifth, **governance**. The recent irregularities involving accounting firms in the US have amply demonstrated the importance of good corporate governance practices. The quality of corporate governance in the banks becomes critical as competition intensifies, banks strive to retain their client base, and regulators move out of controls and micro-regulation. As already mentioned, banks are special in emerging markets since they take a leading role in development of other financial intermediaries and of financial markets, apart from having a large recourse to public deposits. No doubt, there is nothing like an 'optimal' level of governance for one to be satisfied with. The objective should be to continuously strive for excellence. The RBI has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices. It is heartening to note that corporate governance presently finds explicit mention in the annual reports of several banks. The improved corporate governance practice would also provide an opportunity to accord greater freedom to the banks' boards and move away from micro regulation to macro management. Banks in India are custodians of depositors' monies, monies of the millions of depositors who are seeking safe avenues for their hard earned savings, and hence, banks must accept and perform an effective fiduciary role. In this light, improvement in policy-framework, regulatory regime, market-perceptions, and indeed, popular sentiments relating to governance in banks need to be on the top of the agenda – to serve our society's needs and realities while being in harmony with the global perspective.

Thank you.