Indian banks and the global challenges*

It gives me great pleasure and privilege to participate in the Seminar jointly hosted by Indian Merchants' Chamber and IBA at a juncture when financial services sector across jurisdictions is going through a strong phase of increasing globalisation. Integration of economies leads to integration of financial markets catalyzing the globalisation process. The growing role of the financial sector in allocation of resources has significant potential advantages for the efficiency with which our economy functions. Consequently, the adverse consequences of malfunction of the financial system are likely to be more severe than they used to be in the past. Hence, all our efforts today are focused at ensuring greater financial stability. Given the significance of the Indian banking system, one cannot afford to underplay the importance of a robust and resilient banking system.

2. The enhanced role of the banking sector in the Indian economy, the increasing levels of deregulation along with the increasing levels of competition have facilitated globalisation of the India banking system and placed numerous demands on banks. Operating in this demanding environment has exposed banks to various challenges. The last decade has witnessed major changes in the financial sector - new banks, new financial institutions, new instruments, new windows, and new opportunities - and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment revenues, it has entailed greater competition and consequently greater risks. Demand for new products, particularly derivatives, has required banks to diversify their product mix and also effect rapid changes in their processes and operations in order to remain competitive in the globalised environment.

Globalisation – a challenge as well as an opportunity

3. The benefits of globalisation have been well documented and are being increasingly recognised. Globalisation of domestic banks has also been facilitated by tremendous advancement in information and communications technology. Globalisation has thrown up lot of opportunities but accompanied by concomitant risks. There is a growing realisation that the ability of countries to conduct business across national borders and the ability to cope with the possible downside risks would depend, inter-alia, on the soundness of the financial system and the strength of the individual participants. Adoption of appropriate prudential, regulatory, supervisory, and

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technological framework on par with international best practices enables strengthening of the domestic banking system, which would help in fortifying it against the risks that might arise out of globalisation. In India, we had strengthened the banking sector to face the pressures that may arise out of globalisation by adopting the banking sector reforms in a calibrated manner, which followed the twin governing principles of non-disruptive progress and consultative process[1].

Global challenges in banking

4. Recently I was afforded an opportunity to speak on the challenges faced by the Indian banking industry. To recapitulate, I had identified a few broad challenges faced by the Indian banks in the following areas, viz., enhancement of customer service; application of technology; implementation of Basel II; improvement of risk management systems; implementation of new accounting standards; enhancement of transparency & disclosures; and compliance with KYC aspects. If we were to identify a few global challenges which banks face today, I am sure we would cover some common ground. An overview of the global challenges would include the following: Basel II implementation; enhancing corporate governance; alignment of regulatory and accounting requirements; outsourcing risks; and application of advanced technology. I propose to cover these aspects now.

Basel II implementation

5. Basel II implementation is widely acknowledged as a significant challenge faced by both banks and the regulators internationally. It is true that Basel II implementation may be seen as a compliance challenge. While it may be so for some banks, I would venture to mention that Basel II implementation has another dimension which offers considerable opportunities to banks. I would like to highlight two opportunities that are offered to banks, viz., refinement of risk management systems; and improvement in capital efficiency

6. *Comprehensive risk management:* Under Basel I banks were focused on credit and market risks. Basel II has brought into focus a larger number of risks requiring banks to focus on a larger canvas. Besides the increase in the number of risks, banks are now beginning to focus on their inter-linkages with a view to achieve a more comprehensive risk management framework. Basel II implementation, therefore, is being increasingly seen as a medium through which banks constantly endeavour to upgrade the risk management systems to address the changing environment. Further, in the initial stages, banks were managing each risk in isolation. It is no longer

adequate to manage each risk independently. Enterprises worldwide are, therefore, now putting in place an integrated framework for risk management which is proactive, systematic and spans across the entire organisation. Banks in India are also moving from the individual silo system to an enterprise wide risk management system. While the first milestone would be risk integration across the entity, banks are also aware of the desirability of risk aggregation across the group both in the specific risk areas as also across the risks. Banks would, therefore, be required to allocate significant resources towards this endeavour.

7. *Capital efficiency:* Basel II prescriptions have ushered in a transition from the traditional regulatory measure of capital adequacy to an evaluation of whether a bank has found the most efficient use of its capital to support its business i.e., a transition from capital adequacy to capital efficiency. In this transition, how effectively capital is used will determine return on equity and a consequent enhancement of shareholder value. In effect, banks may adopt a more dynamic approach to use of capital, in which capital will flow quickly to its most efficient use. This revised efficiency approach is expected to guide the return-on-equity strategy and influence banks' business plans. With the extension of capital charge for market risks to the AFS portfolio this year and the coming into force of Basel II norms in March 2007, banks would need to shore up the capital levels not only for complying with these requirements but also for supporting the balance sheet growth. With a view to enhancing the options available to banks for augmenting their capital levels, the Reserve Bank has recently permitted banks to issue new capital instruments, including perpetual instruments. A notable feature of these instruments is that these are designed to help banks in not only managing their capital effectively but also efficiently.

Enhancing corporate governance

8. The issues related to corporate governance have continued to attract considerable national and international attention in light of a number of high-profile breakdowns in corporate governance. This becomes all the more relevant for banks since they not only accept and deploy large amount of uncollateralized public funds in fiduciary capacity, but also leverage such funds through credit creation. Banks are also important participants in the payment and settlement systems. In view of the above, legal prescriptions for ownership and governance of banks in Banking Regulation Act, 1949 have been supplemented by regulatory prescriptions issued by RBI from time to time.

9. In view of the importance of the banking system for financial stability, sound corporate governance is not only relevant at the level of the individual bank, but is also a critical ingredient at the system level. Effective risk management systems determine the health of the financial system and its ability to survive economic shocks. To a large extent, many risk management failures reflect a breakdown in corporate governance which arise due to poor management of conflicts of interest, inadequate understanding of key banking risks, and poor Board oversight of the mechanisms for risk management and internal audit. Corporate governance is, therefore, the foundation for effective risk managements in banks and thus the foundation for a sound financial system[2]. Therefore, the choices which banks make when they establish their risk management and corporate governance systems have important ramifications for financial stability. These systems can affect how the institution functions and how others perceive it in the marketplace[3].

10. A good "governance culture" is crucial for financial stability but since it is an 'intangible', rules may not be able to capture its essence effectively. Therefore, banks may have to cultivate a good governance culture building in appropriate checks and balances in their operations. There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure appropriate checks and balances: (1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management, compliance and audit functions. In addition, it is important that key personnel are fit and proper for their jobs. Although some ownership structures might have the potential to alter the strategies and objectives of a bank, these banks will also face many of the same risks associated with weak corporate governance. Consequently, the general principles of sound corporate governance should also be applied to all banks irrespective of their unique ownership structures[4].

Compliance with international accounting standards

11. One of the prime international standards considered relevant for ensuring a safe and sound banking system is the 'Core Principles for Effective Banking Supervision' issued by the Basel Committee on Banking Supervision (BCBS). Accounting standards are now a part of the set of twelve standards that have been identified by the Financial Stability Forum as conducive to a robust financial infrastructure. Financial reporting and

prudential supervision have slightly different perspectives. While the former is oriented towards capturing the historical position, the latter has a forward looking element particularly with reference to measurement of impairment and capital. An important challenge, therefore, is to ensure that accounting standards and prudential frameworks are mutually consistent. While working towards achieving this consistency between the two sets of standards, it is essential for the regulators to be in a position to address any implications that the changes in accounting standards may have for the safety and soundness of banks[5].

12. Derivative activity in banks in India has been increasing at a brisk pace. While the risk management framework for derivative trading, which is a relatively new area for Indian banks (particularly more in respect of structured products), is an essential pre-requisite, the absence of clear accounting guidelines in this area is matter of significant concern. It is widely accepted that as the volume of transactions increases, which is happening in the Indian banking system, the need to upgrade the accounting framework needs no emphasis. The World Bank's ROSC on Accounting and Auditing in India has commented on the absence of an accounting standard which deals with recognition, measurement, presentation and disclosures pertaining to financial instruments. The Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) is considering issue of Accounting Standards on the above aspects pertaining to financial Instruments. These will be the Indian parallel to International Financial Reporting Standard 7, International Accounting Standards 32 and 39. The proposed Accounting Standards will be of considerable significance for financial entities and could therefore have implications for the financial sector. The formal introduction of these Accounting Standards by the ICAI is likely to take some time in view of the processes involved. In the meanwhile, the Reserve Bank is considering the need for banks and financial entities adopting the broad underlying principles of IAS 39. Since this is likely to give rise to some regulatory / prudential issues all relevant aspects are being comprehensively examined. The proposals in this regard would, as is normal, be discussed with the market participants before introduction. Adoption and implementation of these principles are likely to pose a great challenge to both the banks and the Reserve Bank.

Outsourcing risks

13. Banks are increasingly using outsourcing for achieving strategic aims leading to either rationalisation of operational costs or tapping specialist expertise which is not available internally. 'Outsourcing' may be defined as *a bank's use of a third party, including an affiliated entity within a corporate group, to perform activities on a continuing basis that would normally be undertaken by the bank itself.* Typically outsourced financial services include applications processing (loan origination, credit card), document processing, investment management, marketing and research, supervision of loans, data processing and back office related activities etc.

14. Outsourcing might give rise to several risks including, strategic risk, reputation risk, compliance risk, operational risk, exit strategy risk, counterparty risk, country risk, access risk, concentration risk and systemic risk. The failure of a service provider to provide a specified service, ensure security/ confidentiality, comply with legal and regulatory requirements can lead to financial losses/ reputational risk for the bank and could also lead to systemic risks for the entire banking system in a country. It would therefore be imperative for the bank outsourcing its activities to ensure effective management of these risks.

15. It is in this background that RBI has issued draft guidelines on outsourcing, which is intended to provide direction and guidance to banks to effectively manage risks arising from such outsourcing activities. The underlying principles for any outsourcing arrangement by a bank are that such arrangements should neither diminish the bank's ability to fulfill its obligations to its customers and the RBI nor impede effective supervision by RBI. Outsourcing banks, therefore, should take steps to ensure that the service provider employs the same high standard of care in performing the services as would be employed by the banks if the activities were conducted within the banks and not outsourced. Accordingly, banks are not expected to outsource any activity that would result in their internal control, business conduct, or reputation being compromised or weakened.

Application of advanced technology

16. Technology is a key driver in the banking industry, which creates new business models and processes, and also revolutionises distribution channels. Banks which have made inadequate investment in technology have consequently faced an erosion of their market shares. The beneficiaries are those banks which have invested in technology. Adoption of technology also enhances the quality of risk management systems in banks. Recognising the benefits of modernising their technology

infrastructure banks are taking the right initiatives. While doing so, banks have four options to choose from: they can build a new system themselves, or buy best of the modules, or buy a comprehensive solution, or outsource. In this context banks need to clearly define their core competencies to be sure that they are investing in areas that will distinguish them from other market players, and give them a competitive advantage[6]. A further challenge which banks face in this regard is to ensure that they derive maximum advantage from their investments in technology and avoid wasteful expenditure which might arise on account of uncoordinated and piecemeal adoption of technology; adoption of inappropriate/ inconsistent technology and adoption of obsolete technology.

Capacity building

17. As dictated by the changing environment, banks need to focus on appropriate capacity building measures to equip their staff to handle advanced risk management systems and supervisors also need to equally equip themselves with appropriate skills to have effective supervision of banks adopting those systems. In the likelihood of a high level of attrition in the system, banks need to focus on motivating their skilled staff and retaining them[7]. Skill requirements would be significantly higher for banks planning to migrate to the advanced approaches under Basel II. Capacity building gains greater relevance in these banks, so as to equip themselves to take advantage of the incentives offered under the advanced approaches.

18. A relevant point in this regard is that capacity building should be across the institution and not confined to any particular level or any particular area. The demand for better skills can be met either from within or from outside. It would perhaps be worthwhile to first glean through the existing resources to identify misplaced or hidden or forgotten resources and re-position them to boost the bank's efforts to capitalise on available skills. This does not undermine the benefits that a bank may derive by meeting their requirements from the market, but is only intended to prioritise the process.

Conclusion

19. The global challenges which banks face are not confined only to the global banks. These aspects are also highly relevant for banks which are part of a globalised banking system. Further, overcoming these challenges by the other banks is expected to not only stand them in good stead during difficult times but also augurs well for the

banking system to which they belong and will also equip them to launch themselves as a global bank.

Acknowledgements:

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