Indian Banking Sector: Gazing Into The Crystal Ball[1]

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2. At the outset, I thank the Mint Management for inviting me to deliver the keynote address at this Annual Banking Conclave. The galaxy of speakers that headline this event provides a testimony to the importance of this event. A lot in the Indian banking sector has changed since I first spoke at this conclave three years ago. Disruptive events have taken place; innovative practices introduced and competition as it stands today, is stiffer than ever before and is likely to intensify further in the coming months.

3. Some of you who attended this event last year might recall that I had briefly raised certain issues at the end of my address stating that they could emerge as potential challenges for the banking sector in the days to come. Many such challenges which were looking abstract or distant then are appearing imminent now. I have, therefore, chosen to elaborate on few such issues in my address today. These issues essentially revolve around “Disruption, Innovation and Competition” in the banking sector, which is the theme of the Conclave. You may also recollect that in my address last year, I had referred to Brett King’s book ‘Bank 3.0’ in the context of a single channel solution to multiple product offerings. I would once again invoke him. In the concluding chapter of the book, King has raised 15 questions as a checklist to assess whether a bank is prepared to withstand the disruptive process that is currently underway. According to King, answer to these questions would determine whether you are in trouble or you are not making the shift. While some of these questions may not be relevant in the context of Indian banking today, they will become so, soon. Many, however, are already relevant for us. Let me mention a few:

[1] Keynote address by Shri. S. S. Mundra, Deputy Governor, Reserve Bank of India at the Mint Annual Banking Conclave on the theme “Disruption, Innovation and Competition” on February 4, 2016 in Mumbai. Assistance provided by Smt. Usha Janakiraman and Shri Sanjeev Prakash is gratefully acknowledged.

- Do you still require a signature card for account opening?
- Do you have a distinct Head of social media in an executive role?
- Do you have a Head of Mobile, and do you have apps already deployed for your customers?
- Can you approve a personal loan application for an existing customer with a salaried account in real time, instantly?

4. I acknowledge that some of the banks present here can surely claim that they are making the necessary shift. They can move to other eleven questions while remaining ones can make a beginning to address these four questions. The predominant message from the foregoing is that digital innovation and disruption are progressing at a fast pace and are already a subject of huge debate. Hence, I would not dwell any further on them but move to few other areas which can have equal or even greater impact on the way banking is conducted going forward.

5. So, let me now come to those issues that I want to highlight today.

(i) **Account Number Portability:** Just consider the possibility of a dissatisfied or less than satisfied customer asking for shifting his banking relationship; lock, stock and barrel to another bank. He/she would ask "If I can switch my mobile service provider without changing my mobile number, why not banking service provider without changing my account number." This possibility can no longer be dismissed as a wishful thinking. This would need a 'shared' payment system, regulated independently, where all account number and payment instructions are warehoused (such as standing instructions/direct debit etc.),an unique customer ID and a central payment system. Credits/debits would be linked to the unique ID. Interesting bit is that some international banks are already supporting the idea. With Aadhaar as unique ID and NPCI as a central payment system, we are quite well placed to translate this into a reality. Our past record as a country of having swiftly embraced anonymous 'screen based' bond trading or switching from 'open cry' system on the bourses, should portend a much shorter timeline for this transition than a period of few years many in international arena are presently presuming for this to happen. Why can't we be a global first in this? Imagine how this can empower a customer and give an entirely new dimension to the competition, ensuring best of the breed customer service and fair pricing. Let me give a call today to all the banker friends here to commence a serious discussion on making 'account number portability' a reality.

(ii) **Competition from non-bank players in payment system**: All along we have believed that banks would retain the privilege to serve as the sole payment service providers even while their other traditional functions like dispensing credit might have competition. Ground realities have changed. Payment system is no longer the sole preserve of banks. There is competition and how? Large data companies like Google, Vodafone, Apple have been taking over transactional roles. A set of payment banks have been granted licenses and then, there are non-bank payment system providers. A massive disruption is possible based on the technology using Block Chain which would make distributed ledger possible. For the uninitiated, 'distributed ledger' allows a payment system to operate in an entirely decentralized way, without intermediaries such as banks. The banks would need to either develop own capability or seek proper alliances. I say this, however, with a caveat that we or rather the global regulatory community elsewhere have not taken a final stance on the use of distributed ledger technology. It is important to highlight here that Financial Stability Board has already started consultations on developing better understanding of the intricacies involved. Some of the large institutions like Goldman Sachs or J P Morgan Chase have set up internal groups to work in this area. Is it not the time for the Indian banking system to wake up to this possibility?

(iii) **Impact on Lending Business:** A key concern that I had briefly hinted at last year also is whether the large corporates would continue to borrow from the banks or whether the banks themselves would be keen to fawn over them after their on-going experience with such lendings? Many large corporate houses have lately been able to access funds on their own at cheaper rates without needing to reach out to banks. In mature markets, it is usual for the large corporates to access financial markets directly for their funding requirements rather than through banks. As the Indian economy and our financial markets mature further, more and more large corporates are likely to bypass banks for their funding requirements. Even medium enterprises may find alternate avenues of finance. Under the circumstances, banks would need to look at substitutes for deployment of funds. This void could most likely be filled by lending to small and micro enterprises and retail clients. As you are aware, the assessment of credit needs of small & micro enterprises and retail, is a different ball game altogether. A non-disruptive shift would require the bank staff to acquire new capabilities for credit appraisal of self-employed individuals and people with little or

no credit history. The competition in the shape of small finance banks, with a mandate to focus exclusively on small business units, small and marginal farmers, micro and small industries and other unorganized sector entities, which would operate through technology-focused, low cost structure, is already on the anvil.

As part of this strategic shift, banks would also need to improve their analytical abilities for big data. As I spoke earlier about lending to customers with little or no credit history, banks would need to employ some non-conventional tools for assessing credit worthiness of such customers, which can, among others, include credit card usage, travel patterns, bill payment history and so on. Lack of attention to these segments by the banks might allow P2P lenders to sneak in and compete for the piece of the pie. Here again, I would like to use the caveat that we are yet to finalise our regulatory stance on P2P lending.

(iv) IFRS Implementation: With the MCA announcing the much awaited Ind AS implementation road map for the financial sector, scheduled commercial banks (other than RRBs) are required to comply with the standards for accounting periods beginning from April 1, 2018. In this endeavour, the banks would need to deal with challenges resulting from implementation of Expected Credit Loss (ECL) based provisioning framework, classification and measurement of financial assets and impact of alignment of the regulatory guidelines with Ind AS on regulatory capital computations under the Basel III framework, leverage and liquidity ratios, etc. As a supervisor, our off-site reporting formats would need to be revisited. In essence, huge capacity building initiatives at the level of both the regulator and the regulated are required.

While it may not be possible to precisely quantify the impact of Ind AS implementation at this stage, rough estimates globally indicate a transitional impact of 25-50% increase in provisioning levels on account of implementation of ECL based provisioning framework. A 2014 international survey[1] of select banks indicated that over half of them expected an impairment provision increase of up to 50 per cent across all asset classes. Though our policy stance on ECL impairment provisions including possible prudential floors remains to be finalized, it is important

[1] *The Fourth Global IFRS Banking Survey by Deloitte: The survey includes the views of 54 banks from Europe, the Middle East & Africa, Asia Pacific and the Americas. Responses were received from 14 of the 29 global systemically important financial institutions (G-SIFIs) and 25 of the top 50 global banking groups measured by total assets listed in the Banker Top 1000 World Banks 2013*

that our banks start work on strengthening their data capture and risk management systems to enable impairment assessment.

In this context, I wish to raise an issue today for larger debate. The regulatory experience with the internal models employed by the global banks to assess the risks under the Basel framework has not been very pleasant. The assessments carried out since the Global Financial Crisis have pointed out the complex models used by the banks for risk computation under advanced approaches had significantly underestimated risks that the banks had on their books. Since, the ECL framework would involve principle based assessment of credit risk (using models), the concern would be around underestimation of risks by the institutions. Hence, I wonder that as we prepare towards IFRS, could we conceive of an independent, umbrella entity to prescribe or validate models, within the framework of the accounting standards or to at least examine the approach adopted by the banks in computing expected losses so as to ensure consistency in assessment across the sector, besides having supervisory comfort on the adequacy of accounting provisions.

Finally, one last question is whether we could draw some lessons from how banks globally have transitioned to IFRS from local GAAP? While we could get some perspectives about the challenges involved in the transition, the fact is that the challenges would be much greater here in India as we do not have an IAS 39 equivalent framework unlike other jurisdictions which migrated to IFRS from local GAAP largely aligned with IAS 39 or US GAAP. In that sense, IFRS transition is a paradigm shift in the Indian context.

(v) **Consumer Protection**: The profile of the customer that the banks deal with is undergoing a major transformation. This also calls for a transformation in the way banks position their products and services for their customers. Customers as a group are no longer satisfied with off- the- shelf products and would rather have products customised to their individual needs. Towards this end, the banks have to leverage Big Data and proactively offer products and services that suit the needs of individual customers.

A regulatory red flag I would raise here is around rampant mis-selling in sale of third party products, especially insurance. Another recurring consumer grievance is

around compensation for failed transactions/frauds. Of course, as institutions, banks have more muscle as compared to 'resource poor' individuals, but as guardian of customer rights in our role as regulators, we would quite closely monitor misuse of such might against the customers. If violations are observed, the banks wound need to not only compensate the customers, but also be forced to pay penalties.

(vi) **Financial Inclusion**: I don't want to touch this topic in any detail but would just like to caution banks on some aspects in dealing with newly acquired accounts. A large number of new accounts have been added under RBI's Financial Inclusion focus and under the PMJDY push. Periodic updation of the KYC records in these accounts and continuous monitoring is vital. Just to give one example- a news item had appeared the other day mentioning that Rs.1 crore was parked and withdrawn in a labourer's bank account which he was unaware of till he received an IT demand of a tax of 40 lakh rupees. Many similar instances are being reported. This means that the recently opened accounts are susceptible to misuse by money mules and hence, banks must remain vigilant.

(vii) **Other issues:** Lot of debate has surrounded the future of brick and mortar branches and their obituaries been written several times. However, they have survived and are doing well. Of course, the functions they undertook earlier, extent of client interface they had, has undergone a sea change, but my sense is that the brick and mortar braches would continue to remain relevant in India in the foreseeable future. Management would, however, have to think through the future of these branches in terms of the role and functions they envisage for the branches going forward.

Another issue is around the future of ATMs and the plastic money. If Mobile Banking continues to grow at the pace that we see today, would cards still be needed and what use would be there for the ATMs? There is a justifiable call for reducing 'cash transactions' in the system and hence, if more and more people moved to mobile/ internet based payments, the plastic cards and the investments made thus far in ATM networks would be rendered useless, unless put to more imaginative uses.

Last but not the least, I would also like to sound another note of caution for the bankers present here. With all talks surrounding changing profiles, social habits and requirements of the gen-next customer (Gen Y or the millennials), the banks must not lose sight of aging population. The next 15 years would see approximately 70 mn

more people crossing the age of 60 years. These old age people would have different banking needs and would need to be serviced through appropriate delivery channels. Similarly, the pace of urbanisation in the country is only going to get heightened in the coming years and hence, banks would need to be geared up to cater to the requirements of this migrant population also.

Conclusion

6. I think I have scared you enough by highlighting the impending challenges that the banking sector is likely to face going forward. As Clay Christensen, Harvard Professor puts it “Disruptive Innovation can hurt, if you are not the one doing the disruption.” Most of the scenarios that are going to play out are external to our system and hence, you need to be prepared, lest you get hurt.

I believe the elite panel gathered here today would deliberate and reflect on some of the issues I have raised today. I once again thank Mint and Tamal for inviting me and wish you all a fruitful deliberation.

Thank you!