Key Note Address at the Panel Session on "Setting new paradigm in regulation"[1]

The global financial crisis was predominantly a first world phenomenon. The fall out in the emerging market economies (EMEs) was mostly through contagion. The level of financial sector development, complexity of financial markets, extent of deregulation and global integration, the degree of leverage of households and financial intermediaries, the nature of business model and quality of supervision determined the impact of the crisis on any institution or jurisdiction. The impact of the global financial crisis and consequently the corrective actions required in the regulatory regime vary across different countries. According to the International Monetary Fund, upfront government support to the financial sector averaged 5.8 per cent of GDP in developed countries and 0.3 per cent in developing countries. It is important to note that many of the EMEs had their own crises in the past requiring varying degrees of public intervention (Latin American crisis, Asian Crisis, Russian crisis etc.).

2. While the global fora are working out regulatory reforms to ensure that similar crises do not recur, the members of such fora like BCBS and FSB including India have supported such initiatives as it is realized that there is a need for a consistent minimum regulatory framework across countries. For example, we have realized that though all countries had a minimum capital adequacy norm of 8 per cent - the components of such capital were so varying as to result in capital adequacy ratio ranging from 2 to 8 per cent across

[1] Keynote address by Smt. Usha Thorat, Deputy Governor, Reserve Bank of India at the Panel Session on 'Setting New Paradigm in Regulation' at the FICCI-IBA Conference on 'Global Banking: Paradigm Shift' on September 8, 2010

countries if the new proposals are implemented!! India is at the top end of this range. In his talk yesterday, the Governor has elaborated on the new regulatory paradigm under the Basel III initiatives. I will, therefore, not revisit these aspects, but instead focus on the challenges that the regulator in an emerging market economy like India faces in ensuring development of the financial sector for facilitating rapid and inclusive growth, while at the same time ensuring soundness of financial institutions and financial stability.

Role of financial penetration

3. One of the drivers of growth in India has been the high level of savings. Savings rate is 32.5 per cent of GDP today (2008-09) compared to 22.3 per cent ten years ago (1998-99). The contribution of the household sector to savings is 70.0 per cent. While the overall savings ratio has increased significantly, financial savings has remained at around 50 per cent of household savings. Within financial savings, share of bank deposits has increased from 33 per cent in 2000-01 to 55 per cent in 2008-09.. In March 2004, there were 59 savings and current accounts per 100 adult population – in March 2009, the number has risen to 96. The number of borrowal accounts per 100 adult population rose from 12 to 20 in the same period. State-wise coverage shows improvement in all States (Annex**)**. This reflects the impact of increasing banking penetration although there is a long way to go in many regions. Achieving higher rates of growth would call for higher financial savings and this in turn implies much greater penetration of banks and other financial intermediaries like insurance companies, mutual funds and pension funds. Achieving higher level of financial savings also requires a benign inflationary

environment. The freeing up of branch licensing in Tier 3 to 6 centres and the liberalization of the Business Correspondent model are steps for achieving greater penetration. The linking of branch licensing in Tier 1 and 2 centres to performance of banks in opening branches/ banking presence in underbanked areas is an element of banking policy intended to incentivize banks to establish presence in such areas for facilitating greater financial inclusion and inclusive growth. Distribution of NREGA payments through bank accounts with job cards serving as document of identity provides an enormous window of opportunity to achieve higher banking coverage. The speed with which UIDs are provided to residents will further facilitate such penetration as these will serve to meet the KYC norms for account holders with small value transactions.

Role of Payments System

4. I believe that an important task in our national efforts towards achieving inclusive growth is to bring a significant portion of the payment transactions across the length and breadth of the country into the formal channels. Technology adoption by the financial sector offers a unique opportunity in achieving this objective. The National Payments Corporation of India is currently engaged in a project that will roll out in a few months. This project will result in a beneficiary of a remittance being able to use any BC outlet anywhere, even if he/she has no bank account, to receive in cash a remittance up to Rs.5000 irrespective of the bank from where the remittance has emanated. It will also allow seamless transfers across banks using the new payment products driven by technology. Whenever the issue of technology led financial inclusion is flagged, a debate often ensues as to whether the model

for inclusive development should look beyond the formal banking channels insofar as it relates to money transfers/payments. We have studied the experience of Philippines and Kenya in this regard. We believe that providing payments services alone is not financial inclusion as there is need for other products as well. Given that India is still far from being a cash-less society, the cash-in/cash-out arrangements in these models play an important part in scaling up. It is important to note that the high level Inter-Ministerial Group anchored by the Department of Information Technology, Government of India that went into the issue, after extensive discussions on the various issues involved , has reached more or less the same conclusion i.e. to proceed with a bank led model. It is, therefore, essential that banks and mobile /card operators work together as partners in achieving the objective of a ubiquitous and efficient payments system.

Savings bank interest rate – case for deregulation?

5. Given the level of interest rates on bank deposits, common persons are lured by higher interest provided by alternate channels especially in the informal markets. The deregulation of savings bank interest that is currently set at 3.5 per cent by RBI is an issue which is on our radar. A Working Group is being set up to debate the issues and draw conclusions. On one hand, the low cost savings accounts provide banks with low cost funds of an enduring nature which facilitate ALM and help lower lending rates. On the other hand, the costs not currently recovered in handling such accounts have to be considered as well. Totally freeing rates could, in situations where there is virtual monopoly of banking, lead to lowering rates in some areas while leading to increase in other

areas - it would need to be ensured that there is no discrimination between different customers of the same bank. Transparency in cost recovery could facilitate deregulation - this would also need to be non-discriminatory across locations. An important consideration should be whether deregulation of savings rates would draw more population into the fold of formal banking system. All these issues will be gone into in detail by the Working Group..

Capital needs of banks to support inclusive growth

6. A major factor that will determine banks ability to facilitate high growth will be their ability to garner capital. Over the last 5 years, banks have been able to increase their Tier 1 capital by an annual average of nearly 30 per cent while their risk weighted assets increased over this period by more than 26 per cent, of which about one fourth has been from internal generation, small amount from government and most of it from the capital markets. Assuming the same growth in risk weight assets going forward, and given the average return on capital for the Indian banks, raising capital from the markets may not be a problem. Given the requirement of Basel III to have common equity as the dominant part of Tier I capital, and Tier I to be the major part of regulatory capital, and given that Indian banks are already well placed in this respect, it would be advisable to retain the advantage even though the new norms will kick in only in a phased manner.

Forward looking provisioning

7. In a growing economy facing global and domestic shocks, it is likely that NPAs will increase and the NPA ratio could go up and down. The issue,

however, is whether the margins on earning assets are sufficient to make adequate provisions for expected losses, apart from generating internal accruals to support growth in the risk weighted assets. In this context, making forward looking provisions as is being considered at the Basel level is extremely important for a country like India. While we have asked banks to achieve at least a PCR of 70 per cent for NPAs, we are also working on a scheme based on the Spanish dynamic provisioning model for evolving norms for provisioning for standard assets in different sectors based on time series and cross sectional data. Such provisions envisage setting aside profits in good times which can be used in down turn and provide greater comfort from financial stability perspective when the economy is pushing forward for higher growth.

Lending to Infrastructure

8. Aspiration for higher growth implies much more investment in infrastructure. Needless to say, the headroom available in government finances either at the State or Central level for funding or for guarantees (explicit or implicit) is limited. This calls for funding from both financial institutions and capital markets, both domestic and external. The single borrower and group borrower exposure limits of banks have already been relaxed to allow for more funding for infrastructure by Indian banks. Taking into account the concentration risk and asset-liability mismatches, any further relaxation would be imprudent. From regulatory point of view, interest rate derivatives - both OTC and exchange traded – have been allowed and these provide the opportunity to hedge the interest rate risk. Liquidity requirements on a broad SLR basis as also on a more granular basis

are in place and banks' positions are constantly monitored to ensure that mismatches are controlled. To provide liquidity to corporate bonds, repos have been allowed. The final guidelines on single name Credit Default Swap, once issued will facilitate dispersal of risk and help mitigate the exposure related problem to a large extent. Securitization can contribute significantly to redistribute the credit risk across a wide range of investors outside the banking system thereby freeing the credit lines of larger borrowers with the banks. However, securitization should develop in an orderly manner without creating systemic risk. The revised securitization guidelines including introduction of minimum retention requirement and minimum holding period with a view to aligning the interest of the originator and the investor are almost ready as also the guidelines on capital treatment in case of take-out facility. The overarching principle that we follow in tweaking these regulations is to see that the needs of the growing economy are met by the financial system, while taking care that prudential principles are not compromised, nor is financial stability threatened.. We study the global practices and modify them to meet our unique requirements and this has been the hallmark of the Indian regulatory approach. I can assure you that no other sector has posed as much challenge for the regulators as the infrastructure sector.

Given its unique position, India Infrastructure Finance Company Ltd. (IIFCL) as a specialized government owned institution for infrastructure funding is well placed to leverage its parentage and capital in offering more credit enhancement products and risk mitigants which will help investors such as banks, insurance and pension funds in managing their credit and market risks

risk. The real issue remains of incentivising long term savers through insurance and pension schemes with a view to increasing the pool of long term savings in the system for funding infrastructure.

Para banking activities

9. Of late, banks are also getting involved in investing in or setting up infrastructure funds or venture capital funds or even in private equity funds. Where such investments (including the leverage) is below a threshold and do not constitute a significant share (less than 20 per cent of the fund) or where the bank has not lent its name or is not involved in the management, no specific regulatory requirement is being envisaged other than such investment remaining within the overall capital market exposure limit and maintenance of appropriate capital.. However, where a bank lends it name directly or indirectly or floats / manages large private pools of capital, there is a need to have additional capital requirements to take care of reputation, concentration and other risks not captured in the traditional framework. This is the reason why we are looking at bringing out guidance on banks managing large private pools of capital.

Derivatives – risks in leveraged and complex structures

10. One of the important needs of a growing and increasingly globalizing economy is for businesses to be able to focus on their main business and have efficient ways of hedging forex and interest rate risks. Over more than a decade, new products in the derivatives market have been gradually

introduced, to begin with mostly in OTC markets and more recently on the exchanges. While many corporates and businesses have used these products for hedging, the aggressive marketing of these, especially leveraged products, and their use by businesses to ostensibly lower the cost of funding or cost of hedging have led to grief to many – banks and businesses alike. The lessons from this experience underline the need for both banks and customers to understand such products and the associated risks especially in those with leveraged and complex structures, having proper risk management policies, accounting standards and disclosures with adequate guidance to users and auditors alike for appropriate valuation and MTM practices.

Lending to the millions

11. A major challenge of the next decade is going to be financing the millions in the unorganized sector, self-employed in the micro and small business sector, the small and marginal farmers as also oral share-croppers in the agricultural sector; other challenges include financing affordable housing and education needs of low income households. These households and businesses do not maintain proper books of account, have irregular cash flows and hardly any documents of property or other collateral. Drawing these households into the formal banking system through opening of bank accounts is only one and albeit a very first step. The number of borrowers who had borrowed Rs.25,000 and below from the banking system rose from 36.8 million 2004 to 39.2 million in 2009 - an increase of just 2.4 million over five years. The number of borrowers who borrowed less than Rs.2,00,000 increased from 61.9 million in 2004 to 95.8 million in 2009 – although there is an increase of nearly 34 million, a vast

majority of the population still remain unserved. If the coverage of those borrowing less than Rs.2,00,000 has to increase to at least 50 per cent of the adult population in the next three years, the number of borrowal accounts will have to increase annually by at least 41.3 per cent. How are banks going to deal with this scale? Standard products like GCC / ODs against savings products at affordable rates will have to be offered based on the track record in savings and recovery, as there is no likelihood of offer of any security. Risk mitigant products will need to be offered by the development financial institutions.. Already, SIDBI offers today a credit guarantee product for loans to MSE where there is no collateral – the scheme has recently been made more user-friendly. Similar credit risk mitigation products will need to be evolved by NABARD for small farmers, who cannot offer any document of proof of possession of land farmed by them, as also for the landless engaged in non farm and allied activities. Suitable credit guarantees are also required for loans affected by widespread distress in the event of successive and repeated natural calamities. NHB will need to evolve similar products for minimizing documentation risk, credit risk and other risks involved in financing low income housing. Enhanced and well documented property rights would also improve the collateral that households and small businesses can offer to lenders that could lead to reduction in the pricing of such loans. Finally, banks will have to partner with non-banking financial companies, microfinance institutions and financial cooperatives to increase outreach as the latter have been quite innovative addressing the last mile issue. In doing so, banks' attention will have to shift to oversight of such portfolios- assigned or securitized- to ensure asset quality, reasonable rates of interest and fair treatment to ultimate borrowers.

Risk measurement for SMEs

12. In applying a uniform set of regulatory norms across sectors, it is possible that the nature of risk is not properly differentiated or there is a tendency for regulating the mean. It is necessary that the specific nature of certain sectors be kept in focus. First, in retail lending the activity specific cash flow patterns and portfolio level risk profile will need to be recognized. The concept of retail lending was brought into Basel II with a specific focus on SMEs. The diversification benefit resulting in lowering of risk was recognized; under advanced approaches, models that factor in default behavior over business cycles provide a more realistic measure of risk. The challenge lies in enhancing capabilities amongst banks and supervisors to move to advanced approaches where the credit risk in development finance can be properly captured. Second, the ratings based approach for risk weighting may need a relook. SMEs that do not qualify as retail credit are subject to an external rating based risk weight under the standardized approach. EMEs face significant challenges in this regard. First, the rating agencies in these countries may not have adequate credit history to model the default rate. Second, the volumes are huge and difficult to cope with. Third, the ratings could increase the cost of credit. Fourth, even with a good rating the availability and pricing of credit depends on other factors. Finally, the SME borrowers may not able to present well audited accounts and facts about markets and business dynamics that can be relied upon by credit rating agencies. As already indicated above, credit guarantee under the SIDBI scheme takes care of borrowers that have no collateral to

offer. For other SME borrowers credit enhancement schemes would be useful in enhancing flow of credit to this critical segment of the economy.

Role of credit information agencies

13. The role of credit information companies in this context is worth mentioning. Ensuring a healthy credit culture requires building up comprehensive and accurate credit records that can provide information to prospective lenders/ creditors. It can also help build up risk profile in different sectors and regions and other granulated data that can assist lending institutions in meeting the challenges of dealing with large numbers. This, however, needs the full cooperation of credit providers in populating such data bases quickly and accurately. It is hoped that the four credit information companies recently licensed will fulfill the role expected of them.

Multiple borrowing and end use issues

14. While the needs of growing economies are manifold, currently, it is observed that sources of funding of business from non-banks have been equal to, if not more than, from banks. Multiple borrowing, competitive pressures and so called balance sheet funding has further aggravated the problem of ensuring end use. Excess borrowing beyond the needs of production and investment can lead to potential bubbles and possible deterioration in credit quality. The role of credit rating agencies in this regard is critical as they provide the link to capital market funding as also play a role in the capital requirement under standardized approach for non-retail borrowers. While banks should be moving towards advanced approaches with less reliance on rating agencies, the rating

agencies in turn have to take a holistic approach while awarding ratings having regard to end use, asset bubbles and financial stability. The system of exchange of information that has been put in place by RBI should be made use of effectively by banks. Also when borrowers with multiple banking arrangements start showing signs of stress, banks should come together and look at the holistic viability of the entity rather than adopt ad hoc 'go it alone' solutions – this will avert larger sacrifices at later stage.

Conclusion

15. The magnitude of the global financial crisis and consequent corrective actions have necessitated changes in the regulatory regime. The changes however, may vary across different countries depending upon the nature and level of sophistication of the respective financial markets. The new global standards are expected to enhance the resilience of the banking sector as a whole, while promoting financial stability in both developed and EMEs. However, in EMEs such as India, the challenges of rapid and inclusive growth require the regulator to focus on facilitating financial sector development that is conducive to such growth while not compromising on prudential principles and financial stability. This has also implied evolving the regulatory framework to meet the needs of the productive sectors and in particular, paying specific attention to key areas such as infrastructure financing, agriculture , MSE, education and low income housing.

Thank you

Annex
Number of current and savings accounts vis-a-vis population– March 2004 & March 2009

Region/State/Union Territory	Total No. of accounts (savings + current)		Total Population (2001 census)	Adult Pop. (2001 Cens.)	No. of acc. Per 100 of population		No. of acc. Per 100 of adult pop.	
	Mar-04	Mar-09			Mar-04	Mar-09	Mar-04	Mar-09
NORTHERN REGION	**56631826**	**85513359**	**132676462**	**67822312**	**43**	**64**	**84**	**126**
Haryana	8604132	14125096	21082989	11308025	41	67	76	125
Himachal Pradesh	2567880	3894901	6077248	3566886	42	64	72	109
Jammu & Kashmir	3372319	5293074	10069917	5379594	33	53	63	98
Punjab	14898338	20500939	24289296	14185190	61	84	105	145
Rajasthan	12828959	21989369	56473122	28473743	23	39	45	77
Chandigarh	1207303	1625586	900914	546171	134	180	221	298
Delhi	13152895	18084394	13782976	7929589	95	131	166	228
NORTH-EASTERN REGION	**7367684**	**13199596**	**38495089**	**19708982**	**19**	**34**	**37**	**67**
Arunachal Pradesh	219611	430270	1091117	544582	20	39	40	79
Assam	5449787	9488869	26638407	14074393	20	36	39	67
Manipur	213107	451792	2388634	1222107	9	19	17	37
Meghalaya	483084	751812	2306069	1088165	21	33	44	69
Mizoram	121326	307161	891058	476205	14	34	25	65
Nagaland	209271	414093	1988636	995523	11	21	21	42
Tripura	671498	1355599	3191168	1784212	21	42	38	76
EASTERN REGION	**49690359**	**79373634**	**227613073**	**122136133**	**22**	**35**	**41**	**65**
Bihar	13689753	22368417	82878796	40934170	17	27	33	55
Jharkhand	6000348	9969955	26909428	13737485	22	37	44	73
Orissa	7258164	13427147	36706920	21065404	20	37	34	64
Sikkim	129462	236944	540493	288500	24	44	45	82
West Bengal	22487486	33147204	80221171	45896914	28	41	49	72
Andaman & Nicobar Islands	125146	223967	356265	213660	35	63	59	105
CENTRAL REGION	**66456406**	**110517420**	**255713495**	**129316677**	**26**	**43**	**51**	**85**
Chhattisgarh	3538965	6542616	20795956	11209425	17	31	32	58
Madhya Pradesh	12285299	19815273	60385118	31404990	20	33	39	63
Uttar Pradesh	47128859	78817573	166052859	82229748	28	47	57	96
Uttaranchal	3503283	5341958	8479562	4472514	41	63	78	119
WESTERN REGION	**52703203**	**79825097**	**149071747**	**86182206**	**35**	**54**	**61**	**93**
Goa	1665728	2187748	1343998	891411	124	163	187	245
Gujarat	17176226	26049908	50596992	28863095	34	51	60	90
Maharashtra	33695424	51234546	96752247	56207604	35	53	60	91
Dadra & Nagar Haveli	75384	198829	220451	122765	34	90	61	162
Daman & Diu	90441	154066	158059	97331	57	97	93	158
SOUTHERN REGION	**88052912**	**148696075**	**223445381**	**135574225**	**39**	**67**	**65**	**110**
Andhra Pradesh	25130985	48752136	75727541	44231918	33	64	57	110
Karnataka	20234481	34083877	52733958	30623289	38	65	66	111
Kerala	18269788	23262900	31838619	20560323	57	73	89	113
Tamil Nadu	23839326	41564546	62110839	39511038	38	67	60	105
Lakshadweep	23488	40166	60595	33686	39	66	70	119
Pondicherry	554844	992450	973829	613971	57	102	90	162
ALL-INDIA	**32,09,02,390**	**51,71,25,181**	**102,70,15,247**	**54,10,31,553**	**31**	**50**	**59**	**96**

Number of Borrowal accounts vis-à-vis population – March 2004 & 2009

Region/State/Union Territory	Total Population (2001 census)	Adult Population (2001 census)	No. of Borrowal Accounts		No. of acc. Per 100 of population		No. of acc. Per 100 of adult pop.	
			Mar-04	Mar-09	Mar -04	Mar -09	Mar-04	Mar-09
NORTHERN REGION	**132676462**	**67822312**	**6991741**	**11197675**	**5**	**8**	**10**	**17**
HARYANA	21082989	11308025	1091198	1634121	5	8	10	14
HIMACHAL PRADESH	6077248	3566886	377089	556563	6	9	11	16
JAMMU & KASHMIR	10069917	5379594	376520	586533	4	6	7	11
PUNJAB	24289296	14185190	1524061	2092653	6	9	11	15
RAJASTHAN	56473122	28473743	2272974	3473840	4	6	8	12
CHANDIGARH	900914	546171	103559	190403	11	21	19	35
DELHI	13782976	7929589	1246340	2663562	9	19	16	34
NORTH-EASTERN REGION	**38495089**	**19708982**	**1217328**	**2001487**	**3**	**5**	**6**	**10**
ARUNACHAL PRADESH	1091117	544582	30,986	56829	3	5	6	10
ASSAM	26638407	14074393	745588	1300912	3	5	5	9
MANIPUR	2388634	1222107	38,637	73996	2	3	3	6
MEGHALAYA	2306069	1088165	78,113	115229	3	5	7	11
MIZORAM	891058	476205	35,918	60244	4	7	8	13
NAGALAND	1988636	995523	30,626	91328	2	5	3	9
TRIPURA	3191168	1784212	257460	302949	8	9	14	17
EASTERN REGION	**227613073**	**122136133**	**9150268**	**12191968**	**4**	**5**	**7**	**10**
BIHAR	82878796	40934170	2323496	3795805	3	5	6	9
JHARKHAND	26909428	13737485	977306	1326608	4	5	7	10
ORISSA	36706920	21065404	2340734	3076704	6	8	11	15
SIKKIM	540493	288500	24,696	36357	5	7	9	13
WEST BENGAL	80221171	45896914	3469985	3931929	4	5	8	9
ANDAMAN & NICOBAR	356265	213660	14,051	24565	4	7	7	11
CENTRAL REGION	**255713495**	**129316677**	**10104468**	**14178147**	**4**	**6**	**8**	**11**
CHHATTISGARH	20795956	11209425	607764	948331	3	5	5	8
MADHYA PRADESH	60385118	31404990	2223676	3507700	4	6	7	11
UTTAR PRADESH	166052859	82229748	6787589	9002270	4	5	8	11
Uttarakhand	8479562	4472514	485439	719846	6	8	11	16
WESTERN REGION	**149071747**	**86182206**	**9118713**	**31286538**	**6**	**21**	**11**	**36**
GOA	1343998	891411	122574	185453	9	14	14	21
GUJARAT	50596992	28863095	2036263	3224998	4	6	7	11
MAHARASHTRA	96752247	56207604	6948260	27866601	7	29	12	50
DADRA & NAGAR HAVELI	220451	122765	5,777	5072	3	2	5	4
DAMAN & DIU	158059	97331	5,839	4414	4	3	6	5
SOUTHERN REGION	**223445381**	**135574225**	**29807772**	**39200362**	**13**	**18**	**22**	**29**
ANDHRA PRADESH	75727541	44231918	7777824	12013970	10	16	18	27
KARNATAKA	52733958	30623289	5967108	8469354	11	16	19	28
KERALA	31838619	20560323	4068814	5702986	13	18	20	28
TAMIL NADU	62110839	39511038	11890839	12803893	19	21	30	32
LAKSHADWEEP	60595	33686	2,469	4641	4	8	7	14
Puducherry	973829	613971	100718	205518	10	21	16	33

ALL-INDIA	1027015247	541031553	66390290	110056177	6	11	12	20

Source: BSR 1

Note: No. of Borrowal accounts is as per place of sanction as on 31st March 2004 & 2009