Banking and Beyond: New Challenges before Indian Financial System [1]

Lord Stephen Green, Minister for Trade and Investment, UK, distinguished panelists, distinguished guests, ladies and gentlemen. First of all my thanks to Mint, Mumbai, and to my good friends Tamal and R Sukumar for inviting me to initiate today's debate – "Banking & Beyond: New Challenges Before Indian Financial System" with a panel of luminaries on the stage. Over the years, Mint, through its Clarity Through Debate trail-blazer series has been flagging topical public policy issues and challenges and acquired a niche of its own in the corporate mindscape as a thought leader in the financial sector. Good work. Kudos and my best wishes for the Mint Team.

2. Winston Churchill once said that "in finance, everything that is agreeable is unsound and everything that is sound is disagreeable." I suspect many of my views may spark a strong feeling of disagreement but will hopefully stimulate passionate public debate. I am more convinced than ever that financial markets require a healthy dose of regulation to function efficiently. I am more convinced than ever that too-big-to-fail, or too-big-to-save banks represent veritable systemic risk concerns, which are sure to bring in more unpredictability in the system, need to be credibly and effectively tackled. And I am more convinced than ever that central banks operate most effectively and optimally when insulated from any external interference.

3. Even though it is a bit customary now-a-days to have a discussion on any topic with the tag "next" or "beyond", this particular issue holds enormous importance for all of us in India. However, in today's integrated world, what I shall be talking would be very much relevant for other emerging markets also. Hence, I would dwell upon the issues that stare the global economic recovery in the face and the key elements that will shape the emerging new financial architecture. These issues are pretty much similar to what banks in India are / will be struggling with.

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[1] *Address by Dr K C Chakrabarty, Deputy Governor, Reserve Bank of India at the Mint's Clarity Through Debate, Mumbai, on 15th March 2011.*

4. Although, the recent global financial crisis and the resultant recession had its origin in the developed western world; but its contagion did not spare the emerging economies like India. Once in a life-time crisis warranted a commensurate response in terms of a major overhaul of the financial system involving almost everything from regulation to risk management to mergers / acquisition to capitalization to executive compensation to financial engineering to governance.

5. In this connection, interface between banks and financial markets, has undergone a fundamental shift in the recent times - banks have become intricately linked to financial markets and hence more vulnerable to financial markets stress. At the same time, functioning of markets has become intricately linked to banks which then emerge as the carrier for most of risks within the financial markets. We have seen these correlations at their most devastating during the sharp deepening of recession triggered off by the collapse of the apparently infallible Lehman Brothers which encompassed the whole world in its whirlwind spiral. However, I would restrict myself to sharing my thoughts in terms of "next" issues and, that too, to the banking system, which are somewhat already visible in the global financial firmament.

Financial Inclusion

6. Before I address other individual issues, I shall highlight a very basic and core issue for the Indian banking system and that is the challenge of achieving Financial Inclusion. Without being inclusive, financial and economic stability cannot be sustainable. Financial inclusion is about credible access to appropriate financial products and services needed by vulnerable groups such as weaker sections and low income groups at an affordable cost in a fair and transparent manner from mainstream institutional players. More recently, there has been a strategic shift in sustainable financial inclusion to the adoption of market oriented approach viewing financial inclusion as a viable business proposition. It has been made possible by the availability of Information and Communication Technology required by the formal financial sector for penetrating widespread unbanked areas in a cost effective way and the realization that the " Poor is eminently Bankable". Financial inclusion is related to financial stability also through the

key of financial education and literacy. In my opinion, financial literacy is an integral part of financial inclusion of the public or users of financial products/services. Financial literacy is instrumental in expanding financial inclusion and financial inclusion is itself helpful in further expanding financial literacy thus mutually reinforcing each other in a positive manner. The knowledge about the risk and return framework holds the key to prudent participation in the market and welfare maximisation within the given constraints for each market player. As financial literacy involves imparting the required knowledge of risks and returns of financial products to the users *and* suppliers of these products, it would help in controlling risks in the financial system thus helping in maintaining systemic stability. It would be inappropriate to assume that financial literacy and inclusion are not global challenges. At the present juncture as the global financial system is dealing with the aftereffects of financial crisis, it is not so much a question of access but advanced countries are more in need of financial literacy/education than ever before. In India, it is a question both of access to financial products and services and financial literacy. It implies not just providing access but also to educate all stakeholders about the fairness and other characteristics of the financial products/services, such as their risks and returns.

Capital

7. Let me now turn to some other specific issues. First issue staring in the face of banking industry is capital. Even though reasonably well capitalized today, banks will be facing the challenge of growing their business due to capital constraints. India's financial system is better at capital allocation than most of the emerging market players. It has some high performing banks, very low stock of gross non-performing loans of about 2.5% and deep and liquid equity markets that efficiently discover price in stocks of globally competitive companies in BPO, IT, R&D, pharmaceuticals, automobiles, telecom and hospitality space. Still one of the challenges will be capital raising by corporate sectors but not at the expense of agriculture, small industries and business. Debate over channeling larger portion of available credit to the most potentially productive sector or to the sectors where the investment efficiency is lower is yet to be fully resolved. In any case, to make banks allocate increased credit to the productive sectors of the economy is strongly predicated on the bank capital strength. To do so,

more capital would be required to be infused into banks. With requirements of Basel III looming large, banks would be facing challenges in raising additional capital for meeting the funding needs of Indian economy potentially growing at 9% plus.

8. Post-crisis, regulators worldwide are discussing a macro-prudential framework that would involve a regulatory policy focused on the system as a whole, rather than individual players. Capital buffers are an extremely important component of the new macro-prudential regulatory framework. The new framework aims at improving both quality and quantity of capital. Let us understand that capital is a competitive charge on the resources available for lending with a bank and hence, stepping up counter-cyclical capital requirements and providing capital buffers comes with a cost for the banking system. Capital enhancement, however, is a prudential requirement, as financial products and transactions are becoming increasingly complex and prudent risk management has assumed considerable importance. With higher and modified nature of capital requirements proposed through the new Basel III accord in the aftermath of the financial turmoil, keeping banks well capitalised would be an added challenge.

9. Banks are already suffering from inadequacy of capital as the return on such capital does not encourage new investors. Era of cheap capital is over and investors are also wary of the volatility of returns. Newer instruments and techniques would be required to attract investors. While creation of enabling conditions for capital flow to the sector would continue to remain on the top of the reform agenda, banks would need to grow their balance sheets by raising capital from the markets rather than count on government. Considering the back-to-basics common equity focus of Basel II, growing bank balance sheets will increasingly pose the challenge of balancing interests of shareholder and depositors/ financial stability.

Liquidity Management

10. Traditionally, capital adequacy requirements have been imposed to ensure solvency. However, that is not the only issue. The next issue that will continue to engage substantial management attention is the management of liquidity. Is liquidity an offshoot of economic crisis or management crisis? I think a bit of both. In short, banks and FIs

are destined to be facing the unpredictability they like to believe as non-existent. Liquidity crises, although recurrent, are yet to be effectively managed. Responses are varied and such crises leave a trail of devastation clearly visible in the post crisis stage. Issue of liquidity management requires much defter response than what is so far seen. How the banks will graduate from "lazy banking" (as response to credit market growing more unsecure) to "crazy banking" (when it became more fashionable to jump onto retail lending bandwagon with some of the banks burning their fingers) to "edgy banking" is an issue which is yet to find a resolution. The truth is that the liquidity management requires more sophisticated, comprehensive, nuanced and razor-sharp approach in order to prevent it from being the carrier of contagion.

IFRS Implementation

11. The third issue that is going to cast a spell over the financial sector players is the compliance with IFRS or International Financial Reporting Standards. Globalization of financial markets has meant an increased focus on international standards in accounting and has intensified efforts towards a single set of high quality, globally acceptable set of accounting standards. Financial statements prepared in different countries according to different set of rules, mean numerous national sets of standards, each with its own set of interpretation about a similar transaction, making it difficult to compare, analyse and interpret financial statements across nations.

12. In respect of banks and NBFCs, in view of the special issues involved (finalisation of IFRS 9 expected in the middle of 2011), a separate road map was prepared in March 2010 for convergence with IFRS for the banking industry and NBFCs. The convergence process would be from period beginning April 1, 2013, with a phased approach for urban banks and NBFCs. This gives the banking system some time to adapt to the standards in a smooth and non-disruptive manner. It has to be noted, however, that banks will be significantly affected by the IAS 39 replacement project and a number of other accounting developments including those relating to financial instruments, fair value measurement, financial statement presentation and consolidation. Some of the major changes pertain to certain critical areas such as classification and valuation of

financial assets, classification and valuation of liabilities, impairment provisions and fair value measurement. One area of concern has been the drawback of the incurred loss model of IAS 39 and the need to introduce more forward looking provisioning. We have seen the how concept of “marked to market” turned to be useless at the time of real crisis through the potential futility of the idea of “marked to model” as being divorced from real market and virtually ended up with a situation that can best be described as “marked to madness”. The IFRS convergence process will involve significant challenges for the banking system in general. Banks would need to upgrade their infrastructure, including IT and human resources, to face the complexities and challenges of IFRS. Some major technical issues arising for Indian banks during the convergence process would be differences between the IFRS and current regulatory guidelines on classification and measurement of financial assets, focus in the standard on the business model followed by banks and the challenges for management in this area, application of fair values for transactions where not much guidance is available in India in terms of market practices or benchmarks, and expected changes in impairment rules.

Beyond CBS

13. Today we cannot think of banking services without technology. IT has become the central cog in whatever banks are doing or strategizing to do in future. All of us would agree that technology has no longer remained just a means for automating processes. It has revolutionized every industry in the world by rendering faster and cost effective delivery of products and services to customers, who in the normal course could not have afforded the same. Technology is the surest and most appropriate way of bringing inclusion in respect of any product and/or service. Is technology in banks being leveraged adequately?

14. Technological advancement enables a broader and inclusive banking sector and in the process, is a key driver for the sustained and inclusive growth of the economy. Technology by itself is not a panacea. But technology has evolved to such an extent that it can hold the key to achieving goals – if banks are willing to accept the changes that they will need to make to get there. Banks have implemented Core Banking

Solutions (CBS) which marked a paradigm shift in more senses than one and branch customers are now bank customers as they can access their accounts from any branch for defined purposes. It was envisaged that the CBS would offer new opportunities for information management, better customer service and improved risk management. However, banks have not been able to reap the benefits of this technology in terms of reduction in costs of small value transactions, speed with which the transactions are done if both successful and unsuccessful transactions are considered, improved customer services and effective flow of information within the banks as also to the regulator. Banks have not gained in terms of efficiency partly because the much needed business process re-engineering was not done. Further, banks have deployed technology for transaction processing and the same has not been explored extensively for analytical processing like customer relationship management and decision making. Thus, there is a need to take care of what we could not achieve in the first round of technology implementation and think beyond CBS. Supported by the latest technology, banks would need to identify new business niches, to develop customized services, to implement innovative strategies and to capture new market opportunities.

15. Optimum leveraging of technology would critically hinge upon the following:

a. Skilled resources
b. Supportive HR policy
c. Appropriate IT governance structure
d. Effective business continuity plan

Banks & FIs would require review of the issues relating to recruit appropriate skill, retain then over a longer time horizon by offering them a clear career growth opportunities and supporting enabling process. However, it is equally important to embed inside the management structure a proper IT Governance structure which will also enable the technology strength of the banks to play a supporting role with a degree of assurance and sustainability.

Risk Management

16. Issue of risk management in banks and financial institutions would, however, continue to be at the centre of an ongoing search for the right policy prescription. While newer skill set for managing newer areas and unfamiliar elements of risks would continue to pose questions even to the most savvy of banks. Banks will have to adopt a converged approach to risk where they will reevaluate their risk management acumen in a manner that calls for higher levels of transparency, structural integrity and operational control. To combat internal fraud and protect clients and accounts, behavior and rules-based tools will have to be brought in. Better risk management and surveillance applications that address systemic and customer-oriented risks, potential conflicts of interest, financial valuation, volatility of market movements and regulations will have to be embedded into the operational structure. Future pricing will be dependent on risk minimization even while relationship-based pricing will continue to hold sway. Today banks and FIs are facing with the risks of mis-pricing, adverse selection and mis-selling. On the one hand, banks are operating in the market where only about one-third of the adult population are within the banking fold leaving out the market potential to grow twice the current size and, on the other, banks' propensity to take banking services to the silent majority is very slow. While expanding market is a matter of survival, further challenge for the banks would be to ring-fence its operations by establishing a sound risk management system that is not only protective but also inclusive and acts as a business enabler. But for this to happen, analytics have to be developed and data integrity has to be improved.

17. Going forward, more focused approach would have to be given to strict adherence of AML / KYC norms so as to prevent the elements of fragility to come into the system. Strong tracking system for verifying the movement of funds, especially cross border transaction and skillful analytical capabilities will be the prescription of the future. Along with that, the most important issue will be customer protection. When I talk of the customer protection, I mean making banking services or banks economically feasible for the customers and protect them from the bad banking practices. Can we devise a system by which poor subsidizing the rich can be reversed? When banks make huge

profit, it is because the customers paying through their nose. When the banks incur loss, again it is the customers who are made to take less for their deposits or pay more the loans. When the banks go out of business, it is the millions of tax payers' hard-earned money that goes down the drain. Customer protection also needs to be seen from protecting customer information and transaction security. The writing on the wall is clear: 'keep your customers happy and survive'.

Risks and Rewards

18. Next important issue that warrants a really careful consideration is the issue of executive compensation. How much compensation is too much? Can the industry have a different kind of compensation structure for the same job? Can there be uniform board level accountability? Flawed incentive compensation practices in the financial sector were one of the important factors contributing to the recent global financial crisis. I am aware that booms are propelled by greed and busts are born out of fear. This quirk of human nature will always ignite the euphoria that fuels the ups and exacerbates the downs. Employees were too often rewarded for increasing the short-term profit without adequate recognition of the risks the employees' activities posed to the organizations.

19. These perverse incentives amplified the excessive risk taking that severely threatened the global financial system. The compensation issue has, therefore, been at the centre stage of the regulatory reforms. Issue of appropriate compensation commensurate with risk or built-in checks to avoid excessive risk taking would have to be managed through a sound corporate governance framework based on strong corporate ethics principles and with reference the principles laid down by Financial Stability Board (FSB). The principles are intended to reduce incentives towards excessive risk taking that may arise from the structure of compensation schemes. The principles call for effective governance of compensation and its alignment with prudent risk taking and effective supervisory oversight and stakeholder engagement. The principles have been endorsed by the G-20 countries and the Basel Committee on Banking Supervision (BCBS) and are under implementation across jurisdictions.

However, banks and other financial system players need to appreciate that good governance is more a matter of practice rather than a matter of compliance.

20. Now the question is: with so much of constraints and problems, whether the system will survive? The answer is an emphatic yes because banking is a highly regulated business. But having flagged some of the challenges before the banks, it is incumbent upon me that I flag certain challenges for regulators. We all know that:

- the financial system is growing to be highly complex and opaque—sometimes making it difficult to assess the extent of exposures and potential spillovers. This opacity magnified the shock to confidence as the recent crisis unfolded.
- the financial system has a propensity to become over-leveraged and heavily interconnected, leading to massive deleveraging and easily available propagation channels, both domestically and globally.
- liquidity risks, both the funding risks incurred by institutions and the associated market liquidity risks of assets, are often much higher than recognized.
- financial intermediation has increasingly shifted to the non - or less-regulated "shadow" banking sector, in large part to avoid the more stringent requirements imposed on banks.
- there is a critical absence of effective mechanisms to deal with institutions that were deemed "too big to fail."

How do regulators meet the above challenges?

21. Central banks must take a long-term view of the economy and craft appropriate policy responses. We must have the latitude to raise interest rates when others want cheap credit and rein in risky financial practices when others want easy profits. There has to be greater societal consensus on taking tough corrective actions.

22. While progress on macro and micro-prudential regulations will be the key for moving forward, some work is still needed from the regulators in providing guidance to the market in instituting a mechanism in the area of managing not only several "known unknowns" but also a number of "unknown unknowns."

23. With the benefit of hindsight, low nominal interest rates, abundant liquidity and a favorable macroeconomic environment encouraged the private sector to take on ever-increasing risks. Financial institutions provided loans with inadequate checks on borrowers' ability to pay and developed new and highly complex financial products in an attempt to extract ever higher returns. Meanwhile, many financial regulators and supervisors were lulled into complacency and did not respond to the building up of vulnerabilities. We have to develop more sensitivity in our policy tools to capture and quickly correct our policy stance to control such covert signs of overheating.

Conclusion

24. In summing up, I would like to reiterate that though each one of the key challenges facing the Indian financial system begins with the banking system, it does not and should not stop at the banking system. Banks have to look beyond the way banking is traditionally defined in a narrow fashion; they need to look towards the vulnerable and other excluded sections of the population as bankable. Stakeholders other than banking too need to involve themselves in the process of expanding the outreach of the financial services, and thus partner with banks in the process of inclusive economic growth. That is the key challenge.

Thank you for your kind attention.

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