*Sustainable Growth in the Financial Sector**

Raghuram G. Rajan

Coimbatore Krishnarao Prahalad was born in Tamil Nadu. One of nine children, he obtained an undergraduate degree in physics from the University of Madras and went on to a diploma at IIM, Ahmedabad as a member of the first graduating batch. He followed that with a DBA from Harvard Business School in 1975. Prahalad started his academic career at the University of Michigan in 1977, and in 1990, he and Gary Hamel co-authored an article in the Harvard Business Review titled, *'The Core Competence of the Corporation.'* In this influential article, building on the work of Edith Penrose who first stressed the importance of the unique capabilities of a firm, Prahalad and Hamel encouraged corporate executives to 'identify, cultivate, and exploit the core competencies that make growth possible.'

In their 1994 book, *Competing for the Future*, Prahalad and Hamel analysed how established market leaders like IBM tend to lose ground to innovative upstarts like Apple – IBM failed to see the future of the personal computer because it was too focused on maintaining its leadership in the mainframe business. Perhaps most important to India, Prahalad's 2005 book, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits*, explored how businesses might pursue sustainable growth while catering to the poorest of the poor. Indeed, much as the term 'core competence', the term 'the bottom of the pyramid' has entered the common lexicon. He received many awards and honors during his life time, but perhaps the greatest honor is the continuing influence of his work.

I met C. K. Prahalad when I was at the University of Chicago. Despite his enormous reputation and the exalted circles he moved in, he was always down to earth, and immensely insightful. He cared deeply about India, and gave freely of his time and money to make a difference here. Many of you have attended the seminars he organised to improve Indian business practice. He believed we Indians could be second to none; some of the businessmen here have taken his message to heart and delivered. He and I never got a chance to do research together, but we did write a joint letter to the then Prime Minister in 2009, together with Abhijit Banerjee, advocating, among other steps, accelerated efforts to bring out a unique ID in India. Perhaps, therefore, we all had a small role in the Prime Minister setting up the Unique ID Authority, headed by Nandan Nilekani.

As an aside, given how far Nandan's UIDAI has taken us towards a universal unique identity for India, it would be sad if its use were severely restricted. Other countries like the United States have used unique IDs, such as social security numbers, without serious allegations of violations of privacy. Learning from worldwide experience, we need to see how we can satisfy the concerns of the Supreme Court without undermining the value of the unique ID. The unique ID can enable a variety of economically valuable activities that particularly benefit the bottom of the pyramid. For instance, not only can UIDs expand the access of the poor and young to credit as they borrow against the collateral of their future good name, it will also allow the regulator to detect and curb over-lending to individuals by asking lenders to report the IDs of borrowers to credit bureaus. Today, unscrupulous lenders can avoid current regulations against over-lending by simply misreporting the borrower's name or address. Similarly, the Government has used UIDs to weed out duplicate beneficiaries for various welfare schemes, allowing better targeting of scarce funds to the very poor. I think C. K. would want us to find a way to move forward with UIDs. I do believe, as C. K. did,

* Speech delivered by Dr. Raghuram G. Rajan, Governor, Reserve Bank of India on September 18, 2015, at the 4th C.K. Prahalad Memorial Lecture.

that India can be far more successful and influential than it is today. What do we need to do to succeed? How can we compete effectively against the best? Do we need to identify our core competencies as a nation? Rather than attempt to speak from the perspective of business, let me speak from the vantage point of a central banker.

Let me also quickly offer my standard disclaimer: *For any hints on what we will do in the upcoming policy statement, please read the guidance in our last policy statement. I quote: 'Significant uncertainty will be resolved in the coming months, including the likely persistence of recent inflationary pressures, the full monsoon outturn, as well as possible Federal Reserve actions. As the Reserve Bank awaits greater transmission of its front-loaded past actions, it will monitor developments for emerging room for more accommodation.' Nothing I say in what follows is meant to offer further guidance, and please don't read veiled meaning where none is intended.*

If we look around the world today, it does not present a pretty picture. Industrial countries are still struggling, with a few exceptions, to grow. Our fellow BRICS all have deep problems. Indeed, India appears to be an island of relative calm in an ocean of turmoil. What is different and how can we be assured that it will continue?

A lesson from Brazil?

Perhaps Brazil offers a salutary lesson. Only a few years ago, the world was applauding the country's thriving democracy, its robust economic growth, and the enormous strides it was making in reducing inequality. It grew at 7.6 per cent in 2010, and had discovered huge oil reserves which the then President Lula likened to 'winning a lottery ticket'. Yet the country is expected to shrink by 3 per cent this year, and its debt just got downgraded to junk. What went wrong?

Paradoxical as it may seem, Brazil tried to grow too fast. The 7.6 per cent growth came on the back of substantial stimulus after the global financial crisis. In an attempt to keep growth high, the New York Times says the central bank was pressed to reduce interest rates, fuelling a credit spree that overburdened customers are now struggling to repay.[1] Further, Brazil's government funded development bank hugely increased subsidised loans to corporations. Certain industries were favored with tax breaks while price controls were imposed on gasoline and electricity, causing huge losses in public sector firms. Petrobras, the national oil company, which was supposed to make enormous investments in oil drilling, instead became embroiled in a corruption scandal. Even as government pensions burned an ever larger hole, budget deficits expanded, and the political consensus to narrow them has become elusive.

Towards sustainable growth

While the Brazilian authorities are working hard to rectify the situation, let us not ignore the lessons their experience suggests. Growth has to be obtained in the right way. It is possible to grow too fast with substantial stimulus, as we did in 2010 and 2011, only to pay the price in higher inflation, higher deficits, and lower growth in 2013 and 2014. Of course, India is not in the same situation today. But with the world being an inhospitable place, we have to work hard to strengthen our current recovery and put it on a more sustainable footing. And while monetary policy will accommodate to the extent there is room, we will expand sustainable growth potential only by continuing to implement reforms the government and regulators have announced. These are intended to strengthen the environment for doing business and to expand access to financing, and these will then in turn allow our companies to find and exploit their core competencies.

For the RBI, the key tasks are to keep inflation low not just today but well into the future so that we get moderate nominal interest rates that satisfy not just the vocal borrowers but also the silent savers. We also

[1] 'As a Boom Fades, Brazilians Wonder How it all Went Wrong', Simon Romero, New York Times, September 11, 2015.

need to clean up the banking system of distressed assets so that it is in a position to fund growth again. While we understand the difficulties industry has and will work as hard as we can on improving the environment, India must resist special interest pleas for targeted stimulus, additional tax breaks and protections, directed credit, subventions and subsidies, all of which have historically rendered industry uncompetitive, government over-extended, and the country incapable of regaining its rightful position amongst nations.

Belief

What will be critical in success, as the Prime Minister said earlier this month while meeting industrialists and bankers, is that business has to believe in the tremendous possibilities and opportunities the nation has, and be willing to take the investment risks that will generate returns. No country succeeds without believing in itself – I do not mean the unwarranted belief that we are intrinsically better than everyone else but the confidence that given our population, our demographics, our massive infrastructure investment opportunities, and the wide range of capabilities in our people, the arc of history is turning towards us. While Indian business has been hurt by public authorities' acts of omission and commission in the past, it has to look forward. And I have no doubt that as business presses people in positions of public responsibility to make the changes needed to ease doing business, we will respond.

What specifically are we doing on the environment in the financial sector and what more do we need to do? Let me turn to that, dwelling specifically on the need to foster competition and innovation, on creating an environment hospitable to those who do not belong to the club, on improving the structures we have to deal with distress, and on strengthening human capital in the financial system.

Fostering Competition and Innovation

In order to get sustained growth, we need more competition, especially from new entrants who are in a better position to reach hitherto excluded parts of our economy. After a decade of no new entry, we will see two new private banks this year, and a large number of payment banks and small finance banks next year. Licensing is likely to go on tap.

Incumbents have expressed fears about unfair competition. Competition is only unfair if it is not on the same playing field. In fact, new entrants have no privileges that incumbents do not already enjoy. We hope, though, that the new entrants will find innovative ways of giving customers better services at lower prices, thus shaking up and changing the banking sector for the better.

Regulators are naturally a conservative lot. It is good we are that way else there would be no speed breakers in the economy to slow its propensity to get into trouble. But we also should not stand in the way of innovation. There is a Chinese saying: 'Cross the river by feeling the stones'. We have tried to follow that path of experimentation and incremental liberalisation. So, for example, as increasingly innovative new services want their customers to have the ability to make payments quickly, we have allowed small value card payments without two-factor authentication. As we and financial institutions gain experience, and as new technologies ensuring security emerge, we can liberalise further. More generally, our philosophy is to allow innovation in institutions, instruments and practices so long as they do not present a clear and present danger. Once we understand them better, and they grow to a material size, we can do a deeper analysis on how they should be regulated.

Similarly, we have been allowing more and more participation in derivative markets by what are typically known as speculators – those without an underlying risk they are hedging. Speculators are much maligned in India and often confused with market manipulators. The two are different. Speculators take positions in an instrument and thus take risks, much as an investor in a stock takes risk. They typically take the necessary other side to hedgers. Without speculators, there would be little depth in most markets and prices would be distorted. The market manipulator moves thin markets in a preferred direction so as to make a quick profit, in contrast to the speculator who simply takes a side she thinks will make money. In the securities we regulate, we intend to encourage broader participation while discouraging manipulation.

More generally, we would like to improve regulation by focusing on what is absolutely necessary to create a sound business environment – focusing on enabling regulation rather than paternalistic regulation – while increasing enforcement of what is on the books. We will trust but we will also verify. To this end we are streamlining all our regulations by the end of the year into new Master Documents which will be placed on the internet and updated on a real time basis, so that any regulated entity can know quickly the gamut of what is required when undertaking an action.

Including Outsiders

As India grows, financial sector participants will grow beyond the insiders who typically dominate economic activity in the early stages of growth in every country. Outsiders and new entrants will want access, arm's length contracts that they can trust, and a dispute settlement system that is transparent and predictable.

Start first with access. We need to bring more of the hitherto excluded to participate in the financial system. The Prime Minister's Jan Dhan Yojana has created accounts for much of the excluded population. Government has taken the next step of attaching a variety of financial services such as accident and life insurance to these accounts, and sending Direct Benefits such as scholarships, pensions, and subsidies to these accounts. We also have to ease access to bank accounts through Business Correspondents, payment banks, and point-of-sales machines so that they are used frequently. Easy payments, access to cash-in and cash-out facilities, and widespread availability of safe savings instruments have to be our next objectives in the financial inclusion of households.

We also need to ease lending to small producers, whether they are farmers, Self Help Groups, or businesses. For this, we need to improve the structure and working of credit information bureaus, collateral registries, and debt recovery tribunals – ironically, credit flows easily only when the lender is persuaded that he will get his money back, so easier access to credit necessitates harsher consequences of default. Perhaps the most important source of collateral value is land. We need better digital mapping and clean records of land ownership across the country so that land can be used more effectively as collateral.

Newcomers and outsiders rely, not on relationships to get things done, but on arm's length auctions and contracts, enforced quickly by an impartial bureaucracy and judiciary. The clean-up that is taking place in methods of allocating resources like mines and spectrum, and the attempts to improve the speed of bureaucratic and judicial decision making are all much needed to increase participation, though much more has to be done over time. Any reforms have to be institutionalised, so that they outlive the reformer's passing.

Finally, newcomers and outsiders need protection against unfair practices. As one example of what we are doing, the RBI has developed a Charter of Consumer Rights following public consultation. Bank boards have been asked to put in place frameworks that ensure those rights are protected. After those frameworks have been in operation for some time, the RBI will take a view on best practices, and regulation, if any is needed. In the meantime, field visits by the RBI, to check mis-selling as well as the proper functioning of bank infrastructure such as branches and ATMs, will be expanded.

Resolution of Distress

Failure is inevitable in a free enterprise system. An effective resolution system is needed to preserve residual enterprise value after financial failure. Two critical elements are the speed of resolution and the predictability of how losses are shared amongst contracts. For instance, few outsiders will want to lend if they believe they will be subordinated to promoter interests in bad times. So we need a speedy bankruptcy code to resolve distress while maintaining the priority structure of claims, and I am glad the Finance Ministry intends to bring one in soon. The bankruptcy code will give creditors more ability to resolve distress, and help strengthen the corporate bond market, which is so essential to infrastructure financing.

In the meantime, we have to find ways to deal with the distress in the banking system. Regulatory forbearance, where the RBI softens its rules on classifying bad loans, only makes it easy for banks to 'extend and pretend'. It is not a solution. Since no other stake-holder – such as the promoter, tariff authorities, tax authorities, etc. – contributes to resolution, the real project limps along, becoming increasingly unviable. Meanwhile, analysts grow increasingly suspicious of bank balance sheets and the growing volume of 'restructured' assets. Also, some large promoters take advantage of banker fears about assets turning non-performing to extract unwarranted concessions, without any sacrifice in the value of their stake. Regulatory forbearance therefore ensures that problems grow until the size of the provisioning required to deal with the problem properly becomes alarmingly large – which then prompts calls for yet more forbearance.

Forbearance is also a disservice to the bank's owners (which may include the Government) who, instead of being faced with a small problem early and being given the opportunity to apply corrective action, are faced with large problems suddenly when they cannot be pushed into the future any more.

The RBI ended the forbearance accorded to restructured loans. Henceforth, restructured loans will be classified as non-performing loans. However, the RBI has made it easier to recognise and deal with distressed projects. In other words, while ending forbearance, we have introduced flexibility for those who recognise and deal with stressed assets early – the early warning database of large loans, the Joint Lenders' Forum, the Strategic Debt Restructuring process, the 5/25 mechanism, and so on should all be seen as the RBI's way of giving banks the flexibility to deal with the stressed asset problem in the absence of a functioning bankruptcy code, even while bringing more urgency and discipline to dealing with the problem.

Naturally, some criticise our easing the way for restructuring. One gentleman accosted me the other day and asked why, when he was paying his debt regularly, his competitor who had siphoned money out of the firm through over-invoicing was getting his debt written down because it was unpayable. The reality is that firms have got into trouble for a variety of reasons, only one of which is over-invoicing. Wherever possible, of course, promoters should share fully in the costs of restructuring. But the restructuring process is not meant to deal with criminality. Siphoning money out of a business is a crime against lenders and investors, and should be dealt with as such by the investigative authorities. However, the original sin of over-invoicing should not be a reason to keep idle a spanking new plant and to let its workers go.

Developing Human Capital

The country needs many more finance professionals with specific skills for the enormous financing needs that lie ahead. Today, for example, too many of our project decisions are made by banks listening to the same set of consultants, which means that too few independent views get embedded in the evaluation decision. Ironically, the same consultants who advised on the project initiation are also called in when the project goes bad. Banks need to have these skills in-house so they are not forced to follow the herd. This problem is most apparent in public sector banks, though private banks are not immune.

The quick way is for our public sector banks to recruit the needed talent in the short run from the market. While the challenges of making a mark in the public sector may attract some to the top public sector bank positions, for subordinate positions it may be essential to pay a market wage. That cost will be small when set against the enormous national benefit of banks making better decisions.

Of course, the bulk of public sector promotions will continue to come from in-house talent. Also, poaching talent from other banks is a zero sum game for the system. Therefore, our banks will have to develop skills in-house by training staff – not so much in soft skills such as leadership but hard skills such as risk management capabilities.

In our development role, the RBI has to help strengthen the human capital in the financial system. Some of our teaching units such as the College of Agriculture and Banking and the Staff College have been training bankers in important areas such as agricultural lending and MSME lending. Increasingly, our Center for Advanced Financial Research and Learning (CAFRAL) will provide courses in state of the art financial techniques such as project evaluation, structuring and resolution of distress as well as risk management. Banks may want to pool resources to set up other such facilities, or press CAFRAL to expand its offerings.

Conclusion

These are some of the ways I think we can position the financial system towards sustainable growth. Before I end, let me try to answer one last question. In the same way as firms have core competencies, do countries have core competencies?

Perhaps they do. But it is very hard for public authorities to determine what they are in the face of massive lobbying and disinformation from interested parties. If we say we want to focus on national core competencies, every industry will be out to show why it thoroughly fits the bill – in the same way as every industry today wants to tell us why they especially deserve special tax benefits or interest subventions. Remember, the License Permit Raj persisted precisely because some industries were favoured over others in the so-called national interest. So even if nations have core competencies, it will be very hard to determine what they are, and very easy to succumb to vested interests in supporting the wrong ones. Better to focus on creating an enabling environment, and let the core competencies emerge from the fillip given by the environment – much as the IT sector emerged as a result of the investment the country made in technical education, but without specific encouragement by the government.

Let me conclude. C. K. Prahalad believed Indian business was capable of scaling world heights and so do I. But there are no easy paths to the top. Jugaad or 'working around' difficulties by hook or by crook is a thoroughly Indian way of coping but it is predicated on a difficult or impossible business environment. And it encourages an attitude of short cuts and evasions, none of which help final product quality or sustainable economic growth. While we should respect the entrepreneurial abilities of our business people in difficult environments, it is better for us to change the environment for the better. That is indeed what we are trying to do.

All this requires patience. The current difficulties of emerging markets stem from a complicated set of reasons, but an important one is impatience to regain growth by overemphasizing old and ineffective methods of stimulus. Brazil may have overspent, China may have overinvested. The world is a difficult place. Let us recognise we are doing quite well in comparison – indeed, many industries in difficulty have a problem because exports are low or imports are very competitive, and not because domestic demand is inordinately weak. We cannot compensate entirely for what is happening across our borders, else we will risk acquiring the problems our fellow emerging markets have. We have to have the discipline to stick to our strategy of building the necessary institutions and creating a new path of sustainable growth where Jugaad is no longer needed. For this, we need the understanding and cooperation of business, not impatience and pressure for quick impossible fixes. Only then can we realise our true potential as a nation. Thank you.