*Challenges and Concerns of the Central Bank: Opportunities and Role for the Commercial Banks**

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It is a pleasure to be in the midst of so many bankers & colleagues in this serene temple city of Thiruvananthapuram in God's own country of Kerala. Bankers' Club, as we all know, provides an informal platform for exchange of views and information on the banking system and about the economic environment in which banks operate. This has assumed added importance in these challenging times for the economy and the financial system. Today, I intend to cover ten major challenges confronting the Reserve Bank and focus on the opportunities available to the commercial banks in relation to some of those challenges and role that the bankers can play to meet the challenges. The 10 challenges & concerns I would focus today are: (i) propelling revival of domestic growth; (ii) controlling persistent inflation; (iii) mitigating external sector vulnerabilities; (iv) deepening the financial markets; (v) maintaining a robust banking system; (vi) ensuring integrity of the financial system; (vii) building efficient government banking business models; (viii) moving towards a less-cash society; (ix) better customer service orientation of banks and (x) enhancing the quality of financial inclusion.

I. Propelling revival of domestic growth

2. Several structural and transient factors, both global and local, have stymied the growth drivers in India in recent times. Given the persistence of inflation, challenge for Reserve Bank of India has been how to address growth risks without losing control over inflation. As you are aware, the global economic activity still remains moderated amidst signs of diverging growth paths across major economies. In India, recovery was rather sharp and swift in 2009-10 (8.6 per cent) and sustained in 2010-11 (9.3 per cent). Thereafter, overall GDP growth witnessed sharp decline to 6.2 per cent in 2011-12 and further to 5 per cent in 2012-13 (provisional). The potential growth, which was around 9 per cent in the pre-crisis period, has come down to about 7 per cent now. The Reserve Bank has been arguing that growth cannot be revived without increasing the level of investment or gross domestic capital formation. In India, the level of investment has been mostly financed by domestic savings. As inflation rate in India remained above the comfort level for a long period, the gross domestic savings as a percentage to GDP has fallen from 33.7 per cent in 2009-10 to 30.8 per cent in 2011-12. As inflation erodes the value of financial savings, there has been a compositional shift in household savings, *i.e.*, from financial savings to physical savings. In fact, the financial savings of the households as proportion to GDP which was about 12 per cent in 2009-10, has come down to around 8 per cent in 2011-12. Per contra, physical savings of households as percentage of GDP have increased from 13.2 per cent to 14.3 per cent during the same period. This trend is not conducive to growth as physical savings are not available for further investment.

3. During 2004-05 to 2008-09, investments in India were supplemented by external savings only to a limited extent as evident by the current account deficit (CAD) which averaged around 1.2 per cent of the GDP. Thereafter, the CAD widened further and has now reached a very high level of about 5 per cent. This has implication for composition of external debt, debt servicing ratio and risks associated with flight to safety in case of any adverse international developments. In view of the above, India has to finance higher level of investment through domestic savings. This could be possible only through containing inflation so that

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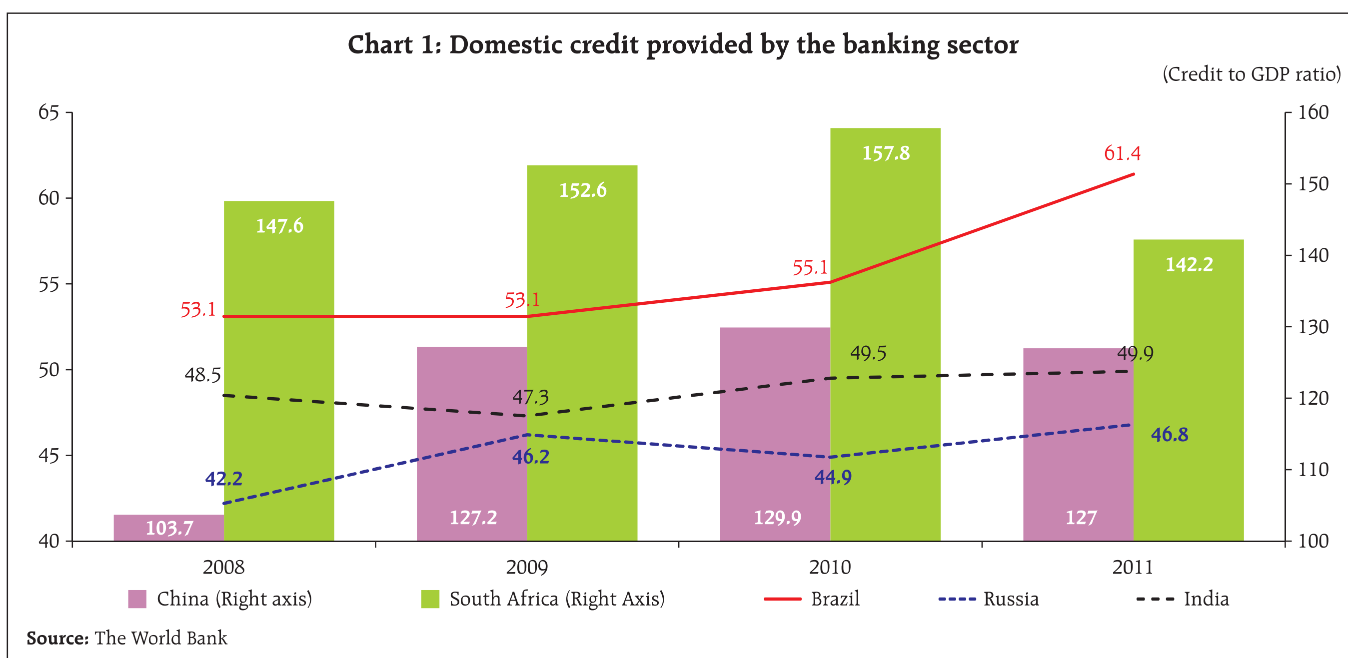
households can get a positive rate of return on their deposits and do not fall prey to unscrupulous offers made by unauthorised entities collecting public deposits under varied nomenclatures.

4. Given the uncertainties, both in the domestic and external fronts, one cannot be sure whether growth slowdown has bottomed out. Gradual recovery will be aided by the concerted efforts made by the Government for fiscal consolidation and boosting private investments. There are number of nascent signs of revival of growth which are likely to be supported by expected normal monsoon. Even in these trying economic conditions, there is a plethora of opportunities for the banks to provide the much needed fillip to the economy. Structural shift from services to manufacturing, greater focus on financial deepening leading to a wider base of consumers, particularly in the rural and small towns and more efficient credit markets are expected to be the factors in improving the country's credit-GDP ratio, which is one of the lowest amongst the BRICS nations (Chart 1).

5. Unlike in China, much of India's growth performance in the recent years has been contributed by the services sector with share of manufacturing sector stagnating at around 15 to 16 per cent of the GDP. A competitive manufacturing is not only necessary for taking advantage of the demographic surge that the country is now experiencing but also for sustaining growth. With the New Manufacturing Policy, India is refocusing on positioning manufacturing sector as drivers of growth. The policy aims at increasing the manufacturing sector growth to 12 – 14 per cent over the medium term, thereby enabling manufacturing to contribute at least 25 per cent of GDP over the next one decade and create additional 100 million jobs.

6. Banks should actively consider lending to the MSME sector as credit growth to this sector has decelerated. 14th Standing Advisory Committee on MSMEs was constituted a Committee (Chairman: Shri K. R. Kamath) to look into the entire gamut of credit flow related issues pertaining to the sector. It is heartening to note that a recent survey of the Confederation of Indian Industry (CII)[1] revealed that bankers expect 20 per cent increase in credit for the sector in the financial year 2013-14. Banks should also consider stepping up credit delivery to the agriculture sector, particularly for small & marginal farmers under

Chart 1: Domestic credit provided by the banking sector



Source: The World Bank

[1] CII Survey on Health of Indian Banking sector in current regulatory environment.

different aggregation models and investments, credit for value addition in the sector besides now forgotten project based lending to the allied sectors. With expected normal monsoon and good level of harvests, increasing purchasing power and huge labour shortage for farm activities demand for consumer goods and capital goods like farm equipments is likely to register growth. This opens up new opportunities for bank lending.

7. Recently, over half of economists surveyed by CNN Money have identified recovery in the housing sector as the primary driver of economic growth this year. In 2011-12, the housing sector contributed 5.9 per cent in the GDP of the country, five per cent of GDP in 2010-11 and 9.3 per cent of the GDP in the year 2009-10. In a report of 2012, ICRA has observed that during the period 2007-12, the level of mortgage penetration remained stagnant at around 7 per cent of the GDP and this is significantly lower than developed countries. Such low level of mortgage penetration, however, offers immense growth potential of the sector. The criticality of the sector further increases due to the fact that housing is the second largest generator of employment, next only to agriculture, with both forward and backward linkages in nearly 300 sub-sectors, such as, manufacturing (*e.g.*, steel, cement, and builders' hardware), transport, electricity, financial services, *etc.* Banks could grasp the opportunity of being part of the development of the affordable housing sector and, in turn, contribute more actively in the overall inclusive growth of the Indian economy.

8. Another important sector which offers tremendous business opportunity for the bankers is the infrastructure sector. It is well-proven that infrastructure development facilitates economic growth and economic growth increases demand for more infrastructure. Successful implementation of infrastructure projects is dependent, among others, on efficient financial intermediation. Banking services are required for the entire life cycle of the project and spread across a wide spectrum of products including advisory, lending, transaction banking, debt and equity raising. The banks could seize the new opportunities like take-out finance, transfer of liabilities to the Infrastructure Debt Funds (IDFs), *etc.* to manage their Asset Liability Management concerns while financing the infrastructure.

II. Controlling persistent inflation

9. Inflation-growth dynamics in India is more complex than in most other countries. Demand and supply side factors like high fiscal deficit aiding demand pressures, rising food prices due to structural factors like higher income levels of people, change in their dietary habits with focus on proteins, inefficient supply chain management, acceleration of wages, particularly rural wages and high commodity prices have contributed to the persistence of inflation. Recent trends are, however, comforting and show that inflation, at the wholesale level, is moderating.

10. Particularly, the dilemma is to decide about the overriding objective of monetary policy when growth is much below the potential and inflation persists. The challenge is to strike a balance between the two primary objectives of monetary policy. The Reserve Bank could not be more aggressive on monetary policy front as the battle against inflation is not yet over. The upside risks to inflation persists and is in fact more pronounced at the retail level. In this context, it is crucial to ascertain the threshold level of inflation which provides fillip to growth. Recent research studies indicate that the threshold level of inflation in India is about 5 per cent beyond which inflation harms growth by putting sands on the wheels of commerce. For example, given the level of disposable income, consumption of the same level of goods and services by households requires more spending and, therefore, less amount of disposable income is left for savings. It is not only the household savings but also government savings which could be augmented by inflation control. According to the recent Report on Currency & Finance published by the Reserve Bank, the elasticity of government expenditure with

respect to one percentage change in WPI inflation is as high as 2.7, while such elasticity with respect to collection of revenues in 0.9. Higher inflation thus entails higher net government expenditure, leading to higher gross fiscal deficit, other things remaining constant. As the Union Government is currently under the fiscal consolidation programme, unless inflation is controlled, it may be difficult to check revenue expenditures. Inflation control will help achieve fiscal consolidation without cutting capital expenditure. In fact, it is the quality of fiscal consolidation which matters much as this helps to improve investment climate in the country.

11. The challenges emanating from production and productivity constraints, particularly in the manufacturing sector and infrastructural deficits can to a large extent be met by sustainable bank financing. Another challenge emanating on the inflation front is the food inflation. The price increase in cereals and pulses have been significant during the current year. The increases have been persistent despite existence of large buffer stocks. The upward pressure has been reinforced with significant increase in the minimum support prices of most cereals and pulses. Apart from cereals, volatility in prices of vegetables and fruits added to domestic price pressures. Also, inflation in protein rich food items continued to remain elevated due to significant price increase in eggs, fish and meat. The persistence of food inflation calls for a relook at the agriculture price policy of the country. Further, there is a need to revisit the buffer stock policy as recent evidence reflects the absence of dampening of price rise even with availability of large buffer stocks. Another factor that is proving to be a major constraint in curbing food inflation is the rise in cost of agriculture largely driven by the rise in wage costs. It is a matter of concern that supply elasticity has not been sufficiently matching for the rise in demand for protein-rich food like milk, egg and meat.

12. Banks can play an important role in inflation fighting strategy of the country. In respect of food inflation the issues that could be addressed with the support of the banks would include banks focussing on supply and value chain financing, monitoring productivity of increasing bank credit disbursed to the agriculture sector, and helping in risk-proofing of the agriculture sector by adopting a credit plus approach. Timely, adequate and sustainable credit flows to various segments of the economy will also remove supply bottlenecks. Wide variance in the prices of vegetables and fruits the consumer level and mandi level is a common feature across the country. One plausible reason for the huge variance is the dependence of vendors on informal sources of finance for buying vegetables from the wholesale market in the cities/towns. Such sources of funds, though easily accessible, are usually available at exorbitant rates. Banks can explore creating extremely short-term small denomination credit products for such vendors to provide them easy access to funds at relatively cheaper rates under a mobile banking model. Such a move will enable lowering the prices of food items and help in curbing the inflation to a large extent.

III. Mitigating external sector vulnerabilities

13. Till recently, external sector has been a source of strength for our economy; however, in the last few years, the vulnerabilities in the external sector (Table 1) have increased mainly due to unusually high CAD which increased from 4.2 per cent to 6.7 per cent in the third quarter of 2012-13 and likely to be around five (5) per cent for the year. The sustained capital flows to finance large CAD cannot be taken for granted as quantitative easing by the advanced economies may not continue indefinitely. A major source of concern is that a significant proportion of capital flows has been in the form of FII & other debt creating flows which are more volatile than FDI flows.

14. The positive trend in merchandise export growth since December 2012 has been encouraging. The global growth conditions are, however, projected to remain subdued (as projected by the IMF, output growth of

Table 1: External Sector Vulnerability Indicators

(in per cent)

Indicator	Mar '06	Mar '11	Mar '12	Jun '12	Sep '12	Dec '12
Ratio of Total Debt to GDP*	16.8	17.5	19.7	19.7	19.3	20.6
Ratio of Short-term to Total Debt (Original Maturity)	14	21.2	22.6	23.0	23.2	24.4
Ratio of Short-term to Total Debt (Residual Maturity)#	24.4	42.2	42.6	42.9	43.7	44.1
Ratio of Concessional Debt to Total Debt	28.4	15.5	13.9	13.5	13.2	12.5
Ratio of Reserves to Total Debt	109	99.7	85.2	83.0	80.7	78.6
Ratio of Short-term Debt to Reserves	12.9	21.3	26.6	27.8	28.7	31.1
Ratio of Short-term Debt (Residual Maturity) to Reserves#	32.6	42.3	50.1	51.8	54.1	56.2
Reserves Cover of Imports (in months)	11.6	9.6	7.1	7.0	7.2	7.1
Debt Service Ratio (Debt Service Payments to Current Receipts)	10.1	4.4	6.0	5.8	6.0	5.8
External Debt (US$ billion)	139.1	305.9	345.5	349.1	365.6	376.3
Net International Investment Position (IIP)	-60.0	-209.8	-248.5	-224.1	-271.5	-282.0
IIP/GDP ratio	-7.2	-12.3	-13.3	-12.2	-15.1	-15.4
CAD/GDP ratio	1.2	2.8	4.2	3.8	5.4	6.7

*: Annualised GDP at current market prices; #: RBI Estimate

world economy in 2013 will only be marginally higher than that in 2012). Unless the conditions, particularly in the advanced economies, improve significantly, a durable pick up in India's export cannot be taken for granted. On import side, oil and gold accounting for 45 per cent of total merchandise imports are also subject to global financial conditions. Although recent drop in their prices and restrictions imposed on gold imports and efforts made for passing on the actual price of fuel to the users could act as favourable triggers for India's CAD, there is still uncertainty regarding persistence of softening bias in international commodity prices and consumer behaviour regarding gold demand. Similarly, deceleration in private transfers, mainly the workers' remittances, from abroad also to a large extent depend on source countries economic conditions. The World Bank, in its April 2013 Report on remittances, made a forecast that remittances received by South Asian countries including India, may grow at a lower rate of 6.9 percent in 2013 as compared to 12.3 per cent in 2012. Fortunately, capital flows so far have been adequate to finance the current account gap and going forward pressures on CAD in terms of quantum, quality and safe financing are expected to moderate, particularly as various measures are being taken to improve pace of investment in the country.

15. It has been seen that India's exports were more severely impacted in recent period than many of the peer group economies (*e.g.*, China, Korea, Malaysia and Thailand) suggesting the need for building up of productivity based competitiveness and robust infrastructure to support our exports. The onus of boosting the export sector, however, does not necessarily fall only on the exporters and the government, bankers have an equally crucial role to play. Exporters, to maintain their cost effectiveness, need adequate, timely and cost effective lines of funding for both working capital and capacity creating expenditures. Reserve Bank had introduced a US Dollar - Indian Rupee swap facility for US$ 6.5 billion for extending export credit in foreign currency to exporters. The export credit refinance was earlier expanded to 50 per cent of the outstanding export credit of the banks from 15 per cent and the interest rates on export credit in foreign currency were also deregulated. Still exporters face a lot of difficulties many of which relate to availability of financial services, including timely and adequate export finance and other facilities extended by banks and financial institutions. Non-implementation of exporter friendly guidelines (*e.g.* export credit should constitute 12 per cent of the net bank credit of the banks, extension of hassle-free credit

availability under the Gold Card Scheme, transparency regarding bank charges for various services provided by Authorised Dealer banks, exercise of powers delegated to the AD banks in regard to availment of export advance, write-off of outstanding of export dues, extension of period for realisation of export proceeds, set-off of export receivables against import payables, *etc.* under the FEMA regulations) has been a cause of concern. Keeping these issues in view, a Technical Committee (Chairman: Shri G Padmanabhan) was constituted by the Reserve Bank. The Committee has looked into the entire gamut of facilities/services provided by banks/financial institutions {including the Exim Bank, Export Credit and Guarantee Corporation (ECGC) & Small Industries Development Bank of India (SIDBI)}, such as, export credit, in Indian Rupee as well as foreign currency, hedging instruments, factoring services, insurance coverage, *etc.* and suggested several important recommendations for implementation by the banks.

16. As on March 31, 2013, there were 285 overseas offices of Indian banks abroad spread across 55 countries. Such widespread network of branches can be tapped for providing useful inputs to the Indian exporters for exploring new markets and creating a niche in the untapped economies. Attracting investment into the country, especially in the form of foreign direct investments, is crucial for enhancing the technology-led production capacity and managerial expertise. Another area which the banks need to explore is tapping the Indian diaspora. As you are aware, India is one of the largest recipients of inward remittances, receiving approximately US$ 69 billion in 2012,[2] and this would not have been possible but for the connect of the Indian migrants with the country and efforts of Indian banks. I would, however, expect banks to be more proactive and innovative in developing new products for the non-resident Indians and ease the processes in timely transfer and credit of remitted funds. This is more critical from the point of view of banks in Kerala as the state is one of the largest recipients of remittances.

17. In the present context of high CAD, I intend to highlight the concerns of rising import of gold. The three sources of demand for gold are consumption, investment and speculative. The Reserve Bank has observed that while the growth in consumption demand, primarily driven by households, remained moderate, the demand for gold driven by investment and speculative motive has grown rapidly. The rising demand for gold is a cause of concern because of the management of CAD & financial stability and the larger issue of consumer protection. The Reserve Bank has also been concerned with the aggressive selling of gold and extending loans against gold. Banks should refrain from aggressive selling of gold coins as such an activity should not be construed as the core business activity. In order to moderate the demand for gold for domestic use, the Reserve Bank has issued instructions for restricting import of gold on consignment basis. These restrictions are, however, not applicable on the genuine needs of exporters of gold jewellery. Further, all nominated banks/agencies have been instructed to open letters of credit for import of gold only on 100 per cent cash margin and release documents against payment basis only. Banks also have to ensure that the weight of the specially minted coin(s) do not exceed 50 grams per customer and the amount of loan to any customer against gold ornaments, gold jewellery and gold coins (weighing up to 50 grams) should be within the Board approved limit. Realising the need to provide financial instruments to investors for protecting against inflation, the Reserve Bank in consultation with the Government of India has recently launched Inflation Index Bonds (IIBs) to provide an inflation protecting savings instrument. The first tranche of IIBs with a face value of ₹10 billion was recently auctioned and met with huge success. In the near future, IIBs would be made available to retail investors also. Banks should tap their wide network and huge customer base to educate and encourage retail participation.

[2] World Bank's Migration and Development Brief 2012.

IV. Deepening financial markets

18. Deeper and broader financial markets are desirable for public policy objectives as they play a critical role in improving the efficiency of capital allocation within the economy. The traditional investor base in Indian G-sec market comprises banks, provident funds, and insurance companies. With the entry of co-operative banks, regional rural banks, pension funds, mutual funds and non-banking finance companies, the institutional investor base has been reasonably diversified. Notwithstanding the predominantly institutional character of the market, the Reserve Bank has recognised merit in promoting retail participation. Small and medium sized investors have been enabled to participate in the primary auction of G-sec through a "Scheme of Non-competitive Bidding" and Primary Dealers (PDs) have been mandated minimum retailing targets. Web-based NDS-OM has also been enabled by the Reserve Bank to provide direct trading access to G-sec to non-NDS members like retail/mid-segment/corporate entities having gilt accounts with banks & PDs. Some major banks have also initiated measures like on-line trading portal for facilitating the retail investors. Banks need to focus on attracting more retail investors in the G-sec market by creating awareness and also providing enabling easy-to-use platforms besides sensitising the retail investors that loans against G-sec is permitted.

19. While India has a very advanced G-sec market, the corporate bond market is relatively under developed. Developing a more vibrant corporate bond market has, therefore, become an important agenda among the concerned stakeholders. Some of the challenges which need attention include taking measures to improve liquidity, such as, consolidation of particularly the privately placed bonds, setting up a suitable framework for market making in corporate bonds, providing tools to manage credit, market and liquidity risks {*e.g.,* CDS, Interest Rate Futures (IRF), Repo in corporate bonds, *etc.*}, developing a smooth yield curve for the government securities market for efficient pricing of the corporate bonds, calibrated opening of the corporate bond market to the foreign investors, developing safe and sound market infrastructure and wider participation of retail investors in the market through stock exchanges and mutual funds. Another challenge is the lack of appetite for new and innovative products that are available in the financial markets. The market has not displayed any appetite for instruments with varied structure. A similar response pattern has been observed in respect of products, such as, interest rate futures (IRFs) and repo in corporate bonds. The dilemma is that while participants do not want to trade till liquidity improves, liquidity will not improve till the participants trade. The bottom-line is that the market participants need to be more active in trading across the yield curve and across products. Given very low levels of participation of the treasuries of the public sector banks it is imperative that they look at the prevailing operating structure so that they participate actively in the market with a supportive risk management framework.

V. Maintaining robust banking system

20. Compared to the pre-90's reforms era, Indian banking has undergone a paradigm shift and evolved beyond the traditional role of financial intermediation. Over the last decade and a half, the health and resilience of the banking system has improved though there has been some deterioration in the recent past. Analysing the various components contributing to the recent concerns of the banking sector, the Financial Stability Report of the Reserve Bank (December 2012) found that tight liquidity, deteriorating asset quality and reduced soundness of the banking sector are the major contributors to the decline in the stability of the banking system. Indian banks currently meet the minimum capital requirements of Basel III at an aggregate level, even though some individual banks may have to top up their capital. Going forward, as growth accelerates, need for banking penetration becomes more pronounced and the economy goes

through a structural transformation, Indian banks will need to raise additional capital both to support the growth process and to meet regulatory requirements.

21. The lure of cheaper foreign currency denominated funds has led to higher foreign currency borrowings by Indian corporates. While the external debt could help the corporate sector diversify the funding sources, excessive reliance on the same could pose balance sheet risks. The risk is magnified when availability of funding liquidity is subject to sharp volatility in the international markets. The Reserve Bank has observed that banks generally do not rigorously evaluate the unhedged forex exposure risks and fail to build it into pricing of credit. It is important to appreciate that unhedged forex exposure of corporates is a source of risk to the corporates as well as to the financing banks and the financial system. The Reserve Bank has, therefore, decided to increase the risk weight and provisioning requirement on banks' exposures to corporates on account of their unhedged forex exposure positions.

22. Recent trends in the asset quality of the banking system have been somewhat disquieting. In 2012-13, the gross NPAs of banks increased by 31.8 per cent while restructured standard advances increased by over 40 per cent. The recent trends in asset quality can be largely attributed to the prevailing macroeconomic situation, domestic and global, besides some underlying issues in credit assessment and NPA management of banks. In the fourth quarter of 2012-13, the asset quality of banks has shown some improvement across different bank groups and various industry segments though it is too early to state with certainty that the trend of deteriorating asset quality has reversed. In view of extraordinary increase in restructuring of advances, a Working Group (Chairman: Shri B Mahapatra) was constituted to review the existing prudential guidelines on restructuring of advances by banks/financial institutions. In the background of many inadequacies/ shortcomings on various aspects of restructuring, the Working Group came out with several recommendations, such as, withdrawal of regulatory forbearance on asset classification on restructuring after two years, provision on standard restructured accounts which get the asset classification benefit on restructuring be increased from the present two (2) per cent to five (5) per cent in a phased manner in case of existing accounts (stock) and immediately in case of newly restructured accounts (flow), increasing the promoters' stake in the restructured accounts by way of higher sacrifice and personal guarantee, *etc.* The implementation of these measures has already commenced and overtime will contribute to increased resilience of the banking system and more transparent accounting of asset quality.

23. Banks will need to gear up to the challenge of improving the health and resilience of the banking system even as domestic and global macro-financial conditions remain depressed. As Basel III is implemented, banks will need to re-engineer their internal systems and align the same to the forthcoming challenges of higher capital and liquidity. Appropriate strategies for meeting the capital adequacy requirements will need to be designed and the position of liquid assets bolstered. Banks will need to provide concerted attention to their ALM policies and reduce reliance on short term and volatile liabilities. Going forward, the Reserve Bank expects that the growth in NPAs would be contained at the current levels due to a) likely improvement in GDP growth in 2013-14 and beyond; b) improvement in project implementation due to Government's efforts in clearing the bottlenecks; and c) improved recovery efforts by banks. Nevertheless, asset quality needs to be closely monitored and the credit appraisal and monitoring system needs to be substantially upgraded. Risk management systems also need to be improved and early warning mechanisms strengthened. Information sharing arrangements between banks needs to be made more effective. It is, therefore, imperative that banks, at the levels of branches, controlling offices and head offices, are proactive in facing up to these challenges.

VI. Ensuring integrity of the financial system

24. High level of trust and integrity in the financial system is an important requirement if the financial sector has to serve the real sector in a sustainable manner. In the recent past, there have been reports about non-adherence to KYC/AML norms and adoption of unethical practices by officials of some banks. The Reserve Bank, during the course of scrutiny, has noticed certain irregularities/deviations/aberrations in conduct of banking transactions. The scrutiny revealed that customers, including walk-in customers, were undertaking cash transactions to buy third party products, such as, insurance, mutual funds, *etc.* and also purchasing massive quantities of gold. No doubt some banks had failed to adhere to the laid down guidelines pertaining to KYC/AML, *viz.*, splitting/ structuring of cash transactions, not quoting the PAN number or quoting dummy PAN number, non- reporting of transactions to FIU-IND for the latter to take appropriate action, if need be, *etc.* Though such irregularities have been noticed across many banks, the volume is not very high. In effect the Reserve Bank expects the banks to follow certain drill in the form of implementing and monitoring KYC/AML instructions.

25. There is a need to ensure better regulatory compliance by banks, both in letter and spirit, of the national objectives underlying the AML regulation. Such compliance is not possible in the absence of commitment of the banks. It is important to note that imposition of penalty for regulatory violations cannot be the only solution. Further, there is a need to address the incentive structure at the operating levels by segregating marketing function from the approval process. Banks should ensure that its employees do not receive cash/non-cash incentives directly from third parties, such as, insurance companies and mutual funds. The Reserve Bank is contemplating tightening of wealth management guidelines to avoid mis-selling of bank's own and third party products. Restructuring compensation models should be part of an on-going process as this will help to improve the reputation of banks and banking industry. Further, it will help ensure that incentive structures are aligned to desired behaviors across the organisation, helping to overcome potentially competing demands. Banks also need to assess strength and robustness of their KYC policies and procedures by analysing whether KYC due diligence requirements are understood unambiguously across the bank. Whether the existing infrastructure supports a risk-based KYC due diligence process with appropriate record keeping and documentation retention is the key question. Banks should also check whether their internal systems are strong enough to identify missing or invalid KYC profile certifications required to block transactions. Negative effects of non-adherence include possible reputational risk and brand degradation through negative publicity besides supervisory action. In addition, financial institutions face exposure to litigation from customers, investors and professional counterparties in the event that fraudulent activities are detected.

26. Of course, one has to keep in view the need for hassle-free KYC procedure for general customers, particularly those doing small ticket transactions. This is critical in the context of our thrust to strike balance between integrity of the financial system and expansion of banking outreach for financial inclusion. Reserve Bank is planning to come out with a detailed FAQs on KYC/AML requirements so that the frontline staff of banks and the customers are fully aware of the requirements for easy access to banking. Banks will have to proactively sensitise their staff in this regard.

VII. Building efficient Government banking business models

27. There is a growing need for electronification of Central and State Governments transaction processing. The migration of government payments to the e-mode would bring in higher efficiencies in operations. Banks would be spared of the work relating to issue, handling, clearing and passing of paper based instruments like

cheques which come with the attendant risks. Electronic payments can be processed in a 'Straight Through' manner with the banks effecting the payments/receipts directly using their Core Banking Systems (CBS) in a largely automated manner which would be safe and secure. Besides, e-transactions are superior to paper instruments in terms of traceability, transparency and efficiency, apart from being a green initiative. The resultant available time of the staff of banks can be used for other purposes which would ultimately augur well for banks. Central Government has already initiated action by implementing Government e-payment Gateway (GePG) for Civil Ministries. Some State Governments have been very proactive in this regard and the Reserve Bank has been actively involved with the Governments like those of Karnataka, Odisha, West Bengal, Uttar Pradesh and Uttarakhand for implementation of e-receipts. The Reserve Bank expects agency banks to play a more pro-active role in enhancing the coverage of government transactions under e-mode.

28. Collection of revenue is one of the major functions of an agency bank and in a CBS enabled environment, delay in remittance of such collections is inexcusable. Strict adherence to the timeline prescribed by the Reserve Bank is expected from the branches. Banks should also ensure complete error free reporting under OLTAS and, in particular, with regard to fund settlement, branch coverage, data quality, *etc.* to ensure that tax collected are timely and correctly accounted for without any reconciliation hassles.

29. A recent initiative by the Reserve Bank pertains to its CBS, named e-Kuber. This system, implemented a year ago, is one of the foremost central bank oriented Core Banking Systems in the world and has now well stabilised. The provision of a single current account for each bank across the country, decentralised access to this account from anywhere-anytime using the portal based services in a safe manner and ease of operations are some of the features of the e-Kuber which have been well received by banks. The system also has a host of offerings for the Government users as well. Some of the facilities offered include the provision of portal based access which allows Government departments to access on anywhere-anytime basis, view their balances – of all types including the Ways and Means Advances, drawings, funds positions and the like – all in a consolidated manner through the e-Kuber so as to help them in better funds management. The capability of consolidating revenue collections by banks through the e-Kuber offers the potential for better flexibility for the Government in managing its finances apart from moving over towards higher levels of electronic banking.

30. The scheme of Direct Benefit Transfer (DBT) envisages transfer of cash benefits, benefits and subsidies by lessening the tiers involved in flow of the transactions, accurate targeting of the beneficiaries and curbing pilferage and duplication. The rollout of DBT presents a number of challenges, such as, digitisation of beneficiary database, opening of bank accounts opened and enrolment for Aadhar followed by seeding of Aadhar number with the bank accounts. Reserve Bank has prepared ground for roll-out of DBT in lieu of product subsidies and has advised lead banks of the select districts to co-ordinate for roll out of Aadhar enabled payments. The challenges are not insurmountable but require closer co-ordination amongst the stakeholders, such as, the government bodies, UIDAI & banks. DBT presents a great business prospect as banks will be paid a transaction fee of one per cent of the value for every payment made to the beneficiaries of direct cash transfers, a move aimed at providing a boost to the scheme. Banks need to put in place a strategic action plan for account opening of all the beneficiaries followed by provision of door-step banking. Given the expected magnitude of volumes of DBT, banks need to put in place an effective mechanism to monitor and review progress in the implementation of DBT. Effective engagement with DBT should be seen

by banks as potential source of building a big market of small customers and thereby create a stable business base.

31. Overall, banks should recognise the immense business potential of conducting government business. Earlier business models have to be replaced and made suitable for the latest technology led banking platforms and payment system infrastructure. Greater efficiency in handling government business will create a distinct brand-value for the bank and will enable greater share of business and widening of customer base by catering to various departments of the Government. Unlike any other business, government business is also remunerative as Reserve Bank pays commission to the agency banks.

VIII. Moving towards a less-cash society

32. The dominance of cash in our economy, informal financial system, organisation of economic activity (*viz.*, dominance of retail *vis-à-vis* large-scale business), proportion of migrant workers, *etc.* are some of the factors driving the need for cash in our society. The preponderance and wide acceptance of cash can perhaps be explained by the ***c**onfidence* it exudes as it has very high ***a**cceptability*, it is extremely ***s**afe* for undertaking and completing a financial transaction and it is ***h**ighly* liquid. The importance of currency is prevalent even in the advanced economies. In the US, currency-GDP ratio remained stable around 6 per cent in the first decade of the 21st century whereas in Eurozone, it went up gradually to over 9 per cent in 2010. Further, the currency-GDP ratio in the UK remained in a narrow range of 2.3-3.1 per cent during 2001-10 whereas Japan registered a rise from 14.7 per cent to 18.1 per cent over the same period. India, however, has witnessed an increase in currency demand in relation to GDP with the average currency-GDP ratio hovering around 10 per cent in the 1970s, 1980s and 1990s, before increasing to over 13 per cent in the last decade.

33. Increased usage of currency poses several challenges to the Reserve Bank, such as, ensuring availability of adequate quantity of banknotes and coins in the system, ensuring good quality banknotes, ascertaining their genuineness besides incurring the high cost of printing which has increased by approximately 31 per cent from during the period 2008-09 to 2011-12. Even for individuals, there are associated risks, such as, fear of theft, idle cash itself does not generate income, time and cost for making payments can be exorbitantly high and last but not the least, the danger of forged currency notes in circulation. For banks, the cost of handling cash is higher as compared to electronic modes as it requires more manpower, more transaction time, more expensive to maintain security and segregating re-issuable notes to maintain good quality notes in circulation requires additional resources. Keeping these issues in perspective, the Reserve Bank in its Payment Systems in India Vision 2012-15 document has envisaged a less-cash society. Successful accomplishment of the objective is possible by concerted efforts of all the stakeholders and creation of a modern well-networked payment system.

34. A multi-pronged approach is required to reduce cash usage in the society and requires active support from the banking system. The Reserve Bank has been promoting usage of electronic payments like mobile payments, payments through internet banking, usage of Prepaid Payment Instruments, debit/credit card. In order to improve accessibility, the payment infrastructure is being constantly reviewed. One of the recent initiatives in this regard has been the decision to permit non-bank entities to launch the White Label ATMs (WLAs), thereby increasing the ATM penetration across the country. Banks, however, need to further improve the acceptance infrastructure like mobile POS and also ensure the products are simple to use and has all the critical safety and security features. As you are aware, the Reserve Bank has created NEFT/RTGS system

that is acting as de-facto remittance system in the country. The Reserve Bank is on the verge of putting in place the Next Gen RTGS which will be more secure, safe and efficient than the existing one. To enable remittance for walk-in customers, the Reserve Bank has put in place a very user-friendly Domestic Money Transfer scheme. Unfortunately, despite the business potential, these facilities are either not being extended by the banks or the target masses are not aware of the facility. Further, it is critical that banks tap technologies to cater to the growing needs of the customers and also to the growing number of customers. The notion that customers are unable to adopt to technology stands defeated with wide success and usage of mobile phones. Mobile banking offers a platform for offering a wide range of banking services to the customers anywhere and anytime. Similarly, banks should also endeavour to promote card based payments products, such as, the PPIs, debit cards, credit cards and the recent innovative product like mobile KCC/card-based KCC. Needless to stress, technology enabled banking products and processes are fraught with risks and the banks have to identify and put in place adequate risk mitigants to ensure the safety and security of the products. One such initiative by the Reserve Bank was mandating additional factor of authentication for all card not present (CNP) transactions. Banks have been advised that all new debit and credit cards to be issued only for domestic usage unless international use is specifically sought by the customer. Such cards enabling international usage will have to be essentially EMV Chip and PIN enabled. All the active Magstripe international cards issued by banks should have threshold limit for international usage. Banks have also been advised to frame rules based on the transaction pattern of the usage of cards by the customers in coordination with the authorised card payment networks for arresting fraud. To ensure greater security in electronic payments, banks have been advised to provide options to their customers for fixing a cap on the value/mode of transactions/beneficiaries and also limiting the number of beneficiaries that may be added in a day per account could be considered. Banks should also put in place mechanism for velocity check on the number of transactions effected per day/ per beneficiary and any suspicious operations should be subjected to alert within the bank and to the customer. Given the low level of awareness amongst the frontline staff of the banks and customers, the Reserve Bank has initiated a payment system literacy campaign – e-BAAT (electronic Banking And Awareness Training). The Reserve Bank is actively engaging the banks and payment system participants in raising the awareness of the various products and processes that our payment systems offer. I would expect that banks in Kerala play an active role in popularising the e-payments.

35. Recently a Technical Committee (Chairman: Shri G. Padmanabhan) submitted a report on implementation of GIRO based payment system in India. Bill payment, as you are aware, is a major component of the retail payment transactions and GIRO is expected to be a game-changer. It is estimated that over 30 billion bills are generated each year in the top 20 cities in the country. The cash and cheque collections constitute over 90 per cent and electronic payments through ECS, *etc.* continue to be low. GIRO is expected to address the needs of a consumer to pay the utility bills, school/university fee *etc.* The perceived benefits include interoperability in the bill payment processes thereby enabling consumers to make payments at any third bank/ branch/ATM/BC, a customer can do payment anytime anywhere at her will for any bill, customers can use cash, cheque or card or any other approved electronic mode for payment. With establishment of widespread network across the length and breadth of the country, GIRO will be a business model which perhaps no bank would like to miss.

36. Let me also briefly provide you some insight on a recent discussion paper on 'Disincentivising Issuance and Usage of Cheques'. The Reserve Bank has observed that the e-payment mode has picked up at a rapid pace

and April 2013 recorded higher e-payments as compared to cheque payments. The number of cheque payments are, however, still significantly high. It is important to realise that the safety and security features available in the electronic payment modes are not replicable on cheques, thereby making cheque payments riskier apart from the associated higher handling costs. The Reserve Bank has rolled out the CTS 2010 features envisages higher security features for the cheques and easier detection of modifications/alterations. I would like to urge the banks to realise the vast potential of electronic payments and strive to hand-hold customers for migration away from cheques, thereby reap the full potential of electronic banking.

IX. Better customer service orientation of banks

37. Given the increasing complexities of the economy and banking, banks need to be wary of retaining existing customers while working towards expanding the customer base. The key to an efficient and courteous customer service emanates from having the right orientation keeping different customer segments in mind. For example, one special category of customer – pensioners - require special attention and assistance. It is important that the frontline staff of banks show due respect and courtesy to these senior citizens and be more humane while dealing with pensioners. Keeping in view the large number of pensioners, the Reserve Bank has instructed the banks to disburse pension during the last four working days of the month. The instruction aims at avoiding crowding at the counters and facilitating better service. The Reserve Bank has also instructed banks to establish toll-free help-lines for pensioners, appoint nodal officers for grievance redressal and acceptance of life certificate at any CBS enabled branch. In order to check delay in credit of pension and related payments, Reserve Bank has set-up a mechanism for imposition of penalty at fixed rate of eight per cent on the erring banks. In an effort to improve the overall customer service in banks, the Reserve Bank had set-up a Committee (Chairman: Mr. Damodaran). Some of the major recommendations which have been accepted by the Reserve Bank and guidelines issued include facility of basic savings account, uniform account opening forms, issuance of ATM cards at the option of the customers, two-factor authentication for Internet Banking and debit card transactions at POS, SMS alert for all cheques returned, *etc.* An analysis of the complaints received by the Banking Ombudsmen reflects on the areas of deficient service (Table 2). Banks have to pay closer attention to eliminate these deficiencies in a sustainable manner.

38. A recent survey by the Ernst & Young[3] revealed that for the banks to remain competitive they must give customers the opportunity to choose by making service offers more transparent, rebalance fee structures to achieve transparency and sustainability required by the regulators and the investors. The survey revealed that 50 per cent of the global sample (37 per cent of the Indian sample) changed banks due to high fees or charges. The next major reason for change of bank is poor bank experience which was cited by 31

Table 2: Category-wise distribution of complaints

(per cent of total)

Area	2009-10	2010-11	2011-12
Failure to meet commitments/ BCSBI Codes / Non observance of fair practices code	14.60	22.87	25.20
Card Related (ATM/ Debit / Credit)	23.73	24.01	19.88
Deposit Accounts	4.64	2.42	11.95
Others	23.77	10.10	10.05
Loans and Advances	8.34	6.40	8.25
Pension Payments	6.09	8.32	8.15
Remittances	7.20	5.92	5.39
Levy of Charges without prior notice	6.01	5.82	5.22
Out of Subject	3.39	11.51	5.04
DSAs and Recovery Agents	2.03	2.42	0.63
Notes and Coins	0.20	0.20	0.23

Source: Annual Report of Banking Ombudsman Scheme.

[3] http://www.ey.com/GL/en/Industries/Financial-Services/Banking---Capital-Markets/Global-consumer-banking-survey-2012--Adapt-business-models

per cent of the global sample (32 per cent of Indian sample). Lack of personalised contacts, poor internet/mobile experience, poor rates on accounts, *etc.* were some of the other major reasons cited. Banks also need to devise innovative plain vanilla products and easy to understand processes for the unbanked populace and also offer a slew of services encompassing conventional banking and more sophisticated financial services for the advanced customers. Banks have to cater to technology savvy customers and also customers who still prefer personal attention and human interface. Providing customer service and banking facilities to such a broad spectrum of customers poses several challenges to the banks. Banks need to develop business strategies that would amalgamate strength and immediacy of erstwhile style of banking with the capabilities of nex-gen multi-media collaborative technology. Recent experiences by banks have reflected that service expectations are higher than before, product demands are more varied and customer loyalty is no longer assured.

39. By rough estimates, more than half of India's population is under the age of 25, with 65 per cent of the population under 35. According to a study of the IMF, the working-age ratio in the country is set to rise from about 64 per cent currently to 69 per cent in 2040, reflecting the addition of over 300 million working-age adults. In other words, banks need to gear up to provide banking facility to more than 10 million customers every year for the next two and a half decade. This translates into re-orientation of customer service beyond applications that provide solutions to problems and needs of today.

X. Enhancing the quality of financial inclusion

40. In the recent past, financial inclusion has emerged as the buzzword in the Indian financial system. In the zeal to drive the policy initiative in a mission mode, banks have collaborated with Business Correspondents to extend the formal banking services to regions and people who remained unbanked even after six decades of independence of the country. In pursuit of financial inclusion, quantity has, however, become the more important factor than the quality. Banks went into an overdrive mode to open more and more accounts without really looking into the quality of associated services and perhaps and more often without focusing on the need of raising the awareness levels of the financially excluded. The significantly large number of inoperative No-Frill Accounts proves this point. Last year, the Reserve Bank and the Government of Kerala declared the district of Ernakulam as the first district to be 100 per cent meaningfully included. Meaningful inclusion envisages deeper and sustainable financial inclusion much beyond the basic objective of opening accounts. Meaningful financial inclusion hinges on four critical parameters (a) all adults in each family have an operative bank account through which regular credits and withdrawals take place; (b) providing small overdraft/credit facilities to the people who need it; (c) providing remittance services through the banks and (d) providing micro insurance through the banks.

41. Sustaining momentum of financial inclusion is dependent on the broader efforts for economic inclusion. Providing financial services alone would not suffice till the individual is provided guidance and hand-holding to pursue a sustainable economic activity. Economic inclusion efforts require not only banking the unbanked, but also retaining and better engaging current bank customers to prevent them from becoming unbanked or under-banked. The success of financial inclusion in the Ernakulam district needs to be replicated across all the areas of the State and country. As at end of March 2013, the state of Kerala has more than 5000 branches of banks of which 400 plus are rural branches and nearly 400 BCs and other service providers operating in different areas of the State. With this deep penetration and high level of literacy in the State, I am sure that banks are aware of the immense business potential of including more and more financial excluded population, *i.e.*, it is more of a business proposition and less of social obligation. A recent Reserve Bank

Research Project Study titled "*How the Poor Manage their Finances: A Study of the Portfolio Choices of Poor Households in Ernakulam District, Kerala*" has observed that meaningful financial inclusion of the poor by the commercial banks would critically depend on their ability to meet the credit gaps of the poor households. The Reserve Bank expects the level of banking sector engagement at the grass-root level is increased and higher levels of economic & financial activities through the banking system are facilitated even if it involves low-ticket business. This may provide more meaning to the spirit of financial inclusion than the statistics of financial inclusion. Looking beyond the business proposition and social obligations, it is important to appreciate that meaningful financial inclusion provides greater and sustainable financial stability. Recent global experience has revealed that undue reliance on borrowed funds can be a source of instability. In this context, small value deposits from the large source of customers at the 'bottom of the pyramid' can offer more stability and resilience to the deposit base of the bank. In other words, financial inclusion is much beyond social obligation and business proposition rather it is more about providing stability to the bottomline of the banks. Hence, banks, both at the corporate and the field levels, have to focus on both qualitative and quantitative aspects of financial inclusion.

Concluding thoughts

42. India faces several macro-economic challenges influenced by both global and domestic developments. In this background, I have briefly outlined ten major challenges & concerns confronting the Reserve Bank of India. I have touched upon challenges pertaining to domestic growth slowdown, persistence of inflation, external sector vulnerability, deepening of the financial markets, robustness of the Indian banking system, integrity of the financial system, efficiency in government banking business models, moving towards a less-cash society, re-orienting the customer service focus of banks and, finally, qualitative dimensions of financial inclusion. Given the magnitude of challenges, the Reserve Bank attaches a lot of significance to the role of banks. There is also tremendous scope for the banks to convert these challenges into opportunities for their sustainable business growth. Banks will have an important role in providing impetus to the domestic growth drivers and ease supply constraints, particularly with focus on production and productivity enhancement and supply chain management in agriculture so as to promote growth & moderate inflation. By providing boost to exports through hassle-free financial and non-financial services to the exporters, ensuring reduction of gold imports and facilitating FDI flows, they can help in mitigating the external sector vulnerability. By extending the investor base in debt market and increasing their participation in the new products launched in the financial markets, banks can deepen the financial market for improving the capital allocation in the economy. In the context of increasing need for financial stability and the tighter capital requirement regime, banks have to improve their soundness through efficient management of asset quality, better risk management practices & augmentation of their liquidity and capital buffers. Banks also need to tap each and every opportunity for improving their bottom-line by expanding their business including Government banking business under the emerging models and thereby augmenting their profitability and customer base. It is heartening to note the findings of a recent survey conducted by Gallup revealed that nearly 70 per cent of the respondents reposed faith in the Indian banking system. Nonetheless, recent revelations on non-adherence to KYC/AML norms and unethical practices of bankers in mis-selling financial products have potential of denting the system's respectability and integrity which banks ought to guard zealously. Conscious efforts therefore have to be made to ensure regulatory compliance both in letter and spirit. Further, banks should strive to raise the level of customer service and enhance the awareness for electronic

payment system products in pursuit of providing easy & efficient access to financial services with the aim to move towards a less-cash economy. Qualitative dimensions of financial inclusion also should receive serious attention of the banks so that efforts made in this regard result in enduring relationship with the bottom of the pyramid customers and sustainable business proposition for the banks.

43. In the end, I would like to convey my gratitude to the Bankers' Club, Thiruvananthapuram for providing me this platform to enumerate some of the challenges and concerns of the Reserve Bank and role and opportunities for the commercial banks in relation to these challenges. I hope that the issues highlighted by me would be recognised in the right earnest.

44. Thank you for patient listening.