*Indian Banking Sector: Pushing the Boundaries**

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Dr. Pritam Singh, Director General, International Management Institute (IMI), participants from Reserve Bank of India and the commercial banks! It is a pleasure to be amongst you today as you complete the first leg of the learning experience which is the Advanced Management Programme. I believe that the programme is craftily designed with an appropriate blend of lectures and interactive sessions with some leading academicians, industry captains and management experts, both from India and from European business schools. It is a rare learning opportunity for all participants – to understand and gain insights into global banking systems and develop awareness and appreciation of the emerging business environment. Apart from the opportunity to gain from structured classroom learning, such programmes also offer a unique forum through which participants can learn from each other and assimilate the best management practices across organisations. I hope all of you will take advantage of this wonderful opportunity.

2. Being a part of the banking system, which forms the core of the financial architecture of the economy, you have an inimitable opportunity to influence the economic lives of the nation's populace. We all know that banking plays a silent, yet crucial part in our day-to-day lives. The banks perform financial intermediation by pooling savings and channelising them into investments through maturity and risk transformations, thereby keeping the economy's growth engine revving.

3. The central theme of the programme, as in the previous year, is: 'Indian Banking Sector: Towards the next orbit'. The theme is, arguably, even more relevant today than a year ago. While, on the one hand, the outlook for the global economy continues to be grim, the outlook for the domestic economy is also far more subdued than the last year. Growth of the Indian economy for 2012-13 is projected at 5 per cent – significantly below the 9 per cent growth rate envisaged during the Twelfth Plan and well below our desired goal of double digit growth rate. The Indian banking sector has also faced significant challenges. Asset quality of banks has come under increasing pressure with rising NPAs and Restructured loans. The Gross NPA ratio for the banking system, which was 2.4 per cent in March 2011, increased to 3.6 per cent by September 2012. Going forward, the banking system will continue to face a challenging environment given that its fortunes are closely linked with those of the economy - domestic and global.

4. Having seen the challenges before the Indian banking system, what are our motivations for discussing, today, the issue of taking the Indian banking sector towards the next orbit? Our elementary knowledge of astrophysics would tell us that for being propelled to the next orbit, a rocket needs to pull against the earth's gravitational force. For this, the rocket needs to have the requisite fire power to generate the necessary 'escape velocity'. Also, the rocket needs to be in a stable condition before the blast can propel it to a higher orbit. In the absence of adequate propellant force, the rocket would fail to defy the force of gravity and would crash land.

5. So, as we deliberate upon this issue today, are we comfortable with the dynamism and stability that the Indian banking system possesses? What do we actually wish to achieve by taking the banking sector to the next orbit? The issue which needs to be addressed is whether we – from the regulatory community or as part of the commercial banking sector of the country – are satisfied with the financial system as it exists today. The answer to this question is not very comforting. Events in recent years have called to question the relevance and purpose of the financial sector. Episodes like the 'Occupy Wall Street'

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movement leave little scope for doubt that the global financial crisis has left the financial sector discredited. Thus, if the financial system has to play a purposeful and relevant role in the economy and if it has to regain its credibility, it will have to develop the necessary fire power and stability and move to the next orbit.

6. What are the key drivers for propelling the banking sector forward? Which are the key factors that will determine whether the banking system is able to transform itself into a relevant, purposeful and credible system? What are the major challenges and hurdles ahead? What are the major goals that the banking sector has to achieve in the next few years? I will spend some time in trying to answer these questions.

The key drivers and challenges for the banking system originate from different sources.

7. First, the regulatory environment in which banks in India are functioning is undergoing a paradigm shift. In particular, with the implementation of the global reforms agenda relating to Basel III, implementation of OTC derivative reforms, reducing reliance on credit rating agencies, amongst others, the regulatory landscape of banks is set to change forever, both domestically and in the global arena. This will, *inter alia*, require banks to fine tune and refine their risk management systems.

8. Second, the growing global emphasis on fair treatment to customers, financial inclusion and improved Know Your Customer (KYC) practices will require banks to reorient their business models, their data and information systems, and, in fact, the very mindset of banking, if banks have to remain relevant, going forward.

9. Third, impending developments in regulatory policies are likely to result in banks facing a far more competitive environment in the coming years relative to what was, virtually, a sellers' market so far. As banks' customers – both businesses and individuals - become global, banks will also need to develop global ambitions. The challenge for banks will be to develop new products and delivery channels that meet the evolving needs and expectations of its customers.

10. Besides the formidable challenges that the evolving global regulatory and supervisory landscape present for banks, the developments in the domestic business/regulatory environment will also need to be factored in as banks set about recalibrating their business plans. For instance, in line with global developments, India is also embarking upon a project to develop a framework for assigning a unique Legal Entity Identifier for all customers accessing the formal financial system. However, before attaining this goal at a national or global level, we need to immediately ensure that within each institution a customer is assigned a unique ID and that there are no instances of multiple customer IDs for the same customer. This is important not just from the perspective of better management of customer business, but also for an effective AML framework.

11. Similarly, frauds are a cause for concern within the banking system, particularly for the public sector banks, which account for a large proportion of total frauds reported in the banking system. Frauds do not just represent lost money; they also indicate serious gaps in banks' systems and processes and in the internal control framework. Plugging these gaps and institutionalising a mechanism for identifying accountability and taking stringent action against the perpetrators of the frauds is very important for tackling this menace.

12. The leveraging of the banking system by Multi-level Marketing (MLM) companies to defraud common people of their hard earned money is another critical challenge that financial sector supervisors are facing in various jurisdictions, including in India. It results in a loss of confidence of customers in the formal financial system and could have severe adverse implications, particularly at a time when we are putting all our energies into bringing the marginalised groups within the fold of the banking system.

13. All these developments will present significant challenges for the banking system and banks will need to face them head-on in the coming years. To gear up to these challenges, banks will need to look inwards – at their human resource management,

their information systems and the technology at their disposal. Importantly, they will need to look into the efficiency with which they perform their functions – that of credit intermediation and the allocation of funds to the most productive sectors of the economy. These will be the key internal drivers of change if banks are to gear up to the emerging regulatory and external environment and move into the next orbit.

Let me now dwell on some of the major issues in a greater detail.

Risk Management

14. The risk management challenge for banks has been steadily growing over the last two to three decades. This can be attributed to several developments in the financial sector over the last couple of decades. First, the deregulation of financial markets led to increased volatility placing greater demands on banks to manage their risks. Second, banking activities diversified from the traditional function of lending and borrowing to a larger set of activities including, *inter alia*, custodial services, securities underwriting and corporate advisory. Third, complex global financial institutions emerged leading to growing inter-connectedness of the financial system. Fourth, the role of securities and derivative products in banking expanded with increasing growth of complex financial products. The recent financial crises have further reemphasised the importance of risk management frameworks for banks.

15. The question for the Indian banking sector is to what extent the risk management framework in banks are oriented towards identifying risks and tracking the passage and path of risks so as to be able to price the risks appropriately. My own view is that we in India are still at a rudimentary stage and hence, the banking system needs to urgently work on upgrading its risk identification, management and pricing abilities.

16. An associated issue arising in this context is the growing importance of stress testing. Stress tests, typically, assess the resilience of banks to shocks in an extreme adverse scenario as compared to a baseline scenario. It also provides banks' management with a tool to improve their internal risk managements by identifying the stress points in their operations. The relevance of stress tests for assessing banks' resilience to shocks lies in the fact that these tests focus on the unexpected or 'tail' events going beyond typical risk management assessments. If banks are to meet the challenges of the emerging environment and to move to the next orbit, it would be critical that the stress testing results be incorporated in the business and capital assessment and planning exercise of banks. The overall acceptable levels of expected and unexpected loss willing to be incurred by banks should be a management decision driven based on rigorous and analytical assessment of available information. While it is not expected that banks provide for unexpected losses in the manner prescribed for expected losses, the 'economic capital' which the bank seeks to maintain must be driven by considerations which encompass such losses.

17. A risk management framework is incomplete without an effective system of internal controls and methodologies. The first line of defense for risk management has to come from bank managements and, especially, from bank boards. Unless the bank's management is geared to internalise and institutionalise a risk and control culture in banks, any attempts to increase the resilience of banks can be effective only to a limited extent. The management has a critical role to play in ensuring the right balance between the business units and risk management, both in times of stress and in good times, when there is a tendency for misaligned incentives to emerge.

Treating Customers Fairly

18. The touchstone of any successful business lies in the edict that 'customer is king'. Serving customers is, essentially, the reason why the banks exist in the first place. But over the years, I believe, the customer has become rather peripheral in the banks' scheme of things. In my view, while for the private sector banks, shareholders have, perhaps, emerged as the sole focus; for the public sector banks, employees and

their well-being has become the primary focus. In my opinion, neither approach is sustainable in the long run. Improving bottom lines and preserving NIMs are the primary motives for the bank management, while making banking services accessible and the transactions affordable, has reduced to being a regulatory agenda.

19. Ensuring fair treatment for the customers has become a priority for financial sector regulators globally and the regulatory framework is being tightened across jurisdictions. The expectation from financial service providers is that they display high levels of transparency in product design, pricing and financial disclosures. In addition, a credible, cost effective and expedient grievance redressal mechanism has to be made available to all customers. Banks must make use of technology to deliver banking products and services in a cost-effective manner. Customer education is also critical so that the user can have the ability to choose appropriate and need based products and services. Unless the banking system becomes customer centric in all its dimensions, it would fail to attain sufficient momentum to gain access to the next orbit.

Know Your Customer, his business and business risks

20. Across the world, greater emphasis is being laid by the financial service providers on knowing their customers. It has important regulatory and business dimensions. From a regulatory perspective, banks and other financial service providers are expected to understand the business activities of their customers so that they do not, inadvertently, end up being conduits for illegal activities such as terrorism, MLM, frauds, hawala transactions, *etc.* From a business perspective, Know Your Customer (KYC), Know Your Customers' Business (KYCB) and Know Your Customers' Business Risks (KYCBR) are important for understanding the nature of the customer's business, which would help in offering suitable products, managing credit exposure and generating early warning signals for potential delinquency risks.

21. It is important that the emphasis on KYC compliance is effectively conveyed across the organisation by the top management, not just for meeting regulatory requirements, but as an opportunity to understand the customer better and maximise the gains from the customer relationship.

Human Resource Management

22. We must realise that the traditional factors of production named in economics textbooks are no longer relevant in the banking industry. Land, labour, physical capital and enterprise have given way to skills, technology and human capital as the prime factors of production in the banking sector. Employees are no longer 'labour', they are 'people' who ought to be nurtured and cared for. When I say 'people', I mean the bank management and all employees - officers, clerical staff and the sub staff. An organisation's 'people' are the force that can, potentially, make the difference between success and failure. When the marketplace has number of players with broadly similar product offerings, the ability and motivation levels of employees could be the clinching factor when it comes to gaining an edge over rivals. The challenge before management is to use the vast unused potential in people and produce 'leaders' out of 'managers' who can not only work hard but also motivate their co-workers for producing extraordinary results. The sector needs to recognise the transformation in the factors of production in the banking industry early and aim to effectively harness these new factors for its own betterment and, more importantly, in the interest of the society. By effectively utilising these new factors of production, the sector could quickly bring in more and more financially excluded people under the ambit of the formal banking system and help it to be seen as a relevant and purpose-oriented sector.

Promoting Financial Literacy

23. In today's digitised world, stating that information is power, is perhaps to state a truism. Our economy is traversing towards being a knowledge economy. This is amply demonstrated by the

contribution of services sector in our economy. However, much as we would hate admitting it, we are a financially illiterate society. And here, I am not talking about the common man alone. The financial illiteracy is all pervasive – the banks, the regulators, the policy makers – all suffer from some degree of financial illiteracy. Let me quote a few examples to drive home my point. Take the recent instances where banks had sold forex derivatives to their customers without proper understanding of their suitability and appropriateness. Neither the customers nor the banks had an iota of understanding of the quagmire that they were getting into while entering into these contracts. The subsequent legal wrangling and losses suffered by some of the banks aptly demonstrate their financial illiteracy. Take the case of the Benchmark Prime Lending Rate (BPLR), which was, till recently, used by the banks for lending to their borrowers. My understanding of the BPLR is that it is the rate at which the bank lends to its best borrowers *i.e.*, those borrowers who are least likely to default on their loans. However, for years together, the banks continued to lend to their borrowers well below their BPLR until the regulator introduced the base rate regime. Another conundrum that needs to be solved is one surrounding the gold import. Though many of us have realised its implications for the Current Account Deficit, there have not been very sincere efforts to check its imports. We need to examine why public money should be utilised for importing gold by banks. I firmly believe that we need to begin a vigorous campaign to educate the society about the myth of investment in gold as a 'safe asset' and a 'hedge against inflation.' I believe that the Indian banking sector cannot be propelled into the next orbit unless all its stakeholders and the society as a whole, has attained basic financial literacy.

Improving Efficiency

24. What are the attributes of an efficient financial system? To my mind, efficiency of any system may be gauged in terms of its ability to not only deliver products and services in a cost-effective and affordable way, but also in an inclusive manner. Neither of these two traits characterises our present banking and financial system. A wide section of the population remains excluded from the formal financial system even years after 'growth with a human face' has been the clichéd socio-political agenda of the policy makers. Moreover, the operating cost of banking system remains at an elevated level which renders the banking transaction costs unaffordable for the common man. The dream of financial inclusion cannot be realised unless the banking transaction costs are brought down substantially. This would need a collective effort from the policy makers, bank managements, regulator and the employees. Effective use of the new factors alluded to above – skills, technology and human capital – would help in increasing the productivity and, thereby, lowering the transaction costs. For the realisation of this dream, the banking system would need to acquire allocational and operational efficiency:

- **Allocational Efficiency:** This requires banks to ensure that the precious societal resources are allotted to the most productive activities and that the interests of the vulnerable sections of the society are also taken into account.
- **Operational Efficiency:** Operational Efficiency requires banks to provide financial products and services to its customers in a safe, secure and speedy manner and to ensure that the cost of financial intermediation is minimised.

25. As you all gain knowledge and exposure through this Advanced Management Programme, I expect you to deliberate and introspect on how your banks and the banking system as a whole can improve on both – allocational and operational efficiency parameters – so that the financial intermediation function is efficiently performed. You must realise that banks would need to 'perform or perish.' This will be an important takeaway for all of you from the programme and will determine whether banks can, indeed, regain the trust and confidence of the common man on the street and retain their pivotal position in the emerging financial order.

Challenges before Regulator/supervisor

26. Though the Indian banking system remained largely unaffected by the global financial crisis, we cannot pat ourselves on the back, for it was much to do with lack of product innovation and a comparatively lesser degree of integration with the global markets. The coming years, however, will pose big challenges for the supervisors as well. The significant rise in interconnectedness of financial markets across jurisdictions, the growing complexities of banking products and services, introduction of newer delivery channels and the need for emphasising on inclusion of the vulnerable and marginalised groups has significantly increased the challenges presented before the financial sector regulator/supervisor.

27. The supervisory processes within the Reserve Bank are changing so as to make them more forward looking and geared to assess the risks that the supervised entities pose to the supervisory objectives. The processes are being re-oriented to move away from transaction based to risk based and from incidence based to theme based supervision. An effective supervisory regime must facilitate good business and must obstruct bad business. Supervisory practices will also need to imbibe additional lessons from the financial crisis which are emerging in the form of new regulatory and supervisory benchmarks like Basel III, revised core principles for effective bank supervision, increased focus on systemically important banks, *etc.*, if they are to remain robust and relevant in a changing banking environment.

28. The decks for banking systems' flight to the next orbit cannot be clear unless all necessary safeguards have been validated by the regulators/supervisors. The latter have a key role in overseeing the banks' transition to the next orbit for it has to ensure that the banking system smoothly settles into the next higher orbit without crash landing. Some of the major safety checks that the regulator and supervisors need to perform are related to the 'Fit and Proper' assessment of the senior management, adequacy of the management information systems, risk management processes, internal audit, grievance redressal system, compliance to regulatory guidelines and prescriptions, *etc.*

Conclusion

29. We are all living in exciting times – times which offer as many opportunities as it offers challenges. While the global and domestic economic environment might, presently, give little cause for cheer, one needs to look at the opportunities available and also seek to strengthen our systems and processes by institutionalising the lessons learnt during this period. This will help in strengthening the financial system so that it sees through these challenging times and is ready to thrive, as the economy sets on its recovery path.

30. In this process, while the bankers have to act as change agents within their institutions, supervisors have a critical role to play in ensuring that they are equipped with the necessary skills to deal with a rapidly expanding, increasingly complex and global banking system. The financial system the world over has come under increased public scrutiny. Both supervisors and supervised entities are increasingly accountable for their actions. We need to collectively and decisively act in the interests of the economic system.

31. Perhaps, the greatest opportunity that exists is the vast mass of financially excluded people who are waiting to be touched by the formal financial system. The potential benefits to the banking system and to the economy from financially including this segment would be enough to galvanise the economy and restore it back to the high growth trajectory.

32. Each one of us assembled here today has to walk the extra mile to ensure that the Indian banking system acquires the necessary 'escape velocity' to catapult itself to the new orbit. I wish you all the very best of learning in the remaining part of your programme. Thank You!