Agenda for Banking in the New Millennium*

Bimal Jalan

I am very glad to be here. This is a very important occasion because, as Dr. Subrahmanyam pointed out, this kind of Conference is taking place after nearly 10 years. And it is taking place at an opportune moment when we are beginning the new Millennium. We have ended a century and your discussions would give direction to the banking in the next 20/25 years. The agenda is long and I would straightaway move over to it. To my mind, in the next 25 years, perhaps, we would have to deal with three different sets of issues although they are inter-related.

One, the whole question of financial reform of which banking is a part. Next, the supervisory and regulatory matters which affect the banks and other financial intermediaries. Finally, the banks' internal management issues which are directly within the purview of the management themselves. Some of these issues have certain amount of relevance and interconnection and we would go over them in some detail here.

Financial Reforms

It is significant to first consider why have we undertaken financial reforms after 40/50 years of independence? I think this is related to the change in the direction of the economy. In the old Planning era, financial intermediaries played a well-defined role. They were expected to mobilise financial savings and allocate them among the productive sectors of the economy as directed.

Financial savings in our country are relatively small - about 10 per cent of the national income - while domestic savings are 23/24 per cent. Financial intermediaries are expected to offer to the depositors, the rates of return that are positive in real terms. And the banks are a special component of these financial intermediaries. Different financial intermediaries are not necessarily competitors to the banking intermediaries but an integral part of the financial system. If they all function competitively, we should see an increase in the financial savings. We should, therefore, work towards a thriving financial system that is diversified, competitive, deep and broad.

Banks obviously have a special place in the financial system because bank deposits are the only non-collateralised savings. Banks are highly leveraged. Their leveraging in fact is at a much higher level than mutual funds, post office or capital markets. When we talk about liberalisation in the banking system in India, we do have some achievements to recount. Our banking system is well-structured. Pre-emption of bank deposits is much lower now compared to earlier, banks have much greater operational freedom now. But our market development, particularly debt market, is still in infancy. While our capital markets are flourishing, our money markets are less developed. Our priority, therefore, should be to develop a financial system that is competitive, well structured and deep. We have made some progress in the last few years in this direction.

We have taken some action in the development of new instruments and new institutions to make the money market as well as the debt market broader and deeper. We, however, have a long way to go. Liquidity of debt markets and the market dimensions need to be addressed as significant issues. For instance, our debt markets are dominated by private placements. We also have certain rigidities in our system with which it cannot be well-functioning. Our interest rates are not flexible enough for obvious reasons. I have dealt with this in the October Policy statement so I do not want to repeat it. But you can not have a financial system with rigid interest rates that do not reflect different phases of a business cycle.

We also have a problem of legal reforms. You cannot have a financial system in which there is no sanctity of contract; which is why there are NPAs. We have no law to deal with the problem of insolvency, breach of contract, defaults and enforcement of security. Then there are constraints arising out of fiscal deficits.

You cannot have a strong financial system functioning well with such constraints. And money is mobile.

To sum up, we have done well on the arithmetical side but we have a long long way to go particularly in terms of development of market and debt markets and we have some way to go for contract enforcement. I hope you will deliberate upon some of these areas during the sessions in this conference.

The second issue is regulatory and supervisory. Financial markets are different from product markets and, therefore, greater liberalisation goes along with deeper supervision and higher degree of regulation. This is because financial markets are volatile where herd mentality catches up fast. Moreover, there are negative externalities that can destabilise financial markets. And destabilisation in financial markets affects even those who are not in financial markets. On the other hand, financial markets can drive the real economy. Therefore, transparency, much stronger disclosures, prudential norms and capitalisation are a must. This is essential because bank depositors have no other security except that banks are well-regulated. We are constrained partly because of the inflexibility of the human resources side.

We have introduced CAMELS system and are following the best BIS and international norms. The reason to follow international norms is mobility of capital and that is why, it is necessary to make those prudential norms international and tougher. The health of the financial system is now an international concern. The willingness of the rest of the world to do business with us or any other country by way of trade or direct investment or any other kind of investments will depend on their confidence in us. Rating agencies also follow international norms while rating any country or banking system. Our financial system, I believe is not vulnerable because it is publicly owned. But over a period of time we will also be globally rated. International standards are, therefore, important.

The Bank for International Settlement (BIS) has circulated a consultative paper on new norms for capital adequacy. The RBI is currently studying this paper and will shortly send its comments to BIS. Once implemented, you will find that the capital adequacy norms are going to be tougher whether we like it or not. This will have tremendous implications both for NPAs, provisioning, capital adequacy and the whole range of management issues that we are going to talk about later in this session. When higher and higher capital is required, the question of government ownership of banks and the percentage of this ownership will come to the forefront. Even if the economy grows at the current rate and the capital adequacy norms are at the same level as at present, the banks, barring of course, the three weak banks, will require fresh capital worth Rs.10,000 crore in the next five years or so whereas the current headroom available to banks is Rs.1000 crore.

It is important to discuss just how and from where will this additional capital come? Both, the RBI and the Government giving money have the same monetary implications. We need to debate upon this issue and resolve it in the interest of the real economy. I believe that there is a pragmatic case for raising the legislative floor for outside holding in banks. On a case by case basis, we could consider outside holding, particularly the good banks can raise money without affecting their public sector character even without diluting the government's holding. The government could appoint the chairman and the board if it wishes through a transparent process. The question is while being in the public sector, why can't our banks be strong and adequately capitalised? I know that this is a matter not within your purview or the Reserve Bank's purview but in the nation's purview and needs to be debated to find some pragmatic answers.

I will now briefly deal with the set of issues that are relevant to the bank managements. I congratulate the NIBM faculty for preparing papers on IT, HRM and Risk Management which are extremely important for internal management of banks.

Let me dwell upon them individually. First, information technology. This is no longer a matter of choice. The question no longer is whether you would be computerised or not. Those who do not use IT will be out of business. If you are not computerised, you will not be able to do business 10 to 15 years down the road. You would have to use the modern means of communication. What is more important from the banking point of view is that the use of information technology could produce tremendous results. It can reduce your costs. As for human resources management (HRM), for the banking industry, there is no other input except human resources and the output depends entirely on the quality of human resources and we have a lot of ground to cover in this area. There are many constraints because it is a part of the public service that provides job security. But development of this area is vital.

The concern in the area of corporate governance in banking and finance is how to ensure quality in the absence of transparency and modernity. Risk management in banks is equally important. I have just mentioned about capital adequacy issue. If banks have to maintain risk weighted capital, they need to put in place a risk management system. Appropriate risk management system will help banks increase their profitability. This will improve the rating of banks which is crucial for confidence. Confidence in financial transaction is most important. It is also important to open up the system. I believe that we do not have the monopoly of wisdom and, therefore, you would have seen us adopting a consultative route. You would have seen numerous groups and committees set up in the RBI. Guidelines too are circulated before issuing them and are finalised only after receiving comments. We have set up Regulation Review Authority to ensure that regulatory systems are contemporary and deal with regulation not as a control item but in the interest of participants and of the markets. Regulations should facilitate delivery and not cause delays. I hope that all of us together would be able to build an open and competitive system. This should be done by mutual agreement and consultation. If need be, we should not hesitate in bringing outsiders to tell us how to do business.

I would end with a word on NIBM. As you can see, this is a very fine facility that the Reserve Bank has created. The Reserve Bank Governor used to be the chairperson of this Institute. It is a national asset which is owned by all banks. But there is an interesting anecdote about its utility. When I asked a bank chairman if he would miss NIBM if it were not there, the answer was a pleasant silence. So a committee was set up under Shri S.S. Tarapore to deliberate on the issues that ail NIBM. It should not remain a mere institute. It has a great history and great potential. And this potential you have to use to your advantage. We, therefore, persuaded Shri Bhide, a commercial banker, to take over its Chairmanship. I would like this Institute to be vibrant and a critical place for all of you to obtain technical input. This should be taken as a new collaboration, new era not only for the banking system but also the National Institute of Bank Management under Shri Bhide's leadership.

I wish you the best in the deliberations and thank you for listening to me.

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* **Inaugural speech by Shri Bimal Jalan, Governor, Reserve Bank of India, at the Conference of the Bank Chairmen at the National Institute of Bank Management, Pune, on January 6, 2000.**