*Interesting, Profitable, and Challenging: Banking in India Today**

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Thank you for inviting me to give this address to the FICCI-IBA Annual Global Banking Conference. Perhaps the most important issue on the minds of bankers, given the results season, is the Asset Quality Review initiated in early 2015-16. It has improved recognition of NPAs and provisioning in banks enormously, and many of you have fully imbibed the spirit of the review. Some banks have taken significant steps in recognising incipient stress early.

Now focus should move more to improving the operational efficiency of stressed assets, and creating the right capital structure so that all stakeholders can benefit. This implies simultaneous action on two fronts.

Where necessary, new project management teams have to be brought in, sometimes as owners, and where this is not possible, as managers. A creative search for new management teams, including the possible use of public sector firms or private sector agents, is necessary, as are well-structured performance incentives for non-owner teams such as bonuses for meeting cash flow/ profit benchmarks and stock options. Of course, if the existing promoters are capable and reliable, they should be retained.

Equally important, the capital structure should be tailored to what is reasonable, given the project's situation. If the loan is already an NPA, there is no limit to the kind of restructuring that is possible. If it is standard but the project is struggling, we have a variety of schemes by which a more sensible capital structure can be crafted for the project. These schemes include the 5/25, the SDR, and the S4A. A caveat is in order, though. Some of the current difficulties with stressed loans come from an unrealistic application by banks of a scheme so as to prevent a loan turning NPA, rather than because of a carefully analysed bank effort to effect management or capital structure change. RBI will continue monitoring to see that schemes are used as warranted, and targeted at promoters who are cooperative and able rather than misusing the system.

I am sure, though, that you want to look beyond stressed assets to growth. These are interesting, profitable, and challenging times for the financial sector. Interesting because the level of competition is going to increase manifold, both for customers as well as for talent, transforming even the sleepiest areas in financial services. Profitable because new technologies, information, and new techniques will open up vastly new business opportunities and customers. Challenging because competition and novelty constitute a particularly volatile mix in terms of risk. In this talk, I will speak about how we see these aspects at the central bank.

Interesting and Profitable

Over the next year, 17 new niche banks will begin business. In addition, licensing for universal banks is now on tap, so fit and proper applicants with innovative business plans and good track records will enter. Fintech will throw up a variety of new ways of accessing the customer and serving her, so new institutions that we have little awareness of today will soon be a source of competition. These will finally draw customer sectors, firms, and individuals without access today into the formal financial system. Those customers that are already being served will be spoiled for choice.

For the service provider, even though greater competition will tend to reduce spreads, access to new

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customers and new needs will increase volumes. Moreover, risk and cost reduction through information technology and risk management techniques will tend to increase effective risk-adjusted spreads. In sum then, despite increased competition, profitability can increase. The comparative advantage of banks may lie in their access to lower cost deposit financing, the data they have on customers, the reach of their network, their ability to manage and warehouse risks, and their ability to access liquidity from the central bank. These should then be the basis for the products they focus on.

Perhaps a couple of examples may be useful. India will have enormous project financing needs in the coming days. Even though bankers are very risk averse today, and few projects are coming up for financing, this will change soon. What is in the pipeline is truly enormous – airports, railway lines, power plants, roads, manufacturing plants, *etc.* Bankers will remember the period of irrational exuberance in 2007-2008 when they lent without asking too many questions. I am hopeful that this time will be different.

Here are ways it can be different and risks lowered. First, significantly more in-house expertise can be brought to project evaluation, including understanding demand projections for the project's output, likely competition, and the expertise and reliability of the promoter. Bankers will have to develop industry knowledge in key areas since consultants can be biased.

Second, real risks have to be mitigated where possible, and shared where not. Real risk mitigation requires ensuring that key permissions for land acquisition and construction are in place up front, while key inputs and customers are tied up through purchase agreements. Where these risks cannot be mitigated, they should be shared contractually between the promoter and financiers, or a transparent arbitration system agreed upon. So, for instance, if demand falls below projections, perhaps an agreement among promoters and financier can indicate when new equity will be brought in and by whom.

This leads to the third element of project structuring – an appropriately flexible capital structure. The capital structure has to be related to residual risks of the project. The more the risks, the more the equity component should be (genuine promoter equity, not fake borrowed equity, of course), and the greater the flexibility in the debt structure. Promoters should be incentivised to deliver, with significant rewards for on-time execution and debt repayment. Where possible, corporate debt markets, either through direct issues or securitised project loan portfolios, should be used to absorb some of the initial project risk. More such arm's length debt should typically refinance bank debt when construction is over. Hopefully, some of the measures taken to strengthen corporate debt markets, including the new bankruptcy code, should make all this possible.

Fourth, financiers should put in a robust system of project monitoring and appraisal, including where possible, careful real-time monitoring of costs. For example, can project input costs be monitored and compared with comparable inputs elsewhere using IT, so that suspicious transactions suggesting over-invoicing are flagged?

And finally, the incentive structure for bankers should be worked out so that they evaluate, design, and monitor projects carefully, and get significant rewards if these work out. This means that even while committees may take the final loan decision, some senior banker ought to put her name on the proposal, taking responsibility for recommending the loan. IT systems within banks should be able to pull up overall performance records of loans recommended by individual bankers easily, and this should be an input into their promotion.

Note that none of this is really futuristic, but it requires a much stronger marriage between information technology and financial engineering, with an important role for practical industry knowledge and incentive design. There are also inputs to making profitable project loans – such as the availability of CASA deposits – that will accrue to the banks that build out their IT to access and serve the broader saver cheaply and effectively. Few banks have the in-house talent to do all this now, but preparation is imperative.

An area of more intensive use of IT and analysis is customer loans, which is my second example. It seems today that, having abandoned project loans, every bank is targeting the retail customer. Clearly, the risks in this herding will mount over time, as banks compete for less and less creditworthy customers. But some of this risk can be mitigated if they do sufficient due diligence.

New means of credit evaluation are emerging. For example, some lenders are examining not just credit histories from the credit bureau but mining their own data and also data from social media posts by the applicant to see how reliable they might be. Various forms of crowdfunding, intermediated by peer-to-peer lenders, also claim superior credit evaluation. Of course, much of the hoopla surrounding these new forms of lending has yet to be tested by a serious downturn, and it is unclear how responsibilities for recovery will devolve between intermediary and investor at such times.

Nevertheless, in this Information Age, not only are there more data with which to determine a loan applicant's creditworthiness, it is also possible to track their behavior for early warning signs of stress. Furthermore, in this interconnected world, a borrower's inability to hide adverse information such as default when tagged by a unique ID constitutes a big incentive to repay.

Importantly, banks no longer have a monopoly over all credit-related data; Some IT companies may do a better job in pulling together even the bank's data, in addition to trawling for other available data, and analysing it all to make better lending and monitoring decisions. Loan applications and decisions are now being made entirely online, without a borrower having to step into a branch. Alliances between IT companies and banks are likely to increase significantly.

The bottom line is that competition is increasing, and ways of delivering financial services are changing tremendously. Banks have to discover strategies to use their traditional, although eroding, advantages such as convenience, information, and trust to remain on the competitive frontier. Competition and innovation constitute a particularly volatile mix in terms of risk challenging banks' traditional risk management capabilities. They are also a challenge to the regulator, who wants the best for the customer (and therefore wants to encourage competition and experimentation), while maintaining systemic stability (and thus wants to understand risks before they get too large or widespread).

The Authorities' Dilemma

Before turning to how the banks should respond to these competitive and technological forces, let us ask how these forces affect the regulatory compact. Ideally, the authorities should ensure their actions are institution, ownership, and technology neutral so as to ensure that the most efficient customer-oriented solutions emerge through competition. However, if the authorities deliberately skew the playing field towards some category of institutions and away from others, competition may not produce the most efficient outcome.

Banks in India have been subject to the grand bargain, whereby they get the benefits of raising low cost insured deposits, liquidity support and close regulation by the central bank (I am sure some of you see this as a cost) in return for maintaining reserves with the central bank, holding government bonds to meet SLR requirements, and lending to the priority sector.

In addition, public sector banks are further subject to government mandates such as opening PMJDY accounts, or making MUDRA loans. They are also subject to hiring mandates, in particular the need to hire through open all-India exams rather than from specific campuses or from the local community, and to meet various government diversity mandates. In part compensation, public sector banks do get more government deposits and business, and are backed by the full faith and credit of the government. While it is unclear whether the cost of the mandates outweigh the benefits, they do skew the competitive landscape.

Authorities like the central bank and the Government should, over the medium term, reduce the differences in regulatory treatment between public sector banks and private sector banks, and more generally, between banks and other financial institutions.

Some of the differences between public sector banks and private banks can be mitigated if the government pays an adequate price for mandates. If, for example, when every direct benefit transfer is paid a remunerative price, all banks have an incentive to undertake the business and open basic customer accounts. The most efficient bank will garner more business, and the payment can be gradually reduced over time, commensurate with the accrued efficiencies.

Some of the mandates will also become less costly with new techniques. For example, banks are finding ways to make MSME loans more remunerative by decreasing transactions costs. Similar techniques could be brought to agricultural loans, especially as farm productivity increases. Wider use of credit information bureaus and collateral registries should also help improve credit evaluation and lower the cost of repossession. This should make it easier to meet priority sector norms. The cost has been further reduced through the introduction of tradeable priority sector lending certificates, whereby the most efficient lenders can sell their over-performance, while the inefficient ones can compensate for underperformance by buying certificates.

Nevertheless, over time, differences should be reduced further. This is why, for example, the Reserve Bank has been reducing SLR requirements steadily, and allowed over half of the SLR holdings to meet the Basel-mandated Liquidity Coverage Ratio. But we are also trying to shape mandates to new technologies and approaches. For example, it is mandated that a quarter of a bank's branches should be opened in underserved areas. But what exactly qualifies as a branch? Could we accept alternative definitions of a branch so long as they meet the needs of the population for a regular outlet for banking business? Of course, all villages would love to have a full service brick and mortar bank branch. However, if the cost is currently prohibitive, can we accept alternatives that do much of what is needed? An internal RBI committee is looking at these issues.

In sum, mandates should increasingly be paid for, and are becoming easier to achieve as the institutional and technological underpinnings of financial services improve. As competition increases, however, the authorities should ask how long mandates should continue, and keep targeting them better towards the truly underserved. They should also withdraw any preferential treatment, to the extent feasible, at a commensurate pace.

Let me now turn to how banks respond to the emerging competitive challenges. I will talk specifically about public sector banks, which perhaps face the greatest challenges.

Challenges Faced by Public Sector Banks

The most pressing task for public sector banks is to clean up their balance sheets, a process which is well under way and which I discussed earlier. A parallel task is to improve their governance and management. Equally important is to fill out the ranks of middle management that have been thinned out by retirements, and to recruit talent with expertise in project evaluation, risk management, and IT, including cyber security.

(i) Governance

The Bank Board Bureau (BBB), composed of eminent personalities with integrity and domain experience, has taken over part of the appointments process in public sector banks. There are two ways the Government still plays a role. First, the final decision on appointments is taken by the Appointments Committee of the Cabinet. Second, appointments of non-official directors onto bank boards still lie outside the BBB. As the BBB gains experience, it would make sense to allow these decisions also to be taken by it.

Over time, as the bank boards are professionalised, executive appointment decisions should devolve from the BBB to the boards themselves, while the BBB – as it transforms into the Bank Investment Company (BIC), the custodian for the Government's stake in banks – should focus only on appointing directors to represent the government stake on the bank boards. It is important that bank boards be freed to determine their strategies. Too much coaching by central authorities will lead to a sameness in public sector banks that successive Gyan Sangams have criticised.

Management efforts to tighten practices are also needed. Far too many loans are done without adequate due diligence and without adequate follow up. Collateral when offered is not perfected, assets given under personal guarantees not tracked, and post loan monitoring of the account can be lax. The lessons of the recent past should be taken seriously, and management practices tightened. A more stringent approach to evaluating and recovering large loans will give bank management the credibility when they go to their staff with plans for cost rationalisation.

(ii) Talent

The middle management ranks of public sector banks are being thinned by retirements. In addition, they need experts in specific areas like project evaluation and risk management. At the same time, banks have to reduce bloated cost structures. All public sector entities across the world tend to pay more than the private sector to lower level employees, and less than the private sector to higher level employees. This makes it hard for them to attract top talent, but makes it easier to attract good people at lower levels.

Rather than seeing these as difficulties, perhaps they can be opportunities. In the RBI, we find that our compensation packages enable us to attract very highly qualified applicants at the Class III level. Perhaps part of the solution is to enable such new hires, with technology and training, to do far more responsible work than they were given in the past, and give them a brighter prospect of movement up the officer ranks. Banks can also use the opportunity offered by retirements to reorient hiring towards the skills they need, and to offer attractive rapid career progression supported by strong training programs to new hires – with thinning middle management, the mix of experience and capabilities should shift towards capabilities.

And to get talent in specialised areas like project evaluation, risk management, and IT, they may have to hire laterally in small doses. While contractual hires are currently permitted, better personnel would be attracted only by a strong prospect of career progression internally. Banks will have to think about how to enable this.

One of the difficulties public sector banks have is court judgments that prohibit hiring from specific campuses. This leads to anomalies like the public-sector-bank-supported National Institute of Bank Management sending most of its high quality graduates to work for private sector banks. Public sector banks can petition the courts to allow some modicum of campus hire, especially when the campus chooses openly through a national exam. Another alternative is to make bank entrance exams much less onerous to take, with applications, tests, and results, wherever possible, available quickly and online. The banks then have an easier task of persuading students on elite campuses to take the exam. We are following this latter course at the RBI.

To have local information, be comfortable with local culture, be locally accepted, and be competitive in low-cost rural areas, PSBs will have to have more freedom to hire locally, and pay wages commensurate with the local labour market. Alternatively, they will have to be much more effective in using technology to reduce costs. Finally, as banks adopted differentiated strategies, they should move away from common compensation structures and common promotion schemes across all public sector banks.

While one of the strengths of the public sector sometimes is the absence of pay and promotion that is very sensitive to performance, too little sensitivity can also be a problem as high performers get demotivated, and the slothful are not penalised. An increased emphasis on performance evaluation, including identifying low performers with the intent of helping them improve, may be warranted. In addition, rewards like Employee Stock Ownership Plans (ESOPs) that give all employees a stake in the future of the bank may be helpful. With PSB shares trading at such low levels, a small allocation to employees today may be a strong source of motivation, and can be a large source of wealth as performance improves.

(iii) Customers

Public sector banks enjoy trust with customers. An emphasis on customer service and customer-centric advice may allow them to recapture low-cost customer deposits that are migrating elsewhere. Public sector banks should take the lead in emphasising the RBI's 5 point Charter of Consumer Rights. While it is understandable that with stressed balance sheets public sector banks do not want to make too many loans to stressed sectors, it is less clear why their deposit growth is faltering, for the low-cost deposit franchise will be the key to their future success.

(iv) Structure

Some banks may be best off focusing on local activity, and in effect, becoming small finance banks. Others may be best off merging with other banks so as to obtain scale and geographic diversification. As banks get cleaned up, and their boards are strengthened, their boards should focus on appropriate structure as part of an overall rethink on strategy.

None of these changes are easy, but they are also not impossible. It requires work with the unions, persuading them of the need for change that benefits all, especially the long term future of the bank. Since each bank has different challenges and probably different solutions, as these solutions emerge it may also be the occasion to rethink the collective bargaining approach across the public sector bank universe that now prevails.

Back to the Authorities

Today, a variety of authorities – Parliament, the Department of Financial Services, the Bank Board Bureau, the board of the bank, the vigilance authorities, and of course various regulators and supervisors including the RBI – monitor the performance of the public sector banks. With so many overlapping constituencies to satisfy, it is a wonder that bank management has time to devote to the management of the bank. It is important that we streamline and reduce the overlaps between the jurisdictions of the authorities, and specify clear triggers or situations where one authority's oversight is invoked.

In particular, we have to move much of the governance to the bank's board, with the Government exercising its control through its board representatives (chosen by the BBB), keeping in mind the best interests of the bank and the interests of minority shareholders. Wherever possible, public sector bank boards should be bound by the same rules as private sector bank boards – one reason why the RBI has recently withdrawn the Calendar of Reviews PSBs were asked to follow. Similarly, board membership of public sector banks should pay as well as private sector banks if they are to attract decent talent.

As boards take decisions, the Department of Financial Services could move to (i) a program role: for example, ensuring government programs such as PMJDY are well designed, appropriately remunerated to banks, and progress monitored (ii) a coordinating role: for example, ensuring financial institutions join a common KYC registry and (iii) a developmental role: revitalising institutions like the Debt Recovery Tribunals through appropriate legislation. RBI would perform a purely regulatory role, and withdraw its representatives on bank boards – this will require legislative change. Over time, RBI should also empower boards more, for instance offering broad guidelines on compensation to boards but not requiring every top compensation package be approved.

Given strong oversight from the bank's board, the CVC and CAG would get involved only in extraordinary situations where there is evidence of malfeasance, and not when legitimate business judgment has gone wrong.

I have focused on the challenges public sector banks face meeting the new competitive environment, as well as some possible solutions. These should be viewed as opening a discussion rather than the formal views of the RBI. That I have not discussed the challenges private banks will face is not because I think they are perfectly positioned but because they are not as constrained as the public sector banks. But before I end, let me emphasise an immediate area of action for all.

With changes in technology, cyber security, both at the bank level and at the system level, has become very important. I think it would be overly complacent for anyone of us to say we are well prepared to meet all cyber threats. A chilling statement by an IT expert is 'We have all been hacked, the only question is whether you know it or you don't'. While the statement may be alarmist, it is an antidote to complacency. We all have to examine our security culture. Too many access points are left unmonitored, too many people share passwords or have easily penetrated passwords, too little surveillance is maintained of vendors and the software they create. RBI is working on upgrading the capabilities of its inspectors to undertake bank system audit as well as to detect vulnerabilities in them. RBI is also in the process of setting up an IT subsidiary, which will be able to recruit directly from industry, and will give the Reserve Bank better ability to manage and supervise technology. I would urge all of you to take a fresh look at your systems, and more important, of the cyber culture within your bank.

Conclusion

Let me end. We will be living in interesting times. Whether it is a blessing or a curse is up to us. I am confident that we will rise to the occasion.