Five Frontier Issues in Indian Banking*

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First of all, many thanks to the organisers of BANCON 2010 for inviting me to inaugurate this Conference. I understand this is a premier banking Conference on the annual calendar where the top managements of banks and their economists brainstorm on current issues. The theme for this year's conference '*Ideate, Innovate and Inspire*' is thoughtful, imaginative, and most importantly, inspirational.

2. In the aftermath of the crisis, banks, banking and bankers are very much in public consciousness. Bankers around the world are not only doing a lot of soul-searching, but are also reviewing their business models and work ethics. At the same time, there are vigorous efforts internationally to reform banking regulation, reflecting the lessons of the crisis. The Basel Committee on Banking Supervision (BCBS) has come out with several components of a new package – Basel III – aimed at better guarding banks against systemic risks of the type that plunged the world into the crisis. The Financial Stability Board (FSB) is currently engaged in addressing issues relating to systemically important financial institutions (SIFIs) and resolution regimes, improving over-the-counter (OTC) derivatives markets, developing macroprudential frameworks and expanding and refining the regulatory perimeter (hedge funds, securitisation, credit rating agencies).

3. We, in India, have been spared the worst impact of the crisis. This should by no means imply that we have no compulsion to reform. In a globalising world, we are vulnerable to instability anywhere in the global financial system. Indian banks should, therefore, be adapting the best global practices in risk management to the Indian context. Moreover, as a nation, we aspire to double digit and inclusive growth. There are many challenges to achieving this including the challenge of making our financial intermediation more efficient. This, too, presents a formidable reform agenda for banks.

* Inaugural Address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at 'BANCON 2010' in Mumbai on December 3, 2010.

4. Given that overall scenario, I struggled hard to decide what I should say at this inaugural session. I am quite impressed by the way the theme 'ideate, innovate and inspire' has been fleshed out, and by the depth and breadth of topics for discussion in the follow-on sessions. After looking through the Conference programme, I determined that the best way I can add value to your deliberations will be by putting across some of the important issues that should engage the attention of Indian banks. I will present each issue and, on some of them, I may present a point of view. But I want to add that even as I may present a point of view, all these issues are as yet open. My presenting a point of view is merely to provide a reference frame for debate and discussion.

First Issue: Are Indian Banks Prepared for Basel III?

5. The first issue that comes to mind, particularly in the background of the recent global regulatory developments is: Are Indian banks prepared for Basel III? The building blocks of Basel III are by now quite well-known: higher and better quality capital; an internationally harmonised leverage ratio to constrain excessive risk-taking; capital buffers which would be built up in good times so that they can be drawn down in times of stress; minimum global liquidity standards; and stronger standards for supervision, public disclosure and risk management.

Capital

6. Our assessment is that at the aggregate level Indian banks will not have any problem in adjusting

Parameter as on June 30, 2010	Basel III requirement	Actual value banks for Indian	
		Under Basel II	Under Basel III
Capital to risk weighted assets ratio (CRAR) %	10.5	14.4	11.7
Of which			
Tier I capital %	8.5	10.0	9.0
Common equity %	7.0	8.5	7.4

to the new capital rules both in terms of quantum and quality. A quick estimate of the capital ratios of the banking system after taking into account the regulatory adjustments under Basel III is indicated in the table below. This estimate, based on the data furnished by banks in their off-site returns, is approximate. We expect to have a more accurate picture when banks review their Basel III compliance position following the publication of the final Basel III rules scheduled around the year-end.

7. As the numbers in the above Table show, Indian banks are comfortably placed in terms of compliance with the new capital rules. One point to note though is that the comparative position is at the aggregate level; a few individual banks may fall short of the Basel III norms and will have to augment their capital. However as the phase-in time allowed is long enough, these banks should be able to make a comfortable adjustment to the enhanced requirement.

Pro-cyclicality

8. The Basel III package includes capital buffers to contain the pro-cyclicality of the financial sector. Building capital buffers will entail additional costs for banks with consequent implications for investment and, hence, for overall growth. Apart from the general concern in this regard, in India there is an additional concern about the variable used to calibrate the countercyclical capital buffer. Credit-to-GDP ratio is put forward as a natural candidate for this calibration. It is not clear that this will be an appropriate indicator in the Indian context. Unlike in advanced economies where this ratio is stable, in emerging economies such as India, it will likely go up for structural reasons – enhanced credit intermediation owing to higher growth as well as efforts at deepening financial inclusion. However, the proposed framework is flexible enough to allow national discretion to suit the country situation in a 'comply or explain' framework. In India, for instance, sectoral approaches to countercyclical policies have stood the test in the past and we could continue with such sectoral approaches.

9. To effectively deploy countercyclical measures, we also need to improve our capabilities to predict business cycles at the aggregate and sectoral levels, and identify them in real time. This will require better quality of economic and financial data as well as improved analytical capabilities.

Leverage

10. Estimates show that the leverage in the Indian banking system is quite moderate. Notwithstanding the fact that the Statutory Liquidity Ratio (SLR) portfolio of our banks will be included in computing the leverage ratio, Indian banks will not have a problem in meeting the leverage ratio requirement since the Tier 1 capital of many Indian banks is comfortable (more than 9 per cent) and their derivatives portfolios are also not very large.

Liquidity

11. The major challenge for Indian banks in implementing the liquidity standards will be to develop the capability to collect the relevant data accurately and granularly. We do not have much experience to fall back on since our financial markets have not experienced the levels of stress that advanced country markets have. Predicting the appropriate stress scenario is, therefore, going to be a complex judgment call. On the positive side, most of our banks follow a retail business model and their dependence on short-term or overnight wholesale funding is limited. They also have a large amount of liquid assets which should enable them to meet the new standards.

12. There is an issue about the extent to which statutory holdings of SLR should be reckoned in the estimation of the proposed liquidity ratios. An argument could be made that they should not be counted at all as they are expected to be maintained on an ongoing basis. However, it would be reasonable to treat at least a part of the SLR holdings in calculating the liquidity ratio under stressed conditions, particularly as these are government bonds against which the central bank provides liquidity.

13. On the whole, our assessment is that Indian banks are well-positioned to adjust to the Basel III norms well within the phase-in period. That does not mean there will be no challenges. There will be the challenge of upgrading risk-management systems and there will be the challenge of learning to make complex judgement calls. Most importantly, there will be the challenge of meeting the credit needs of a rapidly growing economy

even while adjusting to a more demanding regulatory regime. I trust you will 'ideate' on these challenges in the course of this conference.

Second Issue: Should Indian Banks Aim to Become Global?

14. The second issue I want to address is one that comes up frequently – that Indian banks should aim to become global. Most people who put forward this view, have not thought through the costs and benefits analytically; they only see this as an aspiration consistent with India's growing international profile.

15. In its 1998 report, the Narasimham (II) Committee envisaged a three-tier structure for the Indian banking sector: 3 or 4 large banks having an international presence on the top, 8-10 mid-sized banks, with a network of branches throughout the country and engaged in universal banking, in the middle, and local banks and regional rural banks operating in smaller regions forming the bottom layer. However, the Indian banking system has not consolidated in the manner envisioned by the Narasimham (II) Committee. The current structure is that India has 81 scheduled commercial banks of which 26 are public sector banks, 21 are private sector banks and 34 are foreign banks. Even a quick review would reveal that there is no segmentation in the banking structure along the lines of Narasimham II.

16. A natural sequel to this issue of the envisaged structure of the Indian banking system is the Reserve Bank's position on bank consolidation. Our view on bank consolidation is that the process should be market-driven, based on profitability considerations and brought about through a process of mergers & amalgamations (M&As). The initiative for this has to come from the boards of the banks concerned which have to make a decision based on a judgement of the synergies involved in the business models and the compatibility of the business cultures. The Reserve Bank's role in the reorganisation of the banking system will normally be only that of a facilitator.

17. It should be noted though that bank consolidation through mergers is not always a totally benign option. On the positive side are a higher exposure threshold, international acceptance and recognition, improved risk management and improvement in financials due to economies of scale and scope. This can be achieved both through organic and inorganic growth. On the negative side, experience shows that consolidation would fail if there are no synergies in the business models and there is no compatibility in the business cultures and technology platforms of the merging banks.

18. Having given that broad-brush position on bank consolidation, let me address two specific questions: (i) can Indian banks aspire to global size?; and (ii) should Indian banks aspire to global size?

19. On the first question, as per the current global league tables based on the size of assets, our largest bank, the State Bank of India (SBI), together with its subsidiaries, comes in at No.74 followed by ICICI Bank at No.145 and Bank of Baroda at No.188. It is, therefore, unlikely that any of our banks will jump into the top ten of the global league even after reasonable consolidation.

20. Then comes the next question of whether Indian banks should become global. Opinion on this is divided. Those who argue that we must go global contend that the issue is not so much the size of our banks in global rankings but of Indian banks having a strong enough global presence. The main argument is that the increasing global size and influence of Indian corporates warrant a corresponding increase in the global footprint of Indian banks. The opposing view is that Indian banks should look inwards rather than outwards, focus their efforts on financial deepening at home rather than aspiring to global size.

21. It is possible to take a middle path and argue that looking outwards towards increased global presence and looking inwards towards deeper financial penetration are not mutually exclusive; it should be possible to aim for both.

22. With the onset of the global financial crisis, there has definitely been a pause to the rapid expansion overseas of our banks. Nevertheless, notwithstanding the risks involved, it will be opportune for some of our larger banks to be looking out for opportunities

for consolidation both organically and inorganically. They should look out more actively in regions which hold out a promise of attractive acquisitions.

23. The surmise, therefore, is that Indian banks should increase their global footprint opportunistically even if they do not get to the top of the league table.

Third Issue: Should We Mandate Foreign Banks to Come in Only as Subsidiaries?

24. The next issue I want to address is whether we should mandate foreign banks to come in only as subsidiaries.

25. The road-map for the presence of foreign banks in India put out by the Reserve Bank in 2005 allows foreign banks the option of coming in either as a branch or as a subsidiary, but not both at the same time. Even so, all foreign banks have so far opted to come in only in the branch mode. There are currently 34 foreign banks operating in India with a total of 315 branches and they account for about 7.2 per cent of the total assets of scheduled commercial banks.

26. One of the big issues thrown up by the recent crisis is the systemic risk and moral hazard associated with what have come to be called Systemically Important Financial Institutions (SIFIs). The underbelly of the recent crisis was the failure of SIFIs which, because of their size, complexity and interconnectedness, brought enormous disruption to the global financial system. Among the issues presently engaging the attention of the Financial Stability Board is improving the procedure for orderly resolution of SIFIs in the event of stress. Two considerations are particularly important. First, SIFIs must be able to continue to function at a minimum level even in a period of stress, and second, their resolution should not expose taxpayers to loss. It is these potential constraints in the resolution of SIFIs that have triggered a vigorous debate on the form of presence of foreign banks – branch or subsidiary.

27. The subsidiary form of presence provides several comforts to regulators. First, managerial decisions in subsidiaries are mainly driven by local economic conditions; second, there is a clear delineation of the capital of the domestic bank from its parent bank which protects the interests of domestic depositors; third, independent directors on the boards of the subsidiaries provide sufficient separation between the bank and its owners to ensure that the board does not have unfettered ability to lean in favour of the owners and against the interest of domestic depositors, especially in times of stress; and finally, local incorporation affords greater leverage to host country authorities than does a branch operation, to ring-fence the operations of the bank.

28. But local incorporation of foreign banks is not without costs. A possible downside risk is that foreign banks will dominate the domestic banking system. This could have systemic implications during normal times which would amplify in times of crisis. Many countries where foreign banks dominate have seen them vigorously acquiring business at the expense of local banks in boom times but retrenching their operations equally vigorously in times of stress. This has been the experience in varying degrees of all emerging economies, including countries like India, where foreign banks are present only in the branch mode.

29. Post-crisis, we know that mandatory subsidiarisation is not a sure-fire method of protecting domestic interests since foreign banks facing a crisis at home could very well abandon their subsidiaries. A good illustration of this tendency is what we saw happen in the EU in the wake of the sovereign-debt crisis. It was only after very concerted effort that EU could pressurise or persuade foreign banks to maintain support to their EU subsidiaries. Even so, credit supply was seriously impaired.

30. On balance, the subsidiary mode has potential advantages over the branch mode both from regulatory and resolution perspectives. However, a number of issues arise: (i) Should subsidiaries be given full national treatment by virtue of their local incorporation? If not, what should be the nature and extent of restrictions? (ii) Should the subsidiary form of presence be mandated for all new entrants or should it be selectively applied based on certain parameters? and (iii) What approach should be adopted towards the existing branches of foreign banks – whether incentives should be provided to them to convert into

subsidiaries? These and other related questions will be debated in the discussion paper that the Reserve Bank expects to put out shortly.

Fourth Issue: Why Do We Need to Rewrite Laws Governing the Banking Sector?

31. The current statutory arrangement we have, is a baffling plethora of laws governing different segments of the banking industry. The nationalised banks are governed by the Banking Companies (Acquisition and Transfer of Undertaking) Acts of 1970 and 1980. State Bank of India and its subsidiaries are governed by their respective statutes. Private sector banks come under the purview of the Companies Act, 1956 and the Banking Regulation Act, 1949. Foreign banks which have registered their documents with the registrar under Section 592 of the Companies Act are also banking companies under the Banking Regulation Act. Certain provisions of the Banking Regulation Act have been made applicable to public sector banks. Similarly, some provisions of the RBI Act too are applicable to nationalised banks, SBI and its subsidiaries, private sector banks and foreign banks.

32. Notwithstanding this wide array of legislations of varying vintage, the statutory arrangement has served the system well by helping maintain an orderly banking system. The Banking Regulation Act has not only stood the test of time, but several of its provisions such as the requirement of minimum paid-up capital and reserves, restrictions on payment of dividend, transfer of a percentage of profits to reserves, maintenance of SLR, restrictions on connected lending, maintaining a percentage of domestic liabilities as assets in India have all helped the Reserve Bank in preventing crises and maintaining financial stability.

33. Needless to say, each of the statutes was crafted in a contemporaneous setting reflecting the needs and concerns of the time; and almost all the statutes have had to be amended from time to time to reflect changes in circumstances and context. There is a strong case for reviewing all the various legislations and recasting them for a number of reasons. First, the fact that different banks are governed by different laws has created an uneven playing field and that needs to be levelled to provide for fair competition. Second, a single, harmonised legislation applicable to all banks will provide transparency, comprehensiveness and clarity. Third, there is also a need to iron out inconsistencies between the primary laws governing the banking sector and other laws applicable to the banking sector. Illustratively, the procedure for combination of enterprises under the Competition (Amendment) Act, 2007 is inconsistent with the provisions of the Banking Regulation Act dealing with amalgamation of banking companies. Such inconsistencies need to be removed while reviewing banking laws.

34. The need for revisiting the statutes has been buttressed by the experience of the global financial crisis. The crisis has thrown up a number of areas requiring significant legislative action either because there is no legislation or because the prevailing legislation is inadequate. Illustratively, issues requiring legislative attention include the orderly resolution of failing banks and financial institutions, domestically as well as cross-border, home-host regulatory co-operation in information sharing, convergence of Indian Accounting Standards with International Financial Reporting Standards (IFRS), empowering the Reserve Bank for consolidated supervision, supervision of financial conglomerates, *etc.*

35. The task of rewriting the laws governing the banking sector should be driven by several somewhat inter-related motivations. First, there is a compelling need to integrate the various statutes governing different segments of the banking industry and different dimensions of the banking business into a harmonised law to provide clarity and transparency. The second motivation is to build provisions into our banking sector legislative framework that reflect the lessons of the crisis, acknowledge the dynamics and complexity of a globalised financial system, have a futuristic perspective and aid maintenance of financial stability. Finally, revision of banking sector laws should also be motivated by the recognition that the banking sector has been and remains a critical instrumentality not only for accelerating India's growth but for making it inclusive.

36. The decision of the Finance Minister, as announced in the last budget, to set up a Financial

Sector Legislative Reforms Commission 'to rewrite and clean up the financial sector laws to bring them in line with the requirements of the sector' is therefore very timely and very vital.

37. It is important, however, to recognise that the bringing about of changes in policy or in the regulatory architecture cannot be the remit of a legislative reforms commission. Such changes have to be debated and decided upon as a prelude to the work of the commission so that the commission has a clear mandate on the policy directions. In short, policy directions should drive the work of the legislative reforms commission, not the other way round. That underscores why it is important for all of us – the banks and the banking regulator – to deliberate on the policy directives. I hope this Conference will set the ball rolling by discussing the various aspects of legislative changes required in the banking sector.

Fifth Issue: Where Do Indian Banks Stand on Efficiency Parameters?

38. The growth acceleration that we saw in India during 2003-08 is attributable to a number of factors, both tangible and intangible. One of the less acknowledged factors that drove this growth was the contribution of the financial sector by way of larger and better quality of financial intermediation. Just one statistic will evidence this – bank credit as a proportion of GDP rose from 29 per cent as at end-March 2000 to 55 per cent by end-March 2010.

39. The analysis in the Reserve Bank's Report on Currency and Finance 2006-08 shows that the Indian banking sector has recorded an impressive improvement in productivity over the last 15 years; many of the productivity/efficiency indicators have moved closer to the global levels. There has been a particularly discernible improvement in banks' operating efficiency in recent years owing to technology upgradation and staff restructuring. It is noteworthy that operating efficiency continued to improve even over the last 2-3 years despite the turbulence in the global financial system. Importantly, the performance of public sector banks has converged with that of new private sector and foreign banks. Even, more importantly, contrary to popular perception, there is also no significant relationship between ownership and efficiency – the most efficient banks straddle all three segments – public sector banks, private sector banks and foreign banks.

40. Indian banks can justifiably be proud of this record of achievement. But they can not rest on those laurels. To achieve our collective aspiration of double digit and inclusive growth, we need to raise the level of national savings and channel those savings into investment. This means banks need to raise the interest rates offered to depositors and reduce the lending rates charged on borrowers – in other words, reduce their intermediation costs, or in technical terminology, reduce the net interest margin (NIM).

41. At the aggregate level, the net interest margin of the Indian banking system has narrowed from 3 per cent in 1999-2000 to 2.5 per cent in 2009-10. There has also been a significant improvement in terms of the standard supervisory parameters: Capital, Asset Quality, Management, Earnings, Liquidity and Systems (CAMELS). Even so, the net interest margin of the Indian banking system is higher than that in some of the other emerging market economies even after accounting for mandated social sector obligations such as priority sector lending and credit support for the government's anti-poverty initiatives.

42. The efficiency gap between us and our peer group of countries is indicative of the catch-up job we have to do. There are several ways of improving efficiency. By far the most important task is to further improve operating efficiency on top of what has already been achieved by optimising operating costs, *i.e.* non-interest expenses including wages and salaries, transaction costs and provisioning expenses. This will enable banks to lower lending rates while preserving their profitability.

43. Indian banks have typically posted higher earnings than those of other leading Asian economies as measured by return on assets (RoA) and return on equity (RoE). Even so, they are burdened by a higher operating cost ratio measured in terms of non-interest expenses to total assets which impedes their pricing efficiency and affects their ability to rationalise NIM in a competitive manner. The task for Indian banks clearly is to press on with efforts for sustainable reduction in operating costs through productivity

improvement and skill enhancement and by leveraging of technology. Reduction in operating costs will also come through nurturing asset quality, diligent loan restructuring of viable assets and reducing non-performing loans through recovery or upgradation. The efficiency of some of the larger banks in particular has to improve in line with their domestic peers and relative to global standards.

44. While on the issue of efficiency, I am both troubled and intrigued by the fact that our banks see financial inclusion as an obligation rather than as an opportunity. If pursued effectively, financial inclusion will provide banks access to sizeable low-cost funds as also opportunities for lending in the small volume segment. The latter should be possible since the Reserve Bank has since deregulated the interest rate that can be charged on small value loans. To gainfully pursue financial inclusion, banks will need to constantly reinvent their business models and design products and services demanded by a growing economy and one that is growing through a rapid structural transformation.

Conclusion

45. Let me now summarise. I have raised the following five issues for further deliberation at this conference:

(i) Are Indian Banks Prepared for Basel III?
(ii) Should Indian Banks Aim to Become Global?
(iii) Should We Mandate Foreign Banks to Come in Only as Subsidiaries?
(iv) Why Do We Need to Rewrite Laws Governing the Banking Sector?
(v) Where Do Indian Banks Stand on Efficiency Parameters?

46. I must admit that this is by no means a comprehensive listing of frontier issues in Indian banking. Indeed, in preparation for this talk, I asked my office for a list of issues that I can raise. They gave me a first list of 50 issues and added for good measure that they can expand it should I so desire. Just shows how much banking reform is on the mind of the Reserve Bank. Needless to say, I had to be quite ruthless in winnowing down to just five issues so that I do not overstay my welcome in this inaugural session. I will be happy to share with you other issues and our thoughts on them when we meet formally and informally in due course.

47. After this inaugural session, you will go into specific topic sessions to 'ideate, innovate and inspire'. This theme is broad and deep, and encourages you to reflect on the big picture. The financial crisis has taken a devastating toll on global well-being and put the world economy back by several years. As we all know, in India we have been relatively unscathed by the crisis. But note that this is true only in relative terms. We should not forget that India too paid a heavy price as the crisis interrupted our growth momentum and, thereby, the translation of that growth into poverty reduction. We owe it to hundreds of millions of poor people in the country to make up for lost time and get cracking on an action plan to make our aspiration of double digit and inclusive growth a reality. Towards this endeavour, the banking sector must ideate on what needs to be done, innovate strategies for converting those ideas into action and inspire their staff to implement those strategies.

48. I wish you all the best as you get down to ideate, innovate and inspire over the next two days and beyond.