*The Indian Banking Industry - A Retrospect of Select Aspects**

V Leeladhar

It is my pleasure to be here on the occasion of the birth centenary celebrations of late Shri M. Ct. M. Chidambaram Chettyar. I am thankful to the organisers for affording me this opportunity to share some of my thoughts with this august audience. As you all know, Shri Chettyar was the visionary founder of the Indian Overseas Bank. He established the bank in the pre-independence era in the February 1937, when the banking industry in the country was indeed in its infancy. What is noteworthy is that Shri Chettyar not only had the vision of starting a bank in the early part of the 20th century but he did so when he was not even 30 years of age. And rather interestingly, the bank was inaugurated with opening of three branches, including a foreign branch in the erstwhile Rangoon (now Myanmar), on the inaugural day itself. The bank had also recorded rapid growth in the early days of its formation and within 10 years of its inception, by the time of our independence in 1947, it had 45 branches – including seven branches abroad. Perhaps, those were the early signs of globalisation of the Indian banking industry through the cross-border branch presence of an Indian bank. I understand that the bank, along with its Officers' Association and the Workmen Union, has formed a *Sakthi IOB Chidambaram Chettiar Memorial Trust* in 1995 to commemorate its founder, and that the Trust is doing yeoman service in empowering the downtrodden women in the country by providing them multi-faceted vocational training. I am sure the

* Address by Shri V. Leeladhar, Deputy Governor, Reserve Bank of India on the occasion of the birth-centenary celebrations of Shri M. Ct. M. Chettyar, the founder of the Indian Overseas Bank, on August 2, 2008 at Chennai.

envisaged birth-centenary celebration of the founder of the bank is a fitting tribute to his immense contribution to the Indian banking sector in general and to the growth and development of the Indian Overseas Bank over the past several decades.

The bank has indeed come a long way since its nationalisation in 1969 and has many achievements to its credit. As against 195 branches in 1969, its branch network now comprises 2153 branches. Its deposits and advances have multiplied manifold, aggregating over Rs.79,000 crore and Rs. 56,000 crore, respectively, as on March 31, 2008 compared to the corresponding figures of about Rs. 68 crore and Rs. 45 crore, at the time of nationalisation. I understand that the IOB had the distinction of being the first bank in the Indian banking industry to obtain ISO 9001 Certification for its Computer Policy and Planning Department in September 1999. The bank also made its maiden IPO in September 1999 and the Government's ownership currently stands at 75 per cent. I do hope that the bank would maintain its growth momentum in the days to come and be able to realise the vision of its founder on a larger scale.

In the backdrop of growth and development of the Indian Overseas Bank, I believe, a broader perspective of the Indian banking industry would be of interest to this audience. Let me, therefore, take this opportunity today to present a broad overview of the achievements and progress made by the Indian banking sector in the last two decades and the emerging frontiers of the Indian banking system, in the post-reform era.

The Transformation of the Indian Banking Sector

As you are aware, the financial sector reforms in the country were initiated in the beginning of the 1990s. The reforms have brought about a sea change in the profile of the banking sector. Our implementation of the reforms process has had several unique features. Our financial sector reforms were undertaken early in the reform cycle. Notably, the reforms process was not driven by any banking crisis, nor was it the outcome of any external support package. Besides, the design of the reforms was crafted through domestic expertise, taking on board the international experiences in this respect. The reforms were carefully sequenced with respect to the instruments to be used and the objectives to be achieved. Thus, prudential norms and supervisory strengthening were introduced early in the reform cycle, followed by interest-rate deregulation and a gradual lowering of statutory pre-emptions. The more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place.

The public sector banks continue to be a dominant part of the banking system. As on March 31, 2008, the PSBs accounted for 69.9 per cent of the aggregate assets and 72.7 per cent of the aggregate advances of the scheduled commercial banking system. A unique feature of the reform of the public sector banks was the process of their financial restructuring. The banks were recapitalised by the Government to meet prudential norms through recapitalisation bonds. The mechanism of hiving off bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard. The subsequent divestment of equity and offer to private shareholders was undertaken through a public offer and not by sale to strategic investors. Consequently, all the public sector banks, which issued shares to private shareholders, have been listed on the exchanges and are subject to the same disclosure and market discipline standards as other listed entities. To address the problem of distressed assets, a mechanism has been developed to allow sale of these assets to Asset Reconstruction Companies which operate as independent commercial entities.

As regard the prudential regulatory framework for the banking system, we have come a long way from the administered interest rate regime to deregulated interest rates, from the system of Health Codes for an eight-fold, judgmental loan classification to the prudential asset classification based on objective criteria, from the concept of simple statutory minimum capital and capital-deposit ratio to the risk-sensitive capital adequacy norms – initially under Basel I framework and now under the Basel II regime. There is much greater focus now on improving the corporate governance set up through "fit and proper" criteria, on encouraging integrated risk management systems in the banks and on promoting market discipline through more transparent disclosure standards. The policy endeavour has all along been to benchmark our regulatory norms with the international best practices, of course, keeping in view the domestic imperatives and the country context. The consultative approach of the Reserve Bank in formulating the prudential regulations has been the hallmark of the current regulatory regime which enables taking account of a wide diversity of views on the issues at hand.

The implementation of reforms has had an all round salutary impact on the financial health of the banking system, as evidenced by the significant improvements in a number of prudential parameters. Let me briefly highlight the improvements in a few salient financial indicators of the banking system.

The average capital adequacy ratio for the scheduled commercial banks, which was around two per cent in 1997, had increased to 13.08 per cent as on March 31, 2008. The improvement in the capital adequacy ratio has come about despite significant growth in the aggregate assets of the banking system. This level of capital ratio in the Indian banking system compares quite well with the banking system in many other countries – though the capital adequacy of some of the banks in the developed countries has remained under considerable strain in the recent past in the aftermath of the sub-prime crisis.

In regard to the asset quality also, the gross NPAs of the scheduled commercial banks, which were as high as 15.7 per cent at end-March 1997, declined significantly to 2.4 per cent as at end-March 2008. The net NPAs of these banks during the same period declined from 8.1 per cent to 1.08 per cent. These figures too compare favourably with the international trends and have been driven by the improvements in loan loss provisioning by the banks as also by the improved recovery climate enabled by the legislative environment. What is noteworthy is that the NPA ratios have recorded remarkable improvements despite progressive tightening of the asset classification norms by the RBI over the years.

The reform measures have also resulted in an improvement in the profitability of banks. The Return on Assets (RoA) of scheduled commercial banks increased from 0.4 per cent in the year 1991-92 to 0.99 per cent in 2007-08. The Indian banks would appear well placed in this regard too *vis-à-vis* the broad range of RoA for the international banks.

The banking sector reforms also emphasised the need to improve productivity of the banks through appropriate rationalisation measures so as to reduce the operating cost and improve the profitability. A variety of initiatives were taken by the banks, including adoption of modern technology, which has resulted in improved productivity. The Business per Employee (BPE), as a measure of productivity, for the public sector banks has registered considerable improvement. The BPE for the public sector banks, which was Rs. 95 lakh in 1998-99, almost doubled to Rs. 188 lakh in 2002 and more than re-doubled to Rs. 496 lakh in 2007.

It needs to be noted that the turnaround in the financial performance of the public sector banks, pursuant to the banking sector reforms, has resulted in the market valuation of government holdings in these banks far exceeding the initial recapitalisation cost – which is something unique to the Indian banking system. Thus, the recapitalisation of banks by the Government has not been merely a "holding out" operation by the majority owner of the banks. The Indian experience has shown that a strong, pragmatic and non-discriminatory regulatory framework coupled with the market discipline effected through the listing of the equity shares and operational autonomy provided to the banks, can have a significant positive impact on the functioning of the public sector banks.

The Task Ahead

Let me now turn to some of the areas where the public sector banks face certain challenges and hence, need to work further to achieve the desired results, particularly in regard to fuller leveraging of the available technology for rendering better banking services to the public at large.

Awareness of Electronic Payment Products

As is well known, the financial sector has witnessed a quantum jump in the availability of technological solutions for delivery of financial services, and the Reserve Bank too has launched several payment system products for improving the efficiency of the payment system. It is, however, the general perception that the awareness of these products in the system has remained rather limited. This lack of awareness is not confined only to the members of public at large. It is not uncommon to find that even the branch staff, having direct interface with the banking customers, is not aware of these products and services offered by the bank. This has, therefore, resulted in the continued reliance of the members of public on the traditional methods for availing of various banking services and the benefits of technology have not fully percolated to the level of the customers. I would, therefore, like to urge upon you to take appropriate measures to increase the awareness of the electronic payment products – not only among the clientele of the banks but also among the banks' own staff so that the members of public can be properly guided and efficient and hassle-free customer service is rendered to them.

National Electronic Fund Transfer

As you are aware, the NEFT was launched by the RBI in November 2005 as a more secure, nation-wide retail electronic payment system to facilitate funds transfer by the bank customers, between the networked bank branches in the country. It has, however, been observed that the public sector banks are not the most active users of this product and the majority of NEFT outward transactions are originated by a few new-generation private sector banks and foreign banks. For instance, in June 2008, while these banks, as a segment, accounted for a little over 43 per cent each of the aggregate volume of outward and inward NEFT transactions, the share of public sector banks in total outward NEFT transactions was rather low at a little over 12 per cent, of which half the volume was the contribution of the State Bank of India. The Reserve Bank has been pursuing the matter with the PSBs for increasing their participation in the NEFT system in terms of the number of NEFT-enabled branches and the number of NEFT transactions originated by them. I would like to urge upon the bankers present here to initiate appropriate measures to stimulate greater usage of this payment medium and thereby, improve their share in this regard.

In order to popularise the e-payments in the country, the RBI, on its part, has waived the service charges to be levied on the member banks, till March 31, 2009, in respect of the RTGS and NEFT transactions. The RBI also provides, free of charge, intra-day liquidity to the banks for the RTGS transactions. The service charges to be levied by banks from their customers for RTGS & NEFT have, however, been deregulated and left to discretion of the individual bank. It has been our experience that while some of the banks have rationalised their service charges and a few have made it even cost-free to the customers, there are also certain banks that have fixed multiples slabs or unreasonably high service charges, at times linked to the amount of the transaction, for providing these services to their customers – even though the RBI provides these services to the banks free of charge. I would therefore, like to take this opportunity to impress upon such banks the need to have proper appreciation of the underlying policy intent of the Reserve Bank in waiving the charges for these services, and to adopt a pragmatic approach in determining their own service charges for providing these electronic payment products to their customers.

ATM Networks

As many of you might know, the National Financial Switch (NFS) network started its operations on August 27, 2004 and is owned and operated by Institute for Development and Research in Banking Technology (IDRBT), Hyderabad. NFS is one of the several shared ATM networks which interconnect the banks' ATM switches together and thus, enable inter-operability of the ATM cards issued by any bank across the entire network. While there are a few other ATM networks also functioning in the country, the NFS has emerged to be the largest one, with a network of 28,773 ATMs of 31 banks, including 16 public sector banks. The primary objective of any ATM network, like the NFS, is to make the ATM deployment more economical and viable for banks by pooling their respective ATM resources. The main advantage of an ATM network is that it obviates the need for having bank-specific multiple ATM installations in the same geographical area, thereby reducing the entailed costs for the banks but without compromising on the reach of the banks to their customers. From the customers' perspective, the ATM card of any bank can be used in any ATM – which enables more convenient and wider ATM access to the bank customers of varied banks in different geographical areas.

As regards the charges for use of the ATMs connected through any of the ATM networks in the country, while the balance enquiry by the customers is free of any charges, the cash withdrawal from such ATMs, which currently attracts a nominal charge, would also become cost free for the customers from April 1, 2009,. Thus, the networking of the ATMs across the country, by leveraging the technology, is indeed a very customer-friendly development.

May I also mention for record that as at end-June 2008, the number of ATMs in the country stood at 36,314 of which the number of ATMs deployed by the PSBs, new-private-sector, old-private-sector and foreign banks was 22,525, 10,552, 2,189 and 1048 ATMs, respectively. At the system level, the banks had planned the installation of another 10,560 ATMs during 2008-09. During the quarter ended June 2008, the daily average number of hits on the ATMs of the PSBs aggregated

31,31,431, with the daily average amount of transactions at Rs. 759.81 crore as against the corresponding figure of 14,91,399 and over Rs. 385 crore for the (old and new) private sector banks, of which the new private sector banks accounted for a lion's share at 12,84, 071 hits and around Rs. 329 crore in the value of daily transactions.

Credit Cards

As you are aware, there has been phenomenal increase in the number of credit cards issued by the banks in India during the last few years and a majority of the PSBs has been in the credit card business since long. The number of credit cards outstanding at the end of June 2008 was 27.02 million as against 24.39 million in June 2007. Of these, the number of credit cards issued by public sector banks was 3.8 million, of which 3.09 million cards were issued by the SBI Cards – a joint venture of GE Money and SBI. The usage of credit cards has also recorded an increase of 10.73 per cent during this period, which is mainly at the Point of Sale (POS) terminals. In June 2008, the number of transactions by credit cards at POS terminals was 20.6 million as against 17.2 million transactions in June 2007, reflecting an increase of almost 20 per cent during the year. The amount involved in these transactions recorded a growth of 25.6 per cent during the year ended June 2008 with the aggregate value of such transactions at Rs. 5261.63 crore.

While the increasing usage of the credit cards is a welcome development in as much as it reduces reliance on currency for settlement of transactions, it also entails certain additional elements of operational risk and can be a potential source of customer complaints. The RBI, based on the complaints received from the credit card holders, had undertaken a study of the credit card operations of the banks. The RBI has since advised the banks in July 2008, the recommendations emerging from the study, for implementation. These recommendations are fairly wide ranging and encompass several issues in the areas of card issuance, card statements, interest and other charges on the cards, using the services of direct selling / marketing agents, redressal of customers' grievances, reporting of default information of the card holder to the CIBIL, *etc.* I would urge the banks to put in place necessary mechanism to ensure meticulous compliance with these instructions of the RBI so as to minimise, if not eliminate, the risks and customer complaints in the area of credit card operations.

Satellite Banking

As you might be aware, having regard to much greater reliability of a satellite-based communication link for interconnecting the branches of the banks, particularly in the hilly areas and difficult terrain where terrestrial communication link is difficult to provide, the Reserve Bank had constituted a Technical Group to examine the proposal for providing satellite connectivity to the bank branches in such areas. The objective is to enable greater penetration of the electronic payment products in the hinterland areas also, by facilitating the integration of the rural and remote branches with the core banking solution platform of the banks and help them providing efficient banking services to their customers. Under the proposal, the Reserve Bank would be bearing a part of the leased rentals for the satellite connectivity, provided the banks use it for connecting their branches in the North Eastern States and in the under-banked districts in the rest of the country. Thus, the Reserve Bank would be providing an incentive to the banks for adopting the satellite communication technology for networking their branches in the remote areas. A discussion paper on this scheme was placed on the Reserve Bank website in June 2008 for public comments. The comments received were examined and the modalities of implementing the incentive scheme are being worked out in consultation with the Indian Banks' Association. I would, however, like to take this opportunity to encourage the banks to be in readiness to embrace this latest technology for further improving the delivery of banking services, specially in the remote parts of the country, with a view to enhancing financial inclusion.

Financial Inclusion

Last but not the least, let me now dwell briefly on the issue of financial inclusion, in which the banks have a major role to play. Given the socio-demographic complexities in India, the policy endeavour of the Reserve Bank has been to adopt a multi-institutional and multi-instrument approach to comprehensively address the issue of financial inclusion in all its dimensions, going beyond mere availability of credit to the masses. The term 'financial inclusion' needs to be understood in a broader perspective to mean the provision of the full range of affordable financial services, *viz.,* access to payments and remittance facilities, savings, loans and insurance services by the formal financial system to those who tend to be excluded from these services. The Reserve Bank, while recognising the concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, has been urging the banks to review their existing practices to align them with the objective of achieving greater financial inclusion. The Reserve Bank too has taken a number of measures with the objective of attracting the financially excluded population into the formalised financial system. Let me briefly recount some of the measures taken in this direction.

With a view to achieving greater financial inclusion, banks were advised in November 2005 to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. All the public and the private sector banks as well as the foreign banks, except those not having significant retail presence, are reported to have introduced the basic banking 'no-frills' account.

With the objective of providing hassle-free credit to the banks' constituents in rural and semi urban areas, the banks were advised in December 2005, to consider introduction of a General Credit Card (GCC) to such constituents. The card was to have a credit limit of up to Rs. 25000/-, based on the assessment of income and cash flows of the household without insistence on security or purpose or end-use of credit. The credit facility was to be in the nature of revolving credit entitling the holder to withdraw up to the limit sanctioned. The banks are required to charge appropriate and reasonable interest rate on the facility.

In January 2006, banks were permitted to utilise the services of non-governmental organisations (NGOs/SHGs), micro-finance institutions and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator and business correspondent (BC) models. The BC model allows banks to do 'cash in - cash out' transactions at the location of the BC and allows branchless banking.

The matter of issuing passbooks to the small depositors has been a nagging issue for sometime past. As we all know, the pass books provide the account holders a ready reckoner of the transactions in their accounts and is a convenient reference document – which can not be substituted by periodical bank account statements, particularly by the small account holders. Since non-issuance of the pass books to the small customers could indirectly lead to their financial exclusion, the Reserve Bank had advised the banks in October 2006 to invariably offer the pass book facility to all its savings bank account holders (individuals) and not to levy any charge from the customers therefor. I do hope that the banks, particularly those with greater reliance on technology, have instituted necessary measures to ensure that non-provision of pass books does not become yet another source of financial exclusion.

With a view to facilitating the opening of bank accounts by the common man through a simplified KYC procedure, in the Mid-Term Review of the Annual Policy of the Reserve Bank for the year 2006-07, it was announced that the "banks could open accounts of low balance / turnover (where the balance does not exceed Rs. 50,000/- in all the accounts taken together and the total credit in all the accounts taken together is not expected to exceed rupees two lakh in a year) only with self certification of address by the customers and his photograph." However, this policy announcement is yet to be operationalised as the matter is under consideration of the Government in the light of the provisions of the Rules framed under Prevention of Money Laundering Act.

Promoting credit counselling and financial education of the clientele of the banks is also an area that deserves due attention of the banking community. Towards this objective, the banks were also advised by the Reserve Bank to make available all printed material used by retail customers in the concerned regional language. As far as the Reserve Bank itself is concerned, it has launched on 18 June 2007, a multilingual website in 13 Indian languages on all matters concerning banking and the common person so that the language does not become a barrier to acquiring financial education by the public at large.

Conclusion

I have tried to present a broad overview of the progress achieved by the Indian banking sector in the post-reform era over past two decades or so. While we have no doubt on significant progress made in several fronts in the banking arena, the enduring challenge of ensuring much greater financial inclusion, to my mind, is the mightiest one facing the banking industry and also the Reserve Bank, as the regulator and supervisor of the banking system. Appropriate leveraging of technological innovations holds the promise of providing a cost-effective solution to this challenge. I am sure the Indian banking industry would make concerted efforts at evolving and embracing 'appropriate technology' to secure fullest financial inclusion of the Indian populace, in the days to come.