GOVERNOR'S OVERVIEW: ANNUAL REPORT, 2014-15

1. The Reserve Bank's Annual Report informs the people of India on what RBI intended to accomplish during the past year and what was actually done. In it, RBI also lays out proposals for the coming year. Our actions are influenced both by the current macroeconomic environment as well as our broad medium-term framework for the development of the financial sector.

Challenges in the Current Macroeconomic Environment

2. Despite the immense efforts in recent years of both the Government and RBI to restore macroeconomic stability to the economy, three areas are still "work in progress" from RBI's perspective. First, economic growth is still below levels that the country is capable of. Second, inflation projections for January 2016 (as of early August 2015) are still at the upper limits of RBI's inflation objective. Third, the willingness of banks to cut base rates – whereby they forego income on existing borrowers in order to attract more new business -is muted; not only does weak corporate investment reduce the volume of new profitable loans, some bank capital positions, weakened by NPAs, may prevent them from lending freely.

3. The short term macroeconomic priorities of the Reserve Bank are therefore clear: focus on bringing down inflation in line with the proposed glide path; work with the Government and banks on speeding up the resolution of distressed projects and cleaning up bank balance sheets; ensure banks have the capital to make provisions, support new lending, and thus pass on future possible rate cuts.

Inflation Objective

4. RBI signed a historic agreement with the Government, wherein RBI's mandate is clearly spelled out in terms of a flexible inflation objective over the medium term. This year, the Finance Minister proposes to lay out, after consultation with RBI, the structure of a monetary policy committee that can be formally and legally entrusted with policy decisions. This is a welcome step forward in building the institutions we need for transparent and independent monetary policy.

5. Turning to liquidity management, RBI has largely moved from windows where banks can get liquidity at fixed prices to auctioning liquidity in the market. The intent is to undertake sufficient operations to keep the weighted average call money rate (purged of off-market transactions effected by co-operative banks) close to the policy rate. In choosing between auctioning short term instruments (such as overnight repos and reverse repos) and long term instruments [such as Open Market Operations (OMOs)] to manage liquidity, the Bank estimates the pace at which it wants to grow its "permanent" assets, consisting of the sum of foreign exchange reserves and government bonds, and decides accordingly.

Stressed Assets and Speedy Resolution

6. In dealing with stressed bank assets, RBI has been focused on getting the underlying real projects back on track. There are a number of impediments here. First, the stigma as well as the provisioning (and the associated fall in profitability) attached to a loan being labelled "non-performing" makes banks eager to avoid the label. In some cases, they ignore the reality that existing loans will have to be written down because of the changed situation since they were sanctioned (which includes extensive delays, cost overruns, and overoptimistic demand projections). Regulatory forbearance, where RBI makes it easy for banks

to "extend and pretend" is not a solution. Since no other stake-holder – such as the promoter, tariff authorities and tax authorities - contributes to resolution, the real project limps along becoming increasingly unviable. Meanwhile, analysts grow increasingly suspicious of bank balance sheets and the growing volume of "restructured" assets. Second, some large promoters take advantage of banker fears about assets turning non-performing to extract unwarranted concessions, without any sacrifice in the value of their stake. The judicial process, despite a variety of creditor-friendly bills like the SARFAESI Act, further tends to hamper the ability of creditors to collect their just dues from influential promoters.

7. To remedy both the paralysis as well as the unfair distribution of losses, RBI has taken a number of actions. First, it has created a database of loans over ₹50 million (the CRILC database), and has advised banks and NBFCs to report regularly on the status of the loans. Early identification of distressed projects offers the best opportunity to put them back on track. So if a loan is identified as more than 60 days overdue, all lenders to the borrower have to come together in a Joint Lending Forum (JLF) to see how the underlying problems can be fixed. The JLF has to follow strict timelines, failing which the project loans' classification has to be downgraded. On the other hand, if the timelines are met, the deterioration in loan classification is halted. Furthermore, by bringing the creditors into one forum, RBI has made it easier for the promoter and the creditors to reach a consensus on actions, even while making it harder for the promoter to play one creditor off against another.

8. Some other regulatory actions are worth noting. RBI ended the forbearance accorded to restructured loans. Henceforth, restructured loans will be classified as non-performing loans. To deal with genuine problems of poor structuring, however, it has allowed bankers to stretch repayment profiles for performing loans to infrastructure and the core sector (the so-called "5/25" rule), provided the project has reached commercial take-off, has a genuinely long commercial life, and the net present value of loans is maintained. RBI is undertaking periodic examination of randomly selected "5/25" deals to ensure they are facilitating genuine adjustment rather than becoming a back-door means of postponing principal payments indefinitely. Also, in cases of restructuring, RBI and SEBI have together allowed banks to write in clauses that allow banks to convert loans to equity in case the project gets stressed again. Not only will such Strategic Debt Restructuring give creditors some upside, in return for reducing the project's debt, it can also give them the control needed to redeploy the asset (say with a more effective promoter).

9. Going forward, RBI has to monitor the efficacy of the various measures put in place to speed up resolution, and take remedial action where necessary. The move by the Government to add to the recapitalisation fund for banks is also welcome, as is the proposal to allocate it taking into account the progress in cleaning up balance sheets and generating healthy growth. RBI will welcome progress in the coming year on the creation of the institutions necessary for resolution such as the new Bankruptcy Code and the Company Law Tribunals that will administer it and the Financial Resolution Authority (for resolving financial institution distress).

Medium Term Challenges

10. A regulatory view, fashionable in the past, was that the pace of regulatory reforms had to be limited by the capacity of our banks, especially our public sector banks (PSBs). The current stress in the banking system suggests that the real economy will not wait for the banking system, and a slow

pace of reform could lead to greater, rather than lower risk residing in the banking system. Financial sector reforms need to move on many fronts.

11. For a country as big and populous as India, reforms cannot be shots in the dark, subjecting the economy to great uncertainty and risk. Wherever possible, we have to move steadily but firmly, ever expanding the scope of reforms while always limiting the uncertainty they create. The Chinese term this 'Crossing the river by feeling the stones'. It is an appropriate metaphor to guide our own reforms.

12. In the financial sector, we need to increase efficiency through greater entry and competition. The most appropriate institutions will prevail when the competitive arena is level, so we have to remove regulatory privileges as well as impediments wherever possible, especially those that are biased towards some form of ownership or some particular institutional form. We need more participation in our financial markets to increase their size, depth, and liquidity. Participation is best enhanced not through subventions and subsidies but by creating supporting frameworks that improve transparency, contract enforcement, and protections for market participants against abusive practices. Technology can be very helpful in reducing the costs of supportive frameworks, and can bring hitherto excluded populations into the financial fold. It is these ideas that guide our medium-term reform strategy. Let me be more specific.

Banking and Other Financial Institutions

13. The banking system is dominated by PSBs. While a number of extraordinary officers have led PSBs over time, recent bank underperformance suggests room for improvement. Following the Nayak Committee Report, the Government has decided to separate the posts of Chairman and Managing Director of these banks, follow a more open search by considering private sector candidates also for a number of these posts, and professionalise the Boards of these banks by inducting professional Board members with the relevant experience. Going forward, the Government intends to set up a Bank Board Bureau (BBB), composed of eminent personalities with integrity and domain experience, to take over the appointments process.

14. RBI has also stepped away from micromanaging the functioning of the PSB Boards through regulations, allowing Boards to determine how they will carry out their responsibilities for strategic planning, risk management, accounting, *etc.* RBI has also liberalised the compensation of private bank Board members, while maintaining some checks, to ensure Board members are properly incentivised.

15. Because PSBs compete in the same market place for talent as do private sector banks and foreign banks, and because skill gaps are increasing at middle management levels because of past hiring freezes, they will be unnecessarily hampered if they are unable to pay appropriate compensation to middle and senior managers, as well as Board members. Of course, higher pay should come with better accountability for performance. Given that many PSBs have higher overall costs than private sector banks performing similar activities, there is some scope for cost rationalisation even while improving the pattern of compensation. At the same time, we should recognise that PSBs undertake public interest activities (like the rollout of accounts under the *Pradhan Mantri Jan Dhan Yojana*) that are not always fully compensated. Government should endeavour to keep the competitive playing field level by fully compensating banks for activities it wants undertaken in the public interest.

16. A committee under RBI Deputy Governor Shri Gandhi has detailed the ways governance in urban co-operative banks (UCBs) can be improved, including through implementation of the Malegam Committee report. Licensing of new UCBs will follow after the committee's recommendations are evaluated and implemented. The committee has also proposed modalities by which well-functioning co-operatives, including multi-state co-operatives, can convert to joint stock companies.

17. The banking sector will experience a substantial change in the nature of competition as two new universal banks start operations, and a number of payment banks and small finance banks are approved this year for license. Payment banks are expected to offer bank accounts in every corner of the country, facilitating payments and cash transfers through new technologies and physical access points. Small finance banks are expected to channel loans and financial services to small players. The MUDRA Limited will also help in such efforts through refinancing and securitisation services to unincorporated lenders. After reviewing the experience with this first round of licenses, RBI intends to put the licensing process "on tap", with applications being considered as and when they come in.

18. Non-Banking Financial Companies (NBFCs) are an integral and important part of our financial landscape. RBI has endeavoured to streamline regulations across NBFCs, reducing the regulatory burden in case an NBFC is not systemic, does not face retail customers, or does not raise money from the public. It has also harmonised regulations such as NPA norms, capital requirements, provisioning requirements across different types of NBFCs as also between NBFCs and other financial institutions.

Other Regulatory Changes

19. New Basel norms on regulation will require implementation. The Reserve Bank has put out frameworks on the Leverage Ratio, Countercyclical Capital Buffer, Capital for Domestic Systemically Important Banks, the desirable extent of large exposures, and various liquidity ratios. While tailoring the international accords to domestic conditions, the Reserve Bank intends to meet international commitments on schedule.

20. With rapid changes in regulations, we need to go back periodically and revise the entire regulatory handbook. With this in mind, the Reserve Bank plans to come out by January 1, 2016 with thoroughly revised master documents covering different regulatory issues. Each of these master documents is intended to become a complete user-friendly compendium of applicable regulations on a subject. Each will be updated in real time, and will attempt to streamline and simplify regulations where possible.

Supervisory Changes

21. Even as our regulations change, supervision has to keep pace. We are working on improving our collection and dissemination of information, on refining our methods of inspection and analysis, and on enhancing the capabilities of our staff. We will continuously rationalise regulations but will come down hard on non-compliance when detected.

22. More information is being collected and disseminated through the CRILC database of large loans, through a new fraud registry which is being supported with a detailed framework on detecting and dealing with banking frauds, and through a new Early Warning System to track bank stress. Going forward, we plan to integrate all our supervisory data into a seamless database.

23. RBI moved to risk-based supervision of some of our larger banks in 2013. We have

been evaluating our experience and refining our methods, including validating them with the assistance of multilateral agencies. We are also working on systemic risk assessments through our Financial Stability Unit.

24. With changes in technology, cyber security, both at the bank level and at the system level, has become very important. 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.

25. Finally, RBI will help State Level Coordination Committees (SLCCs) become more effective so that they can ferret out unauthorised financial operators before they can misuse public trust. SLCC sub-committees will keep regulators and law-enforcement authorities in constant contact. RBI will help SLCCs develop websites, where the public can get, and give, information about the legitimacy of financial schemes offered by non-bank operators.

Debt Management and Markets

26. RBI has been managing central government and state government debt issuance with a view to reducing risks even while minimising transactions- and financing costs. This means, among other things, articulating a clear medium term debt strategy, spreading issues over different maturities so that there is no bunching of securities, and switching or buying back certain maturing issues. It also means improving liquidity, resilience and depth in the market for government securities by expanding the role of long term players like pension funds and insurance companies, creating more, and predictable, room for Foreign Portfolio Investors, and making it easier for domestic retail investors to participate through their "demat" accounts.

27. In addition to issuing debt on the government's behalf, RBI works closely with the central government and state governments to facilitate the government's electronic payments and receipts, as well as its accounting. Increasingly, through its e-Kuber platform, RBI has been undertaking some functions itself to reduce costs.

28. The Government has announced its intent to move debt management to a separate agency, the PDMA. While the public discourse has sometimes suggested large reductions in government bond yields from setting up an independent PDMA with no conflicts of interest, these stem primarily from such an agency being unable to sell debt to captive government-owned or regulated institutions, thus forcing the government to reduce fiscal deficits. Given the Government has embarked on a fiscal consolidation path, the benefit from such discipline may be small. At any rate, RBI is working closely with the Government in setting up the PDMA.

29. RBI recognises the role of a vibrant financial market in complementing and competing with the banking system in allocating and absorbing risks. Our focus is on improving the variety of products and participants, as well as on reducing the costs of transaction, all the while keeping financial stability in mind.

30. To improve activity in the corporate debt market, RBI has allowed banks to issue long term bonds that will be free of regulatory pre-emptions. It has encouraged the emergence of an international rupee market by allowing multilateral institutions to issue rupee bonds abroad, and will permit Indian corporates to also do so. It is also exploring ways by which banks can enhance corporate bond credit ratings through credit

facilities. Ultimately, though, a robust bankruptcy system is needed for the corporate bond market to really take off. The Government has indicated it will move quickly to put this in place.

31. RBI has encouraged the development of new instruments such as exchange traded interest rate futures. It plans to open the way to interest rate options, a variety of swaps (including a swap execution facility), as well as cross-currency futures and options. Where possible, RBI will be more liberal in allowing a variety of instrument designs and participation when an instrument is initiated, putting greater focus on stability issues once trading picks up.

Currency and Payments

32. Our country still depends on physical currency in many transactions. RBI is constantly seeking to improve the quality of bank notes it issues, even while making sure that notes are available wherever needed. A new series of bank notes are being issued, and we also intend to start a pilot project with plastic/polymer bank notes. We have also examined the logistics of currency distribution and we intend to make significant changes in our current model, with a greater focus on incentivising banks to take over storage and distribution of currency. Moreover, we will emphasise the decentralised return of coins (into coin machines and through coin collection programs) and notes (through ATMs that accept cash and re-circulate it).

33. It is a reality that cash use will fall off over time, lowering transactions costs and reducing the role of black money. RBI is working with the Government to incentivise electronic payments. New institutions, such as the Bharat Bill Payment System, and new technologies, especially through mobile phones, will emerge that will facilitate such payments. While RBI recognises the need for regulatory adaptation, and will work with stakeholders to achieve that, it will not brook the violation of existing regulations simply because a user thinks they are outdated. For instance, after asking an operator to cease violating rules on small value payments, RBI has permitted issuers to dispense with two factor authentication for small value payments, provided some safeguards are in place. Over time, RBI believes mobile- and Internet-based payments will explode, and is working with the financial sector to facilitate them.

Financial Inclusion

34. The *Pradhan Mantri Jan Dhan Yojana* has created a base of accounts for much of the population. Government has taken the next step of attaching a variety of financial services such as accident and life insurance to these accounts, and sending Direct Benefits such as scholarships, pensions, and subsidies to these accounts. We also have to ease access to bank accounts through Business Correspondents, payment banks, and point-of-sales machines so that they are used frequently. Easy payments, access to cash-in and cash-out facilities, and widespread availability of safe savings instruments have to be our next objectives in financial inclusion of households.

35. We also need to ease lending to small producers, whether they are farmers, Self Help Groups, or businesses. For this, we need to improve the structure and working of credit information bureaus, collateral registries, and debt recovery tribunals – ironically, credit flows easily only when the lender is persuaded that he will get his money back, so easier access to credit necessitates closer attention to default prevention mechanism. Perhaps the most important source of collateral value is land. We need better digital mapping and clean records of land ownership across the country so that it can be used more effectively as collateral.

36. New institutions like the Trade Receivables Discounting System (where small firms can post their receivables from large firms for sale) and Small Finance Banks are being set up to facilitate credit flow to small firms. The MUDRA Limited is also likely to propose innovative new ways of channelling flows to small producers.

37. Priority sector in India pertains to those sectors of the economy which, though viable and creditworthy, may not get timely and adequate credit in the absence of any special dispensation. Typically, these are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections. In the context of India, such sectors are spread across the length and breadth of the country and especially prevalent in the hilly and coastal regions.

38. Priority sector activities have to be carried out by banks as part of their normal business operations and, therefore, banks are expected not to view this as a Corporate Social Responsibility. On the part of the Reserve Bank, one important facilitation in this regard has been that pricing of all credit has been made free, though with the expectation that pricing should not be exploitative. Priority sector efforts will not be successful unless market players are willing to take risks by innovating structures, products and processes.

39. RBI revamped priority sector guidelines so as to reemphasise lending to excluded or nationally important sectors in a changing economy. In particular, it set new targets of 8 per cent of Adjusted Net Bank Credit to small and marginal farmers and 7.5 per cent for micro enterprises, while allowing medium-sized firms, social infrastructure such as toilets, and renewable energy investments to qualify for priority sector credit.

40. Financial inclusion also means greater consumer protection for the newly included and typically unsophisticated customers, an easily-accessed and speedy grievance redressal process, and expanded efforts on financial literacy. Following public consultation, RBI has developed a Charter of Consumer Rights. Bank boards have been asked to put in place frameworks that ensure those rights are protected. After those frameworks have been in operation for some time, RBI will take a view on best practices, and needed regulation, if any. In the meantime, field visits by RBI, to check mis-selling as well as proper functioning of bank infrastructure such as branches and ATMs, will be expanded.

41. RBI is reviewing its Banking Ombudsman system to see how it can be extended to non-banks and how it can be more effective in rural areas. Each bank has also been asked to set up an internal Ombudsman system, which will examine the bank's grievance cases to see if resolution is possible before it is escalated to RBI's ombudsman system.

42. Financial literacy, whether through courses in schools, through literacy camps organised by banks and RBI, or through newspaper or social media campaigns, is extremely important. All too often, unscrupulous operators have discovered that greed trumps education – even the sophisticated fail to apply the maxim that if it is too good to be true, it probably is… Nevertheless, it is our duty to try and educate our public and we have to be better than the unscrupulous at exploiting new technologies, including mass and social media, to reach them. RBI intends to increase its focus on such campaigns significantly.

RBI's Organisational Changes and Human Resources Development

43. To respond to its changing responsibilities, especially the need for more specialisation, the

Reserve Bank created some new departments, merged others, and reorganised all into 5 clusters: 1) Monetary Policy and Research; 2) Regulation and Risk Management; 3) Supervision and Inclusion; 4) Financial Markets and Infrastructure; and 5) Human Resources and Operations. The restructuring was carried out this year.

44. Henceforth, most officers will be recruited through a revamped common entrance exam (starting 2015), given an overall view of the Bank during initial training, and then encouraged to specialise in a couple of clusters in their early years. To encourage specialisation, the Bank will also consider promoting some particularly capable employees in situ. For most employees, however, as they become more senior, skill building will shift from acquiring technical skills to acquiring managerial skills. At very senior levels, these officers will again be posted freely between clusters.

45. The Bank intends to make more postings based on the Bank's needs and the staff member's specialisation interests. This also means that we have to help staff assess their own aptitude through an Assessment Centre and help them identify their strengths and weaknesses through a more discriminating Performance Evaluation System. We also must identify the needs of various jobs through careful job profiling. Staff members have to be given the training support, including through scholarships, to build necessary skills as well as to remedy identified gaps. We plan to set up an RBI Academy to offer higher-order skills to RBI staff and bank officials. And staff members who consistently perform well should also be rewarded with more challenging assignments. All this will require substantial effort in the area of Human Resource Development, but is absolutely necessary.

Conclusion

46. RBI is an efficient organisation, which has steadily reduced its employee count from 35,500 in 1981 to 16,700 today, even while performing ever increasing quantities of work. The surplus it generated from its activities this year is ₹659 billion, which has been paid out entirely to the Government. There is, of course, always scope for improvement. For example, to ensure that we meet our commitment to the public, we have put out on our website timelines within which the public can expect responses to applications made to RBI. We will monitor those timelines to ensure our staff delivers as promised.

47. A key factor in RBI's success has been a satisfied staff. In the past, RBI used to have no problem attracting junior officers, losing only an occasional officer who was successful in the IAS exam. Today, we lose more than we should be comfortable with. This is why a revamp of the professional challenges we offer our staff is very much needed, and we hope the changes outlined earlier will help us become a more attractive employer. In this regard, our review of compensation, as well as the long-pending improvement in pensions for our retirees also assume importance.

48. Let me end by thanking all my 16,700 colleagues for their work in the past year and challenging them, in the 81st year of this great institution, to do even better so that the Reserve Bank of India continues to help the nation secure prosperity and economic opportunity for all for many years to come.