Talk delivered by Smt. Usha Thorat, Director, CAFRAL on the occasion of decennial celebrations of FISAT(Federal Institute of Science and Technology) Business School(FBS)- Annual Lecture Series on November 25, 2011 at Ernakulam , Kerala

Challenges before Indian banks in the next decade

Will Durrant, the legendary historian, once remarked that most of us spend too much time on the last twenty four hours and too little on the last 6000 years. Two thousand years ago, India had the largest GDP in the world. China was close behind. Together, they accounted for more than half of global GDP. And this was at the height of the Roman Empire in Europe, which accounted for just 10 per cent of global output. Over the next 1,800 years, the two Asian giants remained the largest economies in the world, with China pulling ahead of India about 500 years ago. Then, came the Industrial Revolution in Europe. By the start of the First World War, Europe and America accounted for more than half of global GDP. By 1950, the share of India and China fell to less than 10 per cent. China is already the second largest economy in the world, India the fourth largest. According to Deutsche Bank's forecasts, China's economy will become the largest in the world in 2022. India is projected to become the world's third largest economy by 2015. The 21st century is likely to be the "Asian Century", much as the 20th century has been described as the "American Century", and the 19th century the "British Century".

2. In this context, let us look at the kind of challenges which Indian banks are likely to face in the next decade? Banks deal with money and money, as Karl Marx wrote in the Communist Manifesto, plays the largest part in determining the course of history. First, banks need to continue to undertake the task of financial intermediation to maintain a sustained growth rate of 8 to 9 per cent. The traditional role of banks will still be the most critical one in India for the next decade. Second, as part of financial inclusion banks will have to go beyond the

initial steps of providing a banking location and opening no frills accounts and provide whole range of affordable savings, credit , remittance , pension and insurance products. Third, banks will have to meet the needs of infrastructure and urbanization. Fourth, Indian banks need to become global -they need to grow commensurate with the growth of Indian corporates and meet their requirements in India and across the globe. At the same time, the overseas offices will have to become more competitive. Fifth, banks will have to face more competition especially for their blue chip clients. This competition will not only come from foreign banks operating in India but also from new banks that may enter the system. It will come from cross border lending as the external account gets more liberalised as also from financial markets as top rated companies choose to enter the markets directly both within the country and outside.

3. To meet the challenges of the next decade, banks will have to exploit technology, raise capital, gear up their capital planning, risk management and pricing systems and finally and most importantly pursue HR policies to attract talent, reskill and develop their existing staff and groom leaders.

Challenges of mobilising financial savings

4. One of the drivers of Indian growth has been the high level of savings. The savings rate in India is 32.5 per cent of GDP today (2008-09) compared to 22.3 per cent ten years ago (1998-99). The contribution of the household sector to savings is 70.0 per cent. While the overall savings ratio has increased significantly, financial savings has remained at around 50 per cent of household savings. Within financial savings share of bank deposits has increased from 33 per cent in 2000-01 to 55 per cent in 2008-09. Achieving higher rates of growth would call for higher financial savings and this in turn implies much greater penetration of banks and other financial intermediaries like insurance companies, mutual funds and pension funds. Moving people’s preference away from physical savings like in real estate and in

gold will require banks to be much more aggressive in offering savings products that meet the need of households. Achieving higher level of financial savings would no doubt require a benign inflationary environment. The recent deregulation should be viewed from point of view of whether it will encourage more savings to come into the banking system.

Challenges of financial inclusion –dealing with hundreds of millions

5. Civilisations have largely gone by the golden rule that those who have the gold make the rules and the basic rule is to make more and more gold for lesser and lesser number of people. This has to change. I believe that the challenge of the next decade is going to be financing of millions in the rural sector, in the unorganized sector, in the micro and small enterprise, and meeting their needs of production consumption and investment. In particular, the consumption needs for education and housing need to be met at an affordable cost as these constitute investment in human capital. Attempts at drawing the excluded households into the formal banking system through financial inclusion is only one and albeit a very first step. The number of borrowers who had borrowed Rs.25,000 and below from banking system rose from 36.8 million 2004 to 39.2 million in 2009- an increase of just 2.4 million. The number of borrowers who borrowed less than Rs.2,00,000 increased from 61.9 million in 2004 to 95.8 million in 2009- increase of nearly 34 million. If we take Rs 2 lakh as roughly the limit for meeting the needs of the bottom and lower segment of the pyramid, and we want the coverage of those borrowing less than Rs.200000 to increase to at least fifty per cent of adult population in the next three years, the number of borrowal account will have to increase by at least 41.3 per cent per annum.

How are banks going to deal with this scale? Standard products like GCC /ODs against savings products at affordable rates will have to be offered going by the track record in savings and recovery, rather than looking for salary certificates or collateral. If the scale of lending to the low income house holds has to increase on the scale required, several interventions are needed some of which have already been taken. To make them take a big leap forward, banks will have to have the assurance of credit guarantee to cover atleast a part of their lending for small farmers, micro and small entrepreneurs, affordable education and housing. Development financial institutions are best played to make such interventions. Already today SIDBI offers a credit guarantee product for loans to MSE where there is no collateral –the scheme has been made more user friendly. Similar credit risk mitigation products will need to be evolved for small farmers who cannot offer any document of proof of possession of land farmed by them as also landless engaged in non farm and allied activities. Such credit guarantees are also required for loans affected by widespread distress in the event of successive and repeated natural calamities. National Housing Bank is already in the process of evolving product for credit guarantee for low income housing. IBA has approached the Government with a credit guarantee product for education loans to students from poor families. The second intervention is to ensure that there are well documented and digitized property rights through a registry which could be relied upon by banks. Some initiative for this has been taken. Third, the SHG model and the Business correspondent model will have to be well honed by banks and a massive training and certification system launched for banks to get sufficient numbers who can serve at BC outlets. Other interventions required are ensuring unique identification so essential for fulfilling the banks KYC norms –which is already being attempted through the UID project. Having reliable credit records on all individual borrowers as also businesses is essential for banks and financial institutions to get a reliable credit report. The role of credit information companies in this context is worth mentioning. Ensuring a healthy credit culture requires building up comprehensive and accurate credit records that can provide information to prospective lenders and creditors. It can also help build up risk profile in different sectors and regions and other granulated data that can assist lending institutions in meeting the challenges of dealing with large numbers. This however needs the full cooperation of credit providers in populating such data base quickly and accurately. It is hoped that the five credit information companies including those recently licensed will fulfill the role expected of them.

Challenges of Lending to MSEs

6. I would like to specially focus on the micro and small enterprise sector which will be the mainstay of the banks business strategies. This will be especially true as larger borrowers access global markets for their financing needs at more competitive rates. There are a number of issues in this sector –there is lack of full information and a degree of opacity, there are hurdles in obtaining the application in the matter required by banks, credit scoring models are yet to be tested through business cycles, the sector is vulnerable to downturns and business conditions of the larger units to whom they sell their goods and services. Credit history is unavailable or even where available not reliable. While relationship or transaction banking characterizes this sector, there are a whole lot of non fund based services that the sector needs that can be provided by banks. Banks will have to approach this sector differently with investment in handholding which perhaps does not yield results immediately but will be critical if banks have to lend to this sector without the fear of rising NPAs and without lending to this sector no bank can have a steady and sustained growth.

Challenges of Lending for Infrastructure

7. The aspiration for higher growth implies much more investment in infrastructure in the traditional sense of roads ports bridges power water and telecom but also to meet the needs of rapid urbanization. Needless to say, the headroom available in

government finances either at the State or Central level for funding or for guarantees (explicit or implicit) is limited. This calls for funding from both financial institutions and capital markets, both domestic and external. The single borrower and group borrower exposure limits of banks have already been relaxed to allow for more funding for infrastructure by Indian banks. Taking into account the concentration risk and asset-liability mismatches, any further relaxation would be imprudent. This makes the issue, of finding alternative sources of finance for infrastructure projects, critical. RBI has already taken a number of measures in this regard including permitting higher exposure limits for infrastructure, introducing repos in corporate bonds, permitting CDS for corporate bonds, creating a separate category of NBFCs (NBFC-IFCs), etc. The Government has recently come out with a broad structure of Infrastructure Debt Funds (IDFs) which, when set up, might also provide an alternate source of financing. Basel III requires a high level of liquidity to be maintained through a pool of liquid assets. The definition of liquid assets is very stringent including the requirement that they should be freely available. While the Indian banks maintain a large pool of liquid assets through SLR requirement, strictly speaking, these may not qualify as liquid assets under Basel III because SLR requirement, being mandatory, needs to complied with at all times. As was pointed out by Mr Anand Sinha Deputy Governor in a recent speech, “our dilemma is that asking banks to maintain more liquid assets in addition to SLR would put them in a competitively disadvantageous position. We have, therefore, to consider as to what extent the SLR can be reckoned towards Basel III requirements for holding liquid assets.”

Challenges of Going Global

8. 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 188. In the light of the global trends in economic growth, in the next decade Indian businesses and banks will need to look to China and SE Asia for expanding their businesses and forging

relationships. This would require at least some of the banks to be of a size on par with the larger global banks although not in the top ten or even twenty. The growth of banks globally has been linked to the crossing of borders by the country’s businesses and people. Indian companies that have gone global have already established banking relationships with the global banks. Hence it is a tough area where the competition is keen. Indian banks have to seek out pockets of sound and stable economic growth. They have to locate areas where Indian businesses are acquiring businesses overseas and aggressively procure such businesses. In a speech at the bankers conference last year Governor Subbarao said “ Indian banks should increase their global footprint opportunistically even if they do not get to the top of the league table.”

Challenges of Greater Competition

9. Muhammad Ali, the famous boxer once said ‘It’s not the size of the man in the fight… it’s the size of the fight in the man which determines victory. That’s competition. As I said at the beginning, banks will face more competition from global markets and domestic markets especially for their top notch clients as the markets develop and integrate more with global markets. Even in this year the banks are facing competition as their best clients prefer to raise funds abroad rather than from them. Some competition may come from foreign banks as they operate through subsidiaries and some competition from new banks. Banks will also find that the best rated borrowers may approach the markets directly for CPs, NCDs etc. Banks will have to provide more innovative products to meet the specific needs of their clients. These are areas where expertise and skills are more important and banks will face competition in attracting such skills.

The challenges are many but how are banks going to meet them ?

Harnessing IT for payments system, product delivery and internal control

10. Although Einstein was pessimistic when he said that 'it has become appallingly obvious that our technology has exceeded our humanity", nevertheless the fact remains that this is perhaps one of the most creative and innovative times in human history when the environment is suffused with all kinds of creative possibilities made possible by technology. To achieve financial inclusion in its more meaningful sense, technology provides the opportunity for scaling up and increasing outreach, reducing transaction cost and managing risks. Second, banks are quickly realizing that with the rise of stored value cards and mobile wallets, they are facing competition in their most traditional area viz. payments. There is a huge challenge and opportunity for banks as the Indian government seeks to convert subsidies into direct cash transfers to the poor. The requirement that NREGA payments should be done through bank accounts is the beginning of this phenomenon. Unless banks take active steps to make the required investments to put in place points of service for cash in cash out in a ubiquitous interoperable manner, they may find that this opportunity will slip through their fingers. Hence banks have to move strategically in forging links with retail chains for acting as BCs for both ensuring an effective payments mechanism as also provide the range of the most basic financial services needed by the common households across the country while relying on IT to provide the MIS required for managing the risks.

Challenges in ensuring adequate capital to support growth

11. Apart from the extent of household of savings that banks can draw into the banking system, a major factor that will determine banks ability to facilitate high growth will be their ability to garner capital. The effective common equity requirement considering the capital conservation buffer would be 7 % when Basel III requirements are fully in place. Looking at the patter of GDP going forward, considering that GDP may be coming more from manufacturing whose credit intensity is higher, and there will be greater financial penetration, capital needs

would increase even for the same increase in GDP. Over the last 5 years, banks have been able to increase their Tier 1 capital by an annual average of nearly 30 per cent while their risk weighted assets increased over this period by more than 26 per cent.. The return on capital in Indian banks has been averaging at around 13.4 per cent. To maintain atleast a growth of capital commensurate with growth in risk weighted assets , so as to maintain existing capital ratios, would require banks to keep a tight control over the riskiness of their assets. The biggest opportunity lies in moving towards more advanced approaches under Basel 2. The biggest advantage of Basel 2 is that capital is based on risk and hence it incentivizes banks to create proper risk measurement and management system within banks. Hence adoption of IRB approach will help Indian banks to meet the requirements of growth without impairing their soundness and safety. Adoption of IRB also has other advantages ;it enables banks to price risk appropriately and target risk adjusted return across the variety of its businesses and locations. This further helps in performance measurement and performance based incentives for staff.

One of the big lessons of the global crisis is that the three key aspects in banking viz capital planning , product pricing, risk management have to be integrated in the business strategy. In particular at the top management level - at the Board level and the senior executive level - these roles need to be enmeshed well so that it becomes a part of the entire bank. Increase in scope and scale would also manage risk in a much more decentralized manner. This could be done in three ways – in each business unit, in each location or by looking at risk across the bank as per the risk factors. The last approach would require the banks to identify the key areas of risk and monitor those in an integrated across the bank. For example, taking forex risk –this could be direct or indirect through direct forex exposures or on account of exposure to clients with forex risk. This could be present in all segments of business and locations and will need to be managed consciously. The bank may want to monitor its risks on account of its exposure to infrastructure or real estate across businesses and locations. It is now realized by banks that all the efforts spent on promoting growth of business and earning profits can come to naught by taking huge risks which can wipe out the capital. Hence the importance of putting in place a sound risk monitoring and management systems as business grows is something which cannot be emphasized enough. But this needs a supportive IT system to get reports in a timely and intelligible fashion.

Challenges of human resources management

12. The real vital value of a bank is the experience, skills, innovativeness and insights of its people. In one word, human resources. The biggest challenge for Indian banks in the next decade lies in human resources management. A recent study by McKinsey & Company on human capital in Indian banking pointed out that as about 7 lakh employees of public sector banks retire over the next decade these banks will have to recruit on a massive scale, keeping in view the changing roles of the employees and the skills required. Even if the challenges of the next decade outlined by me were not present, mere filling up the vacancies with the right numbers and skills itself would have been a huge task for the banks.

On top of this if we take the requirements of growth in the real economy and the challenges of globalisation and competition, it is clear that banks are not only going to have to recruit the right kind of people in the right numbers, but will also have to develop the skills and capacities of their existing staff to meet the needs of the next decade. Apart from specialised expert skills in specific areas where banks may have to recruit from the market, it is clear that there will be a huge gap in these and other skills for the system as a whole; hence lateral recruitment can be only a limited option. There is thus no option except to re-skill the existing staff of banks looking at their strengths and competencies for meeting the gaps in various areas of the banks businesses. It is here that institutions like the FISAT business school can aspire to provide customised programs with appropriate pedagogy to bank staff.

At a higher level, banks need to groom leaders by spotting talent sufficiently early and grooming potential leaders at all levels apart from framing and implementing succession plans for key roles.

Conclusion

13. To conclude, the challenges that emerging India offers banks are many , we are lucky to be the second fastest growing economy in the world, we are lucky that our banking system is sound and that our credit markets are functioning . But we have to be equally conscious that there are large pockets of society outside the banking system, meeting whose needs is equally, if not more, important. Hence, as Robert Frost said, there are miles to go, before we can sleep.