Four Frontier Issues in Indian Banking

- D. Subbarao[1]

Thank you Usha. Once again, on behalf of the Reserve Bank and CAFRAL, welcome to all of you. As Usha said, the Reserve Bank attaches a lot of importance to maintaining communication with Directors on the boards of the banks, more importantly, to listening to them. I am conscious that interacting with you can be a rich learning experience for me personally, and I must admit I haven't gone out to actively seek that opportunity. I hope to correct for that going forward. I am happy to note that I recognize many of you and am glad to reconnect with you.

2. I also want to acknowledge the presence in this conference of Shri Y.H. Malegam who is a Director on the Reserve Bank's central board. As I am sure all of you know, he is one of the country's most renowned chartered accountants and adds enormous value to our board deliberations. Separately, in her introductory remarks, Usha mentioned that in the RBI, a lot of thought has gone into designing the composition of bank boards. Characteristically, she has been very modest about it. It was Usha, as Deputy Governor in the Reserve Bank, who led that intellectual effort.

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[1] Edited transcript of comments by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India, at the Conference of Directors on the Boards of Commercial Banks, organized by CAFRAL, on December 13, 2011 in Mumbai.

3. I deliberated on what I should focus on in these introductory comments. I know that you all of you want to hear from me about what's happening in the economy. I saw screaming headlines in the papers this morning; very vociferous exhortation to the Reserve Bank to do something about the rupee depreciation. The exchange rate movement is largely a reflection of what's happening outside the country. Of course, here at home too, there are lots of things happening, and indeed not happening that are moving the exchange rate, and more broadly affecting the mood of the country. All that is in the public domain and I really can't add anything new to those perspectives.

4. There are of course a lot of questions about the global situation. No one has all the answers. But there is one question to which I know the answer. That question is: when is the crisis is going to end. Here is the answer. I came to the Reserve Bank on 5th September, 2008, and on 6th September, Freddie and Fannie happened. On 10th September, AIG happened. On 15th September, Lehman Brothers collapsed, and the global financial sector choked to near death on 16th of September. So, quite naturally, people think I brought on the crisis. So, when people asked when the crisis was going to end, I used to tell them when my term of three years would end so that they can work out the answer to their question on the basis of the already established correlation.

5. But then, on 4th of August 2011, a month before my three year tenure was to end, the Government extended my term by two more years. Mark the date - 4th August 2011. On 5th August, the US debt downgrade happened, and all of you are aware of the momentous events since then. Again, there is perfect correlation

between the Government's decision to continue with me in the Reserve Bank and the crisis taking on another *avatar* at the global level. So, I need hardly tell you when this second wave of the crisis going to end.

6. With the issue of the crisis behind us, what I thought I will do on this occasion is to share with you my thoughts on some of the important issues in commercial banking in India. The four issues that I want to talk about are:

i) Implications of Basel III
ii) Challenges of Financial Inclusion
iii) Financing of Infrastructure
iv) Improving the Efficiency of Indian Banks

7. These are not new issues. You have heard many of us in RBI speak on them, and you yourself must have deliberated on these issues in your bank's boards.

i) Implication of Basel III

8. First, on the implication of Basel III. The basic building blocks are quite familiar: higher and better quality capital, counter-cyclical capital buffers to be built up in good times and drawn down in times of stress, internationally harmonized leverage ratios to contain excessive leverage, stronger minimum global liquidity standards, and better standards for supervision, public disclosure and risk management.

Parameter	Basel III requirement	Actual value for Indian banks as on March 31, 2011	
		Under Basel II	Under Basel III
Capital to risk weighted assets ratio (CRAR)	10.5%	14.2%	12.9%
Of which			
Tier I capital	8.5%	10.0%	9.0%
Common equity	7.0%	9.1%	8.4%

9. The numbers in the table above are as on March 31 this year, and are quick estimates. You will see from the table that, after taking into account the regulatory adjustment to CRAR i.e. Capital to Risk Weighted Assets Ratio, Indian banks, at an aggregate level, fulfill the Basel III norms by a comfortable margin. It is true that a few individual banks might fall short and may have to bring in capital. But at an aggregate level, we are quite comfortable. What is, however, important is that capital adequacy today does not mean capital adequacy going forward. We expect the economy to be growing faster than 7% going forward. As the economy grows, demand for credit will rise, putting pressure on bank credit. Credit demand will increase for at least three important reasons:

- First, India will shift increasingly from services to manufacturing because that is the only way we can accelerate growth and generate the required number of jobs for the millions who will be entering the labour market. I have been told that per unit of GDP, manufacturing is more credit intensive than services. So that is the first reason why credit demand will go up.

- Second, we need to be doubling our investment in infrastructure - an issue to which I will revert later - and that again will put a lot of pressure on bank credit.

- The third factor is financial inclusion. As more and more people come into the formal financial sector, not only will they use banks for savings and remittances, but they will also demand credit.

10. So, for all these three reasons, demand for credit from banks will go up. What this means is that we are going to see the cost of credit going up under the Basel III norms at a time when credit demand is going to pick up. That is something we all need to be sensitive to. Of course, this is not to make a case against Basel III; we must conform to Basel III. I am just saying that we need to balance the costs of Basel III *vis-a-vis* the growing demand for credit from the productive sectors of the economy.

11. The other sub issue under Basel III is procyclicality, which is, you build capital buffers in good times for drawing down in stressed times. About this, there are some concerns. The first is that building capital buffers entails capital costs which will have implications for growth. The second concern is how we calibrate this build up of capital and its draw down. We need to have a 'variable' to calibrate it by. That variable, as agreed upon in Basel III, is the credit to GDP ratio. The broad rule is that when the aggregate credit to GDP ratio goes up and reaches a certain threshold, you start running down the capital buffer. But emerging economies, and most importantly India, are undergoing a structural transformation.

So we expect the credit to GDP ratio to be going up for that reason. An increase in the ratio of credit to GDP in India cannot therefore be a good indicator of a credit bubble building up. So, we need to have an alternate trigger/s for activating the buffer.

12. Another concern about the capital buffer is whether we have enough experience, enough background to judge a business cycle. In order to run the capital buffer, i.e. build it up and draw it down when needed, we need to be able to identify the inflection point**.** Unlike America or other advanced economies which have long series historical data, we do not even have a data set for one complete business cycle. So how do we judge what is the inflection point in a business cycle? Even more difficult is the fact that many of the pressures caused by excessive leverage are not visible in real time. Indeed, what happened before the US sub-prime crisis, what is happening today in the euro zone, is because people have not been able to identify pressures in real time. We get to see them only afterwards. So it requires enormous insight, experience and competence to identify the pressures building up and calibrate the inflexion point when pressures will lead to an implosion.

13. The other challenge under Basel III is one of communication. We have, under Basel III, a proviso which says that you can either comply, or if you decide to deviate from the norm, you can explain. That is fine on paper, but will it work in the real world? The apprehension is that the market might penalize us even if we have a credible explanation for deviating. The market will only play up the headline, that India is not complying with Basel III, and will put an additional

penalty on us without paying heed to the explanation. The challenge for the Reserve Bank is to communicate to the market that the deviation does not necessarily represent any policy looseness, and is certainly not a violation.

14. Finally, the cost of Basel III. It certainly is going to cost in terms of growth - across the world and even in emerging economies. All estimates agree that Basel III will impose costs only in the short term. The costs will dissipate over time and, in the medium to long term, the benefits of Basel III by way of financial stability and by way of a crisis prevention, will outweigh the higher costs of credit. That hypothesis, of course, remains to be tested.

15. What does this mean for commercial banks at the senior management level? At board and management levels, we have to improve our skill and competence in risk management. At all levels, banks and the Reserve Bank too have increasingly to become knowledge institutions. So, the one message out of Basel III implementation that I have to give you is that banks have to become knowledge institutions.

ii) Financial Inclusion

16. Let me move on to the second issue which is financial inclusion. Many of you have heard us at the Reserve Bank speak about it.

17. Why is financial inclusion important? It is important because if you see the history of development across any country, no country has evolved from agriculture to manufacturing to services and then on to a post industrial modern society without financial inclusion. While it is not clear whether financial inclusion

is the cause or the effect, it certainly is important for sustaining growth. Second, if you bring the savings of the poor into the formal financial sector, it is good for the economy because it can be used for investment. For the banks, I believe, financial inclusion will provide access to stable and a large amount of low cost funds which will help them manage their asset-liability position more effectively. Further, in a very practical sense, it is important to the state governments, and even more important at the village level for the panchayats, that more low income households come into the formal financial sector. As poor people get to have bank accounts, it will incentivize and facilitate transfer of government benefits electronically (what we call EBT) which will reduce leakages, if not totally eliminate them.

18. In pursuing financial inclusion, it is important to dispel some stereotype views. One stereotype view is that poor people, low income people, do not need sophisticated financial management. We all think that it is people having investible surpluses that need sophisticated models for financial management, and that poor people do not need any such thing. On the contrary, if we think about it, it is actually the poor people who need financial management techniques more dearly than we do; after all they lose their jobs, they suffer illnesses and emergencies, have weddings in the family, or they live thousands of miles away from their families and need to remit money home. So, their need for financial management is much more urgent, much more compelling than for people with comfortable finances.

19. There is this book written by Daryl Collins and Stuart Rutherford, called '*Portfolios of the Poor*'. What they did was to select 100 low income households in each of three countries, Bangladesh, South Africa and India, and maintain diaries of

these individual households for over two years studying their daily patterns of income and expenditures. In the process, they also studied how poor people, without access to formal financial sector, manage their finances. It is a fascinating book and I would urge you to go through it, if only to get insights on how poor people manage their finances.

20. The other serotype view about the poor is that they don't know because they are illiterate. Ela Bhatt, who runs SEWA and has joined our Board as a Director gave me her book *'We Are Poor but So Many'*. It is deliberately titled in irregular English. When you read the book you understand that there are some telling insights which she is pointing to. She says that when she used to go and talk to banks before starting the SEWA Bank, most of the time she realized that illiteracy was on the other side of the table. Banks did not understand what people were asking for, and mindlessly threw the rule book at them. So, I would like to say that there is need for a change in the mindset of bankers in pursuing financial inclusion.

21. The challenge of financial inclusion is huge. You all know the broad statistics. There are 600,000 habitations in the country and only 30,000 (may be a little more at the latest count) or just about 5% have access to a bank branch. The penetration of other products like debit cards, credit cards and micro-insurance products is much, much lower. Also, we know that even where poor people have bank accounts, they do not use them. That is, bank accounts are not effective.

22. Why is financial inclusion a challenge? First, financial inclusion is a challenge because of KYC norms. On the one hand, the Reserve Bank insists that

banks go through KYC procedure without any default. On the other hand, we are pushing financial inclusion. Obviously there is some contradiction here, and we need to manage this contradiction.

23. Dr Chakrabarty, our Deputy Governor, tells me that poor people suffer a lot for want of access to banks. In the Delhi Commonwealth Games, I got to know some of the Andhra labour from Mehboobnagar district who used to work at the construction sites of the commonwealth facilities. They were spending as much as would indeed spend ` 1000 to send ` 10,000 to their families back home. That is how much it costs to send money home if you don't have a bank account, not to speak of the safety of your earnings when you are sleeping on the roadside. We are hoping that UID will help in making adherence to KYC simpler, but that is again yet another chapter.

24. The second problem about financial inclusion is that banks see it as an obligation, something they are doing for the sake of RBI, for the sake of the Government, and not as a part of their business model or as an opportunity for them. Again I am hoping that over time, this perception, indeed misperception, will be corrected.

25. Third, of course, is that we need to spread financial literacy. All our financial inclusion initiatives are from the supply side. We need to do something from the demand side to make poor people interested in opening a bank accounts and using them, and thereby reduce these costs of financial transactions.

26. What has the Reserve Bank done in this regard? We have asked all banks to prepare financial inclusion plans. We have left it to the banks to do it themselves and there were no guidelines prescribed. All we said was, you (banks) please prepare a financial inclusion plan consistent with your business model and have it discussed and approved by your Board. The idea was to get ownership of banks over their financial inclusion plans.

27. We also want that all villages in the country with a population of over 2,000 should have access to banking either through a brick and mortar branch or through a BC model by March 2012, which is three and a half months from now. I believe across the country, around 70,000 villages have been identified under this category, and the coverage is around 60% as of now. My fear again is that this is becoming a target driven programme and losing track of the objective along the way. Banks are going to villages, either appointing a BC or opening a bank branch, giving smart cards or opening accounts there. But we cannot lose sight of the ultimate objective which is meaningful financial inclusion. Every account holder must use the bank account, must get some credit, must use the account for remittance and must get some micro-insurance facility. We have also said that 25% of new branches of every bank should be opened in unbanked villages with a population of less than 10,000.

28. As much as we promote the BC model, we also need to promote a low cost bank branch model. In some states, Chief Ministers have offered space in the village panchayat offices, while in some other states at the village Common Services Centre (CSC). Where states have not offered premises for branches, the

banks must explore and proactively engage the state governments in identifying models for low cost branches.

29. About the BC model, the Prime Minister asked me, ‘how can a person on a cycle do banking business?’ He asked another telling question. “Is financial inclusion happening in the extremist affected districts?” In turn, I came and asked Usha - she was still with the Reserve Bank then - and we offered to demonstrate to the Prime Minister how this hand-held machine worked. Mr. O.P. Bhatt of SBI and Mr. Kamath of PNB demonstrated to the Prime Minister, and of course the machine faltered even in front of the PM! Mr. Bhatt even joked that the machine was getting nervous in front of the Prime Minister. Thankfully, eventually, it worked. The lesson of this demonstration before the PM is that we have to make sure that the technology of the BC model is robust and that the BC is trustworthy.

30. What has RBI done to correct the incentive framework in banks for financial inclusion? Frontline bank managers, according to my understanding, are judged by what and how much credit they have pushed and how much deposits they get. They are not judged by how much they do for financial inclusion. We have requested banks, again without prescribing a format, to include some criteria on financial inclusion in the performance appraisal of their junior and middle level managers who work at the cutting edge, at the frontlines.

31. Let me tell you a story from personal experience. Usha, please pardon me. You’ve heard me say this before. And Jayendra will probably relate to it because when I joined the IAS in 1972, and when he joined IAS one year before me, we

used to have district training. As a part of the second phase of the training at Mussorie, after the district training, we had to relate a district experience. One of my colleagues from Haryana, who subsequently retired as the Chief Secretary of Haryana, related how in villages across Punjab and Haryana, parents of girls would refuse to give their daughters in marriage to a household in a village which does not have drinking water facility. That is because, if you do give your daughter in marriage there, you are condemning her to a lifetime of drudgery. Then, about 10 years ago, I read in India Today that the criterion in Punjab and Haryana is no longer drinking water, but a toilet. Parents judge the eligibility of a boy by whether the family had a toilet at home. We hope that in a year or two from now, parents will say that they will give their daughter in marriage only if the boy's household has a bank account. That is how deep consciousness about financial inclusion must penetrate.

iii) Financing of Infrastructure

32. The issue of financing of infrastructure which is the third item on my agenda, is quite straight forward. The biggest supply side constraint in the economy today is infrastructure. Poor infrastructure is inhibiting growth and adding to production costs. In the 11th plan, they were talking about \$500 billion investment in infrastructure, and last week I saw some statement that the actual might fall significantly below that. During the 12th plan, which will start from April 2012, the estimate or projection is to spend a trillion dollars on infrastructure in the five year period, which means that investment in infrastructure has to more than double from about 4%- 5% of GDP today to 11%-12% of GDP on an average.

33. There are problems in financing infrastructure. As we all know, infrastructure requires long term financing. Across the world, infrastructure is typically financed by long term funds like pension funds and insurance funds. But because those markets are not developed in India, we have to fall back on bank finance. The burden of financing infrastructure is therefore falling on banks.

34. There are two problems banks face in financing infrastructure. The first is exposure risk, how much can a bank expose itself to a company or a group of companies whose main business is infrastructure. The second problem is asset-liability mismatch because funding of banks is short term while lending for infrastructure is long term.

35. In the last one month, at least five Chief Ministers have written to me saying that banks in their states have stopped lending to power sector on the advice of the Reserve Bank. All of them asked, 'can you please do something about it?' First of all, there is no advice from the Reserve Bank to any bank not to lend to power sector or any other sector for that matter. In the RBI, do not advise banks to lend to one sector or another. Senior executives of banks, who are present here, know that we do not give this sort of advice. Banks have to make their own commercial business decisions. What's happening across these five states, and perhaps in many other states, is a reflection of the problems in the power sector, where credit has built up and viability has come down. Banks have stopped lending before taking further action. There is not much that the Reserve Bank can do here. After all, this is a 'real sector' problem and you cannot solve real sector problems

by sheer financial engineering. This is something we have learnt from the crisis, and this is something that the banks have to address.

36. Let me give you another example: airlines. Last year, Kingfisher and this year Air India. Again, there are comments in newspapers that RBI is standing in the way of relief to the airlines; that we have not allowed banks to give any concessions to the airlines industry. That is a mistaken view. We have not told the banks what to do or what not to do. All we have told banks is that; we will not give any additional regulatory forbearance. It is for banks to restructure the loans if they want to. The Reserve Bank did not say no to restructuring of the loans. We told banks, "if you find airline companies are viable after restructuring, please go ahead and do it. But do not ask for any regulatory forbearance because that goes against prudence and the principle of accounting transparency". In spite of this, keeping in view the difficulties of the airline industry, the difficulty of fuel pricing and the downturn all round the world including India; we've allowed some concessions to banks in restructuring the loans of airline companies.

37. The stereotype view that RBI is standing in the way of infrastructure finance is not correct. We have to manage the tension between keeping banks safe, and at the same time keeping the credit flow to the economy going. When Air India officials came and met me last week, I told them that we will bend over backwards to take a positive view, but in the ultimate analysis, we are not going to hold banks hostage to Air India's problems.

38. The problem with infrastructure financing, a lot of people say, is corporate bonds. As regards corporate bonds, RBI is in-charge of only some of the market infrastructure issues, but it is SEBI that is the regulator of the corporate bond market. We have done a number of studies, appointed a number of commissions and committees, conducted several meetings and seminars on corporate bonds, and also relaxed norms to the extent possible. But there is also a view that the real issue is not relaxation of norms from the supply side; the real problem is that there is no appetite for corporate bonds; there is no demand. What is it that we must do to generate this demand for corporate bonds which will go towards financing infrastructure is a big challenge. I hope you will deliberate on these issues at the board level.

iv) Improving the Efficiency of Indian banks

39. Finally, about improving the efficiency of Indian banks. Financial intermediation was a little acknowledged, but a significant factor behind India's remarkable growth acceleration from 2003 to 2008. In common parlance, we attribute that growth acceleration to a number of factors, like productivity improvement, entrepreneurial spirit, increase in savings, demographic profile etc. But one of the less recognized drivers of performance of India's growth was the improvement in the quality and quantum of financial intermediation. Just one statistic - bank credit as a ratio to GDP - went up from 22% in March 2000 to 50% in March 2011. So, in a period of 11 years, credit-GDP ratio has more than doubled.

40. In one of our Currency and Finance Reports, I think three years ago, we did some research on banking. Some of those research findings are very telling. They break some of our stereotype views. I will give you the important ones.

- First - There has been a significant improvement in the operating efficiency of Indian banking in the last fifteen years owing to technology upgradation and staff restructuring.

- Second - More notably, the operating efficiency continued to improve even during the last two years of global turbulence. Note that when the world was going through a crisis, the operating efficiency of Indian banks continued to improve.

- Third - The performance of public sector banks converged with that of private sector banks. The stereotype view that public sector banks are less efficient than private or foreign banks is not borne out by data.

- Fourth - Contrary to popular perception, there is no significant relationship between ownership and efficiency. Efficient banks straddle all ownership segments - public and private. Indian banks can be proud of this impressive achievement.

41. If I had spoken at a forum like this some weeks ago, I would have talked about double digit growth. Now I say this with a little more trepidation. But if we have got to accelerate our growth, we need to improve our savings. It means that we need to raise interest rates offered to the depositors and reduce interest rate charged on borrowers, which means banks need to compress their NIMs. That is the big reason why we need more efficient banking.

Conclusion

42. When people know that you are a director on a bank's board, when you go to a wedding for example, or when you meet friends or go to a party, people will complain about their bank being atrocious in customer service. My sisters, my relatives, all complain to me about their sour experiences in banks. It is common knowledge. You must be in a position to defend your position *vis-a-vis* your family and your relative circle. My final request is that bank boards must pay greater attention to customer service.

Thank you all.