Indian Banking System– Introspection, some questions, a few answers

Good morning. I am delighted to be here to share my thoughts about the Indian financial sector issues that keeps everyone on their toes. The sector as many say is a study in contrast, on one side supporting one of the fastest growing economies and on the other grappling with what McKinsey calls a set of "new realities" that are testing its strength and resilience. Let me start by asking the question to myself, now that I am on the other side of equation having to vacate my mindset of a central banker and in-doctrine that of a commercial banker, what in my view are the two focus areas of banks from the view point of income or profits? Why do I say income and profits? Because to me that is the core. If I have that I can get over any situation. I would say good quality credit portfolio and good quality technology adoption. To be balanced, let me also ask myself the question, what are the problem areas which could negate all the income or profits and put pressure on the bank balance sheet. My answer remains the same, bad loan book and poor technology implementation. Lest I am misunderstood, I am not suggesting that it is possible, given a set of circumstances for the banks to avoid stress and NPA. That is a part and parcel of banking. But can the system particularly the PSBs improve on credit assessment, credit delivery and credit recovery? But as of now to facilitate this turn around, given the balance sheets that we run, a decisive and adequate bank recapitalisation, is a critical intervention necessary. Deputy Governor Dr.Viral Acharya quotes a recent study from the

Bank for International Settlements to conclude that bank capitalisation has a strong effect on bank loan supply: a one percentage point increase in a bank's equity-to-total assets ratio is associated with a 0.6 percentage point increase in its yearly loan growth. He argues that if a banking system remains systematically undercapitalised and new lending is not kept under a tight supervisory watch, then the economy can suffer significantly from a credit misallocation problem, now commonly known as 'loan ever-greening' or 'zombie lending'. In particular, undercapitalised banks have an incentive to roll over loans from financially struggling existing borrowers so as to avoid having to declare these outstanding loans as non-performing. I am not certain these observations are entirely valid to India as the issue is not limited to one bank but several banks or the eco system of PSBs as a whole. I also contest the arm chair view of some who argue that if public sector banks are saddled with the mess, it is more because of their lackadaisical attitude or complicity with the borrowers. To me the fault lies in the governance structure in these institutions which the authorities are now trying to address.

2. As we gather it thoughts for the day long deliberations, let me pose the question in everybody's mind today. Is there a banking crisis in India? To anyone asking this question to me, I would respond without a blink of an eye a loud NO. As you all know banking crisis is generally associated with macro economic instability especially in the external sector or financial sector. This was what had happened in the US which later attained global scale and came to be called the GLOBAL FINANCIAL CRISIS. In India, there are no signs of any

such instability. Economy is doing well. External sector is in fine shape. We are far remote from the days when we were included as a part of the “fragile” group. Banking crisis could also be associated with loss of trust in the banking system and run on the banks. Even conceding that the recent draft bill on resolution or "bail in", did create some panic in the minds of common man, there is no evidence of loss of trust in banking or a tendency to withdraw deposits. True, many banks have the problem of inadequate capital (or capital inadequacy) but it is confined to the public sector banks and not private sector banks. Public sector banks are not limited liability companies but statutory bodies owned by the sovereign and there is no question of insolvency of the sovereign. In brief, we are right in worrying about the problem of capital adequacy in public sector banks, and not about safety of deposits. But that does not mean that there is no stress in the banking system. The banking system is indeed passing through difficult times.

3. The current crisis or stress in my view is a reflection of possibly several factors. First, easy post-crisis macro and regulatory policies since 2009; second the delayed recognition of the problem both by banks and the forbearance of the regulator; third, the impact of slow-down in growth of GDP; fourth, the arguable factor is high credit growth in 2004-06 despite high interest rates and regulatory counter-cyclical measures and finally Indian banks being forced to enter long term financing without either expertise or balance sheet support. Given the history of delays in infrastructure project completion in this country, this was surely a disaster waiting to happen. Given the above realities, what

could be done to improve strategy, governance and risk culture in public sector banks? What are the big issues that need to be addressed if we are to become professional and competitive ? We need to find answers very quickly. Let me now turn to some specific issues.

NPA PROBLEM

4. Let me start with NPA, the root cause of current stress. As I said in the beginning, this issue is neither new or one of its kind. This time around the sheer magnitude of the problem seems to bewilder many. Whatever you do, we need to admit that the borrower knows more about his business and controls cash flow. The lender can never beat the borrower in having relevant information. But our system of consortium seems to incentivise this behaviour. Hence we need revisit the norms of consortium lending. What needs to change? Cloning has to end. Consortium has to be defacto functional. Today it is my view that at best consortium is dejure, that too in a limited way. One of the conditionalities Government has mandated for public sector banks while capitalising them is that no bank shall shall enter a consortium unless they can take up 10 percent of the share. This makes the consortium a manageable number. But this alone in my view will not make it more qualitative unless, we make arrangements to better monitor the cash flows of the borrower which in my view calls for a nodal account.

5. Another aspect of the current situation is the large divergence in the health of the asset portfolio between the bank's classification and subsequent classification by RBI on a detailed scrutiny. This is also not new. May be the

quantum but not the divergence although the word “divergence” is today treat akin to a four letter word. While bank management and auditors are hauled up one wonders about the role of the supervisors ? It cannot be the case that the divergence being pointed out now were not pointed out earlier – if so what was being done about it – was their supervisory forbearance in addition to regulatory forbearance? Or is it being over aggressive or a case of treating the numbers rather than symptoms particularly when it comes to restructuring cases?

6. While several concerted measures are on to solve the present situation including the much hyped NCLT process, one needs to wait for outcomes to declare victory. But going forward what needs to change? To me what differentiates a public sector from a private sector bank in dealing with problems credits is the ability to cut loss and move forward. How do we strategise for that? In other words, the credit portfolio has to be in today's scenario treated like a treasury portfolio where once the price starts moving against you there is definite cut loss strategy. Yes, some of them could be wrong decisions in retrospect but then to my mind we are bankers and not astrologists and bank portfolios whether in the trading or banking book will have to be dynamically managed. This is how private and foreign banks handle these issues. Can indian banks particularly in the public sector be given the same freedom? Unless banks are freed from the threat of future scrutiny with the advantage of a 20/20 vision by any one and every one, I am afraid we will

continue to grapple with the issue. Now let me turn to another contemporary issue in the banking system.

TECHNOLOGY ADOPTION IN PUBLIC SECTOR BANKS

7. After the implementation of a Core Banking Solution (CBS), the next most critical challenge for the Indian banks is to usher in 'Business Process Re-engineering' and 'Change Management' in a comprehensive manner in order for them to be able to reap optimum benefits out of CBS. We need to address the following critical issues. We have data but do we have information? We all have CBS but have we improved MIS? How can we transform data into information? I also have a strong view that technology adoption has another big causality. People have stopped to think. Most of us do not try to understand the whys of whatever we are doing. We need to develop this inquisitiveness to also ensure that we do not waste time doing useless things. As Peter Drucker said, 'there is nothing so useless as doing efficiently that which should not be done at all'. Further, this can lead to out of the box or innovative thinking.

8. One area which remains largely untapped for many indian banks is harnessing alternate business channels. This covers the new way of offering credit as well. This offers huge opportunity but also warrants a robust IT infrastructure. Agility across the organisation will have far reaching implications in the transformation journey. Agility can be defined as the ability of an organisation to renew itself, adapt, change quickly to succeed in a rapidly changing and turbulent environment. According Mckenzie , this calls for changes in three core areas, organisational structure(how resources are distributed), Governance(how decisions are made) and Processes(how things

get done and performance get monitored). They suggest the following shifts in Indian banks:

(i)flexible resource allocation rather than fixed roles

(ii) Defining end to end accountabilities rather than functional boundaries

(iii) Rapid iteration and experimentation rather than standard product development cycle

(iv) Real time knowledge and information sharing

(v) Hands on governance

(vi) Standardised ways of working or putting in place SOPs across the organisation

(vii) Cohesive community rather than soloed departments

CHALLENGES FROM 'NON-BANKERS' AND NEW COMPETITORS

9. Today as a part of strategy every bank wants to go retail. I have often wondered whether we are creating another bubble in that sector? Further the whole business model and monitoring needs a total revamp if we are to remain efficient. Do we have the DNA? Second maximum disruption from non banks is coming in the retail sector. For long, banks were comfortable that competition from them were only from similar entities and that the Reserve Bank of India was ensuring that only the least number entered to compete with them. But as it happens in any business, technological innovation and the regulator's delay in waking up to developments have allowed a new set of companies to play the role of financial intermediary with a different name.

10. As a new breed of digital consumer has emerged, so has a new breed of competitor. These competitors are differentiated by the ability to turn big data into meaningful customer insights. In addition, as the banking industry value chain continues to fragment, more competitors are ready to take on traditional banks especially on the payment services, offering discrete financial services without becoming full fledged banks.

11. An often ignored competitive threat is disintermediation, which could take the form of Peer-to-Peer (P2P) services, the use of capital markets, third party product offerings (like prepaid cards) or a complete vacating of banking services overall.With the new non bank entrants, we need to quickly decide our strategy. Do we compete or cooperate?

RECAPITALISATION AND CONSOLIDATION

12. There was considerable debate and media analysis as to how Government should go about recapitalisation of banks. Experts cautioned that recapitalisation now is vastly different from the one undertaken in 1990s. There is private shareholding in Public Sector banking now; the bond and equity markets are significant and we have globalised financial markets. Further since there was considerable debate about consolidation another stream of debate was should capitalisation follow consolidation or not? Another related issue was should all banks should be recapitalised; and if not, what should be the criteria? Anyway the modality debate has been put to rest by the government that decided to recapitalise across the board at the first instance, reserving to itself the option for selective enhancements in future based on performance and

adherence to agreed financial parameters. PSBs were Broadly divided into two categories, those under PCA and those not under PCA. I am not certain about the rationale of such a categorisation, given under both heads banks differ in size and reach. There are barriers to growth imposed on banks with PCA that could result in such banks reporting poorer results in near term. Further, given the other restrictions on consortium financing and corporate loan exposures imposed on PSBs, I see a shift of assets in favour of large private sector banks happening atleast in the near term. So overall we are going to witness some sort of consolidation and realigning of the banking system in the next 5 yers or so. How this plays out will also decide the focus and speed of the consolidation of PSBs.

13. As I conclude, let me touch upon one other issue that had attracted lot of media attention- I refer to the so called perceived inability or other wise of Indian, particularly public sector, banks to manage interest rate risk. As RBI DG contends, it is certainly not the job of the central bank to manage it for the system. However, to fast forward this, we need to move for a gradual reduction of SLR requirements and the evolving liquidity requirements on par with international norms, that many consider is more moderate. We also need to take a conscious decision to avoid releasing market sensitive data or statements around the mark to market date by the authorities that matter. This is important along with other reforms to develop a two way market which in turn is sine qua non for hedging products to evolve. Further basis for MTM has to be numbers under stable market conditions and not a number prevailing

on a day marked either by euphoria or panic resulting from unusual outlier events. Further efficient hedging requires a two way interest which is conspicuous by its absence in the Indian market. In a one way street as we have now, unfortunate reality is that hedging can at best be praying and nothing more. We Indians tend to pray harder as we think that this helps even in a life after death that we Indians believe in.

Thank you for a patient hearing.

Inaugural address by G Padmanabhan, Chairman, Bank of India, at Dhanam Banking, Finance and Investment Summit & Award Nite 2018 at Kochi on 10th February 2018. The speaker thanks former Governor Dr Y V Reddy for the inputs on some of the thoughts. The views do not represent the views of Bank of India