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# SIR PURSHOTAMDAS THAKURDAS MEMORIAL LECTURE

Mr. R. Gandhi

*Deputy Governor*

*Reserve Bank of India*

Indian Institute of Banking & Finance

ISO 9001 : 2015 Certified

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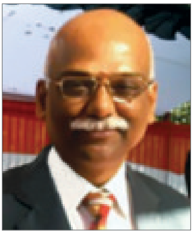
## About the Speaker



Mr. Gandhi is currently a Deputy Governor of the Reserve Bank of India, the central bank of the country, overseeing the Financial Markets & Infrastructure vertical. His current responsibilities in the Reserve Bank include leading and overall direction and oversight on Financial Markets Regulation, Foreign Exchange Management, Debt Management, External Investments & Operations, Payment & Settlement Systems, Currency Management, Government & Bank Accounts and Information Technology management.

Having joined the Reserve Bank of India in 1980, he has built, over these thirty six years, expertise and experience in varied fields which include, beside the payment systems and the information technology areas, financial market operations and regulation, currency operations and management, personnel and human resources management. He oversaw the Regulation & Risk Management vertical for two years. He represented Reserve Bank of India on the Basel Committee on Banking Supervision as a Member.

He had a three year secondment to the Securities and Exchange Board of India (SEBI), the capital market regulator of the country. He was also a Director on the Board of SEBI for about two years. He held the charge of Director of the Institute for Development and Research in Banking Technology (IDRBT), Hyderabad. He was the Executive Assistant to the Governor of the Reserve Bank of India for three years. He also was a Reserve Bank nominee on the Board of Directors of four public sector banks (at different points in time) for five years. He has been associated with various committees, working groups and task forces.

He has been educated in India and abroad. He has a master's degree in Economics from the Annamalai University, in Tamil Nadu, India. He also has post graduate level certificates in Management Information System from The American University, Washington DC, USA and in Capital Market from the City University of New York, New York, USA. His technical education includes a certificate course in System Programming from the IBM Education, Sydney, Australia. He also has a certificate in Gandhian Thoughts from the Madurai University, Tamil Nadu, India.

He was born in 1956.

# 33rd Sir Purshotamdas Thakurdas Memorial Lecture

# Pioneering Best Practices in Banking: India's Record

**Mr. R. Gandhi**

*Deputy Governor*

*Reserve Bank of India*

Bank of India Auditorium, BKC, Mumbai

24th November, 2016

# Pioneering Best Practices in Banking: India's Record

Mr. R. Gandhi*

Good evening!

In the post-crisis era, the international thinking on banking and finance stands fundamentally changed. Not only did the crisis shake the confidence of all stakeholders in the international financial system but also compelled the regulators and policy makers to review whether their policy framework was sound enough to prevent the outbreak of another crisis of a similar magnitude. From the global consultations, emerged newer and more refined norms of prudential regulations and supervision that may appear onerous at the present moment but are expected to make the global financial system reasonably resilient in the long term. When all these consultations about reforming the global financial architecture have been on, I have increasingly felt that India has been leading in many of what we now term as the international best practices in banking and finance.

India's lead in economics is, of course, well known and well accepted. Kautilya's Arthashastra written by Chanakya during 300 BC is regarded as a master piece in diplomacy and economic principles. Kautilya describes the primary role of a ruler and regulator as good governance. He alludes to people-

* Deputy Governor, Reserve Bank of India.

33rd Sir Purshotamdas Thakurdas Memorial Lecture delivered by Shri R. Gandhi, Deputy Governor on Nov 24, 2016 at Mumbai. Assistance provided by the officers of Banking Research Division, DEPR, RBI is gratefully acknowledged.

centric and particularly the poor-centric policies that would enhance welfare and lead to stability in any country. He emphasises on the role of infrastructure, particularly public investment in roads and transport, as an important responsibility of the ruler and also highlights the role of private enterprise, suggesting a mixed economic framework. When we study the Arthashastra, we are amazed by the vision of Chanakya in laying down the best practices in economic administration that continue to be relevant even 2300 years later!

Coming back to the recent times, I am equally impressed by the sagacity of our policy makers and legislators, who built in certain practices in the functioning of the Reserve Bank and the Indian banking system. We see similar practices being recommended now by the international standard setting bodies as international best practices. First, the fact that we have had these practices in place has helped us wither the crises which have shaken the rest of the world. Secondly, these practices have also made our transition to the contemporary international best practices fairly easier.

Most of the issues that I discuss today relate to banking sector regulation. However, there is another area relating to the banking sector that we cannot overlook when we compare Indian banking practices with the rest of world and that relates to 'financial inclusion'. Stepping beyond the banking sector and looking at other core areas of functioning of the central bank, such as foreign exchange reserves management and payments systems also suggest several home-grown practices which are now being regarded as the international best practices.

Let me begin with prudential regulations.

## Statutory liquidity ratio[1] and liquidity coverage ratio[2]

In the wake of the Global Financial Crisis 2007-08, the Basel Committee on Banking Supervision (BCBS) initiated the Liquidity Coverage Ratio (LCR) in an effort to strengthen the liquidity framework of the financial systems of the world. Bank portfolios generally consist of illiquid assets (longer-term loans) that are funded by liabilities (shorter-term borrowings) that must be renewed continuously until the longer-term customer loans are fully repaid. Episodes of uncertainty, however, can cause increases in short-term rates relative to long-term rates, which can translate into a run on and insolvency for financial institutions. To prevent such run on a daily basis, banks need to hold unencumbered, marketable assets that would find buyers at a short notice. A reserve requirement alone may not help enough as a prudential measure for managing liquidity risk; banks world-wide, for lack of incentives to hold up funds in unremunerated reserves, have often resorted to circumventing the statute by veering away from one form of funding to other in an effort to modify the base for calculating the ratio. The extensive use of short term wholesale funding to fund long term assets in the recent crisis being a case in point.

Before the global crisis, USA in particular did not have any concept of liquidity asset ratio requirement from either prudential or monetary control point of view. More recently, liquidity risk management has been manifested in various stress-testing methods as per supervisory guidance. Other developed countries that never had or abolished liquidity asset ratios or traditional reserve requirements so far were Canada, France, Sweden, and New Zealand.

1. SLR rate = (liquid assets / (demand + time liabilities)) × 100%.
2. LCR rate = Stock of high quality liquid assets / Total net cash outflow over the next 30 calendar days.

Indian banks, however, have always had in place a liquidity risk management system in the form of the Statutory Liquidity Ratio (SLR). According to Section 24 (2-A) of the Banking Regulation Act, 1949, all Scheduled Commercial Banks in India are required to maintain, a) in cash, or b) in gold valued at a price not exceeding the current market price, or c) in unencumbered approved securities valued at a price as specified by the RBI from time to time an amount of which shall not, at the close of the business on any day, be less than 25 per cent and not exceed 40 per cent of the total of its demand and time liabilities in India as on the last Friday of the second preceding fortnight. Following the amendment of the Banking Regulation Act (1949) in January 2007, the floor rate of 25 per cent for SLR was, of course, removed. However, even as at present, all Scheduled Commercial Banks are required to maintain a uniform SLR of 20.75 per cent of their total demand and time liabilities in India as on the last Friday of the second preceding fortnight.

SLR, although focusses on maintaining a static stock of assets out of a stock of liabilities vis-à-vis LCR's emphasis on pre-empting net cash outflows on an ongoing basis, has always served India well during crises because the RBI allowed banks to utilize the assets therein to draw on LAF and MSF funds.[3] Financial systems across the world now have to modify their lending behaviour to create such buffers of liquid assets. A Quantitative Impact Study by BIS on the implementation of these liquidity ratio norms find that some banks in developed countries, to be able to implement these norms, might have to exit some businesses altogether because their liquid assets get tied up there. The assets categorized as liquid under LCR are by

3. LAF = Liquidity Adjustment Facility; MSF = Marginal Standing Facility.

and large the ones that Indian banks have always held for calculation of their SLR requirements. Indian banks will not find the implementation of LCR as tedious especially because RBI has now allowed Indian banks to include 11 per cent of their SLR securities for the purpose of calculating LCR. Finally, as suggested by stress tests conducted by RBI, the LCR is not a substitute for SLR. It will only add on to the function that SLR was already meant to perform, i.e., to fill the liquidity gap of Indian banks under stress.

**Credit Management Techniques**

Another area which has drawn the attention of policy makers and standard setting bodies has been the flow of credit in the economy and the resultant risk that can build-up in the system overtime if left unchecked. The basic premise of macro-prudential and micro-prudential policies is early detection of such build ups and initiation of suitable corrective action. Two types of techniques, i.e., quantitative and qualitative credit controls have been used by the central banks world-wide to achieve their objective of managing flow of credit in the economy. The former or traditional method includes banks rate policy, open market operations and variable reserve ratio. Qualitative also called selective credit control instruments work through regulation of margin requirement, credit rationing, regulation of consumer credit and direct action.

As per the Reserve Bank of India Act, Reserve Bank was constituted to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. Thus, the use of credit management techniques to the country's advantage has been enshrined in our Act. Towards this objective Reserve Bank has consistently emphasized on diligent monitoring of the health of loan portfolios of credit institutions and remained pro-active in tightening risk weights and provisioning requirements particularly during rapid credit growth phases. With a view to preventing speculative holding of essential commodities with the help of bank credit and the resultant rise in their prices, Reserve Bank[4], has issued, from time to time, directives to all commercial banks, stipulating specific restrictions on bank advances against specified sensitive commodities.

The Reserve Bank introduced selective credit control for the first time in May 1956 in the context of multiplication of banks' advances. The continued loss of foreign reserves, towards plan financing, again forced the Bank to use an additional credit restraint measure viz., 'quota-slab' system, instituted in October 1960. This was in the form of credit rationing through a price instrument. Under this system, each scheduled bank was assigned a quarterly quota equal to half of the average volume of reserves, which it had to maintain under Section 42(1) of the RBI Act during each week of the preceding year. The quota slab system could be liberalised or tightened as necessary for effective quantitative check on credit expansion. The quota-slab system, where availability of credit was the key control variable, was replaced in 1964 by a scheme of accommodation based on banks' net liquidity ratio (NLR), which was considered to be a less discretionary form of central bank control over the expansion of commercial bank credit than the quota-slab system. The NLR formula envisaged using a variant of the statutory liquidity ratio to regulate the cost of the Bank's loans to scheduled commercial banks.

4. In exercise of powers conferred by Section 21 & 35A of the Banking Regulation Act, 1949.

The credit authorisation scheme as an instrument of credit control was introduced in November 1965 to align credit policies closely with the Five Year Plans. Under the scheme, scheduled commercial banks were required to obtain the Reserve Bank's authorisation before sanctioning any fresh credit of ₹1 crore or above to any one borrower or any fresh limit which would take the total limits engaged by the borrowers from the entire banking system to ₹1 crore. This scheme helped in preventing the problem of pre-emption of scarce bank reserves by a few large borrowers and enforcing a measure of financial discipline on them.

As is evident from the above, in the initial phase of scarce credit, Reserve Bank used credit management techniques to ensure efficacious use of credit. In the recent years, credit management measures have been used to discourage excessive risk build-up in a sector. In view of significant rise in bank credit to the commercial real estate sector in conjunction with that in the prices of real estate, risk weights for banks' exposure to commercial real estate were increased from 100 per cent to 125 per cent in July 2005, and further to 150 per cent in May 2006. The risk weights on housing loans extended by banks to individuals, were also increased from 50 to 75 per cent in December 2004. The provisions for standard assets were also revised upwards progressively in November 2005, May 2006 and January 2007, in view of the high credit growth in select sectors. These measures stood us in good stead during the global financial crisis. Thus Reserve Bank in pursuance of the objective outlined in the RBI Act has been diligently monitoring the flow of credit in the economy and taking appropriate steps to ensure that flow of credit is used to the betterment of the economy.

## Regulation of non- banking financial sector

The idea that shadow banking should be regulated is of recent origin in most of the countries and has found credence in the aftermath of the global financial crisis when the role of shadow banks was brought in sharp focus. However, in India, the scheme of regulation of non-banking financial companies (NBFCs) originated in mid-sixties when sudden upsurge in deposit mobilisation by Non Banking Companies was noticed. The provisions of Chapter III B of the Reserve Bank of India Act, 1934, which regulated the deposit acceptance activities of Non Banking Companies has been in existence since mid-sixties. The focus of regulation was to ensure that the segment serves as an adjunct to banking system and also provides an indirect protection to the depositors. The objective of this legislative frame work was to regulate the deposit acceptance activities of NBFCs. As per the provisions of this framework, the Reserve Bank was empowered to regulate or prohibit issue of prospectus or advertisement soliciting deposit, collect information on deposits and to give directions on matters relating to receipt of deposits. For violation of directions, RBI could issue orders prohibiting erring companies from accepting further deposits. The legislative intent and the focus were thus mainly to moderate the resource mobilisation exercise by way of deposits by NBFCs and thereby providing indirect protection to the depositors by linking the quantum of deposit to their Net Owned Funds(NOF). The focus continued to be the same till early 90s. Over a period of time, especially during late 80s and early 90s, NBFCs penetrated into the main stream of financial sector and established themselves as complements of banking industry. In light of this, an Ordinance was promulgated by the Government in January

1997, effecting comprehensive changes in the provisions of RBI Act. Over the period the regulation for the NBFCs has been modified and made in conformity with the banks. Thus, because of history of regulatory best practices, shadow banking has not posed any problem for the financial sector in India.

**Sector Specific Refinance Facilities**

One of the most important features of the global financial crisis was the aggravation of the problem of bank liquidity, credit market crisis, and to put it simply, the lack of money. This was addressed through various measures undertaken by the central banks to widen access to central bank financing. Objective of the refinance facility by central bank is to provide further comfort on liquidity and to impart flexibility in liquidity management to banks. Refinancing operations were undertaken by most of the central banks to ensure credit flow to the real economy. Some central banks undertook specific measures to ensure smooth flow of credit to exporters, small businesses and entrepreneurs.

Reserve Bank has been following several sector-specific refinance facilities. These have been reviewed from time to time based on the evolving macroeconomic and market conditions. Under Section 17(3A) of the Reserve Bank of India Act 1934, RBI first introduced the scheme of export financing in 1967 which was intended to make short-term working capital finance available to exporters at internationally comparable interest rates. The ECR scheme has been reviewed from time to time based on the stance of monetary policy. It has been merged with the system level liquidity provision with effect from the fortnight beginning on February 7, 2015.

In response to recent global crisis, a special refinance facility was introduced under Section 17(3B) of the Reserve Bank of India Act, 1934 under which all SCBs (excluding RRBs) were provided refinance from the Reserve Bank equivalent to up to 1.0 per cent of each bank's NDTL as on October 24, 2008 at the LAF repo rate up to a maximum period of 90 days. Banks were encouraged to use this facility for the purpose of extending finance to micro and small enterprises. The eligible limit of the ECR facility for scheduled banks (excluding RRBs) was also increased from 15 per cent to 50 per cent of the outstanding export credit eligible for refinance at the prevailing repo rate under the LAF. In order to provide liquidity support to housing, export and MSE sectors, the Reserve Bank also provided refinance facility to the National Housing Bank (NHB), Export and Import Bank (EXIM Bank) and Small Industries Development Bank of India (SIDBI).

Now, in place of Reserve Bank, financial institutions such as National Bank for Agriculture and Rural Development (NABARD), SIDBI, and NHB, extend refinance to banks as well as non-banking financial institutions. MUDRA Bank, new institution for development of micro units is refinancing through State level institutions, and delivering loans to NBFCs, MFIs, Rural Banks, District Banks, Nationalized Banks, Private Banks, Primary Lending Institutions and other intermediaries.

**Financial Inclusion**

The concept of “financial inclusion” gained global attention during the 2000s through its link with the achievement of the Millennium Development Goals (MDGs) set by the United Nations (UN). The Reserve Bank of India has however been undertaking various initiatives over the last five decades to help the underprivileged participate in the country's economic development.

On April 2012, India became the first BRIC member to join CGAP[5], the policy research centre housed at the World Bank dedicated to improving financial access for the world's poor. An analysis done in a 2015 RBI committee report on financial inclusion finds that access to finance is, on average, 0.14-0.16 percentage points higher in India compared with its EMDE[6] peers. These facts uphold India's position as a pioneer and an innovator for many years for a range of financial access initiatives.

Globally, about 38 per cent of the adult population has no or very limited access to formal financial services. This makes a strong case for poor households to penetrate the boundary of formal finance. Loans or savings can help them to accelerate consumption, absorb unforeseen shocks such as health-related issues, make households investment in durable goods, home improvements or school fees (Collins et al., 2009). Indian policy makers have always emphasized the significance of inclusive finance. Our policies like the nationalization of banks, priority sector lending, setting up of Regional Rural Banks and encouragement to co-operatives date back to 1960s and 1970s underlining the fact that inclusive finance was always a national priority. The “Financial Inclusion Policy” introduced by the Reserve Bank of India in the year 2005 helped launch a 100 per cent financial inclusion drive.

In doing this, India stands out as one of the few EMDEs for which the government has a documented financial inclusion

5. The Consultative Group to Assist the Poor.

6. Emerging Market Developing Economies.

strategy that contains specific commitments. As per the 2016 Brookings Financial and Digital Inclusion Project Report on Advancing Equitable Financial Ecosystems, countries like Philippines, Peru and Colombia have only now formalized their commitments towards financial inclusion and a big part of the recent progress in financial inclusion in these countries is due to this formal setting of inclusion targets. Countries like USA have begun to recognize the impediments to using financial services in the form of expensive minimum balance requirements and high fees (e.g., for cashing checks). Increasing consideration is now being given to the promotion of an inclusive financial ecosystem by development of regulations to limit the costs associated with access to credit among low-income populations in the U.S.

The launch of the Pradhan Mantri Jan Dhan Yojana (PMJDY) program in 2014, one of the world's largest financial inclusion initiatives to date that promotes no-frills accounts, is one prominent example of India's national-level commitment to advancing financial inclusion.

**Foreign Exchange Reserves Management**

Official foreign exchange reserves are maintained in any country in order to achieve a set of objectives such as support and maintain confidence in the monetary and exchange rate policies, limit external vulnerabilities by maintaining foreign currency liquidity to absorb shocks during times of crisis, to provide a level of confidence to markets, demonstrate the backing of domestic currency by external assets and meeting its foreign exchange needs and external debt obligations.

However, the design of investment portfolios varies widely across countries, reflecting essentially the exposure to liquidity, currency, interest rate and counterparty credit risks and the scope of active management thereof. Portfolio design takes into account a host of factors such as exchange rate regime adopted by the country, the extent of openness of the economy, the size of the external sector in a country's GDP and integration of financial markets.

India has been frontrunner in terms of international best practices in the management of foreign exchange reserves. According to latest International Monetary Fund (IMF) guidelines, reserve management should seek to ensure that (1) adequate foreign exchange reserves are available for meeting a defined range of objectives; (2) liquidity, market, credit, legal, settlement, custodial, and operational risks are controlled in a prudent manner; and (3) subject to liquidity and other risk constraints, reasonable risk-adjusted returns are generated over the medium to long term on the funds invested. The broad objectives of reserve management in India runs on similar lines. While liquidity and safety constitute the twin objectives of reserve management in India, return optimisation is kept in view within this framework. It can be found even in the Preamble of the Reserve Bank of India (RBI) Act 1934, 'to use the currency system to the country's advantage and with a view to securing monetary stability'. Here monetary stability may be interpreted as internal as well as external stability, implying stable exchange rate as one of the overall objectives of the reserve management policy. While internal stability implies that reserve management cannot be isolated from domestic macroeconomic stability and economic growth, the phrase 'to use the currency system to the country's advantage implies that maximum gains for the country as a whole or the economy in general, could be derived in the process of reserve management[7].

The Reserve Bank of India Act, 1934 provides the overarching legal framework for deployment of reserves in different foreign currency assets (FCA) and goldwithin the broad parameters of currencies, instruments, issuers and counterparties. The relevant provisions are contained in Section 17 and 33 of the Act. The investment universe for FCA comprises deposits with other central banks, the Bank for International Settlements (BIS) and overseas branches of commercial banks, debt securities issued by sovereigns / sovereign – guaranteed with residual maturity not exceeding 10 years and any other instruments or institutions as approved by the Central Board of the Reserve Bank. Thus the parameters and boundaries for managing the credit risk and liquidity risk of the foreign exchange reserve assets have been delineated in the law itself, that too long years before.

**Payment System**

A robust payment system is an essential element of financial inclusion. As per various recent Global Payments Reports, India stands among the select few countries who have already undertaken about 50 per cent of the journey towards modernizing and digitizing its payment infrastructure.

The Reserve Bank has been at the forefront in adoption of technology and modernising payment systems. In adoption of certain technologies and safeguards we have been ahead of many countries world-wide, including even advanced countries. Two Factor Authentication for the 'card not present' transaction, while making payments was the first of its kind in the world. In the same vein, introduction

7. IMF (2005)

of National Unified Unstructured Supplementary Services Data (USSD) platform for providing an interoperable USSD based mobile banking system is an important innovation in payment technologies as it links all telcos and all major banks. Similarly, Unified Payments Interface (UPI) eliminates the need of adding payee details such as bank name, branch, IFSC code and full name of the recipient while making payments and requires only to create a Virtual Payment Address (VPA) to send and receive payments. It leverages on trends such as increasing smartphone adoption and mobile-app usage, Indian language interfaces and increasing access to internet. These are further examples of adoption of frontier technologies to improve the choice set of consumers and are significant step towards moving into a cashless economy. Many other counties are showing interest in these technologies and trying to emulate.

Bharat Bill Payment System (BBPS) seeks to integrate bill payments for various utility services which are repetitive in nature and bring interoperability in bill payments eco-system bringing both banks and non-banks under its fold. It will provide the convenience of anytime, anywhere, any bill payment facility to the users. Similarly, setting up of the Trade Receivables Discounting System (TReDS) platform is another initiative which will facilitate the discounting of both invoices as well as bills of exchange, is another example of adoption of modern payments systems to bring about faster financing of MSMEs and improve their liquidity conditions.

Payment System Vision Document 2016-18 further aims at 'less-cash society' with reduction in the share of paper-based clearing instruments, consistent growth in individual segments of retail electronic payment systems, viz., NEFT, IMPS, card transactions and mobile banking, increase in the registered customer base for mobile banking, significant growth in acceptance infrastructure and accelerated use of Aadhaar in payment systems.

**Conclusion**

To sum up, Reserve Bank has been pioneering several policies which have now been termed as international best practices by the standard setting bodies. I have briefly talked about some of these but this list is not exhaustive. Some of these policies when initiated by Reserve Bank were termed too conservative or were taken as over-regulation by the central bank. However the far-sightedness of our policy makers ensured that Reserve Bank followed the prudent path howsoever less trodden.

With these observations, I conclude my talk.

Thank you very much for your patient attention.

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