

## **Banking and Finance in India: Developments, Issues and Prospects\***

Ladies and Gentlemen:

I am delighted to be here amidst all of you at the 62<sup>nd</sup> International Banking Summer School (IBSS) being organised by the Indian Institute of Banking and Finance (IIBF) jointly with the Indian Banks' Association (IBA). I am thankful to the organizers and sponsors for providing me an opportunity to share my views and interact with you at a forum which I personally rate very high. Central bankers talk among themselves in various fora, it is high time that the bankers talk with each other. The School, open to senior bankers and financial professionals, as we are aware is a 10 days' brisk academic exercise that provides a platform for the practitioners of banking and finance to learn and share the latest developments in the banking and finance field and best practices and products available in today's fiercely competitive global banking arena. In the present situation of global turmoil that we have been going through in the last two years, this forum will provide opportunities to the bankers and finance professionals for understanding each other better. The exchange of views and the ideas which are going to be generated here during the next ten days will certainly throw useful insights and better understanding on how to overcome such problems in future. I am sure, in time to come, many of you are going to occupy high positions in banks including becoming Chief Executive Officers (CEOs).

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2. Considering the theme of IBSS this year and more focus on managing banks in the era of turbulence, I think it would be appropriate if I share my views on a topic of contextual relevance, that is, 'Banking and Finance in India: Developments, Issues and Prospects' in the backdrop of the global financial crisis.

3. A recent BIS report has stated that it is useful to think of the financial system as the economy's plumbing. And like the plumbing in a house, the modern economic system depends on a reliable flow of financing through intermediaries. Modern life requires the smooth operation of banks, insurance companies, securities firms, mutual funds, finance companies, pension funds and governments. These institutions channel resources from those who save to those who invest, and they are supposed to transfer risk from those who can't afford it to those who are willing and able to bear it (BIS, 2009). In India too, we have a well-diversified financial system which is still dominated by bank intermediation, though the size of the capital market has expanded significantly with financial liberalization in the early 1990s. Important components of the financial sector in India broadly fall into categories namely; commercial banks, urban co-operative banks (UCBs), rural financial institutions, non-banking financial companies (NBFCs), housing finance companies (HFCs), financial institutions (FIs), mutual funds and the insurance sector. Commercial banks together with co-operative banks account for nearly 70 per cent of the total assets of Indian financial institutions.

### **Global Banking Trends and the Crisis**

4. Before I dwell on the developments in the Indian banking and financial arena let me first touch upon briefly the global banking trends in view of the present crisis. It is not my intention to repeat a discussion on the causes of the global financial crisis and repeat what has happened since September 2008 by way of the efforts on the part of the Central Banks and Government to stabilize

the global financial system. The causes of the financial crisis have been extensively analyzed, and many proposals have been put forward to prevent another such crisis in the future. Over the past few years, the essential and complex system of finance has been critically damaged. The current global crisis, as is well known by now, has its genesis in the imprudent practices of banks and non-bank institutions worldwide, especially in the US. The fact that more than 70 banks have failed in the US alone is a pointer to how deep and widespread the malaise was. Looking at the past few years, it may be useful to divide the causes of the current crisis into two broad categories: macroeconomic and microeconomic. The macro-economic causes fall into two groups: problems associated with the build-up of imbalances in international claims and difficulties created by the long period of low real interest rates. The microeconomic causes fall into three areas: incentives, risk measurement and regulation (BIS, 2009).

5. The crisis is best regarded as the steep downside of an extraordinary global financial cycle that was amplified by structural weaknesses. The financial imbalances that had built up slowly but inexorably during the boom, on the back of aggressive risk-taking and leveraging, had finally started to unwind. As elaborated in the BIS Annual Report, financial cycles are exacerbated by inherent difficulties in measuring risk and by distortions in incentives. Episodic financial strains cannot be eradicated entirely; the market is not fully self-correcting. But they can be mitigated or magnified by policy.

6. The crisis events can be traced to evidence of serious trouble emerging from when banks became less willing to lend to each other, because they were no longer sure how to value the assets held and the promises made – both their own and those of potential borrowers. For a time, central bank lending was able to fill the gap. But from August 2007 the stress in the financial system increased in waves. By March 2008, we are all aware, the crisis deepened and Bear Stearns had to be rescued from failure; six months later, on September 15,

Lehman Brothers went bankrupt; and by the end of September, 2008 the global financial system itself was on the verge of collapse.

*Global Crisis: US, Europe and Emerging Market Economies*

7. In the United States, the crisis was shaped by particular characteristics of the US financial system such as a complex mortgage financing value chain with opaque securitization structures, a large 'shadow financial system' involving various poorly regulated intermediaries (investment banks, hedge funds, structured investment vehicles—SIVs) and instruments (credit default swaps), the important role played by government-sponsored enterprises (Fannie Mae and Freddie Mac), as well as a fragmented supervisory architecture.

8. The US financial system is in many aspects unique due to the high share of capital market intermediaries and instruments. Deposit money banks account for a relatively low share of financial system assets, the stocks of market instruments are significantly larger (including private bonds), and the ratio of claims on the private sector to deposits is much higher. Overall, these indicators reflect the much greater role played by large investment banks, institutional investors, and other financial institutions, as well the extensive use of securitization.

9. While financial institutions in the US are at the heart of the problem, European banks face similar problems which shows how deeply interconnected national financial systems have become. European banks have been hit nearly as strongly as their American peers by losses from subprime mortgage investments, leveraged loans, failed financial hedges and a surge in conventional credit losses. As per one study of June 2009, banks on both sides of the Atlantic had to cope with combined write-downs of more than USD 1 trillion in this crisis – and they may have to take USD 1.3 trillion more. Governments around the globe have had to intervene to prevent a wholesale collapse of the financial system.

They have injected more than USD 200 billion in fresh capital into the top 20 banks alone; besides there are much larger asset and debt guarantees.

10. Emerging countries have not developed the same complex financing structures as those in the US, but several countries have already suffered from severe external imbalances, caused by fiscal imbalances and/ or over-extended banking systems. These countries have become particularly vulnerable, as the crisis is transmitted through financial and trade channels. However, the specific channels of transmission may differ significantly across countries. The basic structure of the financial system is, however, not expected to change significantly, as banks still play a dominant role and capital markets are generally less developed.

#### *Global Crisis: Global Growth and Financial Outlook*

11. Let me make a quick reference to the global growth and financial outlook. The IMF in its July 2009 Update of the World Economic Outlook (WEO) has projected that the global economy will shrink by 1.4 per cent in 2009, a shade more than the contraction of 1.3 per cent projected earlier in April 2009. The global economy is, however, projected to recover and expand by 2.5 per cent in 2010. The global economy is, thus, showing incipient signs of stabilisation, albeit not recovery, helped by unprecedented macroeconomic and financial policy support. However, the recovery is still expected to be slow, as financial systems remain impaired, support from public policies will gradually diminish, and households in countries that suffered asset price busts will rebuild savings. The main policy priority remains restoring financial sector health. Macroeconomic policies need to stay supportive, while preparing the ground for an orderly unwinding of extraordinary levels of public intervention. Notwithstanding some positive signs, the path and the time horizon for global recovery remain uncertain.

12. Hard-hit by the global financial crisis, the worldwide banking industry's future development has now been sharply drawn into focus. Bankers and government officials will have to grapple with important issues such as the best corporate governance model for the future of an industry in which a number of banks have benefitted from government bailouts. Equally important concerns such as the return of morality to the market, the definition of financial risk and the tradeoff among innovation, self-discipline and regulation require the banking industry to think outside the box. It has changed the face of Wall Street with lots of investment banks changing their business models. What will the future hold for these financial institutions is a subject being widely debated internationally to probe the future of the banking industry world over.

### *Global Crisis: Financial Sector Rescue Programmes*

13. Now, I move to an assessment of financial sector rescue programmes undertaken since the crisis intensified in September 2008. Central banks across countries have continued with an easy monetary policy stance. Governments became crucial during the crisis, as traditional sources of funding for financial institutions dried up. Following the collapse of Lehman Brothers, governments in advanced economies have stepped in to provide support to banks and financial institutions, through both standalone actions directed at individual institutions and system-wide programmes. The measures introduced have consisted of: (i) capital injections to strengthen banks' capital base; (ii) explicit guarantees on liabilities to help banks retain access to wholesale funding; and (iii) purchases or guarantees of impaired legacy assets to help reduce banks' exposure to large losses. The objective of such intervention was to avoid widespread bankruptcies of financial intermediaries and to contribute to restoring a normal functioning of financial intermediation.

14. As per a BIS estimate [Panetta Fabio *et al* (2009)], the overall amount of resources committed to the various packages by eleven countries (namely, Australia, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Switzerland, the United Kingdom and the United States) totaled around €5 trillion or 18.8 per cent of GDP; the outlays have been €2 trillion or 7.6 per cent of GDP. The size of the interventions varies greatly across countries: it is higher in countries such as the United Kingdom and the Netherlands (where outlays have reached 44.1 per cent and 16.6 per cent of GDP, respectively) where the banking system is large relative to the real economy and is dominated by large institutions that have been severely hit by the crisis. It is lower in countries such as Japan (0.1 per cent of GDP) and Italy (0.6 per cent) where banks are more focused on traditional credit activities and so far have been less affected by the crisis. Actions for addressing capital shortages and funding difficulties have been widespread and have mostly taken the form of system-wide programmes. Measures for improving the quality of bank assets have been less common and have mainly targeted individual large institutions. However, some of the most recent initiatives include comprehensive schemes for dealing with illiquid or “bad” assets. Among banks that participate in both recapitalisation and debt guarantee programmes, the intermediaries that have received more capital (in relation to shareholder equity) have also issued more liabilities under guarantee (in relation to total liabilities). Moreover, most instances of asset purchase/guarantee occurred after earlier capital injections, suggesting that this option was used after a first phase of government support failed to fully restore confidence in troubled institutions. The average uptake rate by eligible institutions (i.e, the ratio of outlays under a given programme to total commitments) is higher for capital injections (around 50 per cent) than for debt guarantees (less than 20 per cent). The United Kingdom has the highest participation rate for both capital injections and debt guarantees, possibly reflecting the relatively small number of major banks and the tailoring of government programmes to their needs.

15. Overall, it may be mentioned that the rescue measures have contributed to an avoidance of “worst case scenarios”, in particular by reducing the default risk of major banks. Although, the rescue measures have been effective in stabilising the financial system, it is recognized that this has come at a price, represented by distortions and inefficiencies.

### **Role of Banking / Financial system in India**

16. In the analytical and empirical literature on the subject of finance and growth, there is a consensus among economists that development of the financial system contributes to economic growth (Rajan and Zingales, 2003). Financial development creates enabling conditions for growth through either a supply-leading (financial development spurs growth) or a demand-following (growth generates demand for financial products) channel. Empirical evidence consistently emphasises the nexus between finance and growth, though the issue of direction of causality is more difficult to determine. At the cross-country level, evidence indicates that various measures of financial development (including assets of the financial intermediaries, liquid liabilities of financial institutions, domestic credit to private sector, stock and bond market capitalisation) are robustly and positively related to economic growth (King and Levine, 1993; Levine and Zervos, 1998).

#### *Financial Deepening in India*

17. In the Indian case, healthy growth of the assets of commercial banks in the recent period, driven primarily by credit growth and sharp rise in credit-GDP, deposit-GDP and M3-GDP ratios are reflective of significant financial deepening in India. For example, during the period since 1980s, while bank assets-GDP ratio has tripled moving up from 31.4 per cent in the 1980s to 93.3 per cent in 2008-09, credit-GDP ratio has increased from 19.3 per cent to 52.2 per cent, deposits-GDP ratio has increased from 29.8 per cent to 72.0 per cent and M3-



GDP ratio has increased from 39.0 per cent to 89.5 per cent (Statistical Annex SA 1).

18. In a cross-country perspective, when measured by the ratio of bank assets to GDP, financial depth in India was among the lowest in the world (Barth, Caprio and Levine, 2001). Comparable cross-country data indicated that in 2001, this ratio, at 48 per cent for India, was lower than those prevalent in Asian economies such as Indonesia (101 per cent), Korea (98 per cent), Philippines (91 per cent), Malaysia (166 per cent) and much lower than developed economies, such as UK (311 per cent), France (147 per cent) and Germany (313 per cent). In India, while the ratio of bank assets to GDP has increased significantly to a shade over 93 per cent in 2008-09 – a result of high credit growth in recent years - it is still lower than other emerging countries. Financial deepening, hence, has been taking place on an accelerated pace on a macro basis in recent years and banking productivity has improved significantly.

19. As per the data from India's national accounts, over the period since 1980s, banking and insurance sector has witnessed a growth which is in excess of the overall GDP consistently over the years. In the 1980s, the growth of banking and insurance sector was 10.6 per cent vis-à-vis the GDP growth of 5.6 per cent - this increased to 15.4 per cent in 2007-08 vis-à-vis the GDP growth of 9.0 per cent (Statistical Annex SA 2).

20. Another noteworthy feature discernible in Indian context is that the rise in indicators of financial deepening takes place along with a noticeable rise in the domestic savings rate. The rate of domestic savings has specially picked up in the recent period during 2003-04 to 2007-08 against the backdrop of financial sectors reforms, rise in total factor productivity and investment boom, which had led to acceleration in the growth performance, while in the developed countries like the US and Japan the rise in financial deepening has had a limited effect on the savings rates of the economies. The results may seem contrasting; however,

the country specific reason such as the level of social security measures on welfare of people, wealth effect in the period of rising assets prices and most significantly the demographic profile which explain the Life Cycle Hypothesis (LCH) may have dampened the savings propensity in a country.

21. A *cautionary remark*, however, I would like to make here. In the context of the macro-economic trend of high services sector growth which includes the banking sector growth, I feel that the services growth needs to be well supported by growth from the real sectors of the economy. Financial leverage cannot bring perpetual prosperity. Banks need to keep this in mind, and I am telling this as a banker, not as a central banker.

### **Indian Banking Trends**

22. As you are aware, there is significant transformation of the Indian banking sector. The financial sector reforms in the country were initiated in the beginning of the 1990s. The reforms have brought about a sea change in the profile of the banking sector. Our implementation of the reforms process has had several unique features. Our financial sector reforms were undertaken early in the reform cycle. Notably, the reforms process was not driven by any banking crisis, nor was it the outcome of any external support package. Besides, the design of the reforms was crafted through domestic expertise, taking on board the international experiences in this respect. The reforms were carefully sequenced with respect to the instruments to be used and the objectives to be achieved. Thus, prudential norms and supervisory strengthening were introduced early in the reform cycle, followed by interest-rate deregulation and a gradual lowering of statutory pre-emptions. The more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place.

23. Though public sector banks (PSBs) account for around 70 per cent of commercial banking assets and 72.7 per cent of the aggregate advances of the Scheduled commercial banking system (as on March 31, 2008), competition in the banking sector has increased in recent years with the emergence of private players as also with greater private shareholding of PSBs. Listing of PSBs on stock exchanges and increased private shareholding have also added to competition. The new private banks which accounted for 2.6 per cent of the commercial banking sector in March 1997 have developed rapidly and accounted for nearly 17 per cent of the commercial banking assets by end March 2008.

#### *Financial Health of the Banking System*

24. The implementation of reforms has had an all-round salutary impact on the financial health of the banking system, as evidenced by the significant improvements in a number of prudential parameters. Let me briefly highlight the improvements in a few salient financial indicators of the banking system (Statistical annex SA 3 & 4). The average **capital adequacy** ratio for the scheduled commercial banks, which was around 10.4 per cent in 1997, had increased to 13.08 per cent as on March 31, 2008. In regard to the **asset quality** also, the gross NPAs of the scheduled commercial banks, which were as high as 15.7 per cent at end-March 1997, declined significantly to 2.3 per cent as at end-March 2008. The net NPAs of these banks during the same period declined from 8.1 per cent to 1.08 per cent. The reform measures have also resulted in an improvement in the **profitability** of banks. The Return on Assets (RoA) of scheduled commercial banks increased from 0.4 per cent in the year 1991-92 to 0.99 per cent in 2007-08. The Indian banks are well placed in this regard too vis-à-vis the broad range of RoA for the international banks. The banking sector reforms also emphasised the need to improve **productivity** of the banks through appropriate rationalisation measures so as to reduce the operating cost and improve the profitability. A variety of initiatives were taken by the banks, including adoption of modern technology, which has resulted in improved productivity.

25. One area that needs to be watched continuously due to recent crisis is the off-balance sheet (OBS) exposure of the banks. The spurt in OBS exposure is mainly on account of derivatives whose share averaged around 80 per cent. The derivatives portfolio has also undergone change with single currency IRS comprising 57 per cent of total portfolio at end- March 2008 from less than 15 per cent at end-March 2002.

26. With regard to the assessment of the banking system in India we are in a comfortable position, as confirmed by the Committee on Financial Sector Assessment (CFSA):

- (i) Commercial banks have shown a healthy growth rate and an improvement in performance as is evident from capital adequacy, asset quality, earnings and efficiency indicators. In spite of some reversals during the financial year 2008-09, the key financial indicators of the banking system do not throw up any major concern or vulnerability and the system remains resilient; and
- (ii) The single-factor stress tests carried for the commercial banking sector covering credit risk, market/interest rate risk and liquidity risk have revealed that the banking system can withstand significant shocks arising from large potential changes in credit quality, interest rate and liquidity conditions.

## **Vision from Abroad and India**

### *Vision from Abroad*

27. One key line of defence against financial instability is an improved framework of financial regulation, supervision and oversight. A holistic approach is necessary, covering stronger safeguards for instruments, markets and institutions. This means putting in place improved mechanisms to assess the suitability and risks of new financial instruments. It implies encouraging greater centralisation in clearing, settlement and, possibly, trading. It means making each institution sounder, through tighter consolidation of off-balance sheet exposures,

better accounting and improved capital and liquidity standards. Above all, it calls for strengthening the macroprudential orientation of regulation and supervision. This means focusing firmly on system-wide risks and addressing the procyclicality of the financial system.

28. The need to reform, if not completely overhaul, the current financial regulatory system has resurfaced strongly against the backdrop of the ongoing global financial crisis. It has been widely recognized that not only the American system of overlapping regulators failed, the UK System, which clearly separates regulatory powers, also failed to evolve to cater to the challenges presented by innovations in the financial markets. As risks built up, internal risk management systems, rating agencies and regulators did not understand or address critical behaviours until they had already resulted in catastrophic losses (Federal Reserve, 2009). Thus the current crisis may appear to be a result of failure of the regulatory system to address and contain systemic risks. Various proposals have been put forward by policy makers and international organisations to improve the international financial system including financial regulation and supervision. Although there are certain areas where diverse views still exist, certain key areas - like redefining the scope and boundaries of financial regulation and supervision, managing the pro-cyclicality in the system, strengthening capital and provisioning requirements as well as refining valuation and accounting rules - have witnessed growing consensus.

29. Micro-prudential regulation is not enough; it must be supplemented by macro-prudential regulation that catches the systemic consequences of all institutions acting in a similar manner. However, we must understand that better regulation will not be enough; complementary adjustments to macroeconomic policy frameworks are equally essential. These adjustments would call for a more symmetric response to the build-up and unwinding of financial imbalances. At the same time, there are clear limits to what policymakers can do: the private sector has a critical role to play as well. Business models in the financial sector

will have to evolve if they are to recognise the need for larger, higher-quality capital and liquidity cushions. Similarly, internal and external governance mechanisms will have to be strengthened to ensure better risk management and less risk-taking.

30. The solution to the crisis is not more regulation, though more comprehensive regulation may be required in some areas. Innovations in the form of complexity and sophistication of products and services, coupled with profitability and competitive considerations, have changed the dimensions of risks faced by banks. The Committee on Financial Sector Assessment (CFSA) argued that the present global financial crisis has highlighted the limitations of the present Basel Core Principles in as much as the assessment does not specifically cover areas like SIVs/NBFCs or aspects like dynamic provisioning and countercyclical norms. Hence, the CFSA felt that the Basel Committee on Banking Supervision should revisit the Basel Core Principles to cover the new areas. Secondly, the CFSA also noted that though BCPs are not strictly applicable to financial institutions other than commercial banks, the efforts to extend the scope of BCP assessment to other sectors are commendable in the current context of the potential linkages of such institutions and their impact on the stability of the financial system. The Reserve Bank has already been extending such principles to non-bank entities, subject to certain thresholds and the nature of their operations.

31. Another aspect which also came under criticism is the CEO compensation and the moral hazard generated by the skewed incentive structure. The question being raised is not only about the appropriate level of CEO compensation and its linkage with performance but also the gap between the pay of the top-most executives and employees at the bottom of the hierarchy. How should a proper compensation structure be devised is a challenge that the HR executives in banks have to work on in the days to come.

## *Vision from India*

32. The fact that India has not gone through any financial crisis as a result of financial deregulation is not only remarkable, but a testimony to the correctness of the judgment that reforms to global standards need to be adjusted to local conditions (Mohan, 2007). The need of the hour is to have financial sector reforms in a recalibrated manner to address the issues in light of the crisis. India has so far remained relatively insulated from the crisis that global banking system has experienced in the course of the 1990s. Our exposure to troubled sub-prime assets and related derivatives is negligible in comparison to many other economies. The fact that so far, financial sector reforms have been calibrated with a progressive integration into the world economy has paid us rich dividends. A key consideration in the choice of pace and sequencing has been the management of volatility in financial markets and implications for the conduct of monetary operations. The nuanced approach to financial sector reform has served us well with an accent on conscious gradualism in the implementation of coordinated and sequenced moves on several fronts. What have been ensured are appropriate safeguards to ensure stability, while taking account of the prevailing governance standards, risk management systems and incentive frameworks in financial institutions in the country. Overall, these progressive but cautious policies have contributed to efficiency of the financial system while sustaining the growth momentum in an environment of macroeconomic and financial stability. The policy challenge is to continue to ensure financial stability in India during this period of international financial turbulence, while achieving high growth with price stability.

33. Some of the reasons for India's insulation as highlighted by Dr. Y.V. Reddy, the former Governor of the Reserve Bank of India are: (1) The nascent stage of development of the credit derivatives market; (2) Regulatory guidelines on securitisation do not permit immediate profit recognition; (3) Perseverance of prudential policies which prevent institutions from excessive risk taking and financial markets from becoming extremely volatile and turbulent; and (4) Close co-ordination between supervision of banks and their regulation.

### *Three Critical Issues*

34. I would like to bring to the fore three issues that I consider very important for the qualitative growth of the Indian banking as we move ahead. First is the issue related with 'Know Your Customer (KYC)' in banks; Second, from a central banker's perspective whether the banks are according 'fair treatment' to their customers; and Third, is the issue of 'Risk Management' and its proper understanding. Let us discuss these three important issues in detail now.

### *Know Your Customer (KYC)*

35. First is the issue of KYC in banks and its importance in the overall enhancement in the functioning of the banks. Sound KYC policies and procedures not only contribute to a bank's overall safety and soundness, they also protect the integrity of the banking system by reducing the likelihood of banks becoming vehicles for money laundering, terrorist financing and other unlawful activities. There are three components here. 'Knowing their customers' is not enough for banks, they should also know the 'business' of their customers; and if the banks know the business of their customers, the banks can certainly assess the risks associated with each of their customers. The banks should realize that KYC is not only a risk management process but it also makes a good business sense.



## *Treating Customers Fairly*

36. Second issue is with regard to banks' treating customers fairly (TCF). This requirement is key to the operation of an efficient retail market for financial services. TCF is also central to consumers having confidence in the financial services industry. This principle must be adopted and supported by the leadership of financial firms, and embedded throughout a firm's operations and within its culture. Another important aspect related to TCF is from the Regulator's perspective. One may ask why the regulator should at all be concerned about customers not being treated fairly by banks. In this connection, it is important to note that not all financial entities are accorded the status of the 'Banks'. The banks do business many times more than the deposit resources they raise and hence they have a special responsibility to customers for providing fair treatment. Banks need to respond to the challenge of restoring consumer confidence in the financial services industry and ensuring that they treat their customers fairly.

37. In addition, in a competitive marketplace, TCF should be an important element (alongside service levels, pricing and customer satisfaction) in determining the success of a bank in acquiring and maintaining market share. However, in many markets for retail financial products and services the incentive structure for firms to treat their customers fairly has not always been robust enough to deter all firms from inadvertently or deliberately taking advantage of the relative weakness of the financial services consumer.

38. There should be a blend of regulatory and market-based solutions to delivering fairness to customers. The key issue is the balance between these two. The issue of addressing the fair treatment of customers throughout the product life-cycle comprises:

- Product design and governance;
- Identifying target markets;
- Marketing and promoting the product;

- Sales and advice processes;
- After-sales information; and
- Complaint handling.

These issues will create challenges for banks. They may have to adapt the management, reward and operating systems they currently use and enhance the controls they have in place to monitor whether they are meeting the TCF requirement.

39. Financial Services Authority (FSA), UK sometime back had conducted a limited pilot study to look at how major retail financial services groups, drawn from different sectors, currently approach delivering on their obligation to treat their customers fairly. The results confirmed that these banks are concerned with addressing the requirement to treat their customers fairly, but still significant work is needed to improve practices in some of the areas.

40. To sum up, there is a need to develop a better, and common, understanding of what TCF means in practice. Banks need to examine what most effectively constitutes fair treatment of customers. Banks' senior management needs to assess their current performance against the requirement to treat customers fairly, identify possible areas for improvement and ensure that the principle of fairness is embedded in their work-culture.

### *Risk Management*

41. The third issue is which has assumed critical significance now is 'Risk Management' and its proper understanding. We cannot view banks' risks at individual level in isolation all the time. It has also been argued that the emphasis on micro-prudential regulation may have contributed to the buildup of some macro risks. Collectively, the systemic risk is becoming more and more prominent with the increasing complexities and the associated risk factors in the

banking activities. The banks have to have a proper understanding of all the risk factors and at the same time they have to ensure that their customers also understand and appreciate the associated risk. In the event of such banking activities leading to the emergence of systemic risks, the central bank may intervene which might result in stricter regulation and supervision.

42. Another critical issue is of capital and liquidity risk management in the banks in the wake of the crisis. We may have a situation where the liquidity may dry up and the banks and the financial institutions would face severe liquidity crunch due to adverse market conditions. In this scenario, the liquidity crunch might completely wipe out the capital of the bank as well leading to its failure. Another case might be a scenario where plenty of liquidity in the market may fuel inflation. Therefore, we have to be vigilant and monitor the market conditions more vigorously.

43. In recent times increase in the banks' dependence on bulk deposits to fund credit growth has assumed significance as this could have liquidity and profitability implications. An increase in growth in housing loans, real estate exposure as also infrastructure has resulted in elongation of the maturity profile of bank assets. There is growing dependence on purchased liquidity and also an increase in the illiquid component in banks' balance sheets with greater reliance on volatile liabilities, like bulk deposits to fund asset growth. Simultaneously, there has been a shortening of residual maturities, leading to a higher asset-liability mismatch. There is a need to strengthen liquidity management in this context as also to shore up the core deposit base and to keep an adequate cushion of liquid assets to meet unforeseen contingencies. What needs to be borne in mind is that while at an individual bank level, retail deposits may be volatile, but for the banking system as a collective lot, it provides solid foundation for the banks to fund their long term assets like infrastructure and similar business activities.

### *Inclusive Growth: Financial Inclusion Leveraging Technology*

44. In the history of civilization it has always been the technology which has led to mass availability of products. Same is the case for banking services. We are in the midst of the most exciting period of human civilization when two billion of population is expected to move 'up' from below poverty line (BPL). Majority of this will be in this sub-continent and banks will have an opportunity to participate in this process, which will bring peace and prosperity to the nation.

45. For achieving the goal of Financial Inclusion, experts have recommended the Business Correspondent / Facilitator (BC/BF) model. However, some recent studies have pointed out that the BC model may not be commercially viable due to a high transaction cost for the banks and customers. Here, the appropriate use of technology can help in reducing the transaction cost. The need of the hour is to develop and implement scalable platform independent technology solutions which, if implemented on a larger scale, will bring down the high cost of operation. Technology, thus, really holds the key for financial inclusion to take place on an accelerated scale.

46. The need of the hour is leveraging technology in Indian banking for providing affordable and cost-effective banking services to the masses through multi-delivery channels. All of us know that apart from traditional business, banks now-a-days provide a wide range of services to satisfy the financial and non-financial needs of all types of customers from the smallest account holder to the largest company and in some cases of non customers. The range of services offered differs from bank to bank depending mainly on the type and size of the bank. The key enabling factor has been the adoption of technology. Banking industry is fast growing with the use of technology in the form of ATMs, on-line banking, Telephone banking, Mobile banking etc., plastic card is one of the banking products that cater to the needs of retail segment has seen its number grow in geometric progression in recent years. The internet banking is changing

the banking industry and is having the major effects on banking relationship. Retail banking in India is maturing with time; several products, which further could be customized are in the retails segments of housing loan, personal loan, education loan, vehicle loan, etc.

47. Being convinced that technology is the key for improving in productivity, the Reserve Bank took several initiatives to popularize usage of technology by banks in India. Periodically, almost once in five years since the early 1980s, the Reserve Bank appointed Committees and Working Groups to deliberate on and recommend the appropriate use of technology by banks given the circumstances and the need.

48. Even as global financials face growth and asset-quality issues, Indian banks continue to offer a healthy growth trajectory with minimal balance-sheet risks. Despite the high growth rate of the past decade, penetration for most financial products/services in India remains low. Indian banks can sustain their structural growth trajectory, driven by an under-penetrated financial-services sector, a conducive economic environment and a supportive regulatory regime. Financial penetration holds the key to financial inclusion and inclusive growth. Favorable demographics would be a facilitating factor. Way forward, financial penetration is expected to rise as banks expand into new areas, focus on building their retail business and strengthen their risk-management system.

49. In the past five years, banking sector deposits have seen a healthy growth driven by a host of factors: acceleration in nominal GDP growth; rising savings rate; increasing proportion of bank deposits in total financial savings; and inflow of non-retail deposits. With most of these factors being close to their peak levels, deposit growth would be contingent on banks' ability to boost their deposit growth through their increased presence in semi-urban and rural areas.

## **Conclusion**

50. To sum up, while global banking developments have offered innumerable perspectives, important perceptions are emerging from the Indian banking developments. Given the long term objective of achieving 9.0 per cent of GDP growth, we need to understand that there are significant challenges for Indian banking. Of these, the major challenge would be to achieve financial inclusion through improved financial penetration in hitherto uncovered areas, which in turn would enable inclusive and sustainable growth for the economy. We all have to put our minds together and continually strive towards achieving this in the days ahead.

51. The question currently on top of the minds of most bankers in this room would be: what will be the shape of banking in days to come? Will banks do business differently? What are the changes that are likely to take place? We have to deliberate and explore many options in this regard. The only thing that can be said at this juncture is that regulation may become tighter and supervision more controlled. Other than that, it is difficult to say whether there will be any fundamental change in the way banks work. I am sure participants will deliberate on all these issues in the next few days and bring out some useful insights.

I wish the IBSS deliberations a grand success.

Thank you.

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## Statistical Annex

<b>SA1: India - Indicators of Financial Deepening</b>					
<b>Item</b>	<b>1980-81 to 1989-90</b>	<b>1990-91 to 1999-00</b>	<b>2000-01 to 2008-09</b>	<b>2007-08</b>	<b>2008-09</b>
1	2	3	4	5	6
<b>M3</b>					
Growth rate	14.7	14.8	15.3	17.9	24.4
M3/GDP (per cent)	39.0	47.5	69.9	76.5	89.5
<b>Credit</b>					
Growth rate	14.3	13.9	18.5	18.2	15.0
Credit/GDP (per cent)	19.3	20.6	36.6	50.1	52.2
<b>Deposits</b>					
Growth rate	15.3	14.6	14.2	18.3	16.6
Deposits/GDP (per cent)	29.8	37.4	57.4	67.8	72.0
<b>Bank Assets</b>					
Growth rate	-	15.4	16.0	20.0	12.8
Bank Assets/GDP (per cent)	31.4	34.0	64.4	91.8	93.3
<b>Flow of Funds</b>					
FR	0.22	0.32	0.46#	-	-
FIR	2.41	2.34	2.57#	-	-
NIR	1.42	1.29	1.60#	-	-
IR	0.71	0.82	0.61#	-	-
<p>Note:</p> <p>i) Finance Ratio = Ratio of Total Issues to National Income (Net National Product at Factor Cost at Current Prices).</p> <p>ii) Financial Inter-relations Ratio = Ratio of Total Issues to Net Domestic Capital Formation</p> <p>iii) New Issue Ratio = Ratio of Primary Issues to Net Domestic Capital Formation</p> <p>iv) Intermediation Ratio = Ratio of Secondary Issues (i.e. issues by banks and other financial institutions) to Primary Issues.</p> <p>#: Pertains to the year 2000-01.</p> <p>Source: 1. RBI, Handbook of Statistics on the Indian Economy 2007-08.                  2. Report of the High Level Committee on Estimation of Saving and Investment.                  3. IMF, Global Financial Stability Report, April, 2009.</p>					



**SA 2: Banking and Insurance Sector in India's GDP**

Item	1980s	1990s	2000s	2006-07	2007-08
<b><i>Growth</i></b>					
Banking and Insurance	10.6	9.8	9.9	20.3	15.4
Services	6.3	7.1	9.0	11.3	10.8
GDP	5.6	5.7	7.3	9.7	9.0
<b><i>Share</i></b>					
Banking and Insurance	3.1	4.9	6.1	6.7	7.1
Services	46.3	51.5	59.6	62.0	63.0
GDP	100	100	100	100	100
<b><i>Contribution to GDP</i></b>					
Banking and Insurance	0.3	0.5	0.6	1.2	1.0
Services	2.9	3.6	5.3	6.9	6.7

Source: National Accounts Statistics,  
Central Statistical Organisation

<b>SA 3: Non-Performing Loans (NPL) of Scheduled Commercial Banks</b>				
(Per cent)				
<b>End-March</b>	<b>Gross NPL/</b>	<b>Gross NPL/</b>	<b>Net NPL/</b>	<b>Net NPL/</b>
	<b>Gross Advances</b>	<b>Assets</b>	<b>Net Advances</b>	<b>Assets</b>
<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
1996-97	15.7	7	8.1	3.3
1997-98	14.4	6.4	7.3	3
1998-99	14.7	6.2	7.6	2.9
1999-00	12.7	5.5	6.8	2.7
2000-01	11.4	4.9	6.2	2.5
2001-02	10.4	4.6	5.5	2.3
2002-03	8.8	4	4.4	1.9
2003-04	7.2	3.3	2.8	1.2
2004-05	5.2	2.5	2	0.9
2005-06	3.1	1.8	1.2	0.7
2006-07	2.4	1.5	1	0.6
2007-08	2.3	1.3	1	0.6

**Source:** Reserve Bank of India.

## SA 4: Cross-Country Select Banking Indicators – A comparison

(Per cent)

Country	Regulatory Capital to Risk-Weighted Assets (CRAR)				Non-performing Loans to Total Loans				Provisions to Non-performing Loans				Return on Assets (ROA)			
	2002	2006	2007	2008	2002	2006	2007	2008	2002	2006	2007	2008	2002	2006	2007	2008
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
<b>Developing Economies</b>																
Argentina	-	-	16.9	16.8	18.1	3.4	2.7	2.5	73.8	130.2	129.6	130.9	-8.9	2	1.5	1.6
Brazil	16.6	18.9	18.7	16.6	4.5	4.1	3	2.9	155.9	152.8	181.8	170.9	2.1	2.5	2.9	2
China	-	-	8.4	8.2	26	7.5	6.7	2.5	-	-	39.2	115.3	-	0.9	1	-
<b>India</b>	<b>12</b>	<b>12.4</b>	<b>12.3</b>	<b>13</b>	<b>10.4</b>	<b>3.5</b>	<b>2.5</b>	<b>2.3</b>	<b>-</b>	<b>58.9</b>	<b>56.1</b>	<b>52.6</b>	<b>0.8</b>	<b>0.9</b>	<b>0.9</b>	<b>1</b>
Indonesia	20.1	21.3	19.3	16.8	24	13.1	4.1	3.5	130	99.7	87.7	98.5	1.4	2.6	2.8	2.6
Korea	11.2	12.8	12.3	10.9	2.4	0.8	0.7	1.1	89.6	175.2	199.1	155.4	0.6	1.1	1.1	-
Malaysia	13.2	13.5	13.2	12.6	15.9	8.5	6.5	5.1	38.1	50.7	77.3	86.9	1.3	1.3	1.5	1.6
Mexico	15.7	16.3	15.9	15.3	3.7	2.1	2.7	2.5	138.1	207.4	169.2	184	0.7	3.1	2.7	1.8
Philippines	16.9	-	15.7	15.5	26.5	18.6	5.8	5.2	30.1	37.4	81.5	84.1	0.8	1.3	1.3	1.1
Russia	19.1	14.9	15.5	14.5	5.6	2.6	2.5	2.5	112.5	159.3	144	140	2.6	3.2	3	1.6
South Africa	12.6	12.3	12.8	12.5	2.8	1.2	1.4	2.6	46	-	-	-	0.4	1.4	1.4	1.8
Thailand	13	13.8	14.8	15.3	15.7	7.5	7.9	6.5	62.9	79.4	86.5	-	-	2.3	0.1	-
Turkey	24.4	21.1	19	17.7	12.7	3.2	3.5	3.3	64.2	90.8	88.4	81.6	1.2	2.4	2.8	2.2
<b>Developed Economies</b>																
Australia	9.6	10.4	10.2	10.9	0.4	0.2	0.2	0.5	106.2	204.5	183.7	87.2	1.4	-	1	0.9
Canada	12.4	12.5	12.1	12.7	1.6	0.4	0.7	1.1	41.1	55.3	42.1	34.7	0.4	1	0.9	1.3
France	11.5	-	10.1	-	4.2	3.2	2.7	-	58.4	58.7	61.4	-	0.5	-	0.4	-
Germany	12.7	-	12.9	-	5	4	2.7	-	-	-	77.3	-	0.1	0.5	0.2	-
Italy	11.2	10.7	10.4	-	6.5	5.3	4.6	-	-	46	49.5	-	0.5	0.8	0.8	-
Japan	9.4	13.1	12.9	12.3	7.4	2.5	1.5	1.5	-	30.3	26.4	24.9	-0.7	0.4	0.2	0.3
United Kingdom	13.1	12.9	12.6	-	2.6	0.9	0.9	-	75	-	-	-	0.4	0.5	0.4	-
United States	13	13	12.8	12.5	1.4	0.8	1.4	2.3	123.7	137.2	93.1	84.7	1.3	1.3	0.8	0.3

Source: 1. Global Financial Stability Report, 2007, IMF

2. Global Financial Stability Report, 2009, IMF