

## **Indian Banking Industry – Regulatory challenges**

1. In a recent talk Ravi Menon MD of MAS referred to Angus Maddison's history of the world according to which two thousand years ago, India had the largest GDP in the world. China was close behind. Together, they accounted for more than half of global GDP. By 1950, the share of India and China fell to less than 10 per cent. By the end of the last century, Asia less Japan had doubled its share to 30 per cent of global GDP. China is already the second largest economy in the world, India the fourth largest, According to forecasts, China's economy will become the largest in the world in 2022. India is projected to become the world's third largest economy by 2015.

2. Savings rate in India is about one third of GDP –household savings contribute 70.0 per cent. Financial savings are around 50 per cent of household savings; investments in housing and small enterprises constitute the rest. Gold although treated as consumption is really a form of physical savings. Bank deposits constitute 55 per cent of household financial savings The Indian financial system is heavily dominated by commercial banks. Within the banking system, public sector banks (majority shareholding held by the Government of India) account for nearly 70 per cent of the banking system assets. RBI regulates banking sector, non-banking financial companies (NBFCs), as also the money, forex and Government securities markets which are dominated by banks. There are separate regulators for capital markets, insurance sector and pension funds. Many banks are engaged in securities pension and insurance activities through associates and subsidiaries and there has been a need for coordination among sectoral regulators which has been ensured through inter-regulatory bodies within the umbrella of a high level committee chaired by the Governor, RBI and with representatives from Ministry of Finance. This institutional arrangement has recently undergone a change with the establishment of the Financial Sector Development Council (FSDC) chaired by the Finance Minister.

3. To trace the backdrop of banking regulation in India till the crisis of 1991, there was a repressed financial sector; statutory pre-emptions were high, fiscal

requirements crowded out private credit, interest rates were administered, directed lending was coupled with ceilings on rates of interest, competition was limited and there were tight controls on the external account –both current account and capital. The crisis of 1991 brought in a wake of measures for liberalizing external trade and investment, a more flexible exchange rate regime, increased competition, fiscal reform and consolidation with a view to improving macro economic stability, productivity and efficiency. Financial sector reforms were undertaken “not in the context of responding to a crisis or vulnerability in financial sector, but aimed at improving its efficiency. Its aims were to release the rigour of financial repression, improve prudential regulation, promote competition, and increase openness of the economy.”(Reddy 2011)

5. Rather than spell out the various details of the banking sector regulatory framework as it evolved since 1992, it would be useful to capture the underlying principles or philosophy.

- First, the basic objective has been to attain global best standards in regulation and supervision. The goal posts were clear – the timelines were fixed with a view to move towards these goal posts in a non disruptive manner especially at a time when the economy was going through a process of structural adjustment.
- Second, the fiscal imperative implied that a significant part of bank liabilities had to be mandatorily invested in government securities. This is the Statutory Liquidity Ratio (SLR) which was reduced steadily from 38.5 per cent from the pre reform era to 24 per cent currently. The price of such government securities is market determined, with issuance of securities through auction route. In the more recent period, this ratio has proved to be both a solvency and liquidity buffer.
- Third, banking exposures to real estate and capital markets are consciously contained as these are found to be at the root of many a financial crisis. While no limits, the Boards of banks are required to frame a policy for real estate exposures. In case of capital market exposures, there is limit of 40 per cent of capital funds. As a part of this

approach, banks are not allowed to finance the purchase of land or finance mergers and acquisitions within the country.

- Fourth, foreign currency funding of the banking and financial sector - both wholesale and retail- is constrained other than for exports. In case of wholesale funding the limits are linked to bank's Tier I capital and in case of retail liabilities, there are stipulations on minimum maturity and maximum rates of interest.
- Fifth, capital flows and the impact of such inflows have been actively managed in the interest of financial stability through a variety of instruments of intervention, sterilization, liquidity adjustment and administrative measures.
- Sixth, the focus in market regulation especially forex money and debt markets (including their derivatives ) has been on orderly development ; these markets were practically nonexistent (except for a very basic forex market where some trading was allowed) when the reform process began in 1992. Centralized reporting and settlement for ensuring transparency, restricting uncollateralized exposures in the overnight and short term markets and stipulating limits on interbank/inter agency exposure for limiting the interconnectedness, prescribing higher CCFs for derivatives for addressing higher risk due to volatility, conservative accounting treatment for unrealized gains on securities including on sale of securitized assets, placing limits on cross holdings in the financial sector Tier II bonds, allowing CDS volumes only to the extent of underlying are some of the regulatory measures designed to ensure that the financial markets development is orderly. In case of securitization , minimum capital of 9% is required to be maintained on any credit enhancements provided, and the release of credit enhancement is disallowed during the life of the credit-enhanced transaction.
- Sixth, recognizing the growing importance of financial conglomerates and the spillover of such risk from associate entities to the bank's books, a framework for monitoring and supervising financial conglomerates was put in place in 2004. These include off-site surveillance through

quarterly returns, regular interactions with the CEOs of the Parent Companies and other entities in the Group, periodic reviews by a Technical Committee having members from sectoral financial market regulators.

- Seventh, although the share of shadow banking system is not high, the non banking financial companies posed reputation risk to the regulator, and over the years the approach has been to contain the deposit taking activity of such companies while bringing in CRAR and other prudential norms for larger non deposit taking financial companies that were funding themselves through bank borrowing and other public funds.
- Eighth, recognizing that the system will gravitate to the weakest and the most lightly regulated, Basel norms are being put in place in a phased manner for urban cooperative banks , rural cooperative banks and regional rural banks
- Ninth, regulations such as branch licensing, mandating that every bank should have a basic banking account or no frills account facility, priority sector lending targets and norms, branchless banking have been used to ensure that banking is inclusive. In case of priority sector loans the interest rates are free to be fixed by banks taking into account costs and risks.
- Finally, and most importantly, RBI has been using macro prudential polices, more notably the countercyclical prudential policies and the external account policies, as a part of its toolkit for ensuring financial stability. These policies have focused on banks due to the centrality and criticality of the banking system in the Indian economy and are intended to cushion the financial system from potential stress rather than for dampening assets bubbles or economic cycles. These measures were not based on any statistical models but were rather based on judgments. While adopting harmoniously monetary and macro prudential policies it was at the same time understood that macro prudential policies are not a substitute for monetary action. Having the authority to act on both these in RBI definitely helped the decision making process.

6. Where does the banking system stand today? The aggregate capital to risk weighted assets ratio of the Indian commercial banking system (under Basel II norms) is a little over 14 per cent of which Tier I capital constitutes about 9 per cent. Indian banks already make most of the deductions from capital now being proposed under Basel III. Leverage in the system is moderate. As per the latest Financial Stability Report from RBI, the various macro-financial stress tests, including the newly introduced ones based on more rigorous computation methodologies, also show that the banking sector remains adequately capitalized and resilient to asset quality shocks and other plausible adverse changes in macroeconomic scenario.

7. So what are the regulatory challenges looking ahead? These are obviously linked to the challenges facing the banking system itself.

The first regulatory challenge that I see is balancing the needs of economic growth with those of stability. The cost of credit may go up at a time of growing credit demand arising from strong growth, structural transformation of the economy and financial deepening. The tension between growth and stability can also be illustrated with the example of infrastructure funding for which there is huge demand. Such funding involves liquidity risk, interest rate risk and credit risk. Ideally these could be managed through the bond, currency and derivatives markets. From the stability perspective however, given the growth interest and inflation differential between India and the ROW, the access to global investors has to be calibrated. Thus banks have a large exposure to this sector giving rise to ALM as also concentration risk. While several measures are being taken to develop the long term institutional investors such as insurance and pension funds, these will take time. Another example is of interest rate futures. While allowing these on the stock exchanges, RBI wanted delivery based settlement to ensure the link between the future and the underlying. This, apparently, is impeding the market development.

The second challenge I see is balancing the needs of financial inclusion with those of financial stability and prudential regulation. In some areas like KYC, local and community based banks, proportional regulation is the answer viz. there can be differentiated regulation based on the risk to the system. In other areas it is not so simple. In applying a uniform set of regulatory norms across sectors, it is possible that the nature of risk is not properly differentiated or exhibits a tendency for regulating for the mean. This particularly affects the SME –so critical for inclusive growth. First, in retail lending the activity specific cash flow patterns and portfolio level risk profile will need to be recognized. The concept of retail lending was brought into Basel 2 with a specific focus on SMEs. The diversification benefit resulting in lowering of risk was recognized; under advanced approaches, models that factor in default behavior over business cycles provide a more realistic measure of risk. The challenge lies in enhancing capabilities amongst banks and supervisors to move to advanced approaches where the credit risk in development finance can be properly captured. This requires banks to populate their data base for a sufficient number of years and capture them with sufficient granularity and develop robust models on the basis of which PDs LGDs and EADs can be worked out- these will need to be vetted by the regulators. Second, SMEs that do not qualify as retail credit are subject to an external rating based risk weight under the standardized approach. There are significant challenges in this regard. First the rating agencies do not have adequate credit history to model the default rate. Second, the volumes are huge and difficult to cope with. Third, the ratings could increase the cost of credit. Fourth, even with a good rating the availability and pricing of credit depends on other factors. Finally the SME borrowers may not be able to present well audited accounts and facts about markets and business dynamics that can be relied upon by credit rating agencies. All this means that banks have to systematically capture within their organizations the information so that the internal ratings are developed for this segment which is perhaps the one that delivers the best risk adjusted return. It also means development of skills in banks and supervisors to be able to follow these advanced approaches.

The third regulatory challenge arises from increasing integration of India with the global economy. There are three aspects to this. The first relates to the expansion of Indian business offshore and Indian banks following their clients in these regions. An early regulatory response when the Indian businesses started acquisitions in 2004, was to allow Indian banks to extend credit support to Indian companies for mergers and acquisitions overseas, while continuing to restrict M and A funding in India. While the Indian banks pursue their legitimate business opportunities especially in the potential growth areas in the world, the challenge for both the banks and the regulator will be to see that the governance and risk management systems are tuned in finely so that mid course corrections can be made. Indian banks' expansion overseas would also mean that the home supervisors will have to increasingly work closely with host supervisors. The second aspect relates to the regulation of overseas banks in India. The Reserve Bank of India has recently put out a discussion paper on the subsidiary route as one that should be adopted by foreign banks wanting a larger presence in the country. The advantage of this route will be a more favourable treatment for dispensations such as branch licensing policy. But the banks will be obliged to meet the priority sector targets including loans for agriculture. Here the regulatory challenges are the extent of national treatment and clarity on the policy framework and its implementation. The preference for subsidiary form of presence has got strengthened in the wake of the global crisis when national regulators have wanted to ring fence the domestic depositors from problems faced by the banks globally. Apart from this, there is also the issue of how to cushion the impact on the domestic economy of the credit channel seizing up, when there are problems faced by the foreign banks. This can also happen when there is high dependence on external borrowing and/or larger share of foreign banks in the system. A recent BIS paper attempts to make a distinction between multinational banks and international banks primarily based on their funding models. It argues that from the perspective of stability of banks' exposures to borrowers, local funded positions as in the case of multinational banks are more stable during the crisis than those funded across borders and currencies, as in the case of international banks.

The fourth regulatory challenge will be to handle the fall out of increased competition that will come on account of larger presence of foreign players, new domestic licenses as also on account of increasing cross border lending. RBI has put out a discussion paper on new bank licenses. Draft guidelines are being finalized in consultation with the Government of India. As new banks come in there will be more competition. There will be a tendency for the top rated borrowers in India to seek lower cost of funding in the global markets and domestic markets; and the domestic banking system will be the first victim of such a tendency. Banks will also face competition in the payments systems. Already the mobile wallets, closed and semi closed user groups pose such competition. The challenge for the banks will be to devise low cost payments solutions harnessing technology and their inherent strengths such as core banking to deliver a slew of financial services to the millions of clients targeting the bottom of the pyramid. The challenge for the regulator, especially when the regulator for the payments and settlements system is also the central bank, is to balance between efficiency and safety especially as financial inclusion requires a ubiquitous interoperable payments system.

Fifthly, the banks and the regulator will face challenges as they move to advanced approaches. Migration to advanced approaches under Basel II norms will facilitate a closer alignment of capital requirement with the risk profile of banks, improved quantification of Pillar II risks and enhanced monitoring and reporting processes. The process of migration, however, comes with inherent challenges. The foremost constraint is the availability of skilled personnel and robust data, especially in case of credit and operational risks. Internal rating systems to support the quantification of default and loss estimates, calibration of the exposure at default (EAD) and loss estimates to downturns and validation of risk models are integral to the advanced approach for credit risk. These systems require a large time series data, understanding of credit cycles and quantitative modeling of macro and micro level risk factors. On the other hand, operational risk modeling is a relatively new discipline and the methodologies are still evolving.

The sixth challenge relates to the Basel III proposal for countercyclical capital buffers for the banking system. The primary aim of the buffer is to achieve the broader macro prudential goal of protecting the banking sector from periods of excess aggregate credit growth which are often associated with the build-up of systemic risks. The regulatory authorities in each jurisdiction will therefore be required to monitor credit growth and make assessments of whether such growth is excessive and/or is leading to the buildup of systemic risks. Based on this assessment, they will need to use their judgment to determine whether a countercyclical buffer requirement should be imposed, to what extent it should be imposed and when the requirement should be removed. The common reference guide suggested by the Basel Committee is based on the aggregate private sector credit-to-GDP gap. This indicator does not work so well in all countries like India, where it tends to rise for structural reasons – higher credit off take due to higher growth and greater penetration. Also, some economic sectors are relatively new in India and banks have only recently begun financing them in a big way. The risk build-up, if any, in such sectors cannot accurately be captured by this ratio. To quote from the recent Financial Stability Report , “the calibration of the buffer in the Indian context will, therefore, have to rely on a mix of qualitative and quantitative indicators and will require a considerable degree of judgment. Further, in India, sectoral approaches to countercyclical policies have stood the test in the past. The tools used in India to contain procyclicality are essentially time-varying provisioning for standard assets and differentiated risk weights for sensitive sectors.”

The seventh challenge will be undertaking consolidated supervision over financial conglomerates as several regulators are involved. The supervisory processes for the major banking groups are being strengthened: a revised offsite reporting format has been introduced to improve capturing of the group risk profile; the criteria for the identification of FCs has been revised to include off balance sheet position of banks and NBFCs; and guidelines on the corporate governance framework and management /monitoring of risks arising of intra-group transactions and exposures are being issued. A Working Group

on the Introduction of Financial Holding Company Structure in India constituted by the Reserve Bank has recently recommended that the financial holding company model should be pursued as the preferred model for the financial sector in India. It has recommended that a separate legislation should be enacted for the regulation of financial holding companies and that the Reserve Bank should be designated as the regulator for such companies. The implementation of this approach will pose regulatory challenges.

There are many other challenges that I am not covering such as convergence with IFRS, the public sector nature of the banking system and its implications not because these are not important but because I think they involve the government to a greater extent. Hence finally I come to the biggest challenge- the human dimension. There will have to be team of highly skilled and experienced regulators and supervisors for coping with the challenges articulated. It requires not only skills but also timely responses for mid course corrections –these require the requisite authority and the courage to use the authority. To conclude by adapting a quote from Charles Wilson “ Regulators must look ahead and plan for all types of risks, competition, obsolescence, depletion of natural resources, population movements, fashion changes and political attack. They must grow reserves against hard times, improve efficiencies and make financial services more affordable, and make the public consider them as a national asset.”

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