BANKING SECTOR REFORMS

A journey, not a destination

RBI Deputy Governor SS Mundra speaks at Governance Now's India Banking Reforms Conclave 2016

The title of my speech today is 'Banking Sector Reforms: A Journey, Not a Destination'. Why do I say so? It would be relevant here to peep into some history. Though some of the issues cut across the banking industry, the emphasis here is predominantly on public sector banks (PSBs).

- PSBs came into existence with nationalisation in the years 1969/1980. How was the banking scenario in the next couple of decades?
  - Highly regulated credit flow (selective credit control, credit authorisation scheme, no consumption credit and so on)
  - Militant unionised atmosphere – resistance to technology
  - Stiff branch authorisation norms, loan melas, opaque income recognition and asset classification (IRAC) norms … just to name a few
- Post-reform years (after 1991) saw several far-reaching reforms in banking industry also. A few of these include:
  - Deregulation of credit processes and interest rate structures
  - Introduction of prudential IRAC norms
  - Licensing of banks in the private sector/part divestment in PSBs
  - Migration to CBS
  - VRS (year 2001)
  - Gradual reduction in pre-emptions
- Resultantly, by the year 2008, banks' balance sheets were much stronger/growth was strong/NPAs had come down from the peak of around 12 percent to slightly over 2 percent.

Then two developments took place:
  - Global financial crisis
  - Introduction of PPP model in infrastructure building

Banks were enthusiastic, rather major partners, in this newly opened field supported by accommodative fiscal and easy monetary policies. However, the process got plagued by:
  - Weak governance, lax underwriting, high corporate leverage, several policy logjams
  - Resultant consequences are well known

Fast Forward to June 2016

(See table)

- To be fair to the sector, some of the events were external and hence, not in control of the bank management. But the important lesson is unambiguous: "In absence of strong structural and governance reforms, consistency of the performance would always remain susceptible to such events."
- Such reforms in private sector banks have to be focussed on misaligned incentives/compensations.
- Agenda for PSBs is much larger, however, the immediate and overriding priority is to complete the clean-up of the banks' balance sheets which is underway.
- Resultant provisioning needs coupled with meeting Basel III norms/migration to IFRS and to capture due market share in growth funding would entail recapitalisation of most of these banks. Seeking this capital externally at this stage may be difficult as also value eroding for the majority owner.
- Simultaneously process has to continue to bestow greater 'governance autonomy' to these banks. My sense is that the government ownership of these banks has resulted in crucial stability and resilience in trying times. The immediate roadmap should, therefore, be towards complete 'managerial autonomy'. If the government remains the largest shareholder, not necessarily majority shareholder, it still serves the intended purpose. At the same time, it releases these banks from multi-institutional oversights and overlapping controls.
- HR autonomy would naturally flow from the above. Banks would be able to move towards competitive compensation, flexible hiring and move away from the 'collective bargaining' – just to quote a few from many possible outcomes.
- There could be a reasonable apprehension that such measures can adversely impact the objectives of inclusive growth being attempted through several national missions and

Asset Quality									
Bank Group	Gross NPAs to Gross Advances (%)			Restructured Std Adv to Gross Advances (%)			Stressed Advances (GNPAs+RestStdAdv) to Gross Advances (%)		
	Mar-15	Mar-16	Jun-16	Mar-15	Mar-16	Jun-16	Mar-15	Mar-16	Jun-16
PSBs	5.4	9.8	11.3	7.8	4.6	4.1	13.2	14.4	15.4
Pvt. SBs	2.2	2.7	2.8	2.4	1.8	1.6	4.6	4.5	4.4
FBs	3.2	4.2	3.7	0.1	0.3	0.3	3.3	4.5	4.0
All SCBs	4.6	7.8	8.7	6.3	3.7	3.3	10.9	11.4	12.0

Profitability								
							In ₹Crore	
Bank Group	Return on Total Assets (annualized)		Earning Before Provisions & Taxes (EBPT) FY		Provisions for NPAs during the year		Net Profit/Loss (PAT)	
	Mar-15	Mar-16	Mar-15	Mar-16	Mar-15	Mar-16	Mar-15	Mar-16
PSBs	0.43	(0.26)	127,419	124,810	57,842	1,44,608	30,869	(20,006)
Pvt. SBs	1.65	1.54	66,208	79,858	12,953	20,099	35,832	39,672
FBs	1.82	1.67	25,192	25,160	3,092	5,923	12,764	12,619
All SCBs	0.78	0.29	218,819	229,829	73,887	1,70,630	79,465	32,285

Source: OSMOS returns, Domestic Operations | Figures for June 16 are provisional.

schemes. I would argue that advent of several new institutions (as recently licensed by RBI), new processes, digital advancements and competition would ensure that these objectives are well supported.

■ Similarly, some of the reforms are driven by a global reform structure. These pertain to capital, liquidity and disclosure standards under the Basel III package. Some such other measures are TLAC, SIBs, Misconduct rules, etc. A few other measures are currently under discussion, such as, imposing risk weight on sovereign exposure and new standardised approach for credit and operational risk.

Having dealt with the framework of macro reforms, let me now briefly touch upon nuts and bolts of the reform process.

Governance in banks

■ Some action already taken – setting up of BBB, post of CMD split into a non-executive chairman and a CEO, selection process made more objective

■ Going forward, BBB should also cover selection of other board members

■ Continuity of top management is crucial, hence reasonably longer tenure for CEO (say, five years) is necessary. Initial appointment could be for three years with certain set milestones, which if achieved, should earn automatic extension for next two years

■ An orderly succession plan is crucial to ensure no abrupt changes in key direction of the organisation

Apart from the whole gamut of credit risk, which is already discussed extensively several times and at several places, the following are the other areas needing prior attention of the boards.

Operational Risks

■ Fraud cases – recurrent failure of internal control machinery noticed, delayed recognition and laxity in follow up leads to cold trails, need to bring fraudsters as also errant valuers, accountants, lawyers to book to stop them from duping the system in future

■ Fraud Registry and a Quick Response Team set up at RBI to facilitate information – sharing and for closely tracking high-value fraud cases

■ KYC/AML compliance failures – stricter enforcement action a global norm now, strong centralised processing and surveillance needed as branches do not have the capability to handle such areas effectively

Customer service

■ Charter of customer rights – RBI's observance period now over, implementation monitoring a priority

■ Mis-selling – risk of silent customer simply moving away as account number portability is now a real possibility

Technology: Cyber/Digital

■ Digitisation/Fintech driving new possibilities in the field of finance

■ Technology, a double-edged sword – instances of cyber-attacks, identity thefts, ATM frauds etc. Bangladesh Bank case and other near-misses

Hence, bank boards would do well to focus on the following governance issues:

■ Strategy and risk management are two most important and least focussed items

■ Boards should set the 'Risk Appetite' and ensure adherence. Importance of three lines of defence – business verticals themselves/risk management department and compliance/internal audit

■ Hiring/grooming/retention of frontline staff... e-learning for capacity building

■ Instill organisational culture (what you do when no one is watching)

■ Put an enabling mechanism to ensure that voice of middle/lower level functionaries reaches the top quickly (G-30 report)

■ Bad news should travel faster

Conclusion

■ Reform measures especially on governance have achieved traction and attained a certain degree of maturity. Need now is to accelerate this process on the lines as covered in various preceding points. ■

Governance reforms in public sector banks

Excerpts from the speeches by invited dignitaries and sector experts at Governance Now's India Banking Reforms Conclave 2016

There is a need to bring change in the system, and a need to be concerned about the increasing NPAs. It is mandatory to change with time and with the challenges we have. Change is mandatory according to time.

We need to think why during the economic slowdown, economy of countries like the US and the UK collapsed but our country passed that economic turmoil. There is a display board in New York which shows the debt of an individual which is approximately one lakh dollar. The reason is, in India parents work hard and despite how much they are pressed economically, they save money in banks for their children which is not the case in the US or the UK where people are on high debts. That is why despite being so high on NPAs our banks are able to sustain. Our system sustained for the last many years despite the government spending money, taking loan from banks, giving away money with the permission of Reserve Bank. Rather than spending on capital investment we have spent that money on revenue expenditure and revenue investment. There was a time when our GDP was 25 percent but [it] dropped to the level of high concerns. It happened because we did not reform and bring changes according to time and challenges.

Sudhir Mungantiwar
State cabinet minister, finance, planning, and forest departments, government of Maharashtra

Governance is much better in public sector banks. If that was not there then the banks would have collapsed and that is why we earned trust. You ask anybody where they would like to deal with and they will definitely say public sector banks. We talk about financial inclusion; we have worked beyond that and have removed financial illiteracy. Do you think that 22 crore accounts would have been done in one and half years' time? Last 15-18 months have taught us that it is really worth it. Thirty thousand crore-plus deposits are lying in these accounts. It is just the beginning, and [we are] going forward. When these account holders become more engaged with us, when people like Microsoft or IT penetrates in real sense it would be more satisfying, more rewarding.

The overall need is as an ecosystem. We have to improve our governance structure. I have got 13 board members and if you want to start governance reforms then start with the board. Being the public sector bank, majority of stake is with the government of India. We have to work within the framework. And within that framework and board structure, we have to bring reforms in governance and we are trying to do our best.

Arun Tiwari
Chairman and managing director, Union Bank of India

The PSBs are struggling in mounting non-performing assets mainly in infrastructure, power sector, etc. Recapitalisation is sufficient to help public sector banks. Banks have some inherent structural issues. On NPA issue, despite RBI's resolution mechanism things have not been into decision-making. Decision systems are slow. Moreover, discipline around NPA recognition has been an area of improvement. Mounting of the NPA does not come overnight. Recapitalisation of banks over a period of three years seems to be on track but it seems to be inadequate considering the scale of stress. Apart from financial report, the board deliberation should focus towards critical issues like business strategies, consumer protection, compliance and human resources. The scenario is changing – going forward. Retailing and complex financial products are likely to become more important for banks. Banks need superior human capital to excel in these segments.

M Devaraja Reddy
President, ICAI

Why do we need reforms? Is there a need for reforms? And what is the thing we want from that? A reform is any change that is understood. You may understand the reforms differently. Each employee of the bank would have different perspectives on a reform. Managers have different perspective, lenders have different perspective. Another question that comes to my mind is whether the reforms are required only in the public sector, or private sector, or in foreign banks or all of them. Because sometimes when we say reforms we mean that for public sector.

What are the expectations of society, of the lawmakers, of the government, of the people from banking? Is banking a business? Banking is a social responsibility, because we want banks to lend to poor people, we want them to lend to agriculture, lend money to everyone irrespective of the fact that whether it will earn money for bank or not. So we have to figure out to run a bank as a business or as a social responsibility activity. Accordingly, we have to work because when we mix up two things it creates confusion in the ecosystem. For the private sector it [banking] is running like business and for the public sector like non-business. We expect different things from different people.

Ashishkumar Chauhan
Managing director and chief executive officer, BSE

The public sector bank definitely enjoys some kind of special privileges. To have competition is good because it enables public banks to lace up their shoes and to be sure that they are wobbled by the stiff competition that they have. Having said that, what is the role of regulation? Today, the [way] regulations are being made is like carrot-and-stick policy. Carrot represents the self-mode regulation and that is where the role of professionals becomes very important. Self-mode is if you do this it is fine and if you don't do this then you will end up having a penalty. In 2013, when the new company law came, people started calling it as a strengthened law because if I don't do this I will go behind the bars.

The stick means if you don't do this you are fined or put behind the bars. Now in such kind of a scenario, I think it is very important that as professionals and as bankers, we know the laws and we also know the spirit behind that law. At times we have seen that tick-the-box approach is given much more value than the spirit behind the law.

The over-regulations are something which have to be dealt with in its own way. But I think the real estate act, which has found its place, is very commendable piece of legislation and is really a game changer.

As a professional, I feel the biggest challenge is that in the coming 4-5 years, seven and a half lakh people are retiring from banking systems, so we are losing the best lot and also have to train heavily and add skills to the coming new lot.

Mamta Binani
President, ICSI

Microsoft sees four main things about digital transformation. First, we engage our customers, we enrich them. Then what is changing here? Your customers are changing, the way they are consuming your services is changing from different factors. Second thing is to empower your employees. Looking at the sheer speed at which your consumers are asking for services, how are we empowering our employees to handle it. We can have a system which is much more collaborative among our employees. This way they are much more collaborated and efficiently deliver better services and provide new experience to the customers. Third thing is to optimise your operations. And the last thing is transforming your products to provide a better experience to the customers.

Pushkaraj Kale
Director-BFSI, Microsoft Corporation (India)

Furthering financial inclusion in India: Impact of Mudra and PMJDY

Getting into the priority sector is totally a business call. The banks which can create a priority sector portfolio, because of their proximity and niche, make good money by selling that priority sector lending certificate to the banks which do not have them. That is the viability which can drive the priority sector lending certificate markets and pricing.

Mohan V Tanksale
Former chief executive, IBA

Consolidation, per se, is not beneficial and does not make business sense in all the cases. Rather, consolidation reduces competition among the players. The merging entity, which merges after consolidation, has its own pain of legacy issue as well. So, as a result after consolidation, we are not 100 percent sure that one entity will be stronger. All institutions in the rural sector have their own skills which cater to the requirement of the rural and semi-urban sectors. For example, cooperative banks and regional rural banks have their brick-and-mortar system and they also have established their business correspondent [model]. The point is that everyone has a space in the ecosystem and they have to serve the society, especially the poor from the rural segment. As far as PSBs are concerned, we are more towards the social and government policy implementation. Of course, private banks and other players like payment banks are more towards the profit angle. So, each one has its own space in the system. Consolidation may also be required if institutions face survival issues.

RK Gupta
Executive director, Bank of Maharashtra

Microfinance institutions and NBFC are doing things differently. Microcredit really needs micro analysis. I would like to cite an example on how microfinance is approached by institutions. Before venturing into any area or activity, it is studied by the risk management department and complete survey is conducted of suppliers as well as of the buyers of the product. Only after satisfactory economic viability of the product the funding is given, not because of some target is to be achieved. We are doing the KYC and also expanding it a bit, something that has been done by former deputy governor Dr KC Chakraborty, of moving beyond KYC to KYCBR – the need to know the customer along with his business and the business risk he is taking. There is a need of deep research that includes different research papers, economic viability and questions that are required to be asked to borrowers. Today credit bureaus have the entire ecosystem with customer information that even without meeting the customer banks are lending.

Ravindra Prabhakar Marathe
Executive director, Bank of India

There are around 22 crore Jan-Dhan accounts and over 100 crore people use mobile phones. Mobile banking has turned out to be a major thing today because of increase in internet penetration. However, only 37 lakh people use mobile banking facility across India. TRAI has come up with a consultation paper for using their facility by customers. CMA institute is helping many private sector and state-run banks. Even, the ministry of finance is being assisted by us in a few instances.

Sanjay Gupta,
Vice president, Institute of Cost Accountants of India

SMEs do make good business but when they get profits, their tendency is to invest in fixed assets rather than putting in business or in liquid funds, which they can draw to meet any crisis. Utilisation of hard-earned money in a right place is very important. We are giving loans to new aggregators like Ola and Uber to buy taxis because we know that transactions would happen either on mobile app or through the internet. We are also moving towards non-traditional methods and all of the said loans are provided online.

GK Kansal
Chief general manager, State Bank of India

Jan-Dhan Yojana is a people development programme for raising standard of living of people and ensuring their prosperity. The public sector banks are facing a challenge to ensure usage of bank accounts because if there is no usage there will be financial stress on the economy. The scheme can become successful only when the provider is found sustainable and user of the service finds it affordable. This is the reform era which envisages development of people.

PC Panigrahi
General manager (financial inclusion), Union Bank of India

In private sector lending, even today nothing is below MCLR [marginal cost of funds based lending rate]. In the private sector, NPA is less due to certain reasons. Central Bank of India's NPA in agriculture is less than four percent whereas NPA in private sector is less than six percent. In rural areas, villagers usually pay their loans to the banks unless their crop gets affected by inclement weather.

RB Gupta
General manager (financial inclusion), Central Bank of India

Banks have realised that digital banking is going to cut the cost significantly. Every banker is going to set up the payments bank as they have no choice. If you want the customer, you have to have that.

Abizer Diwanji
Partner and national leader, financial services, Ernst and Young

Banks adapting to the digital revolution and risk management

Our customers are ahead of the banks as far as digital technology is concerned. So the option of not going digital does not exist any longer. With 500 million accounts, 300 million customers and 100 million transactions per day, we have no option but to adopt digital technology. 79 percent of our transactions are happening through digital channel. Without digital, one really can't grow. For instance, today if you want a pizza, you do not go to the pizza shop but order it through a smartphone.

Kajal Ghose
Chief general manager (ESS), State Bank of India

Information technology is the backbone of any organisation today. Connectivity, both digital and physical, in the rural parts of the country is one of the problems that banks are facing. This can be a major constraint. You can think of having the best software available with you but if you do not have the connectivity at the right place, you are dumb. Ultimately going by the figures, cashless transactions will increase over a period of time, perhaps 25 percent by 2020, but still you will have 75 percent transactions being done through cash.

Subrata Gupta
Chief general manager, NABARD

There was a time when banks relied on the vendors' suggestion to adopt the latest technology. Now time has changed as customers tell us what kind of technology they expect; he wants a new comfort level from the banks. With this kind of expectation, the banks are reaching out to the customers to grow their customer base. Besides, the volume of transaction and disputes are growing. The challenge is to tackle risks involved in transactions.

Butchi Babu Burra
General manager & CIO, Bank of India

Risk management is becoming inevitable because of certain obvious factors. If you look at the State Bank of India (SBI), the balance sheet has grown four times in the last 10 years, which indicates an increase in volume of the banking industry. The second factor is that the entire banking industry tends to become complex. It is hard to find any other industry globally wherein people are exposed to multiple types of risks, demands, regulations and laws. Of late, we find there are hardly any losses emanating from the IT so those losses are either non-significant or not being accounted properly.

Rajesh Kumar Sood
General manager (risk management), State Bank of India

We are in an ecosystem where competition is not the game, rather it is disruption. The risk management department is a conscious keeper of the banking sector in taking risk. The role of risk management is to set prudential limits for the bank. Risk management started in the Indian banking domain as a compliance function. Today, risk management has to be the partner of business strategy. The business strategy is going to be sophisticated and complicated, which indicates risk management should also be equally sophisticated. The most challenging part of the ecosystem is that nothing is constant.

Bhaskar Sharma
Deputy general manager (risk management), Bank of Baroda

There are risks associated with the information technology revolution but those will remain and the industry will have to learn to resolve them. There are multiple systems involved in the banking industry and managing them is the biggest risk itself. Risk management needs more regulatory compliances and immediate attention at present.

Prabhat Sharma
Deputy general manager (risk management), Dena Bank

Adoption of information technology started way back in 1998. In order to introduce a digital system, banks should instill a sense of confidence in their customers. Customers should have confidence that his/her transaction would be safe, secure and successful. Banks need to have a more sophisticated platform to ensure safer banking experience. Many IT initiatives are being taken by the banking industry and it would take couple of years to completely digitise the banking sector for the masses.

N Rajendran
Chief technology officer, NPCI

The other big concern that we have heard about is of the regulators. The regulators are in different phases of evolution when it comes to giving guidance around the use of technology. For instance, the outsourcing guidelines came in the last 10 years, whereas outsourcing existed within BFSI sector for the last 20 years. The guidelines of the law always follow the business practice. RBI still wants to have an ability to go out after the concept of branchless banks to be able to find out where the cramp happened.

Apurva Mehta
Commercial attorney, Microsoft Corporation