Indian Banking Sector- A Regulatory Perspective[1]

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2. At the outset, I would like to thank Tamal, Sukumar and the entire Mint Management for inviting me to deliver the keynote address at their Global Banking Conclave here in Singapore. I compliment Mint for conceptualizing this event and deciding to hold it in Singapore which, in some sense, is an ideal setting, as this beautiful City State embodies what banking ought to be- free-spirited yet, conservative. The theme for the event could not have been more apt as it is being organized at a time when the banking system in India is witnessing some transformations of monumental proportions. The year can be considered as a major milestone for the Indian banking sector as it has witnessed the licensing of two new banks in the private sector as also issuance of in-principle licenses to differentiated banks -payments and small finance banks for the first time in history.

3. The theme's relevance also stems from the fact that India is poised to achieve the fastest economic growth rate amongst large economies. There are a lot of positives about the India of today- a stable political system, improved fiscal situation, lower Current Account Deficit, sustained domestic demand emanating from a favourable demography, growing middle class and rising income levels, rapid urbanisation through migration of population, increasing requirements of physical and financial infrastructure, increased mobile and internet penetration, financial inclusion, Government's flagship programmes like Make in India and Digital India- they all gel in perfectly to give a

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potential leg up to investment and economic growth in the country. Being a proxy to the economy, the banking sector would benefit significantly from these developments. Banking sector regulation, in such an environment, should serve the twin purpose of support as well as prudence to ensure a healthy and sustainable growth

4. Against this backdrop, in my address today I would like to talk about our regulatory philosophy and approach to regulation and supervision of banks. I would argue that our regulations have been more forward-looking and when needed, more stringent than the internationally agreed standards. I would also briefly dwell upon our recent initiatives to strengthen the banking system in the country. But let me begin by talking about what is our regulatory philosophy? Well, we have always operated with a conviction that the banking system is meant to sub serve the needs of the real economy and it should not race ahead of the real economy. Our approach to regulation is also guided by the reality that the Indian economy is bank-dominated and hence, banks are central to the process of credit intermediation and allocation of resources in the country. Our regulatory guidelines also predicate on the belief that banks are a key agency for promoting financial inclusion and ensuring a sustainable development of the economy.

5. How have we fared as regulators? To put things in context, it would be in order to ruminate over some of the recent trends in regulation and supervision in the global financial sector and assess where we stand on those. Among the 'add-ons' that are being employed as part of the regulatory reform package are stricter capital prescriptions, liquidity and leverage norms. Measures have also been taken for a more intense oversight of the shadow banking sector, improving the risk management practices of CCPs and regulation of OTC derivatives. Another important plank of the reforms has been to address the systemic vulnerabilities and ending the moral hazard associated with "Too Big to Fail". A Total Loss Absorbing Capacity (TLAC) prescription and the resolution framework for G-SIBs are at an advance stage of negotiation and are intended to precisely address this issue.

6. Let me bring some perspectives. Ever since the Basel Capital standards were first set out, we have sought to not only align our capital adequacy norms with these global

standards, but pitched it at a more stringent level. Likewise, since long, we have had prescriptions on maintenance of CRR/SLR by the banks in place which also serve more or less the same purpose as is now being sought to be addressed through LCR and NSFR regime, post Crisis. Leverage in the Indian banking system has always been kept at a lower level and hence, the leverage ratio that is now being implemented globally as a backstop to the risk measure as part of the overall Basel III package, is more or less a given for the Indian banks. We have also been calibrating risk weights on sensitive sector exposures like commercial real estate as a macro prudential tool to help arrest building of asset price bubbles, much ahead of the prescriptions on countercyclical and capital conservation buffers which have since appeared as part of the Basel III reform pack.

7. In regulation-making we have followed a gradualist approach and have generally been wary of complex and opaque instruments/products. For the same reason, we insisted on the lenders having a ‘skin in the game’ in securitisation transactions, which curtailed reckless origination of loans without proper appraisal with the sole purpose of distributing the same to investors at a later date. We all know now that inadequacy of the market infrastructure to deal with the opacity and complexity of derivative products was the single-most important reason for the Financial Crisis. We, in India, have exercised extreme caution on the financial derivatives, baulked at opaque structures with complex pay-offs and have insisted on banks’ ascertaining the suitability and appropriateness of the customers before selling any complex derivative instruments. RBI’s approach to development of the forex and interest rate derivative market has been one of cautious gradualism. Regulators have also been conscious about the risks emanating from the activities of asset managers, something which is viewed as a significant vulnerability in the global context today. In this regard, there are restrictions around extent of lending and leverage the asset managers in India can undertake and also limits on their use of derivative products.

8. While we have been cautious on introduction of complex products/ instruments, we have not been found wanting on efforts towards deepening and widening of financial markets. India is amongst the first few countries in the world to have a screen based

electronic anonymous order matching system for secondary market trading in Government securities. Similarly, Indian equity markets are amongst the best in the world in terms of use of technology, institutional mechanism, and products. In order to promote transparency, price discovery, cost effectiveness, better risk management and a market for hedging of risks, Exchange traded currency futures and Interest Rate futures have been allowed to trade in India. Few other developmental measures initiated by RBI are:

- Permitting banks to provide Partial Credit Enhancements to bonds issued by corporates /special purpose vehicles (SPVs)
- Allowing banks to issue long-term bonds to raise resources for lending to long-term projects in infrastructure sub-sectors and affordable housing- Instruments exempt from regulatory pre-emptions i.e. maintenance of CRR/SLR and priority sector lending
- Allowing corporates to issue Rupee denominated bonds(Masala Bonds) overseas
- Introduction of tradable Priority Sector Lending Certificate (PSLC)
- Introduction of Trade Receivables Discounting System (TReDS) as an authorized electronic platform to facilitate discounting of invoices/bills of exchange of MSEs

9. Let me now turn to some of our recent regulatory/supervisory measures that are aimed at further strengthening the resilience of the banking system. As I briefly alluded to in the beginning, the asset quality of the banking system has been a subject of concern for us and hence, many of our recent measures are centred around improving the ability of the banking system to overcome these. The principle that has guided our action in this regard is that the banks must recognize the problem and work towards resolution rather than ‘pretend and extend’ while also extending a helping hand in genuine and deserving cases so that any productive capacity in the economy is not put to jeopardy. It is in this spirit that the forbearance on restructuring of accounts has been done away with. The measures include:

- Framework for "Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy covering formation of Joint Lenders’ Forum (JLF), Corrective Action Plan (CAP), ‘Refinancing of Project Loans’, ‘Sale of NPAs by Banks’ to facilitate early recognition/resolution of financial distress

- Banks permitted to grant an extended debt repayment period to their borrowers in long-gestation projects (‘5/25’ scheme)
- Banks enabled to take steps for Strategic Debt Conversion (SDR) giving them the right to convert their outstanding loans into a majority equity stake if the borrower fails to meet conditions stipulated under the restructuring package
- Enhanced fraud monitoring framework

10. Certain other regulatory/supervisory measures introduced by RBI in recent times to improve the financial sector are:

- Framework for D-SIBs
- Introduction of a risk-based approach to supervision
- MOU with supervisors of 29 countries for promotion of greater supervisory co-operation and information exchange
- Setting up of supervisory colleges for Indian banks with significant cross-border assets
- Framework for progressive alignment of regulations for the non-banking finance companies with that applicable to banks for preventing instances of regulatory arbitrage
- Discussion paper on way forward for urban co-operative banks
- Discussion paper on relaxation in ECB norms
- Promulgation of a Charter of Customer Rights for implementation by banks
- Setting up of Financial Benchmarks India Pvt Ltd, with the objective of bringing transparency in the benchmark rate setting process.

11. Apart from asset quality challenges that the banking system is faced with currently, other key challenges that the system faces are on capital and human resources front. In fact, part of the asset quality problem is also attributable to poor underwriting skillset of the bank staff for credit appraisal of large projects at the head office level and for lending to retail and SMEs at operating unit level. It may be useful in such small ticket loans for the credit decisions to be centrally processed and technology-based credit scoring models to be used for making the lending decisions.

12. A similar problem is also observed in meeting the KYC/AML rigor in the banks. Not only is there a general lack of sensitivity about KYC/AML compliance needs, the adherence to laid down norms at the field level is often sidestepped on account of lack of skillsets, time or performance pressure. My sense is that a centralized, technology supported surveillance system would perhaps serve better for ensuring compliance to KYC/AML norms.

Conclusion

13. As I mentioned in the beginning, the landscape in which the banks are operating is changing rapidly. Some of these changes which have direct implications and opportunities for banking system are:

- Inclusion of a large number of new customers within the formal financial system
- Rising levels of literacy
- Growing middle class and increasing income levels
- Growing urbanization
- Increased digitalization
- Thrust on finance to the MSME sector

14. With the gradual widening and deepening of our financial markets, it is expected that banks would be more focused on SME and retail clients while leaving the long-term financing to other players more suited to the task. Enhanced disposable incomes would widen wealth management advisory and services. In keeping with the global trends, corporates may move to raising resources directly from the market but they would still need other financial solutions, which banks would provide. Technology is both a disruptor as well as an enabler and banks would need to leverage it to their advantage. The impact of disruptive technology is already evident in the form of competition from non-banks such as e-commerce companies, P2P lenders, Crowd funding, which is likely to only intensify going forward.

15. Let me conclude by saying that the Indian banking system would continue to remain the prime mover for the Indian economy in the foreseeable future. It is, therefore, important for us to ensure that the system remains healthy and vibrant. As regulators and supervisors, we would also need to be vigilant about the emerging risks that the banks could face and proactively suggest measures to enable banks to mitigate them. On the institutional side, enactment of a bankruptcy code to deal with firms in distress and setting up of a resolution authority for liquidation of failed financial institutions would be key enablers. Similarly, capacity building would be important for both the banks as well as the regulators. Hence, the banks would do well to:

(i) Deal with, rather than postponing the asset quality challenges, so as not to miss on the emerging opportunities.

(ii) Be opportunistic in raising capital

(iii) Be prepared to live with a more intrusive and globalized regulatory framework

I conclude by once again thanking the Mint team for inviting me to this Conference and I look forward to an interesting panel discussion.

Thank you!