

Banks: Shaping India in Challenging Times

At the outset, I take this opportunity to thank FICCI for having given me the honour and privilege of addressing the industry captains of the country. I would like to share with you all today my thoughts on the Indian banking industry, recent events in the economy, efforts for reviving the economy and the role that banks are destined to play in shaping the economy in challenging times.

The Indian Banking Industry:

The Indian Banking Industry is characterized by a wide presence at retail level, comprising of both conventional bank branch network as well as the technology enabled retail outlets in the form of automated teller machines, internet & phone / mobile banking etc. The industry is a mix of public and private sector players with a few foreign banks also present. The banking sector model in the country is one of 'branch banking' with most medium sized banks having a network of more than 1000 branches each with the largest player in the industry, State Bank of India, having well over 10000 branches. Beginning with class banking, the industry underwent a wholesale change in its approach with the nationalization of 14 banks in 1969.

Mass banking had become the mantra of public sector banks since then with emphasis on extending banking services to unbanked and underbanked centres in the country.

The initial efforts to automate the banking processes that began in mid eighties of the last century have transformed the banking industry into a fully automated one over the last two decades. Core banking has become the norm and today, the banks are offering high end products like Internet Banking, Mobile Banking, SMS banking etc. Doorstep banking is becoming a reality and the day when banks will start offering customized products to serve the needs of every customer separately is not far. Probably, the next stage of transformation in banking is one where every banking institution transforms itself into a financial supermarket, 'one-stop' for all financial services and products.

In financial terms, the strength of the Indian banking industry should be an eye opener to all. Even as banks all over the developed nations were collapsing in the aftermath of the sub-prime crisis and the global meltdown during 2008, Indian banks have sailed through the storms without any adverse effect on them. In fact, the old generation public sector banks found themselves in an unenviable situation with the newer private sector banks worried about a flight of deposits away from them to public sector banks. Needless to say, the Indian

banking industry has survived the storms of the second half of the last fiscal due to adequate availability of capital. While internationally the norms for adequate capital adequacy had been pegged at 8%, India had for long followed a norm of 9%, ostensibly to compensate for weaker risk management systems while in practice, most of the Indian banks have capital adequacy of over 12%.

One significant factor about Indian banking industry is the aspect of regulation. The industry regulator, Reserve Bank of India, had functioned as a friend, guide and philosopher to the industry, often going much beyond the role of the Regulator, by constantly guiding the banks in their endeavours to keep upgrading their work technologies, improve efficiency of payment systems and so on.

I have delved upon the Indian banking system at a length because I believe that it necessary to really understand the role that Indian banking industry is set to play in shaping the country's economy in the wake of the challenges ahead.

The Economy: The Recent experiences

If we look back at the economy's performance during the last few years, there are a number of facts that need recognition. The economy has been one of the fast performers among the

world economies, particularly the emerging ones. Three to four consecutive years of GDP growth at over 9% for an economy that has long been viewed as a sluggish one is a critical development. This was made possible by a combination of factors like favourable monsoon conditions, financial sector reforms, availability of skilled & cheap man-power etc. The industry also reacted to the emerging opportunities in an efficient & timely manner by exploiting the economy's areas of strength like in Infotech sector. The last few years have seen Indian industrial houses on a acquisition spree both within the country and abroad.

Against this background, let us also examine some of the global developments during the last year or so. The happenings since September 2008 have resulted in a sharp break to the growth trajectories of the world economies. For the first time in last six decades, the IMF had predicted negative growth in the world economy. The specter of the depression had become a reality with all developed economies of the West facing recession. The contagion effect of economic misfortunes has also resulted in the emerging economies of the world also being dragged down into the cauldron of recession.

The Indian economy has also been affected by these developments notwithstanding the presence of a strong

financial & banking system, large forex reserves, robust performance of corporate sector etc. The GDP growth rate at 6.7% for 2008-09 suffered as a consequence. While the Government of India is confident that the economy is already on a recovery path and expects the conditions to be much better by year end, still it remains that GDP growth for the year may only be around 7%.

Efforts at Revival:

Ever alive to the dynamics of economic growth and business cycles, the Monetary authority of the economy calibrated their reactions in a timely manner to ease liquidity conditions. The monetary stance of the Reserve Bank of India was reoriented towards ensuring adequate liquidity in the system so that interest rate movements can be positioned to aid economic recovery. Reductions in statutory pre-emption requirements, realigning of the Repo / Reverse Repo rates etc in many stages along with other measures that provided for a liberal regime for restructuring of credit assets etc were aimed at both enhancing liquidity as well as to reduce the likely stress on asset quality in the economic downturn.

From the fiscal side, Government of India, in the last 7-8 months, have announced three stimulus packages which seem to have had desired effect. In April 2009, the Index of Industrial Production (IIP) has looked up while the inflation

rate has dropped from around 13% in August 2008 to negative in May 2009. A dampener, though, has been the volatility in the international oil prices which from around US \$40 per barrel towards the end of December 2008 has since risen to over US \$70 per barrel of late. The recent increase in domestic fuel prices may have some adverse impact on general price level and may further hamper the pass through of fall in wholesale prices to retail consumer level prices.

Against this backdrop, the plan of action of the Government of India has been specified as part of the Union Budget for 2009-10. Socio political considerations coupled with economic realities have dictated larger allocation of outlays for the Government's flag ship programmes while the combined impact of the previously announced financial stimuli packages and other factors have resulted in the need for much higher government borrowings in the current year. Taxation measures announced in the arena of personal taxation is expected to release additional purchasing power of around Rs 10000 crore in the hands of tax payers, mainly middle class that will provide a boost to housing and consumer durables sector. Abolition of Commodity Transaction Tax may help commodity players and provide succor to agricultural sector. The Additional interest subvention is also a positive for this sector. Abolition of Fringe Benefit Tax may not amount to much in terms of quantum of tax savings, but will a breather

from the angle of compliance costs & administrative convenience.

The focus on roads & other infrastructure and the decision to allow IIFCL to refinance banks against their lending to infrastructure (to the extent of Rs 100 thousand crore) will provide a fillip to industries like cement, heavy engineering, steel etc. Of course banks will benefit by way of an additional avenue to address their asset liability mismatches arising out of exposure to infrastructure sector.

Challenges before Banking Industry:

Before proceeding to deliberate on the role of banks in facing the challenges before the economy, let me first look at the challenges that the banking industry itself will be facing in the short and medium terms.

The events of the last year are sure to leave a permanent indelible mark on the way the banking industry world over will look at their way forward. The Indian banks will do well to reassess their future plans after taking a hard look at their core competencies and market shares to survive and grow in the face of stringent competition. Organic growth with renewed emphasis on further fostering existing customer relationships may be the preferred route in this reassessment of strategies. Strategy formulations may veer towards packaging products

and services for targeted customer segment rather than on 'mono standalone' products. Harnessing the benefits of technology implementation will be a major challenge. The focus will be entirely upon efficient allocation of capital among various business units, improving the risk adjusted return on capital and building in adequate cushion in terms of capital availability that will stand in good stead against volatile business cycles. Governance, Risk and Compliance will emerge as the guiding principles for bank managements. In this process, banks will be compelled to fully understand and appreciate the underlying risk profiles and risk behaviour of individual lines of business and the organization as a whole. On going internal assessment of adequacy of capital will gradually replace the current methodologies for capital planning.

In short, the greatest challenge the banks face today is transforming themselves into a risk sensitive organization that enables them to continuously reassess both balance sheet and off balance sheet risk factors to ensure stability and long term maximization of shareholder value.

The Challenges Ahead:

The challenges the economy faces are many. While some of the challenges arise out of the fact that the economy is still an emerging one with a large segment of its population still living

below the poverty line, some new challenges have emerged out of the global meltdown. I believe that the Indian banks have a very vital role to play in shaping the economy amidst these challenges.

You are all aware that individual banks are shouldering the responsibility of Convenorship of State Level Bankers' Committee in every state and are responsible to formulate and implement roadmaps for channelling credit flow to preferred sectors like export sector, SME, agriculture etc. At district level also bankers function as Lead Bankers. Lead Bank's responsibilities, among others, include development and implementation of district level credit plans in co-ordination with the State Government and all banks operating in the district / state. In the current context, with various industries being hit by global meltdown, the banks have taken upon themselves the responsibility of financially assisting such industries.

Traditionally, banks have been seen as a catalyst in the growth process. While Indian banks have performed this role to near perfection all these years, the emerging scenario requires banks to rise above the catalyst role to one of being a prime growth driver. Herein lies the major challenge.

The **first** and foremost challenge is one of providing the push to kick-start the economy by injecting adequate credit at affordable prices to the industrial and service sectors. This challenge is primarily to complement the fiscal and monetary measures that have been implemented since November 2008 both by Government of India and Reserve Bank of India. While it is nobody's case that bank credit flow to industries has dried up, the resource crunch that is being felt by industries may partially be due to reduced flow of funds from other sources like equity market, with the funds raised through public offers of equity has considerably come down in the wake of the crash of asset prices through the second half of the last fiscal. The Banking sector has been expected to step in to bridge this gap by enhanced levels of lending. While the banks have demonstrated their willingness to do so, the cost of credit has become an issue of debate. Of course, you will all appreciate that in a market, the buyer wants the rock bottom prices while the seller will expect atleast a reasonable price for his ware. Expectation of lower interest rates and stiff competition among banks has led to many banks holding sanctioned and unutilized limits in their portfolios. While an industrial house's right to scout for the cheapest rates cannot be questioned, it is necessary that the problem of the supplier of credit, the banking industry is also understood in the right perspective.

It will be observed that the banks have reduced their benchmark lending rates by anywhere between 150 to 200 basis points over the last six months. Another round of lending rate cuts is in the offing by most banks with some larger players in the market having already set the ball rolling. This has already resulted in tremendous pressure on the Net Interest Margin of the banking industry. I have heard some arguments that these rate cuts on the lending sides have been accompanied by similar offsets in rates for deposits and therefore banks should not be complaining on this ground. It is true that interest rates on term deposits have also come down by 200 to 250 basis points during the last 9 months. But there are two factors that have to be considered in to the argument. Firstly, Lending rate changes result in anywhere between 70% to 80% of existing loans and advances getting repriced immediately while in case of deposits, rate changes are applicable only to incremental or fresh deposits. Secondly, the level of Prime Lending rates is fast losing its relevance as most of the corporate loans are being priced at sub-PLR levels only. In fact this fact has become an issue to be addressed and in recognition thereof, Reserve Bank of India has recently set up a working group to take a fresh look at PLR concept.

Linked to cost of credit is the issue of credit rating of corporates. Today, banks allocate regulatory capital against their credit exposures to corporates and public sector

enterprises based on their exposure levels, availability of eligible credit risk mitigants and external credit rating. In the absence of issuer ratings, issue ratings are used as substitutes. Experience of banks is that there are still a large number of corporates who are yet to get themselves rated even more so in cases where the corporates have not accessed bonds & debentures market. This results into relatively higher allocation of regulatory capital to such exposures and the banks have to add a mark up in their lending rates to compensate for cost of higher capital allocation. If corporates go for credit rating by one of the accredited external credit rating agencies, banks may be in apposition to reconsider their lending rates, based on the credit rating.

There are some additional issues involved in this matter. While Bank credit is flowing smoothly to infrastructure sector, banks have to now worry about their asset liability mismatches that accrue out of long to very long term lending with, in many cases, long moratorium period for servicing of principal and interest. Banks are also facing credit concentration related issues in their assets portfolios. While the recent decision that permits IIFCL to refinance the banks against their infrastructure exposures to the extent of about 60% partly addresses the ALM mis-match issue, problems arising out of credit concentrations do remain.

A major worry for banking industry atleast during the current year is one of asset delinquency. Economic downturns, the available empirical evidence says, brings in its wake problems of asset delinquency. Slack or falling demand conditions affects sales of corporate sector and disrupts cash flows with inventories of both raw materials and finished goods increasing. This will lead to delinquencies and the banks, being governed by strict regulations with regard to asset classification, income recognition and prudential provisioning, will have to take some hit. Of course, the massive exercise of restructuring of standard assets undertaken by banks in the last 6 months may partially alleviate this problem; however, banks will have to keep their fingers crossed in this matter still such time as economic recovery becomes a fait accompli.

Another area of concern is the marked preference of large corporates to go the multiple banking route which is beset with inherent risk factors. Consortium arrangements are more secure as it provides for constant interchange of information among lenders and also provides for better control on charge creation on assets.

The **second** major area where the banking sector has a vital role to play in the face of emerging challenges is to revive the economy's growth rate. While lending to corporates caters to supply side augmentation in the quest for economic revival,

demand side augmentation also plays a key role in this endeavour. Banks' lending in the retail segment plays a twin role in this regard. Rural markets present a large untapped opportunity on account of strong growth of agricultural income driven by higher MSPs, better farm practices and non agricultural income driven by higher employment, implementation of NREGA and higher minimum wage rate. Increase in wealth in rural areas has been driven by one time events such as government's farm loan waiver and relief and substantial increase in land prices. Banks have been playing a very active role in the development of the rural markets and I am sure that in the coming years too the exemplary role that banks play in rural areas by adequately infusing credit for the needs of various segments of the rural economy will continue.

While lending to agriculture sector aims to increase agricultural production and thus make available enhanced purchasing power in the hands of rural populace (that constitutes a vital ingredient on the demand side), lending in the retail category aids directly purchase of assets, be it housing or consumer durables. Banks have already been gearing up themselves for this role with strategies meant to reach out to small ticket borrowers and home seekers. In Dena Bank, we already had a concept of Fin Marts to cater to retail segment. However, with renewed efforts of business process reengineering designed to drastically reduce the lead time in

processing of credit requests, we have now launched Retail Asset Centres which form the hub of retail business at select centres. We have also placed specially recruited marketing officers to fan out to tap potential customers in retail sectors, we are also working on a strategy to set up Rural Service Centres that will focus on agri credit with assistance of agricultural graduates. The Bank has also recruited a large number of credit officers in the last year and existing officers are also being put through vigorous 2 months credit training to retrain and upgrade credit skills.

Let me also clarify that we are not overlooking the needs of corporate sector. Our specialized branches like Corporate Business Branch and Industrial Finance branches at Mumbai and Ahmedabad have been success stories in this area. Taking this strategy forward, the Bank is scheduled to open more Corporate Business Branches in other major centres like Chennai, Kolkatta and New Delhi very shortly. These branches, headed by a senior Executive will be staffed with specialized manpower like chartered accountants or MBAs in Finance and will provide a one point contact to corporate sector for their banking needs. The Bank is in the process of setting up a "Technical Evaluation Cell" at its corporate office to speeden up the process of techno economic viability assessment of large projects.

The Bank has also identified 68 branches for focused lending to SME with emphasis on channel financing. The Bank has also identified these branches as clusters for SME financing. Further, the specific industries to be focused by each of the identified branches has also been identified. SME Help Desks have been set up at all regional offices. SME credit needs that are covered under CGTMSME are exempted from the need of furnishing collateral cover. The processing of credit requests from SME and corporate segments is also being centralized at the level of controlling / corporate office to reduce the lead time in disposal of credit requests besides standardizing the processes involved. Technology also plays a role in this process, designed to facilitate speedier disposal of loan requests.

The **third** major area for banks is in enhancing smooth flow of money within the economy. A well lubricated payment system is essential to facilitate commerce and trade. From the introduction of MICR technology in cheque processing in mid eighties to the present electronic fund transfer products, the payment systems in the economy have undergone changes. Technology has aided these transformations under the careful guidance of the Regulator. Real time money transfers have become a reality with introduction of products like RTGS, NEFT etc. Internationally too, payment gateways like SWIFT are well stabilized. As the Governor of Reserve Bank of India

recently observed in a Seminar on payment systems, the value of funds transferred through electronic means in the entire payment systems increased phenomenally from about 2% a decade ago to about 74% now. In most banks, core banking implementation has enabled money transfers within the branches of the Bank in matter of seconds and the day when such transfers will be facilitated across banks is not far off. Speedy and efficient transaction settlement is a prime need of the economy and the banks are facilitating the same as never before. Newer technologies like cheque truncation etc are being experimented with and in the next few years, cashless commerce will become a reality.

I have highlighted three major areas of challenges where banks will play a key role in shaping the economy and its responses to the emerging scenarios. More than these areas, I personally feel that the most important role the banks have to play in the next two to three years is the ***challenge of implementing financial inclusion. I will not be surprised if the courts of the country one day declare that right or access to banking services is part of the fundamental rights enshrined in the Constitution of the Country.*** Extending the banking services to cover all sections of the country including the urban and rural poor is a task that is easier imagined than achieved. The sheer numbers involved is mind staggering but at the same time, we need to recognize

that in a democratic country even the poorest of the poor has a right to banking services. It is not just a question of having a bank deposit account, it is also a question of access to bank loans. No Frill Accounts have been a right step in the direction but it is only a beginning. Channelizing bank loans to improve the economic condition of the downtrodden is the endgame of financial inclusion. Banks have taken up the challenge in right earnest. State Level Bankers Committees of various states have prioritized districts for achievement on financial inclusion on 100% basis. Once again, technology is playing a key role in this endeavour. The progress in many states is very encouraging. Another encouraging factor that may facilitate 100% financial inclusion in the coming years is the National ID System proposed to cover the entire population of the country, with Shri Nandan Nilekani, one of the outstanding technocrats of the country in charge of this project. The National ID system will provide a recognizable identity to every citizen and this facilitate easy identification of beneficiaries for financial inclusion. At this juncture, it may not be out of place to note that financial inclusion is a socio economic objective and not a prerogative of banking system alone. The process of achieving financial inclusion is time consuming one and involves huge costs. The banking industry cannot be expected to absorb the entire cost burden and needs partners who can defray some of the costs involved. I take this opportunity to

appeal to all state governments to come forward to share a part of the cost of achieving financial inclusion.

Before I end, I would like to touch upon a challenge that is very close to my heart. It is challenge not only for the banking sector, it is one for all corporates in every industry. It is one of Corporate Social Responsibility. Mahatma Gandhi once said that rich are only trustees of wealth for the benefit of the poor. I believe that every corporate or rich individual falls within the ambit of this saying. Corporates including banks have got a responsibility to the society at large and this responsibility is also a major factor in shaping the economy. Corporate Social Responsibility is not about charity; it is about partnering the socio economic poor in their goal of achieving economic and social elevation. I would like to outline some of the steps we in Dena Bank have taken in this direction.

The first and most important is our project for sponsoring a girl child in every village that our branches serve in Gujarat. Already over 1600 girl children are benefiting under this project with their education being sponsored by the Bank with a scholarship of Rs 1500/- per annum. We have also set up 2 RUDESETIs, institutions aimed at imparting training to rural persons to function as rural facilitators who will reach out to villagers to impart knowledge of banking facilities and new techniques of production & technology relevant to villagers.

Over 3500 rural youth / women have already been trained by the RUDESETIs so far. The Bank is also considering some other CSR areas where the Bank can be of service to this nation.

Conclusion:

It has been my pleasure to interact with the cream of Indian entrepreneurship. Continuing interactions of this nature between banking and other industries and corporates will be of mutual help to both to understand the issues and problems of each other.