

# BANKING SECTOR IN GLOBAL PERSPECTIVE

Inaugural Address by

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at

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Distinguished guests, Ladies and Gentlemen

It is indeed a pleasure and privilege to be amidst this august gathering of eminent bankers, experts and policymakers. Over the years, the Conference has evolved as an important forum for structured information sharing among not only delegates from the banking sector, but also experts from research institutions, credit rating agencies, international institutions and other financial sector bodies. The *Bankers Conference, 2004* is a great advancement over previous years. The most notable feature is that Respected President A.P.J.Abdul Kalam is addressing this gathering. In addition, we have globally renowned policy makers who will give us the benefit of their views. These include, Mrs. Anne Krueger, a very dear friend and a distinguished Central Banker, Governor Caruana.

The subjects selected for the Conference are of great importance and we in RBI look forward to the benefit of your deliberations. The inaugural address today will be brief and in the nature of comments on three areas: status of Indian banking industry, challenges ahead for our banking industry and the changing role of the Reserve Bank of India during this process of policy reform and transformation of banking industry.

## I. Status of Indian Banking Industry

It is useful to note some telling facts about the status of Indian banking industry when compared with other countries, recognising differences between developed and emerging economies.

First, the structure of the industry: the number of large and medium domestic banks, defined as the number of banks ranked in the world's top 1000, tends to be much larger in developed countries as compared with emerging economies. According to *The Banker 2004*, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan, over 80 in Germany, over 40 in Spain and around 40 in the UK. Even China has as many as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. India had as many as 20 banks within the top 1000 out of which 6 were within the top 500 banks. This is reflective of differences in sizes of economy and the financial sector.

Second, the share of bank asset in total financial sector assets. In most emerging markets, banking sector assets comprise well over 80 per cent of total financial sector assets, whereas these figures are much lower in developed economies. In India, the share of banking assets in total financial sector assets is around 75 per cent, as of end-March 2004. There is, thus, merit in recognising the importance of diversification in the institutional and instrumental aspects of financial intermediation in the interests of wider choice, competition and stability. However, the dominant role of banks in financial intermediation in emerging economies, in particular India will continue in the medium-term; and banks will continue to be special for a long time in future.

Third, industry concentration, measured by the percentage of a country's banking sector assets controlled by the largest banks. In most emerging market economies, the five largest banks (usually domestic) account for a significant

proportion of bank assets. The corresponding figures tend to be much lower in developed economies. Illustratively, for 2001, in India, the said figure was around 44 per cent. The corresponding percentages during the same period were 33 for New Zealand, 28 for Italy and 27 for the United States. In 2004, for India, the aforesaid figure was around 41 per cent. This is an interesting factor that should be borne in mind while considering the way forward in consolidation.

Fourth, internationalisation of banking operations. Internationalisation, or the share of foreign-owned banks as percentage of total bank assets, tends to be much lower in emerging economies. However, this pattern is not uniform across world regions. As per cent of total domestic assets, foreign-controlled assets increased significantly in several European countries (Austria, Ireland, Spain, Germany and Nordic countries), but increases have been fairly small in others (UK and Switzerland). Among emerging economies, while there were marked increase of foreign-controlled ownership in several Latin American economies, the increase has, at best, been modest in East Asian economies. Available evidence seems to indicate some correlation between the extent of liberalisation of capital account in emerging markets and share of assets controlled by foreign banks. As per evidence available, the foreign banks who are present in the form of branches, seem to enjoy greater freedom in their operations including retail banking in the country virtually on par with domestic banks, compared to most other developing countries. Further, the profitability of their operations is considerably higher than domestically-owned and, in fact, are higher than the foreign banks operating in other developing countries. India continues to grant branch licenses more liberally than the WTO commitments. Our opening of banking sector to foreign ownership is not on account of crisis, but by deliberate policy choices.

Finally, the share of state-owned banks in total banking sector assets. Emerging economies, with predominantly Government-owned banks, tend to have much higher state-ownership of banks as compared with their developed counterparts. While many emerging countries choose to privatise their public sector banking industry, after a process of absorption of overhang problems by the Government, we have encouraged state-run banks to diversify ownership by inducting private share capital and absorb the overhang problems. The process has helped reduce burden on Government, improve efficiency as reflected in stock market valuation, promote new efficient private sector banks, while gradually reducing the share of public sector banks in a rapidly growing industry.

Added to these, the process of consolidation. Another notable difference between the consolidation process in developed *versus* emerging markets is the overwhelming cross-border nature of mergers and acquisitions in the latter. In particular, cross-border merger activity in continental Europe and also between US and European institutions has been more an exception rather than the rule. In contrast, there has been a perceptible increase in foreign ownership of emerging market banks. In this regard, it is useful to recognise that consolidation, in particular expansion of foreign ownership in many emerging countries was a consequence of crisis. In transition economies, it was part of overall market action, including prospects of joining European Union.

## II. Challenges Ahead

Let me highlight some thoughts on certain areas which have a key bearing on the ability of Indian banks to remain competitive and enhance soundness. Needless to state, these are more in the nature of random thoughts, rather than any structured thinking, and are meant to invite your attention.

First, cost management. Cost containment is a key to sustainability of bank profits and their long-term viability as well. To highlight this point, let me, take recourse to some figures. In 2003, operating costs of banks as per cent of total average asset [i.e., total asset at the beginning of the year plus total asset at the beginning of the subsequent year)/2] in UK were 2.12, for those in Switzerland they were 2.03 per cent, and less than 2 per cent in major European economies like Sweden, Austria, Germany and France. In India, in 2003, operating costs as per cent of total asset of scheduled commercial banks were 2.24 per cent. The tasks ahead are thus clear and within reach.

Second, recovery management. This is a key to the stability of the banking sector. There should be no hesitation in stating that Indian banks have done a remarkable job in NPL containment considering the overhang issues and overall difficult environment. The process would, however, need to be pursued in right earnest, while persisting with changes in legal, institutional and procedural to bring about a conducive environment for banks' operations. In 2003, non-performing loans to total loans of banks were 1.2 per cent in US, 1.4 per cent in Canada and in the range of 2-5 per cent in major European economies; France was an exception at 4.9 per cent. In contrast, the same for Indian banks was 8.8 per cent and that for Chinese state-owned banks was 22.0 per cent. Let me add that the 2004 gross NPL ratio for Indian scheduled commercial banks at 7.3 per cent is ample testimony to the wonderful efforts being done by our banking system and they deserve all the plaudits for their efforts. In fact, recovery management is also linked to banks' interest margins. Net interest margins of scheduled commercial banks in India was 2.8 per cent in 2003, whereas it stood far lower in the range of 0.6-2.4 per cent at major European and Japanese banks. Clearly, cost and recovery management supported by enabling legal framework holds the key to future competitiveness of Indian banks.

Third, technological intensity of banking. This is one area where perhaps India needs to do significant 'catching up', notwithstanding the rapid strides made over the last few years, though data on this score are difficult to come by. Some available figures indicate that in late 1999, the percentage of customers using online banking was less than 1 per cent in India, compared with anywhere between 6-30 per cent in developed economies like US, UK, Germany, Finland and Sweden. Even in Latin America, these figures are much higher than India's. While admittedly the numbers for India are likely to be much higher at present than these figures suggest, so would be the case for these other economies as well. The issue, therefore, remains what has been the extent of 'catching up' by India on this score? In fact, this seems somewhat intriguing: India happens to be a world leader in information technology, but its usage by our banking system is somewhat muted. With so much expertise available domestically, Indian banks are urged to exploit this globally state-of-art expertise domestically available to their fullest advantage.

Fourth, risk management. Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II is likely to lead to an even closer focus on risk measurement and risk management at the institutional level. Thankfully, Basel II has, through their various publications, provided useful guidelines on managing the various facets of risk. The institution of sound risk management practices would be an important pillar for remaining ahead of the increasing competition. Banks can, on their part, formulate 'early warning indicators' suited to their own requirements, business profile and risk appetite in order to better monitor and manage risks.

Fifth, governance. The recent irregularities involving accounting firms in the US have amply demonstrated the importance of good corporate governance practices. The quality of corporate governance becomes critical as competition

intensifies, ownership is diversified and banks strive to retain their client base. No doubt, there is nothing like an 'optimal' level of governance for one to be satisfied with. The objective should be to continuously strive for excellence. The RBI has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices. It is heartening to note that corporate governance presently finds explicit mention in the annual reports of several banks. The improved corporate governance practice would also provide an opportunity to accord greater freedom to banks' boards and move away from micro regulation to macro management.

Sixth, the complexity and sophistication of the New Basel Norms poses a major challenge for implementation due to lack of adequate technical skills, underdeveloped financial markets, structural and legal rigidities. Both banks as well as supervisors would be required to invest considerable resources in upgrading technology systems, and human resources to meet the minimum standards. The level of rating penetration is not yet adequate and it is restricted to issues (rather than issuers, as required by Basel II). Secondly, Basel II provides scope for the supervisor to prescribe higher than the minimum capital levels for banks for, *inter alia*, interest rate risk in the banking book and concentration of risks/ risk exposures. Thirdly, there are several issues in cross border supervision which have to be dealt with. Fourthly, although Basel II could actually imply a degree of pro-cyclicality of minimum capital requirements, there is a need to ensure that prudential norms are, in general, business cycle-neutral.

Seventh, the regulatory challenge. In view of some countries' moving towards unification of supervision under a single entity, there is a debate on whether this is the trend for the future. In the context of ongoing reforms in the financial sector in India, the regulatory regime has also undergone certain fundamental changes. New regulators like those for the insurance and capital

markets have been created. The issues of regulatory coordination have also been discussed. Under any system, issues of information exchange and coordination are inevitable. In the final analysis, the regulatory objectives, coverage, skills, operational effectiveness and credibility are important and structures remain one element of financial regulation. While it is difficult to be precise or comprehensive as regards the major areas for immediate attention in regard to financial regulatory system, it appears that the rationale, the scope, the limits the objectives and the instruments ought to be clarified to the extent possible since there is a paradigm shift in the role of the financial sector in economic growth and social justice. At an operational level, arrangement for information exchange and coordination needs to be instituted and reviewed on a continuous basis. At a legislative level, changes to distinguish owners, regulators and market participants in the financial system are essential. Above all, designing and managing all these changes require a combination of political will and professional skill.

Eighth, emerging markets often do not have adequate self-correcting mechanisms in respect of cross-border capital flows which necessitates special defenses for ensuring financial stability. In this context, issues relating to cross-border supervision of financial intermediaries have gained prominence. In this context, there is a need to provide greater focus on overseas operations of Indian banks and instituting a more formal system of information sharing arrangements with overseas supervisors. In view of the recent global concerns about money laundering, it needs to be ensured that branches of Indian banks overseas, particularly those which are yet to be fully compliant with the anti-money laundering principles of the Financial Action Task Force (FATF), do not pose any significant risks to their parent banks in India. Additionally, periodical visits and meetings with overseas supervisors, in addition to formal MoUs for exchange of

supervisory information are being worked out as part of the process of implementation of the *Core Principles* on cross-border supervisory cooperation.

Ninth, in the context of issue of national ownership of financial intermediaries, banks appear to have a unique place in public policy. There are several noteworthy features of ownership and control of banks in all major economies – irrespective of whether they are developed or emerging. In almost all cases, banks tend to be widely held. Furthermore, there are special conditions governing the extent of ownership, the nature of ownership and control, and transfers of such ownership or control through statutory backing. These are justified since the banks are admittedly special. Data clearly indicates that banks continue to play a pre-dominant role in financial intermediation in developing countries. This is understandable for several reasons viz., the savers' eagerness for assured income; inadequate capacity to manage financial risks and the fact that the banking institutions in some sense and in different degrees, enjoy deposit insurance and either implicit or explicit guarantee of government. Accordingly, as the financial sector matures and becomes more complex, the process of deregulation would need to take cognizance of financial stability. Such financial stability has to be particularly ensured when the financial system is undergoing structural changes to promote efficiency. The structural changes relate to ownership, regulation and competition, both domestic as well as external competition.

### **III. Changing Role of the Reserve Bank**