Dr. Rajan begins by stating that healthy and growth-inducing inclusive competition is a necessity for the society. It however, requires intervention by the Government to ensure that entry barriers are low, that there are reasonable rules of the game and clear enforcement of contracts, and that all participants have the basic capabilities such as education and skills to compete. However, governments typically are tempted to go beyond intervening to create a fair competitive environment; eliminating this caveat could be the government's most important contribution to sustainable economic growth in India over the medium term.

Moving on to the competition in the banking system, Dr Rajan states that competition in the banking sector in India is best seen as the product of two grand bargains. The first was between successive governments and the banks, whereby banks got privileged access to low cost demand and time deposits, to the central bank’s liquidity facilities, as well as some protection from competition, in return for accepting obligations for the Government. The second grand bargain was between the public sector banks (PSBs) and the government, whereby these banks undertook special services and risks for the government, and were compensated in part, by the government standing behind the public sector banks.

Today, the investment needs of the economy, especially in areas like infrastructure, have increased. As more sources of financing emerge, not only will banks no longer be able to have a monopoly over financing corporations and households, they will also have to compete for the best clients, who can access domestic and international markets. Similarly, deposit financing will no longer be as cheap, as banks will have to compete with financial markets and real assets for the household’s savings. As low risk enterprises migrate to financing from the markets, banks are left both with very large risky infrastructure projects and with lending to small and medium sized firms. The alternative to taking these risks is to plunge into very competitive retail lending, so public sector banks may have little option especially if the government pushes them to lend to infrastructure.

To survive in the changing business of lending, public sector banks need to have strong capabilities, undertake careful project monitoring, and move quickly to rectify problems when necessary. Unfortunately, employee actions in public sector banks are constrained by government rules and second-guessed by vigilance authorities, even while pay is limited. It will be hard for public sector banks to compete for talent. If, in addition, these banks are asked to make sub-optimal decisions in what is deemed the public interest, their performance will suffer more than in the past. This will make it hard for them to raise funds. With the government strapped for funds, its ability to support the capital needs of public sector banks as part of the second grand bargain is also coming into question.

The best approach may be to develop the financial sector by increasing competition and variety, even while giving banks, especially public sector banks
(PSB), a greater ability to compete. The Reserve Bank of India (RBI) has recently allotted licenses to two new entities to operate as banks, and is considering a more regular process of the same. To be absolutely confident of the capabilities and integrity of applicants, the RBI gives licenses only to those who have a proven track record and reasonable capital. However, Dr Rajan feels that differentiated licenses with restrictions on the geographical reach or the products offered by a new bank can generate more organizational variety and efficiency.

On a different note, according to him, banks seem to be at a disadvantage vis-a-vis other financial institutions in the raising and lending of long term money, especially for infrastructure financing. Since construction lasts for 5-7 years, banks should be able to raise long tenor money for these purposes. But if they raise such money today, they immediately become subject to CRR and SLR requirements, and any lending they do attracts further priority sector obligations. Relieving them of such obligations will immediately put them on par with other financial institutions such as insurance companies and finance companies in funding long term infrastructure.

Dr Rajan feels that a change in governance, management, and operational and compensation flexibility are almost surely needed in India to improve the functioning of most PSBs. If public sector banks become competitive, especially by distancing themselves from the influence of the government without sacrificing their “public” character, they will be able to raise money much more easily from the markets.

In conclusion, Dr Rajan hopes to see a much more varied set of banking institutions using information and technology to their fullest, a healthy public sector banking system, distant from government influence but not from the public purpose, and a deep and liquid financial markets that will not only compete with, but also support, the banks.

Source: www.rbi.org.in
Mr Khan in his introductory statement points out that Indian banking in future is expected to grow exponentially supported by technology intensive processes and customer friendly models with focus on convenience and cost effectiveness. Against this, he feels it is appropriate to take stock of the challenges facing banks going forward in terms of strategies and business models that they will need to adopt more specifically from the regulatory and payment system perspectives.

According to Mr Khan, the share of public sector banks (PSBs) in total banking assets, which was 90 per cent on the eve of reforms in 1991, has since declined to around 72 per cent, a decline of roughly 1 percentage a year. In a move that is further expected to increase competition in the domestic banking industry, the Reserve Bank released the framework for setting up of Wholly Owned Subsidiaries (WOS) by foreign banks to India in November 2013, besides the framework for new universal banks and differentiated banks. Going ahead, there may be increase in the non-bank related financing activities through innovations like Peer-to-Peer (P2P) lending, direct consumer lending and social investing. With increasing competition, banks, will need to tap into untapped business opportunities.

The adoption of Basel III capital requirements by Indian banks would push down their return on equity (RoE) to an extent. Investors have a wider choice and it may be difficult to convince the investor community to invest in Indian banks in the short-term. It needs to be recognized that while moderation of growth in RoE is inevitable, the key to cushion this impact is to optimise capital and augment efficiency.

On June 9, 2014, the Reserve Bank issued guidelines for the implementation of the Liquidity Converge Ratio (LCR), which is a part of the Basel III framework on Liquidity Standards. In India, the LCR will be introduced in a phased manner starting with a minimum requirement of 60 per cent from January 1, 2015 and reaching minimum 100 per cent on January 1, 2019. Government securities in excess of minimum SLR requirements and the Government securities within the mandated SLR requirement to the extent allowed by the Reserve Bank under Marginal Standing Facility (MSF) are permitted to be treated as Level 1 assets for the computation of LCR. Adoption of liquidity standards under Basel III may induce changes in funding preferences of the Indian banks reflecting the fact that availability of and access to quality liquid assets may be a challenge going forward when the LCR requirement increases incrementally.

Moving on to the next challenge, Mr Khan states that the required magnitude of capital in the run up to the full implementation of Basel III will be substantial. During the last four years, the Government has infused Rs 586 billion in the PSBs, and has made a provision of Rs 112 billion in the interim budget for 2014-15. PSBs hold more than 70 per cent of the banking assets. Therefore, capital infusion from the Government of this order may not be sufficient. He feels that there has been over reliance on the Government to infuse equity, without any concerted effort made by PSBs to shore up their equity capital base. Their internal generation of capital has suffered mainly due to sharp deterioration in the asset quality possibly due to adverse selection of assets.

Keynote address delivered by Mr Harun R Khan, Deputy Governor at the BFSI Conference 2014 organized by SBI Cap Securities on June 12, 2014 in Mumbai
There are however, several potential options available to meet the challenges of mobilization of additional capital. These include divestment of Government’s shares in PSBs, reviewing roles and responsibilities of the Boards of PSBs, raising equity in the form of qualified institutions’ placement (QIP) and ESOP, providing tax incentive to investors’ on investments in banks’ Tier 1 bonds like tax exemption of interest income, issuing non-voting equity shares to the public etc.

The economic slowdown has affected the asset quality of banks adversely though the impact is not similar across bank groups. Sector-wise and their size-wise analysis of asset quality shows that the GNPA ratio of PSBs across the sectors and their size are significantly higher than the other bank-groups. The Reserve Bank, on January 30, 2014, has issued a ‘Framework to Revitalise the Distressed Assets in the Economy’, wherein banks would recognise at an early stage the stress in their assets and take prompt steps towards resolution/recovery of distressed assets and detailed guidelines in this regard were issued on February 26, 2014.

The Reserve Bank of India has set up the Central Repository of Information on Large Credits (CRILC) to collect, store and disseminate data on all borrowers’ credit exposures including Special Mention Accounts (SMA 0, 1 & 2) with aggregate fund-based and non-fund based exposure of Rs 50 million and above. Banks will have access to asset classification of individual large exposures by different banks, and are required to activate the Joint Lenders Forum for initiating corrective actions when a lender reports a borrower as SMA2 to CRILC.

Moving on to the governance perspective, Mr Khan points out that according to the Nayak Committee, there is a need to upgrade the quality of board deliberation in PSBs to provide greater strategic focus. The Committee is also of the view that as the quality of board deliberations is sensitive to the skills and independence of board members, it is imperative to upgrade these skills in boards of PSBs by reconfiguring the entire appointments process. For this, the Government has to move towards establishing fully empowered boards in PSBs, solely entrusted with the governance and oversight of the management of the banks. The proposed BIC should commence the process of professionalising and empowering bank boards by reconstituting them and this in turn would help to improve the corporate governance in a big way.

Outlining the challenges in the payment system, Mr Khan feels leveraging technology enabled payment system for electronic transactions provides challenges and opportunities to the banks by expanding outreach in terms of expanding customer base. However, the vision of financial inclusion cannot be achieved unless the rural and semi-urban areas find an equal footing in the policy horizon for banks. He also points out that it is imperative that banks see the potential for synergetic growth by partnering with non-banks and leveraging on their strengths so as to reap efficiency gains for both the entities.

Concluding, Mr Khan states that he is hopeful that Indian banks will be able to find ways to convert the challenges into potential opportunities to redeem their mandate of serving the real economy in an efficient manner. The Reserve Bank, for its part, will continue to endeavour to ensure an enabling regulatory framework that can act as catalyst in the process.

Source: www.rbi.org.in