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Evolving Business Strategies in the Emerging Regulatory Landscape
Transcript of Governor's Inaugural Remarks

Good morning. Once again, on behalf of the Reserve Bank, CAFRAL and all of us here, I want to welcome you all to this first milestone learning event of CAFRAL. Although CAFRAL has been in existence technically for about 4 years, it is only over the last 4 months that it has been active, after Usha took over as Director. In her remarks, Usha invoked Mao to say that even a thousand mile journey has to start with a first step. Indeed so. Only in the case of CAFRAL, this first step happens to be a significant milestone event like today's thematic conference with CEOs of banks.

As you know, the Reserve Bank used to have the Bankers' Training College (BTC). It was wound up years before I joined the Reserve Bank. The BTC provided a forum for communication, learning and knowledge sharing between banks and the Reserve Bank, and between banks and other regulators. As the financial sector grew in sophistication, banks had grown large enough to set up their own training institutions. So the BTC lost its business model and was closed down. Nonetheless, that closure created a vacuum. And that vacuum, I have personally experienced.

USP of CAFRAL

Over the last two and a half years in the post-crisis period, from the RBI we have been attending a number of international meetings - G-20, FSB, BCBS - of which India is a member. What struck me most of all about these meetings is that the agenda somewhat overtakes the emerging economy concerns. My experience has been that we could not meaningfully engage in these meetings because there was nothing relevant about India or about emerging economies in general being discussed.

It is not as if there are no issues or concerns relating to India or other emerging economies that need to be discussed at the global fora. But we are not able to raise them effectively because there is not enough research happening in emerging economies to concretize issues and concerns relevant to us. CAFRAL is best positioned to meet that need, to give us the intellectual backing to further our interests in international fora.

In designing its business model to meet this need, CAFRAL has to be mindful of the fact that we are an emerging economy with a bank dominated financial sector that has its own dynamics, its specific merits and demerits. While attending international conferences, we notice that the divide between the US & Europe on many reform areas in bank regulations arises because Europe is bank dominated whereas America has a non-bank dominated financial sector. So the positions they take on regulatory reform issues, differ on that basis. We too are a bank dominated economy, indeed a public sector bank dominated economy. The positions we take at international fora should reflect our specific interest stemming from this feature. CAFRAL should aid us in this regard.

CAFRAL has a vital role for another important reason. Since I joined the RBI nearly three years ago, I have been saying that it must become a knowledge institution. I think our entire financial sector, at a larger level, must become knowledge based. That's the only way we will thrive in this competitive, globalizing environment. And to pursue this goal, we need an institution like CAFRAL to provide a forum for disseminating learning, for experience sharing and for providing a platform for interaction between banks, regulators and policy makers.

I am very happy to see that some of India's foremost banking experts and banking leaders are participating in this first learning event organized by CAFRAL. Today's event is important because today's experience with this event will shape how CAFRAL's work programme will roll out in the months and years ahead. In that sense, all of you here will be setting important directions for CAFRAL's future.

Evolving Business Strategies in Emerging Regulatory Landscape

The topic for today's discussion, very appropriately, is 'Evolving Business Strategies in the Emerging Regulatory Landscape'. I can hardly overemphasize the importance of thinking through this. Post-crisis, there is very active, very vigorous discussion on business strategies, particularly of banks. These straddle a wide canvas - business models, risk management, governance, incentive structure, accountability mechanism etc. Many of these are applicable to us in India also. Although we came out of the crisis relatively unscathed, although our banks have remained healthy, our banks too need to rethink their business strategies reflecting the lessons of the crisis. To do so, we need to engage in the international debate, try and shape the reforms and implement the reforms here at home, adapting them to the Indian situation where necessary. Some people say that there is no need for us to change because it is "others" who got affected. Perish that thought. Just because we were not touched very much by this crisis does not mean that we have insulated ourselves from all crises for all time. Protecting our banking system and making sure that it continues to support the growth and development of our economy is an enduring endeavour. We need to be retrofitting ourselves all the time.

Business Strategies in the Macroeconomic and Socio Economic Context

The topic for today is revisiting bank business strategies in the emerging regulatory landscape. In my remarks today, I would like to take on a large canvas. All of us are agreed, of course, banks surely have to revisit their business strategies in the emerging regulatory landscape, but they also have to do so in the evolving macroeconomic and socio economic contexts. If you think about it, you will note that the evolving regulatory context is one part, one dimension of this larger context. One way of understanding the evolving macroeconomic and socioeconomic contexts is to understand the megatrends in the Indian economy. Let me spend a few minutes on these megatrends.

1st Megatrend - Globalization

The first megatrend is globalization. Globalization, as we know, has costs and benefits. It provides incredible opportunities but also imposes immense costs. If the 'Great Moderation' in the years before the crisis - steady growth in advanced economies and accelerating growth in emerging economies, and low and stable inflation around the world - was an indication of the positive side of globalization, the devastating toll of the crisis was its negative side. Economic theory tells us that a crisis, or a problem in a non-tradable sector will remain confined within the boundaries of the economic entity. Economics text books, for a long time and indeed even today, would cite housing as a quintessentially non-tradable sector. It is, therefore, perplexing that a crisis which started in the non-tradeable housing sector of one country has snowballed into a global housing crisis, then a global banking crisis, then a global financial crisis and finally a global economic crisis.

Indeed, India's remarkable growth acceleration in the period 2003-08 is a demonstration of the positive side of globalization. We benefited from steady growth and low inflation around the world. But on the flip side, the fact that we were affected by the crisis and our growth momentum was interrupted by it, is an illustration of the negative side of globalization. There was dismay in India that we were affected by the crisis. Several people ask me: "If as RBI claims, the Indian financial sector was safe, sound, well regulated and in resilient health, then how come a crisis, which had roots in the financial sector, affected us?". People also say: "All right, there was a financial crisis around the world and that mutated into a global economic crisis. There was a recession, and that hit demand around the world. But why should that affect India? After all, exports are only 15% of our GDP. You shout from the roof tops saying that the drivers of India's growth are domestic. So how come an external sector problem had really hit us?".

Those are very pointed and relevant questions. The reason we were affected by the crisis, the reason for both the above paradoxes, is that we are more globalised than we tend to acknowledge. If we look back at the ten year period between the Asian crisis and now, our trade integration has gotten deeper; it has more than doubled. Our financial integration has gotten even deeper; it has nearly trebled. So, since the Asian crisis, India has integrated with the world more in trade terms and much more in financial terms. It is this deepening integration into the world that explains why we were affected by the crisis.

In the G-20, there is a lot of discussion these days on the cross-border spillover impact of domestic policies, triggered, no doubt, by the impact of QE2 on other countries, particularly EMEs. And there is a lot of political debate on the extent to which countries, especially systemically important countries, must take into account the spillover impact of their domestic policies.

If we analyse, we will note that there are four types of policies. First, there are policies which are bad for the home country and bad for the rest of the world. An example is loose regulation. Second, there are policies which are good at home, but which probably have net negative implications for the rest of the world. An example is QE2. It is good for America. But it is not yet clear to what extent QE2 has been good or bad for the rest of the world. It is a different conclusion, of course, if you believe that what is good for America is necessarily good for the whole world! Third, there are policies which are good at home but certainly bad for the rest of the world. An example is undervaluation of currency. It is good for the home country. May not be in the long term, but certainly in the short term, it delivers some good. But it certainly is not good for the rest of the world. Finally, there are policies which are good for you and good for the rest of the world which is what we are talking about today - regulatory policies. Good regulation is good for the host country, good for the home country and good for the rest of the world too.

So, the first megatrend is globalization, and we need to rethink our bank business strategies in the context of the spillover impact of developments beyond our borders.

2nd Megatrend - Focus on Manufacturing

The second megatrend in India's macroeconomic context, I would think, is the importance of manufacturing. We all learnt of the paradigm they talk about in development economies - that, as countries grow and develop, they shift from being agrarian societies to industrial societies and then on to post industrial modern societies. That is traditional development theory. When India's growth took off after the reforms in the nineties, the text books were revised, saying that India defied the conventional development paradigm by leap-frogging from agriculture directly into the services, skipping the manufacturing sector. Now, after twenty years the hard truth has hit us - we did not really defy that development paradigm. Our growth prospects going forward hinge critically on getting into manufacturing in a big way. Why? Because there are at least 150 million people trapped in the agricultural sector, with low productivity, who need to be found jobs, productive jobs outside the agriculture sector. Plus, there are additions to labour force every year. If we have to generate so many jobs, the only answer is manufacturing. You cannot generate jobs of that magnitude in the services sector.

Many of you may have read the latest Economist which had written about "the service elevator" in its Economic Focus. Even there, they said that the productive jobs in the services sector of India is just 2 million - 2 million in a population of 1.2 billion! The modern service sector is of course productive, but the service sector cannot generate jobs in the numbers we want. The services sector, therefore, is just not an adequate response to India's employment problem. We need to develop the manufacturing sector in order to provide jobs for the hundreds of millions of people who are going to come into the job market.

Raising share of manufacture from 15% to 25% is going to be difficult. China did this in the 90s when the global environment was benign and there was global growth and demand. We are having to do it at a time when the conditions are much less favourable. The 'manufacturing' challenge entails other challenges like skill development, entrepreneurial development etc. Banks have to be sensitive to this changing paradigm.

3rd Megatrend - Shift in Terms of Trade

The third megatrend in India's growth and development story, in my view, is the shift in terms of trade from urban, modern sectors to rural sectors. For the first 45/50 years after independence, we had a control regime that had obviously biased the terms of trade in favour of the modern, industrial sector. The industrial sector was nurtured through protection from external and internal competition and cheap access to capital. So, the terms of trade for nearly fifty years were decisively in favour of the industrial sector. But that has changed in the last 4-5 years.

This change is due to a number of reasons and circumstances. First, at the global level, technological improvements have reduced the prices of non-agricultural products. Second, at home, economic reforms and liberalisation de-protected the industry and service sectors. It reduced, if not eliminated rent seeking opportunities. Agricultural yields were stagnant, support prices went up and affirmative action programmes generated income and demand. Note that all these factors are resulting in shifting of terms of trade in favour of the agriculture sector, even as the per capita income of the country is $1500 or less. Because of the low per capita income, rising rural incomes are translating quickly into demand. To address the challenge of this megatrend, the focus has to once again shift towards agriculture. We need to improve production and productivity in agriculture. Agriculture contributes only about 15% of GDP. So people ask "How can agriculture be important if it is only 15% of GDP?" It's important because 55%-60% of our people are trapped in agriculture sector. Our economic prospects, and indeed our cohesion as a nation, depend on how we perform in the agriculture sector.

Banks have to take into account this shift in terms of trade and the need to improve production and productivity in agriculture in drawing up their business strategies.

4th Megatrend - Regional Disparities

The fourth megatrend is regional disparities. Regional disparities is a very emotive issue. Almost every country, all the time, all through history, has had disparities. Even America talks about disparities. President Clinton used to claim that he hailed from Arkansas, the most backward state in the US. But disparities in a large, poor country like ours cause much more pain and frustration than disparities in rich countries. When reforms first kicked off in the early nineties, the paradigm used to be that you could divide India into two halves. If you draw a line from Kashmir to Kanyakumari, you have an eastern half and a western half. The eastern half of the country traditionally depended on natural resources, on public sector and on government investment. But the west was entrepreneurial and depended on the private sector. The eastern half, therefore, enjoyed a comparative advantage in the pre-reform licence permit regime. That changed with the reforms. The megatrend impact of reforms was to give a big opportunity to the west and shift comparative advantage in its favour. Ten years after reforms, the east- west divide yielded to a north-south divide. For some time we were talking about southern states growing faster than northern states. But today, even as disparities persist, there is no discernible trend. They are all over the place.

In RBI, we went to the North-East recently. Just the day before we went there, the Home Minister laid the foundation stone for an integrated check post. Also, there was talk of a corridor from West Bengal into the North- East through Bangladesh. There was such jubilation about this that it appeared to have surpassed, in its impact, anything else that the country has been able to do for the North-East over the last 50 years. This is understandable. The NE rightly sees this access as a gateway to opportunity and to development.

There are any number of similar stories from around the country. People who studied development know that the first thing to do to develop a region is to open access. You lay a road and that's the biggest thing you can do for opening up opportunities for economic activity in a region. I have seen this happen in my own state of Andhra Pradesh. So, as much as the North-East needs skills, as much as the North-East needs entrepreneurial development, as much as the North-East needs financial inclusion, as much as the North-East needs banks and indeed the Reserve Bank, the North-East most importantly needs infrastructure and access. The case of the North-East is an illustration of the maladies of disparities and of the huge benefit - cost calculus of narrowing regional disparities.

The problem of regional disparities is not the same as it was 20 years ago. Twenty years ago, if I were living in some tribal tract of Andhra Pradesh or Kerala or Rajasthan, I could not see what was happening around the world. I lived in a cocoon as it were. But today I can see what is happening in India, and around the world on the TV, right? This exposure has had a huge impact on raising the aspirations of people across the country, no matter that they live in far flung areas. Now, people even in the remotest parts of the country know what is possible and want a better quality of life for themselves, and for their children.

The challenge here is infrastructure. We are talking about a trillion dollar investment in the XII Plan which means we need to take up infrastructure investment from 4-5% of GDP to 9-10% of GDP. That is going to challenge both the capacity and the resourcefulness of the banking sector.

5th Megatrend - Urbanization

The last megatrend I am going to talk about is urbanization. Our economists in RBI tell me that there is almost a perfect correlation between urbanization and rising per capita income. I heard the Deputy Chairman, Planning Commission speaking about urbanization at the IGIDR last week. He was saying that India is not only the fastest urbanizing country or among the fastest urbanizing countries in the world, but also that unless we address the problems of urbanization, this double digit growth etc. is going to be a vacuous aspiration. The most important thing for urbanization, you all know, is building urban infrastructure etc. Again, this megatrend of urbanization is something that banks have to reckon with in their business strategies.

Megatrends and Banking in India

The reason I have gone into the megatrends and consequent mega challenges in our macroeconomic and socioeconomic context is to share with you the kind of challenges that the banks have to be responding to. In India, banks have traditionally been not just financial agents, but also social engineers. In developing India, you have not just a financial intermediation role, but also that of change agents. In fact, in many villages across the country, a bank branch is probably the only modern edifice. So banks are in many ways the symbols of modernity in our rural areas. Banks will need to get their hands dirty in rural areas. As you develop your business models, you need to factor in these megatrends.

Regulatory Reforms

Let me now spend five minutes on some of the challenges, some of the tasks, some of the issues that RBI is grappling with so far as BASEL III and other regulations are concerned. We all know the building blocks of BASEL III - higher and better quality of capital, countercyclical buffers, an internationally harmonized leverage ratio, and some minimum global liquidity standards. We have gone to town, both in international meetings as well as here at home, saying that our banks are well capitalized. It is true that our banks are well capitalized at the aggregate level though some individual banks may have to bring in more capital to meet the norm. But the problem is not about today, the problem is about the situation going forward. Because India is a structurally transforming economy, credit demand will go up. As credit demand goes up, and as banks grow their balance sheets to meet that credit demand, banks will need to increase their capital. There are a few other concerns about Basel III apart from the requirement of higher capital.

The first concern is that the cost of BASEL III will drive up the cost of credit at a time when the credit demand of the economy is going up. Credit demand in the economy will go up for a number of reasons: the shift from services to manufacturing which is more credit intensive, investment in infrastructure and financial inclusion. If the economy has to grow at 8-9% per annum, the credit to GDP ratio has to increase, which means credit will have to grow much faster – which will require more capital. If this results in increase in cost of credit, the apprehension is that this might hit our competitiveness and our development aspirations.

The second concern is about our ability to judge a business cycle. As you know, judgement of the trajectory of business cycles is critical for operationalizing of Basel III, especially for triggering the countercyclical buffers. You can make both types of errors - type 1 error and type 2 error. Type II error is when regulators become excessively cautious, choke credit and therefore choke growth. Type II error is when regulators are loose for too long, till it is too late; till an asset bubble builds up and blows up on your face. So, you should be able to judge the business cycles, because misjudging that can be costly in macroeconomic terms. The third concern is about the division of business between banks and non-banks. If we regulate banks very tightly, obviously business will shift to the less regulated part of the financial sector. And we have to take a call on that. It is not as if we will bring non-bank regulation at par with bank regulation. Obviously, the loosely, lightly regulated non-bank sector serves a useful purpose. We have got to have the right mix between banks and non-banks. The fourth concern is about managing globalization. We have to ensure that as much as India keeps opening up its financial sector, we need to build in buffers so that we minimize the impact of adverse external developments. Those are the concerns as far as regulation is concerned.

Risk Management

In responding to these mega challenges, banks have to build in risk management tools which the experts present here will talk to you about. Banks, like other enterprises in a competitive environment, look to expanding their market share. I am not sure if that is the right metric. What I learnt from my economics classes is that what a company must be aiming for is to improve its long term net worth; not necessarily its market share. So you have to institute risk management tools so that you can focus on increasing the long term net worth of your institution.

Financial Inclusion

Finally, there are few instances, if any, around the world historically of any economy increasing per capita income on a sustainable basis without broad based financial inclusion. The one issue that I want to raise is that the usual response to the financial inclusion is "Look, there is no business model, there are no economies of scale, the capital cost of putting in infrastructure is not viable even in the medium term and that the delivery mechanism entails reputation risk". Those assertions are based on misgivings about the costs and risks, and also some apprehensions about what might be politically acceptable. Lending small amounts to low income people entails higher risk premium, hence higher transaction cost. This would mean charging higher rate of interest. Banks are wary about charging higher rate of interest because they believe that it would make them unpopular and uncompetitive. The usual things that we see in the media and talk about in some of the conferences, is that if a big corporate in Mumbai, Delhi, Chennai can get loans at single digit interest rates, how come our low income households are being charged 30-40%. Even as that concern is legitimate in a broader sense, the assertion is ill informed. If you are lending small amounts to low income households where the risk premium and the transaction cost are high, you should be charging higher rate of interest.

In charging higher interest rate however, you must be transparent and be willing to show your costing. Much of this cost of lending to lower income households is being colored by the controversy around the microfinance sector of last year. We had since then studied the sector and came out with Malegam Committee recommendations, implemented much of them and capped the interest rate at 26%. But the larger question the banks must be addressing is whether you still want to operate through intermediaries or whether you would walk the last mile yourselves. Again, this has got something to do with the banking culture, something to do with you getting your hands dirty, something to do with your larger commitment to the quality of growth. From the Reserve Bank we have done two important things to encourage you to walk the last mile. We have removed the interest rate ceiling on loans of less than ` 2,00,000. We have also removed the priority sector status for bank lending to NBFCs. We expect banks to explore the "fortune at the bottom of the pyramid" that is available to people who innovate, to people who experiment and people who are the first movers. So I urge each of you to be the first movers.

Financial Intermediation

Let me conclude by acknowledging that banks, indeed the entire financial sector, played a very important role in our growth phase in 2003-08. Actually, when we talk about that growth phase, we talk about a number of drivers: entrepreneural spirit, productivity improvement, higher savings rate etc. One of the unacknowledged drivers of that growth performance is the improvement in the quality and quantum of financial intermediation. Both our growth and our financial intermediation have got slightly off track because of the crisis. But now we have got to get back on track. And financial intermediation has to play a very critical role in putting the country back on a high growth trajectory.

Over the last two and half years that I have been with the Reserve Bank, and therefore been a regulator, I have been trying to understand the wisdom of this adversarial relationship between the regulators and the regulated. Perhaps there is some value to that. In fact, this adversarial relationship is not unique to India; I have noticed it in practically every jurisdiction. I think that's the way it should be. Regulation is all about controlling so that safety and stability come ahead of profit, there are no excesses and the long-term good is not compromised for short-term profits. Banks try to get around the regulations, try to be innovative and get ahead. Then the regulators try to catch up with banks and sometimes get ahead of them. And together in this game, hopefully, we are building a robust system that's good for the economy and good for the world.

However, we also require a forum where the adversarial relationship between the regulator and the banks yields to cooperation, experience sharing and knowledge sharing. Today's conference is such a forum, where you tell us what you know and we tell you what we know. Sometimes we may have difference of opinion and sometimes we will have convergence of opinion but wisdom comes out of both finding a consensus or at any rate agreeing to disagree. I hope today's forum will set the tone for what is going to be a very fruitful, constructive, meaningful relationship between the regulators and the regulated.

Thank you very much and all the best.