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INTERDEPENDENCE, INTEGRATION AND CO-CREATION'**

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Having spent my working life of over three and a half decades in the realm of commercial banking, you will no doubt appreciate my natural inclination to dwell on the discursive issues focused on banking. In particular, I would like to share my thoughts on three contemporaneously relevant issues – Basel-II, Consolidation in Banking space and Financial Inclusion- which are engaging the attention of commercial banks like us, the central bank i.e. the Reserve Bank of India and of course the Government.

Indian Banking Universe: Emerging Trends

The Indian Banking landscape is vast and complex. The monolithic public sector banks and single unit co-operative banks comprise two distinct ends of the spectrum, with private sector banks, regional rural banks and foreign banks populating the intermediate space. The complexity of the banking system can be assessed from its pure bandwidth, straddling 21 public sector banks, SBI and its seven associates, 25 private sector banks, 29 foreign banks, around 100 regional rural banks and around 1800 urban co-operative banks. Between them, these banks have deposits of around Rs. 29 lakh crore, advances of around Rs. 20 lakh crore and investments of around Rs. Nine lakh crore. The deposits, advances and investment numbers clearly highlight the signal role essayed by Banks in propelling India's economic growth.

Indian banks have come a long way from being mere aggregators of resources and purveyors of credit to their current positioning as financial supermarkets, geared to provide customized financial solutions to their constituents. Besides offering the discerning customer the convenience of modern banking services, branches of many a bank, among others, now also sell mutual funds and insurance, offer equity broking, wealth management

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and other financial advisory services, all under the same roof. However, if you thought commercial banking is only about extending housing loans, auto loans, personal loans, credit cards, working capital loans, term loans, and cash management in metros and Tier-I cities, you are mistaken. The ambit of commercial banking now goes far beyond extending loans to only those who are affluent. Banks now seek to meaningfully touch the lives of those living 'at the bottom of the pyramid'. Slowly but surely, banks are realizing the benefits of empowering the underprivileged via financial inclusion programmes. These underpin Banks' concerted efforts to increase their footprints into the rugged interiors of the country in the pursuit of inclusive growth.

With India's GDP growth averaging 8.6% in the last four years and poised to tip 8.5% in the current financial year, Asia's third largest economy has become the toast of the world economy. Burgeoning cross-border trade and investments have led banks to extend lines of credit and bankroll domestic and cross-border acquisitions by India inc. Indian banks are putting their money where their mouths are. Their quest for growth has seen them follow the great Indian Diaspora and trade and set up operations overseas.

Banks need to garner more capital now than ever before in order to satiate the funds appetite of India Inc, SMEs, the farm sector and retail consumers, diversify into new businesses like insurance, asset reconstruction and private equity, as well as establish a global footprint. Banks' quest for growth by reinforcing existing operations and diversifying into newer lines of business and geographies makes business sense.

But quest for business and profits should not make banks oblivious to the underlying risks involved. Diversification into non-traditional products like derivatives and insurance, increased globalization on account of cross-border dealings coupled with web-based banking and e-commerce has increased the risks – credit, market, and operational – faced by banks manifold. This is where the new framework for capital adequacy – the Basel II – comes into the picture.

On the competition aspect, as per the RBI's roadmap for the presence of foreign banks in India, come April 2009, the central bank may permit merger/ acquisition of any private sector bank in India by a foreign bank. In this context, competition from foreign banks is inevitable and it is therefore imperative for Indian banks to gear up for the same. With their deep pockets, foreign banks can easily bankroll acquisition of many of India's private sector banks. In view of the impending march of foreign banks to India, it is important for

Indian banks to explore mutually gainful consolidation opportunities to stave off competition.

That, in a sense, is the broad canvas of the Indian banking universe as it stands today. I shall now, with your permission, cherry-pick three important issues from among those I've touched upon earlier viz. Basel-II, financial consolidation and financial inclusion and share my thoughts on each one of them.

Basel-II

As we are all aware, a Bank's capital base serves as the foundation for its future growth and as a cushion against unexpected losses. Adequately capitalized banks that are well-managed are better able to withstand losses and provide credit to consumers and businesses alike throughout the business cycle, including during downturns. Adequate levels of capital thereby help to promote public confidence in the banking system.

The technical challenge for both banks and banking regulators/supervisors has been to determine how much capital is necessary to serve as a sufficient buffer against unexpected losses. If capital levels are too low, banks may be unable to absorb high levels of losses. Excessively low levels of capital increase the risk of bank failures, which, in turn, may put depositors' funds at risk. Per contra, if capital levels are too high, it is an indication that banks may not be making the most efficient use of their resources.

The Basel Capital Accord of 1988 set out the first internationally accepted definition of, and a minimum measure for, bank capital. This Accord, which came to be regarded as a benchmark measure of a banks' solvency, was designed as a simple standard so that it could be applied to banks in many jurisdictions. It requires banks to divide their exposures into broad "classes" reflecting similar types of borrowers. Exposures to the same kind of borrower – such as all exposures to corporate borrowers – are subject to the same capital requirement, regardless of potential differences in creditworthiness and risk that each individual borrower might pose.

Taking cognisance of further advances in risk management practices, technology, and banking trends and practices, particularly in respect of internationally active banks, the Basel Committee on Banking Supervision released the Report on 'International Convergence of Capital Measurement and Capital Standards', popularly known as Basel-II, on June 26, 2004 for phased implementation worldwide during 2007-09. The main objective for the revision in the 1988 Accord was to develop a framework that would further strengthen the soundness and stability of the international banking system by promoting adoption of stronger risk management practices by the banking industry. Basel-II sets out a new framework for adopting more risk-sensitive minimum capital requirements for banks.

The new framework reinforces these risk–sensitive requirements by laying out principles for banks to assess the adequacy of their capital and for supervisors to review such assessments to ensure that banks have adequate capital to support their risks. It also seeks to strengthen market discipline by enhancing transparency in banks' financial reporting. The new accord, while building on the earlier Accord's basic structure for setting capital requirements, is more reflective of the underlying risks in banking and provides stronger incentives for improved risk management. Taking the concept forward, it aligns capital requirements more closely to the risk of credit loss by introducing a new capital charge for exposures to the risk of loss caused by operational failures. The Basel Committee, however, intends to broadly maintain the aggregate level of minimum capital requirements of the 1988 Basel Accord while providing incentives to adopt the more advanced risk-sensitive approaches of the revised Framework. Basel-II combines these minimum capital requirements with supervisory review and market discipline to encourage improvements in risk management.

One of the major shortcomings of the 1988 Basel Accord was that it concentrated more on credit risk and, to an extent, on market risk to the exclusion of operational risk. The New Accord provides a comprehensive approach to risk management i.e. it takes into account all major risks – credit, market and operational – faced by banks. The New Accord consists of three mutually reinforcing "Pillars" which together are expected to contribute to the safety and soundness of the financial system. "Pillar 1', which stipulates the Minimum Capital Ratio, introduces a menu of options for determining the capital charge for each of the three categories of risks – credit, market and operational. The credit risk measures used by banks have been specifically recognized to provide appropriate capital relief. 'Pillar 2', or the Supervisory Review process, requires an upgrading of supervisory practices to review banks' internal capital adequacy assessments. In fact, this element makes the revised framework very comprehensive in its sweep by addressing the entire risk domain of the banks. It requires banks to develop an Internal Capital Adequacy Assessment Process (ICAAP) which should encompass their whole risk universe – by addressing all those risks which are either not fully captured or not at all captured under the other two pillars – and assign an appropriate amount of capital internally for all such risks, commensurate with their risk profile and control environment. Under the Supervisory Review, the supervisors would conduct a detailed examination of the ICAAP of the banks and, if warranted, could prescribe a higher capital requirement, over and above the minimum capital ratio envisaged in Pillar 1. 'Pillar 3, or 'market discipline', focuses on effective public disclosures to be made by the banks and is a critical complement to the other two Pillars. It recognizes the fact that, apart from the regulators, banks are also monitored by markets and the discipline exerted by the markets can be as powerful as the sanctions imposed by the regulator. It is premised on the basic principle that the markets would be quite responsive to the disclosures made and the banks would be duly rewarded or penalised, in tune with the nature of disclosures, by the market forces.

A two-stage implementation of the guidelines has been envisaged to provide adequate lead-time to the banking system. Accordingly, Indian banks having operational presence outside India and foreign banks operating in India are required to migrate to the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these two approaches on or before March 31, 2009.

It has been a conscious decision to begin with the simpler approaches available under the framework. As regards market risk, banks will continue to follow the Standardised – Duration Method, already adopted under the Basel-I framework, under Basel-II also.

Basel-II will no doubt enhance banks' safety and soundness, strengthen the stability of the financial system as a whole, and improve the financial sector's ability to serve as a source for sustainable growth for the broader economy.

It is equally obvious that transition to the new capital adequacy framework would require banks to further shore up their capital funds as, under Basel-II, capital requirements are not only more sensitive to the level of credit risks but are also applicable to operational risks. This would be over and above capital required to support expansion in each bank's balance sheet. For a smooth transition to Basel-II, banks are considering a combination of traditional instruments like follow-on public offer/rights issue as well as newer offerings such as innovative perpetual debt instruments eligible for inclusion under Tier-I capital, debt capital instruments eligible for inclusion as upper Tier-II capital, perpetual non-cumulative preference shares eligible for inclusion as Tier-I capital and redeemable preference shares, which would qualify for inclusion as Tier-II capital.

Mergers and consolidation of well-capitalised banks is another option in this regard.

Consolidation

Hon'ble Union Finance Minister Shri P. Chidambaram once said and I quote, "Consolidation alone will give banks the muscle, size and scale to act like world-class banks. We have to think global and act local and seek new classes of borrowers."

I can think of no better reason for consolidation than what the FM has said. The compulsions imposed by globalization will see consolidation becoming more prevalent in the Indian financial system in the near future. Key drivers of consolidation include revenue growth from larger customer base, synergy and/or efficiency in operations, optimal deployment of excess capital, stablisation of asset quality, need to upgrade technology and offer a comprehensive bouquet of products, savings in cost and shrinking margins. Size is critical for banks since it makes it possible to tap opportunities and overcome competition.

Our financial sector is destined to be opened up to global competition sooner rather than later, once the rules of the game are set under the WTO. Banks will have to gear up to meet stringent prudential capital adequacy norms under Basel-II as they compete with banks with greater financial strength. With the implementation of Basel-II norms, weaker banks may have no option but to merge with banks with excess capital. In fact, the Indian Banks' Association, in its document titled "Banking Industry Vision 2010", has visualized that mergers between public sector banks or between public sector banks and private sector banks would be the next logical step for sustained viability in the emerging financial landscape. Our banking system needs to be prepared for such a scenario. However, such mergers should ideally be voluntary, dictated by underlying synergies and business arithmetic rather than imposed from above.

The RBI has already unveiled a two–phased roadmap for the presence of foreign banks in India. In the first phase (between March 2005 and March 2009), foreign banks can establish a presence in India by way of setting up wholly- owned banking subsidiary (WOS) or conversion of the existing branch into a WOS. Further, during this phase, foreign banks are permitted to acquire shareholding in Indian private sector banks, which have been identified by the RBI for restructuring.

If a foreign bank, already having a presence in India, acquires a bank, it will have to conform to the 'one form of presence' concept within a maximum period of six months. The second phase, which commences in April 2009, may see extension of national treatment to wholly-owned subsidiaries, dilution of stake and mergers/ acquisitions of any private sector bank in India by a foreign bank.

Smaller banks with firm financials as well as large ones with weak income statements would be the obvious targets for the larger and better-run banks. As I mentioned earlier, pressures on capital structure, in particular, are expected to trigger a phase of consolidation in the banking sector.

It may be pertinent to note here that increased competition too leads to banks becoming more efficient and productive. For example, when new generation private sector banks set up shop in India they, in a sense, forced an otherwise conservative public sector banking fraternity to get their act together by embracing state-of-the-art technology and taking customer service to a different level.

Hence, competition from within and without will do a world of good to the Indian banking system and its participants, provided the latter pro-actively gear up to leverage its upsides by beefing up their capital base to Basel-II-plus requirements as well as consummate consolidation with 'best fit' banks well ahead of the opening up of the domestic financial sector to international banks.

Financial Inclusion

In the last couple of years, the RBI and the Government have set much store by the concept of financial inclusion as a means to empower those at the 'bottom of the pyramid'. The emphasis on financial inclusion is important as, notwithstanding financial sector liberalization and rapid progress of banking sector in the country, India's informal sector, more particularly the rural sector, still has very little access to formal finance. Informal finance channels, leveraging on the demand–supply gap, levy exorbitant interest rates on the borrowers with stiff conditionalities, which are overwhelmingly skewed in favour of the lenders.

As you may be aware, GoI have set up the Rangarajan Committee on Financial Inclusion headed by Shri C. Rangarajan, Chairman of the Economic

Advisory Council of the PM, of which I am also a member. As per the available data only 52% of the country's population has access to both informal and formal banking service, with banking sector catering to 25% and the informal sector to another 27% of the population. Access to other financial services, such as savings accounts, life, health and crop insurance are also marginally available to the people in this sector, particularly in rural areas. There is, therefore, a crying need for availability of alternative financial services, for providing the required finance at an affordable cost, on transparent and equitable terms, which would thereby help to meaningfully improve the welfare of these disadvantaged strata of society. This will also facilitate widening and deepening of the financial sector as also bridging the gap between the formal and informal sectors of the economy.

Banks have taken the cue and are doing their best to ensure access to timely and adequate credit and financial services by vulnerable groups that are convenient, flexible and affordable. Let me emphasize at this stage that financial inclusion has gainful business implications and need not be viewed purely as a socio-economic objective. As I see it, financial inclusion is a robust tool for vastly expanding the banking outreach, which is also a logical step in the financial sector reforms process. Further, the widening and deepening of the markets, through inclusion, provides the banking sector with immense scope to benefit from opportunities available at the 'Bottom of the Pyramid'.

In order to further the cause of financial inclusion, the RBI has issued guidelines for banks to open 'no frills' accounts either with 'nil' or very low minimum balances, as well as charges, that would make such accounts accessible to vast sections of population. The central bank has also issued guidelines to banks enabling them to use the services of Non-Governmental Organizations / Self Help Groups, Micro Finance Institutions and other Civil Society Organizations as intermediaries in providing financial and banking services through the use of Business Facilitator and Correspondent models.

Further, banks are issuing general credit cards to eligible beneficiaries without insistence on security, purpose or end-use of credit; Kisan Credit Cards to ensure availability of credit; and utilizing the services of Non-Governmental organizations, Self Help Groups, Micro Finance Institutions and other Civil Society Organizations as intermediaries in providing financial services. By providing access to mainstream financial services and designing and delivering credit to every household that seeks credit, banks are indeed finding opportunities at the bottom end of the pyramid for expanding the volume of business without sacrificing commercial aspects of banking. Focused approach to financial inclusion has the potential to lift the lives of the rural poor.

Cross-country studies indicate that many of the advanced countries have given a thrust to promoting financial inclusion. There is a Financial Inclusion Task Force in the UK, which has set up a Financial Inclusion Fund. The USA has a Community Reinvestment Act, which ensures affirmative action by banks for financial inclusion. In terms of quantitative indicators such as bank branches / ATMs per sq. km. of area or bank branches / ATMs per 1000 population, it has been observed that developed countries mostly have higher level of financial inclusion.

Similar patterns are also observed in terms of loan/deposit accounts per capita, household share of bank accounts etc. These data reinforce the earlier observation that financial inclusion is a prerequisite for sustained economic development.

I also feel, in this context, that a partnership-based outreach model along with the direct banking model, and not only the latter, is generally more effective in reaching the people in a vast and populous country like India. Towards this end, it is desirable that financial service players develop community-based financial initiatives, leveraging mutually gainful partnerships with responsible and responsive bodies and organizations, which would help provide flexible and need-based financial solutions, customized to suitably address localised needs.

The international experiences of successful Inclusive Banking also indicate that it is useful for banks to deal with groups of customers organized in the form of Self-Help Groups rather than trying to approach and attract customers individually. Peer pressure within SHGs ensures that the risk of default is minimized. The developments in computing and indigenous technology provide another avenue by which products and services can be distributed among widely dispersed categories. Further, banks are also partnering with micro finance institutions to take an indirect exposure to the lower strata of society.

International experiences also attest to the benefits accruing from a flexible approach, suited to the needs of potential customers and continuous innovation and experimentation with different banks using distinct methods and models to reach customers spread out over the vast hinterland of the country. Banks can significantly cut down on transaction costs and increase profit margins by employing information technology.

Evidence clearly suggests that taking credit exposure to those of small means in rural as well as urban pockets of the country via direct financing as well as funding Self-Help Groups has proved to be a bankable proposition.

CONCLUSION

I've spoken at length on the three critical issues facing the banking sector today. In this era of financial globalisation, the challenges facing a banker are manifold. However, a strategic and timely response, combined with an 'out-of-the-box' thinking and risk-taking ability, could well turn the challenge into a gainful business opportunity.