'There are Interesting, profitable and challenging times for the financial sector'
Multiplicity of monitoring bodies not good for bank managements: RBI Governor
2-Day FICCI-IBA Conference, 'FIBAC 2016' gets under way

MUMBAI, August 16, 2016. The Reserve Bank of India Governor, Dr. Raghuram Rajan, today sought to disentangle the performance monitoring maze that public sector banks have to contend with, suggesting that "It was important to streamline and reduce the overlaps between the jurisdictions of the authorities, and specify clear triggers or situations where one authority's oversight is invoked."

Addressing the **annual FICCI-IBA Conference, FIBAC-2016,** Dr. Rajan said, "A variety of authorities – Parliament, the Department of Financial Services, the Bank Board Bureau (BBB), the board of the bank, the vigilance authorities, and various regulators and supervisors including the RBI – monitor the performance of the public sector banks. With so many overlapping constituencies to satisfy, it is a wonder that bank management has time to devote to the management of the bank."

The RBI Governor said that there is a need to move much of the governance to the bank's board, with the Government exercising its control through its board representatives (chosen by the BBB), keeping in mind the best interests of the bank and the interests of minority shareholders. Wherever possible, public sector bank boards should be bound by the same rules as private sector bank boards – one reason why the RBI has recently withdrawn the Calendar of Reviews PSBs were asked to follow. Similarly, board membership of public sector banks should pay as well as private sector banks if they are to attract decent talent, he emphasised.

As boards take decisions, Dr. Rajan suggested that the Department of Financial Services could move to a program role such as ensuring government programs such as PMJDY are well designed, appropriately remunerated to banks, and progress monitored; a coordinating role that ensures that financial institutions join a common KYC registry and a developmental role for revitalizing institutions like the Debt Recovery Tribunals through appropriate legislation. RBI, he added, would perform a purely regulatory role, and withdraw its representatives on bank boards, subject to legislative change. Over time, RBI should also empower boards more, for instance offering broad guidelines on compensation to boards but not requiring every top compensation package be approved.

Furthermore, the Governor pointed out that given strong oversight from the bank's board, the Central Vigilance Commission and the Comptroller & Auditor General should get involved only in extraordinary situations where there is evidence of malfeasance, and not when legitimate business judgment has gone wrong.

In his speech, perhaps the last to bankers and industry leaders before his terms as Governor ends, Dr. Rajan spoke on 'Interesting, Profitable, and Challenging: Banking in India Today'.

He said the time had come to move more to improving the operational efficiency of stressed assets, and creating the right capital structure so that all stakeholders can benefit. This implies simultaneous action on two fronts. Where necessary, new project management teams have to be brought in, sometimes as owners, and where this is not possible, as managers. A creative search for new management teams, including the possible use of public sector firms or private sector agents, is necessary, as are well-structured performance incentives for non-owner teams such as bonuses for meeting cash flow/profit benchmarks and stock options.

"These are interesting, profitable, and challenging times for the financial sector. Interesting because the level of competition is going to increase manifold, both for customers as well as for talent, transforming even the sleepiest areas in financial services. Profitable because new technologies, information, and new techniques will open up vastly new business opportunities and customers. Challenging because competition and novelty constitute a particularly volatile mix in terms of risk, Dr. Rajan said.

He said, despite increased competition, profitability of banks can increase. The comparative advantage of banks may lie in their access to lower cost deposit financing, the data they have on customers, the reach of their network, their ability to manage and warehouse risks, and their ability to access liquidity from the central bank. These should then be the basis for the products they focus on.

India, he said, will have enormous project financing needs in the coming days. Even though bankers are very risk averse today, and few projects are coming up for financing, this will change soon. What is in the pipeline is truly enormous – airports, railway lines, power plants, roads, manufacturing plants, etc. Bankers will remember the period of irrational exuberance in 2007-2008 when they lent without asking too many questions. “I am hopeful that this time will be different. Here are ways it can be different and risks lowered. First, significantly more in-house expertise can be brought to project evaluation, including understanding demand projections for the project’s output, likely competition, and the expertise and reliability of the promoter. Bankers will have to develop industry knowledge in key areas since consultants can be biased. Second, real risks have to be mitigated where possible, and shared where not. Real risk mitigation requires ensuring that key permissions for land acquisition and construction are in place up front, while key inputs and customers are tied up through purchase agreements. Where these risks cannot be mitigated, they should be shared contractually between the promoter and financiers, or a transparent arbitration system agreed upon, “ he said.

The third element of project structuring, said, was an appropriately flexible capital structure. The capital structure has to be related to residual risks of the project. The more the risks, the more the equity component should be (genuine promoter equity, not fake borrowed equity, of course), and the greater the flexibility in the debt structure. Promoters should be incentivized to deliver, with significant rewards for on-time execution and debt repayment. Where possible, corporate debt markets, either through direct issues or securitized project loan portfolios, should be used to absorb some of the initial project risk. More such arm’s length debt should typically refinance bank debt when construction is over. Hopefully, some of the measures taken to strengthen corporate debt markets, including the new bankruptcy code, should make all this possible. Fourth, financiers should put in a robust system of project monitoring and appraisal, including where possible, careful real-time monitoring of costs. For example, can project input costs be monitored and compared with comparable inputs elsewhere using IT, so that suspicious transactions suggesting over-invoicing are flagged? 4

And finally, the incentive structure for bankers should be worked out so that they evaluate, design, and monitor projects carefully, and get significant rewards if these work out. This means that even while committees may take the final loan decision, some senior banker ought to put her name on the proposal, taking responsibility for recommending the loan. IT systems within banks should be able to pull up overall performance records of loans recommended by individual bankers easily, and this should be an input into their promotion.

As for the challenges faced by Public Sector Banks, the most pressing task is to clean up their balance sheets, a process which is well under way. A parallel task is to improve their governance and management. Equally important is to fill out the ranks of middle management that have been thinned out by retirements, and to recruit talent with expertise in project evaluation, risk management, and IT, including cyber security.

Concluding his address, the RBI Governor said that with changes in technology, cyber security, both at the bank level and at the system level, has become very important. “I think it would be overly complacent for anyone of us to say we are well prepared to meet all cyber threats. A chilling statement by an IT expert is 12 ‘We have all been hacked, the only question is whether you know it or you don’t’. While the statement may be alarmist, it is an antidote to complacency. We all have to examine our security culture. Too many access points are left unmonitored, too many people share passwords or have easily penetrated passwords, too little surveillance is maintained of vendors and the software they create.” RBI, he added, was orking on upgrading the capabilities of its inspectors to undertake bank system audit as well as to detect vulnerabilities in them. RBI is also in the process of setting up an IT subsidiary, which will be able to recruit directly from industry, and will give the Reserve Bank better ability to manage and supervise technology.

On the occasion, Dr. Rajan released the FICCI-IBA-BCG Knowledge Paper and and launched the report on ‘FIBAC 2016—Benchmarking Digital Tools’.

In his remarks, **Mr. Ashwani Kumar, Chairman, IBA and CMD, Dena Bank,** stated that competition intensifies, not just amongst banks but also also against other financial institutions, what will differentiate the better performs from other will be the quality of service delivery and the cost of service. He emphasised the need to develop user-friendly products and maintained that face-to-face banking will remain relevant and important.

Mr. Harshavardhan Neotia, President, FICCI and Chairman, Ambuja Neotia Group, lauded the efforts of the Dr. Raghuram Rajan who took over at a time when the economy was experiencing a period of high inflation, high fiscal and current account deficits, low foreign exchange reserves and weak currency. He listed out the challenges that the banking sector still has to overcome and said that industry would like to see a more accommodative stance from the RBI so that demand gets a push, capacity utilization rates improve and investments start kicking in.

Mr. Arun Tiwari, Chairman, FICCI's Banking and Financial Institutions Committee and CMD, Union Bank of India,pointed out that the centre of financial activity was moving to Asia. This was a happy augury for trade, industry and finance, he said and added that it was imperative to keep a watchful eye on new technological developments to bring down transaction costs and improve efficiency ratios.

Mr. Rajeev Rishi, Deputy Chairman, IBA and CMD, Central Bank of India, shared his views on the issues and challenges faced by the banking sector while **Mr. Saurabh Tripathi, Senior Partner and Director, BCG India,** presented the theme of the conference.

The inaugural session of the conference was moderated by **Dr. A Didar Singh, Secretary General, FICCI**

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