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Address by RBI Governor, Dr. Raghuram G Rajan

at

CAFRAL Advanced Leadership Program

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Thank you for inviting me to CAFRAL Advanced Leadership Program. Let me start by outlining what we have been trying to do in the financial sector over the last year and a half. We can then go to the issues that directly concern you.

We have been trying to work on 5 different dimensions of the financial system. As you know, we experienced turmoil in the summer of 2013. Exchange rates plummeted, we had to resort to severe interest rate tightening, and a fair amount of intervention in the currency markets to restore stability. I think the lesson from that episode of turmoil is, that we cannot afford to take a risk on monetary and fiscal stability. Macroeconomic stability for a country like India is absolutely essential. If we lose that, then we go down a long way before we come back. One of our efforts here has been to make clear on what to do on the monetary front, because the fiscal front would be the government's arena.

On the monetary front we are going to focus on bringing down inflation. For far too long we had focussed on WPI inflation, which while representing some things that firms look at, doesn't really represent what the common man sees. So we said we are going to move towards targeting CPI inflation, and we said we will bring it under control in two years' time. This was based on a report by our Deputy Governor, Urjit Patel. We thought the targets we announced then were doable with some difficulty, and would involve some pain – it was 8% by January this year, and 6% by January of next year. When we announced these targets everybody thought we were crazy to announce targets. We didn't have a history of meeting any targets in India, especially inflation targets, and we would be subjecting the economy to a fair amount of pain without any gain. Fortunately, the result has been inflation below even our 2016 projection, as early as Jan 2015. This was with a little bit of help from the global situation, but also from the effects of a monetary focus as well as the realisation that fiscal policy and monetary policy have to work together. That will give us a fair amount of comfort, but there's a long way to go before we reach the kind of credibility that Central banks in other countries have (which eventually gives them the freedom to act much more) than perhaps Central banks in developing countries have had. We have some way to go, but we have started the process of monetary easing. So long as you banks pass these interest rate cuts and lower the lending rates, we can have some effect on growth.

The second element was deepening markets. As many of you know, in India all the risks in the system eventually come back to the banking system. For example, we have institutions trying to lend long term, but a fair amount of their borrowings eventually find a way directly or indirectly into the banking system - directly in your portfolios, and indirectly via NBFCs that you finance. So we need to have a clear cut separation between market risk which is funded by institutions unconnected to the banking system, and banking system risk, which comes with the kind of loans that you make. To do that, we need stronger stock markets to raise equity, which gives you the cushion when you make the loans, and also a stronger bond market, so that corporate bonds can be issued. We have introduced better instruments in some of these markets - the

Interest Rate Futures market has picked up quite strongly, with the average trading volume in some weeks reaching 4000 crores. Moving forward, I am hopeful that the corporate bond market will also develop, partly on the back of the corporate bonds that you banks issue. We made it easier for you to issue long term bonds which will absolve you of CRR, SLR and priority sector obligations if you are invested in infrastructure. Those bonds will form a class of bonds in between the government bond and the pure corporate bond, because banks to some extent are seen to enjoy the protection of the sovereign, and therefore treated as quasi-sovereign. I am hopeful that you will participate in strengthening the corporate bond market through this vehicle. There are also other vehicles, such as partial guarantees that you offer corporate bonds which may also further that. But I think the most important element in getting a strong corporate bond market, is a bankruptcy system that works, so that bond investors can get their money back in case a firm defaults.

The third element of the financial landscape is financial inclusion. The Pradhan Mantri Jan Dhan Yojana has been a very large part of it these last few months. It is up to us to convert these accounts that have been opened into functioning accounts. For that a few things are required to be done. Money needs to flow through these accounts. The government intends to do that through Direct Benefit Transfer schemes. We also need people to transact through these accounts. For that, they need access to their accounts, for which the last mile reach becomes very important. The last mile issue can be addressed in different ways. One is through the Business Correspondent route. We are trying to make the Business Correspondent a little more flexible, so that they have enough business – not just one bank's business but multiple banks' business. The second is technology, which means full utilization of cellphones. Banks and telecom companies have been talking about USSD technology, but it hasn't really taken off so far. What is required is a simple app, which will enable person A to send money to person B just by knowing his cellphone number. For that we are talking to NPCI about creating a registry which would have cellphone numbers as well as bank account numbers and Aadhar numbers. Once that is in place, money sent to a cell phone number will be credited automatically to the associated bank account. The registry and a simple app enabling such transactions will go a long way in facilitating cellphone based payments. Other things will automatically follow. The institution of payment banks, which we hope to inaugurate soon, will also help further this. A number of banks have been linking up with telecom companies for that purpose. Hence, inclusion will require DBT payment through the banks, commissions for banks processing these direct benefits (therefore giving some profitability to the banks), banks using the information based on these accounts to offer other products to the account holders, and finally, traversing the last mile through Business Correspondents as well as through mobiles. If all these things are done, and done through many different ways until the ideal way emerges, we will have a very rich process of financial inclusion which is very important for this country.

The fourth element is the resolution of distress. Many Public Sector Banks are sitting on large piles of bad loans, and unfortunately I am not sure we have recognised the full extent of the bad loans in the system. I hope we have, but history suggests that banks rarely recognise the full extent of the problem, preferring to extend and pretend, rather than recognising it as it comes.

We need to clean up the banking system. Without cleaning up, there is limited room for the new lending that is needed for the massive new demands. In order to do that you have to find a way that your stressed borrowers bring more money to undertake the projects. If that is not possible, then either the bank will have to take-on the risks or it would need to devolve on somebody else who is willing to take the risk. For the process to go forward, it is absolutely essential that the real asset be put back on track. We must not waste the real asset. RBI has been trying very hard to give you the flexibility to get the real assets back on track, including with the 5-25 scheme, as well as other ways. What also needs to be ensured, is that banks recognise the size of the losses that are already in place. This constant demand from the banks for more forbearance is something that we simply cannot accede to, because their balance sheets are now opaque. It was observed last week when the banks announced their results. Until banks build more credibility in their balance sheets (Public Sector Banks and to some extent Private Sector Banks too), the valuations will not recover. Forbearance needs to end for the balance sheets to become more credible. If a certain gas or power plant has been non-functional, it should be treated as such, and not as a functional asset. There is a concern that a number of professionals in the system have expressed, which is that if a bad loan is recognised as such then fresh loans can not be made to that asset. This converts a financially distressed asset into an economically distressed and unviable asset. That mind-set needs to be broken. If there is an asset which is an NPA, it can still be revived. The fact that it is financially distressed does not necessarily mean that it is economically distressed. If it can be revived with fresh lending etc, banks should be willing to put more money, promoters should be asked to bring more money. If they are not willing, then an alternate can be thought of. But non- declaration of NPAs is not acceptable. Not declaring it an NPA just creates more confusion on the bank balance sheet, and makes analysts discount them more. It is important to call a spade a spade, but if you make fresh loans, these can be thought of as performing loans, so long as the project is restructured.

We also need to work very hard on corporate resolution. I have spoken in another forum on the difficulties bank have in recovering their money because of the non-performance of the Debt Recovery Tribunals, and because of the gaming of the SARFESI Act by larger participants in the system. We have to change this, but it is something we have to live with for at least the time being, because change doesn’t come soon. So we have to find a way to work the system despite the slowness of the Debt Recovery Tribunals, despite the fact that there are injunctions given to SARFESI when no injunctions were supposed to be given. I don’t think the answer lies in even more draconian laws because the laws tend to be implemented differently for different players. For the strong big players who can hire the best lawyers, laws don’t weigh very much, but for the small player who has no recourse, law is implemented immediately. We cannot keep having this unlevel playing field, and the answer is make it work better for the large players, which means banks have their lawyers better prepared and they don’t ask for injunctions and postponements. PSBs have been known to ask for postponements and to not have their documents ready on time. This is something we need to work on. To make sure the system works effectively, everyone has a role to play in recoveries.

In most other countries, banks negotiate with the shadow of bankruptcy behind them, and this is important. The threat of pushing the firm into bankruptcy works very well in concentrating the mind of the promoter and forcing the promoter to work with the banks. Unfortunately in India, we have BIFR, which is not an effective bankruptcy code, due to which you don't have the kind of threats that exist in other countries. Which is why we try to give you more tools as regulators. Hopefully you will be able to use the *Non-Cooperative-Borrower* tool against borrowers who stall you at every step. With the bankruptcy code in place, we will have a device which will help you in your out-of-bankruptcy negotiations in future. The Finance Ministry is working on it.

We also need a system of resolution of bank distress. Of course, it is not an issue as of now, and I don't think any of you are in danger of having the kind of turmoil that western banks had in 2008. Yet, in future as you get into more complicated businesses, there is a possibility that some of you may get into difficulty. We don't have a good system of resolution for financial institutions, and that's something we are working very hard on for the proposed Financial Regulatory Authority. In the meantime, we are examining all the banking powers that we have as the banking regulator, and making sure we have enough power to dissolve a distressed bank in the very short run. We are making some changes with the help of the government to ensure that happens.

I finally come to bank structure. Despite the difficulties that you have right now with distressed assets, there are still areas where the banking system is still healthy (retail loans etc). We have to be careful of turning from one set of bad assets, to another set of assets that turns bad. We have to be careful that retail loans' credit quality remains high.

Over the next few years there is going to be an expansion of opportunities for banks - new towns become cities, villages become towns, and the middle class gets substantially more spending power. Some new areas of banking will open up, like wealth management in upper middle class. However, there will also be much more competition in the banking sector. We have just given licence to two new banks, they are getting ready to roll out. Today we end the application process for the first set of Payment Banks as well as Small Banks. These two will also be licenced hopefully over the next three months. Beyond that, we will see a whole new set of players emerge. You have about 18-24 months before the whole gamut of players emerge. These are going to be players who are going to develop competition in the system considerably. You also know that foreign banks now have the option of becoming wholly owned subsidiaries, which will give them expansion capabilities. Thus far, no foreign bank has done so, but a couple are in the process. That will accelerate if they find opportunities in the small and medium sized cities.

Competition is going to increase tremendously and the banking system has to gear up to this. I have insisted time and again that the PSBs cannot fight competition with one hand tied behind their back. They need the ability to compete, and this means the following important things. One is governance. The governance process has to change, both to limit interference from the governmental side, and to give you the kind of governance that good banks from the world have

- good professionals on the Board who understand the business, who bring different facets to the Board. It is also important to have MDs with sufficiently long tenure that they can look to making changes within the bank and see those changes out. It's important to have separation of control between MD and Chairman, so that there are some checks and balances on the operations through the governance process. These are all things that are already under way. MDs' tenures are likely to be increased from 3 to 4-5 years over time. We are already seeing a separation of Chairman and Managing Director posts. The next few weeks may see some more appointments. Opening up appointments over time to private sector selection is important. This will also open up the possibility of improvement in the pay of the existing higher level management of the public sector banks. As you know, most public sector organisations tend to underpay at the top, and overpay at the bottom. As you move to more competitive environment, that kind of structure will be more difficult to sustain. You will find a lot of competition for people like you, among all the private sector entities that are setting up, and in order to retain talent, public sector banks will have to pay more across the upper echelons.

The second element which you have to work on as EDs of public sector banks, is capabilities. I think across the public sector, the demands in terms of profit evaluation, in terms of risk management, in terms of ALM, have increased tremendously, and it is no longer sufficient to do this using only your experience and judgement. One has to be able to do the detailed analysis and evaluation, one has to know what it means to have a weighted average cost of capital, to understand risk management and its tools. Some of you understand these issues in great detail, others need support and refreshing. Everybody right up to the top should understand these concepts, otherwise we are primed for difficulties. I believe that the second element of capabilities has been poor, not just at the top, but right through the organisation. I understand fully that one of the problems with the public sector is the hiring freeze that was put in place in the past, which has weakened the middle management layers because of retirements. This presents a concern as well as an opportunity. Given that middle management layers are depleted, there is a possibility of hiring good people and promoting them faster up the hierarchy based on performance. This is something PSBs have not been able to do, but this provides an opportunity. I think we should try and take advantage of it. But of course, we also need to be able to attract people. This is where appropriate compensation and challenges make a lot of sense. PSBs can potentially offer very challenging assignments to prospective employees. PSBs need to recreate that kind of environment, which will involve tremendous amount of work by the HR departments.

An issue generating a lot of interest is PSBs need of capital. I think banks and government ownership in banks can be structured in such a way that sufficient capital can be raised without tapping into government coffers. Capital raising should not be a problem, provided banks show a cleaner balance sheet, and show a path towards the future where they can proceed really effectively. What is extremely important is making the bank capable for the future, which means clean ups, capabilities, non-interference, better governance. All those things are reforms that PSBs have to undertake. I am sure the people in this room will be central figures in that process.