Shaktikanta Das: Current issues in the Indian banking and financial sector

Inaugural address by Mr Shaktikanta Das, Governor of the Reserve Bank of India, at the Financial Express Modern Banking, Financial Sector and Insurance (BFSI) Summit , Mumbai, 19 July 2024.

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I am happy to be back at the Financial Express Modern BFSI Summit. I remember having participated in the June 2022 edition of this summit where I had spoken on 'Disruptions & Opportunities in the Financial Sector'. The macroeconomic conditions back then were very different and challenging to say the least, as we were grappling with overlapping shocks from the war in Ukraine and the surge in inflation at a time when the world was still recovering from the Covid-19 pandemic. Since then, we have come a long way. Amidst global challenges and uncertainties, India stands out as a fast growing major economy with stronger macroeconomic fundamentals and a healthy and resilient financial sector.

The theme for today's summit "Decoding Inclusive Growth" aptly captures our combined aspirations for high growth with inclusiveness during the next decade and beyond. The financial sector is a key enabler for the realisation of this aspiration. With India's strong macroeconomic configuration, favorable demographics and significant pace of digitalisation, the Indian financial sector is poised to scale new heights. The recent annual financial results of banks and NBFCs indicate that the financial system remains sound and resilient.[1] Further, macro stress tests[2] done by the Reserve Bank reveal that the banking sector will continue to remain resilient even under stress scenarios.

In terms of market dynamics, the financial landscape in India is undergoing a structural transformation, driven by factors like innovations in technology, financial deepening, and changing savings and investment patterns, etc. Each of these shifts has a bearing on how financial entities carry out their business and adapt to the emerging risks.

New and emerging technologies have reshaped the financial services industry by bringing in innovative solutions and personalised products. The demand-side factors such as rising customer expectations for digital services and the supply-side factors relating to regulatory support and emergence of Fintechs have converged to deliver a frictionless customer experience. The Reserve Bank has also been actively fostering innovation by envisaging mechanisms like the United Payment Interface (UPI), regulatory sandbox, co-lending models, account aggregator framework, etc. With the synergies provided by mobile phone penetration, internet availability, reoriented payment systems and the multitude of customer data points, lending institutions as well as financial markets have been able to leverage upon such mechanisms to amplify their reach to the target segments and also carry forward the agenda of a more inclusive financial sector.

Overall, there has been a transformation in the banking and financial landscape in the last decade driven by technological innovations, changing consumer preferences and emergence of alternative business models. While these have fostered competition and

collaboration, they also have implications for consumer trust and regulatory oversight. Such structural changes also create opportunities as well as challenges. Financial institutions like banks, NBFCs and others need to carefully assess the impact of these changes on their business models, resilience and sustainability.

As Walter Bagehot said: "Adventure is the life of commerce, but caution,-,is the life of banking"[3]. These words are relevant even today. As I have stressed in various fora, good times often sow the seeds of complacency and vulnerability. In my address today, I would like to present my perspective on some of the contemporary issues and emerging risks that banks and other financial entities need to address. There are nine issues which I wish to highlight.

I. Loan and Deposit growth

Let me first touch upon the current divergence between loan and deposit growth rates. It goes without saying that there will always be some gap between the two, but credit growth should not run ahead of deposit growth by miles. More so, when banks are required to maintain CRR, SLR, LCR, etc. It is, of course, recognised that almost every loan creates a new deposit in the borrower's name or adds to his or her account balance. In other words, money begets money in the banking system. But the fundamental point is that there has to be a reasonable balance between credit and deposit growth.

As I just mentioned, deposit mobilisation has been lagging credit growth for some time now. This may potentially expose the system to structural liquidity issues. While there could be a debate regarding 'deposits funding loans' vis-à-vis 'loans funding deposits', the current regulatory concern stems from the fact that there could be structural changes happening which banks need to recognise and, accordingly, devise their strategies. Households and consumers who traditionally leaned on banks for parking or investing their savings are increasingly turning to capital markets and other financial intermediaries. While bank deposits continue to remain dominant as a percentage of financial assets owned by households, their share has been declining with households increasingly allocating their savings to mutual funds, insurance funds and pension funds. To be precise, households are increasingly turning to other avenues for deploying their savings instead of banks.

On their part, banks have sought to fill the credit-deposit gap by increasing their reliance on other sources like short term borrowings, Certificates of Deposit, etc. This increases their sensitivity to interest rate movements and poses challenges to liquidity risk management. The shift in deposit preferences from current account and savings account (CASA) deposits[4] has various implications which banks need to keep in mind. With credit growth remaining strong, banks need to continuously focus on improving and refining their credit underwriting standards and pricing of risks.

II. Management of Liquidity and Interest Rate Risks

The 2023 banking crises in certain advanced jurisdictions have brought to focus the risks to banking stability from certain business models and their inherent vulnerabilities.

These incidents have also triggered debates and rethink at the global level[5] about design and calibration of the Basel III liquidity standards, deposit insurance and resolution tools. Hence, it is imperative that our banks put in place prudent liquidity management measures proactively. It has to be borne in mind that incorrect valuation of liquid assets can give a false sense of short-term liquidity resiliency, which is not desirable. The Reserve Bank, on its part, is reviewing the Liquidity Coverage Ratio (LCR) framework to address the emerging issues. This will be done after detailed public and stakeholder consultations.

Interest rate risk is inherent to the business of banking. Last year's banking crises in certain countries have also shown the importance of managing Interest Rate Risk in the banking book[6]. The books of banks are highly sensitive to interest rate fluctuations. It goes without saying that banks need to manage their interest rate risk exposures using processes and systems commensurate with their business models, risk profile, earnings and capital levels, complexity, and scope of operations.

III. Cybersecurity and IT related risks

In an era of increasing technological footprint and rapid digitalisation, it is critical that due emphasis is placed on managing cybersecurity and IT risks. Globally, there are growing incidences of cyber attacks on the IT systems of banks and financial institutions. This necessitates highest level of vigil and strengthening of the IT systems by banks and other financial institutions. The Reserve Bank's supervisory assessments continue to stress on the importance of improving Information Technology governance arrangements; making the technology systems, processes and infrastructure more resilient; and mitigating third-party risks. Banks and other financial entities need to continuously invest in technology while also developing the right kind of capabilities to successfully tackle these challenges.

IV. Digital Frauds

Another area of concern is the rise in digital frauds. Though many of such frauds are due to various social engineering attacks on customers, there is also a rapid increase in use of mule bank accounts to perpetrate such frauds. This exposes the banks not only to serious financial and operational risks but also to reputational risks. Banks, therefore, need to strengthen their customer onboarding and transaction monitoring systems to monitor unscrupulous activities, including suspicious and unusual transactions. This also requires effective co-ordination with the Law Enforcement Agencies so that the concerns occurring at a systemic level are detected and curbed in time.

The Reserve Bank is working with banks and Law Enforcement Agencies to strengthen transaction monitoring systems and ensure sharing of best practices for control of mule accounts and prevention of digital frauds. I would again impress upon banks to ensure that necessary measures are taken, including for customer education and awareness, to maintain public confidence in use of digital banking channels.

V. Third Party Risks

In the current business environment, it has become necessary for banks and other financial institutions to outsource certain functions to third parties. While doing so, it is necessary to exercise strong oversight and monitoring of such outsourced activities. Regulations clearly provide that outsourcing of any activity by a regulated entity does not diminish its own obligations. Banks and NBFCs also need to consider whether cost optimisation strategies are leading to over-dependence on third-party vendors even for critical functions without commensurate oversight. We have seen a few instances of this and have dealt with it. Strong governance and oversight mechanisms with regard to third party relationships for both IT and non-IT services are essential components of resilience for any financial institution. The protocol with the outsourced agency should clearly define the roles and responsibilities of both the parties in such relationships. The Reserve Bank has already issued guidelines on IT outsourcing[7] and draft directions on managing risks and code of conduct in outsourcing of financial services[8].

VI. Issues in unsecured retail credit

The rise in share of retail portfolio within overall bank credit is a recent system-wide trend. As you may be aware, the Reserve Bank has taken certain pre-emptive measures in November, 2023 to ensure that growth in these segments does not lead to potentially excessive risk build-up. These measures appear to have led to a certain degree of moderation in the targeted segments, as observed in our recent Financial Stability Report. It needs to be emphasised that the delinquency levels and leverage in small ticket consumer loans warrant enhanced vigil. Matters such as fixing limits on unsecured exposures are left to the Boards of banks and NBFCs. It has, however, been observed by our supervisory teams that some entities have fixed very high ceilings, even where they already have a high exposure. While it is not our intention to be prescriptive on such matters, banks and NBFCs are expected to show prudence and avoid exuberance.

VII. Conduct related issues

Fair conduct is not just a regulatory requirement; it is a core business requirement. I am emphasising on this issue of fair conduct because conduct risks may arise even when the going is good, as it prevails now. Conduct risk needs to be seen together with risk culture. Fair conduct and practices foster consumer confidence and public trust in financial institutions and strengthen their stability. The Reserve Bank has issued regulations from time to time to ensure fair and responsible conduct by the regulated entities. In the recent past, guidelines have been issued on Key Facts Statement (KFS); penal charges in loan accounts; reset of floating interest rate in EMI based personal loans; and release of movable or immovable property documents on repayment or settlement of loan accounts. We still come across instances of regulatory entities resorting to high-handed recovery practices; framing non-transparent loan contracts with inadequate disclosures of important terms or non-disclosure of charges; levying excessive interest rates, especially in micro finance loans, etc. Let me emphasise that overall there has been considerable improvement in governance, quality of assurance functions and adherence to fair conduct guidelines in recent years. The concerns I have highlighted here pertain to some of the Regulated Entities of the Reserve Bank. These are not system-wide issues but are essentially outlier cases.

Critical issues relating to conduct sometimes get sidestepped in the pursuit of short-term gains. For instance, charging of very high interest rates by certain regulated entities for micro finance loans is not in order. I would like to reiterate what I said in my monetary policy statement on June 7, 2024: regulated entities should use their regulatory freedom responsibly to maintain fair and transparent pricing of small value loans. Unfair or usurious practices under micro finance loans would compel us to have a re-look at the revised regulatory framework for microfinance loans issued in March 2022.

VIII. Transition Financing

Climate change poses a growing threat to economic growth, and it needs immediate and sustained action on all fronts. Recent extreme weather events globally and in India such as heat waves, droughts, floods and wildfires are stark reminders that we have to take decisive actions.

The Reserve Bank has initiated steps to address the risks posed by climate change to the financial system. Since we commenced this journey, several initiatives have been undertaken, which inter alia include issuance of framework for Sovereign Green Bonds; acceptance of green deposits; and issuance of draft disclosure framework for climate-related financial risks[9]. Going forward, our overarching approach would be to consider 'sustainability aspects' as a focal point of the entire credit ecosystem. The onus of spearheading sustainability initiatives will, however, reside with the regulated entities eventually. These entities have a crucial role to play in climate action by taking steps to provide climate finance. They need to explore innovative transition financing models. At the same time, they should also be mindful of associated risks and greenwashing concerns. In addition, the regulated entities may undertake "transition planning"[10] to prepare for risks and potential changes in business models of their borrowers who may undertake such transition.

IX. Private credit markets

Private credit as a preferred alternative mode of capital mobilisation is growing rapidly. It is emerging as an attractive investment avenue for investors with high-risk appetite. While these markets may carry economic benefits by providing a greater pool of financing outside of the regulated financial markets and institutions, and their risks appear contained at present, it is important to bear in mind that vulnerabilities and interconnectedness in these markets can amplify negative shocks and pose financial stability concerns. We continue to remain watchful of such developments and would welcome ideas and thoughts in this regard.

Conclusion

In conclusion, I would like to emphasise that banks and financial institutions have a critical role in taking India to the next phase of economic growth. Regulated Entities of the Reserve Bank like Banks and NBFCs are well positioned in terms of capital, asset quality and profitability to contribute to the economic acceleration. Embracing technology and innovation, while remaining focused on governance and risk management, can ensure sustained capacity and resilience of the financial sector and

enable it to meet the needs of our growing economy. While much has been achieved, there is still more to accomplish.

With these words, I thank the organisers for giving me this opportunity and wish the Summit all success.

Thank You.

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[1] Backed by improvement in asset quality, enhanced provisioning for bad loans, sustained capital adequacy and rise in profitability. Notably, the gross non-performing assets (GNPAs) of scheduled commercial banks is now at a multi-year low of 2.8 per cent and that of NBFCs is below 4 per cent as at end of March 2024. Excluding NBFCs under resolution, the GNPA ratio for NBFCs is below 3 per cent.

[2] Financial Stability Report (RBI), June 2024

[3] Lombard Street: A Description of the Money Market by Walter Bagehot, 3rd edition, 1873, the Online Library of Liberty.

[4] The share of CASA in overall deposits of SCBs have declined from 43.66 per cent in March 2022 to 39 per cent in March 2024.

[5] 'Report on the 2023 banking turmoil', Basel Committee on Banking Supervision (BCBS), October 2023 and 'Bank Failures Preliminary lessons learnt for resolution', Financial Stability Board (FSB), October 2023.

[6] Banking book includes all financial instruments, except instruments that are part of trading book on account of their classification as "Held for Trading". The interest rate risk in trading book is capitalized as part of market risk framework which is much nuanced by design vis-à-vis the interest rate risk in banking book which attracts a different treatment. While there is a prudential rationale for the differential treatments, the banking turmoil last year has revealed how mismanagement of interest rate risk played a significant role in the failure of a particular bank due to its alleged failure to manage rising interest rate risk on its the long-term fixed interest rate securities classified under Held to Maturity category.

[7] Master Direction on Outsourcing of Information Technology Services, April 2023

[8] Draft Master Directions on Managing Risks and Code of Conduct in Outsourcing of Financial Services, October 2023

[9] Draft Disclosure framework on Climate-related Financial Risks, 2024

[10] This refers to the internal strategic planning and risk management processes undertaken by a financial institution