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MAKING RULES PAY OFF

Some internal measures can actually help transform banks' compliance requirements to their competitive advantage

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Photograph by Subhabrata Das

THERE IS A NEED TO ENSURE THAT THE INDIAN BANKING system grows in size and sophistication to meet the needs of a fast growing, modern economy. Over the next few years, banks will not only play an important role in continuing to support the capital required to fund India's growth, but will also drive financial deepening, financial inclusion, create innovations in customer service and improve overall productivity and efficiency in the sector.

Given the above, it is important that banks are robust financial institutions with access to capital, strong risk management capabilities, geographical reach, and trust driven by high governance standards.

The Indian economy is going through a structural transformation. At such a time, it is imperative that the objectives of financial stability and management of the pace of growth are appropriately balanced. In an economy such as India, the demand for credit is expected to expand faster than the Gross Domestic Product (GDP) for several reasons:

- Economists predict a strong growth in the manufacturing sector over the next few years — the credit intensity of this sector is much higher than that of the services sector (which has been the mainstay of growth over much of the last decade).
- Increased investment in infrastructure required to support growth would place greater demands on credit.
- Deepening financial inclusion is expected to bring in millions of new consumers into the formal banking sector along with their credit needs.

The advent of the Basel III norms entails higher capital standards, stricter liquidity and leverage ratios along with a more cautious approach to risk. These, in an environment where credit demand is expanding rapidly, will put increasing pressure on the banks' capital requirements.

Not only would banks need to increase their chest of capital in the normal course of business, but the composition of this capital would also need to be re-jigged in order to create buffers to deal with particular economic conditions.

Broad-level estimates published by the Reserve Bank of India in its annual report for the financial year 2011-2012 suggest that in order to achieve full Basel III implementation by 31 March 2018 (assuming a 20 per cent per annum uniform growth in risk-weighted assets or RWA of banks), the banking sector will require approximately Rs 1.6-1.75 lakh crore of common equity in addition to Rs 3.15-3.35 lakh crore in the form of non-equity capital.

Indian banking is still dominated by the public sector, which accounted for roughly 73 per cent of the total assets of the banking sector as of March 2013. The government's shareholding in public sector banks ranges between 55 per cent and 81 per cent.

The above requirement of common equity will thus have to be met by one of the following:

- Equity infusion by the government: Fiscal pressures could potentially limit the government's ability to infuse capital. Also, the government's stake in PSU banks is at 57 per cent (on an aggregate basis) which will limit the ability of the government to raise capital through dilution.(Assuming the government will not dilute its stake below 51 per cent).
- Investment in the sector by new players: New players with access to capital and a long-term commitment could help fund the above capital gap.
- Private sector banks in India have been fairly successful in raising equity capital (both domestic as well as foreign). Most of the private banks in India seem currently well capitalised with regards to the requirement for additional capital to meet Basel-III norms and, therefore, their needs ought to be proportionately lower. Given their past track record in raising capital, most analysts believe that capital challenges for the private sector are likely to be lower.

> **Indian banks need to change their perception from looking upon the regulatory capital framework as a compliance requirement to a necessary pre-requisite for keeping the banks sound, stable and, therefore, profitable**

Most banks in India have robust risk management systems that meet the standardised approach of Basel II, with some of the larger banks en route to the implementation of more advanced approaches. The adoption of advanced approaches to risk management enables banks to manage their capital more efficiently and thus improve returns. Essentially, the risk culture of banks needs to adopt the following:

- A change in perception from looking upon the regulatory capital framework as a compliance requirement to a necessary pre-requisite for keeping the bank sound, stable and, therefore, profitable.
- Deeper and broader based capability in risk management.
- Adequate and good quality data

Keeping the above in mind, those banks with strategic scenario planning and stress-testing capabilities at the heart of their risk-management engine will be better placed to address ongoing systemic threats and capture

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opportunities that will emerge in the future.

The path of optimising capital allocation by reducing capital wastage and transitioning to a streamlined capital model is not straightforward. Banks need to prepare the ground if their efforts are to succeed. This ground work could consist of three steps:

- Banks must establish clear governance of capital management at every level. This task must be incorporated into the mandate of a senior leader, usually the chief financial officer or the chief risk officer, and people responsible for the activity in every major business unit should report into this lead.
- Banks must ensure close collaboration of the businesses, risk and finance groups by creating cross-functional teams. These cross-functional teams need to be tasked with addressing any differences that crop up.
- Finally, banks must focus on execution. One way to maintain focus is to continually track the increases in capital and the resultant impact on the bottom line. Some leading banks have already institutionalised capital optimisation by setting up RWA and capital management units and encouraging organisation-wide efforts to find capital-savings opportunities.

Strategic management of funding and liquidity is equally important for a bank as an effective capital allocation and management tool. These include the challenges stemming from maturity mismatches and the overall need for long-term funding to support growth.

In several emerging Asian economies, forecast disparities between the growth in lending and in deposits mean that banking growth could hit a roadblock over the next few years, with credit growth expected to be significantly higher than deposit growth.

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Consequently, there will be increased competition for deposits and a need to innovate on products and services offered by banks in this regard.

The interest rate deregulation in India has led to banks starting to attract customers by offering better rates. From the perspective of each individual bank, however, this has led to an increased level of inherent risks — customers are encouraged to switch more easily, with the associated dangers that the asset liability mismatches and systemic risk will increase. The lack of reliable alternatives in the form of a liquid and well-developed corporate bond market or easy access for the banking sector to local-currency long-term funding is an issue that needs to be addressed.

For banks to deal with the above mentioned risks, they need to take the following steps: First, create a full, unbiased, transparent view on their current situation. Second, they need to align on a mid- to long-term view of the development of liquidity and funding and initiate measures to deal with it, incorporating some of the structural changes and contingencies that can be expected in line with the metamorphosis of the economy. Most importantly, the above changes must be built into the organisation's models to make them a true part of their enterprise.

In general, banks also face challenges regarding poor data quality. There is often a tendency to rely on historical data and extrapolation of the same in modelling the scenarios essential for robust decision making. It is, therefore, extremely important that banks strive to be more data driven at every level of the organisation.

Ultimately, banks must realise that increased capital requirements are a pre-requisite to running their businesses in the post-2009 crisis scenario. Banks need to take a close look at all their lines of business, identify those that are capital intensive while yielding low returns and put in place measures that streamline them.

Additionally, at an enterprise level, a framework needs to be put in place that balances the increased capital requirements and risk realities with returns both at a strategic as well as an operational level. This will chart the way forward for banks to operate in a more efficient manner, ultimately improving the profitability of the organisation.

Banks which are successful in doing the above would have potentially transformed regulatory requirements into a compelling competitive advantage. BW