

# *Responding to Change*

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## **Introduction**

Mr. Basu has described, in detail, the gaps in the business, as it were, while Dr. Reddy has provided us with a fascinating perspective on the market. In his address to us, Dr. Reddy has covered most of the issues that are pertinent to a Conference of this sort and has left a few thoughts for us to deliberate upon. I will try to put in perspective what in my opinion are the issues and challenges facing the Indian financial services industry and how the market is going to evolve in the coming years. I will begin by outlining the changing market environment, an understanding of which is critical to both the aims of this Conference, and to comprehend the extent of change that we are likely to witness.

## **The Changing Environment**

The process of liberalisation in the real sector that started about 6 years back has gathered momentum. Liberalisation in the financial sector has also

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made firm beginnings and is gathering pace. It is my belief that this process of liberalisation will cause much turbulence and change in the later part of 1997 and 1998. The present domestic environment is one that is characterised by major structural change and it is in this turbulent environment that business will have to be conducted. In the midst of such change, our objective is to achieve industrial growth rates of between 7% and 8%. However – and this is of prime consideration to the participants of this Conference – the funding requirements of the market are doubling. This is amply evident from the number of deliberations held on the need for infrastructure funding. My analysis indicates that infrastructure funding needs will be equal to the requirements that we have seen in the manufacturing sector in the past few years. Adding the needs of infrastructure sector with those of the existing manufacturing sector, we can conclude that funding requirement should double. Clearly, debt markets will have to provide a majority of these funds.

### Industrial Sector

The future will present both opportunities and challenges. Capital will continue to be scarce – a reflection of the enhanced requirements for capital. Increasing competition in the industrial sector, including both domestic and global competition, coupled with the changing financial structure will push industry into searching for various types of financing alternatives. The issue of corporate governance which has made corporates tighten up their own operating philosophies, has also made it imperative for them to respond to this change. Pro-active responses are today necessary for survival and those who do not respond will not survive in this environment. While at the initial stages, we will need to respond quickly to events, we must focus on developing pro-active mechanisms for the future. Responding to both change and the new environment that confronts us involves a fundamental change in mindset. The indisputable fact is that change is all around us and the market will have to operate in this context.

### Financial Sector

Let us view the financial sector in the same way that we looked at the industrial sector. After 40 years of an administered structure, today we are

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steadily moving towards a market-driven structure. This has been particularly so since May 1997, when the Reserve Bank initiated certain steps in deregulation. I have seen more change in the financial structure and in the financial system in the last 5 months, than I have seen in 25 years of being in the banking industry. While some of us have seen this change, and have come to accept it, there are some who are still not fully aware of these changes. Irrespective of the outlook, these changes are happening everywhere and we cannot reverse the process. As we proceed further, we have to face up to the demands that these changes impose on all of us. This means that we need to alter the way we do business. We need to activate markets, lower funding costs and keep industry competitive. All this must be done in the background of foreign competition and this will prompt us to tighten up. We will have to respond to this challenge and our response will deepen the markets. Corporate governance – that would be the guiding principle in how we do business – must follow global best practices. Again, as in the industrial sector, this also means a change in our mindset and herein lies our greatest challenge.

### Recent Changes in the Financial Sector

The Reserve Bank of India has liberalised the market significantly. The CRR and SLR requirements on interbank liabilities have been removed, the bank rate has been activated, foreign financial institutions are allowed to invest in gilts and forward covers and banks are now allowed to invest in corporate debt securities without restriction. Underlying all such policy and structural change is the greater freedom offered to market players. This is very welcome as it allows players to create new products in response to growing market needs and changing market realities.

### Debt Market Players

Let us now take a quick look at those debt market players who have a key role to play in this changing market. We have savers (retail savers and FIIs), real sector investors (corporates and Government), intermediaries (banks, NBFCs, insurers, asset managers) and regulators (SEBI and RBI). Dr. Reddy mentioned the new type of regulatory organisation that we will shortly see – the SROs. Some action has already been initiated on this front and as we progress, we are likely to see further developments in this respect. New regulatory institutional developments of this sort are

necessary and appropriately timed. Other players include those in infrastructure (stock exchanges, depositories), and ancillaries (information services, technology, back-office staff, agents, marketing persons, credit rating agencies).

### **The Requirements of a Developed Debt Market**

We need to look at risk-return trade-offs to increase the attractiveness of debt. Therefore, we have to minimise associated costs and risks that exist in addition to the regular interest rate and credit risks.

#### **Transaction Costs**

Transaction costs is one area that needs to be addressed and regulators must focus on minimising transaction costs, especially for retail investors. As may be seen from our own cost of raising bonds, the cost of issuance and transaction costs together form a significant proportion of the total costs. If these costs could be substantially reduced, we could deliver credit at a lower rate to corporates and this would directly fuel the growth process. Some of the other factors that contribute to higher costs include stamp duties, lack of market access – particularly from remote areas – the issue of bid-offer spreads, as also events like delivery and transfer delays, lost certificates and interest warrants.

#### **Transaction Risks**

Regulators will need to focus on minimising transaction risks – like regulatory and legal risks, and income tax ambiguities including the need for advance tax rulings. Settlement risks are high with bad trades, theft on transfer, theft of interest warrants, and so on. Addressing these issues and providing workable solutions will reduce transaction risks to a great degree.

### **Components of an Efficient Debt Market**

One of the primary components of an efficient debt market is a level playing field. Given that the Indian financial services industry is characterised by multiple categories of players – banks, insurers, NBFCs,

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etc. – we need to develop prudential norms that harmonise the roles of these players. The important issues that we need to address include the development of structures for intermediating debt with minimal equity and no tax load. More particularly, we need to create a special purpose vehicle to facilitate the process of development in this market. A good example in this regard is the development of securitised instruments. Trading in these instruments today is not possible, primarily because of the need to bring in large equity in such structures, and the lack of any real associated tax breaks. There exists a critical need to do away with such inefficient structures, if securitisation – which is a primary force driving the global debt market – is to take root in India and create an opportunity for the players in this business.

Technical infrastructure holds another key in this development process. The impact of technology on the pace, complexity and cohesion of the financial markets has been a revolutionary influence and a catalyst for much of the change. Developments in trading, clearing, fund transfers, settlement, depositories and banking will be driven by technology on the Internet – or on a fixed-wire basis – wherein distributors can be linked electronically. We need only to look at what needs to be done in our banking system to understand the enormity of the problem. We need to ask ourselves some basic questions: How many of our bank branches are really linked electronically? How many of them do we need to link to get the whole system moving efficiently and cost-effectively? With the advances in information technology and the rapid decrease in the cost of accessing information, it has now become easier for corporations to work on a near real time basis and thereby operate over a wide variety of product markets. The future of the market will be effectively re-written should we be able to fully harness the power of technology and connectivity.

### **Product Proliferation**

Though we have seen all sorts of products penetrating the market, it is my belief that we have yet only scraped the surface. Repos and tripartite repos, futures and options, investment products, commingled portfolio management, securitisation, securitisation through SPVs, mutual funds for addressing specific needs, and structured products are just a few of the products that we need to explore in depth. I will pause on structured

products for a moment. Just 3 or 4 months ago, if ICICI had been asked whether we run anything on structured products, we would probably have said no, and if somebody had asked if we planned to, I would have probably said the same. Yet, only 8-12 weeks later, we have had to create a separate business group for structured financing deals and products, including securitisation. While structured products are nothing new as far as foreign banks and institutions are concerned, these are new and revolutionary concepts in the Indian context. Today, we have mobilised people from various parts of our business to run this department and are working on several structured products for our clients. This is in no way reinventing the wheel. Rather, what we are doing is moulding what exists to fit the uniqueness of the Indian context. This becomes particularly challenging in the context of the constraints that I spoke about, particularly with regard to the problems that we face in securitisation. About 10 years ago, before I left India, I had started work on securitisation. When I came back last year, I found that we were exactly where we had been when I left. This was certainly not because we did not want to progress; but because the system was just not conducive enough to allow for the growth of this business. However, the last few months have seen heartening changes and this crucial driver of debt markets is now poised to bring about positive change in the near future.

### **Standards**

We need to think about ISO standards for the securities business. SROs have been touched upon and I am happy to know that FIMMDA (Fixed Income, Money Markets and Derivatives Association) has already been mooted and set up. This institution is expected to look at standard transaction procedures, rules, dispute resolution and other regulatory issues.

### **New Players**

There has clearly been an increase in professional asset managers, and I can say with certainty that we will see many more entering the market and offering a variety of products. This trend will forge ahead irrespective of

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deregulation in the insurance sector. However, deregulation in the insurance sector will perhaps result in an acceleration in the number of asset managers operating in India. These new entrants will introduce innovative debt products, deepen the market and give the industry contours that are completely different from those visible today. The business will increasingly be retail driven, technology driven and product driven. So, essentially the future will see greater consumer choice, more options in the market, more business to transact and a consequent widening of the market. Insurance companies and the opening up of the pension industry will be one of the primary drivers of the market. This will also bring in global best practices to the market's trading, middle and back office operations as well as in disclosures.

On observing global trends, one notes definite swings taking place. Initially, banks held sway for a long period of time. Later, we thought investment banks and then insurance companies would hold sway. Today, we have the concept of universal banking where both investment banks and commercial banks have come together and this process is continuing. In addition to this, today we have a whole new set of entrants comprising asset managers and distributors. We must ask ourselves: Where does all this fit-in along with the changes taking place in the banking sector which is itself in transition? It is going to be interesting to witness how these new players come in, what sort of an entry they would make into this country and what impact they would have on the financial system that we are familiar with today. This would indeed be a fascinating transition to witness.

### **Changing Role of Banks and Financial Institutions**

Dr. Reddy elaborated in great detail about the need for a change in our legal system, particularly in the context of the developments that have taken place in the market today. But how do we really revamp this system to cater to what is needed today, given the changing role of banks and financial institutions? Traditional regulatory intervention is very likely to distort natural market forces and lead to serious inequities and dysfunctional behaviour. Financial intermediaries would continue to add value only if regulation permits them to rapidly redefine their roles in the most optimal manner. Plain vanilla lending is today a declining industry. Plain vanilla lending, as we know it, is characterised by three products. Two of them deal

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Rapid change in the financial services sector is what we have seen in the recent past and that is something that would continue to be witnessed in the future. The economies of scale and scope that can be reached with new technology would dramatically reduce the cost of intermediation and create a more efficient financial system. While tomorrow's products and processes are certainly going to be even more different from those prevailing today, business leaders of today need to be proactive in anticipating the future. The creation of a level playing field, greater usage of electronic infrastructure, a world in which products proliferate, SROs leading to new standards, new professional players and a pro-active regulatory system are necessary for us to meet the challenge of growth in our new environment. Managing growth in an environment where change is the only constant is the challenge that each one of us must prepare to face up to.