Chapter VII
Perspectives

7.1 The Indian financial landscape has undergone significant transformation during the ten years of financial liberalisation. Banking sector reforms, introduced a decade ago in 1992-93, have been based on five fundamentals: strengthening of prudential norms and market discipline, appropriate adoption of international benchmarks, management of organisational change and consolidation, technological upgradation, and human resource development. A hallmark of the entire financial sector reform process has been the element of 'gradualism', with due consideration of the timing, pacing and sequencing, following extensive consultations with the stakeholders at each stage.

7.2 It is widely recognised that as a result of these reforms, the Indian banking system is becoming increasingly mature in terms of the transformation of business processes and the appetite for risk management. Deregulation, technological upgradation and increased market integration have been the key factors driving change in the financial sector.

7.3 In line with this general strategy of reforms in the financial sector, the banking sector saw several notable developments during 2002-03. Salient among these are the passage of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, institution of risk-based supervision and operationalisation of the Prompt Corrective Action (PCA) framework. Furthermore, the revised guidelines on infrastructure financing, guidelines on lenders' liability laws, the guidance note on management of credit and market risks, guidelines on country risk management, consolidated supervision and the revised Corporate Debt Restructuring mechanism, have all been brought together to provide for a more resilient, vibrant and healthy banking sector.

7.4 Against this backdrop, the present chapter outlines the opportunities and challenges facing the Indian financial sector over the medium term in the context of the recent measures initiated by the Reserve Bank. These policy challenges are broadly categorised under three heads: (a) strengthening prudential norms, (b) effecting structural changes in the system, and (c) redefining the regulatory role of the Reserve Bank.

Strengthening Prudential Norms

7.5 The process of licensing, regulation and prudential supervision of banks focuses on achieving a stable and viable banking system by setting several norms and indicators, and monitoring their observance. The prudential supervision of banks has been aimed at preventing systemic risk with due consideration to the autonomy of each bank in organising and carrying out activities in a competitive environment. The approach has been to benchmark Indian norms against international best practices and gradually align them with international standards over a period of time.

Basel Accord

7.6 Internationally, the move towards convergence in capital adequacy standards has gained credence with the gradual operationalisation of the new Capital Accord, popularly known as Basel II, by 2006. The Reserve Bank has been actively participating in international discussions on the proposals and has also been in the forefront of initiatives with other non-G-10 supervisors to promote a feasible approach that could be adopted by less complex banks

without imposing significant costs. It has transmitted its comments on the recently released Third Consultative Document of the Basel Committee on Banking Supervision in July 2003.

7.7 A basic international concern regarding the proposed framework has been the relative merits of the standardised *vis-à-vis* internal rating-based (IRB) approaches. Most banks in the world are expected to apply the standardised approach. Considering the fact that it is based on the ratings by external agencies, there is a limitation of low penetration of such ratings in emerging market economies. There is also an important issue of the cost that this rating process would impose upon the system. In view of the above constraints, it is perceived that such an approach might not significantly enhance risk sensitivity in developing economies. On the other hand, the IRB approach is viewed as being more risk-sensitive and is expected to lead to better risk management practices. However, only banks that have the necessary wherewithal in terms of adequate data, a sophisticated management information system and a high degree of technical skills are likely to be in a position to adopt this approach in the contemplated timeframe. For banks that are less active internationally, the standardised approach seems to have an edge over its IRB counterpart. In the ultimate analysis, however, adoption of one over the other would have to be viewed in both the country- and bank-specific contexts.

7.8 The Reserve Bank has already taken steps to implement two major components of the second pillar of Basel II, *viz.*, Risk-Based Supervision (RBS) and Prompt Corrective Action (PCA). The PCA framework has already been put into operation, on an experimental basis, by the Reserve Bank. Further, a pilot-run of risk-based supervision has been introduced in October 2003.

Loan Classification Norms

7.9 In the Indian context, the regulatory environment of the prudential norms for loan impairment has been made stricter with the abolition of the concept of 'past due' (grace period of 30 days), effective March 31, 2001. With a view to moving closer to the international practices, it has been decided to phase in the 90-day norm for loan impairment from the year ending March 31, 2004. Furthermore, the periodicity of classification of an asset as 'doubtful' is also sought to be reduced from 18 months to 12 months, effective March 31, 2005. The gradual stringency in the loan classification norms has been accompanied by improved risk management practices as well as greater recovery efforts, backed by enabling legislative changes.

7.10 It needs to be recognised that prudential norms in respect of loan classification vary widely across countries. Countries follow varied approaches, from the subjective to the prescriptive. Illustratively, in the United Kingdom, supervisors do not require banks to adopt any particular form of loan classification and neither is there any recommendation on the number of classification categories that banks should employ. Other countries, such as, the United States follow a more prescriptive approach, wherein loans are classified into several categories based on a set of criteria ranging from payment experience to the environment in which the debtor evolves. The adoption of such a system points to the usefulness of a structured approach that facilitates the supervisor's ability to analyse and compare banks' loan portfolios.

7.11 Loan classification criteria generally appear to rely on both objective and subjective signals of loan quality, although the balance between the two is often difficult to ascertain.

Objective criteria include the number of days a loan is past due and more broadly, the current condition of the debtor. On the other hand, subjective criteria include features like insufficient working capital, absence of adequate financial information and the like. While the number of days of past due payments represents a minimum condition for loan classification purposes, other criteria, which exhibit forward-looking features, such as, an accurate assessment of the expected probability of default, might provide useful leads towards appropriate loan classification and prevention of erosion in net worth of the bank. The recent prescription of 'special mention accounts' by the Reserve Bank for voluntary adoption by banks is a case to the point.

Provisioning

7.12 It is now recognised that generalised financial instability has its roots in macroeconomic factors. Crises typically occur because banks are jointly exposed to a common macroeconomic shock. This is often related to the business and financial cycle. In response to this challenge, supervisors have been searching for techniques that would make banking systems more resilient to the vicissitudes of the financial cycle. In particular, banks need to be encouraged to build up capital cushion in good times so as to protect their lending when the cycle turns down.

7.13 A central feature of provisioning systems is typically to refer to losses that have already been incurred or are anticipated with a high degree of confidence. However, even in cases where there is no explicit reference to general loan loss provisions, bankers can follow a forward-looking approach, depending on the fiscal and accounting incentives for adopting such a practice. The Union Budget has provided several such incentives in recent times. The Union Budget 2002-03 announced improved tax incentives for provisioning. Subsequently, the Union Budget 2003-04 proposed a scheme wherein the gains arising out of the voluntary buyback of high-coupon, thinly-traded Government securities would be tax exempt, provided they are utilised for NPA provisioning.

Non-performing Assets

7.14 The principal challenge of banking soundness emanates from the persistence of the significant amount of non-performing assets (NPAs) on bank balance sheets. A mix of upgradation, recoveries and write-offs has steadily reduced gross NPAs of scheduled commercial banks to 8.8 per cent as at end-March 2003 from 15.7 per cent per cent as at end-March 1997.

7.15 A major factor contributing to the high level of NPAs in India has been the inadequate legal framework for collecting overdue loans. Although loans are largely collateralised, in practice, the value of the collateral may not be commensurate with the loans. More importantly, timely execution of collateral often remains difficult. The large difference between banks' gross and net NPAs, typically equal to nearly one-half of gross NPAs, reflects both obligatory provisions against NPAs and the limited write-offs of NPAs by the public sector banks. As a consequence, NPAs tend to be carried on the books and provisions against them gradually built up. In this context, in line with the announcement in the Union Budget 2002-03, Asset Reconstruction Companies (ARCs) have been established with the participation of public and private sector banks, financial institutions and multilateral agencies. Such a move is expected not only to add an extra avenue to banks to tackle their NPAs, but also to provide them with an opportunity to take the NPAs out of their balance

sheets. At the same time, it is expected that the ARCs would be able to recover more bad loans (perhaps at a faster pace) because they would be exclusively dedicated towards loan recovery.

7.16 The passage of the SARFAESI Act in 2002 has increased the scope for the recovery of NPAs. The Act envisages relatively stricter legislations to provide comfort to banks in taking possession of the securities. Public sector banks have identified (as per latest estimates) NPAs worth over Rs.12,000 crore to be sold to the ARCs; however, the process of valuation of the loans prior to sale is yet to be completed.

7.17 The Reserve Bank has recently issued guidelines on preventing slippage of NPA accounts. Under this process, banks have been advised to introduce a new asset category: 'special mention accounts', in between 'standard' and 'sub-standard' categories for their internal monitoring and follow up. This is expected to enable banks to look at accounts with potential problems in a focused manner right from the onset of the problem so as to impart efficacy to monitoring and remedial actions.

Risk Management

7.18 The Reserve Bank has initiated several steps in the recent past to strengthen risk management practices in banks including asset-liability management (ALM). More recently, the Reserve Bank has issued guidelines on country risk management. The guidance notes on credit and market risks have also been issued in 2002. Banks have been advised to use these guidance notes for upgrading their risk management systems, keeping in view their own requirements, based on the size and complexity of business, risk philosophy, market perception and the expected level of capital.

Interest Rate Risk

7.19 An important facet of risk, particularly in the Government securities market relates to interest rate risk. This is especially relevant in the recent Indian context with banks holding gilts well above the statutory requirements. In particular, banks are exposed to repricing risk, arising from timing differences in the maturity and repricing of banks' assets and liabilities, and yield curve risk, arising from changes in the slope and shape of the yield curve. This highlights the importance of monitoring and reporting requirements on the maturity structure of interest-sensitive assets and liabilities and conducting sensitivity analyses of balance sheets to changes in interest rates. The Basel Committee has come out with several guiding principles for the interest rate risk management process; this includes development of a business strategy, as well as a system of internal controls.

7.20 An analysis of the sources of profitability for the scheduled commercial banks in India shows that much of the recent increase in profits emanates from trading incomes, reflecting the sustained softening of interest rates. Bank balance sheets are, thus, getting linked to the interest rate environment. To the extent bank stock valuations are being driven by the expectations of trading profits, a new linkage is being forged between debt and equity markets. It is in this context that the Reserve Bank has been emphasising that high profitability emerging from gilt trading should not lull banks into a state of complacency. There is a need to recognise the potential interest rate risks and accordingly, put in place appropriate risk management systems, provisioning and building up of reservess in line with the best international practices. To safeguard the banks against such eventualities, the

Reserve Bank has advised them to build up an Investment Fluctuation Reserve, since end-March 2002, as a proportion of their traded securities portfolio, to serve as a cushion against adverse interest rate movements. For scheduled commercial banks, the investment fluctuation reserves amounted to 1.8 per cent of their investments in the 'Available for Sale' and 'Held for Trading' categories of the investment portfolio taken together as at end-March 2003. Banks have been advised to achieve a minimum IFR of 5 per cent of their tradable paper by end-March 2006.

Effecting Structural Changes in the System

7.21 Policy-driven structural changes are necessary for ensuring the viability and sustainability of the financial system in the long run. Keeping this objective in view, the financial sector reform process in India has focused on a number of specific issues of a structural *genre*.

7.22 A major structural rigidity in Indian context relates to the cost of credit. The cost of credit is gradually emerging as a key determinant in investment decisions. The Reserve Bank has followed a soft interest rate policy stance in recent years - the Bank Rate, at 6.0 per cent, is now at a 30-year low. While interest rates in the money markets and the yields in the Government securities markets have been coming down in response to the monetary policy initiatives, the passthrough to the credit markets is still not very strong.

7.23 The Reserve Bank has, time and again, emphasised the need to combat the structural rigidities that impede flexibility in lending rates. Of the original set of factors identified as constraining such flexibility in interest rates, at least two, *viz.*, high reserve requirements and sticky interest rates on small savings, are no longer operative. Of the others, non-performing assets can be reduced further but operating expenses tend to be sticky, highlighting the need for initiatives to enhance productivity.

7.24 The rigidities, thus, largely emanate from low productivity apart from the overhang of NPAs of the past. To move to a more efficient, productive and competitive set up, the banking system would need to grapple with the challenges of transformation in a number of areas, such as, corporate governance, economic value added, and technology upgradation.

7.25 Large-scale investments in Government paper by banks in the face of easy liquidity conditions have yielded some benefits. The large trading profits emanating from the sustained rally in Government securities markets has helped to boost banks' bottom lines, and provide resources for provisioning of non-performing assets. Finally, excessive lending in times of poor industrial growth could have generated problems of adverse selection which could be avoided. At the same time, it needs to be emphasised that the primary business of banking is the creation of credit. While this kind of narrow banking could be appropriate at times of easy liquidity, the macroeconomic performance of the banking system in the long-term would hinge on their ability to fund industrial and other enterprises.

Technology in Banking

7.26 Issues relating to technology in banking are of paramount importance in view of their relationship with productivity, efficiency, and customer satisfaction. Technology has brought about manifold changes in a number of major areas of bank functioning, such as, management of risks, collation of returns across the bank branches and providing value-

added services to customers.

7.27 The Reserve Bank has been playing a pivotal role in the upgradation of technology in the banking sector with the objective of putting in place a safe, robust, efficient and integrated payment and settlement system. This includes measures aimed at integration of financial entities through the INFINET, encouraging retail electronic mode of payment including implementation of an electronic funds transfer (EFT) system, establishing the negotiated dealing system (NDS), development of a centralised fund management system (CFMS) and national settlement system (NSS) and finally, introduction of the real-time gross settlement (RTGS) system. The Reserve Bank has commenced the implementation of the RTGS system in a phased manner.

Transparency

7.28 Banks are becoming increasingly complex organisations. Investors are finding it harder to understand the quality of financial performance and risk exposures of banks. The traditional set of information as contained in banks' balance sheet often fails to convey information to readers of financial statements that can enable them to ascertain the quality of earnings. Accordingly, supervisors world-wide are making conscious efforts towards increasing the quality and quantity of disclosures in banks' balance sheets. Transparency challenges are met where market participants not only provide information, but also place the information in a context that makes it meaningful to accurately reflect risks. The quest for transparency has, therefore, to be continuous and persistent.

7.29 The Reserve Bank has been adopting a gradual approach to enhanced transparency in banking organisations. Illustratively, with effect from the year ending March 1998, banks were directed to disclose information on, among others, capital adequacy ratios, several financial ratios pertaining to income and non-interest income as percentages to average working funds as well as return on assets and the percentage shareholding of the Government of India as 'Notes on Accounts' in their balance sheets. Over a period of time, the set of disclosures has gradually been expanded to encompass areas like maturity pattern on select items on the asset and liability sides of their balance sheets, movements in provisions held towards NPAs and those held towards depreciation of investments as well as lending to sensitive sectors (*viz*., capital market, real estate and commodities). In view of the increased focus on empowering supervisors for undertaking consolidated supervision of bank groups, effective from March 31, 2003, preparation of consolidated financial statements (CFS), which include consolidated balance sheets, consolidated statements on profit and loss, principal accounting policies and notes on accounts have been mandated for all groups where the controlling entity is a bank. Within the consolidated supervision framework, a prudential reporting system encompassing information on accounts of related entities has been put in place under which a half-yearly report (consolidated prudential report) is required to be submitted to the Reserve Bank. Additional data relating to results of different business segments are being disclosed by banks effective March 31, 2003. The gradual expansion of the range of disclosures has been bringing the disclosure standards in India at par with those prevalent internationally.

Financing at the Longer End

7.30 The Reserve Bank has initiated several policy incentives to the banking sector in the recent past to boost the flow of credit to infrastructure, which generally tends to require long-

term finance. For example, the Monetary and Credit Policy of April 2003 provided several regulatory and prudential relaxations, *viz.,* a) relaxing the prudential single borrower exposure limit, b) assigning concessional risk weights on investment in securitised paper (satisfying certain conditions pertaining to an infrastructure facility) and c) permitting lending to Special Purpose Vehicles (SPVs) in the private sector, registered under the Companies Act for directly undertaking viable infrastructure projects subject to certain safeguards. The net effect of these measures is reflected in the fact that outstanding gross bank credit to infrastructure has risen from Rs.5,945 crore as at end-March 1999 to over Rs.20,000 crore as at end-March 2003.

7.31 The demand for housing in India is strong, as is the case with most economies, which are now industrialising and urbanising rapidly. Besides, construction has significant forward and backward linkages with a number of other industries. There has been a significant increase in housing finance during 2002-03 at soft interest rates. It must be recognised that the bank lending to potential home-owners in the Indian case is fundamentally different from the speculation in the property prices by banks in many countries. Importantly, the housing sector provides a relatively safe destination for bank credit on account of the lower than average rates of default. Besides, there is, an overall cap on the bank lending to sensitive sectors, including real estate.

Redefining the Regulatory Role of the Reserve Bank

7.32 Recent years have witnessed a gradual move on the part of the Reserve Bank away from micro-regulation towards macro-governance. The supervisory mechanism has incorporated intensive reporting requirements, with a focus on technology-driven off-site returns, inspections and audits, ratings (based on annual on-site inspections) and strengthening of prudential norms. The annual inspection reports are reviewed by the Board for Financial Supervision and recommendations on issues arising therefrom are discussed with the respective institutions for implementation in a time-bound manner.

Corporate Governance

7.33 Corporate governance has gained increasing importance in the Indian financial sector, especially when ownership is being diversified and competition is increasing. The issues have become all the more important in view of the recent accounting irregularities in the US. When banks are compelled to take decisions and formulate policies at board levels, questions of autonomy and efficiency have come to the forefront. Accordingly, the Reserve Bank has initiated a number of consultative processes, such as, the Reports of the Advisory Groups on Corporate Governance and that on Banking Supervision, both of which contain far-reaching proposals to improve corporate governance practices in banks. The Reserve Bank had also set up a Consultative Group to review the supervisory role of boards of banks and financial institutions and obtain feedback on the functioning of the boards *vis-à-vis* compliance, transparency, disclosures, audit committees, and make recommendations for making the role of board of directors more effective with a view to minimising risks and over exposure. In this context, the explicit mention of corporate governance in the annual reports of several banks during 2002-03 is a welcome development.

7.34 A feature unique to the Indian financial system relates to the dominance of Government ownership in the public sector banking system in India. To the extent there is public ownership in banks, there are possibilities of multiple objectives of the Government as owner

and the complex principal-agent relationships.

Governance Issues in Co-operative Banking

7.35 The supervision of co-operative banks continues to pose a challenge, not only because their numbers are large, but also because of the multiplicity of supervisory authorities. Cooperative banks are regulated by the State Government as well as the Reserve Bank (in case of urban cooperative banks) and NABARD (in case of state co-operative banks and district central co-operative banks). There is an urgent need to rationalise the supervisory authority of various control institutions. The Reserve Bank has repeatedly drawn attention of the Government of India to the fact that the present system of multiple regulatory and supervisory control limits the efficient functioning of the cooperative banks in the interest of their depositors. The Government has since tabled before the Parliament, a Bill entitled 'The Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003', which has been referred to the Standing Committee on Finance. In the meanwhile, the Reserve Bank has initiated several measures aimed at good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly-emerging business areas like micro finance, commitment to better customer service, adequate mechanisation and pro-active policies on house-keeping to improve the performance of urban co-operative banks.

Concluding Remarks

7.36 Increasing competition among banks, emanating not only from peers, but also from new entrants and other intermediaries, has been exerting pressure on bank spreads. The technology-intensive new private and foreign banks are positioning themselves as 'one-stop-shop' financial services and providing customers greater convenience and high quality services backed by appropriate investments in technology and other infrastructure. Therefore, the future profitability of public sector banks would depend on their ability to generate greater non-interest income and control operating expenses. Blue-chip clients continue to have the option to raise low-cost funds directly from domestic and international markets. The reforms-supported new environment is offering depositors and borrowers a wider range of opportunities to transact their business. Apart from the applicability of capital adequacy standards being in force, new methods of measuring market risk such as value-at-risk and pre-commitment approaches are expected to provide a more standardised but tighter framework for the banking sector. Simultaneously, the banking industry is undergoing a change driven by technological advancements. Since retail customers are fast becoming more demanding, in the competitive environment, banks have to offer the value-added services. Harnessing technology to improve productivity so as to produce highly competitive types of banking and generating greater non-interest income by diversifying into non-fund based activities will be important features of the Indian banking of tomorrow.