I THE THEME

1.1 A well-functioning financial system, by facilitating efficient allocation of resources from savers to investors, promotes economic growth. Within the financial system, the banking system has important ramifications for the level and growth rate of national income through the identification and funding of productive investments. This, in turn, is expected to induce a more efficient allocation of capital and foster growth. One of the most influential theories which recognised the role of financial development in economic growth through improvements in productivity was propounded by Joseph Schumpeter (1911). For a long time, however, this view did not get due attention. A contrary view also prevailed till the early 1970s, according to which economic growth creates demand for financial services and the financial system responds automatically to these demands (Robinson, 1952). This meant that financial development would follow growth more or less automatically and it was a by-product of economic development. Policymakers and academics also believed that 'management' of the financial system was a better tool of achieving social objectives rather than letting the market forces take their own course. However, the limitations of the planning process as reflected in 'financial repression', underlined the central role played by the free and efficient financial system.

1.2 The importance of financial development in the economic growth process gained prominence again in the early 1970s, when it was recognised that financial development has a two-pronged effect, *viz*., enhancing the efficiency of investments and increasing savings and hence, the scale of investments. The discussion was led by McKinnon (1973) and Shaw (1973), who argued that policies of administered low interest rates for containing the burden of public debt led to financial repression. Controls that resulted in artificially low or negative real interest rates, for instance, reduced the incentive to save, resulting in lower investment and growth. Liberalisation of the repressed credit markets could foster development since raising interest rates to their 'equilibrium' levels would lead not only to higher savings but also to a more efficient use of investible resources.

1.3 Although the McKinnon-Shaw hypothesis enjoyed overwhelming support, it also had to face some criticism. For instance, Robert Lucas asserted in 1988 that economists badly over-stress the role of financial factors in economic growth. In recent years, however, theories of endogenous growth have led to a better understanding of the criticality of efficient financial systems in economic development. The consensus now is that there is a positive two-way causal relationship between economic growth and financial development (Greenwood and Jovanovic, 1990). Financial intermediation enhances economic growth by channeling savings into productive areas of investment, while allowing individuals to reduce the risks associated with their liquidity needs (Bencivenga and Smith, 1991). According to Levine (1997), financial services affect economic growth through five main channels, *viz*., saving mobilisation, resource allocation, risk management, management monitoring and trade facilitation. Each of the five main channels contributes to both capital accumulation and the process of technological innovation. These, in turn, feed directly to economic growth through the Solow growth model.

1.4 The role of finance in growth has also been validated by empirical work (Gelb, 1989; Greene and Villanueva, 1991; Gertler and Rose, 1991; De Gregorio and Guidotti, 1995; Levine and Zervos, 1998). Most of these studies are based on cross-country analysis, which find that a measure of financial development, such as credit or market capitalisation, has a positive and significant effect on growth. There is evidence that financially developed economies seem to allocate their resources more efficiently (Carlin and Mayer, 1998; Beck *et al.*, 2001). Developed domestic financial markets, proxied by the size of the domestic stock and credit markets relative to GDP, are found to be associated with a better allocation of capital (Wurgler, 2000). Measures of allocative efficiency of stock markets (such as stock price synchronicity) are associated as much with market size, volatility, country size, diversification of economies and the co-movement of firm-level fundamentals, as with the measures of institutional development (Morck *et al.*, 2000).

1.5 King and Levine (1993), using data for 80 countries for 1960-1989, found a significantly positive relationship between several measures of financial development, including total credit extended to the private sector by banks, and economic growth. Their finding that the initial level of financial development in 1960 was a significant predictor of the subsequent average rate of growth over the next 29 years suggested a causal relationship between financial sector development and overall economic development. Levine, Loayza and Beck (2000), using data for 74 countries, found that the exogenous component of financial intermediation was positively associated with economic growth. Also addressing the issue of causation, Rajan and Zingales (1998), using industry-level data for 41 countries, concluded that industries more dependent on external financing tended to grow faster. Similarly, Demirguc-Kunt and Maksimovic (2002) also using firm-level data across 40 countries found that in more financially developed economies, a larger proportion of firms grew above the maximum rate of growth achievable by similar firms when they lacked access to external finance.

1.6 The McKinnon-Shaw thesis and the empirical literature, suggesting significance of the financial sector for economic development, encouraged many emerging market economies to introduce reforms in their financial sectors. This was reinforced by the East Asian crisis in the mid-1990s, which suggested that a weak financial system could be a serious threat to the real economy. In recent years, therefore, increased emphasis has been placed on strengthening the financial system.

1.7 While the significance of finance is now widely recognised, it was less clear until recently as to what were the essential features of a successful financial system. This issue related to the debate about the role of financial institutions such as banks *versus* financial markets, which are two generic mechanisms for transferring resources from savers to investors and each one of them has its own distinct advantages/ disadvantages.

1.8 Financial institutions have a distinct advantage in information gathering and processing to distinguish between a good borrower and a bad one. Thus, financial institutions can monitor the efficiency and productivity of projects much more effectively than the markets. In fact, in recent years, the existence of banks is attributed more to their information gathering capacity arising out of the existence of asymmetric information and moral hazard problems than to the classic explanation relating to their ability to mobilise savings and channeling them into investment. Savers usually have incomplete information on the affairs of companies, which makes it more difficult for the latter to obtain direct financing from the market. Intermediation by banks mitigates such agency problems. Recent research suggests that as the cost of acquiring information on a company by the providers of financial resources is high, financing of companies can be done more efficiently if the prospective investors are able to delegate the collection of such information to a specialised organisation (Diamond, 1984).

1.9 Firms in developing countries generally tend to rely more on debt finance, including bank credit. The emphasis on credit rather than equity arises due to various reasons. The cost of equity in developing economies is often much higher than the cost of debt due to the existence of higher perceived risk premia than in developed countries. The existence of artificially repressed interest rates contributes further to the problem. The other reasons for heavy reliance on debt in developing countries include the fragility of the equity markets, lack of suitable accounting practices and absence of adequate corporate governance practices. Given the high dependence on bank credit and lack of substitutes for external finance, banks and other intermediaries become extremely important. Financial intermediaries in developing countries, in particular, play an important role, where apart from industry, agriculture is also an important segment of the economy. Besides, there are also a large number of small and medium enterprises in the industrial and service sectors, which are not able to access the capital market and have to depend on the financial institutions for their funding requirements.

1.10 Capital markets can be used to fund activities whose risk is more easily measurable and classified so that standardised instruments can be issued for raising finance to fund them accordingly. On the other hand, banks and other financial institutions can fund more complex activities taking account of the different kinds of risks embedded in them. This is also enabled by a one to one relationship between the lender and borrower, which is reinforced through continuous supervision. Notwithstanding this debate, in actual practice both the systems co-exist in most countries even as one system may be more dominant than the other. Generally, bank-based systems tend to be stronger in countries where governments have taken a direct role in industrial development such as Germany in the 19th century, and Japan, East Asia, South-East Asia, China and India in the 20th century (Mohan, 2004a). The historical experience suggest that both the mechanisms have worked well. If the market-based system worked well in the UK and the US, the bank-based system was successful in Germany and Japan. The debate about the superiority of one mechanism over the other ended after the East Asian crisis, which led to realisation that the financial systems, in order to function smoothly, need to be well-diversified, where both financial markets and financial intermediaries play important roles.

1.11 While both banks and financial markets are important, banks are special for several reasons. According to the banking theories, banks exist because they perform certain special functions that no other financial services firms can replicate. Keynes identified two major functions of banks, *viz*., financial intermediation and money creation. Apart from financing growth, variations in bank credit are an important channel of monetary policy transmission even for central banks that rely on interest rates to convey their policy stance. Modulations in policy interest rates by the central bank influence credit market conditions which reinforce the effects of the traditional interest rate channel of monetary transmission. Banks are also 'special' as their operations have systemic implications. Banks not only accept and deploy large amounts of uncollateralised public funds in a fiduciary capacity, but also leverage such funds through credit creation. The owners or shareholders of banks have only a minor stake and the considerable leveraging capacity of banks (more than ten to one) puts them in control of very large volume of public funds. Banks are, thus, regarded as special type of financial intermediaries that need a differentiated treatment by regulatory authorities. Calomiris and Kahn (1991), Flannery (1994), and Diamond and Rajan (2001), however, argue that the fragile capital structure in banks and, hence, their vulnerability to deposit runs serve important economic functions. Deposit runs represent a powerful disciplining device that limits banks' incentives for risk-taking and misallocation of resources. This provides some degree of quality assurance in banks' loan portfolio.

1.12 The banking industry all over the world has undergone transformation since the early 1980s under the impact of deregulation, advances in information technology and globalisation (Box I.1).

1.13 The forces of deregulation, technology and globalisation have increased competitive pressures, which have (a) unleashed the strong forces of restructuring and consolidation with the number of banks declining all over the world; and (b) prompted banks to seek new sources of revenue beyond traditional products. These, in turn, have led to the blurring of distinctions among providers of various financial services and emergence of financial conglomerates. Although these developments have made institutions more efficient by lowering transaction costs, they have also challenged the traditional regulatory arrangements based on institutions. Also, heightened competitive pressures, by squeezing profit margins of institutions, could lead them to pursue riskier strategies, raising the possibility of failure. Financial instability can also impinge on a country's ability to pursue a prudent macroeconomic policy. The safety and soundness of financial institutions, therefore, have come to occupy a centre-stage in the policy making.

1.14 Under the forces of liberalisation and globalisation, many banking institutions have expanded beyond their home countries and traditional lines of business leading to emergence of large international banks. Many product innovations and new ways of doing business have also emerged that have led to widespread use of securitisation, derivatives and other financial products linking traditional banking functions to the operations of capital markets, whereas these developments have led to some degree of efficiency in financial intermediation, new issues have emerged over the past year that merit attention. Most, if not all of these large banks have become financial conglomerates operating in all the different segments of the financial sector. This movement has been enabled both by technological developments leading to faster transmission of financial transactions and financial innovations, and by falling national barriers allowing cross border capital flows.

1.15 The recent developments in international financial markets have, however, raised several concerns over the existing risk pricing and management tools and techniques employed in banks and financial institutions, particularly, the business strategies based on the model of 'originate to distribute'; issues relating to securitisation; enhancement of off-balance sheet exposures; liquidity commitments to conduits; and valuations regarding structured credit products. The functioning of the credit rating agencies and excessive reliance of institutional investors on the ratings has also been questioned.

Box I.1
Transformation of the Banking Sector – Major Drivers

Banking, especially in the emerging economies, has traditionally been a highly protected industry with regulated interest rate structure for deposits as well as lending, and restrictions on foreign and domestic entry. However, the regulators were forced to deregulate the banking sector under the influence of global market and technological developments, macroeconomic pressures and banking crises in the 1990s. Some measures, such as removal of ceilings on deposit rates and the lifting of prohibitions on interest payments on current accounts, significantly increased the competitive pressures on banks, thereby leading to changes in the structure of the banking industry. Accompanying deregulation has been greater emphasis on capital adequacy, which has encouraged banks to securitise some assets, generate more fee-based income, and improve efficiency. In some emerging economies, higher requirement of regulatory capital also became an important stimulus for mergers (or sales to foreign banks) of poorly performing banks.

Deregulation has also increased the competition between banks and non-banks, especially for lending to large companies. The despecialisation of financial institutions has been an important force in changing the structure of the financial services industry. Banks are emerging as a one-stop shopping centre for all financial services, offering insurance products, mutual funds and other financial services. Securitisation has allowed unbundling of the traditional lending process into various parts - originating loans, packaging them for sale to others, servicing loans, and funding loans. This, in turn, intensified the competition between banks and non-banking firms.

In the recent past, the technological developments have also impacted the banking business in a variety of ways, both directly, through Information Technology (IT) applications in risk management and marketing of financial products, and indirectly, through its impact on corporate behaviour and the development of financial markets, especially in the area of financing new capital investments. Technological innovations have led to development of new financial instruments and sharp reduction in the cost of gathering, processing and disseminating information. This has led to the creation of new markets. On the commercial banking front, several services like ATMs, debit cards, telephone, internet and electronic banking have become an integral part of banking.

With the reduction in barriers to trade and commerce, driven by a combination of government policy and improved communication facilities, the market for financial services has been becoming increasingly global. Growth of non-financial companies across the border has resulted in greater demand for institutions that can provide financial services across borders. In recent years, there has also been a drastic reduction in global barriers to competition in the financial services industry. Deregulation all over the world has encouraged consolidation of banks across the border and among different types of financial institutions. Advances in IT have facilitated greater geographic reach by allowing institutions to manage larger information flows from distinct locations.

Reference:

Hawkins, J. and D. Mihaljek. 2001. “The Banking Industry in the Emerging Market Economies: Competition, Consolidation and Systemic Stability: An Overview”, BIS Paper No. 4.

EVOLUTION OF BANKING IN INDIA

1.16 As in several other emerging market economies, the financial system in India has traditionally been dominated by financial intermediaries, especially banking institutions. Banking in India has a long history and it has evolved over the years passing through various phases. At the time of independence, the Indian banking system was weak. The entire banking sector was in the private sector and the credit requirements of agriculture and other needy sectors were ignored. With a view to better aligning the banking system to the needs of planning and economic policy, the policy of social control over the banking sector began in 1967. The nationalisation of private sector banks in 1969 was a major turning point in the history of the banking sector in India. With the nationalisation of banks (fourteen in 1969 and again six in 1980), the major segment of the banking sector came under the control of the Government. Massive expansion of the branch network that followed the nationalisation of banks resulted in large deposit mobilisation by banks, which helped in stepping up the overall savings rate of the economy. However, during this period, a major portion of banks’ resources were pre-empted at below market rates by way of directed credit and directed investments. Profitability of the banking sector was, therefore, affected. Banks were also saddled with large non-performing assets. Their capital base also became weak.

1.17 With a view to overcoming several weaknesses that had crept into the system over the years and with a view to creating a strong, competitive and vibrant banking system, several measures were initiated beginning the early 1990s. First, the banking system was strengthened by introducing prudential norms, which were subsequently tightened in line with international best practices. Second, competition in the banking sector was enhanced by allowing entry of new private sector banks and enhanced presence of foreign banks. Foreign direct investment in private sector banks was also allowed up to 74 per cent. Third, public sector banks were allowed to access the capital market and also provided with operational flexibility and functional autonomy. Fourth, the system of administered interest rates was almost dismantled and pre-emptions in the form of reserve requirements were reduced. Fifth, the supervisory system was revamped in view of its crucial role in the creation of a sound banking system. Sixth, corporate governance practices and disclosure standards were strengthened. Seventh, regional rural banks, urban co-operative banks and rural co-operatives were also strengthened.

1.18 As a result of constant evolution, the size and structure of the banking sector have undergone a significant change. The present banking structure in India consists of commercial banks, urban co-operative banks, regional rural banks (RRBs) and rural co-operative banks, which, in turn, comprise short-term co-operative credit structure (State co-operative banks and district central co-operative banks) and long-term credit structure (state co-operative agriculture and rural development banks and primary co-operative agriculture and rural development banks). Commercial banks form the bedrock of the Indian financial system accounting for around three-fourths of the total assets of all financial institutions at end-March 2007 (Table I.1). The 96 RRBs, although small in size, play a critical role in extending credit in the rural areas. The co-operative banking system, with two broad segments of urban and rural co-operatives, forms an integral and sizable part of the Indian banking system. Primary co-operative banks, also referred to as urban co-operative banks (UCBs), play an important role in meeting the growing credit needs of urban and semi-urban areas of the country. The rural co-operative credit institutions, with a wide network and extensive coverage, play an important developmental role in enlarging the ambit of institutional credit by inculcating banking habits among the poor and in remote areas.

1.19 The banking sector in India plays a crucial role in the economy not only by mobilising savings and channeling them into investments, but also contributing directly to GDP and generating employment. Bank deposits constituted 56.5 per cent of the financial assets of the household sector during 2006-07. Financial assets of the household sector are a major form of saving. By mobilising household sector savings, the banking sector plays a significant role in promoting investment and growth. Banking and insurance together constitute 6.7 per cent of GDP as at end-March 2007. Although separate data on the banking sector's contribution to GDP are not available, an idea of its contribution to GDP can be had from its share (83.1 per cent) in the combined assets of the banking and insurance sectors at end-March 2007. The employment generated in the banking sector constituted 3.2 per cent of the organised sector employment at end-March 2005.

Table 1.1: Financial Intermediaries in India*
(End-March 2007)

Type of Institution	No.of Institutions	Share in Total Assets (per cent)
A. Commercial Banks	**182**	**75.2**
a) Scheduled Commercial Banks (Excluding RRBs)	82	72.9
i) Public Sector Banks	28	51.4
ii) Private Sector Banks	25	15.7
iii) Foreign Banks	29	5.9
b) Regional Rural Banks	96	2.2
c) Local Area Banks	4	0.0
B. Co-operative Banks	**1,09,310**	**12.8**
a) Urban Co-operative Banks	1,813	3.4
b) Rural Co-operative Banks	1,07,497	9.5
i) Short-term	1,06,781	8.5
• State Co-operative Banks	31	1.8
• District Central Co-operative Banks	369	3.3
• Primary Agricultural Co-operative Societies	97,224	3.3
ii) Long -term	716	1.0
• State Co-operative Agriculture and Rural Development Banks	20	0.5
• Primary Co-operative Agriculture and Rural Development Banks	696	0.5
C. Non-Banking Financial Institutions	**591**	**12.0**
a) Financial Institutions**	6	3.5
b) Non-Banking Financial Companies#	577	8.2
c) Primary Dealers	8	0.3

* : Excludes insurance companies regulated by Insurance Regulatory and Development Authority (IRDA) and mutual funds regulated by Securities and Exchange Board of India (SEBI).

**: Data pertain to six FIs, *viz.* IFCI Ltd., TFCI Ltd., NABARD, NHB, SIDBI and Exim Bank. IIBI Ltd. was under voluntary winding-up as on March 31, 2007.

: Data pertain to Residuary Non-banking Companies, Deposit taking NBFCs (NBFC-D) and non-deposit taking systemically important NBFCs (NBFC-ND-SI).

1.20 The banking system in India has undergone significant transformation following financial sector reforms since the early 1990s. The thrust of the banking sector reforms was on increasing operational efficiency, strengthening the prudential and supervisory norms, removing external constraints, creating competitive conditions and developing the technological and institutional infrastructure. The impact of the reform measures is reflected in an improvement in profitability, financial health, soundness and overall efficiency of the banking sector. Banks have been able to maintain or increase their capital adequacy ratio, despite the sharp increase in their risk-weighted assets. Banks' loan portfolio, which had decelerated during 1998-2003 due to some risk aversion on the part of banks along with the overall slowdown in the economy accelerated sharply in recent years. A significant feature has been increased credit flow to the agriculture and the SME sectors. Banks' retail credit portfolio has also expanded rapidly. Significant progress has also been made on the financial inclusion front. Credit by banks to households during 1991-2002 continued to expand broadly at the same pace as during 1981-1991. However, deposit and credit penetration improved significantly after 2002 as a result of several measures initiated by the Reserve Bank.

1.21 With the entry of new private sector banks and increased presence of foreign banks, the Indian banking sector has become more competitive. Public sector banks have also been raising capital from the market and are subject to market discipline. Efficiency, productivity and soundness of the banking sector improved significantly in the post reform phase. Banks have increasingly diversified into non-traditional activities, as a result of which several financial conglomerates have emerged. This has posed several regulatory and supervisory challenges. Thus, while deregulation has opened up new avenues for banks to augment incomes, it has also entailed greater risks. The banking sector has witnessed the emergence of new banks, new instruments, new windows, new opportunities and, along with all this, there have been new challenges.

ISSUES IN BANKING DEVELOPMENT IN INDIA

1.22 The Indian banking system is currently passing through a crucial phase. Although the banking sector has become strong, competitive, dynamic and resilient, it is faced with several newer challenges as a result of macroeconomic and financial sector developments, both domestic and global. The major issues/challenges faced by the Indian banking sector could be identified as: (i) mobilising resources to sustain and even accelerate the current economic growth momentum; (ii) implementation of Basel II norms by foreign banks in India and Indian banks having operational presence abroad with effect from March 31, 2008 and by other Scheduled Commercial Banks not later than March 31, 2009; (iii) issues involved in allowing increased presence of foreign banks in India as the roadmap for foreign banks is due for review in April 2009; (iv) progressive move towards fuller capital account convertibility, which will expose the banking system to greater risks and would require addressing certain issues in banking, including some regulatory and supervisory aspects; (v) the emergence of financial conglomerates, which has raised the issue of appropriate regulatory structure/ arrangement; (vi) the emergence of complex financial products, which pose several supervisory challenges; and (vii) the need to extend financial services to the large number of people, who continue to remain outside the banking system.

Banking and Economic Growth

1.23 The main function of the banking system in any economy is to mobilise the resources and channel them into productive purposes. The more developed the banking system is, the better it is in a position to perform this role. The Indian economy has moved on to a high growth trajectory with the average growth rate during the last five years (2003-04 to 2007-08) being at 8.8 per cent. This was facilitated by a significant increase in the investment rate from 22.8 per cent in 2001-02 to 35.9 per cent in 2006-07. The saving rate in India also improved from 23.5 per cent in 2001-02 to 34.8 per cent in 2006-07 to support the investment needs of high growth. Loans and advances extended by SCBs registered a threefold rise during the same period. In order to sustain the growth momentum, it would be necessary to sustain and even accelerate the savings rate, which in turn, would, critically depend on efficient intermediation between savers and investors. In this context, the Approach Paper to the Eleventh Five Year Plan observed, "a key feature which affects feasibility is the financial system and its ability to intermediate savings to potential users. Accelerated growth involves expansion in investment, economic restructuring of existing enterprises as they gear themselves for competition, and encouraging new entrepreneurs to respond to opportunities. All this is possible only if the financial systems can finance the structural changes taking place".

1.24 In order to achieve the desired savings and investment rates, there would be need to generate large resources domestically. India has a reasonably high and growing savings rate. However, for meeting the financing requirements of a growing economy what is important is the financial savings. Although financial savings have increased over the years, physical savings have also grown in tandem with financial savings. The substitution of unproductive physical savings in favour of financial savings can generate large resources for investment. Also, there is an enormous untapped saving potential in rural and semi-urban areas. However, conversion of unproductive physical savings into financial savings and mobilisation of the hitherto untapped savings of rural and semi-urban areas requires innovative and cost effective products. Given their outreach as also special features of deposits, *viz.*, safety and liquidity, banks indeed are in a better position to perform this role than other constituents of the financial system.

Basel II

1.25 India has been adopting international best practices in the area of regulation and supervision with a view to strengthening the banking sector. Following the Basel Accord of 1988, the capital to risk-weighted assets ratio (CRAR), which took into account the element of risk involved in both balance sheet as well as off-balance sheet business, emerged as a well recognised and universally accepted measure of soundness of the banking system. Accordingly, as a part of banking sector reforms, India adopted the Basel norms in a phased manner. In fact, India went a step further and stipulated CRAR at nine per cent as against the international norm of eight per cent. Furthermore, India also prescribed the capital charge for market risk in June 2004, broadly in line with the 1996 amendment to Basel norms.

1.26 Over the years, however, several limitations of Basel I norms surfaced. In view of emergence of large and complex banking institutions, and with increasing sophistication of institutions in risk management, the straight jacket system of risk weights under Basel I became less meaningful. Furthermore, improvements in credit risk measurement facilitated increased use of securitisation and credit derivatives to arbitrage those capital rules. Therefore, the Basel Committee on Banking supervision (BCBS) introduced the new capital framework (Basel II Framework), which provides a more risk sensitive capital requirement for banks not only for credit and market risks but also for operational risk. The capital requirements are complemented by supervisory review and market discipline. The Basel II framework in India would become fully operational from end-March 2009, while a part of domestic banks and foreign banks are already Basel II compliant. The implementation of Basel II poses several challenges for the banks as well as the Reserve Bank. At the banks' level, the implementation would require, *inter alia,* upgradation of branch inter-connectivity, which entails cost and also raises some safety issues. The implementation of Basel II also raises several issues relating to development of human resource skills and database management. Banks would also need to explore the various capital raising options. Each national superviser is expected to consider carefully the benefits of the revised framework in the context of its domestic banking system when developing a timetable and approach for implementation. The Reserve Bank has indicated the timetable for implementation of Basel II framework for commercial banks. The Basel II framework also offers multiple options available for computing capital requirements for the three major risks. While for the present, banks would be following simple approaches, it is likely that subsequently some banks move to advanced approaches under the Reserve Bank's supervision. Consequently, a progressive improvement in quality of human resources equipped with quantitative techniques would be required in future. Under Pillar II of the framework, the Reserve Bank would be required to review and revise its supervisory processes as banks indulge in more sophisticated products. Besides commercial banks, several other types of banking institutions such as urban co-operative banks and regional rural banks also operate in the country. There is a need to carefully look into what kind of regulatory treatment, insofar as capital adequacy norms are concerned, needs to be applied to such institutions.

Role of Foreign Banks

1.27 It is now widely believed that for financial institutions to operate efficiently, there is a need to maintain competitive conditions. The empirical and theoretical literature in banking also suggests that a competitive banking system is more efficient. It has therefore, been the endeavour of the Government and the Reserve Bank to enhance competition through entry of new private sector banks, increased presence of foreign banks and provision of operational flexibility to public sector banks. To diversify ownership, public sector banks were allowed to raise funds from the capital markets, subject to the Government shareholding being retained at 51 per cent. Various other restrictions hindering the competitive process have also been, by and large, phased out.

1.28 In recognition of the emergence of foreign banks as key vehicles in the international integration of the financial systems, a liberalised policy towards foreign banks' entry has become a high priority in policymakers' agenda in various countries in recent years. Liberalisation of financial services by allowing foreign financial institutions to participate in the domestic market improves competition, thereby facilitating better and cheaper financial intermediation. Apart from increasing competition and efficiency through infusion of technology and skill management, some of the other benefits of foreign banks' entry are said to include introduction of superior risk management practices and stronger capital base, which is also less sensitive to host country's business cycle. Cross-country evidence, however, reveals that the benefits and costs of foreign banks are not unambiguous, and have been contextual, depending upon the sequencing of financial sector reforms and the level of development of the concerned country. A number of empirical studies suggest that foreign banks play a stabilising role during periods of banking stress (Levine 1996; Martinez Peria *et al.,* 2002; Detragiache and Gupta, 2004; and Goldberg *et al.*, 2000). Furthermore, the costs and benefits of foreign banks' entry are guided to a large extent by the mode of entry of foreign banks. Liberalisation of financial services industry also raises some concerns. For instance, the potential of increased foreign bank presence can expose a country to external shocks. Opening the domestic financial system to foreign financial services providers without any restrictions also raises the possibility of domestic financial institutions being taken over by foreign banks.

1.29 India also liberalised the entry of foreign banks in the post-reform period. In the roadmap by the Reserve Bank released in February 2005, the opening up of the domestic banking sector to foreign banks was envisioned in two phases. The first phase envisaged that foreign banks wishing to establish presence in India for the first time could either choose to operate through branch presence or set up a 100 per cent wholly owned subsidiary (WOS) following the one-mode presence criterion. In the second phase (April 2009 onwards), the policy on foreign banks is to be taken up for a review. At that stage, various issues associated with the increased presence of foreign banks such as impact on the domestic banks, supervisory and regulatory challenges in view of their sophisticated operations and their involvement in complex and sophisticated products, financial inclusion, credit to agriculture and SMEs, and public policy on credit delivery, cost and allocation would need to be weighed. The issues relating to co-ordination between home and host countries regulators would also pose a challenge.

Capital Account Convertibility

1.30 As the economy gets increasingly integrated with the global economy, the Indian banking system would also get progressively integrated with the rest of the world. The Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore), which submitted its report in July 2006 had, *inter alia,* recommended a broad timeframe of a five-year period to be implemented in three phases for fuller capital account liberalisation, *viz.*, 2006-07 (Phase I), 2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11 (Phase III).

1.31 Further liberalisation of capital account transactions is expected to result in a larger two-way flows of capital in and out of the country. In a regime of fuller capital account convertibility, banks will be expected to undertake transactions in multiple currencies acting as channels for the flow of funds in and out of the country when they are enabled to receive deposits and raise borrowing from both residents and non-residents and lend and invest in both domestic and foreign jurisdictions. Likewise, non-resident banks and financial institutions are expected to undertake similar transactions. The non-financial entities having links with the banking system would also conduct transactions in multiple currencies when they borrow, lend and invest overseas. All these types of transactions add to the risks of the banking system that are not so evident in a less open domestic banking system. Thus, the banking system in a freer capital account regime would be exposed to enhanced risks in terms of currency risk, counterparty credit risk, transfer risk, legal risk, risk of regulatory arbitrage, risk in derivatives transactions and reputation risk. This underscores the need for risk management capabilities in the banking system. Freer capital regime would also require improvement in the liquidity management and disclosure practices by financial institutions as they would be encouraged to diversify funding sources to contain maturity mismatches and improve debt-equity mix. In a liberalised environment, banks' own exposures to exchange rate risk, coupled with their exposures to corporates which are exposed to similar risks, spanning across national jurisdictions add to the multiplicity of risks which also raise the issue of close monitoring and prudential management. A strong banking sector in a fuller capital account regime is also important for implementing appropriate monetary policy.

1.32 Thus, increased integration of the domestic economy with the rest of the world requires the banking sector to develop appropriate capabilities to manage the varied and enhanced risks. In particular, exchange rate risks and spill-over effects across markets are specific challenges to be dealt with in a globalised scenario. Inability to meet these challenges might translate into instability in the financial system. In a freer capital transactions regime, the magnitude of money laundering might also scale up along with the overall increase in financial flows, requiring appropriate policy responses.

Financial Conglomerates and the Regulatory Structure

1.33 Traditionally, the regulation of financial intermediaries all over the world has been on institutional lines, whereby regulation is directed at financial institutions, irrespective of the mix of business undertaken. In recent years, distinctions between banks and non-banks financial intermediaries have become blurred. A number of financial conglomerates have also emerged that undertake various financial activities under the same corporate structure. These have challenged institution-based regulation as it fails to take into account the gaps and overlaps in regulation. Moreover, the risk assumed by the financial conglomerates as a group may be higher than the sum total of risks assumed by its affiliates/subsidiaries undertaking a number of activities. Therefore, the regulatory structure based on institutions has become a major issue of policy and public debate in several countries.

1.34 In order to overcome the issues raised by operations of financial conglomerates, some countries have followed a system of super/single regulator, which oversees all segments of the financial system. Some other countries have followed objectives-based regulation under which regulation is directed based on the objective (prudential regulation or market conduct). However, each of the structures has its own advantages and disadvantages and the regulators are grappling with the issue as to which is the most appropriate structure. The recent financial market developments and the failure of Northern Rock in the UK, which had a supervisory structure outside the central bank, have added more uncertainty to this issue.

1.35 In India also, there has been some blurring of activities among providers of various financial services. Some financial conglomerates have also emerged. A monitoring mechanism for financial conglomerates has been devised in collaboration with other regulators, *viz.*, SEBI and IRDA. In this regard a very closely related issue is that of appropriate structure of financial conglomerates. Financial conglomerates in India have been patterned on the parent-subsidiary structure. In some countries such as the US, Japan and Canada, financial conglomerates are organised in a holding company structure. In this context, the Reserve Bank released a 'Discussion Paper' in September 2007, wherein it was indicated that it will be useful to explore the possibility of adopting a bank holding/financial holding model.

Complex Products

1.36 In recent years, complex financial products such as asset-backed securities, derivatives, credit-default swaps (CDSs) and collateralised debt obligations (CDOs) proliferated in developed countries. These products became highly popular with banks and financial institutions as they allowed them to hedge their risks and manage their regulatory and economic capital more efficiently.

1.37 Although various structured products have enabled the transfer of risks and enhanced the liquidity of instruments, the recent turmoil in the US sub-prime mortgage market and related developments connected with complex derivatives have also brought to the fore the risks posed by these instruments. The lack of long historical data on the performance of these instruments, and their correlations with other assets and instruments, made it difficult to assess their overall risk-return profile. Moreover, in the sub-prime residential mortgage-backed securities market, many market participants were willing to proceed without conducting robust due diligence and without establishing appropriate risk-management structures and processes. The aggressive risk-taking was amplified by the great opacity of new instruments such as structured credits. While the practices of increased use of innovative credit instruments and complex layering of risk diffusion reduced information costs, it also enabled the investor or risk taker to become progressively remote from the ultimate borrowers where the actual risks resided. With a host of intermediaries in the form of mortgage brokers, mortgage companies and societies, packaging their mortgage assets including non-conforming loans and selling down to different categories of investors, including special investment vehicles (SIVs), and hedge funds, the identification and location of risks in the whole chain became increasingly challenging.

1.38 In India also financial products such as mortgage-backed securities (MBS) and asset-backed securities (ABS) are in existence. Besides the securitised products, the Indian forex and rupee derivative markets have also developed significantly over the years. In respect of forex derivatives involving rupee, residents have access to foreign exchange forward contracts, foreign currency-rupee swap instruments and currency options – both cross currency and foreign currency-rupee. As stated in the Annual Policy Statement for the year 2008-09, the Reserve Bank announced the introduction of currency futures in the eligible exchanges for which the broad framework has been announced in August 2008. In future, some more innovative and complex products might emerge. These products may pose several regulatory and supervisory challenges.

Financial Inclusion

1.39 Notwithstanding the rapid spread of banking over the years, a significant segment of the population, predominantly in the rural areas, is excluded from the formal financial system. There is currently a clear perception that there are a large number of people, potential entrepreneurs, small enterprises and others, who are excluded from the financial sector, which leads to their marginalisation and denial of opportunity for them to grow and prosper (Mohan, 2006). Therefore, access to a greater proportion of the population to the organised financial system has been high on the agenda of the Reserve Bank. The key issue, however, is how to mainstream the institutional sources so as to achieve wider coverage in terms of extending credit. There are also a large number of households with low income and small savings, which need to be mobilised. Apart from the rural areas, there is significant degree of financial exclusion in urban areas as well. The cost of financial exclusion is recognised to be enormous for the society as well as for individuals, particularly in terms of inability to realise full potential due to financial constraints. There are, however, several challenges that require concerted efforts from banks, the Reserve Bank and the Government to ensure convenient and cost effective delivery of financial services to the public at large. In particular, the challenge is to introduce innovations in risk assessment, reduce transaction costs, devise new credit delivery channels, and use information technology to make financial inclusion a viable model.

STRUCTURE OF THE REPORT

1.40 In order to strengthen the understanding of the various issues/challenges faced by the banking sector and identify the substantive issues that need to be addressed to ensure the growth of the banking sector along sound lines, the theme of this Report for 2006-08 has been selected as "**The Banking Sector in India: Emerging Issues and Challenges**". The Report undertakes an in-depth analysis of various aspects of banking in India such as managing resource mobilisation, capital and risk; lending and investment operations of banks; financial inclusion; efficiency, profitability and soundness; competition and consolidation; and regulatory and supervisory challenges. These aspects are analysed using inter-temporal and cross-country data/information, highlighting the current major issues and challenges. An attempt is also made to outline the way forward for each of the aforementioned aspects of banking. The thrust of the Report is to critically examine the various issues and, going forward, what further needs to be done to ensure the growth of the banking sector in a way that supports/accelerates India's current growth momentum and enhances the stability of the financial system. Various measures suggested in this Report set out only the broad direction in which reforms in the banking sector could move in future. The pace and sequencing of measures would need to be calibrated keeping in view the degree of comfort in moving forward in a credible way.

1.41 The theme of this Report complements the themes of the previous three years' reports, *viz.,* 'The Evolution of Monetary Policy in India and Challenges Facing It' (2003-04), 'The Evolution of Central Banking in India' (2004-05), and 'Development of Financial Markets and Role of the Central Bank' (2005-06). Keeping in view the significance of developing financial markets, the 2005-06 Report undertook an in-depth analysis of their various segments with a view to identifying the key issues that needed to be addressed to develop them fully. The theme of the present Report is, thus, in keeping with the objective of developing a financial system that is well-diversified and well-equipped to effectively meet the challenges that lie ahead. Taken together, these four reports would have covered the evolution of thinking and the way forward for the major areas of responsibility of the Reserve Bank.

1.42 The Report, including this chapter, is organised into eleven chapters. As a prelude to the substantive theme based discussion, Chapter II of the Report titled “Recent Economic Developments” presents an analytical account of macroeconomic developments in the Indian Economy during 2007-08. Besides, latest macroeconomic developments for 2008-09, wherever data are available, are also covered. The chapter covers six broad sections, *viz*., the real sector, fiscal situation, monetary and credit situation, financial markets, banks and financial institutions and the external sector.

1.43 Chapter III titled ‘Evolution of Banking in India’ traces the history of the banking sector in India. Although the focus is on the post-independence history, it starts with a broad brush sketch of the early years of banking. The chapter narrates the story as it unfolded historically and discusses the major developments in the banking sector broadly under the three periods, *viz*., from 1947 to 1967; 1967 to 1991; and from 1991 onwards.

1.44 Chapter IV, ‘Managing Resource Mobilisation’, looks into various aspects of resource mobilisation by the commercial banks in India, and identifies the challenges faced by them to sustain the resource mobilisation. Besides providing the theoretical underpinnings on the intermediation role of banks, the chapter examines the role of financial intermediaries in mobilising resources as reflected in the flow of funds of the Indian economy. The thrust of the chapter is on various aspects of the deposit mobilisation process with a view to understanding the underlying changes. The significance of deposits in the overall liability structure of banks is also discussed. In the light of cross-country experiences, the chapter identifies the emerging issues and challenges faced by banks in resource mobilisation and makes suggestions to meet them effectively.

1.45 Chapter V on ‘Managing Capital and Risk’ discusses the evolving issues in risk and capital management faced by banks in India, especially in the context of implementation of Basel II framework. The chapter begins with the international convergence of capital measurement and capital standards and delineates several issues relating to implementation of Basel II framework, including its benefits, limitations, its likely impact and the progress of its implementation in major countries. The policy developments in the area of managing capital and risk together with progress made in implementation of Basel II in the Indian context are dealt with in detail. Risk management practices, asset-liability management and corporate governance in the Indian context are also discussed. After analysing the management of capital by banks in the post-reform period, the chapter assesses the capital requirements in each of the next five years (2007-08 to 2011-12), with a special focus on public sector banks. The chapter also details the challenges and issues of relevance for the future.

1.46 Chapter VI titled ‘Lending and Investment Operations of Banks’ deals primarily with the various lending and investment operations of commercial banks in India. After a brief outline of the theoretical underpinnings of bank lending, the chapter analyses in detail the trends in lending operations of banks with a special focus on the period beginning with the early 1990s. Against the backdrop of cross-country experiences, the chapter spells out the issues and constraints in lending by banks to certain critical sectors, *viz*., agriculture, small and medium enterprises and infrastructure. Investment operations of banks have also been detailed. Based on the analysis of the domestic and international pattern in lending by banks, the chapter makes certain suggestions with a view to improving the flow of credit to the various sectors of the economy.

1.47 Chapter VII on ‘Financial Inclusion’, drawing upon the theoretical developments, country experiences and empirical analysis, examines key issues in financial inclusion/exclusion in India. After discussing the conceptual framework, measurement related issues and the nature, causes and consequences of financial exclusion, the chapter delineates the policy initiatives undertaken for financial inclusion in India. The focus of the chapter is on assessing the nature and extent of financial inclusion/exclusion in India. Issues relating to the operating cost of financial inclusion and the role of technology are also touched upon. Drawing from country experiences and empirical analysis in the Indian context, the chapter, as a way forward, makes several suggestions to promote financial inclusion in India.

1.48 Chapter VIII on ‘Competition and Consolidation’ discusses the theoretical perspectives and country experiences on consolidation and competition along with various facets of consolidation and competition in the Indian banking sector. The focus of the chapter is to examine the extent and nature of the process of consolidation and its impact on competition in the banking sector and the efficiency of the merged entities in the Indian context. The chapter also examines the impact of consolidation on the market structure. Issues relating to the future course of the consolidation process, role of public sector banks, increased presence of foreign banks and the combining of banking and commerce are also analysed. The chapter also makes several suggestions with a view to ensuring that the competitive conditions are maintained in the banking sector in India even as the consolidation process is strengthened.

1.49 Chapter IX on ‘Productivity, Efficiency and Soundness of the Banking Sector in India’ after discussing the conceptual issues relating to the measurement of efficiency and productivity, assesses productivity and efficiency of the banking sector as a whole as well as various bank groups based on accounting measures or financial ratios. A comparison has also been made with other countries, wherever possible. The factors affecting the net interest margin (NIM), the main source of income for banks, have been analysed. The chapter also measures productivity and efficiency of the banking sector in India in terms of economic measures. The relationship of efficiency on the one hand and ownership, size and diversification on the other is also assessed. The chapter also establishes the relationship between efficiency and soundness before assessing the soundness of the banking sector in terms of capital-to-risk-weighted asset ratio (CRAR) in India. As a way forward, the chapter makes several suggestions for further improving the efficiency, productivity and soundness of the banking sector.

1.50 Chapter X on ‘Regulatory and Supervisory Challenges in Banking’, after presenting the theory behind regulation of banks, deals with the recent thinking on various regulatory and supervisory issues relating to banks in the global context. After setting out the extant regulatory and supervisory framework in India, the chapter focusses on the regulatory and supervisory issues/challenges that have arisen in the Indian context. In the light of global and domestic developments, suggestions have been made with a view to further strengthening the regulation and supervision in India.

1.51 Chapter XI titled ‘Overall Assessment’ sums up the main findings and suggestions made in the various chapters of the Report and presents some final reflections with a view to enabling the banks and the Reserve Bank to meet the emerging challenges effectively.