SPEECH

FINANCIAL SECTOR REFORMS: A CONTINUUM*

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At the outset I would like to thank the Principal of the Bankers' Training College for giving me the opportunity of interacting with the RBI nominee directors on the Boards of Public Sector Banks. We have now entered the fourth year of the reform process and a number of us are asking the question as to whether the reform is almost over; this is unfortunately not so and rather like W.E. Bates 'The Pilgrim on the Ganges', we have to keep moving on from one reform to the next. I am sure that all of you are familiar with the course of the reform and its rationale and it would, therefore, be useful to discuss the issues at the frontiers, the tasks ahead and the unfinished agenda and we should not be disheartened if we do not have all the answers to our doubts and fears. If we take a quick hindsight, nominee directors could scarce believe that we would come so far in such a short period. It was only a short while ago that we felt that avoidance of automatic monetisation was a mirage, that a market related system on government borrowing would not be attained in our working lives, that cleaning up of banks' balance sheets would result in a banking crisis and that deregulation of lending rates would have disastrous consequences on the economy. None of these fears have materialised. While we should not hoist our own petard it is necessary to note that the success of the Indian reform process and its durability is attributable to the measured step by step approach.

2. I would now like to get into the unchartered seas of the future financial sector reform process and we should not be alarmed if we continue to have fears and continue to be flummoxed by the myriad of problems. I do hope that this Conference will provide a forum for a fruitful discussion of some of these vexatious issues.

3. On the question of interest rate policy, there is now a general consensus and a sudden acclamation that we have arrived at the goal post of lending rate deregulation. The question now being raised is how the Central Bank would provide signals to the market on interest rates. It is argued that the Reserve Bank should provide a reference rate of interest and it is sometimes erroneously claimed that the Reserve Bank is not allowing a BIBOR (a take off from LIBOR) from developing! Nothing can be farther from the truth. The central issue is that a reference rate cannot be merely anointed by the Reserve Bank; to be effective it has to earn its place in the market. Given the predominance of sector specific export refinance, it is unlikely that the Reserve Bank's refinance rate would emerge as the reference rate. What is likely is that the family of interest rates relating to Government securities and liquidity support provided by the Reserve Bank against the collateralisation of these securities would provide the sheet anchor for interest rates in the system.

4. While the co-operative banks' lending and deposit rates have been deregulated, the deposit rates of the commercial banks continue to be regulated. The writing on the wall is clear and deposit rates would sooner or later need to be deregulated. The literature on deregulation of interest rates provides that the deregulation of deposit rates should be undertaken at the end of the process and at a time when inflation is reasonably under control. It is also observed that when there is a total deregulation of interest rates, *inter se* bank competition and bank and non-bank competition intensifies and results in a shrinking of spreads between a fourth and a third.

* Inaugural address by Deputy Governor, Shri S.S. Tarapore, to the Conference of Nominee Directors of the Reserve Bank of India on the Boards of Public Sector Banks at the Bankers'Training College, Bombay on November 11, 1994.

5. As you are all aware there has been a clear shift in the emphasis of monetary policy from direct to indirect instruments of monetary control which implies the emergence of open market operations as a major tool of monetary control. With the recent growth of primary liquidity, as a result of the sharp increase in the foreign exchange reserves, it has been necessary to undertake large open market operations. Such operations necessarily imply changes in interest rates and prices of securities. While the interest rate differentials drive the capital flows, the dilemma is that open market operations to absorb liquidity widen the wedge between domestic and international rates and could once again stimulate capital flows. Banks will, therefore, have to undertake their operations under a deregulated interest rate regime wherein they will have the freedom to decide on their own lending/deposit rates, while monetary policy will impinge on the level of interest rates in the economy. Thus, banks will have to develop the necessary skills to adjust rapidly to these changes.

6. Treasury operations are one of the weakest elements in the banking system and banks would be well advised to put their best personnel into Treasury management. The advantage here is that the number of skilled personnel required in Treasury management is much less than in credit management and banks can quickly develop these skills. The present level of Treasury skills is extremely poor and nominee directors would be well advised to give attention to this aspect. Again, while asset-liability management has been given much lip service, poor asset-liability management is bound to result in large losses for banks. As exacting prudential norms are in place and there is increasingly securitisation of debt, there would be a relative slow down in conventionally defined credit and an increase in investments; thus in terms of a broader and more meaningful concept of flow of resources to the commercial sector we should take a total view of flow of resources.

7. In a deregulated regime, we must expect the bank/non-bank competition to intensify and this will require banks to increase their efficiency of operations. The system is still used to clamouring for concessions. But the days of providing concessions to weak and inefficient units are clearly over and banks should reorient themselves from a 'subvention' strategy to a 'survival' strategy.

8. The interest rate deregulation leads straight into the issue of the strong bank/weak bank and big bank/small bank argument and the need for succour for the afflicted banks. Since all of us represent some type of bank, it would be useful if this forum were to focus on what the overall banking strategy should be and within this how individual banks should respond to these changes. At the cost of simplifying the issue, let me outline the strategy that best suits each type of bank. If a bank is a strong giant, it is best if it concentrates on consolidation rather than growth. It would be disastrous if such a bank were to try and keep increasing its market share, for if it did, its lines of control will inevitably weaken and with deterioration of loan policies its NPA would deteriorate and ultimately affect its profit line. Thus, such a bank should concentrate on quality rather than quantity. In contrast, if a small/medium sized bank is strong, it would have a potential for growing faster than the system and if it maintains or improves its credit management then it could grow to an optimum size where its rate of return would improve with well planned growth. For a relatively small weak bank it would be best for it to identify its areas of strength and the solution could well be to concentrate on regions of strength and/or slow down in areas where it is weak and yet preponderant. While mergers are more easily said than done, they are not beyond the realms of reality. The most difficult case is the weak giant which has wide geographic spread, poor lines of control and is too large to be merged; in these cases a damage containment approach would be to drastically reduce the pace of growth of such banks. Ultimately in the restructuring process we need to realise that there is no *deus ex machina* which can easily resolve

hard problems. We should, therefore, not look for gimmicks and subventions to resolve the problem of such banks.

9. Before I conclude, I would like to briefly touch upon the role of the RBI nominee director. As you are no doubt aware, there is a viewpoint expressed in the Narasimham Committee report that there is a conflict of interest as the Reserve Bank is a regulator and that the Reserve Bank nominee director should no longer be on the bank boards. Another view is that the RBI nominee director plays a useful role and should continue on the bank boards. There is much merit on both sides of the issue and it would be necessary to carefully view the pros and cons. While the role of the RBI nominee director in a strongly regulated system was clear, the role in a liberalised deregulated regime is less clear. While it is important that the nominee director should not be a supervisor, it is often difficult to delineate the role of the RBI nominee as supervisor and the RBI nominee as a member of a bank board. My own **personal** preference is that the RBI should not have a nominee on the bank boards but this is a debatable issue and we could usefully discuss this in the course of this session. I wish your deliberations all success.