SPEECH

FINANCIAL SECTOR REFORMS AND BANKING INDUSTRY*

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I am delighted that State Bank of Patiala is celebrating its Platinum Jubilee. From a single branch princely state bank, the State Bank of Patiala has come a long way and gained eminence as a bank with potential and progressive outlook. Its performance parameters have been strong. The Bank has been constantly working out schemes to expand its activities, to enhance resource mobilisation and identify business potential in the areas of its operations. I wish to congratulate all those responsible for this creditable and commendable progress.

Punjab is witnessing significant changes after a decade long nightmare. The industrial and economic prospects are once again looking up and there is a new hope. Despite what Punjab has gone through in the last few years, the achievements on the economic side are impressive. The compounded annual growth rate of Punjab in the second half of the eighties was 6.2 per cent compared with the all-India figure of 5.6 per cent. Foodgrains production in Punjab accounts for 11 per cent of all-India production. With peace returning to Punjab, we all hope that the people of the State will rededicate themselves, build upon their strengths and usher in a period of sustained economic growth for the State and the country.

Financial Sector Reforms and the Banking Sector

The country has embarked upon a massive programme of stabilisation and structural reforms as a part of the new economic policy. Financial sector reforms are an important component of this process. The reforms aim at making the financial sector more viable and more efficient. The major policy thrust is to improve the operational and allocative efficiency of the system, by reducing many of the exogenous and structural factors affecting the performance of banks and financial institutions. In the emerging environment only those banks can expect to grow strongly which can understand the current evolution of the banking business. Someone has even gone to the extent of calling modern banking, marked by a changing and competitive environment as "Darwinian Banking," in which only the fittest will survive. Banks and financial institutions are therefore expected to develop fast adequate dynamics to meet the new challenges and avail of the emerging opportunities. It is however important to note that 'bigness' is not synonymous with success. Small and medium size banks can also compete effectively and succeed, if appropriate niche strategies are adopted.

The agenda of financial sector reform is clear. Easing of external constraints, such as, administered structure of interest rates and reserve requirements for banks, exploring indirect monetary control instruments, prescribing prudential regulations and norms, strengthening the supervisory apparatus, and facilitating the entry of new institutions are the major elements of the reform programme.

The major objective of monetary and credit policy in the recent period has been to enlarge the availability of credit while bearing in mind the general need to contain inflationary pressures. Measures have been undertaken to ensure that genuine credit requirements of the productive sectors of the economy including agriculture, large and small scale industries and the export sectors are fully met. The policy thrust has been to simultaneoulsy expand the lendable resources of banks and entitlements of borrowers to borrow

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from banks. Significant moves have been made towards interest rate liberalisation and rationalisation. There has been a considerable reduction in concessional slabs, and a sizeable reduction in the element of cross-subsidisation. Rates on Government securities have gone up and they are now sold in auction at rates which are much higher than the fixed coupon rates which existed earlier.

Legislative changes are also being contemplated to strengthen the legal framework supporting the financial sector. To improve loan collections, the Government is proposing to set up tribunals to hasten recovery of bank overdues which bear upon the banks' financial viability. Health and soundness of the banks' is being ensured through an aggressive recapitalisation programme. In the 1993-94 budget, the Government has clearly recognised the need to re-capitalise banks and made a provision for contributing Rs. 5,700 crores towards the capital of public sector banks.

The success of these policy efforts, however, lies in our ability to assemble the required blend of public policies and private actions in order to find sustainable solutions to some of the structural problems of the Indian financial system. The banks in this changing scenario have to respond at the firm level by bringing about discernible changes in their productivity and efficiency patterns. The collectivity of this process will ensure improvement of the productivity and efficiency of the entire financial system.

Our financial system today consists of a vast network of banks and financial institutions offering a wide range of products and services. Banking and other financial facilities have over the last three decades come to be extended over a large cross section of the people and this is a significant achievement of the banking sector. Despite the overall progress and an impressive list of past achievements, concerns are being expressed about the operational efficiency of the system and whether banks will successfully face the competitive pressures.

The policy direction and objective are now well set. While ensuring a balance between structural continuity and structural change, the effort is towards accelerating the overall growth which is the best solution to many of the social and economic problems of India. The very objective of the reforms is to create an environment in which banks will be compelled to improve productivity and reduce costs so that they can act as autonomous business units fully responsible for their performance. In a highly protected environment, there is no incentive to cut costs. The initiative to adapt and improve technology or to adopt new management practices also dries up. The financial sector reforms seeks to change this regime.

Profitability of Indian Banks

Policy changes themselves do not provide the total answer to improving productivity. They may be a necessary condition, but they are not sufficient. The very fact that some banks are more efficient and profitable than others even in the same operating environment indicates that policy changes themselves may not be adequate. Banks need to react appropriately. Ultimately an efficient financial structure can be built up only if the banks provide the necessary response.

Among the major variables bearing upon the banks' profitability and efficiency are, the interest margin, loan quality and overheads. Worldwide, it is recognised, that the best route to higher earnings is through improvement of the management of net interest margins. Net interest margin is the engine which drives the bank's earnings and is fundamental to its long term growth. A good ratio reflects effective deployment of earning assets, a judicious mix of liabilities and good yields. Besides net-interest margin management, it is the control of non-interest expenses which has now become increasingly important to bank managements. This appears to be particularly true in the case of public sector banks in India.

The net interest margin of public sector banks for the year 1991-92, was 3.47 per cent of the average working funds, while the relative figure for all scheduled commercial banks was 3.59 per cent. However, establishment and other costs have been exceptionally high. The employee compensation and other operating costs for public sector banks worked out to 1.95 per cent and 0.86 per cent of the average working funds, respectively. As a result, the surplus from the interest income was quite small, being 0.66 per cent of the average working funds for public sector banks. After taking into account income other than interest and allowing for provisions and contingencies, the net profit works out to 0.29 per cent of the working funds. However, the average figures hide a wide degree of variation among banks with respect to the various parameters. Thus, the fact that banks working more or less in the same environment and under the same set of policies have shown considerably different results indicates that substantial opportunities exist for several banks to improve their profitability and returns.

The reasons for such significant variations lie in the quality of liability management and funds management and the quality of major items of assets such as, advances. The level of non-performing assets and incidence of bad debts vary significantly. Employee productivity levels and rising operating costs, compound the problem further. Significantly, the variations in the performance parameters are not related to the size of branch network and size of business of the bank. The variations are clearly noticeable as between banks of comparable size whether at the lower or upper end of business.

Commitment to Improve Productivity and Efficiency

The key to successfully facing the new environment therefore lies in the banks improving their productivity and efficiency. This philosophy has to permeate all areas of banking operations. The concept of productivity which is normally associated with manufacturing industries applies equally to the services sector like banking. Financial services constitute an important part of the nation's infrastructure required for rapid industrial and agricultural development. The improved functioning of the banking sector therefore is a necessary pre-requisite for the overall improvement of the economy. Banks must find new ways and methods to respond adequately to the positive changes being ushered in by the financial sector reforms. The spirit of enterprise in the banking industry must rise to the occasion. Fears of adjustment must be replaced by a commitment to seek out new opportunities and excel.

Viability and sustainability of every bank must be improved. Banks must become efficiency conscious and focus on balancing profitability with liquidity, while also servicing the necessary socio-economic objectives of our development efforts. Strategies must be adopted which generate additional revenues, reduce operating costs and result in increased operational effectiveness. Detailed business plans at individual unit levels must be drawn up and a machinery put in place to constantly review and monitor the implementation of these plans. The thrust of these plans should be to attack low profitability and the high and growing non-performing assets so that rate of growth of earnings is accelerated. Greater emphasis should be laid on the quality of operations. Functional efficiency must be improved through soundness of appraisals, and the quality and speed of delivery of services. Management of maturity mismatches and interest mismatches and management of risks should be given due emphasis. Old practices and standards must be improved upon and banks should reorient their focus to risk-related considerations and costs of poor lending and investment decisions. Appropriate micro-level planning by banks also becomes important in view of the specific commitments banks are now required to make in view of the proposed capital contribution of Rs. 5,700 crores made by the government recently in order to strengthen banks on a durable basis.

Customer satisfaction should figure as a key factor in any action programme. The competition for customers specially, good customers, is likely to intensify. Banks which develop the best products and delivery systems are likely to win most of the battles for customers. In the Porter framework, these battles can be viewed as competitive struggle models. According to Michael Porter, the key structural features of industries that determine the strength of the competitive forces and hence industry profitability are (i) threat of entry (ii) intensity of rivalry among existing competitors, (iii) pressure from substitute products (iv) bargaining power of buyers and (v) bargaining power of suppliers. In the context of the Indian market, the first three factors are undergoing a massive change consequent to the various financial sector reform measures, including the guidelines for the entry of private sector banks. Banks will have to continually reassess the effects of these industry structure changes on customers and financial products and services. For example, successful technology and financial product strategies might introduce competition into the banks' existing markets and threaten their market share. Items (iv) and (v) i. e. the bargaining power of buyers and the bargaining power of suppliers, in general, can be interpreted as the combined bargaining power of customers. Banks must therefore maintain a customer-oriented strategic perspective to become leaders in the financial services arena. A pervasive vision of service excellence is a powerful source of competitive strength.

The banking system is on the threshold of far reaching changes. The emphasis on efficiency is not divorced from considerations of equity. Banks and term lending institutions are legitimate instruments of social and economic change. However, their ability to respond to certain socio-economic concerns will depend on their overall performance. The productive sectors need for their successful functioning an efficiently operating banking system which while transferring funds from the surplus units to deficit units will do so at minimal operating costs. If banks become high cost units, they have an impact on the rest of the system. Hence the compulsion to cut costs, improve productivity and show better profitability and this will have to become the mission of the banking system in the coming years.