SPEECH

ISSUES IN COMMERCIAL BANKING REFORM*

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Since the nationalisation of the major banks in 1969 the commercial banking system has undergone a metamorphic change with a scorching pace of expansion. The number of commercial bank branches rose from a little less than 8,300 in June 1969 to a little over 60,500 in March 1992. Over the years, the pressures to garner resources for the Plan and the need to contain inflationary pressures resulted in an inexorable increase in reserve requirements to quite clearly unsustainable levels. As part of a conscious policy to reorient credit flows, priority sector allocations became a large segment of the lendable resources of banks. With the wider geographical coverage, lines of control lengthened and were generally attenuated, while lending to risk prone areas increased significantly resulting in a deterioration in the quality of assets. As of March 31, 1992, the aggregate non-performing advances (i.e., those classified under Health Codes 4-8) of all public sector banks formed about 14.5 per cent of total bank credit. From the mid 1980's increasing concerns have been expressed regarding the deterioration of the banking system and it was in this context that there has been a slowing down of the pace of branch expansion and the emphasis has been on consolidation of the system. While the Indian banking industry has been going through a very difficult transition, hopefully its current problems have peaked and, with determined reforms in place, it would be reasonable to expect a continuing improvement in the years to come.

The year 1991-92 was in a sense a watershed as it signalled the emergence of a coherent programme of financial sector reform with the Narasimham Committee Report providing a comprehensive reference document for implementation of the reform programme. While the recommendations of the Narasimham Committee are well known, it would perhaps be useful to focus attention on some of the major issues which have implications for the commercial banks. There is a need for a cohesive strategy of financial sector reform as invariably there is a general skepticism that the reform process may not be durable. In this context it is necessary to have a broad understanding of the inter-linkages of various segments in the reform process. This Seminar is an opportunity to assess the reform process from the view point of commercial banks.

Prudential Norms

The Narasimham Committee recommended the introduction of capital adequacy norms, prudential norms for income recognition, asset classification and provisioning for bad debts and all these have been introduced by the Reserve Bank of India with some modifications. Based on tentative estimates made by the Reserve Bank, it would appear that the provisioning requirements would be around Rs. 10,000 crore. There would also be a need for additional resources to meet capital adequacy requirements. As such, the total resources required by the nationalised banks and the State Bank Group could be close to Rs. 14,000 crore; of this, banks may be able to provide about Rs. 4,000 crore by generating surplus funds over the next two years and about Rs. 10,000 crore would be required by the system as additional resources. To the extent that there is future growth of business, additional provisioning would be required.

Prima facie the dimensions of the financing problem appear staggering; however, it may be useful to discuss some possible modalities which would reveal that although the problem is large it is not unmanageable. The overall financing could take various forms: there could be access to the capital market directly and also capital could be subscribed by bank employees and there could be cross holdings of equity between public sector units and public sector banks. The Government being the owner of the nationalised banks would also need to assess the burden which

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could devolve on the Government budget and in this context it would be relevant to consider the possibilities of obtaining resources from the multilateral agencies. The budgetary support had best be of a nature which does not result in an increase in monetisation. In fact the budgetary support could well have the stipulation that the banks in turn invest these funds in Government securities which are not eligible assets for the statutory liquidity ratio. As such, there would not be any cash outgo from the budget, other than interest payments and, of course, over the longer run, the amortisation of bonds.

The recapitalisation issue will necessarily have to be tackled on a bank by bank basis. Some banks will be able to immediately access the capital market while others will be able to raise capital from the market after some assistance for an asset clean up. There would, however, be some banks which would not be able to approach the capital market in the foreseeable future and it is essentially for such banks that a modified asset reconstruction scheme would need to be worked out.

Asset Reconstruction Fund

While the Narasimham Committee recommended the setting up of an Asset Reconstruction Fund (ARF) to take over bad and doubtful debts off the balance sheets of banks and financial institutions, before implementing such a scheme, it would be necessary to be clear about the sources of funding and the impact of such a scheme on the recovery climate. The Committee's recommendations on the setting up of Special Recovery Tribunals, when implemented, would enable speedy enforcement of banks' claims. It is recognised that the introduction of an ARF, combined with prudential requirements will, as a consequence, necessitate a large injection of funds. If these capital requirements are to be met by the Government or the Reserve Bank, it may imply a large monetisation with obvious deleterious effects on the economy. Thus, the strategy for raising fresh capital by banks needs to be carefully worked out. An ARF poses the problem of moral hazard of lenders being distanced from the recovery process and this may not provide for the most efficient procedure for recovery; furthermore, such a fund could give rise to an erosion of accountability as a climate could get generated with expectations of a repetition of such waivers in the future. A limited ARF could, however, be considered for the smaller weak banks, which are unlikely to be able to access the capital market, provided the alternatives of merger are ruled out and the modalities of avoiding a repetition of the bad lending scenario are worked out. These banks could be provided the facility of the bad debts being taken over at face value but this should be strictly conditional on major adjustments being made by them in terms of drastic changes in their management sacrifices by the staff, control on the growth of assets and, above all, an increase in productivity and all this would need to be clearly spelt out in a Memorandum of Understanding which would need to be closely monitored on an on-going basis. Issues remaining to be solved are the management of such ARFs and their ability to recover more efficiently than the banks. Once, such aspects are resolved, a limited approach to ARFs may be considered. The ARF route should be the option available to only those banks which cannot undertake the adjustments through recourse to other options. To ensure against some of the problems raised here, the ARF could be modified to ensure that the bank has an abiding interest in the recovery process. Under the modified ARF, the bank could be made responsible for recovery and could even have an incentive by being given a share of the recovery proceeds. The recovery proceeds could be used to at least partly provide for the redemption of the bonds. Considered expert advice on this subject is that cash injections under these circumstances would not be prudent. Cleaning up of the books of banks always carries the risk that, after the process banks would continue to take imprudent risks in the expectation of a bail out. In this context it is best to emphasise the need for a hard budget constraint to prevent the books of banks from being 'dirtied' again.

Impact on Banks of Reduced Reserve Requirements and an Active Government Securities Market

In 1991-92, the reserve requirements had reached an unsustainable level of 63.5 per cent on an incremental basis which, if continued,

would have had a serious effect on banks' viability. While the deleterious effects of very high reserve requirements are well understood, it is important to note that any precipitous reduction in such requirements would result in a total loss of monetary control with consequent inflationary implications, thereby jeopardising the reform process. The pace of reduction in reserve requirements in 1992-93 is not easily comprehended. This is best assessed with reference to the effective incremental reserve requirements (CRR and SLR taken together) which declined from 63.5 per cent in 1991-92 to 45 per cent in the first half of 1992-93 and further to less than 25 per cent in the second half of 1992-93.

The monetary policy in 1992-93 reflects a distinct tilt away from reserve requirements and direct controls to developing open market operations in Government securities as a major instrument of monetary control. While there is a lot to be done in terms of developing a well functioning Government securities market, the direction of change is clearly towards interest rates on Government securities moving over time towards market rates. The activation of internal debt management policy and the development of a secondary market with sufficient depth to provide adequate liquidity and capital adequacy requirements would need banks to balance the advantage of high risk weighted credit *vis-a-vis* zero risk-weighted investment in Government securities. Over the next few years it could well emerge that banks will hold Government securities on their own volition rather than as captive investments under a reserve requirement prescription.

Interest Rate Structure

In regard to the regulated interest rate structure, the basic thrust of the Narasimham Committee that real interest rates should be positive and that concessive interest rates should not be the vehicle for subvention has been well accepted and a series of reform measures have been put in place: (a) considerable rationalisation has been effected in banks' lending rates with reduction in the number of concessive slabs and enhancement in some of the rates thereby reducing the element of subsidy; (b) the regulated deposit rate structure has been replaced by a single prescription setting a maximum rate for maturities of 46 days and above; (c) rates of interest on Government securities have been raised; and (d) for certain instruments such as Certificates of Deposit, Money Market Mutual Funds and Non-Resident (Non-Repatriable) Deposit Schemes the interest rates are freely determined by individual banks. There is, however, a need for further rationalisation of interest rates and, in particular it is desirable to evolve a Reserve Bank Reference Rate of Interest which could then be the basis for determining the entire gamut of interest rates. Such a Reference Rate to be effective has to earn its place in the market and can develop as a pivotal rate in the system only over time. While these measures need to be persevered with, there is need for a cautious step-by-step approach rather than a rapid deregulation of all interest rates in the system. The experience in a number of countries has been that too rapid a deregulation of interest rates can be destabilising — something which the Indian banking system can ill-afford at this stage.

Priority Sector Lending

The question of priority sector credit has been under discussion for quite sometime. It is often erroneously argued that the problem of the commercial banks has been the large priority sector credit, which apart from involving high cost of servicing is afflicted by poor recovery. There is little evidence to show that recovery is any better in the case of larger loans than smaller loans. Small-scale industry and agriculture account for a significant part of national output and it would not be appropriate to starve these sectors of credit. While ensuring that the genuine credit requirements of the priority sector are fully met, a policy of a fixed proportion of total credit to a particular sector does not commend itself in the context of substantive reductions in the incremental reserve requirements. This can be explained by way of an illustration. When the incremental reserve requirements were 63.5 per cent, a 40 per cent priority sector allocation implied that 14.6 per cent of incremental deposits

were available for the priority sector. If the effective incremental reserve requirements, are say, 25 per cent then even a 30 per cent priority sector allocation on an incremental basis would mean that 22.5 per cent of incremental deposits are available for the priority sector. Thus, with substantive reserve requirement changes it is necessary to review the incremental priority sector allocation. While there is a case for reviewing the targets for priority sector lending, it must be stressed that some directed credit is imperative in the development process.

Rural Credit

A sharper thrust on agricultural production that is sought to be achieved by various policy measures and institutional changes would concomitantly necessitate expansion and diversification in the operations of agricultural credit delivery agencies with the cbjective of improving the quality of rural lending. A basic prerequisite for a successful financial sector reform is that the rural credit delivery system, which has developed serious problems in the recent period, is revamped and an enduring institutional structure put in place. While the question of imparting viability to the rural credit structure has engaged the attention of various Committees, a viable structure has yet to be evolved. It is imperative to devise a rural credit delivery system which will not require large subvention. In this context, better alignment of interest rates and mix of target and non-target lending would need to be given attention. There are also various other areas where the rural credit delivery system is quite clearly unsatisfactory and it is imperative that early measures are taken to bring about an enduring improvement.

Role of Private Sector Banks

The Narasimham Committee envisaged a larger role for private sector banks. While, at present, there is no legal ban on entry of new private sector banks, in practice no new private banks have been licensed. The time is now apposite to consider allowing a few new private sector banks so as to generate an element of competition. In this context, a number of issues need to be considered. In the case of new private sector banks it would be desirable to set a sufficiently high minumum start-up capital so as to ensure that the banks have inherent strength and the capital risk-assets ratio and prudential norms must be observed from the inception. The question of level-playing fields in areas such as rural branches and priority sector credit needs to be addressed. Issues relating to limits on concentration of shareholding by individuals/groups and limits on voting power also need to be considered. The issue has also arisen as to whether financial companies should be allowed to set up banks and in such cases the question of cross-shareholdings and cross-directorships need to be given attention. Important aspects that need to be considered include the question of controlling groups lending money through the banks to projects owned or managed by them. Commingling of industrial groups and banks can lead to concentration of economic power, which was one of the objects of nationalisation of banking, to avoid. The various issues involved in the subject of opening up private banks need to be examined in depth and it is itself a subject which deserves a separate seminar.

Supervision of Commercial Banks

As the regulatory and supervisory roles have been intertwined the conceptual differences have often been blurred. The emphasis in the recent period has been to clearly delineate supervision from regulation. Regulation is codification of sound principles, norms and practices, while supervision is a means of ensuring banks' compliance with the regulations. While effective supervision can minimise the need for regulation, supervision cannot be substituted merely by more intensive regulation. Herein lies the role of an effective supervisory system. In the process of reforms, the system would have to cope with new risks and therefore a more sophisticated supervisory system will be required. In fact, a strengthened supervisory system constitutes an essential prerequisite for the success of the reform process. As the volume, value and complexity of banking transactions increase, new linkages and interdependencies between markets and institutions will be introduced, carrying greater and varied problems and, in this scenario, the role

of prudential supervision becomes critical. The supervisory focus would need to be on the well-being and safety of the system as a whole. Emphasis should be less on mere routine scrutiny or verification of compliance with various guidelines and directives and greater emphasis will need to be placed on prudential internal control and risk assessment systems within banks. Supervision would need to be based on expeditious on-site inspections as well as off-site assessments. Supervisors should adequately evaluate credit quality and standards, operating procedures and other aspects of banking, which are essential to the sound operations of a bank without getting involved in the minutiae of banks operations. Strengthening of supervisory policies and practices should constitute an important part of the financial reform agenda. These supervisory policies and practices should be combined with a regulatory framework which rewards prudent operations and expeditiously detects and penalises imprudent practices. While strengthening the supervisory function, it is necessary to avoid excessive supervisory and regulatory burdens on the banks. It is important to note that supervision cannot be a substitute for prudent bank management. A strengthened supervisory system must go along with an equally improved system of banks' own internal controls. Supervisory burden will be minimal and yet most effective, if supervision is viewed as a back-up support system for the banking industry. Again, while a certain degree of regulation is desirable and necessary, there is a need for an on-going review of regulations to ensure that the burden on banks of the regulatory system is not excessive; moreover, there is a need for purposeful regulation rather than a mere carry over of a historical past which may no longer be relevant. In the ultimate analysis, the burden of excessive regulation or the absence of relevant regulation is borne by the bank customers.

An Overall Assessment of Commercial Banks' Reform

While concluding, it would be useful to bring together these broad strands in the reform process as it affects commercial banks. With strong prudential norms in place, banks would be required to be transparent in their operations and would hopefully be required to assess risks more carefully than hitherto. This would, it is expected, result in a significant improvement in the quality of banks' assets. While the resource requirements of banks to meet the capital adequacy and provisioning for bad debts would be very large, it needs to be stressed that greater transparency by itself in no way results in a deterioration in the solvency of banks, if at all a sharper focus on these issues would work towards an improvement in the banks' overall position. In other words the move towards implementing stricter prudential norms should in no way cause anxiety to depositors as to the safety of their deposits; on the contrary, all these measures would protect depositors' interests. With reduced reserve requirements, improved rates of returns on investments in Government securities and the proper reckoning of risks in credit, banks would on their own evolve an appropriate admixture of bank credit and investments. With the gradual reduction in interest rate prescriptions, banks would only look to the monetary authorities for signals and would have to take on a greater degree of responsibility in the interest rate determination process. Finally, in a rapidly changing environment, the supervision of commercial banks and their own internal control mechanisms will need to be strengthened. The regulatory burden needs to be so framed that it is eased for those banks which fully conform to the various parameters set out by the regulatory system. The overall pace of deregulation and its sequencing is also a matter of importance as too rapid and abrupt deregulation could result in an avoidable upheaval. In this context, the modulation of the pace of reform is sometimes as important as the reform itself.