SPEECH

BANKING SECTOR REFORM*

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It is a great pleasure for me to be here at this Sixteenth Annual Conference of Bank Economists. I must thank the host — The Saraswat Cooperative Bank Limited — for asking me to deliver the inaugural address.

I have interacted with you before in this forum, but today we are meeting, perhaps, at the most challenging time for bankers in India. The theme of the conference is of critical importance as we are in the midst of the process of stabilising the Indian economy and simultaneously undertaking measures to bring about structural adjustments in order to achieve better macro economic balance and sustainable economic growth.

Many of you are aware of my views on issues of financial liberalisation and reform. However, let me confess that since assuming office of the Governor of the Reserve Bank of India, I am realising, more than ever before, what it will take from all of us to make the process of structural and financial reforms a success. The task is enormous. Our collective goal is to create a smoothly functioning banking machinery, based on the principles of sound banking. Such a system is needed to effectively manage the financial requirements of the economy and to perform functions essential for a modern economy such as the payments arrangements.

While policy has to play an important role in helping to shape an appropriate environment for banks to work within, it has also to take care not to stultify the spirit of innovation in the financial sector. Ultimately, however, it is in an institution's own hands that its future lies.

I know that you have been discussing the various issues relating to the performance of banks in your annual conferences. However, in the process of banking sector reform, I visualise bank managements striving for higher standards in individual risk assessments, framing of business and growth plans and finding solutions to the knotty problems of raising productivity, efficiency and profitability. Needless to say bank economists can provide invaluable guidance in these areas.

Assessment of Indian Banking System

The Indian financial sector today comprises an impressive network of banks and financial institutions and a wide range of financial instruments. All the indicators of financial development have significantly increased implying the growing importance of financial institutions in the economy and growth of financial flows in relation to economic activity, both in the form of direct and indirect finance. The extent of the growth of the Indian financial system, measured in terms of the "finance ratio", which is the ratio of total financial claims to national income, shows, that the ratio, which was less than 0.05 during 1951-55 and around 0.14 in the late 1960s, rose to reach as much as 0.44 by 1989-90. The "financial interrelation ratio" which is the ratio of financial assets to physical assets has also gone up from less than 0.1 in 1951-52 to 1.18 in 1970-71 and further to 2.50 in 1989-90, indicating that the financial structure in India has grown more rapidly than the national income. As at the end of March 1991, the total financial assets of all financial institutions, including banks, amounted to Rs. 3,54,039 crores of which the scheduled banks accounted for Rs.2,22,613 crores or 62.9 per cent.

The Indian financial system is characterised by the predominance of public sector institutions and a high degree of regulation, motivated mainly by socio-economic considerations. Entry and expansion are controlled. There is an administered structure of interest rates, under which interest rates on deposits and credit are specified in detail.

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Besides there is a mandatory allocation of credit for specific sectors with varying degrees of concessionality in interest rates. Inevitably, such concessionality for some sectors pushes up the rates for those not so favoured.

The mid-1980's saw some movement away from this regulated regime. Commercial banks were permitted to undertake new activities. Several money market instruments were introduced and interest rates in the mony market were freed from control. Greater flexibility was introduced in the administered structure of interest rates, with deposit rates made positive in real terms and the lending rates structure simplified.

There is no doubt that there has been a considerable widening and deepening of the financial system in the last two decades. The extension of banking and other financial facilities to a larger cross section of the people stands out as a significant achievement. Despite the overall progress made by the financial system, there has been a growing concern about the operational efficiency of the system. Low profitability, high and growing non-performing assets and relatively low capital base continue to cause anxiety. It is estimated that in 1991-92 gross profits of scheduled commercial banks (excluding RRBs) after provisions and contingencies were no more than 0.35 per cent of working funds, as compared with 0.4 per cent in 1969. In 1991-92, the spread between interest earned and paid as a proportion of working funds was 3.3 per cent. The proportion of 'other operating expenses' to working funds in the same year was 2.06 per cent. The rate of growth of earnings has been slower than the rate of growth of business and working funds. Profitability of banks has fluctuated rather than showing any consistent trend. With the decline in the quality of loan assets (domestic non-performing advances of all public sector banks formed 14.5 per cent of their total outstanding advances) the need for provisioning has become more urgent. Several banks are in fact not in a position to make adequate provisions for doubtful debts. The capital base — the ratio of paid up capital and reserves to deposits of Indian banks — at slightly over 2 per cent in 1991-92 is much lower by international standards and, in fact, has gone down over time. The attitude thus far that with government ownership there is little to worry about the ratio has resulted in a situation where the capital -deposit ratio has been falling. Lack of proper disclosure norms has led many banks to keep the problems under cover. The financial position of the Regional Rural Banks is far worse. The balance sheet of the performance of the banking sector is thus, mixed — strong in widening credit coverage but weak as far as viability and sustainability are concerned.

The present predicament of the Indian financial system is a result of combination of factors—both internal and external. Any reform of the financial sector must address both these factors. The ulitmate objective of financial sector reform in India should be to improve the operational and allocational efficiency of the system. Even from the point of view of meeting some of the socio-economic concerns, it is necessary that the viability of the system is maintained. While the thrust of the reform is to correct many of the endogenous, exogenous and structural factors affecting bank profitability, individual banks have to become conscious of efficiency focusing on balancing profitability with liquidity and servicing the necessary socio-economic objectives of our development efforts.

External Constraints

The external factors bearing on the profitability of the banking system have centered around pre-emptions in the form of Cash Reserve Ratio and the Statutory Liquidity Ratio and the administered structure of interest rates. In India the growth of high-powered money (reserve money) has been largely the result of increases in the net RBI credit to the Government. The inability of RBI to deny or regulate credit to Government due to both legal and practical reasons has been an important factor contributing to RBI's limited control over reserve money expansion. The high levels of SLR and CRR that were in operation till the end of 1991-92 stemmed from the need to moderate monetary growth in the context of high budget deficits and their automatic monetisation. There have, however, been important changes in this area. The Central Government is committed to reduce its fiscal deficit in the current year to 5.0 per cent of GDP from 6.5 per cent in the previous year. The Government has also expressed its intention to reduce the fiscal deficit further in the coming years. As fiscal and budget deficits come down, it will be possible to reduce the CRR and SLR and thus enable banks to provide larger amount of credit at their discretion. This has already happened. Because of the changes made in these ratios, pre-emption of incremental deposits which stood at 63.5 per cent in 1991-92 came down to 45 per cent in the first half of 1992-93 and will come down further to 25 per cent in the second half of the year. This implies that in the second half of the year, almost 75 per cent of incremental deposits are available for expanding credit.

A central feature of the Indian monetary and credit system is that the interest rates are administered. In the case of commercial banks, both the deposit rates and lending rates are regulated. Until recently the rate at which corporate entities could borrow in the form of debentures was also regulated. The rate of interest on the government securities can be maintained at lower levels because commercial banks and certain other institutions are required to invest a certain proportion of their liabilities in government securities. The purpose behind an administered structure of interest rates is to enable certain preferred or priority sectors to obtain funds at concessional rates of interest. An element of cross-subsidisation gets automatically built into the system if the concessional rates provided to some sector are to be compensated by higher rates charged to other non-concessional borrowers. Regulation of lending rates leads to the regulation of the deposit rates. If the average lending rate is to be maintained at a certain level, the deposit rate has to be accordingly adjusted. Over the years, the system of administered interest rate structure became complex as the number of sectors and segments to which concessional credit is to be provided proliferated.

The last few years have seen some important reforms in relation to administered structure of interest rates. These are: (a) considerable rationalisation has been effected in banks' lending rates with reduction in the number of concessional slabs and enhancement in some of the rates, thereby reducing the element of cross-subsidisation; (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 several instruments, such as Certificate of Deposits, the interest rates are freely determined by individual banks.

The broad outlines of the reform agenda in terms of the interest rate, as far as India is concerned, are quite clear. At least initially, from an elaborate administered structure of interest rates, we should move towards a more simplified system where only a few rates are specified. The Committee to review the Working of the Monetary System (1985) focused on three rates: (i) The maximum deposit rate; (ii) The minimum lending rate; and (iii) One concessional rate below the minimum lending rate. This may be a model towards which one can work.

Structural Reform of the Banking System

Even as the external constraints, such as the administered interest rates structure, reserve requirements, etc., are eased, the financial institutions must act as business units with full autonomy and transparency in operation, and by the same token, become fully responsible for their performance. There are instances of countries like France where the major banks are in the public sector but they are allowed to operate with a high degree of autonomy without any interference from Government.

The need for stringent prudential regulations in a more deregulated environment has already become apparent in many countries. The elements of prudential regulation are also well known. However, two aspects of prudential regulation which have assumed greater importance in the recent period relate to capital adequacy and provisioning. The Indian banking system, until recently, has been slack in relation to both these aspects. Capital adequacy did not perhaps receive adequate emphasis because of the false assumption that banks and financial institutions owned by Government cannot fail or cannot run into problems.

With major Indian banks now having branches operating in important money market centres of the world, this question can no longer be ignored. That apart, even banks operating domestically need to build an adequate capital base. The Bank for International Settlements has prescribed the norm for capital adequacy at 8 per cent of the risk-weighted assets. While there can be some variations in assigning weights to the various classes of assets in the Indian context, broadly speaking, the need for Indian banks to achieve the internationally accepted standards is absolutely essential. Obviously, this has to be a phased programme since the capital required to reach the desired level is quite large. What has been said about banks holds good in relation to term-lending institutions as well as other financial institutions. Whether they be leasing companies or hire purchase companies or investment companies, prescription of appropriate capital requirements is a must since capital is the last line of protection for all depositors.

Another important aspect of prudential regulations relates to adequate provisioning for bad and doubtful debts. If the profits of banks and other financial institutions are to be a true reflection of their functioning, loan losses must be adequately provided for. Both in relation to banks and the term-lending institutions, prescription of uniform accounting practices relating to income recognition and provisioning against doubtful debts has become imperative.

It is in this context that Reserve Bank introduced in April 1992 a capital risk-weighted asset ratio system for banks (including foreign banks) in India as a capital adequacy measure. Indian banks which have branches abroad will have to achieve the norm of 8 per cent as early as possible and in any case by March 31, 1994. Foreign banks operating in India will have to achieve this norm by March 31, 1993. Other banks will have to achieve a capital adequacy norm of 4 per cent by March 31, 1993 (Tier I or core capital having been set at not less than 50 per cent of total capital) and the 8 per cent norm by March 31, 1996. The total of Tier II elements will be limited to a maximum of 100 per cent of total of Tier I elements for the purpose of compliance with the norms. Banks have been advised to review the existing level of capital funds vis-a-vis the prescribed level and plan to increase funds in a phased manner to achieve the prescribed ratio by the end of the period stipulated.

The implementation of the norms for asset classification and income recognition introduces transparency in the profit and loss statements and balance sheets of commercial banks. Such a transparency has three distinct effects. To begin with, there is the liquidity effect. Where a bank does not really receive interest and is merely capitalising it in the borrower's account there is less of flexibility. In particular, the bank loses the opportunity to redeploy the income stream for a better purpose. Secondly, there is an effect on bank profitability. Unrealised interest receipts, when booked as income, cannot just be dismissed as harmless window dressing. It has important implications. Besides the loss of credibility of the financial statements, doctored declarations of profits can accelerate the erosion of a bank's capital base through unjustified tax and dividend payments. Thirdly, there is an effect on the balance sheet of the bank since non-performing loans need to be provided for and eventually written off against capital and reserves. If adequate provision is not made against non-performing assets it will impair the bank's capital base thus reducing the protection available to depositors and creditors of the bank.

Fortunately or unfortunately, there is by now extensive experience in both developed and developing countries in the context of workout programmes for commercial banks. Considerable ingenuity in financial engineering has been devoted to the restructuring of commercial banks, particularly to meet the Tier II requirements. It is beyond the scope of this address to review all possible approaches but certain general points can be made.

In the first place, to be meaningful financial restructuring should be dovetailed to a wider programme of recoveries of bank dues. Such a programme needs to address a whole spectrum of issues for restoring viability: markets, product mix, quality of human resources, technology, cost structure and so on. Secondly, we have to examine which of the two alternatives is preferable — fresh injections of equity while leaving the doubtful assets in the books of the bank or replacing the latter with assets of better quality. The second alternative certainly reduces the encumbrances on the bank's capital and reserves. It may even improve liquidity and profitability depending on the yield and liquidity of the replacement assets. A similar approach was recommended by the Narasimham Committee when it suggested that doubtful assets of banks might be purchased by an Asset Reconstruction Fund (after being discounted to market value). It would then assume responsibility for recovery. Countries like Chile have preferred to purchase doubtful assets at par in exchange for government bonds but subject to the condition that the assets be repurchased as bank profits increased. So far as nationalised banks in India are concerned perhaps there is not much of a financial difference between topping of equity and asset exchange. The issue is more a behavioural one linked to the question of which approach is likely to maximise recovery of past loans and encourage sound credit assessment of future loans. What is, however, clear is that any such financial support should be given only against a well-designed strategic plan concurrent with legislation to speed up the recovery of collateral from delinquent debtors.

In relation to income recognition, Reserve Bank of India has instructed banks to treat an amount in respect of term loans, overdrafts and cash credit accounts, bill purchased and discounted and other accounts as "past due" when interest has not been paid 30 days from the due date. A "non-performing asset" has been defined as a credit facility in respect of which interest has remained unpaid for a period of four quarters from the date it has become "past due", during the year ending March 31, 1993, for three quarters from the date it has become "past due", during the year ending March 31, 1994 and for two quarters from the date it has become "past due", during the year ending March 31, 1995 and onwards. Banks have also been instructed that they should not charge and take to income account, interest on any non-performing assets. As compared with the existing system of eight health codes, banks are required to classify their advances into four broad groups: (i) standard assets, (ii) sub-standard assets, (iii) doubtful assets, and (iv) loss assets, by compressing the existing eight health codes. Broadly, classification of assets into these categories has to be done taking into account the degree of well-defined credit weaknesses and extent of dependence on collateral security for realisation of dues. The existing health code system of classification of assets would, however, continue as a management information tool. Banks have to make provisions on advances depending on the classification of assets ranging from 10 per cent to 100 per cent. Fifty percent of the aggregate provisioning required should be made by 31st March 1993 and balance amount of provisioning together with additional provisioning required should be made up by 31st March 1994.

Quite clearly there is a link between capital adequacy and provisioning. The criterion of capital adequacy will have to be met after ensuring that adequate provisions have been made. Thus, the task before the commercial banks in reaching capital adequacy is truly difficult. While the Government will have to come in in a strong way to provide adequate capital, some of the stronger banks may be in a position to go to the capital market to raise funds on the strength of their balance sheets. Going to the capital market will require certain legislative changes except in the case of State Bank of India, where the existing provisions only specify that the share of the RBI will not go below 55 per cent.

Closely related to prudential guidelines is supervision. A strong system of supervision becomes necessary in order to ensure that the prudential regulations are followed faithfully by financial institutions. As the financial sector grows, it is quite possible to have different agencies supervising different segments of the market and institutions. In this background two issues arise. One relates to the co-ordination among supervisory agencies and the other regarding consolidated supervision. Financial institutions no longer operate in one segment of the market. Under the circumstances, the segmentation of the market for regulatory purposes can run into a number of difficulties. Apart from multiple authorities exercising control over one institution, differing prescriptions by different authorities can also lead to inconsistencies and conflicts. It is in this context that the concept of 'lead regulator' has emerged under which one authority is recognised as a primary regulator in relation to one type of institution. "Consolidated supervision" is also a related issue. With the entry of banks into a number of activities such as investment banking and merchant banking it is being stressed that the official oversight must be predicated on the principle of consolidated supervision. This will, in fact, mean looking at the entire gamut of activities of a bank and its affiliates so as to ensure that all their operations are conducted prudentially. It is some times argued that so long as the different functions are performed by separate entities there is no need for consolidated supervision. Some regard "fire walls", which is a term used for corporate separateness, as a substitute for consolidated supervision. "Fire walls" serve a useful purpose. They help guard against conflict of interests. They may also prevent the safety net facility from being abused. Corporate separateness may, however, not be of much use in times of crises. As the President of the Federal Reserve Bank of New York remarked: "when the temperature goes up, the fire wall stands to melt". A supervisory oversight of all institutions forming part of a single group may be necessary and useful.

Reform of supervisory practices can be effective and successful, if supervision is viewed as a backup support system for the banking industry. Banking supervision cannot be a substitute for prudent bank management. A strengthened supervisory system must be accompanied by an equally improved system of bank's own internal control. The first line of defence against financial distress and banking crisis is the quality and character of management within the bank. Strengthening of supervision policies and a vigilant internal control system together can ensure protection of the safety and soundness of the banking system and reduction of systemic risks.

While there exists a convergence of views on the goals of bank supervision, i.e., to promote a safe, stable and efficient financial system, supervisory structures vary across the world. Broadly, there are three approaches (i) separation between regulatory and supervisory bodies, like in Germany, (ii) regulatory and supervisory functions under the same agency such as in UK, USA and India and (iii) separate regulatory and supervisory institutions working in close co-ordination, such as, in France with on-site inspections carried out by the officials of the Central Bank.

In India's case, despite the recent events which have exposed the weaknesses of the existing supervisory system, I do not think we need to 'reinvent the supervisory wheel'. What is perhaps needed is the strengthening of the system in terms of supervisory policies, focus and skills. While retaining the strength of the central monetary authority, the revamped system of supervision should be able to devote exclusivity to the area of supervision and provide effective supervision in an integrated manner. Emphasis should be on compliance with various guidelines and directives as well as on prudential internal control and risk assessment systems within the different constituents of the financial system, viz., banks, financial institutions and non-banking financial intermediaries. Supervision should be based on expeditious on-site inspections as well as off-site assessments. The information and reporting systems will have to improve.

Government and RBI are working towards determining an optimal model for supervision of the Indian financial system. A model, which is under active consideration, envisages the setting up of a Supervisory Board within RBI which would attend exclusively to supervisory functions. The board can have powers to ensure implementation of regulations in the areas of credit management, asset classification, income recognition, provisioning, capital adequacy and treasury operations. Such a supervisory structure along with concomitant shifts in supervisory focus and policies could constitute a major step towards strengthening the institutional foundation of prudential regulation and supervision of the Indian financial system.

Two questions arise in relation to financial sector reform. The first relates to the implications of recent revelations with respect to gross irregularities in the securities operations for financial sector reform. The second question is whether the scheme of financial sector reform as adumbrated by the Government lacks social content. Scams occur in various types of situations. The only way to avoid scams is really to see that when a scam occurs the guilty are found out quickly and punished adequately and the system appropriately improved. The irregularities that have surfaced have caused a great public concern and, as the central regulatory authority, RBI has initiated several steps to fully comprehend the magnitude and dimension of the irregularities and follow up by taking several remedial actions to prevent the recurrence of similar lapses in the future. What has been revealed are gross violations of the guidelines issued by the Reserve Bank of India. Recent events have clearly underscored the need for a supervisory system that is efficient and prompt. But these events do not take away the need for banking sector reform aimed at improving the viability of the banks and at the same time ensuring their accountability. Banks should become both autonomous and accountable.

As regards the social content, it is not the contention of anybody that the special needs of the various sectors of the economy should not be adequately taken care of by the financial institutions. Banks and term-lending institutions are legitimate instruments of social and economic change. In fact during the 80's priority sector credit as a proportion of total net bank credit increased even beyond the stipulated 40 per cent. What is stressed is only that social responsibility must be balanced with the needs to ensure the viability of the financial institutions.

RBI's recent guidelines for the entry of new privately-owned domestic banks are aimed at fostering a healthy and competitive banking system. For well over two decades, after the nationalisation of 14 larger banks in 1969, no banks have been allowed to be set up in the private sector. Progressively, over this period, the public sector banks have expanded their branch network considerably and catered to the socio-economic needs of large masses of the population, especially the weaker sections and those in the rural areas. The public sector banks have now 91 per cent of the total bank branches and handle 86 per cent of the total banking business in the country. While acknowledging the importance and the role of pulbic sector banks, there is increasing recognition of the need to introduce greater competition, which can lead to higher productivity and efficiency of the banking system. Thus our financial system will now have room for both public and private sector banks, subserving the underlying goals of the financial sector reform. The guidelines aim at ensuring that the new entrants are financially viable. They also lay down norms to prevent concentration of credit, monopolisation of economic power and cross-holding with industrial groups. These are provisions that already form part of the Banking Regulation Act. The minimum paid-up capital of Rs. 100 crore, together with the 8 per cent capital adequacy ratio, will ensure entry of those who can lend strength to the financial system. With these stipulations, these banks can have a risk asset base of Rs. 1200 crore, which will accelerate the overall rate of growth of the banking industry. Insistence on the new private sector banks meeting the priority sector lending targets and other social obligations is in keeping with the principle of creating a level playing field for all banks. However, in recognition of the fact that new entrants may require some time to lend to all categories of the priority sector, modifications in the composition of the priority sector lending will be considered by RBI. Our expectation is that the entry of new banks will exert some degree of competitive pressure on the existing banks and lead to higher productivity and efficiency of the banking system as a whole.

Even as steps are being taken to improve the system in general, functional efficiency which is also an endogenous factor will require greater attention. Functional efficiency relates to the main economic functions of the financial sector, viz., administering the payments mechanism and intermediating between savers and investors. Banks must assess functional efficiency in terms of soundness of appraisals, resource cost of specific operations and the quality and speed of delivery of services. While it is true that the determinants of functional efficiency are the market structure and the regulatory framework within which a bank operates, easing of the external constraints must bring about commensurate changes in the approach of individual banks in their commitment to improve their functional efficiency.