BANKING AND PROFITABILITY

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I am happy to be here once again at the Bank Economists' Conference. It is indeed a befitting tribute to the Vysya Bank in its Diamond Jubilee Year to be the first private sector bank hosting the Meet. I am sure you have had useful deliberations on the subject of improving bank profitability. As the session draws to a close, I will leave you with a few observations. I would like to spend a few minutes first, though, on the banking scenario abroad, for the basic issues and dilemmas are not without relevance to us here.

The Current Banking Scenario in Developed Countries

The 1980s have seen increasing globalisation and integration of financial markets. These developments have been aided by rapid technological advances and deregulation of domestic markets. The globalisation of capital markets and the phenomenal expansion of the financial sector have led to increased competition, lower costs of financial intermediation and a more rapid spread of innovations. This process has not, however, been without strains. Intense competitive pressures have resulted in declining profit margins, overcapacity and the demise of less viable securities firms. Volatility and risk seem to have increased and financial markets may even be more vulnerable now to systemic risk.

The banking industry too has come under pressure. Banks in the USA, UK, Japan, Australia and some European countries such as France are facing a squeeze in profitability and a deterioration in the quality of their assets. Although not as devastating as the thrifts crisis, many banks in the US are in difficulties; the UK domestic banking market is considered to be undergoing its most severe crunch since 1982; the profits of Japan's biggest banks have fallen by an average of 40 per cent in 1990; in Australia many banks that offered retail-banking services have been hit by a series of corporate collapses; in France leading banks have recorded a marked decline in earnings and an increase in provisioning for defaulting corporate and consumer loans (the latter because of the ending of credit controls and new legislation rescheduling individuals's debt). In the US, UK and Japan, the increased exposure to real estate and highly leveraged transactions indicate a still greater risk of decline.

The US Congressional Budget Office has estimated that there could be between 600 and 700 bank failures by 1993, costing the federal system of deposit insurance over $ 20 billion, well beyond the funds it has. This cost would be in addition to the heavy burden to the government of at least $ 150 billion that the bail-out of the savings and loan is now expected to cost.

While the circumstances differ across countries, there have been similar compulsions. Fierce competition to maintain or improve upon market share and rising cost of funds have led to narrower margins, driving many banks into riskier assets. Japanese banks, in particular, relied on volume growth to offset the narrow margins on which they operated. Their rapid expansion in the 1980s, supported by low cost of funds and a soaring stock market, led them to extend and diversify their client base. In the US, the generous system of deposit insurance has come in for criticism, as being responsible for encouraging greater risk-taking and providing an insulation from market discipline.

Deregulation of financial markets has not been an unmixed blessing either for banks. Deregulation of interest rates at a time when market rates are high has increased banks' cost of funds and further weakened their profitability. Moreover, the increased competition it has

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brought has led to a slimming of margins. In the UK, banks are turning to fee-based income from life assurance and other financial services as both loans and deposits are becoming less profitable in the highly competitive market. Even in Germany the three largest banks have now entered the insurance business.

But some countries have been slower in removing barriers to entry in other financial services. In the USA and Japan, for instance, banks have not been able to take advantage of financial deregulation as they are prohibited from entering the securities business— a handicap especially with the increasing securitisation (high-quality corporate borrowers shifting to the securities markets). Banking reform proposals in the US envisage reduced regulation that will allow banks to diversify into other businesses as well as inter-state banking, thereby removing their present competitive disadvantage. In Japan, too, there are proposals to permit banks into the securities and possibly even broking business.

Lax regulations on non-banks are considered to have contributed to the growing difficulties in the financial sector. Non-banks (leasing and consumer credit companies) in Japan and the savings and loan industry in the US have been substantially responsible for fuelling over-speculation in property. Rules governing savings and loans institutions were relaxed, allowing them to make commercial loans, equity investment in securities (e.g. junk bonds) and real estate, whereas S & L managers were not prepared for these activities and at the same time supervision was relaxed.

This underscores the preconditions for deregulation; it must be recognised that there is inherently greater *risk* in a deregulated environment and that is why prudential regulation is even more important. In this context, it is sometimes argued that the deposit insurance system might have contributed to excessive risk taking.

An immediate concern, in the industrialised countries, is the inadequate capital base of many banks. While in early 1990 many banks seemed able to meet the Bank for International Settlements (BIS) guidelines on capital adequacy [whereby minimum capital-to-(risk-adjusted) asset ratios were specified], the large loan losses and the steep fall in the stock market since then have revealed the greater extent of under-capitalisation of banks.

Of course, the key problem is that these banks have not been earning an adequate return to support the growth in their assets. And with the stock market decline and prices of bank stock badly affected, raising new capital is not a feasible option at present for banks. Subordinated debt issues have also become prohibitively expensive. This underscores the dilemma faced by the troubled banks. Without recourse to outside capital, the requisite *growth* in bank profitability and retained earnings to attain higher capital-asset ratios is formidable. Thus, many banks are being forced to sell off assets, merge and cut back net new lending. The repercussions, already being felt in the US economy, could be world-wide as international lending is affected.

Profitability of Indian Banks

In India, bank profitability has been under severe strain for some time now. Given the nature of banking as a business which has inherent risks, it is essential that banks earn enough to build reserves and enhance their owned resources. The capital adequacy criterion evolved by BIS may not be strictly and exactly applicable in the Indian situation. However, the need to make profits and build adequate reserves cannot be over emphasised.

Although international comparisons are rendered less meaningful because of different accounting practices and other regulations, it is worth noting that the net interest margin (interest income less interest expense as a per cent of working funds or average net assets) of Indian banks in the recent years at 3.2 per cent is almost equal to that of US banks at 3.5 per cent. However, establishment and other costs are exceptionally high in India while non-interest

income is not as high as in many other countries, resulting in low overall profitability.

Bank profitability is affected considerably by policy actions - what we may term the "external environment" that banks face. But profitability also depends on the internal efficiency of operations. I will cover these in turn, focussing mainly on changes in the policy-related constraints.

Environmental Factors or Policy-Related Constraints to Profitability

Banks in India have had to operate under several constraints dictated by socio-economic objectives, which have had a bearing on their profitability. These relate primarily to the rapid and vast expansion of banking facilities with its associated costs, the allocation of credit for priority needs and the element of cross-subsidisation to assist preferred sectors. Banks have also been subjected to a large pre-emption of funds by way of the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR), which have also imposed constraints on their profitability.

Several steps have been taken in recent years to ease the policy-related constraints on banks' profitability. Conceptually, we could demarcate them into two phases. In the first phase, the measures aimed at directly improving profitability by an increase in the administered rates, including an improvement in bond yields and in interest on eligible cash balances with the Reserve Bank. The second phase was marked by a move towards a freeing of the system, thus giving banks more discretion to set their rates competitively.

Accordingly, the maximum coupon rate on dated government securities has been raised over the years from 6.5 per cent in 1977-78 to 11.5 per cent by 1985-86. Since then, while the coupon rates have not been raised further, there has been an effective increase in their yield as the maximum maturity of the securities was reduced from 30 years to 20 years in 1986-87. Furthermore, to encourage a more active market in government securities, a new instrument, the 182-day Treasury Bill has been introduced on an auction basis, whose yield has been close to 10 per cent. In addition to the improved yield, adequate liquidity has been provided to this instrument in the secondary market. As a result of these steps, the average yield on investments has increased steadily over the years, from 8.95 per cent in 1986 to 10.34 per cent in 1990.

Along with the measures to improve profitability, the capital base of the public sector banks has also been enhanced by issue of special securities yielding a return of 7.75 per cent per annum to the banks. Ideally, the requisite capital should come from the profits of the banks, but where this is not possible it would be necessary for the shareholders to put in the funds in a phased manner.

The second phase of policy changes has involved an element of deregulation in order to create a more competitive environment in the financial sector. The reforms have introduced some flexibility in the administered interest rate structure, introduced new instruments and broadened the sphere of activities that banks may engage in.

The Indian banking system has been characterised by very high reserve requirements and administered interest rates on deposits and lending. Over the decade of the 1980s the banks' returns on pre-empted resources have been vastly improved and a gradual rationalisation has been undertaken of deposit and lending rates. The low deposit rates at the short end were raised to more realistic levels and the maturities were reduced to enable banks greater flexibility in adjusting to interest rate changes; accordingly, in April 1987 the maximum deposit rate of 10 per cent was fixed at the 2-year maturity instead of 11 per cent for 5 years. There has in the recent period been an increase in various savings instruments offering attractive interest rates and banks had been feeling increasingly uncompetitive. It was felt that deposit mobilisation efforts would be strengthened by offering a better rate on savings in the form of deposits for somewhat longer maturities.

Accordingly, without disturbing the existing maturity structure of deposit rates, a new category of deposit of three years and over with an interest rate of 11 per cent per annum was introduced in October 1990. Banks are facing increasing competition from some of the newer instruments like Mutual Funds. These Mutual Funds are not subject to the burden of reserve requirements and concessional directed credit and as a number of these Mutual Funds are closely associated with banks and financial institutions, they carry the image of the safety of bank deposits. The provision of a guaranteed minimum rate of return quite clearly goes against the grain of the very concept of a Mutual Fund. The Mutual Funds also enjoy fiscal concession. It is in this context that, despite the pressure on their profitability, the banks have been seeking higher deposit rates at somewhat longer maturities; however, higher deposit rates have implications for lending rates. It is necessary that the level playing fields do not remain tilted against banks. As there are a number of fiscal concessions, such as under section 80 L, 88 and 80 M, there is a need to rationalise the structure of fiscal concessions on various savings instruments taking into account the maturity, liquidity and risk attached to each instrument.

The lending rates of banks had, over the years, become complex and highly constraining from the view point of bank profitability. As a result of a series of measures banks have now been given some degree of freedom in equilibrating their cost of funds and the return on funds. First, in October 1988, banks were given the freedom to determine the lending rate for those parties (essentially larger borrowers) which were subject to the maximum lending rate. Secondly, in October 1989, the banks' ceiling lending rate for term loans was freed. Thirdly, in September 1990, a major reform was undertaken of the entire lending rate structure. It is appropriate that the rationale of this reform is clearly set out. The lending rate structure prescribed for banks had, over time, evolved into a complicated one. The structure was characterised by a multiplicity of rates with concessionality in the interest rate related to numerous criteria, such as size of loan, priority of a sector, location of activity, specific programmes, income of borrowers, etc. Administering such a rate structure had become difficult and a rationalisation was overdue. An element of cross subsidisation within the rate structure was, however, necessary since societal concerns warrant continuation of an element of concessionality for small borrowers and the weaker sections of society. It was against this backdrop that a restructuring of the lending rate stipulations for banks has been introduced. In the revised structure all sector-specific and programme-specific lending rate prescriptions have been discontinued except the Differential Rate of Interest (DRI) Scheme and credit for export. By linking the concessionality in interest rates to the size of the loan the new structure ensures that the credit needs of the weaker society are taken care of while significantly reducing the multiplicity and complexity of the previous structure. The revised structure removes the distinction between short-term and long-term credit except in the case of term loans for agriculture, small-scale industry and road transport operators owning up to 2 vehicles for amounts of over Rs. 25,000. Where banks have been given the discretion to determine the rate of interest for advances of over Rs. 2 lakhs they have been advised to use this discretion judiciously. Fourthly, a question had been raised by a number of banks whether the lending rate structure made effective from September 22, 1990 would be applicable to loans for purchase of consumer durables, loans to individuals against shares and debentures and other non-priority sector personal loans. Since it was not the intention to encourage the demand for such loans by offering relatively lower interest rates, effective October 10, 1990, scheduled commercial banks were permitted to freely determine the rates of interest applicable to the following categories of loans: (i) Loans for purchase of consumer durables, (ii) Loans to individuals against shares and debentures/bonds, (iii) Other non-priority sector personal loans. This measure would provide further leeway to banks to enhance their interest income and thereby cushion the additional cost due to the increase in the maximum deposit rate. As a result of all these measures, a little over one-half of total credit is now free from interest rate ceilings and this should

enable the banks to better equilibrate their costs and returns on funds. The various measures taken in recent years need to be considered in a totality. What has been sought to be achieved is a balance between enabling banks, on the deposit side, to compete effectively with other instruments of saving and at the same time giving banks greater flexibility in determining lending rates while taking care of the credit needs of the weaker sections.

While the policy measures I have just mentioned give banks much greater discretion over the deployment of a significant part of their funds, a large and growing portion of their resources have, nevertheless, been pre-empted by way of the CRR and SLR. Monetary policy responses during the 1980s are best viewed against the backdrop of developments in the economy. Monetary management had to take into account the impact of large and growing fiscal deficits. Thus, a relatively expansionary fiscal policy in recent years has necessitated a cautious monetary policy entailing higher reserve requirements in an endeavour to contain inflationary pressures. Thus the levels of reserve requirements are influenced by fiscal deficit in general and within it by budgetary deficit.

Efficiency Factors

Though banks operate in the same socio-economic and regulatory environment, there are marked differences in their operational performance. Gross profit to working funds of public sector banks averaged 1.19 per cent in 1989-90, but ranged as high as 3.56 per cent when individual bank's performance is reviewed. This indicates that there is substantial room for improvement in profitability in several banks.

Measures to raise the efficiency of banks' operations have no doubt been discussed in the Technical Sessions over the last couple of days. Moreover, in last year's Bank Economists' Conference, I also referred to the increased scope for both asset and liability management in improving profitability. Instead of repeating these I would like to emphasise a few points which assume greater relevance in the light of developments that I mentioned in the beginning of my talk.

Possibly the most important lesson one can draw from the experience of the banking industry world-wide is the importance of risk-management. As banks are moving into new areas of activity where the element of risk is greater, they need to develop the expertise for risk-management. But even in their core activity, banks must constantly weigh the risks and provide a cushion for them. One of the main factors responsible for the erosion in bank profitability is the extent of non-performing assets. It is the responsibility of the banking institutions to maintain the quality of their credit protfolio. Directed credit *per se* does not lead to non-performing assets; banks have a choice of borrowers. There is evidence to show that the proportion of non-performing loans to total loans varies considerably among banks, even though figures in this regard have to be treated carefully because until recently there was no uniform procedure for classifying non-performing loans. Rigorous credit appraisal and administration should complement early detection of incipient sickness and expeditious rehabilitation. Tools of credit management such as the health code system can be effectively used in monitoring accounts and improving the overall quality of loan assets.

Needless to say, there should also be a continuous effort to improve productivity and cut costs. Moderation in branch expansion, introduction of computer technology on a selective basis and inculcation of a more effective managerial culture should result in improved productivity and cost-effectiveness.

And finally, a few words on funds management and particularly short–term funds management. The money market provides an outlet for short-term funds for banks and it is this market which has undergone several significant changes in the last four years. The introduction of the new Treasury Bill instrument of 182-days as well as the creation of DFHI should provide increased opportunities for commercial banks to manage their liquidity better. This should facilitate

banks in the maintenance of CRR. The penalty due to default in CRR in a single fortnight can outweigh the loss resulting in investment in Treasury Bills rather than in long-dated 20-year government securities. The pertinent question that arises in this context is what should be the level of Treasury Bill holding of a bank, consistent with the optimal funds management. A broad guideline can be that, to the extent a bank has volatile liabilities, it should have a matching portfolio of short-maturing near-liquid assets of which Treasury Bills constitute a prime example.

The commercial bills market is an important segment of the money market in the industrialised countries. Though the development of the bill culture has been repeatedly emphasised in India, there is still a strong preference on the part of the borrowers to go in for the cash credit system. Bills being self-liquidating papers, discounting of such instruments is an ideal form of providing credit for short-term purposes by banks. In order to encouragte the use of commercial bills, several steps have been taken in the recent period by the Reserve Bank of India. It is incumbent on industry and trade, both in the public and private sectors, to move strongly towards the use of bills in the settlement of transactions. Banks need to play an effective role in this regard.

The most important segment in the short term money market in India is the call money market. Some of the developments in this market need a close look.

After the freeing of the call money market interest rates in May 1989, there have been several bouts of volatility during which the rates have reached dizzy heights. Such gyrations in the call money market are not conducive to the emergence of a stable, mature and healthy money market. Quite often it is argued that the freeing of the call money rate has adversely affected the profitability of the weaker banks. It needs to be noted that while the call rate was nominally subject to a ceiling of 10 per cent, in practice it was only observed in the breach and during periods of tight money the effective rates were as high as they have been since the freeing of the rate. It must be recognised that "weak banks" (defined as those banks which have over-extended credit positions with large and chronic dependence on the money market) just cannot expect to resolve their structural problems merely by resorting to the money market for large amounts for prolonged periods. Notwithstanding these problems the Reserve Bank has taken certain significant measures in the recent period to ensure that the money market develops on sound lines. First, the loss of interest in cases of CRR shortfalls has been softened so that the cost of such shortfalls is limited to 25 per cent per annum so long as shortfalls are within a reasonable range.

Secondly, the limits for Certificates of Deposits (CDs) has been raised which would enable banks which are short of funds to offer slightly higher rates to bridge their gap but still not pay unreasonably high rates. Thirdly, banks have been provided wider access under the discretionary refinance facility so that they would not be required to pay unduly high rates in the call money market. Fourthly, while banks have been given the facility to vary their cash balances with the Reserve Bank, banks, particularly those vulnerable to the money market, would be well advised to ensure that they evolve a strategy of minimising their fluctuations in their cash balances.

While the short-term money market is the outlet for investment for surplus banks, it is a source for obtaining funds for the deficit banks. Banks' recourse to the call money market, the Reserve Bank refinance and rediscounting of treasury bills must hang together and must stem from an integrated approach as each source of finance has its own distinct advantages.

In the task of augmenting profitability, the major attention of banks should be towards improving the quality of loan assets which in turn requires better credit appraisal and better monitoring. This every banker must realise is his primary task. Several measures have been taken in recent years to alleviate the policy-related constraints to improved profitability. It is for banks to use the opportunities created and step up their efficiency. With increasing freedom, however, must come greater accountability.