COPING WITH FINANCIAL SECTOR REFORM : A STRATEGY FOR WEAK BANKS*

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I am sure that over the past three days, participants would have had detailed deliberations on Banks' MOUs and Balance Sheet Management. In this Valedictory Address I thought I should focus exclusively on the strategy for weak banks.

2. The financial sector reform has been gathering momentum over the past two years and is now all set to take-off. It has long since been recognised by various agents that the reform process has achieved a critical mass and unless agents learn to cope with the rapidly changing environment, they would be extinct. In such a milieu palliatives like protection and subsidies for weak institutions are not the appropriate measures. On the contrary, there is renewed emphasis on a level-playing field and as such the burden of adjustment is that much more severe for the weaker banks. As banks have been required to present transparent balance sheets, a number of weak banks have gaping holes in their balance sheets. It is often argued that overall financial policies and the environment are responsible for the losses of banks. While this is a general proposition, it is important to recognise that in the same environment some banks have performed better than others. The answer therefore lies in something else. Instead of a sterile debate on such issues, the Government has taken a mature stance and, as owner, has underpinned the banking system by allocating a large sum of Rs. 5,700 crore for recapitalisation of banks.

3. The problem of weak banks is indeed not easily resolved and we need to debate what is the appropriate strategy for the weaker banks. Lest this address be considered a cause for despair for the weak banks let me hasten to emphasise that my view is that a sound and viable strategy can be conceived for these weak banks.

4. Greater transparency by itself in no way results in a deterioration in the solvency of banks; if, at all, emphasis on these issues works towards an improvement in the overall position of these banks. Thus, the implementation of stricter prudential norms should cause no anxiety to depositors; on the contrary, such measures protect the depositors' interest. It is sometimes erroneously argued that unless banks increase their advances portfolio, their deposits will not increase. Invariably, the class of persons who are depositors are not the class of persons who are borrowers and a slowing down of the pace of increase in lending by the weaker banks will not result in an exodus of deposits from these banks. The weak banks must recognise that depositor loyalty is far greater than borrower loyalty. A borrower finding a bank in a bind would be sufficiently fickle to seek greener pastures; a depositor would not. Thus, the first element in the strategy of a weak bank should be to improve customer service to the depositor. Such improvements are well within the reach of all banks as the depositors needs are relatively uncomplicated.

5. With the shift in emphasis from reserve requirements to capital adequacy, it is only logical for weak banks to give attention not merely to the total size of their assets but also the composition of their assets. A weak bank would, ex-definition, have non-performing assets (NPA) above the national average. It is sometimes argued that a weak bank to improve its profitability should raise its credit-deposit ratio (C-D ratio). In my view, adoption of such a strategy would be nothing short of a disaster. The very fact that a bank has a high NPA indicates that its credit

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management system is weak and any attempt to push up the C-D ratio would be a sure way of increasing the NPA. Thus, the second element in the strategy of a weak bank should be to maintain a C-D ratio below that of the system and to the extent that the C-D ratio is high, a reduction would be beneficial to a weak bank. A weak bank with a high C-D ratio should eschew from credit expansion and concentrate its energies on loan recoveries and strengthening credit management in the bank.

6. Reserve requirements are considered as a tax on the banking system and it is sometimes argued that the reserve requirements should be lower for the weak banks. It is the high reserve requirements which protected a number of weak banks from even further erosion. Thus, the third element of a weak bank's strategy should be the maintenance of excess liquid assets over the prescribed stipulations. Given this element in the strategy, the need for improved funds management becomes a priority. While there is a need for improved funds management skills — an area where weak banks would invariably be deficient — such skills are more easily acquired as the numbers of trained persons required in this area are far fewer than in, say, improved credit management. A weak bank needs to work out a programme on use of funds where credit growth is kept to the irreducible minimum and the returns on the investment portfolio are maximised. This would require banks to undertake intensive training of its dealers in the art of bidding in securities auctions and encashing on trading opportunities. These are fairly elementary skills which, with some perseverance, could be developed within a very short time. There are significant market imperfections at the short-end of the market and banks which maintain excess liquid assets can earn a reasonable profit by having surplus funds to equilibrate rates in the securities market particularly at the short-end.

A modest investment in public sector bonds, spread over a number of PSUs, would be a desirable portfolio for the weak banks. Again, while banks need to develop non-fund business they should approach such business with great caution as non-fund activities can, on occasions, require banks to lay down funds to meet commitments. The lessons of recent history point to the need for great caution in this area.

7. As part of a 'damage containment' policy, weak banks need to undertake a critical analysis of the operations of their branches and consideration needs to be given to a selective closure of a few branches which are totally non-viable. Such selective closure is unlikely to affect the needs of customers as in most cases other stronger banks would have branches in the proximity of the branches of weak banks. Such a policy would also require a virtual ban on recruitment for sometime other than for very selective induction of skills. Thus, this forms the fourth element of a strategy for weak banks.

8. The fifth and last element of a strategy for weak banks is the imperative need for a loss making bank to recognise the need to cut down its 'standard of living'. Weak banks must recognise that they cannot afford to provide to their employees the same benefits as provided by the stronger banks. A culture of self-abnegation has to develop from the very top and then trickle down into the system; this may appear to be only of limited relevance to the profitability of weak banks but these small contributions can snowball and become significant over time. Moreover, such measures provide a strong spur to improved productivity.

9. While I have endeavoured to set out five broad elements of an appropriate strategy for weak banks, this should be considered as being an illustrative list and by no means a complete list. I am convinced that if weak banks follow a multi-pronged strategy oriented to the over-riding objective of reducing and wiping out losses, these banks could come back into the mainstream of the banking sector within a period of three to four years. It is often the first steps that are the most difficult and these banks need to be encouraged to strengthen their resolve to improve.