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(Address by Shri. S.P.Talwar, Dy. Governor, Reserve Bank of India)

Financial Stability and the Role of Banks

Introduction

I am grateful to the Indian Banks' Association (IBA) for extending me the opportunity to address this highly enlightened gathering of bankers and economists.

Many of you might have participated in the last conference held at Bangalore in December 1998 with the theme focussed "Towards Sound and Strong Banking". That was built around the then emerging scenario of Indian financial system being exposed to competition and several reform measures initiated by the Reserve Bank for achieving convergence between Indian standards and international best practices. Since then, the market players have been moving towards adopting sound practices like risk management systems, enhanced transparency, disclosures and accounting standards, good corporate governance, etc. which are aimed at promoting financial stability. In this context, I thought it would be appropriate to dwell on the role of Indian banking system towards this end.

Importance of Financial Stability

Broadly speaking, promoting financial stability is the task of limiting the effects of financial disturbances on the economy. This has gained considerable prominence in the recent past as a policy objective of central banks and supervisory agencies, primarily reflecting the concerns about the growing number, breadth and the severity of bouts of financial crises.

Amongst financial crisis, banking crises are the most difficult to predict and have more lasting and damaging effects on the economy than those in other financial sector groupings. The recapitalisation costs associated with such crises in the recent past have been very high and it is estimated that on account of the Asian crises, some of the affected countries could have recapitalisation costs ranging from 15% to 50% of GDP. Since society at large has to pay a huge cost for banking crisis, there is an increased focus on banks and banking supervision in recent times.

I may add that India could avoid the crisis mostly due to a cautious approach towards short-term external borrowings and capital account convertibility, and insignificant exposure to sensitive sectors like real estate and equity capital market. We also took care to have phased implementation of reform process. particularly when it came to prescribing stricter prudential regulations in conformity with global standards.

Banks and Financial Stability

A strong and efficient financial system is critical to the attainment of the objectives of creating a market driven, productive and competitive economy. Promoting healthy financial institutions, especially banks, is, therefore, a crucial prerequisite for financial stability. It has been observed that largest number of crises still arise, in emerging market economies or industrial countries, due to over-extension in aggregate balance sheets in good times and receding widely afterwards.

I would like to emphasise that financial stability require appropriate action at both the micro and macro level. The micro dimension consists of three pillars – institutions, markets and infrastructure. Preventive attention by the Regulators must then focus on each of the three pillars supporting both the domestic and international financial systems, namely,

- the good health of financial institutions through appropriate regulation and supervision,
- the proper functioning of the markets, and establishment of a sound infrastructure including legal and judicial system, payment and settlement systems, and
- establishing transparent accounting and adequate disclosure standards.

The Central Bank is expected to safeguard the three pillars by developing and implementing norms of behaviour as well as sanctions against non-compliance (regulations), by monitoring the norms (supervision) and by providing supportive role through emergency liquidity support, deposit protection schemes, etc. At the macro level, however, the safeguarding lever continues to be the monetary and credit policy.

The banking system in India, being the dominant segment of financial sector accounting for a major portion of the fund flows, is the main vehicle for monetary policy signals, credit channel and facilitator of payments systems. Hence, the health of banks remain the most crucial concern for the markets and the regulators. In this background, I will dwell upon some of the measures which have been taken to safeguard the health of the Indian banking system and the challenges which still lie ahead for both banks and their supervisors.

Banking Sector Reforms

In the post liberlisation era, RBI has initiated several measures to ensure safety and soundness of the banking system and at the same time encouraging banks to play an effective role in accelerating the growth process. It has been recognised that the Indian banking system should be in tune with well laid down international standards of capital adequacy and prudential norms. Banks have also been encouraged to adopt appropriate internal control systems and corporate governance procedures to foresee and manage all types of risks.

Banks in India have contributed significantly to the expansion of branch network, increase in savings rate and in extending credit in rural and small sectors. However, certain weaknesses such as decline in productivity and efficiency and erosion in profitability had developed in the system which were to be addressed to enable the financial system to play an effective role in a competitive environment. Keeping in view this objective, the Committee on Financial System (Narasimham Committee I) was set up. The Committee made a number of recommendations aimed at improving productivity, efficiency and profitability of the banking system on the one hand and providing it greater operational flexibility and functional autonomy in decision making on the other. The Report was conceived as a holistic exercise and its recommendations were accordingly interrelated.

Progressive reduction of reserve requirements to correct the impact of directed investments on the profitability of banks, deregulation of complex and administered interest rate structure to move to market determined rates and introduction of prudential norms for asset classification, income recognition and provisioning in order to remove subjectivity were some of the major steps taken in the direction of banking sector reforms. Accounting practices had been prescribed in consonance with internationally accepted standards with the objective of enhancing transparency and credibility and ensuring accuracy of financial statements.

In the mean time, major changes had taken place in macro economic environment and institutional structures. These called for a critical evaluation of policy initiatives already undertaken. The Government of India had therefore, set up the Committee on Banking Sector Reforms in 1997, to review the record of implementation of financial sector reforms recommended by the earlier Committee and chart the reforms necessary in future to make India's banking system stronger and better equipped to meet the global competition.

A major part of the reform measures recommended by the Committee were primarily aimed at strengthening the banking sector which can be broadly grouped as under:

- Strengthening of Capital Adequacy including explicit capital for market risk
- Tightening of the prudential and disclosure standards in line with international best practices.
- Consolidation of banking system
- Restructuring of weak public sector banks
- Dilution of government equity in public sector banks to 33% and providing functional autonomy to government banks
- Technology improvements to modernize Indian banking
- Adoption of scientific tools for management of risks
- Legal reforms to expedite recovery of banks' dues

Capital adequacy measures

All of you will agree that strong capital base is very essential for absorbing unexpected losses. As a part of the follow-up of the recommendations of the Committee on Banking Sector Reforms, CRAR was raised to 9% from the year ended 31 March 2000. Government of India had recapitalised a number of nationalised banks to the tune of Rs 20,446 crore to bolster their CRAR. Also, eleven public sector banks have raised capital from the market. As a result, all public sector banks except one had maintained the required level of CRAR as on 31 March 2000. The risk weightage pattern has also been realigned to fall in line with the Basel accord.

The first Capital Accord of 1988 evolved by the Basel Committee provided a framework for a fair and reasonable degree of consistency in the application of capital standards. However, the methods used to determine the capital charge for credit risk in the Accord were not sufficiently sophisticated and not perceived to be risk sensitive. Keeping in view the financial innovation and growing complexity of financial transactions, a need was felt for a more broad based and flexible framework for capital adequacy. Towards this end, the Basel Committee released a consultative paper on "New Capital Adequacy Framework" in June 1999 for comments by market players. The new framework envisages a three pillar approach viz; **minimum capital requirement**, which seeks to develop and expand on the standardised rules set forth in the 1988 accord, **supervisory review** of a bank's capital adequacy and internal assessment process and effective use of **market discipline** as a lever to strengthen disclosure and encourage safe and sound banking practices.

Although it is too early to gauge the full impact of the new proposals, it is very likely that there would be an increase in capital requirements for our banks over the next few years on this account.

Prudential norms

With a view to move towards the international standards, the prudential norms have been further tightened. Timeframe for doubtful assets would be reduced to 18 months from 24 months by March 31, 2001. General provision of minimum of 0.25% has been introduced on standard assets from the year ended March 31,2000. Exposure ceiling in respect of individual borrower has been lowered from 25% to 20% of the capital funds. However, this is not the end of the tunnel.

As Governor Bimal Jalan observed recently, "It is no longer possible for developing countries to delay the introduction of strong prudential and supervisory norms, and introduce structural reforms in order to make the financial system more competitive, more transparent and more reliable."[1]

We need to further tighten the prudential norms by increasing provisioning requirements on standard and sub-standard advances, revise the time-frame for migration to doubtful losses to 12 months and further reduce the exposure limits as we go along.

Recovery of bad loans

RBI had issued a number of instructions to the banks to tackle the problem of recovery of bad debts. While pursuing the compromise settlements arrived at Lok Adalats more effectively, the banks were also advised to constitute Settlement Advisory Committees (SACs) for compromise settlements of chronic cases of NPAs under small sector. With a view to have a more realistic approach to reduce the stock of NPAs in all categories, revised guidelines were issued in July 2000 which provide a simplified, non-discretionary and non-discriminatory mechanism for recovery of the NPAs. We need hardly to emphasize that banks should take utmost advantage of these guidelines so that maximum realisation of dues is achieved within the stipulated time; i.e. March 2001.

Government of India has recently made necessary amendments to DRT Act with a view to empower the DRTs for expeditious recovery of dues. Steps have been initiated to constitute 7 additional DRTs; four in Mumbai and one each in Calcutta, Chennai and New Delhi, taking the total number of DRTs to 21. Further, the proposed introduction of Bankruptcy and Foreclosure laws, setting up of Credit Information Bureau, etc. would strengthen the institutional framework for dealing with impaired assets.

Supervisory Machinery

The pace of innovation of new products, intense competition, rapid technological developments in the banking system and integration of financial markets has underscored the need for a strong and efficient supervisory system. The focus and methodology of the Annual financial Inspections of the banks conducted by the RBI have undergone change in order to give emphasis to the analysis of the systems prevailing in the bank for taking care of various risks in the banking business. The inspection is conducted in a more objective manner under the CAMELS model and a comprehensive rating system has been put in place. The banks have been advised about the procedure followed in the rating exercise in the interest of transparency and to help them in their effort to improve the rating in the subsequent period. The system which is in place for last three years is being reviewed in order to make it more objective and transparent.

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[1] "International Financial Architecture: Developing Countries Perspectives" 49th anniversary lecture delivered at the Central Bank of Sri Lanka, 25th August 1999.

As announced by the Governor in the Monetary and Credit policy for the year 2000-2001, RBI is now in the process of moving towards Risk Based Supervision which would incorporate international best practices for supervision suitably customised for the Indian environment. In the changed scenario of diversified banking business and emerging product innovations with complex risk profiles, the Risk Based Supervision approach will more efficiently allocate supervisory resources by monitoring the risk profile of the supervised institution to supplement the traditional transaction based approach. However, for the Risk based approach to work, the banks must also put in place the desired level of risk management systems as have been envisaged in our guidelines on the subject.

As a further step towards more effective banking supervision, a system of Prompt Corrective Action is being contemplated which will help to identify problem banks at an early stage for taking mandated and discretionary preventive/curative action and limiting the losses and contagion effect. Some important financial indicators such as CRAR, net NPA and Return on Assets are to serve as signalling parameters for the purpose.

Use of Technology

One of the most important challenges facing banking in India currently is the need for effective utilisation of technology in the various facets of banking aimed at not only for improving customer efficiency but also for improving management information systems, better house-keeping including and empirical decision making. Technology has also brought in a sea change in payment and settlement systems which has resulted in the Reserve Bank initiating many measures aimed at reforms in this area. The immediate need in the current scenario is for computerisation of branches of banks and the attendant standardisation of hardware, operating systems and networking platforms to synchronise computerisation with the ultimate goal of development of sound generic architecture model for interconnectivity between branches, the controlling offices and the Head office, using the Indian Financial Network (INFINET) implemented by the Institute for Development and Research in Banking Technology (IDRBT). The culmination of such efforts would be that almost all branches of banks in the commercially important centres would be inter-connected and be able to transmit messages between themselves in the respective cities as also amongst other bank branches.

Many new payment and settlement products are at various stages of implementation by the Reserve Bank of India. The Centralised Funds Management System (CFMS), the Securities Settlement System (SSS), the Real Time Gross Settlement System (RTGS) and the Structured Financial Messaging System (SFMS) are some of the major projects which would be of high utilitarian value for banks. It is imperative that if banks have to actively participate in all these systems, they should be in a position to either develop their internal applications to generate messages in these formats or provide for interfaces which would facilitate generation of the messages from the existing applications in the banks. Once Real Time Gross Settlement (RTGS) is in place, the system would take care of the requirements of large value settlements on a gross basis. This would have the impact of cutting down the time lag for collection / credit of funds to the accounts of beneficiaries and increase the velocity of money and cut costs.

Corporate Governance

Corporate Governance has as its backbone a set of transparent relationship between an institution's management, its Board, shareholders and other stakeholders. It should therefore take into account a number of aspects such as enhancement of shareholder's value, protection of rights of shareholders, composition and role of Board of Directors, integrity of accounting practices and disclosure norms and internal control system. As far as the banking industry is concerned, corporate governance relates to the manner in which the business and affairs of individual banks are directed and managed by their Board of Directors and Senior management. It also provides the structure through which objectives of the institution are set, the strategy of attaining those objectives is determined and the performance of the institution is monitored.

The paper of the BCBS on the subject envisages certain strategies and techniques basic to sound corporate governance in banks. Basic elements of corporate governance are capable and experienced Directors in the Board, efficient Management, coherent strategy and business plan and clear lines of responsibility and accountability. While the primary responsibility for good corporate governance in banks rests with the Board of Directors, the roles played by the Government, regulator, auditors and banking industry associations are equally important.

The recommendations of the Kumarmangalam Committee, paper of the Basel Committee and the practices in other central banks are being examined by the RBI and guidelines would soon be issued in the interest of promoting effective corporate governance in banks.

Accounting and Disclosure Standards

The standards of accounting and valuation methods adopted by the banks in India are comparable to a great extent to the international standards. The extent of transparency and disclosure standards of balance sheets of banks has been substantially enhanced in a phased manner. Banks have been advised to disclose maturity pattern of deposits, borrowings, investments, advances and foreign currency assets and liabilities, movement in NPAs and lending to sensitive sectors with effect from 31 March 2001. The existing disclosure standards do not fully provide for necessary feedback for the market participants to evaluate the efficiency, competitive strength, market standing of banks, etc. These need to be further enhanced to incorporate risk management policies, concentrations, connected lendings, evaluation of investment in subsidiaries, performance measures and indicators thereof, etc.

HRD Initiatives

The VRS scheme which was introduced by several Public Sector Banks has received a good response. In the immediate future, banks have to ensure that their normal functioning is not disrupted and they complete the consequential part of reallocation and redeployment without delay. This will be accentuated by the fact that banks are going to lose a number of experienced and skilled personnel. Appropriate Human Resources Management policy with a focus on extensive training is required to be adopted by the banks in order to carry on the business more efficiently. Banks should also endeavour to reduce the existing tiers of decision-making and empower personnel at the functional levels adequately for increasing efficiency and competing with foreign and new generation private sector banks.

An organisational restructuring including branch rationalization and business rationalization needs to be undertaken to make banking services product and customer friendly. In this context, I would like to stress that banks need to recognise the concept of change management. Banks must concentrate on `team building' and reorient their staff to align with the evolving market and customer driven financial system.

Supervision Plus

As I have brought out earlier, one key ingredient of the post-liberalization agenda of banking supervision in India has been to propagate compliance with a regime of prudential regulations based on international best practices. While banks have responded well to the regulatory requirements, they now need to go beyond externally imposed supervision to internally adopted supervision by putting in place standards and Internal Controls which are more stringent than those prescribed by the RBI. Prudential regulation should be seen as minimum requirements and banks should set internal benchmarks which are over and above those mandated by supervisors. I would like to call this approach as **'supervision-plus'**. This is not a new approach. The well managed international banks already follow this whether it is for allocating capital or setting exposure norms or deciding adequate level of provisions.

The balance sheet of corporates are mirrored in the balance sheets of the banking system and their financial condition affects that of the banking system. Excessive leverage in the corporate (and even the public) sector, especially due to borrowings from the financial system, can contribute to fragility in the economy. In order to guard against such situation developing, banks should set individual and group exposure norms which are below the 20% and 50% set by the RBI. The banks should collect data on the debt equity ratio of borrowing entities, particularly the large borrowers and groups for effective prevention of these borrowers turning into highly leveraged institutions posing a systemic threat to the financial system.

What is more critical than mere definition issues in the arena of asset quality is the extent to which banks have provided for their NPAs over and above the minimum stipulated requirements. As a thumb rule, it will be desirable for banks to endeavour to build up loan loss provisions to a level of 50% of total NPL's in the near future.

We have recently introduced circulation of lists between banks and Financial Institutions of willful defaulters. Banks must learn the art of distinguishing genuine defaults from willful defaults. While a different approach could be considered in respect of former category, the banks should come down heavily on willful defaults and consider instituting criminal cases against some of the large willful defaulters to provide a demonstrative impact on the rest of the recalcitrant borrowers.

To Sum up

The Indian Banking system has stood the tests of time and it has the inherent strength to adopt itself to the changing environment. What is needed is the proper direction coupled with motivation. The leadership must instill confidence in the ranks and they will then find their tasks much easier.

I am confident the deliberations in the conference would turn out to be quite rewarding.

I wish a very happy and prosperous new year to all the delegates.