'Indian Banking - Second Phase of Reforms - Issues and Imperatives' Keynote Address by C. Rangarajan Governor, Reserve Bank of India at the Bank Economists' Conference 1997 at Mumbai Monday, 6th October 1997

1.It gives me great pleasure to be in your midst this morning and to participate once again in the Annual Conference of Bank Economists. I am indeed happy that these Conferences have become occasions for serious discussions on the issues facing the banking industry.

2.The theme of the current years' Conference is `Indian Banking: Second Phase of Reforms'. Even as we begin discussing about what should constitute the second phase of reforms, it is perhaps appropriate to take a brief look at what the impact of the First Phase of Reforms has been and what issues have been thrown up by the reform measures.

3.Financial Sector Reforms were initiated as part of the overall structural reforms aimed at improving the productivity and efficiency of the economy. The Financial Sector Reforms recognise the fact that the Indian Banking System had over the years grown and that the geographical and functional coverage of the banking system have been truly impressive. However, questions have been raised from time to time on the viability of the banking institutions. Concerns have also been expressed about the deterioration in the quality of services provided by banks. It is with a view to finding solutions to these problems that Financial Sector reforms were initiated. The broad objective of the reform has thus been to create a banking system that is both viable and efficient.

4. As I had mentioned at the time of the last meeting of the Bank Economists' Conference there are four building blocks which have formed part of the Banking Sector Reforms. These are :-

a. Modifying the policy framework;
b. Improving the financial soundness and credibility of banks;
c. Creating a competitive environment;
d. Strengthening of the institutional framework.

5.Let me briefly emphasise the components of these various building blocks and also deal with some questions that have been raised in this context.

POLICY FRAMEWORK

6. The improvements in the policy framework are aimed at removing and reducing the external constraints bearing on the profitability and functioning of commercial banks. In effect, an attempt has been made to bring down very substantially, the pre-emptions in the form of reserve requirements and to give greater freedom to banks in the determination of interest rates. The reductions in the reserve requirements have indeed been very substantial. This has had the effect of both expanding the lendable resources of banks as well as to improve the profitability. Between November 1995 and January 1997 the Cash Reserve Ratio had been reduced by five percentage points. Such a reduction has not happened in the past. The de-regulation of the interest rate structure has given a high degree of freedom to banks in determining the deposit rate and the lending rates. Obviously this has put greater responsibility on the banks and banks have to manage this freedom judiciously.

Financial Soundness and Health

7. In trying to improve the financial health and credibility of banks, a major step that has been undertaken has been to introduce internationally accepted prudential norms relating to income recognition, asset classification, provisioning and capital adequacy. While worldover it is recognised that strict prudential norms are extremely important in ensuring the soundness and solvency of commercial banks, sometimes questions are raised in this country as to the relevance of the prudential norms and more particularly with those relating to capital adequacy. The origin of the prescription of capital adequacy norms goes back to the Basle Committee Report on International Convergence of Capital Measurement and Capital Standards published in July 1988. In the early eighties, increased competition internationally led to a concern over deteriorating capital levels in international banks and the erosion of reasonable risk/return relationship for banking business. Consequently, national authorities in many countries began to press their banks to improve their capital ratios. Furthermore by 1982, market developments, particularly, the growth of new off-balancesheet instruments and techniques were requiring banks and regulators to address a range of risks other than those traditionally arising from the banks' loan portfolio. All these factors came together to produce a growing realisation among central banks and regulatory authorities that some greater standardisation and enhancing of capital measures and standards were highly desirable in the interest of the system. The framework suggested a minimum of eight percent capital to risk-weighted assets ratio which includes both on and off balance-sheet items.

8. The aim of this system is to relate capital to the risk of the portfolio of assets held by a bank. Further, atleast four per cent risk weighted assets was to be in the form of pure capital that is equity capital and free reserves. In looking at the pressures and influences on banking, it is difficult to overestimate the importance of the capital ratios now imposed on banks.

9. However the prescription of Basle capital ratio of eight per cent has also drawn certain adverse comments. The prescription of a eight per cent ratio seems to follow a `one size fits all' formula. In fact, the desired capital ratio should be an appropriate way of controlling and reflecting the riskiness of banks' portfolios. Also, the uniform application of a 100 per cent weighting to non-bank private sector corporates does not recognise the different quality of borrowers as reflected in their ratings. Further the treatment of collateral was overly restrictive, as no credit is given for collateral which are not in the form of cash or government securities. Another argument heard particularly in India is that there is no need for this solvency based measure for government owned banks. The basis for this argument is that when Government is the owner, it will meet all the obligations and there is no possibility of a public sector bank failing.

10. It is true that the eight per cent norm cannot be operated like a `one size fits all' formula. This reflects only the minimum and it is for each regulatory authority to prescribe capital ratios for individual banks. The merit of the eight per cent prescription is that it is superior to a regime when there were no such prescriptions and to countries introducing these norms in the initial phase the objective has to be to attain this minimum and then make the prescription bank specific. The concerns over the broad weighting categorisations and the lack of allowance for differences in quality between borrowers are being met by countries setting individual target ratios above 8% bank-wise where the regulatory perception is that the bank's portfolio carries a higher element of risk. Countries are at liberty to follow a detailed risk weighting model but this could distort comparisons among banks across countries. The risk weighting categorisation was only a broad brush formula so as not to make it too complicated. The argument that government banks do not have to follow prescribed capital adequacy ratios as public are indifferent to the level of capitalisation in a public sector bank does not recognise the fact that banks are commercial entities and not departments of government. Capital is a cushion against losses. Just because banks are owned by government does not mean that the intrinsic commercial element is to be ignored. Banks deal in money and not in goods and this could lead to their being highly leveraged. More important, these norms prevent banks' balance sheets ballooning rapidly during booms with inevitable adverse consequences.

11. Capital gives owners and managers powerful incentives to run the bank safely and soundly. The banks' capital ratios are now seen by the investment community and rating agencies as a sign of strength while at the same time providing flexibility for future business growth. If government banks are exempt from complying with capital adequacy ratios, they will be at a disadvantage as compared to other banks particularly in their foreign exchange and international operations as it is not possible for the foreign banks and rating agencies to assess their solvency. The approach of wholesale and institutional clients is also to assess the counterparty risk (in this case the risk on the bank) and capital adequacy ratio is an important financial indicator. If government banks which have disclosed large losses have not been affected in any manner and the public continue to have confidence in them, it is because these banks are under restructuring and steps are being taken for turning them around with capital adequacy norms having been already prescribed. Besides serving as a cushion against losses, bank capital promotes better corporate governance. There is also the question of level playing field when private banks are also operating in the country. If capital adequacy ratios were to be abandoned, it will be very hard to put anything else in its place which can prevent anarchy in competition and unstable monetary developments. The eight per cent ratio is seen as a floor and banking systems in some countries have ratios that are considerably higher.

12. One criticism of capital adequacy requirements is that banks prefer investments in risk free securities. In several countries where capital adequacy norms were introduced, initially there was some degree of down-sizing of assets. Nevertheless, in the Indian context, the introduction of the capital adequacy requirements has not been the prime reason for higher investments in government securities. For example, in 1994-95 and 1995-96, non-food credit expanded by 29.8 per cent and 22.6 per cent respectively, despite the fact that these were the years when the pressure was greatly on to maintain capital adequacy requirement. The reasons for a larger investments in government securities in subsequent years must be traced to other reasons. Nevertheless, this ratio does emphasise the need for banks to have a balanced portfolio between risk-free assets and risk-assets.

Creating a Competitive Environment

13. The two major steps taken in this regard are -

a. Allowing the nationalised banks access to capital markets and thereby reduce share of the government in the total equity. It has, however, been decided that the government will hold at least 51 per cent of total equity;
b. Within the current provisions of the Banking Regulations Act, new banks in the private sector are being allowed to be set up.

14. Some question the impact of partial privatisation in bringing about any change in the functioning of commercial banks. Having public as a part of the ownership of the banks indeed makes banks more conscious of the need to run the institutions efficiently and earn more profits. Access to the capital markets and listing of shares on the stock exchange themselves entail obligations on such banks in terms of publishing half-yearly results etc. Presence of elected directors do make a difference to the functioning of the board. Banks under such circumstances become accountable to diverse categories of shareholders and become more responsive in that process.

Institutional Strengthening

15. A distinct feature of the Indian financial sector reform process has been the strengthening of the institutional framework relating to banking. This has taken the form of (1) re-capitalisation; (2) strengthening the supervisory process; and (3) creating new institutions; such as Ombudsman and Debt Recovery Tribunals.

16. In this context, I must refer to the strengthening of the supervisory system, including the role of the external auditors. The RBI supervisory strategy comprises now both off-site surveillance and on-site inspections. A detailed off-site surveillance system based on prudential supervisory reporting framework on a quarterly basis covering capital adequacy, asset quality loan concentration, operational results and connected lending has been made operational. In regard to on-site inspection, the focus is now on the evaluation of the total operations and performance of the banks under the CAMELS system, i.e. capital adequacy, asset quality, management, earnings, liquidity and internal control systems. Apart from evaluating asset quality and compliance with prudential norms, focus is now on the effective functioning of the Board, management, earning capacity of banks as also efficacy of internal audit and control systems and risk management systems besides regulatory compliance. The new approach to annual financial inspections has been adopted from the cycle of inspections commencing July 1997. An efficient result-oriented on-site inspection system requires an efficient follow-up mechanism without which the very objective of inspections will be vitiated. The entire cycle of inspection and follow-up action is now completed within a maximum period of twelve months. Monitorable action plan for rectification of irregularities/deficiencies noticed during the inspection within a time frame is drawn up and the progress in implementation pursued with the bank. Thus the present supervisory system makes a substantial improvement over the earlier system in terms of frequency, coverage and focus as also the tools employed.

17. The role of the external auditors has been enhanced and enlarged. In the auditing of a bank, the auditors' primary duty is to express an opinion on the financial statement such as the balance sheet and the profit and loss account. Besides the audit report on the financial statements, auditors of banks are also required to submit what has come to be known as Long Form Audit Report. Auditors are now required to verify compliance with SLR computation and prudential norms and also report serious irregularities to RBI. Further, auditors of nationalised banks should certify whether the transactions of bank are within the powers of the bank, and whether the returns received are adequate for the purpose of audit. The RBI has taken a number of measures to improve the transparency and disclosure in the published accounts of banks. From 1996-97, banks are required to disclose under `Provisions and Contingencies' in the Profit and Loss Account, details of provision for bad and doubtful debts, provision for diminution in the value of investments, provisions for tax separately instead of showing it as a conglomerate item. Banks are also

required to disclose the capital adequacy ratio, as well as percentage of net NA to net advances. The above information will also have to be audited.

Impact of Financial Sector Reforms

18. One has begun to see the impact of the financial sector reforms, both on the financial results as well as in the services provided.Operating profits have gone up from Rs.7568 crore in 1995-96 to Rs.8898 crore in 1996-97 and net profit from a loss of Rs.371 crore to a net profit of Rs.3095 crore. All banks except two have met the minimum capital adequacy ratio. Sixteen public sector banks have capital adequacy ratios over 10 per cent and five between 9-10 per cent.

19. Reduction in NPAs has acquired more focussed attention. The level of NPAs is no doubt high but the percentages are showing a decreasing trend. The percentages vary sharply among banks. Percentage of gross NPAs has come down from 23 per cent in 1992-93 to 17.8 per cent in 1996-97. The percentage of net NPAs to Net advances was 9.18 per cent. For purposes of international comparisons, it is this figure that should be taken into account. The priority sector advances accounted for 47 per cent of the total NPAs and non-priority sector for the balance.

NEW CHALLENGES

20. The first phase of financial sector reforms has laid the base for a sound and viable banking system even though we have to travel still some distance. What the is the emerging banking horizon? What are the new challenges and new opportunities? Going by the experiences of commercial banks in other countries, the following trends as I have indicated elsewhere may dominate the future course of banking development in India :

- greater specialisation by banks in different niches of the market such as retail, agriculture, export, small-scale and corporate sector;
- greater reliance on non-fund business such as advisory and consultancy services, guarantee and custody services;
- greater overlap in product coverage between commercial banks and non-bank financial intermediaries; and
- greater financial disintermediation with large companies accessing securitised debt domestically and from financial markets abroad.

21. All of these will require the banks to prepare a corporate plan over the next five years taking into accounts its own strengths and the markets in which it is looking to operate. Banks should not expect customers to walk in. They should seek customers. That will be the important change in the new scenario.

The Imperatives

22. In the environment of tomorrow, banks will have to learn to operate in a more deregulated interest rate environment and a diversified competitive market place. Both these will require banks to manage risk better.

Interest Rates

23. Interest rate regime in India has undergone a rapid transformation in the last five years or more. The structure of interest rates, which was extremely complex, has now been rationalised to fixing only three as far as banking system is concerned. Besides a maximum deposit rate for one year maturity, the prescriptions include a lending rate for loans upto Rs.25,000, another lending rate for loans between Rs.25,000 and Rs.2,00,000. The money market rates have been completely freed as have the rates at which corporate entities can borrow from the capital market. Perhaps, the most striking transformation has been in the Government securities market where the Central Government borrows both in terms of dated securities and treasury bills through the auction system.

24. Banks need to equip themselves to operate in such a deregulated interest rate environment. This will imply that they should be able to fix the rates on deposits and loans depending on the overall liquidity conditions and demand factors. Obviously, in such situations, certain market leaders always emerge. Banks, over the last few years, have evolved a set of criteria for determining the rate charged on the individual borrowers. They have also understood recently that this does not give them unlimited freedom to fix the rate. Pressures of competition and the intensity of demand will determine what the appropriate level is. These lessons will have to be modified and improved upon as interest rate structure becomes more flexible. The deregulation of interest rates will also lead to innovations of various types and corporates and others have already started experimenting with floating rate issues.

25. With abundant liquidity, the interest rates have clearly shown a downward decline. This is reflected in Treasury Bills of all maturities and dated securities. The CP rate as well as PLR have come down substantially. The lending rates are at the lowest level since 1988.

26. The management of the investment portfolio of the commercial banks will also require greater attention, since the prices of the securities will be affected with changes in interest rates. Therefore the maturity pattern of the investment portfolio, and the distribution according to instruments are matters which must receive the attention of technical experts in the banks. It is quite conceivable to have a situation in which the investment portfolio will consist not only of Government and quasi-Government paper, but also other instruments including securitised loans. All this will demand a proper attention on existing and expected levels of interest rates.

Diversified Market Structure

27. Banks will begin to function increasingly under competitive pressures. These may emanate from within the banking system as well as from non-banking institutions. A greater overlap in product coverage between commercial banks and non-bank intermediaries will occur. Thus, both on the liability and asset sides, banks will face increasing competition. Banks should be willing to offer products to savers which are competitive in terms of both price and service. On the lending side, apart from the competition from other intermediaries, corporates seeking funds directly from the market will also have an impact on the asset distribution of banks. This is already happening in our country. Apart from the very large funds that corporates have been able to raise from the domestic capital market, with the lower interest abroad, big Indian corporates have also begun to raise funds from the international markets. Some of the corporates have used the funds so raised to retire high cost domestic commercial bank credit. This type of disintermediation is not uncommon. Banks will have to take note of these developments. Lending is an important function of commercial banks and will remain the most profitable form of utilising funds. They cannot let an important asset of theirs to go down. Competition will compel banks to keep the interest spread to the minimum and in this context bank can earn enough for themselves only by reducing the proportion of non-performing assets.

28. Banks will also have to pay attention to market segmentation, and greater specialisation in different niches of the markets. It is important to note that `bigness' is not synonymous with success. Small and medium sized banks can also effectively compete if appropriate niche strategies are adopted.

Asset and Liability Management

29. In the context of these changes, risk management is emerging as an important area which needs a great deal of attention. Originally banks concentrated on asset management treating themselves purely as deposit takers. Funds supply was regarded as a factor beyond their control. Asset management was governed by the basic principle that liquidity and profitability are opposing considerations. Risks and return were two inversely related variables which influenced the composition of assets. Effort was to distribute the assets in such a way that for a given level of liquidity the return was of the maximum. This approach is being substituted by a more comprehensive approach of asset liability management which has been described as 'a continuous process of planning, organising and controlling asset and liability volumes, maturities, rates and yields'. The objective is to avoid the mis-match of asset liability characteristics and liability is no longer treated as given. The liability structure can also be modified in tune with the asset structure that is desired. Banking is much more of a risky business today than it was a decade ago. The kinds of risks and the frequency of occurrence of such risks have increased dramatically. Both liabilities and assets are subject to interest rate risks. The asset quality of loans can be influenced by factors which go beyond the control of the lenders. It is in this context that provisioning for loan losses and need for adequate capital become important. In terms of asset liability management, portfolio managers look at the variable and fixed components both under assets and liabilities. Asset-liability management is not a static concept. The most important element in the process of asset-liability management is to build into the analysis of possible future behaviour of variables such as interest rates. Thus, the asset liability management is a process

and it must be practiced in an on-going manner. Managements must regularly forecast assumptions and develop contingencies to accommodate changes expected.

30. Given these challenges, banks will need to chalk out a plan of action. In this context, two tasks appear important. One is technology upgradation and the other is organisational improvement.

TECHNOLOGY UPGRADATION

31. The impact of technology on banking has been spectacular in the industrially advanced countries. Against the background of growing volume of transactions and the need to meet customer needs expeditiously, technology upgradation has become indispensable. To strengthen internal control, to improve accuracy of records and to facilitate provision of new products and services, banks will have to rely increasingly on computer based technologies. Apart from improving the functioning of banks at various levels, technology has a key role to play in developing a payments system network through which funds can be transmitted quickly and efficiently. I hope the VSAT Satellite based network will come into operation soon. Much groundwork has already been done by RBI and banks.

Organisational Improvement

32. The second phase of reforms will have also to focus on the organisational effectiveness of banks for which the initiatives will have to come from banks themselves. I find many banks have already taken the initiative to seek the advice of in-house as well as external experts to look into these issues. The areas which need improvement are known. In depth corporate planning combined with organisational restructuring are a necessary prerequisite to achieve desired results in terms of productivity and profitability. A properly designed management system that improves productivity and drives the behaviour of employees in delivering quality service must be clearly spelt out. There must be a vision and mission to which employees can relate. To achieve all these goals public sector banks need to be given greater autonomy with respect to recruitment and promotion of personnel and in general management of staff and in determining the organisational structure. Greater accountability has to go with greater autonomy. RBI and Government are actively looking into these issues.