Address by C. Rangarajan Governor, Reserve Bank of India at the Bankers' Training Centre of the Nepal Rastra Bank Kathmandu on 18th May 1997

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Financial Sector Reforms: The Indian Experience

I. Introduction

1. In any economy, the financial sector plays a major role in the mobilisation and allocation of savings. Financial institutions, instruments and markets which constitute the financial sector act as a conduit for the transfer of financial resources from net savers to net borrowers, i.e. from those who spend less than they earn to those who earn less than they spend.
2. The financial sector performs this basic economic function of intermediation essentially through four transformation mechanisms :
    i. liability-asset transformation (i.e.,accepting deposits as a liability and converting them into assets such as loans);
    ii. size-transformation (i.e., providing large loans on the basis of numerous small deposits);
    iii. maturity transformation (i.e., offering savers alternate forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities); and
    iv. risk transformation (i.e., distributing risks through diversification which substantially reduces risks for savers which would prevail while lending directly in the absence of financial intermediation).
3. The process of financial intermediation supports increasing capital accumulation through the institutionalisation of savings and investment and as such, fosters economic growth. The gains to the real sector of the economy therefore depend on how efficiently the financial sector performs this basic function of financial intermediation.
4. A distinction is often made in the literature between operational efficiency and allocational efficiency; while the former relates to transaction costs, the latter deals with the distribution of mobilised funds among competing demands. Sustained improvement of economic activity and growth is greatly enhanced by the existence of a financial system developed in terms of both operational and allocational efficiency in mobilising savings and in channelling them among competing demands. In addition, functional efficiency of a financial system must be judged in terms of (a) the soundness of the appraisals as measured by the level of overdues, (b) the resource cost of specific operations, and (c) the quality and speed of delivery.

    This is an update of author's Fourth SICOM Silver Jubilee Memorial Lecture delivered at Mumbai on 29th July 1996. of services. Both operational and allocational efficiency, to a large extent, are influenced by market structure and the regulatory framework, and on both grounds the central bank has an important role to play in a developing economy like India.

II. Financial Sector Reforms - The Global experience

5. The process of changing the character and structure of financial markets has in many ways been a global phenomenon, though the motivations for reforming domestic financial markets have varied from country to country. Issues of financial sector liberalization and reform, including elements such as effective bank supervision, changing banking regulations, interest rates policies, etc., have received attention not only among developing countries but also a large number of developed countries. The debt crisis of the early '80s and a series of financial crisis witnessed, particularly, during the 1980s, accentuated the move towards adopting measures to impart greater depth, liquidity and stability to the international financial markets. According to the BIS more than 30 Governments across the world have had to help their financial institutions in distress over the last 10 years or so and also bring about consequent changes in their regulatory environment and market structure.
6. The reform of the financial sector in the industrially advanced countries was triggered to a major extent by the global isation of banks and the financial markets. The globalisation trend began at the end of '60s and '70s and was influenced by factors such as restrictive regulations on banking, like Regulation Q in the United States. In fact, the creation of the Euro dollar market was perhaps a precursor to the creation of freer and market driven financial systems. Further, the collapse of the Brettonwoods system had ushered in an era of floating exchange rates in most countries. The subsequent abolition by several countries of capital controls resulted in the development of strong cross-border flows and trading. Simultaneous technological advances in the financial sector strengthened the information resources of banks enabling them to offer real time buying and lending of financial assets, creating profit and loss opportunities throughout the day. These trends were reinforced by the growth of strong competition among institutions especially from the non-bank financial institutions. With the distinction between banks and non-banks coming down, several restrictions specific to the banking sector got dismantled.
7. These developments however raised the level of risk being handled by the global financial system. While risk rose, the margins decreased. Response to increasing competition and decreasing margins came in the form of financial product innovations engineered particularly so as to remain off-balance sheet.
8. Greater opportunities, competitive pressures, financial deregulation and liberalization however led to a tendency on the part of the banks and financial institutions to over extend their lending and investment decisions, such as, by accepting debtors of lower credit worthiness in an attempt to maintain profitability. In the mid 80s, these forced the monetary authorities to strengthen the regulations and raise capital requirements which came to be popularly known as the `Basle norms'. Rules were laid down for reporting non-balance sheet items and prescribing higher risk capital to cover contingencies.
9. Apart from the general objective of improving the working of the financial system, financial sector reforms in many developing countries in Latin America and Asia, were introduced as part of an overall programme of economic stabilisation. In some of the Latin American countries, financial sector reforms were initiated as early as from the middle of 1970s but in most of the countries this phenomenon gained prevalence in the mid '80s. While in some countries financial sector reforms helped in the strengthening of the financial system, some other countries had to initially face some setbacks.
10. A recent study draws the following lessons from the experience of several developing countries which introduced financial liberalisation programmes. First, a minimal system of prudential regulation is necessary before embarking on financial sector reforms. Second, the speed and nature of interest rate liberalisation has to take into account the pace with which problem banks and their debtors can be restructured. Recapitalising the weak banks and restructuring their portfolios must receive attention in this context. Third, the success of the financial liberalisation programmes critically depends upon maintaining

macro economic control during the reform period. Fourth, introduction of convertibility should move from trade to current to capital account.

III. Background of Financial Sector Reform in India

11. The financial sector reforms currently underway in India must be seen as a component, of the overall scheme of structural reforms. The overall package is aimed at enhancing the productivity and efficiency of the economy as a whole and also in creasing international competitiveness. The reforms are comprehensive in scope covering besides financial sector reforms, several other components of economic policy including, liberalisation and deregulation of domestic investment, opening up of key infrastructure areas hitherto reserved for the public sector for private sector participation, opening up the economy to foreign competition by reducing protective barriers such as import controls and high tariff, encouraging direct foreign investment as a source of technology upgradation and also as a source of non-debt finance for investment, reform of the public sector to impart greater efficiency of operations and reform of the tax system to create a structure with moderate rates of tax, broader base of taxation and greater ease of administration. All these reforms are closely inter-related, and progress in one area helps to achieve objectives in others. Since the reforms are being introduced in a phased manner the extent of progress differs from area to area. Importance of the financial sector reforms in this structured package needs to be delineated clearly. Structural reforms in areas such as industrial and trade policy can succeed only if resources are redeployed towards more efficient producers which are encouraged to expand under the new policies. This reallocation is possible only if the financial system plays a crucial supportive role. The reforms in the banking sector and in the capital markets are aimed precisely at achieving this primary objective.
12. The Indian financial system comprises an impressive network of banks and financial institutions and a wide range of financial instruments. There is no doubt that there has been a considerable widening and deepening of the Indian financial system, particularly 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.
13. Despite the overall progress made by the financial system in terms of geographic and functional coverage, the balance sheet of the performance of the banking sector was a mixed one - strong in widening the credit coverage but weak as far as viability and sustainability was concerned. It was against this background that the financial sector reform was initiated aimed at addressing the causal factors both internal and external to the system.

IV. Financial Sector Reforms in India: Philosophy and Strategy

14. The ongoing financial sector reform programme aims at promoting a diversified, efficient and competitive financial sector with the ultimate objective of improving the allocative efficiency of available resources, increasing the return on invest ments and promoting an accelerated growth of the real sector of the economy.
15. More specifically, the financial sector reform programme seeks to achieve the following:
    i. suitable modifications in the policy framework within which various components of the financial system operate, such as rationalisation of interest rates, reduction in the levels of resource pre-emptions and improving the effectiveness of directed credit programmes;

ii. improvement in the financial health and competitive capabilities by means of prescription of prudential norms, recapitalisation of banks, restructuring of weaker banks, allowing freer entry of new banks and generally improving the incentive system under which banks function;
iii. building financial infrastructure relating to supervision, audit, technology and legal framework; and,
iv. upgradation of the level of managerial competence and the quality of human resource of banks by reviewing the policies relating to recruitment, training, and placement.

16. There are certain `commandments' or pre-requisites for systemic reform of the financial sector. First and foremost, macroeconomic stabilisation is a must during the reform process. Fiscal and external policies must support monetary policy in maintaining the overall macroeconomic balance. Secondly, during the reform period, prudential regulation must be introduced and adhered to in order to help safeguard against a financial crisis and prevent the undermining of monetary control and macroeconomic adjustment. Thirdly, the Government must simultaneously implement wide-ranging reforms in other sectors, specially those which require support from the financial system to get the best results.

V. Salient Features of Financial sector reform in India

17. In conformity with the broad philosophy and strategy for reform, salient features of the financial sector reform in India could be analysed under three broad categories :
    a. Policy framework,
    b. Improvement in financial health, and
    c. Institutional Strengthening.

(a) Policy Framework

18. The external factors bearing on the profitability of the banking system related to the administered structure of interest rates, high levels of pre-emptions in the form of reserve requirements, and credit allocation to certain sectors. Easing of these external constraints constitutes a major part of the reform agenda.

(i) Interest Rate Policy

19. The reform of the interest regime constitutes an integral part of the financial sector reform. For long, an administered structure of interest rates was in vogue. The purpose behind this structure was largely to direct implicit subsidy to certain sectors and enable them to obtain funds at concessional rates of interest. An element of cross subsidisation automatically got built into the system where concessional rates of interest provided to some sectors were compensated by higher rates charged to other non-concessional borrowers. The regulation of lending rates, ipso facto,led to the regulation of the deposit rates mainly to keep the cost of funds to banks in reasonable relation to the rates at which they are required to lend. This system of setting the interest rates through administrative fiat became extremely complex and was characterised by detailed prescriptions on the lending as well as the deposit side.
20. In recognition of the problems arising from administrative control over the interest rates, such as, market fragmentation, inefficient allocation of resources, and the like, several attempts were made since the mid-1980s to rationalise the level and structure of interest rates in the country. Initially, steps were taken to develop the domestic money market and freeing of the money market rates. The rates of interest offered on Government

Securities were progressively raised so that the Government borrowing could be carried out at market-related rates. The rates at which the corporate entities could borrow from the capital market were also freed.

21. In respect of banks, a major effort was undertaken to simplify the administered structure of interest rates. In September 1990, a process of simplification was undertaken by reducing the number of slabs for which lending rates had hitherto been prescribed. Until some time ago, the Reserve Bank was prescribing a minimum lending rate, two concessional rates of lending for small borrowers and a maximum deposit rate. The rationalisation in the structure of interest rates culminated in the move by the Reserve Bank, abolishing the minimum lending rate in October 1994 and leaving banks to determine their prime lending rates, while retaining the two concessional rates of lending for small borrowers. On the deposit side, since July 1996 the Reserve Bank prescribes only a maximum rate for deposits upto one year.
22. A gradual approach has thus far been adopted in reforming the interest rates structure in India. Care has been taken to ensure that banks and financial intermediaries do not have incentives which tempt them to lend at high rates of interest assuming higher risks. A major safeguard in this regard has been the prescription of prudential norms relating to provisioning and capital adequacy. These combined with higher standards of operational accountability and appraisal of credit risks would ensure that banks lend prudently and with care.
23. In the context of the deregulation of interest rates, there was an urgent need for developing a reference rate to signal the policy stance of the Reserve Bank. Accordingly, to make the Bank rate an effective signalling rate, in the monetary and credit policy for the first half of 1997-98 announced recently there has been a rationalisation of the interest rate structure with link ing of several interest rates of significance to the Bank rate.

(ii) Pre-emption of Deposits

24. Indian banking system has operated for a long time with a high level reserve requirements both in the form of Cash Reserve Ratio and Statutory Liquidity Ratio. This is really a consequence of the high fiscal deficit and a high degree of monetisa tion of that deficit. In mid 1991. pre-emption in the form of CRR and SLR requirements on incremental deposits amounted to 63.5 per cent. Our efforts in the recent period have been to lower both the CRR and SLR. Apart from removing the incremental CRR, since 1991, the average CRR has been brought down. The objective has been to take the CRR to 10 per cent and below. We are already on this path and the effective CRR has come down from 15.7 per cent at the end of March 1995 to less than 10 per cent by March 1997. With a view to facilitating the development of a more realistic rupee yield curve and term money market, liabilities to banking system have been exempted from maintenance of CRR since April 1997. The SLR has also been brought down from the pre-reform peak of an effective rate of 37.5 per cent to an overall effective level of 26.7 per cent in March 1997. With the SLR on incremental deposits set at 25 per cent and the exemption of inter-bank liabilities from SLR, the average SLR will also come down to 25 per cent.

(iii) Directed Credit

25. In respect of directed lending, there is a prescription that 40 per cent of the net bank credit should go to certain sectors - the priority sector - such as agriculture, small scale industry and small businesses and the programmes for poverty alleviation. Given the imperfections of the credit market, credit allocation for certain sectors becomes necessary in the Indian context. The prescription of 40 per cent of net bank credit going to the priority sector as well as the prescription of two concessional rates of interest applicable for small loans have been retained. Since the bulk of borrowers with such credit needs fall within the priority sector, they will continue to obtain bank finance at

concessional rates. Priority sector borrowers with credit needs of higher amounts will however, be governed by the general interest rate prescriptions. This will ensure that a certain proportion of bank credit goes to the designated sector and to the needy borrowers, without unduly affecting the viability and profitability of banks.

(b) Improvement in Financial Health

26. Another major element of the financial sector reform has been the introduction of prudential norms and regulations aimed at ensuring the safety and soundness of the financial system, impart greater transparency and accountability in operke these (financial) markets function better but will also improve the performance of the economy". The need for intervention in finan cial markets is not denied by anyone. All advocates of financial sector reform have pleaded that deregulation should be accompa nied if not preceded by putting in place a rigorous set of prudential standards to be met by financial institutions. As John Crow former Governor of the Bank of Canada said, "deregulation does not mean desupervision". Internationally accepted common standards for income recognition, provisioning and capital ade quacy have come into force in almost all countries. It is when Stiglitz argues for a more intrusive form of intervention which includes directed credit and maintaining low interest rates through a system of financial repression, that differences begin to emerge. Even here the differences are one of degree rather than of kind. Stiglitz himself talks of the failure to distinguish between small and large repressions. While cross subsidisation of interest rates as well as some forms of directed credit can be built into a system of credit dispensation, the issue becomes serious when such subsidisation reaches levels at which the very viability of the financial institutions is at stake. To some extent, Stiglitz recognises this when he says that `there is a role for Government in financial markets but the success of Government interventions has been mixed. It is important that intervention be well designed'. In fact, what he calls for, are imaginative forms of Government intervention. The crux of the problem lies in determining whether or not a specific policy intervention is imaginative enough i.e. whether it would be more effective than reliance on market force. The art of policy making thus really lies in the eclectic selection of policy interventions.
27. In the context of the banking sector reforms in India, two issues have been raised which need to be addressed squarely. One relates to the rate of interest and the other to the prudential norms. With respect to interest rates the two main questions that are being raised are -
    . should the interest rate be allowed to be determined by market forces? and
    a. should Government meet its borrowing requirements by raising funds at market determined rates of interest?
28. It is being argued that when market forces are allowed to determine the rate of interest, the rate will tend to remain high and such high rates can hinder the process of growth. But these critics fail to understand that if rates of interest are kept at artificially low levels, it can only result in diverting funds from the organised to the unorganised sectors, losing total control over the end-use of funds. While aggregate savings may not be significantly influenced by changes in interest rate, there is enough evidence, nevertheless to show, even in the Indian context, that savings in the form of financial assets are considerably influenced by interest rate. Therefore, if the financial institutions are to perform effectively their major role of mobilising resources, the rate should be allowed to be determined by the forces of supply and demand. The interest rate is, however, a strategic variable and its level can be and is influenced by the actions of the monetary authority. In that sense, interest rate nowhere in the world is purely determined by market forces. It is the function of the monetary authority's policy intervention through the various instruments available to it to move the rate of interest towards a level considered appropriate. Within this overall policy framework, market forces have a greater role in determining the structure of interest rates rather than its level. The monetary authority, however, cannot keep interest rates for long at levels that are inconsistent with the basic supply and demand balance.

29. On the issue of Government borrowing at market related rates of interest, the only way in which Government can meet its requirements at below market rates will be either through a mandatory requirement forcing banks and other financial institutions to invest a certain proportion of their liabilities in Government paper or by simply borrowing from the central bank generat ing an increase in money supply. The first alternative leads to a situation in which the viability of the financial institutions themselves gets eroded. While obviously certain liquidity requirements can be imposed, beyond a point it can only turn the financial institutions into loss making entities. If Government borrows excessively from the central bank, it can only fuel inflation by expanding money supply beyond reasonable limits. It is some times argued that the high rates of interest that the Government has to pay on its borrowings worsens the fiscal deficit. But it is overlooked that high interest rates themselves are not the cause but the effect of unduly large fiscal deficits. The answer to reducing the interest payments lies basically in the Government containing the fiscal deficit and not artificially trying to keep the rates of interest low. While a high interest rate may not be a sufficient deterrent in containing borrowing, nevertheless, it serves a useful function in making explicit the true cost of Government borrowing.
30. Some critics have even taken objection to the introduction of prudential norms. They regard such an introduction either as irrelevant or premature. It is indeed surprising that objections could be raised against introduction of prudential norms. These norms are basically intended to improve the soundness of the working of institutions. In order to avoid a serious set back to the functioning of banks and other institutions, prudential norms have also been introduced in India in a phased manner. Progressively the definition of Non Performing Assets has been tightened. The circumstances prevailing in the Indian financial sector have been taken into account in determining the phasing in of prudential norms. The prudential norms have served a useful role wherever they have been introduced. They have compelled institutions to pay greater attention to the quality of lending. It is true that as a consequence of the introduction of capital adequacy norms, Government have had to allocate a fairly large amount of funds in order to enable the public sector banks to achieve the required capital adequacy standards. There has been no cash outflow because capital has been inducted in the form of bonds. Nevertheless, there is an outflow as far as the Government is concerned in the form of interest payments and the phased amortisation of the bonds. The recapitalisation became neces sary in order to strengthen the balance sheets of banks. Some critics have even sought to establish a relationship between write-off of bad loans and recapitalisation but it is necessary to recognise that these two are independent processes. Write-off of bad loans is part of the programme of cleaning the balance-sheet of banks while recapitalisation has been necessitated by the weakened financial position. Had the prudential norms been introduced earlier, much of the problems of non-performing assets confronted by banks today could have been avoided.
31. One argument against liberalisation has been that it could lead banks to lend at higher and higher rates of interest and thereby accepting higher levels of risk. Literature describes this phenomenon as a process of `adverse selection'. In fact, the answer to adverse selection is the prescription of prudential norms, which will compel banks not to accept risks beyond a point. In any case, banks have never been pure profit maximisers. Profit maximisation has always been subject to the constraint of acceptable level of risk. The prudential norms make this constraint explicit.
32. The chief merit of our reform process has been the cautious sequencing of reforms and the consistent and mutually reinforcing character of the various measures taken. Introduction of prudential norms, widening of the capital base and strengthening of the organisational infrastructure have all gone hand in hand.
33. The first stage of the banking sector reform is coming to an end and we are now moving on to the next stage of the reform. In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and as the financial markets acquire greater width and depth. While the policy environment will remain supportive of healthy growth and development with accent on greater operational flexibility as well as greater prudential regulation and supervision,

the thrust of the second phase of reform would have to be on improvement in the organisational effective ness of banks and other financial entities.

34. Through the various reform measures we have laid the foundation for an efficient and a well-functioning financial system in order to support and sustain a high level of real growth. Significant changes have already taken place. True, as the saying goes, we have miles to go. But our experience so far shows that the steps that have been taken are in the right direction.