Indian Banking : Paradigm Shift –
A regulatory point of view

I am very happy to be here today in the midst of this distinguished gathering of practising bank economists. The decade gone by witnessed a wide range of financial sector reforms, with many of them still in the process of implementation. Some of the recently initiated measures by the RBI for risk management systems, anti money laundering safeguards and corporate governance in banks, and regulatory framework for non bank financial companies, urban cooperative banks, government debt market and forex clearing and payment systems are aimed at streamlining the functioning of these instrumentalities besides cleansing the aberrations in these areas. Further, one or two all India development financial institutions have already commenced the process of migration towards universal banking set up. The banking sector has to respond to these changes, consolidate and realign their business strategies and reach out for technology support to survive emerging competition. Perhaps taking note of these changes in domestic as well as international arena, organisers of this Conference have appropriately chosen the topic 'paradigm shift in Indian Banking' as the central theme for this year's bank-economists Meet and they deserve our appreciation. I would like to take this opportunity to take stock of the impact of regulatory changes initiated, and the central bank's expectations as regards response and performance by the banking system in order to achieve the avowed objectives of ongoing financial sector reforms.

2. All of you will agree that regulatory framework for banks was one area which has seen a sea-change after the financial sector reforms and economic liberalisation and globalisation measures were introduced in 1992-93. These reforms followed broadly the approaches suggested by the two Expert Committees both set up under the chairmanship of Shri M. Narasimham in 1991 and 1998, the recommendations of which are by now well known. The underlying theme of both the Committees was to enhance the competitive efficiency and operational flexibility of our banks which would enable them to meet the global competition as well as respond in a better way to the regulatory and supervisory demand arising out of such liberalisation of the financial sector. Most of the recommendations made by the two Expert Committees which continued to be subject matter of close monitoring by the Government of India as well as RBI have been implemented. Government of India and RBI have taken several steps to -

(a) strengthen the banking sector,
(b) provide more operational flexibility to banks,
(c) enhance the competitive efficiency of banks, and
(d) strengthen the legal framework governing operations of banks.

3. (a) The important measures taken to strengthen the banking sector are briefly, the following:

- ? Introduction of capital adequacy standards on the lines of the Basel norms,
- ? prudential norms on asset classification, income recognition and provisioning,
- ? Introduction of valuation norms and capital for market risk for investments
- ? Enhancing transparency and disclosure requirements for published accounts ,
- ? Aligning exposure norms – single borrower and group-borrower ceiling – with inter-national best practices
- ? Introduction of off-site monitoring system and strengthening of the supervisory framework for banks.

(b) Some of the important measures introduced to provide more operational flexibility to banks are:

? Besides deregulation of interest rate, the boards of banks have been given the authority to fix their prime lending rates. Banks also have the freedom to offer variable rates of interest on deposits, keeping in view their overall cost of funds.
? Statutory reserve requirements have significantly been brought down.
? The quantitative firm-specific and industry-specific credit controls were abolished and banks were given the freedom to deploy credit, based on their commercial judgement, as per the policy approved by their Boards.
? The banks were given the freedom to recruit specialist staff as per their requirements,
? The degree of autonomy to the Board of Directors of banks was substantially enhanced.
? Banks were given autonomy in the areas of business strategy such as, opening of branches / administrative offices, introduction of new products and certain other operational areas.

(c) Some of the important measures taken to increase the competitive efficiency of banks are the following:

? Opening up the banking sector for the private sector participation.
? Scaling down the shareholding of the Government of India in nationalised banks and of the Reserve Bank of India in State Bank of India.

(d) Measures taken by the Government of India to provide a more conducive legal environment for recovery of dues of banks and financial institutions are:

? Setting up of Debt Recovery Tribunals providing a mechanism for expeditious loan recoveries.
? Constitution of a High Power Committee under former Justice Shri Eradi to suggest appropriate foreclosure laws.
? An appropriate legal framework for securitisation of assets is engaging the attention of the Government,

4. This paradigm shift in the regulatory framework for banks had achieved the desired results. The banking sector has shown considerable degree of resilience.

(a) The level of capital adequacy of the Indian banks has improved: the CRAR of public sector banks increased from an average of 9.46% as on March 31, 1995 to 11.18% as on March 31, 2001.

(b) The public sector banks have also made significant progress in enhancing their asset quality, enhancing their provisioning levels and improving their profits.

✍ The gross and net NPAs of public sector banks declined sharply from 23.2% and 14.5% in 1992-93 to 12.40% and 6.7% respectively, in 2000-01.
✍ Similarly, in regard to profitability, while 8 banks in the public sector recorded operating and net losses in 1992-93, all the 27 banks in the public sector showed operating profits and only two banks posted net losses for the year ended March 31, 2001.
✍ The operating profit of the public sector banks increased from Rs.5628 crore as on March 31, 1995 to Rs.13,793 crore as on March 31, 2001.

- ✍ The net profit of public sector banks increased from Rs.1116 crore to Rs.4317 crore during the same period, despite tightening of prudential norms on provisioning against loan losses and investment valuation.

The accounting treatment for impaired assets is now closer to the international best practices and the final accounts of banks are transparent and more amenable to meaningful interpretation of their performance.

WAY FORWARD

5. Much more has to be done in this area and I would like the banks to view these measures for strengthening their fundamentals as a seamless exercise. Globally some of the best managed banks in developed countries are proactive in building up reserves when the profits are on the upswing and do not wait for regulatory goading. Many of them unhesitatingly resort to timely write off and provisioning in respect of problem assets. This is a culture I would like Indian banks to emulate. I would suggest to Indian banks to go for larger provisioning when the profits are good without frittering them away by way of dividends, however tempting it may be. As a method of compulsion, RBI has recently advised banks to create an Investment Fluctuation Reserve upto 5 per cent of the investment portfolio to protect the banks from varying interest rate regime.

6. One of the means for improving financial soundness of a bank is by enhancing the provisioning standards of the bank. The cumulative provisions against loan losses of public sector banks amounted to a mere 41.67% of their gross NPAs for the year ended March 31, 2001. The amount of provisions held by public sector banks is not only low by international standards but there has been wide variation in maintaining the provision among banks. Some of the banks in the public sector had as low provisioning against loan losses as 30% of their gross NPAs and only 5 banks had provisions in excess of 50% of their gross NPAs. This is inadequate considering that some of the countries maintain provisioning against impaired assets at as high as 140%. Indian Banks should improve the provisioning levels to at least 50% of their gross NPAs. There should therefore be an attitudinal change in banks' policy as regards appropriation of profits and full provisioning towards already impaired assets should become a priority corporate goal.

7. The banks should also develop a concept of building **desirable capital** over and above the minimum CRAR which is insisted upon in developed regulatory regimes like UK. This can be at, say around 12 percent as practised even today by some of the Indian banks, so as to provide well needed cushion for growth in risk weighted assets as well as provide for unexpected erosion in asset values.

8. As banks would have observed, the changes in the regulatory framework are now brought in by RBI only through an extensive consultative process with banks as well as public wherever warranted. While this serves the purpose of impact assessment on the proposed measures it also puts the banks on notice to initiate appropriate internal readjustment to meet the emerging regulatory prescriptions. Though adequate transitional route has been provided for switchover to new regulatory measures such as scaling down the exposure to capital market, tightening the prudential requirements like switch over to 90 day NPA norm, reduction in exposure norms, etc., I observe from the various quarters from which RBI gets its inputs that the banks are yet to take serious steps towards implementation of these measures. I would like to exhort my banker friends to move in this regard at a faster pace so

that compliance with the norms is in place and at the same time, it will turn out to be a painless exercise.

9. I would like to inform that the prompt corrective action framework which had already been circulated amongst all concerned and undergoing consultative process with the Government may reach the enforcement stage shortly. Such a mandatory framework when it comes into effect won't distinguish between banks; banks which fall short of the prescribed levels of CRAR and ROA and exceed net NPA level would be facing the mandatory enforcement actions irrespective of the stable ownership. The banks should well note to go in for proactive measures towards improving the financial fundamentals and restore the soundness and stability of the institution than waiting for the supervisor's cease and desist orders to initiate such corrective steps.

10. The Boards of banks have been accorded considerable autonomy in regard to their corporate strategy as also several other operational matters. This does not, however, seem to have translated to any substantial improvement in customer service. It needs to be recognised that meeting the requirements of the customer – whether big or small – efficiently and in a cost effective manner, alone will enable the banks to withstand the global competition as also the competition from non-bank institutions.

11. The profitability of the public sector banks is coming under strain. Despite the resilience shown by our banks in the recent times, the income from recapitalisation bonds accounted for a significant portion of the net profits for some of the nationalised banks. The Return on Assets (RoA) of public sector banks has, on an average, declined from 0.54 for the year ended March 31, 1999 to 0.43 for the year ended March 31, 2001.

12. Therefore, the Boards' attention needs to be focussed on improving the profitability of the bank. The interest income of public sector banks as a percentage of total assets has shown a declining trend since 1996-97: it declined from 9.69 in 1996-97 to 8.84 in 2000-01. Similarly, the spread (net interest income) as a percentage of total assets also declined from 3.16 in 1996-97 to 2.84 in 2000-01. The importance of interest spreads and ways of improving net interest margins by public sector banks were discussed threadbare in a technical seminar at NIBM recently which many of you attended. If the new private banks and foreign banks can despite a high cost of funds could still optimise their profits, why not public sector banks and old private sector banks which have a much wider reach to low cost deposits through large branch network achieve the same? I would like the CMDs of banks to initiate cost cutting measures in the operating expenditure besides giving a customer oriented thrust for attracting quality clientele through quality service. The banks should learn to operate with inherent constraints. You should compete in areas where you have competency and cooperate with competitors where it pays. This change in attitude would, I believe, bring in better margins and optimise your profits.

13. A disheartening feature is that a large number of public sector banks have recorded far below the median RoA of 0.4% for 2000-01 in their peer group. Incidentally the RoA recorded by new private banks and foreign banks ranged from 0.8% to 1% for the same period. An often quoted reason for the decline in profitability of public sector banks is the stock of NPAs which has become a drag on the bank's profitability. As you are aware, the stock of NPAs does not add to the income of the bank while at the same time, additional cost is incurred for keeping them on the books. To help the public sector banks in clearing the old stock of chronic NPAs, RBI had announced 'one-time non discretionary and non

discriminatory compromise settlement schemes' in 2000 and 2001. Though many banks tried to settle the old NPAs through this transparent route, the response was not to the extent anticipated as the banks had been bogged down by the usual fear psychosis of being averse to settling dues where security was available. The moot point is if the underlying security was not realised over decades in many cases due to extensive delay in litigation process, should not the banks have taken advantage of the one time opportunity provided under RBI scheme to cleanse their books of chronic NPAs ? This would have helped in realising the carrying costs on such non-income earning NPAs and released the funds for recycling. I would expect the banks to pursue action in tackling large wilful defaults, effective utilisation of DRTs, and go in for compromise settlements wherever feasible under the banks' own schemes with transparency and accountability.

14. The Boards of public sector banks need to be alive to the declining profitability of the banks. One of the reasons for the low level of profitability of public sector banks is the high operating cost. The cost income ratio (which is also known as efficiency ratio of public sector banks) increased from 65.3 percent for the year ended March 31, 2000 to 68.7 per cent for the year ending March 31, 2001. The staff expenses as a proportion to total income formed as high as 20.7% for public sector banks as against 3.3% for new banks and 8.2% for foreign banks for the year ended March 31, 2001. There is thus an imperative need for the banks to go for cost cutting exercise and rationalise the expenses to achieve better efficiency levels in operation to withstand declining interest rate regime.

15. As you have observed from Governor's address in the recent NIBM annual day function, the corporate governance principles acquire a different connotation when applied to the banking system. Unlike other sectors, banks are highly leveraged institutions and depositors being larger stake holders than equity owners require to be protected. In a deregulated environment, the Boards of banks are expected to play a more pro-active role in preserving the financial soundness and stability of the institution for depositors' protection, besides enhancing shareholders value. The decisions in regard to deployment of resources and pricing of the assets and liabilities are vested with the Boards themselves. This brings us to the need for a professional and qualified Board of Directors who are able to guide the bank in regard to audit, risk management, transparency, etc. in a de-regulated environment.

16. Taking a cue from the recent happenings in some of the banks in relation to capital market exposures and recognising the need for better corporate governance in the banks, RBI has recently constituted a High Powered Group under the Chairmanship of Dr Ashok Ganguly, a director of the Central Board of RBI. The group has drawn representatives from various fields including from management institutes, non official directors of banks, and eminent industrialists and is in the process of formulating its recommendations to strengthen the internal defences at all levels. The international recommendations in this area call for transparency and accountability at the Board level as well at various senior management and other functional levels so that policy and operational aberrations and deviations from good practices are effectively checked and prevented. The CMDs/CEOs of banks both in private and public sector should try to promote participative governance and adopt well defined disclosure standards at Board level as well as at controlling levels down the line.

17. Boards of banks have much more freedom now than they had a decade ago, and obviously they have to play the role of change agents. They should have the expertise to identify, measure and monitor the risks facing the bank and be capable to direct and supervise the bank's operations and in particular, its exposures to various sectors of the economy, and

monitoring / review thereof, pricing strategies, mitigation of risks, etc. The Board of the banks should also ensure compliance with the regulatory framework, and ensure adoption of the best practices in regard to risk management and corporate governance standards. The emphasis in the second generation of reforms ought to be in the areas of risk management and enhancing of the corporate governance standards in banks.

18. Before I conclude, I would also like to touch upon another crucial area which should receive the attention of the Board, viz., the preparedness for switching over to the New Capital Adequacy Framework being introduced by the Basel Committee on Banking Supervision, effective from 2005. The basic thrust of the New Framework is to assign capital in relation to the underlying risk of the counterparties instead of the existing one-size-fits-all formula for assessing credit risk. This would require a more scientific assessment of the credit risk by the banks. In order to have a smooth transition to the New Framework, the banks would need to substantially upgrade their MIS and risk management systems. The banks would also need to upgrade the technical skills of their staff. The adoption of the New Framework, it has been estimated by some analysts, could lead to an increase in the existing level of capital of banks by about 2 percentage points. The signals to the banks are therefore, to enhance the level of core capital, strengthen MIS and historical data base and upgrade the skills of the personnel.

19. I am very grateful to the hosting institution of this Conference and particularly to Dr.Bidhu Bhusan Samal, the Chairman of Allahabad Bank, for giving me this opportunity to share my views on issues which are considered vital for the financial sector in their efforts to move towards changing future scenario.

I wish the Conference all success.

Text of address by Deputy Governor(Shri G.P.Muniappan) at the Bank Economist Conference on January 14, 2002 at Kolkata