Seminar oBanking Reforms and Strategies [1]

The first phase of banking sector reforms initiated in pursuance of the recommendations of the Committee on Financial Sector Reforms provided the necessary platform to the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. Keeping in view the major changes that took place in the macro economic environment and policy and institutional developments in the interim period, the Government of India set up in 1997 a Committee on Banking Sector Reforms under the Chairmanship of Shri M. Narasimham to review the record of implementation of financial system reforms recommended by the earlier Committee and to look ahead and chart the reforms necessary in future to make India's banking system stronger and better equipped to meet the global competition.

The recommendations of the Committee were directed at further improvements in prudential and other reforms to strengthen the banking sector and to move towards international best practices in a number of areas which formed the very basis of the second phase of banking sector reforms. These covered aspects of banking policy, institutional, supervisory and legislative aspects. The Government of India and the RBI have taken various measure policy initiatives in this regard.

The statutory preemptions in the form of SLR and CRR have been brought down in a phased manner to 25% and 5.5% respectively. The interest rates have been deregulated in a phased manner. Except lending to small borrowers and a part of export finance, all lending rates have been deregulated. Interest rates on deposits are now almost free except for prescription in respect of savings deposits. The interest rate on Government borrowings is also now market determined. In order to strengthen the financial position of banks, CRAR was further increased from 8% to 9% from the year ending March 31, 2000. With a view to adopting the international best practices in regard to income recognition, asset classification and provisioning, number of policy changes have been made, viz., prescription of provisioning requirement of 0.25% in respect of standard (or performing) assets, reduction of the time period for classification of doubtful asset from 18 months to 12 months from March 31, 2005, introduction of 90 days norms for classification of NPAs w.e.f. March 31, 2004. The ceiling on exposure to a single borrower has been reduced from 20 per cent to 15 per cent of the bank's capital funds that had been redefined w.e.f March 31, 2002, etc. Banks were also advised to classify investment portfolio into three categories viz., Held to Maturity, Available for Sale and Held for Trading, effective from September 30, 2000, in line with international best practices,

The transparency and disclosure standards recommended in the International Accounting Standards have been implemented in a phased manner. Disclosures requirements have been further broad-based and banks have been advised to disclose maturity pattern of deposits, borrowings, investments and advances and foreign currency assets and liabilities, movements in NPAs and lending to sensitive sectors with effect from March 31, 2000. From year ended March 31, 2001, banks were advised to disclose total advances against shares and total investments made in equity shares, convertible debentures and equity – oriented mutual funds. Further, from year ended March 31, 2002 the banks are required to disclose movement of Provisions held towards NPAs and movement of Provisions held towards depreciation of investments, the total amount of standard/ sub-standard assets subjected to CDR, etc.

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[1]Inaugural address by Shri Vepa Kamesam, Deputy Governor, Reserve Bank of India at Hyderabad on August 30, 2002 at National Seminar on "Banking Reforms and Strategies" organized by The Federation of Andhra Pradesh Chambers of Commerce and Industry.

With a view to injecting greater competition in the banking industry, 10 new private sector banks have been set up since 1993 and RBI has since granted in-principle approval of setting up of two new private sector banks. The banks have been given greater autonomy in the areas like branch licensing, credit delivery, recruitment and creation of posts, etc, subject to fulfillment of certain criteria.

The rigidities in the legal system have come in the way for early resolution of the stock of NPAs in the banking system. Recognising the need for expeditious recovery of banks' dues, Government and RBI have initiated a number of steps for expediting the recovery of NPAs. The important legal reforms measures include amendment of Recovery of Debts due to Banks and Financial Institutions Act in March 2000 vesting DRTs with new powers which focus on improving the infrastructure facilities of DRTs by way of posting of additional Recovery Officers, setting up of an expert group under the chairmanship of Shri T.R. Andhyarujina to suggest appropriate amendments in the legal framework affecting the banking sector issuance of an Ordinance in June, 2002 for regulation of securitisation and reconstruction of financial assets and enforcement of security interest and allied matters thereto, etc.

With the gradual liberalisation of the Indian Financial System and growing integration of the domestic market with the external markets, the risk associated with the banks' operations have been complex and large, requiring strategic management. RBI has issued guidelines on ALM systems and on integrated risk management systems in banks. Due to diversity and varying size of balance sheets, banks have been advised to design risk management architecture, dictated by the size, complexity of business, risk philosophy, market perception and the level of capital. To fine tune the risk management systems in banks, RBI has since issued draft guidance notes on credit and market risk.

The development financial institutions have evolved in India with specific focus on long term financing which the commercial banks were not able to meet. The distinctions between short term and long term financing are increasingly getting blurred over time. The complexities involved in harmonising the role and operation of development financial institutions have been examined and RBI has already allowed the merger of ICICI and ICICI Bank as a major step towards universal banking.

As a major step towards corporate governance in banks, banks were advised to place before their Board of Directors the Report of the Consultative Group of Directors of banks and FIs (Dr. Ganguly Group) set up to review the supervisory role of Boards banks. The recommendations included the responsibility of the Board of Directors, role and responsibility of independent and non-executive directors, fit and proper norms for nomination of directors in private sector banks, etc. The banks were advised that based on the decision taken by the Board, these recommendations can be adopted and implemented. Certain recommendations of the Group require the approval of the Government or legislative amendments and hence they have been referred to Government for consideration.

Co-operative banks as corporate entities possess unique characteristics. Paradoxical as it may sound, evolution of Co-operatives in India as people's organisations rather than business enterprises adopting professional managerial systems has hindered growth of professionalism in Co-operatives and proved to be a neglected areas in their evolution. The co-operative banks should indeed work like professional organisations on sound managerial systems in tune with the needs of the time taking care of future projections of requirements to retain and improve their market share and identity in the long run. It is in this context that

professionalism and accountability of the banks' boards assume such critical significance and introduction of corporate governance in Urban Co-operative Bank's would long way to promote this professionalism.

One area which is essential for best corporate governance practices is transparency and in particular the transparency in the balance sheet. The Auditors have big role to play in bringing transparency in the balance sheet of the co-operative banks. They are expected to be well-versed with all aspects of the new guidelines issued by the Reserve Bank of India and they should ensure that the profit & loss account and balance sheet of co-operative banks are prepared in a transparent manner and reflect the true state of affairs. Auditors should also ensure that other necessary statutory provisions and appropriations out of profits are made as required in terms of Co-operative Societies Act/Rules of the state concerned and the bye-laws of the respective institutions.

Although regulators are external pressure points for good corporate governance, even the most comprehensive regulatory and effective supervisory system need not be a foolproof mechanism against a plaint management acting in collusion with unscrupulous clients. Supervision is only periodic and therefore it cannot be a substitute for effective and continuous internal control backed by an independent and efficacious audit system. It is therefore, imperative to have in place Audit Committees of the Board independent of the management in co-operative banks

Co-operative bank network is vast and disparate with different states having their own rules by way of state co-operative Acts and state registrar of co-operative societies. As of now, co-operative banks are under the dual control of RBI and state registrar of co-operative societies. Recent experiences have shown that disturbance in financial system has a contagion affect. With the objective that no disturbances are caused in the financial sector the requirement for a separate regulator is keenly felt as it will monitor enforcement of banking regulations in the co-operative sector from district to state levels and co-ordinate activities of apex state co-operative banks.

As a major step towards foreign direct investment in the banking sector, Reserve bank of India issued guidelines/ clarifications in February, 2002. Foreign Direct Investment upto 49% from all sources is permitted in private sector banks under the automatic route, subject to conformity with the guidelines issued from time to time.

Technology is at the root of all reforms in the service sector the world over with the financial sector having been one of the major beneficiaries of utilizing technological advancements. The Banking sector in India too has gained from large scale implementation of technology. While technology has resulted in facilities such as 'Total Branch Automation', 'Single Window Service' and other accounts related functions in the recent past, the thrust areas of the present relate to the use of technology for providing centralised systems for banks where centralised data exists with decentralised access to branches and their constituents. This would result in the customer being treated as a customer of a bank as a whole rather than of a particular branch.

The area of Payment and settlement systems – which is at the core of banking activities has also got a shot in the arm thanks to emerging new technologies. The Reserve Bank has taken upon itself the implementation of reforms in payment and settlement systems – right from paper based cheque clearing systems down to novel methods of non-paper modes of funds transfer. Thus, we have MICR based cheque processing, Electronic Clearing Service and Electronic Funds Transfer as products which have stabilized well, apart from the INFINET

(Indian Financial Network) which is a Closed User Group safe and secure network for the use of banks within the country. Other projects in the offing relate to the implementation of the Real Time Gross Settlement and the Structured Financial Messaging Solution (SFMS) which would result in standardised message based inter-bank funds based information exchange. All these would be to the ultimate advantage of the customers, in reducing costs, apart from better housekeeping, improved customer service and overall systemic efficiency.

STRATEGIES FOR FUTURE REFORMS

The Basel Committee intends to replace the current Capital Accord with a New Framework which is built on a three-pillar approach - *minimum capital requirement*, *supervisory review* and *market.* It would be necessary for our banks to move in the direction of the proposals contained in the new Framework as and when they are introduced. Towards this objective, banks have to refine their existing MIS and the risk management architecture. There is also a need for improving further the accounting and disclosure standards to fall in line with the international best practices. Further refinements in market risk management will have to be made by adopting sophisticated techniques like VaR, Duration and Simulation and adoption of internal model-based approaches and credit risk modelling techniques at least, by top banks.

Reserve Bank has accepted the Basel Committee's Core Principles for Effective Banking Supervision. However, there are gaps in the areas of consolidated supervision, country and transfer risk monitoring, inter-agency co-operation and cross-border supervision. Necessary steps are already on hand for implementing consolidated supervision for both domestic and international operations of banks and putting in place a reporting system on a consolidated basis.

Further, a framework of Prompt Corrective Action (PCA) is being evolved with various trigger points with the approval of the Government. The framework is based on three parameters viz capital adequacy, asset quality and profitability. The framework contemplates a set of mandatory and discretionary actions for dealing with banks that cross the trigger points.

India has been sharing the increasing international concern on the use of the financial system for money laundering and financing of terrorism. RBI is in the process of setting out the policy, procedures and controls required to be introduced by banks. These include strict adherence to "Know Your Customer" (KYC) procedures for prevention of misuse of banking system for money laundering and financing of terrorist activity.

I have highlighted some of the important reforms measures undertaken in the past, the future challenges confronting the banking sector in the next few years and the probable strategies to counter these challenges in the foregoing paragraphs. However, to meet the unforeseen challenges, the banking and financial sector has to be sensitized as a whole to the need for internal strength and effective management as well as to the overall concerns for financial stability.