Banking Sector Reforms in India: An Overview[1]

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Governor Ishrat Husain and distinguished bankers,

At the outset, let me express my gratitude to Governor Husain for inviting me to visit Karachi and meet with you. I consider it an honour to be here amidst the banking fraternity. I would like to congratulate Pakistan for its impressive economic performance. Governor Husain, in his address at the Seminar on Management of Pakistan Economy in Lahore, a few weeks ago, had this to say about recent economic performance of Pakistan and challenges ahead, in his characteristically candid fashion:

> *"Economic growth rate has reached a solid 6 per cent plus, inflation has been contained to 5 per cent which has only recently started rising, exchange rate has been stabilized, fiscal deficit has been drastically reduced, domestic interest rates have declined dramatically, international reserves have jumped twelve times their 2000 level, debt ratios have fallen significantly and investment is booming."*

He further added that,

> *"Pakistan has achieved macroeconomic stability, introduced structural reforms, improved economic governance and resumed the path for high growth rates. But there is no room for complacency."*

Taking account of the nature of audience here and following the example of Governor Husain, who spoke eloquently on the banking sector reforms in Pakistan in January this year, I have chosen to present an overview of banking sector reforms in India.

It is useful to very briefly recall the nature of the Indian banking sector at the time of initiation of financial sector reforms in India in the early 1990s. The

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[1] Address by Dr. Y.V. Reddy, Governor, Reserve Bank of India at the Institute of Bankers of Pakistan, Karachi on May 18, 2005.

Indian financial system in the pre-reform period (i.e., prior to Gulf crisis of 1991), essentially catered to the needs of planned development in a mixed-economy framework where the public sector had a dominant role in economic activity. The strategy of planned economic development required huge development expenditure, which was met through Government's dominance of ownership of banks, automatic monetization of fiscal deficit and subjecting the banking sector to large pre-emptions – both in terms of the statutory holding of Government securities (statutory liquidity ratio, or SLR) and cash reserve ratio (CRR). Besides, there was a complex structure of administered interest rates guided by the social concerns, resulting in cross-subsidization. These not only distorted the interest rate mechanism but also adversely affected the viability and profitability of banks by the end of 1980s. There is perhaps an element of commonality of such a 'repressed' regime in the financial sector of many emerging market economies. It follows that the process of reform of financial sector in most emerging economies also has significant commonalities while being specific to the circumstances of each country. A narration of the broad contours of reform in India would be helpful in appreciating both the commonalities and the differences in our paths of reforms.

Contours of Banking Reforms in India

First, reform measures were initiated and sequenced to create an enabling environment for banks to overcome the external constraints – these were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. Sequencing of interest rate deregulation has been an important component of the reform process which has imparted greater efficiency to resource allocation. The process has been gradual and predicated upon the institution of prudential regulation for the banking system, market behaviour, financial opening and, above all, the underlying macroeconomic conditions. The interest rates in the banking system have been largely deregulated except for certain specific classes; these are: savings deposit accounts, non-resident Indian (NRI) deposits, small loans up to Rs.2 lakh and export credit. The need for continuance of these prescriptions as well as those relating to priority sector lending have been flagged for wider debate in the latest annual policy of the RBI. However, administered interest rates still prevail in small savings schemes of the Government.

Second, as regards the policy environment of public ownership, it must be recognised that the lion's share of financial intermediation was accounted for by the public sector during the pre-reform period. As part of the reforms programme, initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. The share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2004. The share of wholly Government-owned public sector banks (i.e., where no diversification of ownership has taken place) sharply declined from about 90 per cent to 10 per cent of aggregate assets of all scheduled commercial banks during the same period. Diversification of ownership has led to greater market accountability and improved efficiency. Since the initiation of reforms, infusion of funds by the Government into the public sector banks for the purpose of recapitalisation amounted, on a cumulative basis, to less than one per cent of India's GDP, a figure much lower than that for many other countries. Even after accounting for the reduction in the Government's shareholding on account of losses set off, the current market value of the share capital of the Government in public sector banks has increased manifold and as such what was perceived to be a bail-out of public sector banks by Government seems to be turning out to be a profitable investment for the Government.

Third, one of the major objectives of banking sector reforms has been to enhance efficiency and productivity through competition. Guidelines have been laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As already mentioned, an element of private shareholding in public sector banks has been injected by enabling a reduction in the Government shareholding in public sector banks to 51 per cent. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

Fourth, consolidation in the banking sector has been another feature of the reform process. This also encompassed the Development Financial Institutions (DFIs), which have been providers of long-term finance while the distinction between short-term and long-term finance provider has increasingly become blurred over time. The complexities involved in harmonising the role and operations of the DFIs were examined and the RBI enabled the reverse-merger of a large DFI with its commercial banking subsidiary which is a major initiative towards universal banking. Recently, another large term-lending institution has been converted into a bank. While guidelines for mergers between non-banking financial companies and banks were issued some time ago, guidelines for mergers between private sector banks have been issued a few days ago. The principles underlying these guidelines would be applicable, as appropriate, to the public sector banks also, subject to the provisions of the relevant legislation.

Fifth, impressive institutional and legal reforms have been undertaken in relation to the banking sector. In 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of the RBI Board with a variety of professional expertise to exercise 'undivided attention to supervision'. The BFS, which generally meets once a month, provides direction on a continuing basis on regulatory policies including governance issues and supervisory practices. It also provides direction on supervisory actions in specific cases. The BFS also ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban cooperatives banks and primary dealers. A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has also been recently constituted to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems. The Credit Information Companies (Regulation) Bill, 2004 has been passed by both the Houses of the Parliament while the Government Securities Bills, 2004 is under process. Certain amendments are being considered by the Parliament to enhance Reserve Bank’s regulatory and supervisory powers. Major amendments relate to requirement of prior approval of RBI for acquisition of five per cent or more of shares of a banking company with a view to ensuring ‘fit and proper’ status of the significant shareholders, aligning the voting rights with the economic holding and empowering the RBI to supersede the Board of a banking company.

Sixth, there have been a number of measures for enhancing the transparency and disclosures standards. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain.

Seventh, while the regulatory framework and supervisory practices have almost converged with the best practices elsewhere in the world, two points are noteworthy. First, the minimum capital to risk assets ratio (CRAR) has been kept at nine per cent i.e., one percentage point above the international norm; and second, the banks are required to maintain a separate Investment Fluctuation Reserve (IFR) out of profits, towards interest rate risk, at five per cent of their investment portfolio under the categories ‘held for trading’ and ‘available for sale’. This was prescribed at a time when interest rates were falling and banks were realizing large gains out of their treasury activities. Simultaneously, the conservative accounting norms did not allow banks to recognize the unrealized gains. Such unrealized gains coupled with the creation of IFR helped in cushioning the valuation losses required to be booked when interest rates in the longer tenors have moved up in the last one year or so.

Eighth, of late, the regulatory framework in India, in addition to prescribing prudential guidelines and encouraging market discipline, is increasingly focusing on ensuring good governance through "fit and proper" owners, directors and senior managers of the banks. Transfer of shareholding of five per cent and above requires acknowledgement from the RBI and such significant shareholders are put through a `fit and proper' test. Banks have also been asked to ensure that the nominated and elected directors are screened by a nomination committee to satisfy `fit and proper' criteria. Directors are also required to sign a covenant indicating their roles and responsibilities. The RBI has recently issued detailed guidelines on ownership and governance in private sector banks emphasizing diversified ownership. The listed banks are also required to comply with governance principles laid down by the SEBI – the securities markets regulator.

Processes of Banking Reform

The processes adopted for bringing about the reforms in India may be of some interest to this audience. Recalling some features of financial sector reforms in India would be in order, before narrating the processes. First, financial sector reform was undertaken early in the reform-cycle in India. Second, the financial sector was not driven by any crisis and the reforms have not been an outcome of multilateral aid. Third, the design and detail of the reform were evolved by domestic expertise, though international experience is always kept in view. Fourth, the Government preferred that public sector banks manage the over-hang problems of the past rather than cleanup the balance sheets with support of the Government. Fifth, it was felt that there is enough room for growth and healthy competition for public and private sector banks as well as foreign and domestic banks. The twin governing principles are non-disruptive progress and consultative process.

In order to ensure timely and effective implementation of the measures, RBI has been adopting a consultative approach before introducing policy measures. Suitable mechanisms have been instituted to deliberate upon various issues so that the benefits of financial efficiency and stability percolate to the common person and the services of the Indian financial system can be benchmarked against international best standards in a transparent manner. Let me give a brief account of these mechanisms.

First, on all important issues, workings group are constituted or technical reports are prepared, generally encompassing a review of the international best practices, options available and way forward. The group membership may be internal or external to the RBI or mixed. Draft reports are often placed in public domain and final reports take account of inputs, in particular from industry associations and self-regulatory organizations. The reform-measures emanate out of such a series of reports, the pioneering ones being: Report of the Committee on the Financial System (Chairman: Shri M. Narasimham), in 1991; Report of the High Level Committee on Balance of Payments (Chairman: Dr. C. Rangarajan) in 1992; and the Report of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham) in 1998.

Second, Resource Management Discussions meetings are held by the RBI with select commercial banks, prior to the policy announcements. These meetings not only focus on perception and outlook of the bankers on the economy, liquidity conditions, credit flow, development of different markets and directions of interest rates, but also on issues relating to developmental aspects of banking operations.

Third, we have formed a Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets (TAC). It has emerged as a key consultative mechanism amongst the regulators and various market players including banks. The Committee has been crystallizing the synergies of experts across various fields of the financial market and thereby acting as a facilitator for the RBI in steering reforms in money, government securities and foreign exchange markets.

Fourth, in order to strengthen the consultative process in the regulatory domain and to place such a process on a continuing basis, the RBI has constituted a Standing Technical Advisory Committee on Financial Regulation on the lines similar to the TAC. The Committee consists of experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. The Committee examines the issues referred to it and advises the RBI on desirable regulatory framework on an on-going basis for banks, non-bank financial institutions and other market participants.

Fifth, for ensuring periodic formal interaction, amongst the regulators, there is a High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM) with the Governor, RBI as the Chairman, and the Heads of the securities market and insurance regulators, and the Secretary of the Finance Ministry as the members. This Co-ordination Committee has authorised constitution of several standing committees to ensure co-ordination in regulatory frameworks at an operational level.

Sixth, more recently a Standing Advisory Committee on Urban Co-operative Banks (UCBs) has been activated to advise on structural, regulatory and supervisory issues relating to UCBs and to facilitate the process of formulating future approaches for this sector. Similar mechanisms are being worked out for non-banking financial companies.

Seventh, the RBI has also instituted a mechanism of placing draft versions of important guidelines for comments of the public at large before finalisation of the guidelines. To further this consultative process and with a specific goal of making the regulatory guidelines more user-friendly, a Users' Consultative Panel has been constituted comprising the representatives of select banks and market participants. The panel provides feedback on regulatory instructions at the formulation stage to avoid any subsequent ambiguities and operational glitches.

Eighth, an extensive and transparent communication system has been evolved. The annual policy statements and their mid-term reviews communicate the RBI's stance on monetary policy in the immediate future of six months to one year. Over the years, the reports of various working groups and committees have emerged as another plank of two-way communication from RBI. An important feature of the RBI's communication policy is the almost real-time dissemination of information through its web-site. The auction results under Liquidity Adjustment Facility (LAF) of the day are posted on the web-site by 12.30 p.m the same day, while by 2.30 p.m. the 'reference rates' of select foreign currencies are also placed on the website. By the next day morning, the press release on money market operations is issued. Every Saturday, by 12 noon, the weekly statistical supplement is placed on the web-site providing a fairly detailed, recent data-base on the RBI and the financial sector. All the regulatory and administrative circulars of different Departments of the RBI are placed on the web-site within half an hour of their finalization.

Ninth, an important feature of the reform of the Indian financial system has been the intent of the authorities to align the regulatory framework with international best practices keeping in view the developmental needs of the country and domestic factors. Towards this end, a Standing Committee on International Financial Standards and Codes was constituted in 1999. The Standing Committee had set up ten Advisory Groups in key areas of the financial sector whose reports are available on the RBI website. The recommendations contained in these reports have either been implemented or are in the process of implementation. I would like to draw your attention to two reports in particular, which have a direct bearing on the banking system, *viz.*, Advisory Group on Banking Supervision and Advisory Group on Corporate Governance. Subsequently, in 2004, we conducted a review of the recommendations of the Advisory Groups and reported the progress and agenda ahead.

What has been the Impact?

These reform measures have had major impact on the overall efficiency and stability of the banking system in India. The present capital adequacy of Indian banks is comparable to those at international level. There has been a marked improvement in the asset quality with the percentage of gross non-performing assets (NPAs) to gross advances for the banking system reduced from 14.4 per cent in 1998 to 7.2 per cent in 2004. The reform measures have also resulted in an improvement in the profitability of banks. The Return on Assets (RoA) of the banks rose from 0.4 per cent in the year 1991-92 to 1.2 per cent in 2003-04. Considering that, globally, the RoA has been in the range 0.9 to 1.5 per cent for 2004, Indian banks are well placed. The banking sector reforms also emphasized the need to review the manpower resources and rationalize the requirements by drawing a realistic plan so as to reduce the operating cost and improve the profitability. During the last five years, the business per employee for public sector banks more than doubled to around Rs.25 million in 2004.

Continuity, Change and Context

We lay considerable emphasis on appropriate mix between the elements of continuity and change in the process of reform, but the dynamic elements in the mix are determined by the context. While there is usually a consensus on the broad direction, relative emphasis on various elements of the process of reform keeps changing, depending on the evolving circumstances. Perhaps it will be useful to illustrate this approach to contextualising the mix of continuity and change.

The mid-term review in November 2003, reviewed the progress of implementation of various developmental as well as regulatory measures in the banking sector but emphasised facilitating the ease of transactions by the common person and strengthening the credit delivery systems, as a response to the pressing needs of the society and economy. The annual policy statement of May 2004 carried forward this focus but flagged major areas requiring urgent attention especially in the areas of ownership, governance, conflicts of interest and customer-protection. Some extracts of the policy statement may be in order:

> *"First, it is necessary to articulate in a comprehensive and transparent manner the policy in regard to ownership and governance of both public and private sector banks keeping in view the special nature of banks. This will also facilitate the ongoing shift from external regulation to internal systems of controls and risk assessments. Second, from a systemic point of view, inter-relationships between activities of financial intermediaries and areas of conflict of interests need to be considered. Third, in order to protect the integrity of the financial system by reducing the likelihood of their becoming conduits for money laundering, terrorist financing and other unlawful activities and also to ensure audit trail, greater accent needs to be laid on the adoption of an effective consolidated know your customer (KYC) system, on both assets and liabilities, in all financial intermediaries regulated by RBI. At the same time, it is essential that banks do not seek intrusive details from their customers and do not resort to sharing of information regarding the customer except with the written consent of the customer. Fourth, while the stability and efficiency imparted to the large commercial banking system is universally recognised, there are some segments which warrant restructuring."*

The annual policy statement for the current year reiterates the concern for common person, while enunciating a medium term framework, for development of money, forex and government securities markets; for enhancing credit flow to agriculture and small industry; for action points in technology and payments systems; for institutional reform in co-operative banking, non-banking financial companies and regional rural banks; and, for ensuring availability of quality services to all sections of the population. The most distinguishing feature of the policy statement relates to the availability of banking services to the common person, especially depositors.

The statement reiterates that depositors' interests form the focal point of the regulatory framework for banking in India, and elaborates the theme as follows:

> *"A licence to do banking business provides the entity, the ability to accept deposits and access to deposit insurance for small depositors. Similarly, regulation and supervision by RBI enables these entities to access funds from a wider investor base and the payment and settlement systems provides efficient payments and funds transfer services. All these services, which are in the nature of public good, involve significant costs and are being made available only to ensure availability of banking and payment services to the entire population without discrimination".*

The policy draws attention to the divergence in treatment of depositors compared to borrowers as:

> *" … while policies relating to credit allocation, credit pricing and credit restructuring should continue to receive attention, it is inappropriate to ignore the mandate relating to depositors' interests. Further, in our country, the socio-economic profile for a typical depositor who seeks safe avenues for his savings deserves special attention relative to other stakeholders in the banks".*

Another significant area of concern has been the possible exclusion of a large section of population from the provision of services and the Statement pleads for financial inclusion. It states:

> *"There has been expansion, greater competition and diversification of ownership of banks leading to both enhanced efficiency and systemic resilience in the banking sector. However, there are legitimate concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, in particular pensioners, self-employed and those employed in unorganised sector. While commercial considerations are no doubt important, the banks have been bestowed with several privileges, especially of seeking public deposits on a highly leveraged basis, and consequently they should be obliged to provide banking services to all segments of the population, on equitable basis."*

Operationally, it has been made clear that RBI will implement policies to encourage banks which provide extensive services while disincentivising those which are not responsive to the banking needs of the community, including the underprivileged.

The quality of services rendered has also invited attention in the current policy. I quote further,

> *"Liberalisation and enhanced competition accord immense benefits, but experience has shown that consumers' interests are not necessarily accorded full protection and their grievances are not properly attended to. Several representations are being received in regard to recent trends of levying unreasonably high service/user charges and enhancement of user charges without proper and prior intimation. Taking account of all these considerations, it has been decided by RBI to set up an independent Banking Codes and Standards Board of India on the model of the mechanism in the UK in order to ensure that comprehensive code of conduct for fair treatment of customers are evolved and adhered to".*

It is essential to recognise that, while these constitute contextual nuanced responses to changing circumstances within the country, the overwhelming compulsion to be in harmony with global developments must be respected and that essentially relates to Basel II.

Basel II and India

RBI's association with the Basel Committee on Banking Supervision dates back to 1997 as India was among the 16 non-member countries that were consulted in the drafting of the Basel Core Principles. Reserve Bank of India became a member of the Core Principles Liaison Group in 1998 and subsequently became a member of the Core Principles Working Group on Capital. Within the Working Group, RBI has been actively participating in the deliberations on the New Accord and had the privilege to lead a group of six major non-G-10 supervisors which presented a proposal on a simplified approach for Basel II to the Committee.

Commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk, initially. After adequate skills are developed, both at the banks and also at supervisory levels, some banks may be allowed to migrate to the Internal Rating Based (IRB) Approach.

Let me briefly review the steps taken for implementation of Basel II and the emerging issues. The RBI had announced in its annual policy statement in May 2004 that banks in India should examine in depth the options available under Basel II and draw a road-map by end-December 2004 for migration to Basel II and review the progress made at quarterly intervals. The Reserve Bank organized a two-day seminar in July 2004 mainly to sensitise the Chief Executive Officers of banks to the opportunities and challenges emerging from the Basel II norms. Soon thereafter all banks were advised in August 2004 to undertake a self-assessment of the various risk management systems in place, with specific reference to the three major risks covered under the Basel II and initiate necessary remedial measures to update the systems to match up to the minimum standards prescribed under the New Framework. Banks have also been advised to formulate and operationalise the Capital Adequacy Assessment Process (CAAP) within the banks as required under Pillar II of the New Framework.

It is appropriate to list some of the other regulatory initiatives taken by the Reserve Bank of India, relevant for Basel II. First, we have tried to ensure that the banks have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital. Second, Risk Based Supervision (RBS) in 23 banks has been introduced on a pilot basis. Third, we have been encouraging banks to formalize their capital adequacy assessment process (CAAP) in alignment with their business plan and performance budgeting system. This, together with the adoption of RBS would aid in factoring the Pillar II requirements under Basel II. Fourth, we have been expanding the area of disclosures (Pillar III), so as to have greater transparency in the financial position and risk profile of banks. Finally, we have tried to build capacity for ensuring the regulator's ability for identifying and permitting eligible banks to adopt IRB / Advanced Measurement approaches.

As per normal practice, and with a view to ensuring migration to Basel II in a non-disruptive manner, a consultative and participative approach has been adopted for both designing and implementing Basel II. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) has been constituted wherein representation from the Indian Banks' Association and the RBI has also been ensured. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework have been issued.

Implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. Though last year has not been a very good year for banks, they are exploring all avenues for meeting the capital requirements under Basel II. The cushion available in the system, which has a CRAR of over 12 per cent now, is, however, comforting.

India has four rating agencies of which three are owned partly/wholly by international rating agencies. Compared to developing countries, the extent of rating penetration has been increasing every year and a large number of capital issues of companies has been rated. However, since rating is of issues and not of issuers, it is likely to result, in effect, in application of only Basel I standards for credit risks in respect of non-retail exposures. While Basel II provides some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to rating of issuers. Encouraging rating of issuers would be essential in this regard. In this context, current non-availability of acceptable and qualitative historical data relevant to ratings, along with the related costs involved in building up and maintaining the requisite database, does influence the pace of migration to the advanced approaches available under Basel II.

Above all, capacity building, both in banks and the regulatory bodies is a serious challenge, especially with regard to adoption of the advanced approaches. We in India have initiated supervisory capacity-building measures to identify the gaps and to assess as well as quantify the extent of additional capital which may be required to be maintained by such banks. The magnitude of this task, which is scheduled to be completed by December 2006, appears daunting since we have as many as 90 scheduled commercial banks in India.

Concluding Observations

In the current scenario, banks are constantly pushing the frontiers of risk management. Compulsions arising out of increasing competition, as well as agency problems between management, owners and other stakeholders are inducing banks to look at newer avenues to augment revenues, while trimming costs. Consolidation, competition and risk management are no doubt critical to the future of banking but I believe that governance and financial inclusion would also emerge as the key issues for a country like India, at this stage of socio-economic development.

Once again, let me thank Governor Husain for his kind invitation and the audience for their patient hearing.

Thank you.