Reforming India's Financial Sector: Changing Dimensions and Emerging Issues*

Prof. Wyplosz, Mr. Roth and Distinguished ladies and gentlemen,

I am honoured and indeed privileged to be amidst such an eminent gathering of central bankers and policymakers at the International Centre for Monetary and Banking Studies. In particular, I am grateful to Mr. Roth, Chairman, Swiss National Bank and Mr. Hildebrand for providing me this forum. The presentation today is on reforming India's financial sector. I eagerly look forward to the benefit of productive discussions in this august gathering. In the address today, I will present a detailed account of the broad lines on which reforms in financial sector have progressed and then will narrate the distinguishing features of the reforms in India. Further, a broad assessment of the impact of reforms will precede a description of the work in progress.

II. Progress of Reforms

India embarked on a strategy of economic reforms in the wake of a balance-of-payments crisis in 1991; a central plank of the reforms was reforms in the financial sector, and with banks being the mainstay of financial intermediation, the banking sector. At the same time, reforms were also undertaken in various segments of financial markets, to enable the banking sector to perform its intermediation role in an efficient manner. The thrust of these reforms was to promote a diversified, efficient and competitive financial system, with the ultimate objective of improving the allocative efficiency of resources, through operational flexibility, improved financial viability and institutional strengthening. The reform measures in the financial sector can be envisaged as having progressed along the following lines.

First, the reforms included creating a conducive policy environment – these were related to lowering of the erstwhile high levels of statutory pre-emption in the form of reserve requirements, gradual rationalisation of the administered interest rate structure to make it market-determined and streamlining the allocation of credit to certain sectors.

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Second, the efficiency and productivity of the system has been improved by enhancing competition. Since the onset of reforms, clear and transparent guidelines were laid down for establishment of new private banks and foreign banks were allowed more liberal entry. A precondition for new banks was that the bank had to be fully computerised *ab initio*. This was done in order to infuse technological efficiency and productivity in the sector and also to serve as a demonstration effect on existing banks. As many as ten new private banks are operating in India at present; foreign banks operating in India numbered over 30 at end-September 2005. Competition was encouraged among public sector banks also.

Third, the ownership base in domestic banks has been broad-based. The equity base of most public sector banks was expanded by infusing private equity, though the government continued to retain majority shareholding. At present, public sector banks with hundred per cent government ownership comprise around 10 per cent of commercial bank assets compared to around 90 per cent at the beginning of reforms. The share of listed private banks – both old and new – in total assets of private banks, stood at over 90 per cent at end-March 2005.

Fourth, a set of micro-prudential measures were instituted, to impart greater strength to the banking system and also to ensure their safety and soundness with the objective of benchmarking against international best practices (risk-based capital standards, income recognition, asset classification and provisioning requirements for non-performing loans as well as provisioning for 'standard' loans, exposure limits for single and group borrowers, accounting rules, investment valuation norms). These norms have been tightened over the years in order to gradually converge towards international best practices.

Fifth, the process of regulation and supervision has also been strengthened. A strategy of on-site inspection and off-site surveillance mechanism together with greater accountability of external audit has been instituted. This has been complemented with a process of prompt corrective action mechanism.

Sixth, in tandem with the improvements in prudential practices, institutional arrangement to improve supervision and to ensure integrity of payment and settlement systems has been put in place. As early as in 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of RBI Board to pay undivided attention to supervision. The BFS ensures an integrated approach to supervision of banks, non-banking finance companies, urban

cooperative banks, select development banks and primary dealers. As part of the process of ensuring a coordinated approach to supervision, a High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM) was constituted in 1999 with the Governor, RBI as Chairman, and the Chiefs of the securities market and insurance regulators, and the Secretary of the Finance Ministry as the members to iron out regulatory gaps and overlaps. To minimise settlement risks in the money, government securities and forex markets, the Clearing Corporation of India Ltd (CCIL) was established in 2002. Acting as a central counterparty through novation, the CCIL provides guaranteed settlement, thereby limiting the problem of gridlock of settlements. A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has also been recently constituted to prescribe policies relating to oversight of the financial infrastructure relating to payment and settlement systems. Finally, to address the systemic risks arising from growth of financial conglomerates, the RBI has put in place an oversight framework which envisages periodic sharing of information among the concerned regulatory bodies.

Seventh, the legal environment for conducting banking business has also been strengthened. Debt recovery tribunals were introduced early into the reforms process exclusively for adjudication of delinquent loans in respect of banks. More recently, an Act to enforce securities and recover loans was enacted in 2003 to enhance protection of lenders rights. To combat the menace of crime-related money, the Prevention of Money Laundering Act was enacted in 2003 to provide the enabling legal framework. The Credit Information Companies (Regulation) Act, 2004 has recently been enacted by the Parliament which is expected to enhance the quality of credit decision making. The Government is considering several major legal amendments to enhance the powers of the RBI. Major changes relate to removal of the restrictions on voting rights in banks, providing legal basis for consolidated supervision, removal of the floor of 25 per cent in respect of statutory liquidity ratio and empowering the RBI to supercede the board of a banking company.

Eighth, the reforms have focused on adopting appropriate processes in order to ensure development of various segments of the markets. In the banking sector, the Indian Banks' Association (IBA) has emerged as an important self-regulatory body working for the growth of a healthy and forward-looking banking and financial services industry. In the debt market segment, the RBI interacts closely with Fixed

Income Money Market Dealers Association of India (FIMMDA) and the Primary Dealers Association of India (PDAI) for overall improvement of government debt markets and promoting sound market practices. With regard to the payments system infrastructure, the introduction of the Real Time Gross Settlement (RTGS) system since 2004 has made it possible for large value payments to be transacted in a faster, efficient and secure manner. In order to enhance transparency of secondary market trades in government securities, a screen based anonymous order matching system has been operationalised.

Ninth, the banking system has also witnessed greater levels of transparency and standards of disclosure with greater volume of information being disclosed as Notes on Accounts in their balance sheets. Salient among these include major profitability and financial ratios, details of capital structures, as well as movements in non-performing loans, movements in provisions, advances to sensitive sectors, to mention a few. The range of disclosures has gradually been expanded over the years to promote market discipline.

Tenth, corporate governance in banks has improved substantially over the years. A Consultative Group was constituted to explore the issue in all its facets in accordance with best extant practices. Based on its recommendations, in June 2002, banks were advised to adopt and implement appropriate governance practices. As part of its efforts to promote sound corporate governance, the RBI has been focusing on ensuring 'fit and proper' owners and directors of the bank and laying stress on diversified ownership. Banks have been advised to ensure that a nomination committee screens the nominated and elected directors to satisfy the 'fit and proper' criteria.

III. Features of Reforms

The unique features of the progress in financial sector reforms may be of some interest to this audience. First, financial sector reforms were undertaken early in the reform cycle. Second, the reforms process was not driven by any banking crisis, nor was it the outcome of any external support package. Third, the design of the reforms was crafted through domestic expertise, taking on board the international experiences in this respect. Fourth, the reforms were carefully sequenced in respect to instruments and objectives. Thus, prudential norms and supervisory strengthening were introduced early in the reform cycle, followed by interest rate deregulation and gradually lowering of statutory pre-emptions. The

more complex aspects of legal and accounting measures were ushered in subsequently when the basic tenets of the reforms were already in place.

A unique feature of the reform of public sector banks, which dominated the Indian banking sector, was the process of financial restructuring. Banks were recapitalised by the government to meet prudential norms through recapitalisation bonds. The mechanism of hiving off bad loans to a separate government asset management company was not considered appropriate in view of the moral hazard. The subsequent divestment of equity and offer to private shareholders was undertaken through a public offer and not by sale to strategic investors. Consequently, all the public sector banks, which issued shares to private shareholders, have been listed on the exchanges and are subject to the same disclosure and market discipline standards as other listed entities. To address the problem of distressed assets, a mechanism has been developed to allow sale of these assets to Asset Reconstruction Companies which are in the private sector and operate as independent commercial entities.

In terms of the processes also, certain interesting features of the reforms are in evidence. The first has been its gradualism, wherein reforms were undertaken only after a process of close and continuous consultation with all stakeholders. This participative process with wider involvement not only encouraged a more informed evaluation of underlying content of policies but also enhanced the credibility of policies and generated expectations among economic agents about the process being enduring in nature. The second has been a constant rebalancing of reform priorities predicated upon the domestic and global business environment, institution of prudential practices, upgradation of the regulatory and supervisory framework, institution of appropriate institutional and legal reforms and the state of openness of the economy. The third important feature of the reforms has been its harmonisation with other policies dictated, among others, by the state of preparedness of the financial sector and above all, the underlying macroeconomic environment. Fourth, the reforms have progressed with emphasis on the common person with the aim of developing a system that is responsive to the needs of all sections of society.

IV. Assessment of Impact

How useful has been the financial liberalisation process in India towards improving the functioning of markets and institutions? First, with the development of appropriate market regulation and associated payment and settlement systems and

the greater integration into global markets, the financial markets have witnessed rapid growth and robustness. A range of instruments in domestic and foreign currency are traded in financial markets. In addition, the market in corporate bonds has been spurred with increased use of external credit ratings. Further, derivative products covering forwards, swaps and options as also structured products are transacted enabling corporates and banks to manage their risk exposures. The market in securitised paper both mortgage backed and asset backed securities has also grown significantly supported by a well developed credit rating industry. Second, liberalisation in financial sector has led to emergence of financial conglomerates since banks have diversified their activities into insurance, asset management securities business, etc. Third, prudential regulation and supervision has improved; the combination of regulation, supervision and a better safety net has limited the impact of unforeseen shocks on the financial system. In addition, the role of market forces in enabling price discovery has enhanced. The dismantling of the erstwhile administered interest rate structure has permitted financial intermediaries to pursue lending and deposit taking based on commercial considerations and their asset-liability profiles. The financial liberalisation process has also enabled reduction in the overhang of non-performing loans: this entailed both a 'stock' (restoration of net worth) solution as well as a 'flow' (improving future profitability) solution. The former was achieved through a carefully crafted capital infusion from the fisc, which aggregated, on a cumulative basis, to about one per cent of GDP; the flow solution, on the other hand, necessitated changes in the institutional and legal processes which were implemented over a period of time.

Moreover, financial entities have become increasingly conscious about risk management practices and have instituted risk management models based on their product profiles, business philosophy and customer orientation. Additionally, access to credit has improved, through newly established domestic banks, foreign banks and bank-like intermediaries. Moreover, government debt markets have developed, enabling RBI to undertake monetary policy more effectively, providing options to banks for liquidity management and allowing less inflationary finance of fiscal deficits. The growth of government debt markets has also provided a benchmark for private debt markets to develop.

There have also been significant improvements in the information infrastructure. The accounting and auditing of intermediaries has strengthened. Availability of information on borrowers has improved which will help reduce

information asymmetry among financial entities. The technological infrastructure has developed in tandem with modern-day requirements in information technology and communications networking. Moreover, the concept of finance has permeated across various institutions and a 'finance view' of all market transactions has emerged. Finally, the quality of human capital involved in the financial sector has typically been of the highest genre, facilitating non-disruptive progress of the reforms process.

The improvements in the performance of the financial system over the decade-and-a-half of reforms are also reflected in the improvement in a number of indicators. Capital adequacy of the banking sector recorded a marked improvement and stood at 12.8 per cent at end-March 2005, comparable to 13.0 per cent for the US during the same period. Typically, the capital adequacy position of developed countries has remained range-bound within 10-14 per cent and judged from that standpoint, our capital position compares favourably with those numbers.

On the asset quality front, notwithstanding the gradual tightening of prudential norms, non-performing loans (NPL) to total loans of commercial banks which was at a high of 15.7 per cent at end-March 1997 declined to 5.2 per cent at end-March 2005. These figures are broadly comparable to those prevailing in several leading European economies (like Italy, Germany and France) which typically ranged within 4-7 per cent of total loans and lower than those in most Asian economies, although they were higher than those prevailing in countries such as, the US, Canada and Australia. Net NPLs also witnessed a significant decline and stood at 2.0 per cent of net advances at end-March 2005, driven by the improvements in loan loss provisioning, which comprises over half of the total provisions and contingencies.

Operating expenses of banks in India are also much more aligned to those prevailing internationally, hovering around 2.21 per cent during 2003-04 (2.16 per cent during 2004-05). In developed countries, in 2004, banks' operating expenses were 3.5 per cent in the US and 2.8 per cent in Canada and Italy and 2.6 per cent in Australia, while they were in the range of 1.1 to 2.0 per cent in banks of other developed countries such as Japan, Switzerland, Germany and the UK. Bank profitability levels in India as indicated by return on assets have also shown an upward trend and for most banks has been a little more than one per cent.

Incidentally, the turnaround in the financial performance of public sector banks has resulted in the market valuation of government holdings far exceeding

the recapitalisation cost. The Indian experience has shown that a strong regulatory framework which is non-discriminatory, market discipline through listing on stock exchanges and operational autonomy has had positive impact on the functioning of the public sector banks.

V. Work in Progress

Financial sector reform is a continuous process that needs to be in tune with the emerging macroeconomic realities and the state of maturity of institutions and markets, mindful of financial stability. In this changing milieu, there are several areas which are being addressed now.

The first issue pertains to capital account convertibility. In view of the rapid changes that have taken place over the last few years and the growing integration of the Indian economy with the world economy, the RBI has recently set up a Committee comprising eminent policymakers, financial sector experts and academia to suggest a roadmap for fuller capital account convertibility. The Committee is required to, in this context, examine the implications of fuller capital account convertibility on monetary and exchange rate management, financial markets and financial system.

The second issue relates to the fiscal area. The institution of the rule-based fiscal policy, as envisaged in the Fiscal Responsibility and Budget Management Act, 2003 (FRBM) has been on revenue-led fiscal consolidation, better expenditure outcomes and rationalisation of tax regimes to remove distortions and improve competitiveness of domestic goods and services in a globalised economic environment. In this context, the RBI has refrained from participating in the primary issues, except in exceptional circumstances. These *de facto* arrangements, which have been working satisfactorily for some period, have come into effect through legislative sanction effective April 1, 2006. While Central Government restated its commitment to fiscal consolidation as per FRBM Act, several state governments have enacted legislation on similar lines while some others are in the pipeline.

An important issue, specifically relating to the banking sector, is consolidation. Despite the liberalisation process, the structure of the Indian banking system has continued without much change though development finance institutions were merged with banks. The consolidation process within the banking system in recent years has primarily been confined to a few mergers in the private sector segment induced by financial position of the banks. Some mergers may take place in future for compliance with minimum net worth requirement or norms on

diversified ownership. The RBI has created an enabling environment by laying down guidelines on mergers and acquisitions. As the bottom lines of domestic banks come under increasing pressure and the options for organic growth exhaust themselves, banks will be exploring ways for inorganic expansion.

The fourth aspect is the role of foreign banks. In terms of assets, the share of foreign banks has roughly been around a quarter within the non public sector banking category. They are dominant in certain segments, such as, the forex market and the derivatives market, accounting for over half of the off-balance sheet exposure of commercial banks. The RBI had, in February 2005, laid down clear and transparent guidelines which provide a roadmap for expansion of foreign banks. As it stands at present, foreign ownership in domestic banks is quite significant. In several new private banks, this share is well over 50 per cent; these banks account for around half of the total assets of domestic private banks. Even in several public sector banks, the extent of foreign ownership within the private holding is close to that of the domestic private holding.

The fifth issue pertains to Basel II. Commercial banks in India are expected to start implementing Basel II with effect from March 31, 2007 though a marginal stretching is not ruled out in view of the state of preparedness. They will initially adopt Standardised Approach for credit risk and Basic Indicator Approach for operational risk. 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. Under Basel II, Indian banks will require larger capital mainly due to capital required for operational risk. The RBI has introduced capital instruments both in Tier I and Tier II available in other jurisdictions. In addition, the RBI is involved in capacity building for ensuring the regulator's ability for identifying and permitting eligible banks to adopt IRB / Advanced Measurement approaches.

The sixth aspect is the role of capital in case of regional rural banks (RRBs) and cooperative banks, which provide banking services primarily in the rural and semi-urban areas. The problems with regard to this segment have been widely documented: these include constraints on timely credit availability, its high cost, neglect of small farmers and continued presence of informal lenders. It is argued that most part of the cooperative credit structure is multi-layered, undercapitalised, over-staffed and under-skilled, often with high level of delinquent loans. The RRBs also appear to share these problems, although there are several viable institutions in this category. These are being addressed on a priority basis. A national-level

committee had recently made recommendations to revive and restructure the rural cooperative credit structure. These have been accepted by the government which has set up a National Level Implementation and Monitoring Committee under the Chairmanship of the Governor for overall guidance in implementation. A process of revitalising RRBs and urban cooperative banks in a medium-term framework is also underway.

Seventh, we are adopting a three-track approach with regard to capital adequacy rules. On the first track, the commercial banks are required to maintain capital for both credit and market risks as per Basel I framework; cooperative banks on the second track are required to maintain capital for credit risk as per Basel I framework and surrogates for market risk; RRBs on the third track which though subject to prudential norms do not have capital requirement on par with the Basel I framework. In other words, a major segment of systemic importance is under a full Basel I framework, a portion of the minor segment partly on Basel I framework and a smaller segment on a non-Basel framework. Even after commercial banks begin implementing Basel II framework in March 2007, we may witness Basel I and non-Basel II entities operating simultaneously. This would not only ensure greater outreach of banking business, but also, in the present scenario of high growth, enable them to usefully lend to the disadvantageous sections and successfully pierce the informal credit segment.

The eighth issue of relevance is that of financial inclusion. While resource limitations experienced by low-income households will continue to constrain their access and use of financial products, the challenge remains for developing appropriate policies, procedures and products that can overcome this difficulty within the bounds of resource constraints. Apart from greater latitude in the range of identity documents that are acceptable to open an account, there is also a need for independent information and advisory service. This needs to be supplemented by nurturing appropriate public-private partnerships. Some development to this effect is already evidenced in the significant growth and development of micro-finance activities. Self-help groups formed by non-government organisations and financed by banks represents an important constituent of this development process in India.

As part of its ongoing efforts to encourage greater financial inclusion, the Annual Policy Statement released in April 2006, gives particular attention to issues relating to farmers. A beginning has already been made to ensure greater outreach of banking facilities in rural areas through appointment of reputed non-

governmental organisations (NGOs) / post offices, etc., as banking facilitators and banking correspondents. A Working Group has also been proposed to ensure greater outreach of banking facilities in rural areas and to ensure availability of bank finance at reasonable rates. A Working Group has also been proposed to suggest measures for assisting distressed farmers, including provision of financial counselling services and introduction of a specific Credit Guarantee Scheme under the Deposit Insurance and Credit Guarantee Corporation (DICGC) Act. The convenors of the State Level Bankers Committee in all States/Union Territories have been advised to identify at least one district in their area for achieving 100 per cent financial inclusion by providing a 'no-frills' account and a general purpose credit card (GCC). A Technical Group has also been proposed to renew the existing legislative framework governing money lending and its enforcement machinery so as to provide for greater credit penetration by the financial sector in the rural areas at reasonable rates of interest.

The final area that has gained prominence in the recent past relates to customer service. The focus of attention is on basic banking services provided to the common persons and the need for ensuring effective customer grievance redressal as also fair practice code. A Banking Ombudsman facility has been established covering all States and Union Territories for redressal of grievances against deficient banking services. The recently constituted Banking Codes and Standards Board of India is an important step in this regard which is expected to ensure that the banks formulate and adhere to their own comprehensive code of conduct for fair treatment of customers. Additionally, constitution of a Working Group has been proposed in the latest policy to formulate a scheme for ensuring reasonableness of charges offered by banks on its various services.

It is widely acknowledged that India is the repository of the best of human skills, especially in the financial sector. The technological competence of the Indian workforce is perhaps presently part of folklore. The present levels of growth optimism about the economy suggest that India is expected to remain one of the important growth drivers of the global economy in the near future. The financial infrastructure and regulatory framework in the country are broadly on par with those prevailing internationally. We are working towards evolving a globally competitive banking sector, stressing on banking services relevant to our socio-economic conditions and contributing to both growth and stability.