Regulatory Regime in Financial Sector – Emerging Issues *

Hyderabad, known also as a Bagya Nagar, is well known for housing some of the premier institutions of this country, of which Administrative Staff College of India occupies a pride of place. The city has become a trendsetter in the emerging thrust area of Indian economic resurgence, namely Information Technology. It has provided congenial functional environment for many of global IT Giants, in the process earning the name of Cyberabad. It is just the other day, precisely on 19th June, I had been in this great city for inaugurating the RBI's VSAT secured financial communication network which is designed to revolutionise the payment systems framework in India. Again, I am proud to be back in this city to associate myself with this all-important Seminar organised to chart the future role and operations of the Development Financial Institutions (DFI) of this country.

It is in fitness of things that the College which is a premier institution in advanced management, research and consultancy issues has been chosen as the venue for discussing the transformatory role and future functional direction of the Indian Development Financial Institutions. The more important reason for RBI getting closely involved in this exercise is that Shri Narasimham, the luminary of financial reform is Chairman of this college.

On a perusal of the agenda for the day, I note that after the Key Note address by Dr Y.V.Reddy, an authority on Development Banking besides being one of my senior colleagues in the Bank, the participants have been through three thematic and analytical sessions guided by panels of luminaries from current day Indian financial world.

In any fora where issues relating to financial sector reforms are discussed, the task will be left incomplete without a reference to the contributions of the Architect of modern financial architecture i.e. Shri.M.Narasimham. I consider it as my foremost duty to pay my respects to him before starting the material part of my paper. In the first part of my address, I shall, therefore, be covering the present status of Regulation and Supervision in India after the advent of Financial Sector Reforms in the early nineties, before proceeding to sum up the issues relating to harmonisation arising out of the Day's Seminar.

Earlier developments – Pro-reform measures

Major reforms and shift in focus in financial sector regulation & supervision started in Indian system in 1992 i.e. after acceptance of the recommendations of Narasimham Committee (I) on financial sector reforms and more rapidly after formation of Board for Financial Supervision in November 1994. I would like to state that most of the recommendations of the Committee had been implemented. I would like to list some of the important hereunder:

- **Reduction of pre-emptions like high level of Cash Reserve ratio (CRR) and Statutory Liquidity Ratio (SLR).** The pre-reform level of CRR, which was at 15 per cent of NDTL plus incremental 10 per cent on NDTL over the level of 3 May 1991, has since been brought down to a low of 10 per cent from the fortnight beginning 8th May 1999. The effective rate would be still lower if the exemptions on foreign currency and inter bank liabilities from NDTL are reckoned. Similarly, the SLR has also been brought down from 38.5 percent on domestic liabilities and 30 per cent on non resident liabilities in pre-reform days to the statutory minimum of 25 per cent prescribed under the Banking Regulation Act,

1949.

- **Deregulation of Interest Rate both in respect of deposits and advances.** Only saving deposits and those for less than 15 days and loans upto Rs.2,00,000 are yet under administered interest rate regime.

- **Adoption of prudential norms** relating to capital adequacy, income recognition, asset classification, provisioning standards for impaired assets, and classification and valuation of investment portfolio almost on par with global best practices.

One of the two main areas of divergence from international norms in this regard is our sticking to 2 quarter (+one month) default status for reckoning a borrowal account as NPA. Another area of divergence is in bringing down the time lag for classification of doubtful category (which is to be brought down from 24 to 18 months by March 2001 and will be gradually reduced to 12 months). These divergences have to be understood in the broader context of otherwise stringent Indian prudential system wherein,

- collaterals are not to be reckoned while providing for substandard advances, (collaterals are an integral part of lending system for Indian banks, as banks' unsecured exposures cannot exceed 15% of their total credit outstanding)
- non restoration to standard category for one year even in case of regular performance of the account subsequently,
- elongated payment cycles for commercial and trade transactions
- poor communication network and absence of on-line payment systems, etc.

- **Promotion of competition by licensing new banks in private sector.**

Though the number of banks newly licensed are only nine, they accounted, within a short period of four years of their functioning, for around 4 percent of the total assets of the Indian banking system as against 7 per cent by 26 old private banks and 8 per cent by 43 foreign banks. The new banks have made a niche in the type of services offered, use of networked technology, array of new products and provide a healthy competition to that of some of the well established foreign banks. The banks promoted by the DFIs have further benefitted from the qualitative credit appraisal techniques of their parents enabling them to contain their Net NPLs around 1 per cent in 1997-98 and at less than 3 per cent (as against industry's provisional average of about 8 per cent) even in a difficult year like 1998-99 for Indian banking industry.

Laying down transparency and Disclosure standards

RBI achieved this by mandating disclosure of some of the essential strength indicators and performance related parameters as part of the Notes on accounts in the Annual published accounts of the banks. Some of the important items relate to disclosure of accounting policies, capital adequacy ratio separately under Tier I and II, percentage of government shareholding, percentage of net NPAs to net Advances, category-wise provisions towards depreciation, NPAs, extent of sub-ordinated debt, gross value of investments less cumulative depreciation, income ratios, business and profit per employee.

As a sequel to the recommendations of Narasimham committee (II), RBI has already advised the banks, effective from 31 March 2000, to disclose maturity pattern of loans and advances, investment securities, deposits & borrowings, foreign currency assets and liabilities,

movement in NPAs, lending to sensitive sectors as defined from time to time. The list is ever growing.

Besides prescribing these disclosure standards, RBI has, at the instance of the BFS, published a consolidated account of status of non performing assets of individual banks from 1997-98 onwards in its annual statutory report on Trend and Progress of Banking.

The recommendations of Narasimham Committee (I) that remain still under consideration or partially implemented essentially relate to structural aspects like, public ownership and autonomy of public sector banks, formation of asset reconstruction companies, etc.

The reform process was reviewed by Narasimham Committee (II), and within a short period of acceptance of the Report in August 1998, a large number of its recommendations have been implemented or taken up for implementation in stages. The announcements in this regard were made in the Mid Term Review of Monetary and Credit Policy in October 1998 followed by another stream of measures adopted in the April 1999 Policy of the Bank. They are:

Adoption of BIS Capital Adequacy standards

- CRAR for banks and FIs increased to 9% from 1st April 1999

(3 banks had CRAR at less than the minimum level of 8 per cent as on 31st March 1998 and as many as 84 banks had CRAR of more than 10 per cent as on that date. Provisional estimates indicate that 4 banks have a level of CRAR less than 8 per cent, 10 banks at less than 9 per cent while 86 banks more than 10 per cent as on 31st March 1999.)

- Prescription of CRAR for open position on forex and gold
- CRAR for Market Risk for government and approved securities to be implemented in 2 phases - first 2.5 per cent by 31st March 2000.
- 20% risk weight for Government guaranteed securities of PSUs which do not form part of the RBI approved market borrowing programme from 1st April 2000
- 20 per cent Risk weighting of state government guaranteed advances which remain in default as on 31st March 2000 and 100 per cent for continued default after 31st March 2001

Loan Review Mechanism

- for larger advances soon after sanction and monitoring weaknesses

Provisioning Norms

- reduction in time frame for classification of doubtful category (24 to 18 months)
- provisioning for advances covered by state government guarantee which are invoked
- provisioning for standard assets at 0.25% from end of March 2000

Constitution of Settlement Advisory Committees for promoting recoveries under chronic cases of NPAs under small sector I can claim that these measures have committed the Financial system towards implementation of most of the operational recommendations of Narasimham Committee (II). Those, where action is yet to be initiated for implementation, require assessment of the amendments to various enactments and an expert Group constituted by the Government as suggested by the Committee is already on the job.

Strengthening of Financial Supervision

During the last 5 years, the Indian supervisory system has come of age under the close and incisive oversight of the Board for Financial Supervision. The BFS which is an off shoot of

the recommendations of Narasimham Committee (I) and formed under the aegis of the central bank meets every month under the chairmanship of Governor. Its deliberations and directions are guided by four non-official members drawn from the central board of directors of the Bank and who are also experts in their respective fields of accounts, law, management and socio economics. Members spend considerable time in deciding on all matters of supervisory concern and there has been all round improvement in the banks' NPA management, housekeeping and reconciliation of books and internal controls and in responding to the new Asset Liability management prescriptions. Also the new off-site supervision system focuses on identifying the major risk areas in banks. The following are some of the salient policy directions of BFS and duly implemented by the Bank in financial supervision area:

Banks

RBI has put in place comprehensive Rating system based on CAMELS (CACS for foreign banks) arrived from annual on-site examination findings and is ably supplemented by technology driven quarterly off-site surveillance system.

System monitoring and major fraud reporting at quarterly intervals by BFS combined with exhaustive guidelines for concurrent audit, internal audit / inspection and close board level supervision by Audit Committee of the Board in banks has brought down the level of unreconciled inter branch accounting entries, arrears in balancing of books (a perennial bug bear in non computerised / non networked environment), and improved the efficiency level in housekeeping areas, particularly in public sector banks which have a large branch network.

Basle's Core principles for effective banking supervision have been accepted and steps are already on to address the few gaps in the area of inter agency cooperation, consolidated supervision and risk management. A committee has already gone into the procedures for streamlining licensing of new private banks and its recommendations are being finalised for adoption.

You will thus notice that the Indian banking system has covered many milestones in a short period of over last five years in implementation of the various measures aimed at strengthening their prudential base and operational systems. With the adoption of ALM and Risk Management guidelines by them before end of March 2000, there will be a discernible shift in their operational focus from mere solvency approach to hedging against all types of risks inherent in funded and non funded exposures, taking them in the process to such efficiency levels on par with the financial systems of the developed countries.

NBFCS

A major thrust of RBI's regulatory and supervisory policy over the last 3 years has been in the area of non banking companies. Required legislative powers were acquired by RBI and a separate department was formed for supervising NBFC segment of the financial system, though small in size but sensitive in the context of investment climate.

Some of the land mark measures initiated by RBI in regulation and supervision of NBFCs are: Compulsory registration, higher entry norms of net owned funds initially pegged at Rs.25 lakhs (since enhanced to Rs. 2 crores), stricter prudential norms, enhanced capital adequacy standards, rating, elimination of weak players from the arena of acceptance of public deposits, formation of self regulatory organisations and commissioned audits through

professional accountants at RBI's behest, etc.

CRAR levels which were 10 per cent as on 31st March 1998 have been enhanced to 12 or 15 per cent according to the nature of operations and as per the level of regulatory compliance. Equipment Leasing / Hire Purchase Finance companies without credit rating or with rating at less than investment grade as well as Loan / Investment Companies are required to maintain CRAR at 15 per cent. Equipment Leasing / Hire Purchase Finance companies with minimum investment grade rating are required to maintain CRAR at 12 per cent as on 31st March 1999. The Bank intends to raise the CRAR in respect of all types of NBFCs to a uniform level of 15 per cent over a period.

Similarly, the minimum level for maintenance liquid assets requirement has also been increased from 12.5 per cent to 15 per cent from 1st April 1999.

Development Financial Institutions

Till the year 1990 RBI had not taken upon itself the task of broad oversight of the operations of DFIs. As brought out in the RBI Discussion Paper, these institutions are not similar in regard to their ownership, role functions and statute under which they are established. The monitoring of the DFIs started after 1990 on the basis of the recommendations made by an In-house group formed for the purpose. The monitoring work was limited to calling for prescribed returns on liabilities/assets, source and deployment of funds etc. on quarterly basis from the DFIs. It was mainly for obtaining a macro perspective data for the purpose of Monetary and Credit policy, assessing the quality of assets of the financial system and improving co-ordination between banks and DFIs.

With the setting up of BFS the responsibility for prudential supervision of DFIs devolved on RBI from April 1995. Under the powers available to RBI in terms of provisions contained in Section 45N of the RBI Act, 1934 and more explicitly in terms of powers given to the BFS, the first on-site inspection of DFIs started in May 1995. Though the CAMELS approach is being adopted to start with for the on-site inspection assessment, it has been well recognised that the scope and coverage of such inspections would also have to take into account developmental, co-ordinating and supervisory roles of DFIs. The task of designing an enhanced off-site monitoring system and on-site supervisory model for regulation and supervision over DFIs is already on hand.

Year 2000 (Y2k) compliance measures

One of the important supervisory issues relating to business continuity of the financial system pertains to resolving year 2000 compliance which is better known as Y2k issue. RBI has spared no efforts in this regard. It had initiated measures for awareness, problem identification, remediation and compliance in this area as far back in September 1997 on the lines of BIS guidelines. Contingency measures have been prescribed including testing of the plans. Disclosure of compliance efforts have been mandated for inclusion in annual reports and later publishing in the media. While more than 70% of the banks have reported compliant by April 1999, remaining are committed to become compliant by June 1999. Penal enforcement measures like higher capital adequacy standards, denial of branch expansion, etc. have also been envisaged for the non compliant institutions.

New regulatory and supervisory measures on the anvil

Recently, I had the opportunity of visiting the regulatory institutions in USA along with

Special Secretary (Banking Division) Ministry of Finance. Our interaction with some of the regulatory agencies like FDIC provided us a detailed insight into the ways these regulators approached resolution of problem credit and quick responses to triggers and failings in the depository institutions. As a follow-up to the visit, RBI has constituted special task oriented in-house groups to examine the various regulatory and supervisory issues like,

- Redefining the role of DICGC on the lines of FDIC which is entrusted with the responsibility of Insuring deposits, assuming receivership of problem depository institutions, and supervision under the multi-regulatory dispensation practiced in USA. The model envisaged for DICGC in Indian context would be sans the FDIC's supervisory function, and focused on faster recovery of the troubled institution.
- setting up of Credit Information Bureau, supervisory enforcement measures for breaches of CRAR standards,
- augment the regulation and reporting standards for overseas operations of Indian banks,
- suspicious activity reporting in tandem with the provisions of Money Laundering enactment,
- new look to on-site inspection procedures with orientation towards adoption of Risk management systems on the model followed by Federal Reserve System,
- Skill upgradation of RBI supervisors particularly in handling the emerging ALM and risk management areas, and understanding the risks and controls in computerised environment
- Upgradation of off-site processing system incorporating the ALM returns and providing for introduction of Returns for Consolidated Supervision

An Expert Legal Group has been set up to look in to changes required in the legislative framework in regard to certain important issues, such as penal provisions against directors indulging in connected and related lendings , foreclosure and bankruptcy, besides broad-basing of certain provisions designed to plug the existing lacunae as well as achieve more clarity in banking related Acts. Once the legislative framework is put in place, it will strengthen the arms of both banks and FIs which will help smoothen gradual switch over to universal banking.

We are also contemplating to put in a regulatory regime for stringent action against banks whose level of CRAR falls below the prescribed minimum level and CAMELS rating slips to D, the lowest rating under the supervisory rating process evolved by the Bank. The directions that may be issued to such banks may include one or more severe restrictions like, freezing the level of outstanding loans and advances, denial of branch expansion, hiving of non profitable business areas and locations, down-sizing of domestic and overseas branches, imposing of cuts in expenditure in non-productive areas of operation, disposal of non-performing assets, change of top management or the entire board of directors, insistence on infusion of fresh capital for continuance of dominant ownership, and also **compulsory mergers**.

To conclude,

While I have tried to illustrate the Central Bank's firm resolve in promoting the financial stability and transparency of the Indian banking system, I would at the same time like to emphasise that we would like to have the global norms tailored to suit Indian environment. We are constantly endeavoring to move towards international best practices in the arena of prudential and disclosure standards but shall prescribe and enforce them in a phased but firm

manner.

With all the progress made, I believe that there is still a long way to go in financial supervision. We have to improve the early warning systems, enhance the supervisor skill to cope up with new products, meet the challenges that may arise on wide acceptance of E'Commerce and Internet banking practices, requirements of cross border processing and evolve acceptable and reciprocal inter-supervisory norms between home and host country regulators. Technology and communications have shortened the geographical limits but enlarged supervisory gaps and the battle will go on for bridging the gaps, as in other parts of the world.

Mr. Chairman, let me now move on to the second part of my speech where I am supposed to give a formal valedictory address.

As you are aware that, Reserve Bank constituted the Khan Working Group in December 1997and the final Report was made available in May 1998. In the meantime, the Reserve Bank had the benefit of Second Narasimham Committee Report (April 1998) and hence we thought that it would be a prudent way to prepare a Discussion Paper which would contain Reserve Bank's draft proposals for bringing out greater clarity in the respective roles of banks and DFIs for greater harmonization of facilities and obligations applicable to them.

The deliberations of seminars held at Mumbai, and Delhi earlier and today at Hyderabad clearly indicate that on many important issues, we are on the same wave length.

For the future financial system of India, the Discussion Paper has thrown open a number of issues regarding harmonisation. I must mention here that we do not have any fixity of views on any issue. All we are interested is that we put in place a feasible and stable system.

The draft proposals as contained in the Discussion Paper encompass three main issues, viz. (i) approach to universal banking, (ii) meeting the long term capital requirements of the corporate sector and the (iii) future role of DFIs and RFIs.

Approach to Universal Banking :

As rightly mentioned by many speakers, in India we have some elements of universal banking and there are no legal obstacles to such an approach. The Banks are already providing a length of financial services such as investments, merchant banking, leasing and hire purchase and project financing either in-house or through the subsidiary route. Likewise, the DFIs are undertaking bank-like activities such as short-term non-project lending and retail deposit taking either in-house or through subsidiary route.

The question is how much more of it now, or how gradually or how fast we could move so that this process is defined to be orderly.

There is no universally accepted definition of universal banking. Universal banking must be evolved in future so that the banks and DFIs could reap all the beneficial effects. However, before moving towards this, there should be enough capacities in both banks and DFIs to deal with new types of risks, viz. market risk, credit risk, etc. and hence the need for putting in place appropriate risk mitigation mechanism is to be recognized.

Capital Requirements of the Corporate Sector :
Regarding capital requirements of the corporate sector, the Discussion Paper clearly recognised the special role for DFIs and further stated that until the long term debt market improves, in terms of liquidity and depth, there is a special role for DFIs in the financial system. Large and medium-sized firms continue to depend on DFIs for long term financing. DFIs have acquired special skills in project appraisal, which banks are yet to fully specialise.

During the last five years, i.e. 1993-94 to 1997-98, disbursements by All India DFIs amounted to Rs.1,86,075 crores compared to the incremental term loan from scheduled commercial banks approximately at Rs.20,000 crore which formed only about 12 per cent of AIFI disbursements. This clearly indicates that the core competence of commercial banks lie outside the area of project finance and term lending and for the time being at least they may not be in a position to undertake long term financing in a significant way.

Future role of DFIs
Regarding Discussion Paper's stance on the timing of transformation of a DFI into universal bank, it is important to recognise that the Discussion Paper's approach clearly is to give the option to DFI to convert or not to convert at all. A DFI opting to convert may do so at any time without any stipulated time limit though five years appears "ideal".

In the last 2/3 years, many corporates depended heavily on DFIs even for their equity requirements. It is doubtful, to what extent commercial banks would have been able to fill the gap. As rightly observed by many speakers, DFIs have a special role to play in this sphere. This is also one of the reasons for suggesting a five year waiting period. However, if a DFI can demonstrate its capacities to transform into a bank sooner and conform to the totality of regulatory framework of a bank, there should be no objection to such transformation. … When a DFI chooses to transform itself into bank, the transitionary arrangements, on a time-bound basis, could be worked out, after a detailed examination by the RBI, on a case by case basis".

This is essential because each DFI would be in a unique position in terms of its capacity to transform into a bank, necessitating a transition period and tailor-made transition path would need to be worked out.

It is easier to enable DFIs to become full fledged banks if the reserve requirements such as CRR and SLR are drastically reduced – say to international levels. One of the reasons for suggesting a five year period as ideal is the expectation that fiscal consolidation would be complete and would facilitate reduction in reserve requirements. The recent budget of Government of India clearly gives a medium-term commitment to reduce gross fiscal deficit of Centre to 2 per cent of GDP. This is an important input to decide the timing of transition of DFIs into full fledged banks.

To sum up,
Mr. Chairman, let me express my observations on a few important issues before this Seminar. Although universal banking is a desirable one, we should be cautious in moving towards this and a gradual and a well thought out process is required.

DFIs and banks have functioned parallel to each other for decades and avoided overlaps, though more recently banks have gone into long term finance and DFIs have also been

extending short term finance on a modest scale. The convergence therefore should be gradual and not appear to be dramatic or supplanting each other. In the mean time it is important that vital issues like making available long term funds at low cost, proper co-ordination between FIs and banks, a flexible and speedy approach towards rescheduling/rehabilitation of viable projects are given immediate attention.

Let me assure you that very detailed suggestions made here will be noted by us and reviewed internally before finalising actions on the Discussion Paper.

On behalf of RBI and on my own behalf I thank all the participants for valuable debate and advice.

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* Address by Shri S.P.Talwar Deputy Governor, Reserve Bank of India at the seminar on "Harmonising the Role of & Operations of Development Financial Institutions & Banks" (Sponsored by RBI at Administrative Staff College of India, Hyderabad)