Paradigm Shift from Micro-Credit Management to Market-Led Growth*

JAGDISH CAPOOR

It gives me immense pleasure to be a part of this distinguished gathering and to speak on the subject of 'Paradigm Shift from Micro-Credit Management to Market-led Growth'. In the new millennium, India is poised for playing a role on the world economic scene larger than ever before. Last decade has been an extremely eventful one for the Indian economy. Though the record of development in the 'nineties has been a disappointing one for the developing world as a whole, there have been a few exceptions, India being one of them. As a result of the radical steps taken by the Indian authorities, we have heralded a shift from a regime of micro management to one driven by the forces of the market. Let us take this opportunity to assess the present state of the economy and various policy measures initiated recently to shift the economy on to a higher growth trajectory.

The movement from micro management to market-driven growth covers a broad spectrum and I would take this opportunity to present an overview of this paradigm shift with the focus primarily on the banking sector, and some of the other related developments.

As Stiglitz[1] has observed, the financial sector constitutes the 'brain' of the economy and banks are a major constituent of the financial sector. This is especially true in bank-dominated economies like India where the banking system plays a crucial role in the intermediation process and also constitutes the mainstay of the payments system. However, the banking sector, in isolation, cannot purport to be efficient unless there exists a conducive framework in other sectors of the economy as well.

India has amply demonstrated her capacity for higher growth combined with low inflation. The average rate of growth, post liberalisation has been of the order of 6.5 per cent, with the average at 6.8 per cent for the last five years. This is perceptibly above the 5.8 per cent during the decade of the 'eighties. The consistently single-digit inflation throughout the decade, buoyant capital markets and a comfortable foreign exchange are no doubt able testimony to the successful management of a difficult transition process.

To recollect a bit, in response to the balance of payments crisis of the early 'nineties, the guiding consideration was to minimise the extent of macro-economic losses as well as to generate new impulses for growth in the real sectors in consonance with the strengthening of the financial system. The devaluation of the exchange rate in 1991 set the stage for a deregulation of trade, industrial and foreign investment policies. A major rationalisation of trade policy was instituted, leading to progressive abolition of licensing and quantitative restrictions. The structure of tariff rates has been drastically simplified and the average tariff rates are gradually converging towards international levels.

Industrial policy has gone through sweeping changes involving the removal of industrial licenses and state monopoly, shortening the list of industries reserved for the public sector and the infusion of a strong element of competition. Foreign investment policy has also undergone radical changes. Likewise, the agriculture sector has also been exposed to international terms-of-

trade. In fact, if you look at recent policy announcements in the external sector, you will observe that the State has gradually reoriented its role in the economy from one of promoter and developer to one of enabler-to act as the 'wheel' as opposed to the 'engine' of growth. The erstwhile Foreign Exchange Regulation Act (FERA) has been replaced by Foreign Exchange Management Act (FEMA). The new EXIM policy also allows for enhanced participation of private entrepreneurs.

On the fiscal front, consequent upon the agreement between the Government and the Reserve Bank, the system of creation of *ad hoc* and tap treasury bills which led to automatic monetisation of Government deficit, has been phased out. These apart, the setting up of well capitalised Primary Dealers (PDs) in March 1995, adoption of Delivery *Versus* Payment (DvP) for Government securities in July 1995 have established the basis for market-related rates of interest on government paper. The introduction of the Ways and Means Advances (WMA) by the Reserve Bank to the Government of India to accommodate temporary mismatches in Government receipts and payments has enabled the Reserve Bank to conduct a more flexible and independent monetary policy. Even the state governments have been given freedom in terms of method, timing and maturities to access the market borrowings. In the recently announced Union Budget for 2000-01, the Finance Minister announced the institution of a Committee to examine the issue of developing a strong institutional mechanism embodied in a Fiscal Responsibility (FR) Act and make suitable recommendations on the same.

In the sphere of external financial policy, while the exchange rate has been made market determined, there has been a progressive liberalisation, over the years, of foreign direct and portfolio investments. Approval procedures have been considerably simplified. As a result, there are very few restrictions on flow of capital into the economy, or its repatriation and servicing. There has also been a significant liberalisation of policy regarding industry's access to foreign equity and borrowing through long-term debt instruments. The banking sector has been given a greater degree of freedom with regard to raising funds abroad and managing external liability, subject to prudential guidelines. The end result of all these and other reforms has been the growing integration among various segments of financial markets, closer convergence of Indian financial system with practices prevailing internationally, and greater opportunity for investors to access both domestic and international markets.

However, none of these measures would have been singularly successful without concomitant reforms in the financial sector. Just as industry and commerce in India have moved towards greater degrees of competitive efficiency consequent to their liberalisation and global integration, the banking sector has evolved in step, to aid and enhance the process of structural adjustment. As you are aware, the operations of the banking sector in India for a long time were oriented towards the development of the real economy - a concept that gained currency as 'social banking'. With the onset of the reform process in the real sector, it was felt that pure 'social banking' had outlived its purpose and it was opportune to move towards more commercial modes of operation. Consequently, the early initiatives in banking reforms were geared towards removing the functional and operational shackles impinging upon bank operations, and subsequently, providing them with greater operational autonomy to take decision based on commercial considerations. This is expected to serve two purposes. First, with the end of the regime of administered controls, banks and financial institutions are expected to evolve as truly

commercial entities. Secondly, the operation of banks under the umbrella of free interplay of market forces in a deregulated atmosphere may be expected to lead to increased allocative efficiency of scarce resources among competing sources of demand. Consequently, the Reserve Bank as the regulator of banks has sought not only to deregulate the commercial operations of banks thereby allowing them greater freedom to react to market signals in the best possible manner, but also create an enabling environment for banks to operate freely on commercial lines.

The "arithmetics" of reform clearly reveal that significant progress has been made in the past few years. There has been a steady decline in the level of pre-empted resources from the banking system. Both cash reserve ratio and statutory liquidity ratio have been reduced from their pre-reform highs of 15 per cent and 38.5 per cent, respectively to 8 per cent and 25 per cent, respectively, at present. Interest rates in various segments of financial markets have been deregulated in a phased manner with the Prime Lending Rate of individual banks acting as the benchmark rate. The Bank Rate has been reactivated as a signaling rate, regular short-term Repos at a pre-announced rate are being conducted, and a system of Prime Lending Rates has been introduced to provide direction to movement of interest rates in the credit market.

Competition in the banking industry has been facilitated by permitting new private sector banks and foreign banks to enter the field and also by permitting the public sector banks to raise additional capital from the market. While public sector banks continue to be predominant, accounting for around 80 per cent of the total assets of Scheduled Commercial Banks (SCBs), the changing competitive environment, consequent upon the entry of new private sector banks and foreign banks, have made a significant difference to banking practices. The Finance Minister's recent statement that the Government is willing to reduce its holding in public sector banks to 33 per cent without changing their "public sector character" is very encouraging, especially in view of the increased capital requirements of Indian banks. The issue of weak banks is also being pro-actively addressed, as is evident from recent Budget announcements. Even in profitable banks, vigorous efforts are underway to strengthen their internal systems and controls so as to decipher early warning signals of crisis for timely remedial measures.

I am sure you will agree with me that move towards progressive deregulation of the banking sector must go hand in hand with its closer supervision. The East-Asian crisis has amply demonstrated the vital importance of the health of financial institutions in sustaining the momentum of growth and development even though countries may have sound economic fundamentals. In recognition of the fact that it is no longer possible for developing countries to delay the introduction of strong prudential and supervisory norms, the Reserve Bank has, over the past few years, orchestrated a conscious move from operational regulation towards prudential regulation.

The financial sector reforms ushered in by the implementation of the second Narasimham Committee's Recommendations (NCR), focussed primarily on the establishment of prudential regulation relating to income recognition, asset classification, provisioning, and capital adequacy standards in line with the international best practices. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Banks are presently required to achieve a capital adequacy ratio of 9 per cent, effective March 31, 2000 up from 8 per cent, earlier. With regard to the new capital adequacy framework, the Reserve Bank

has conveyed its comments to Bank for International Settlements (BIS) and the same has been disseminated to the public for their reaction and comments. The mark to market practice for valuation of government securities has been gradually enhanced from 30 per cent in 1992-93 to 75 per cent by 1999-2000. Further refinement, in line with international best practices, in valuation and classification of investments by banks is currently under consideration. As a further prudential measure against market and operational risks, risk weights have been made applicable to government and other approved securities to take account of price variations.

An attempt has also been made to avoid the problems arising from "connected lending". There have been regulations that limit the exposure of individual banks and non-banking finance companies to any particular borrower or groups of borrowers. Recent policy announcements in respect of exposure limits for individual borrowers have lowered the ceiling to 20 per cent of lending bank's own funds, with a view to move towards international standards of 15 per cent at a future date. Restrictions on banking system's exposure to equity and lending against equity as collateral, and banks' exposure to real estate have gradually been relaxed, keeping the financial stability considerations in mind. Prudent limits have been placed on external borrowing with the focus being on encouraging long-term capital and discouraging volatile, short-term flows.

In the area of supervision, a full-fledged institutional mechanism has been developed keeping in view the needs of a strong and stable financial system. The system of off-site surveillance has been combined with periodic on-site inspection and further reinforced through external auditing and market intelligence mechanism for monitoring the risk profile of banks and their compliance with prudential guidelines. The assessment with regard to the Basle Core Principles had shown that most of the Core Principles were already enshrined in our existing legislation or current regulations.

A rating system has been introduced for banks which is based on certain specific parameters *viz.*, capital adequacy, asset quality, management, earnings, liquidity and systems commonly known as CAMELS. For foreign banks, parameters relevant for rating are capital adequacy, asset quality, compliance and system commonly known as CACS. The Reserve Bank's regulatory and supervisory responsibility has been widened to include financial institutions and non-banking financial companies.

As a result of these measures, significant progress in the performance of the Indian banking system in recent years is clearly noticeable. The trend in erosion of profit and capital base has been reversed. The net profits of the public sector banks, as a percentage of their total assets, averaged 0.4 per cent during 1994-95 to 1998-99, against the loss of about 1.0 per cent in 1992-93 and 1993-94. The gross non-performing assets of public sector banks as per cent of total assets have declined from 11.8 per cent in 1992-93 to 6.7 per cent in 1998-99. As of March 1999, all public sector banks (except one) had achieved capital adequacy ratios exceeding the prescribed norm of 8 per cent and have even exceeded the 9 per cent ratio to that was to be achieved by March 2000.

Keeping in line with the emerging regulatory and supervisory standards at international level, the Reserve Bank has initiated some macro level monitoring techniques to assess the true health of the supervised institutions. The format of balance sheets of commercial banks have now been

prescribed by the Reserve Bank with disclosure standards on crucial performance and growth indicators, provisions, net non-performing assets, staff productivity, etc. appended as Notes to Accounts. To bring in further transparency in the banks' published accounts, the Reserve Bank has also advised the banks to disclose data on movement of non-performing assets and provisions and lending to sensitive sectors (*i.e.*, capital market, real estate and commodities). These proposed additional disclosure norms would bring the disclosure standards almost on par with the international best practices.

The Reserve Bank has instituted a mechanism for critical analysis of the balance sheet by the banks themselves and scrutiny of such analyses by their Boards to provide an inner feel of the health of the bank to the top management. The analysis, which is made available to the Reserve Bank, forms a supplement to the already stabilized system of off-site monitoring of banks.

Furthermore, the Reserve Bank advised banks to put in place an Asset Liability Management (ALM) system, effective April 1, 1999, and set up internal asset liability management committees at the top management level to oversee its implementation. Banks were advised to ensure coverage of 100 per cent of their business by April 1, 2000. In December 1999, the Reserve Bank released guidelines on asset liability management system for all-India term lending and refinancing institutions, as well to be effective from April 1, 2000.

Another significant development had been the emergence of guidelines for risk management systems in banks. In October 1999, the Reserve Bank issued detailed guidelines in this regard, embracing broadly the areas of credit, market and operational risks. With regard to credit risk, it has been suggested that banks should put in place the loan policy, approved by the Board of Directors, covering the methodologies for measurement, monitoring and control of credit risk. The guidelines also require banks to evaluate portfolio on an on-going basis, rather than near about the balance sheet date. As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. Banks have also been asked to fix a definite time frame for moving over to Value-at Risk (VaR) and duration approaches for measurement of interest rate risk.

India is one of the very few countries where the insurance sector has hitherto remained a public-sector monopoly. The Malhotra Committee (1994) on insurance sector reforms had recommended opening up the insurance sector to new private companies as early as 1994. In January 2000, the Reserve Bank circulated to banks and financial institutions draft guidelines for diversification into insurance business. The draft guidelines were framed with a view to assessing the scope, desirability and eligibility of institutions to take up the insurance business. The Insurance Regulatory and Development Authority Act, 1999 is a major milestone in liberalisation as it opens up the way for foreign equity in domestic private insurance companies upto a maximum of 26 per cent of total paid-up capital. Guidelines for entry of the NBFC sector into the insurance business has also been recently issued. Although several issues like the design of appropriate regulatory framework and overall regulatory co-ordination would need to be sorted out before any notification or permission for banks or FIs to be involved in any type of insurance activity is envisaged, a positive beginning has been made in this regard.

Recognizing that the legal framework pertaining to the banking system might act as an

impediment to its efficient functioning, initiatives have been taken to align the legal system suitably. Reforms in the legal systems are aimed at helping banks, particularly public sector banks, to reap the benefits of financial sector reforms. Well-defined bankruptcy procedures can provide proper incentives for repayment and improve asset recovery. Support from the judicial system for speedy enforcement of contractual rights and obligations is crucial for the health of banking sector. Work in this area is reflected in the Government of India constituting an Expert Group under the Chairmanship of Shri T.R.Andhyarujina, former Solicitor General of India, to suggest appropriate amendments in the legal framework affecting the banking sector. The Committee, in its Report submitted recently to the Government has made important and far-reaching recommendations in achieving this goal and these are under consideration of the Government.

I would like to take this opportunity to mention an important development in the Indian financial sector. In various meetings of the Financial Stability Forum and the G-20, the need for positioning and nurturing best international standards and codes were amply recognized. In India too, it was felt that there is no institutional mechanism to check the availability of these standards and codes. Furthermore, this exercise would enable us to chalk out a road-map for implementing the remaining international standards and codes. With this view, in October 1999, the Reserve Bank appointed a Standing Committee of International Standards and Codes. Subsequently, the Standing Committee appointed ten Advisory Groups under the Chairmanship of eminent personalities in respective fields, viz., international accounting and auditing, monetary and financial policies, banking supervision, fiscal transparency, securities regulation, insurance regulation, data dissemination, payments system and corporate governance and legal reforms. The Standing Committee is expected to come out with a detailed Report on each of these sectors which would no doubt instill a greater degree of confidence to do more business with India.

This, in a nutshell, demonstrates the essence of the changing face of the banking sector in India, a face designed to reflect vibrancy, resilience and efficiency in the backdrop of vicissitudes in the global operating environment. The informed observer will clearly note that one important feature of the current reform exercise has been the credibility of commitment to policies. The passage of the various Acts in the Parliament are able testimony to this. We envisage a dynamic 'knowledge-based' economy achieving sustained and rapid growth with a controlled rate of inflation, based on sound fundamentals and effective distribution mechanisms. This economy is to be powered by a sufficiently wide and deep financial sector. With an enormous and diversified natural, biological and human resource base; a large and expanding market for consumer and capital goods; some of the best technological minds in the world; a rapidly developing information and communications network and a motivated and enlightened polity, I know this is a not-too-distant a possibility.

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* **Speech delivered by Shri Jagdish Capoor, Deputy Governor, Reserve Bank of India, at Global Investors' Meet organised by Governement of Karnataka at Bangalore on June 5, 2000.**

[1] J.E.Stiglitz (1998) : "Principles of Financial Regulation: A Dynamic Portfolio Approach",

Lecture delivered at NCAER.