Financial Sector Reforms: an Update *

Y.V. REDDY

I am happy to be here again in this gathering of friends in the banking community on the occasion of the annual general meeting of the Indian Banks' Association and Bankers' Sports Board. I feel that it is more an occasion to conduct focussed business and celebrate rather than one to deliberate on policy issues. Yet as per tradition, I believe that there has to be an address by the chief guest. As a central banker, one always has to seriously consider market expectations and sometimes respond positively, even if somewhat unpredictably!

The vision of the Indian Banks' Association (IBA) is stated to be "to work proactively for the growth of a healthy, professional and forward looking banking and financial services industry, in a manner consistent with public good". The critical words are: 'proactively' and 'public good' and it is in this light that the Reserve Bank of India (RBI) has consistently interacted with IBA. I would like to place on record, on behalf of the RBI, and on my own behalf, the impressive achievements of IBA during the past one year and also the spirit of active co-operation extended by IBA in the whole process of reform of the financial sector. In particular, the Reserve Bank had the benefit of IBA's advice on several regulatory reforms and also in the work of the Regulations Review Authority. The Reserve Bank is always with you, "proactively" in the cause of "public good". While talking of serving "public", I am reminded of what our Professor in the then National Academy of Administration told us, the civil service probationers on training, 37 years ago. He said that civil servants are public servants and that they should serve the public, and added that civil servants should remember that public are those who are not in civil service! Often, in many of our public systems, and perhaps in all large organisations, lot of attention is given to house keeping and staff welfare, often overlooking the broader purpose for which the organisation itself exists.

Of course, in a competitive environment that is evolving in the financial sector, banks and other financial intermediaries are compelled to place the cost and quality of delivery of services at the forefront. This is a healthy development, in which the RBI, Government of India and members of IBA have a stake. In this spirit, I will recall and share with you important issues that have been addressed by each of the three stakeholders in the recent past. Of course, the narration is illustrative and not exhaustive and covers the last couple of years.

Reserve Bank of India

First, the status of pursuit of medium term objective of reducing pre-emptions through both Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). SLR has been brought down to the statutory minimum. Progress in reduction in CRR continues to be closely related to the pace of reduction in fiscal deficit, monetary developments vis-à-vis growth in real output, and uncertainties in forex markets. On all these fronts, greater comfort in the past could have helped more rapid reduction in CRR, to achieve the medium-term objective. In a structural sense, the Reserve Bank has since progressed in the pursuit of the objective viz., proposal to amend the law relating to pre-emptions to give flexibility to the RBI to bring the CRR and SLR even below 3 per cent and 25 per cent, as and when rendered possible.

In a procedural sense, significant progress has been made in the prescribed manner of calculating and maintaining the reserve requirements.

The medium-term objective of reducing pre-emptions and imparting a greater flexibility and simplification of procedures continues to be at the top of the RBI's agenda for reform. In pursuing this objective, the Reserve Bank keeps in view not only the balance sheets of the banks but also the need to move towards universal banking, and diversifying financial intermediation which is heavily concentrated now in banks rather than non-banks. Reduction in refinance window and introduction of Liquidity Adjustment Facility have provided greater flexibility in this regard, and further progress in these two areas is bound to ensure lesser recourse to preemptions in the conduct of monetary policy.

Second, on interest rates, the reform objectives in terms of greater deregulation and rationalisation of small savings rates etc., have been achieved to a significant degree. Further progress in deregulation continues to depend on some stability in inflationary expectations, which in turn is dependent on credibility of price-stability. The emphasis in future has to be to impart greater flexibility to interest rate regimes, in an environment of reasonable price-stability and a rational tax-regime. A rational tax-regime in the context of an appropriate interest regime should factor in several elements viz., treatment of interest-income vis-a-vis dividend income and of contractual savings vis-à-vis marketable debt-instruments. The statement of the Finance Minister in the latest Budget Speech that an Expert Committee will be appointed to provide recommendations on the issue of better system for determination of the interest rates governing Provident Funds and Small Savings is welcome. It is hoped that the Expert Committee would address broader issues such as tax-regimes affecting all forms of savings, especially the possible distortions between debt and equity instruments. However, interest rate flexibility should not be taken to mean a continuous downward movement in interest rates. In fact, the reference in the Economic Advisory Council Report to stable real rates of interest does imply that depending on the inflation rates, the nominal interest rates would move up and down. Furthermore, it is necessary for banks to appreciate the need for reduction in their interest-spreads. Cost of debt-funds to investors can come down, without hurting the saver, the goose that lays golden eggs, only and only as the interest-spreads of banking sector comes down further.

Third, the issues of prudential requirements including those relating to weak banks, capital adequacy, etc. Here, the public sector banks continue to be on a different footing from private sector banks and approaches for reform do vary. In any case, impressive progress has been made in imparting a supervisory environment conducive to enhancing efficiency while maintaining stability of the system. The banking system of India has shown remarkable resilience in the face of several challenges and changes in external environment. In the medium-term perspective, the main challenge will be to subscribe to the proposed New Basel Capital Accord meant to replace the existing 1988 Capital Accord. The new Accord is likely to be finalised by the end of 2001 and mandated for adoption by 2004. It should be clear to all concerned that the new Accord is likely to be more complex and more binding, warranting early and vigourous preparatory work by both banks and the RBI.

Fourth, the issue of competition between banks and between banks and non-banks, and the related issue of a level playing field. The Reserve Bank's policy framework in regard to approach to universal banking has already been spelt out. An approach to reform of urban co-operative banks and rural co-operatives has been drawn up with the recommendations of the Madhava Rao Committee and the Jagdish Capoor Committee. There are significant legal and institutional changes that need to be addressed to ensure further progress in imparting competition without serious systemic implications, including ensuring availability of adequate credit to rural areas and agriculture. In fact, in the recent past, there has been a fast growth in urban banks and perhaps we should focus on the cooperative bank segment, which should get activated to serve the rural areas.

Fifth, improvements in transparency, disclosure standards as also accounting standards to attain the best international practices. Since 1998, there have been dramatic developments in this sphere, especially in codifying the international practices and assessing the domestic standards. The Reserve Bank has put out for discussion, several reports of Advisory Groups on a variety of Standards and Codes, and a road map for bringing about changes is bound to evolve out of these reports. Of particular interest to IBA are the reports on (1) Transparency in Monetary and Financial Policies, (2) Payments and Settlement System, (3) Banking Supervision, and (4) Bankruptcy Laws. These are already in the public domain through RBI's website.

Sixth, on credit delivery systems several procedural initiatives have been taken. The two major areas that need immediate attention to ensure credit delivery are: the fast growing services sector and the critical 'peoples sector' viz., agriculture on which a large part of our population depends.

Seventh, improvements in financial markets. Over the last three years, impressive growth can be observed in all the three segments of financial markets that are of direct concern to the RBI viz., money, government securities and forex. The markets have grown in size, depth, instruments and participants while imparting both efficiency and stability to the system. The next landmark development would be the operation of Clearing Corporation, an organisation being promoted by several banks. A successful operation of the Clearing Corporation would inter alia help quicker forex settlement, enlargement of repo market and retailing of government securities market. The Finance Minister in his budget speech has set a clear time-table in this regard.

There are some developments in the financial sector, which had not been flagged a few years ago but have received attention recently. First, changes in Deposit Insurance that have been proposed by the RBI to Government. Second, establishment of a Regulations Review Authority to review procedural requirements. As IBA is aware, Master Circulars have replaced hundreds of earlier circulars and these will be updated annually. Third, setting up of Credit Information Bureau in which some members of IBA had taken initiative. Fourth, banks' foray into insurance business, which has been carefully crafted. Fifth, the extremely complex task of bringing an almost totally unregulated non-banking financial companies sector into a system of focussed regulation of those which accept public deposits. Sixth, technological upgradation, which has several dimensions. These include computerisation in the RBI and projects for use of banks and financial institutions mainly in the areas of payment and settlement as well as public debt office. The Reserve Bank also closely monitors upgradation of technology in banks. Eighth, and a related measure under implementation is the Reserve Bank's Central Database Management System, which will become a pioneering project among emerging countries. Ninth, there has been an increasing recourse to auditors as a supervisory resource from the RBI. Finally, to monitor developments in financial markets and take prompt actions, a Financial Markets Committee (FMC) has been constituted within the RBI which meets at least once a day and often several times during periods of excess activity in the financial markets. The FMC provides crucial inputs in assessment of short-term liquidity and operation of Liquidity Adjustment Facility. FMC also helps in designing of development of financial markets.

Thus, the Reserve Bank has not only focussed on a medium-term agenda for financial sector reform outlined earlier but has refined and reoriented the agenda from time to time, as warranted by developments.

Government of India

Three broad areas were identified as critical for reform viz., fiscal deficit, legislative changes and structural issues affecting public sector banks. Undoubtedly, Government has devoted some attention in regard to all the three areas, and the measures taken are well known. Yet, it will be interesting to recall the relevant budget pronouncements.

The Budget for 1999-2000 concentrated on reform of the banking sector i.e., Debt Recovery Tribunals, restructuring of weak banks, Settlement Advisory Committees, and tax deductibility for provisions made by banks. The reform of capital markets focussed on UTI and mutual funds but of interest to financial markets was abolition of Stamp Duty on transfer of debt instruments within the depository mode.

The Budget for 2000-2001 carried forward reform on public sector banking by announcing intention for a more diversified ownership of public sector banks, establishment of Financial Restructuring Authority, debt recovery, etc. Of particular interest are announcements relating to establishment of a Credit Information Bureau and possible legislative amendments to accord greater operational flexibility to the RBI. Most important of all was the intention to bring about a Fiscal Responsibility Act.

The canvass gets further enlarged beyond public sector banks and fiscal management to development of debt markets and interest rate flexibility in the Budget for 2001-02. No doubt, in all the budgets there is progressive liberalisation of capital account.

In brief, the Budgets over the last three years have contained larger and wider reference to reforms in the financial sector. The canvass is spreading from banks to financial markets. During the period, the regulatory jurisdiction of the RBI was fine-tuned and clarified through amendments to Securities Contract Regulations Act, and enactment of Foreign Exchange Management Act. While these are some of the several governmental initiatives, significant changes in legal and institutional framework are necessary for further progress in reform of financial sector.

Banks

Elaborating on issues related to banks, in this gathering would certainly be superfluous. Suffice it to say that there has been noticeable progress in respect of all the four issues flagged before viz., internal control systems, placement and work practices, flexibility in hiring people and use of technology in banks. However, there is a long way for public sector banks to traverse from current industry-wise approaches to bank-wise autonomy to enhance efficiency and profitability. It may be worthwhile to chart a roadmap for genuine autonomy for public sector banks consistent with principles of good corporate governance.

Conclusion

In brief, a notable part of agenda for reform has been completed and in the process, some items, not in the original medium-term agenda, became necessary for reform.

Currently, the focus is rightly shifting to legislation, markets, technology and beyond banks to non-banks.

It is also evident that reforms can succeed only and only if coordinated efforts are made by the RBI, Government of India and banks, themselves.

It must, however, be recognized that key to financial sector reform is banking reform; key to banking reform is public sector banking reform; and key to public sector banking sector reform is Government’s initiative.

Finally, you would appreciate that, by and large, we in the RBI try to be aware of what is desirable and we are implementing whatever is feasible.

Before concluding, I must mention that the tasks ahead of you listed by the IBA are appropriate, complex, and urgent. These are broadly divided into four areas viz., human resources management, technology, structure of banking, and sound banking. The Banks’ Sports Board, a relatively recent institution has already impressive achievements to its credit and is bound to advance the course of national sports in the coming year also.

---

* Address by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at the 53rd Annual General Meeting of the Indian Banks’ Association and the 13th Annual General Meeting of the Banks’ Sports Board on March 15, 2001 at Mumbai.