Indian Banking: Paradigm Shift in Public Policy

Y.V. Reddy

I am thankful to the organisers for inviting me to deliver this address. It is good to see that the focus on paradigm shift did not extend to shifting the traditional speaker at the Valedictory Address. Today's address will be divided into five sections. The first section would capture the paradigm shift in the environment in the Indian banking as presented in the Conference and the deliberations as captured by the Rapporteurs' presentations. In the second section, I would like to highlight the general achievements of public policy in the financial sector and in particular the banking sector during the last ten years, so that we recognise our strengths. The third section would be in the nature of critical introspection of public policy. It is meant to share some dilemmas and issues that might not have been highlighted so far or some aspects of policy that could have been misconstrued. The fourth section attempts a bold technical vision, unconstrained by the existing policy framework and the possible political economy implications. The purpose of the bold technical vision is to provoke a debate for substantial paradigm shift in public policy in banking. The final section presents select actions under contemplation in the Reserve Bank which would enhance the scope for a paradigm shift in public policy.

Paradigm Shift in the Indian Banking Environment

I am glad to note from the summary of the inaugural section that there is a formal recognition of the closeness between Indian Banks' Association (IBA) and BECON and also that a holistic approach to industry is being considered as part of such closeness. In particular, Governor Jalan's suggestion about setting up a group of 4-5 middle level officers is extremely relevant for operationalising not only capital adequacy requirement, but to do further work on coping with the inevitable paradigm shift on the structural aspects.

The most important point made in the first session is that mergers and acquisitions in the banking sector must be market-led rather than prompted by Government or regulator, except perhaps where there is a systemic crisis. At the same time, there must be close monitoring and supervision of merging institutions to preclude threats to systemic stability. Second, advanced risk management systems, sophisticated information technology infrastructure, human expertise and a comprehensive database are pre-requisites for Indian banks to adopt the New Basel Capital Accord. Indian banks must also improve their internal audit, loan review and internal rating systems. Third, capital requirements must be supplemented by adequate provisioning for non-performing assets. While capital adequacy constitutes an important part of supervision, unless overall economic reforms are pushed forward, problems of the real sector would spill into the banking sector as well. Fourth, human resource management has assumed ever-greater importance, particularly in the post-VRS scenario. The measures should include retraining of staff, performance linked compensation packages, transparent promotion and transfer policies, *etc.* Fifth, regulatory issues relating to conversion of banks and Development Financial Institutions into universal banks should include enforcing corporate governance, transparency, consolidation of accounts, risk management and firewalls to prevent conflicts of interest relating to the operational aspects.

In the second session, there is a broad consensus on several issues relating to operational aspects.

First, factors like market positioning, cost of intermediation and service delivery will determine the efficiency of banks with respect to their competitiveness. Indian banks need to reorient their business strategies to meet the challenges of a 'buyer's market' and in this regard, public sector banks have certain core strengths which they can utilise to make the best of new opportunities. Second, given their size and customer base, the opportunities for Public Sector Banks (PSBs) in retail banking and micro-credit are immense. However, a systematic and calculated approach is a prerequisite for success in the long run. Third, in respect of risk management, areas yet uncharted by Indian banks include dynamic estimation of cash flow profile and risk profiles, adoption of risk-adjusted return on capital framework of pricing, *etc.* Fourth, in respect of directed credit, there is a consensus on using the conduit of self-help groups for credit delivery and the adoption of a participatory approach to development.

Somewhat surprising was the enthusiasm on the part of some papers for infrastructure financing at a time when many issues relating to regulatory reform and full cost recovery are still to be resolved and also at a time when even a specialised institution for the purpose like Infrastructure Development Finance Company (IDFC) finds it difficult to achieve its disbursement intentions. However, I am glad to notice some caution from the Rapporteurs' report and it clearly shows that when securitisation, take-out financing, sound debt markets dominated by public issues are in place, banks could proceed with such financing, especially at the shorter end. It is very satisfying to see some serious effort to improve financing of priority sector - a less fashionable, but more legitimate area for banks.

Governance aspects covered in the third section are somewhat tricky to be handled for several reasons, but some of the distinguished speakers seem to have made telling points such as the need for arms-length to be maintained by owners with the Board, and the fact that best corporate governance exists when ownership is widely distributed. I wonder Government is treated as a single owner for this purpose ! There appears to be some broad consensus on reform in this area. First, effective corporate governance arises out of responsible and vigilant simultaneous actions by the managers, the board of directors and the shareholders of a company. Second, the essence of corporate governance relates to a system in which the interests of the whole gamut of stakeholders of an organisation are recognised and conflicts among them are sought to be reconciled. Third, Indian banks will have to enhance the transparency of their operations and make greater disclosures to the public to attain international standards of corporate governance. Fourth, one may expect to see governance rating of institutions along the lines of credit rating.

Some issues relating to cooperative banks, especially urban cooperative banks have been discussed, particularly on regulatory matters relating to access to capital funds from the capital market, lending rate stipulations, evolution of a credit rating system, giving a level-playing field with commercial banks, *etc.* A significant point raised though perhaps not debated extensively relates to the conflicts of interests among various stake holders. It is heartening to note that a paradigm shift in banking recognises the need for resolving the complexities of cooperative banks, especially urban cooperative banks, regional rural

banks and perhaps local area banks. Critical to appreciating these issues is perhaps the appropriate framework of corporate governance for institutions, which are under the cooperative fold at their current stage of legal and regulatory framework.

It is also interesting to note that public sector banks have made legitimate points about the level-playing field and the need to consider public sector banks fully owned by the government and others where there is shareholding by public. The external constraints imposed on them, the restrictions on internal consolidation due to work practices need to be addressed in any debate on paradigm shift, while the distinction between fully-owned and others is critical to issues relating to corporate governance. The broader issue of the case for or against privatisation should recognise the new insights provided by one of the papers –a paper backed by significant data.

Governor Jalan's poser in the latest annual meeting of the National Institute of Bank Management (NIBM) is a relevant starting point to discuss paradigm shift: "The crucial issue that the country has to debate is whether Corporate Governance is compatible with public ownership, which makes the system accountable to political institutions and not to the economic institutions or even regulators. This is a big and fundamental issue which our country has to debate and decide. Is a 'via media' possible? Could we have public ownership without Government or political control or do we need to change to a corporate structure?"

While this is one type of challenge, Governor Jalan makes a telling point when referring to non-public sector banks in the banking system (*i.e.,* co-operative and private). "One thing which is common to all is that Corporate Governance is highly centralised with very little real check on the CEO, who is generally also closely linked to the largest owner groups. Boards or auditing systems are not very effective".

In brief, my view is that the paradigm shift in banking sector has to be seen in terms of two dimensions: one relates to operational aspects especially risk-management system. There is some sensitisation on these issues when the participants discussed technology, customer-centric approach, motivation of workforce, performance incentives, outsourcing, off balance-sheet items, *etc.* Many of these have overlap with regulatory regime which has also displayed significant progress. The second dimension relates to structural and external environment or exogenous aspects, and these can be tackled only with a paradigm shift in public policy addressed to ownership, form of organisation, regulation and competition. My address would, therefore, concentrate on the second dimension and select aspects of public policy.

Achievements of Public Policy in Financial Sector

It is necessary to recall our achievements in the field of public policy.

First, public policy has ensured the development of multi-institutional structure in the financial system. The Asian crisis demonstrated the risks of a single institution dominated system and underscored the importance of a well-diversified financial system in maintaining systemic stability. The diversification of ownership of public sector banks is a welcome form of diversification.

Second, public policy has changed the system's flexibility to manage credit. Progressive reduction in the pre-emptions has accorded greater flexibility to banks to lend based on genuine credit decisions. By deregulating interest rates both on the deposits (barring saving deposit) and lending side, the banking system has also been accorded the flexibility to price their loans as needed, keeping in view the cost of funds and the appropriate credit and term premia.

Third, it is absolutely essential to ensure adequate credit flows to meet emerging needs. Thus, even as banks have greater flexibility to lend and price their loans, the Reserve Bank has urged that credit to sectors such as agriculture and small and medium industries are critical for the overall development of the economy. Policies over the years have attempted to ensure adequate flow of credit to these sectors, but based on commercial terms and in a non-micro regulated manner.

Fourth, public policy has infused greater competition in the banking system by permitting entry of private sector banks. This has given a wider choice to customers (both lenders and borrowers) to approach their bank of choice. At the same time, it has created an incentive mechanism for banks to enhance their efficiency.

Fifth, at the same time, public policy has, by and large, preserved the branch network of the banking system to ensure that banking services continue to reach the remote corners of the country.

Sixth, prudential standards are being imposed on banks to bring them on par with international best standards. Thus, while banks have greater freedom to take credit decisions, capital adequacy norms, exposure norms, income recognition rules, asset liability management systems in banks not only help to identify risks but also contain risks thereby contributing to financial stability.

Seventh, the system is more transparent now than before both in terms of disclosure of accounts by banks and data/ information disseminated by the central bank. Looking at the data on the banking system, there is a contention that the banking system is more vulnerable now than before. My response has been that it is not so. There is a degree of transparency that ensures awareness and corrective action today. The Indian banking system is not unstable or vulnerable, but there are problems of efficiency.

Eighth, in most areas, be it deposits or credit or investment or risk management, public policy has moved away from micro-regulation to macro-management. While the Reserve Bank issues general guidelines, it is now more often left to individual Boards of banks to implement these measures and set internal rules and guidelines.

Ninth, initiatives have also been taken to develop financial markets in a gradual manner and integrate them cautiously. By developing the money market, it is ensured that the signals of the central bank are transmitted to the system without friction. For pricing of loans to be market-based, development of government securities market is crucial since all the rates in the rest of the markets are priced off the zero-risk yield curve, *i.e.,* the government securities. Impressive progress has been made in Government securities market.

Tenth, on macro-policy side, the Reserve Bank has ensured stability in interest rates, exchange rates and reined in inflationary expectations to a reasonable level and contained the threats of external contagion and domestic uncertainties, thus making it easier for the banking system to cope up with competition in a deregulated environment. To quote from Dr. Jalan's inaugural address: "… despite a turbulent year and many challenges we have made progress towards this goal" and by goal he means the vision of a sound and well-functioning banking system.

Thus, public policy has contributed to an efficient transitional path of the banking system to move from a regulated focus on predetermined objectives to a more and more liberalised regime. Public policy is ensuring non-disruptive gradual changes with intensely participative approach providing some flexibility in the pace but not the direction of overall objectives. Governor Jalan said in the inaugural address to this Conference: "There is greater awareness now of the need to prepare the banking system for the technical and capital requirements of the emerging prudential regime and a greater focus on core strengths and niche strategies."

Introspection

Introspection is seldom structured and not really conclusive. Perhaps introspection revolves around the questioning of assumptions or values rather than the logic. In many cases, it may be looking at facts which one failed to notice before. Briefly stated, there will be an element of randomness in the focus of such introspection.

First and foremost relates to the foundation of reform *viz.,* promoting efficiency through competition, which involves some objective criteria in assessing performance. The Reserve Bank's annual statutory report on banking attempts to do it by categorising the banks into public sector, private sector, *etc.* How appropriate is that?

(a) Given the size and variety of public sector banks and in particular the varied ownership pattern, aggregating their performance as a category can be questioned. After all, a category accounting for over 70 per cent of all activity may not be clubbed together and compared with two other small segments. Sub-dividing them into, say, those closer to private sector banks' in terms of performance, like Corporation Bank, or very weak banks could have been attempted. Are there insights on why some public sector banks are able to cope up better than others? Are there no lessons for the owner who owns several units that perform differently?

(b) Are facts of market segmentation on both demand and supply recognised while comparing prices and spread between the categories of banks?
There is a relationship between interest spreads and market segments, *e.g.,* with regard to food credit, the interest charged is the average of participating banks' prime lending rate (PLR). Similarly, government business, pension business etc. are with PSBs. Is it possible that the real competition among the three different categories is only on a small part of the balance sheet?

(c) Time dimension is also critical in any analysis on net interest income. In other words, legacy problems can distort the current picture. Further developments in financial markets over the last few years are unique.
For example, in a rising interest rate scenario, it is possible that public sector banks might

have done better. When interest rates are falling, it does have an adverse impact on the net interest margins of public sector banks. Should that also be reckoned?

(d) To what extent do macro-factors have an impact on the net interest margins of different categories is perhaps an area requiring closer attention. In the last three to four years, there has been some decelerating of growth, especially in traditional brick and mortar type manufacturing sector where public sector banks are heavily exposed.
They have been opened to international competition and are subject to domestic restructuring.

These affect the portfolio of older banks which are mostly PSBs, disproportionately.

(e) As regards staff costs, new private sector banks have enormous flexibility of entry and exit. The public sector banks simply do not have the freedom. If such a freedom, genuine freedom is given to public sector banks, would the benefits be more or less, to all concerned, *i.e.,* owner and work force?

(f) Public sector banks have an element of public sector accountability and institutional factors operate differently for different banks. For instance, public sector banks have a large number of branches in backward areas and hence it may not be feasible in a socio-economic sense to permit closure or sale of these branches. If 20 per cent of branches of public sector banks account for 80 per cent of business and if the only objective is profitability, could they close the 80 per cent?

Second, on Asset Reconstruction Companies (ARC) as a solution to current problems facing public sector banks several issues arise:

(a) Normally ARCs are conceived when there is a collapse of financial systems and may not be treated as a substitute for poor credit-recovery processes. There is an existing mechanism through Debt Recovery

Tribunal (DRT) which provides for expeditious recovery of dues by banks and financial institutions. The question is whether the proposed framework should give more power for recovery than the DRT mechanism. If it gives more powers and if it is to be a private or semi-private company, is it justifiable? If such enhancement of powers is possible, then why not enhance the powers of the banks themselves?

(b) If there is no Government guarantee, the ARC will have to have better ways of collecting the dues than banks. If there is an assumption that in view of its professional expertise, the proposed ARC will be superior to the bank in this respect, it is an assumption at this stage. Hence any decision to transfer the distressed assets of a bank to the proposed ARC may have to be left to each bank in respect of each asset; either to transfer or not.

(c) Government is only one of the owners in regard to many public sector banks and hence the issue of transfer of an asset from the books of a bank to a proposed ARC would presumably be the decision of the Board and the Management and not that of the owner or one of the owners.

(d) Is it possible to have several ARCs on an ongoing basis to create an enabling competitive environment for recovery of dues in respect of their assets so that the banks

will have options from time to time to choose among ARCs and decide on individual assets?

Third, there is a view that priority sector lending generally generates higher non-performing assets than non-priority sector lending. Is that a fair comparison? When food credit, which is a large part of non-priority sector and credit to public enterprises are netted to arrive at non-performing assets for private sector in non-priority sector and a comparison made, would that difference get reduced? Would that get further reduced if subsidised lending under government-sponsored programmes is also netted?

Fourth, there is a demand for disclosure of defaulters. What purpose has disclosure of suit-filed cases served? Similarly, there is a demand for punishing 'wilful defaulters' but has severe punishment prescribed in law served a purpose if there is a perception that the probability of being caught is less, being punished is remote and being severely punished promptly even more remote? Have centrally-directed one-time settlements and somewhat unclear basis of dispensations of BIFR helped in improving credit-recovery process?

Fifth, because of unwillingness to change structural rigidities, distortions in governance structures may be possible. For example, the organisation of IDFC as a private company while the financial participation by Government and the Reserve Bank is relatively large, represents a compromise to enable flexibility in view of rigidities of majority public sector ownership. Is it better to have in-built flexibility in the structures?

Finally, and this indeed is a troubling thought – In a regime where the governance structures are yet to be fully strengthened and contract enforcement through legal means is difficult as well as delayed, the preference for dominant private-ownership should be accompanied by intensive efforts to strengthen efficiency and autonomy of public ownership. In other words, should privatisation be a credible threat to ensure reform of public sector and movement between the public and private be a more dynamic process than unidirectional or rigid ? In other words, are the choices only in terms of centrally decided nationalisation or privatisation? Is it possible for each bank to evolve into different ownership patterns to meet the challenges of paradigm shift ?

Technical Vision

A technical vision is, and for that matter any vision is generally clear in terms of broad contours and certainly vague in respect of detail. A vision is not necessarily feasible but hopefully possible. A technical vision is, above all, one that transcends existing policy framework and is exploratory. Having identified the crux of the paradigm shift as one relating to structural aspects, a brief outline of such a technical vision is presented below in respect of each segment of banking, mainly to provoke a discussion and definitely, it is not the Reserve Bank view, but a technical vision.

(a) All public sector banks could be converted into companies, to accord flexibility for changes in ownership, mergers, acquisitions, sound corporate governance and motivation for workforce to compete effectively.

(b) To professionalise the ownership functions and ensure that portfolio is shuttled around to optimise public interest, a holding company of public sector banks can be formed to which all shares held by Government and the Reserve Bank are transferred.

The mandate for holding company can be three-fold, *viz.*, fiscal neutrality, protecting the interests of those banks that are serving special public purpose by infusing resources and enhancing bank-wise, genuine board management and worker motivation to cope with paradigm shifts occurring in banking industry. The critical element for success here is manning of holding company, but Government will be able to devote significant attention to a focussed task compared to several tasks of many institutions.

(c) To ensure genuine corporate governance and protect a private shareholder, even if the Government owns a majorit y, a Government company should be one where 100 per cent ownership vests with Government directly and not 51 per cent or above.

(d) The provisions of central vigilance (CBI) *etc.,* would be applicable to a public servant, but not to any person employed in an organisation that is substantially competing with private sector organisations, procedures similar to private sector should apply.

(e) Co-operatives as a genuine peoples movement should be differentiated from a co-operative as a mere form of organisation. Co-operatives should also be distinguished between those who accept public deposits and those who do business with only members in a restricted area. In other words, a distinction should be made between a bank and a credit union.
A bank should be covered under the Banking Regulation Act, irrespective of whether it is registered under Companies Act or Co-operatives Act. The rest will have to be credit unions of some form or the other.

(f) Regional Rural Banks (RRBs) should be revamped so that ownership of Centre and State is also made optional. They could be brought under Companies Act and flexible ownership promoted through National Bank for Agriculture and Rural Development (NABARD). The RRBs have unique capabilities to enhance credit delivery in rural areas if the overhang problem is sorted out.

(g) The Development Financial Institutions (DFIs) should be similarly corporatised where they are not and they should formally be brought under the regulatory framework of NBFCs as a distinct category.

(h) Above all, a national consensus must be attempted among all the stakeholders to seek a banking system that is flexible, dynamic, fair and truly national - where the owners, workers, depositors, borrowers and regulators commit themselves to a real paradigm shift in public policy. It is pragmatism and not ideological extremes that has made India strong in external sector and perhaps a similar approach will work in financial sector also.

Select Actions under Contemplation with RBI

In this concluding section, I will mention a few actions under contemplation in the Reserve Bank that would enable paradigm shift in banking.

With respect to ownership of the Reserve Bank in banks and other refinancing institutions, the Monetary and Credit Policy of April 2001 had expressed the Reserve Bank's intentions to divest its holdings in State Bank of India, NABARD and National Housing Bank through transfer to Government. The Reserve Bank has also sent proposals to the Government to transfer its loan portfolio in respect of Industrial Development Bank of India (IDBI), Industrial Development Finance Corporation (IDFC), etc.

I understand that you have had lively discussions on International Standards and Codes. As you are aware, a Standing Committee on International Standards and Codes was set up to benchmark Indian practices against international standards. The Standing Committee had set up ten advisory Groups in key areas of the financial sector. The Groups have completed their Reports, which are available on the RBI website. I would like to draw your attention to two reports which have a direct bearing on the banking system

– Advisory Group on Banking Supervision (Chairman: Shri M.S.Verma) and Advisory Group on Corporate Governance (Chairman: Dr.R.H.Patil). The Group on Corporate Governance emphasised the strengthening the rights of shareholders in banks and financial institutions, appointment of risk management committees, withdrawal of special status of Government directors, withdrawal of RBI Directors and improvement in regard to disclosure of information. The Group on Banking Supervision recommended on issues such as independence of supervisor, capital adequac y, management of credit risk, connected lending, functioning of Board of Directors etc.

Currently, the Standing Committee is in the process of consolidating the reports of the ten Advisory Groups and identifying the legal, procedural and policy changes required in implementing the recommendations. A number of recommendations would need amendments to the Banking Regulation Act, Companies Act, RBI Act, *etc.* Following the Finance Minister's Budget speech last year, the Reserve Bank had already indicated a number of legal changes that would be required to give more flexibility to monetary policy. In the financial markets, the Government Securities Bill is at the final stages of consideration. A Working Group in the Reserve Bank has already proposed a draft bill on securitisation, to Government.

An important issue in regard to banks' operational area relates to the sharing of credit information. Currentl y, banks are sharing information on an informal basis. However, the Reserve Bank has been collecting and disseminating information on the list of suit filed defaulters, including wilful defaulters. Formalising the system of sharing information would require amendment to secrecy laws. In order to overcome this aspect in the short run, pending legislative amendment, the Reserve Bank has constituted a Working Group to operationalise the process of collection and dissemination of data on credit information by the Credit Information Bureau. The Group is also considering the suggestion given by bankers that information regarding the defaults of State Governments be collected and widely circulated and published.

Yet another area critical for financial stability relates to several international initiatives undertaken over the last couple of years with the goal of maintaining financial stability by strengthening the financial infrastructure. The Reserve Bank and SEBI were members of one such Task Force on Securities Settlement Systems constituted by Bank for International Settlements (BIS). The report has since been finalised and released by BIS. An Expert Group is being set up by the Reserve Bank to examine the adherence to the recommendations in regard to government securities market in important areas such as legal risk, pre-settlement risk and settlement risk.

Efficient payment system is also very critical to meet the new challenges. The Reserve Bank has been engaged in the design and development of the payment system in India as

part of the financial sector reforms. The broad objective of this process is to ensure the setting up of a robust, efficient, secure and integrated payment and settlement system for the country. The ultimate aim to be achieved in this regard is to ensure quick settlement of financial transactions, especially in an electronic environment based on a sound legal foundation. The Reserve Bank is addressing the task of drafting the Indian payment system legislation considering among others issues, finality of payment/settlement in an electronic environment, issues of failure from bankruptcy and the formulation of the framework for the Payment System Act, the Netting Act and other related issues. To bestow focused attention, a Payments Systems Department is being contemplated within the Reserve Bank by appropriate restructuring and retraining of the existing officers and staff. The functions of this department will include among other things, formulation of payment system policies, regulation of payment system, implementation of *Core Principles* of the BIS relating to payment system, *etc.*

Finally, with regard to the financial sector, banks have always been concerned at the regulatory burden on them due to the CRR requirement. The Reserve Bank desires to move to a 3 per cent CRR regime, but at the current stage, early movement can be considered only if it is a package and one of them relates to the present way of maintenance of cash balances by banks with the Reserve Bank. Apart from this, as mentioned in an address yesterday, the time has come to take a hard look at the access of banks to call money. The call money window should be used to iron out temporary mismatches in liquidity and not on a sustained basis as a source of funding their normal requirements. An option to be discussed is reducing banks' access to the non-collateralised call market to about 2 per cent of aggregate deposits as in the case of urban co-operative banks, or, as an alternative to 25-50 per cent of their net owned funds. Simultaneously, in order to gain greater effectiveness in money market operations of the Reserve Bank through Liquidity Adjustment

Facility, the automatic access of refinance facility from the Reserve Bank to banks would also have to be reassessed. Thus, as CRR gets lowered and repo market develops, the refinance facilities may have to be lowered or altogether removed, and the access to the non-collateralised call money market restricted with the objective of imparting greater efficacy to the conduct of monetary policy.

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