**Indian Economy – Financial Sector Reforms and Role of RBI**

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It gives me immense pleasure to address this august gathering at the National Defence College (NDC) on a subject of paramount policy importance for the country. The NDC has been an important preparatory ground for Indian policy makers among both civilian and defence personnel. The college has the distinction of attracting the sharpest minds both from India and abroad. NDC imparts training on the dynamics of Indian security strategy against the backdrop of the ever-evolving international scenario. It prepares participants to address macro level issues with a holistic view of the interrelated world order. NDC assists officials in the highest level of strategic thinking and decision-making.

My topic for the day is 'Indian Economy –Financial Sector Reforms and Role of RBI'. Money and finance have key roles to play in today's world – it is said that money makes the world revolve. Whether for poverty eradication or development of supercomputers, devising counter-terrorist strategies or new communication channels, money and finance play a pivotal role. In recent years, innovations in the spheres of information technology and communication and rapid emergence of a number of financial instruments have led to two distinct changes. First, is the integration of the financial sector into a seamless world. Financial players from any location can access financial markets anywhere, at any time, with utmost ease and very little cost. Second, the integration has rendered the system extremely complex and interdependent. Developments in distant markets get quickly transmitted to major markets across the world. Naturally, regulation and supervision have become very skill-intensive and national norms are getting aligned to global standards. It is against this backdrop that one must comprehend the intricacies in the functioning of and challenges faced by the financial sector in India.

In discussing the reforms of the financial sector in the 'nineties, we start with an overview of the sector, discuss the reform measures, their objectives, rationale and future direction. Then I will review the performance of the financial sector and the effect of relaxation of financial controls. Contextually, the changing role of the Reserve Bank will be analysed. I will conclude with perspectives on the future of the Indian banking sector.

## Financial Sector: An Overview

Financial systems comprise three distinct components – institutions, markets and instruments. Financial institutions include banks, insurance companies, development financial institutions, non-banking financial companies, stock exchanges, clearing houses, stock broking companies, foreign exchange dealers, etc. Financial markets consist of market for government securities, corporate securities, foreign exchange, derivatives, short-term finance or money market, equity markets, etc. Instruments, in turn, comprise domestic and foreign currencies, stocks, equities, bonds, debentures, futures products, financial options, financial derivative products, etc. The Reserve Bank, as the central bank of the country, closely monitors developments in the whole financial sector. It is, however, the deposit-taking institutions and development financial institutions, which directly come under the regulatory ambit of the Reserve Bank. Therefore, I plan to address developments relating to these institutions and related markets.

Banks as the major group of deposit taking financial companies assume a position of predominance in the financial sector. Savings in bank deposits are the most important form of financial savings accounting for around 45 per cent of the total during the late 'nineties. The banking sector is dominated by scheduled commercial banks (SCBs). As at end-March 2001, there were 296 commercial banks operating in India. This included 27 public sector banks (PSBs), 31 private, 42 foreign and 196 regional rural banks. Further, there were 67 scheduled co-operative banks consisting of 51 scheduled urban co-operative banks and 16 scheduled state co-operative banks. The financial institutions consist of all-India and state-level institutions including development banks, specialised financial institutions, investment and refinance institutions. The non-bank financial sector also consists of non-banking financial companies and unincorporated bodies, which are engaged in financial activity.

**Rationale of the Reforms**

While the genesis of modern banking in India could be traced to the nineteenth century, involvement of Government in policy formulation for financial sector started much later. Financial sector legislation was initiated with the passage of the *Co-operative Societies Act* , 1904, providing a framework for establishment and operation of co-operative banks. The banking crisis of 1913-1917 with the failure of almost 600 banks highlighted the need for regulating and controlling commercial banks. The *Banking Companies (Inspection Ordinance) Act* and *the Banking Companies (Restriction of Branches) Act* were passed in 1946. The *Banking Companies Act* was passed in February 1949, and subsequently, amended to read as the

*Banking Regulation Act.*

The first two decades of independence saw a major portion of bank credit flowing towards big industries. There were apprehensions that the allocation of credit by the predominantly private banking structure was not in conformity with Plan objectives. By mid' sixties, it was decided to exert direct state control over banks and bank policy. The Government issued an Ordinance in July 1969 acquiring ownership and control of 14 major banks. Subsequently, six more commercial banks were nationalised in April 1980.

With bank nationalisation, the state sought a more proactive role in the development process through directing the allocation of financial resources. The overarching considerations in late-'sixties through early' nineties were those of social banking. The accent was on increasing the spread of formal banking to all parts of the country, in particular disadvantaged areas. Policies of the PSBs were framed to pool and complement each other through modes such as consortium approach and Lead Bank Scheme, rather than competing with each other. Banks had specific social objectives of mobilising household savings and channeling financial resources to specific sectors and social groups at concessive rates. Banks spread to unbanked centres and directed credit into sectors, which were considered important for all-round development, though not necessarily commercially profitable for the banks. Profitability considerations were not material to the performance of banks. Progressively, banks accumulated unremunerative asset portfolios of which large chunks were non-performing. The period was characterised by high levels of pre-emption of lendable resources through statutory reserve requirements, administered interest rates,

schemes for cross-subsidisation, close regulation of banking operations and restricted entry.

Operational and allocative efficiencies had deteriorated even though the extent of financial intermediation increased. PSBs had low capital base, large proportion of low quality assets in the portfolio and low levels of operational profit. The financial health of banks had become fragile and was progressively becoming weak. For the sector as a whole, the result was high cost of intermediation, low quality of banking services and fragile financial health of the institutions. In spite of their poor financial health, for the public, Government ownership of PSBs translated into a sovereign guarantee on the safety of deposits. So even when PSBs performed badly they never faced a liquidity crisis or a 'run on their deposits'. Needless to say this bred inefficiencies in bank operations. Thus when income recognition and asset classification norms were introduced in the 'nineties, several PSBs were holding a large volume of NPAs and causing consternation in banks. Gross NPAs of PSBs were as high as 24.8 per cent of their gross advances as at end-March 1994.

**Financial Sector Reforms**

As you are aware, 1991 marked a watershed in the history of Indian economy. Faced with a balance of payments crisis, the Indian economy undertook an extensive reform programme ushering in an era of deregulation, liberalisation and gradual globalisation coupled with a liberalised exchange rate management system (LERMS) and devaluation of the rupee exchange rate. The roadmap of the financial sector reforms was traced largely by two committees under the chairmanship of Shri M. Narasimham – the Committee on the Financial System and the Committee on Banking Sector Reforms – popularly known as the Narasimham Committees I and II. Narasimham Committee I defined its approach to "… ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability". Narasimham Committee II was entrusted with the task of evaluating the extent of implementation of reforms recommended by the Narasimham Committee I in 1991 and mandated to chart the course for future reforms required to further strengthen the banking sector in India and to bring the efficiencies of the system upto international standards.

The reform measures since 1992 can be divided into three categories based on their aims. The first category of measures seeks to strengthen the financial system and institute systems and processes to reduce its vulnerability. Second category of measures seek to enable market players to respond to market signals in an optimal manner on the basis of commercial considerations, without external restrictions. The third set of measures are aimed at putting in place appropriate institutions and mechanisms to ensure a level-playing field for all market participants.

*Measures to Strengthen the System*

Measures to strengthen the financial sector include capital adequacy requirements, prudential norms and means to enhance transparency in the balance sheets of banks and financial institutions by appropriate disclosures. A minimum stipulated capital adequacy ratio was introduced to strengthen the ability of banks to absorb losses and this has subsequently been raised from 8 per cent to 9 per cent. Recognising the risks posed by deregulated markets, explicit

capital charges have been assigned to market risk. Risk-weights have also been extended to investments in government securities and other approved securities, which was showing a rising trend.

As a step towards prescribing capital adequacy on a consolidated basis, banks were asked to voluntarily build-in the risk-weighted components of their subsidiaries into their own balance sheets on notional basis. Banks are required to earmark additional capital in their books so as to obviate the possibility of impairment of their net worth when switchover to unified balance sheet is adopted.

Prudential norms have progressively been brought closer to international best practices and the process of convergence continues. Higher provisioning norms, tighter asset classification norms, dispensing with the concept of 'past due' for recognition of NPAs, guidelines in respect of debt restructuring/ rescheduling/ renegotiating, lowering of ceiling on exposure to a single borrower etc., are among the important measures in this area.

Accounting norms help in gauging the health and performance of a bank. Initiatives have, therefore, been taken in this area also. To make the valuation of banks' investment portfolio reflective of the purpose for which such investments were made, commercial banks have to classify their entire investment portfolio under three categories, *viz.*, "held to maturity", " available for sale " and "held for trading" and make appropriate capital adequacy provisions.

Recognising the need for expeditious recovery of banks' dues, the Government and the Reserve Bank have initiated a number of steps for expediting the recovery of NPAs. Government of India has undertaken legislation to vest Debt Recovery Tribunals with greater powers and improve their infrastructure facilities providing much needed relief to banks in reducing their assets by sale. Several initiatives have been taken by the Reserve Bank to enable banks to effectively recover their dues. These include guidelines to PSBs for constitution of Settlement Advisory Committees for compromise settlements of chronic NPAs in the small sector and guidelines to PSBs to provide a simple, non-discriminatory and non-discretionary mechanism for the recovery of the stock of NPAs with outstanding up to Rs. 5 crore. It is also proposed to popularise the use of *Lok Adalats* for recovery of banks' dues with outstanding balance of Rs.10 lakh.

Transparency of operations is an essential pre-requisite for the market to exercise a disciplining influence on banks. To enhance transparency in the banks' balance sheets, banks have been advised to disclose maturity pattern of deposits, borrowings; investments and advances; foreign currency assets and liabilities; movements in NPAs and lending to sensitive sectors. Banks have also been required to disclose total advances against shares as well as investments made in equity shares, convertible debentures and equity-oriented mutual funds. Banks have been asked to disclose the movements of provisions held towards NPAs and depreciation on investments. Reduction of NPAs by banks is still the highest priority concern of the Indian banking system.

With liberalisation, deregulation of interest rates and growing integration of domestic markets with external markets, the risks associated with banking operations have increased, both in volume and complexity. To address these risks comprehensively and systematically, banks were advised to upgrade their risk management skills and adopt more comprehensive asset-liability

management practices. To give a direction to these efforts, the Reserve Bank issued guidelines on asset-liability management (ALM) systems and risk management to banks in February and October 1999, respectively. Guideline notes on credit and market risk to fine-tune the risk management systems in banks, are under preparation. Substantial delegation is available with Boards of Banks to bring into effect the above measures and manage the risks.

*Enabling Measures*

Measures to enable banks to operate freely in a commercially justifiable manner and competitive environment include the reduction of statutory pre-emptions, deregulation of interest rates and giving banks greater autonomy and flexibility in day to day operations. Other measures in this direction include greater streamlining of the operations of development financial institutions and deregulation of the capital market.

To allow banks greater freedom to deploy their funds on commercial considerations, statutory pre-emptions have been lowered since 1991. The cash reserve ratio has been reduced from 15 per cent of net demand and time liabilities (NDTL) to 5.5 per cent of NDTL since December 29, 2001. Statutory liquidity ratio has been lowered from 38.5 per cent of domestic liabilities and 30 per cent of non-resident liabilities to the statutory minimum of 25 per cent. These measures have added liquidity and widened opportunity to invest in assets of good quality.

Deregulation of interest rates to provide operational flexibility to banks was initiated in October 1994 with the introduction of the prime lending rate. Since 1997 almost all interest rates have been deregulated. The Reserve Bank no longer dictates the deposit rate schedule nor interest rates for loans. The areas where Reserve Bank still retains control on a minuscule portion of interest rates include the rates paid by banks on savings accounts and ceiling rates as advised for certain types of advances (below Rs.2 lacs to weaker sections in the priority sector). Though priority sector lending continues, its coverage has been enhanced and banks have also been allowed to deposit the unfulfilled portion of their priority sector lending with a few apex institutions. It is mandatory to fulfil the target of 40 per cent to this segment with a sub-ceiling of 18 per cent for lending to agriculture.

Free entry and exit constitutes an important precondition for competition. Competition in the banking sector has been increased by laying down entry norms for private sector banks. Joint ventures with Non-Resident Indians and Overseas Corporate Bodies have been allowed. During 2001, the Union Cabinet has cleared a proposal to allow up to 49 per cent foreign direct investment in new private sector banks to be established in India.

*Institutional Measures*

The importance of institutional arrangements for proper functioning of markets cannot be overemphasised. Consequently, this has been one of the primary aims of the reform process. The first of such measures was a review of the legal framework to gauge its adequacy in the face of rapid changes in the financial sector.

It is well recognised that the success of financial sector reforms hinges crucially on appropriate

support of the underlying legal framework. Expert committees have reviewed the overall legal framework as well as specific aspects of it. Consequent initiatives in this area relate to preparation of draft bills on asset securitisation and foreclosure of securities by banks and FIs without intervention of courts, amendments to the Negotiable Instrument Act and fraud on banks. Changes have also been recommended in the key Acts that govern the operations of banks and their regulation and supervision by the Reserve Bank.

With a view to provide an institutional mechanism for sharing of information on borrowers/ potential borrowers by banks and FIs, the Credit Information Bureau (India) Ltd. (CIBIL) was set up in August 2000. The Bureau provides a framework for collecting, processing and sharing credit information on borrowers of credit institutions.

A major debate in the area of financial sector reforms relates to the issue of ownership of PSBs. It was felt that ideally the Reserve Bank should not own the institutions it regulates so as to avoid conflicts of interest that may arise in its role as owner and regulator or supervisor. A Discussion Paper[1] prepared by the Reserve Bank called for the transfer of ownership of financial institutions from the Reserve Bank to the Government. The Reserve Bank has accepted the recommendations for the transfer of its stakes in the State Bank of India, National Housing Bank and National Bank for Agricultural and Rural Development to the Government. The Reserve Bank has already divested its holdings in DFHI and STCI.

Ownership of PSBs also raises the issue of recapitalisation. Between 1985-86 and 1998-99 the Government expended Rs.20,446 crore towards recapitalisation of PSBs. With higher capital adequacy requirements, the expanding asset base of PSBs calls for progressively greater volumes of capital. This is likely to pose a large fiscal burden on the Government if it is to continue maintaining its share in total capital unchanged. Therefore, the Government has sought to lower its holding in PSBs to a minimum of 33 per cent of total capital by allowing them to raise capital from the market. Banks have already accessed the capital markets while SBI has gone for GDR issue and domestic issue as well bringing the Reserve Bank's stake to 60 per cent from a peak of 95.5 per cent some years ago.

**Effects of Reforms and Overview of Performance**

Reforms are a continuous process. The Reserve Bank is introducing advanced measures such as consolidated supervision of the interrelated financial institutions, arrangements for risk management and risk-based supervision, creation of framework for micro- and macro-prudential measures for detecting early warning signals, etc. What distinguish the banking sector reforms in India from the financial liberalisation measures initiated in other developing countries are the elaborate arrangements to maintain stability at the institutional and systemic level as preventing contamination and a domino effect. Financial liberalisation without proper prudential norms and appropriate supervisory oversight generally lead to misallocation of resources and severe financial problem. The financial sector reform strategy in India, in its gradualist approach and sequencing of measures, has been specifically framed to avert such situations.

Since the introduction of banking reforms, there have been noticeable improvements in the various aspects of the financial health of the banks operating in India. Due to requirements on

provisioning and capital to risk weighted asset ratio (CRAR), the banking sector has become less vulnerable to shocks than before. Improvement in asset quality has been among the most noteworthy aspects of financial performance of banks. It may be pointed out that due to significant tightening of accounting norms, and the norms for income recognition and asset classification, the NPAs during the pre- and post-reform period are not strictly comparable. While the profitability situations of a majority of the public sector banks show definite improvements during 1990s, the profits remain low in comparison with the new private sector banks and branches of foreign banks operating in India. With the deregulation of entry norms, the number of foreign banks operating in India has increased from 23 in 1991 to 42 in 2001, while that of domestic private sector banks has increased from 24 to 31 in the same period. Nevertheless, over the past 10 years scams have surfaced in the banking system and capital markets and weaknesses thrown up are being suitably addressed and controls tightened.

*Scheduled Commercial Banks*

The performance of Indian banks in the decade of the 1990s can b e analysed on three fronts, *viz.*, profitability, efficiency and stability. The profits net of provisions and contingencies of SCBs increased more than five-fold from Rs.1,205 crore in 1991-92 to Rs.6,424 crore in 2000-01. The profits of PSBs net of their provisions and contingencies increased more than five-fold from Rs.804 crore in 1991-92 to Rs.4,317 crore in 2000-01, while those of Indian private sector banks increased fourteen-fold from Rs.82 crore in 1991-92 to Rs.1,162 crore in 2000-01.

The ratio of net profits to total assets of all SCBs increased from 0.39 per cent in 1991-92 to 0.50 per cent in 2000-01. For PSBs, the ratio increased from 0.28 per cent to 0.42 per cent in the same period, while for Indian private sector banks, the ratio increased from 0.57 per cent to 0.71 per cent. Thus there has been an unambiguous improvement in profitability of Indian banks.

The efficiency of operations of a bank group is reflected in the spread (net interest income as a proportion of assets) as well as the ratio of operating expenses to total assets. However, increasing competition puts pressure on interest margins. This has been true for all SCBs whose spread declined from 3.31 per cent in 1991-92 to 2.84 per cent in 2000-01, as well as for PSBs and private banks.

However, the ratio of non-interest income to total assets of SCBs increased from 1.38 per cent in 1991-92 to 1.42 per cent in 1999-2000. The ratio, however, declined to 1.32 per cent in 2000-01. The ratio for PSBs increased from 1.22 per cent in 1991-92 to 1.29 per cent in 1999-00 which, however, declined to 1.22 per cent in 2000-01. Private banks recorded an increase in the ratio from 1.05 per cent in 1991-92 to 1.28 per cent in 2000-01.

The ratio of operating expenses to total assets of SCBs declined from 2.60 per cent in 1991-92 to 2.50 per cent in 1999-2000. However, expenses on account of the voluntary retirement scheme have pushed up the ratio to 2.64 per cent in 2000-01. PSBs recorded a decline in the ratio from 2.60 per cent in 1991-92 to 2.53 per cent in 1999-2000 and thereafter an increase to 2.72 per cent in 2000-01. For private sector banks the ratio declined from 2.98 per cent in 1991-92 to 1.87 per cent in 2000-01.

Stability of the system is reflected in the level of NPAs in the system and the capital adequacy ratio. The proportion of gross NPA in total advances of the public sector banks declined from 24.8 per cent in 1994 to 14.0 per cent in 2000. The Indian banking system is well placed in terms of capital adequacy as well. As at end-March 2001, 25 out of the 27 PSBs and 28 out of 31 Indian private banks had achieved the minimum stipulated capital adequacy of 9 per cent. However, in absolute terms, the NPA level at over Rs.60,000 crore is a cause for concern.

It would be fair to state that the banking sector has shown clear improvements in profitability and stability since the initiation of the reforms.

*Co-operative Banks*

At the end of March 2001, the number of urban co-operative banks (UCBs) stood at 2,084 including 90 salary earners' banks. Information on the financial performance of UCBs relating to profits/losses during 1999-2000 are available for 1,747 banks, which roughly cover 84 per cent of the total UCBs. Of these UCBs 1,499 banks registered profits while the rest incurred losses.

*Scheduled UCBs*

Total deposits and advances of the 51 scheduled UCBs as at end-March 2001 were Rs.33,164 crore and Rs.21,511 crore, respectively. During the financial year 2000-01, the total income increased by 17.2 per cent. Interest income accounted for 93.3 per cent of the total income of the scheduled UCBs. The total expenditure of the scheduled UCBs increased by 49.7 per cent in 2000-01.

*Financial Institutions (FIs)*

The profitability analysis of the 10 FIs indicates that the combined net profits of these institutions registered a decline of 35.1 per cent during the year 2000-01. The ratios of net NPA to net loan as on March 31, 2001, in respect of ICICI, SIDBI and EXIM Bank were below 10 per cent while that of IFCI, IDBI, IIBI and TFCI ranged between 14.0 per cent and 23.0 per cent. The CRAR of all the financial institutions, except IFCI, was above the required level of 9 per cent as at the end of March 2001.

**The Role of the Reserve Bank**

With rapid changes in all segments of the financial sector post-reform, it is but expected that the role of the Reserve Bank undergo changes – not merely in its capacity as the regulator and supervisor but also in several of its other capacities as well. The role of the central bank in transition is a topic vast enough to merit a book. I will focus on the changing role of the Reserve Bank only in the context of the changes that we have discussed so far.

*Major Areas*

In most of the industrialised countries policy focus of the central banks are limited to ensuring price stability. In developing countries like India central banks also play a developmental role.

Like most central banks, the Reserve Bank is entrusted with the task of conducting monetary policy. In addition, the Reserve Bank regulates and supervises the banking system under the provisions of the Reserve Bank of India Act (1934) and Banking Regulation Act (1949). The Reserve Bank regulates a part of the non-banking financial companies and issues instruction to certain all India financial institutions under the provisions of the Reserve Bank of India Act (1934). The Reserve Bank is banker to the Governments and banks and also responsible for maintaining orderly conditions in the foreign exchange markets and public debt management.

*Monetary Policy*

Generally the conduct of monetary policy remains the most important function of the central banks. Since the introduction of economic reforms the mode of conduct of such policies has changed. In the pre-reform period, the conduct of monetary policy was more through direct instruments such as reserve requirement, administered interest rates, etc. Since the initiation of financial sector reforms, the reserve requirements have been reduced significantly. The pre-emption of resources from the banking system through reserve requirements has come down from more than 60 per cent during the early-1990s to about 30 per cent. The administered controls on interest rates offered and charged by the banks have largely been phased out. Steps have been taken to reduce reliance of financial institutions on the resources of the Reserve Bank. These measures were part of the financial sector reform process, which aimed at creating a market-based, competitive and efficient financial system. With the reduction of reliance on direct instruments for the conduct of monetary policy, indirect instruments such as open market operations, liquidity adjustment facility, etc. are being increasingly utilised. The bank rate, which is the reference rate at which the central bank makes resources available to the financial sector for select purposes, is being used as the single most important signaling device by the Reserve Bank. It is important to note that the transition from direct to indirect conduct of monetary policy has been greatly facilitated by initiatives outside the sphere of monetary policy, most important of which is the discontinuation of automatic monetisation of Government deficit. It is heartening to note that the conduct of monetary policy in the post-reform period has resulted in a significant level of price stability.

*Open Market Operations*

The Reserve Bank, like other central banks, aims to achieve monetary objectives through various policy instruments. In the conduct of monetary policy, indirect instruments such as Bank Rate and open market operations (OMO) are more efficient instruments than direct instruments. In the pre-reform period prior to 1991, due to inadequate development of financial markets, the Reserve Bank had to perforce resort to the direct instruments in monetary management. This compulsion stemmed from the absence of a government securities market with sufficient depth and liquidity which is an essential prerequisite for conduct of OMO.

With deregulation and liberalisation of financial markets, yield on government securities were made market-related in 1997 and, consequently, the Reserve Bank created an array of market-related financial products. Interest rate structure was simultaneously rationalised and deregulated and banks were given freedom to determine their lending and borrowing rates. All these developments facilitated the use of OMO as an effective instrument for liquidity management

including containing volatilities in the foreign exchange market.

The reactivation of the Bank Rate and introduction of fixed rate repo during 1997-98 helped in creating an informal corridor for call money rates, with the repo rate acting as floor and the Bank Rate as the ceiling. Subsequently, the introduction of Liquidity Adjustment Facility (LAF) from June 2000 enabled the modulation of liquidity conditions on a daily basis and also short-term interest rates through the LAF window, while signaling the stance of policy through changes in the Bank Rate.

The operation of OMO, both through outright purchase/sale of government securities at Reserve Bank's discretion and repo and reverse repo transactions as part of LAF available to banks and primary dealers, has helped liquidity management in a flexible manner. Large capital inflows have been accommodated by the Reserve Bank while its monetary impact has been sterilised through OMO. This has helped in reducing the Government's reliance on credit from the Reserve Bank leading to a secular decline in monetised deficit. Additionally, LAF helped in successful implementation of the first phase of the move towards pure inter-bank call money market by moderating the volatility in the money market. For instance, daily repo transactions, on average, rose to Rs. 5,861 crore during the current year so far from Rs. 3,286 crore during the corresponding period last year. The OMO window was used in successfully stabilising market volatility following the September 11, 2001 events in the US. The efficacy of OMO can be judged from the fact that it was possible to successfully lower the CRR recently by 200 basis points in a liquid market by mopping up liquidity through repos, as and when necessary.

However, monetary policy operating procedures are continuously evolving, and to make LAF fully effective, measures are being taken, in consultation with experts and market participants to make it the primary instrument of liquidity adjustment.

*Regulatory and Supervisory Policies*

In the post-reform period, the Reserve Bank has included within its regulatory and supervisory ambit, several non-banking financial companies (NBFCs), particularly those accepting deposits from the public. The regulatory approach has changed from micro-management to one marked by greater focus on systems and processes for prudential conduct of the financial companies. Efforts have been made to benchmark these systems and procedures with international best practices. India's compliance to international best practices is one of the best among the developing countries. To enhance the role of market discipline, stress has been laid on transparency of operations, corporate governance and increasing role of external auditors and rating agencies. On the supervisory front, on-site supervision has been supplemented by off-site monitoring. In order to safeguard the systemic stability as well as the health of individual banks and NBFCs, macroeconomic and micro-prudential indicators have been identified and the same are being monitored on an ongoing basis.

*Management of the External Sector*

The recommendations of the High Powered Committee on Balance of Payments (Chairman: Dr. C. Rangarajan) have guided the management of India's external sector in the 1990s. The main

ingredients of the reform in this sector since 1992 have been to maintain a sustainable current account deficit, discourage debt creating flows, impose a ceiling on external commercial borrowings, and in particular, short-term debt, encourage non-debt flows especially foreign direct investment, adopt a flexible exchange rate regime and build up foreign exchange reserves. In 1994, India adopted the

Article VIII Status of the International Monetary Fund, which signifies convertibility on the external current account transactions. Thus, the pre-reform objective of the preservation of scarce foreign exchange has been replaced by the aim to create a comfortable environment for international trade and payments system. Determination of daily exchange rate has been left to the market forces. The Reserve Bank, however, keeps a watch on the movements in the exchange rates and to maintain orderly conditions in the foreign exchange market, acts to smoothen fluctuations as and when the situation warrants. The Reserve Bank has taken several measures to strengthen and deepen the foreign exchange market. In the capital account, the policy has been to liberalise cautiously, based on some achievement of certain preconditions on the inflation, fiscal and financial sector fronts. Residents have been permitted to hold, own or transfer or invest in foreign currency/securities, moveable and immovable assets abroad if the same were acquired while they were resident outside India or was inherited from a person who was resident outside India. Likewise, permission has also been granted to non-residents to hold, own or transfer or invest in Indian currency, security or any immoveable property in India if such currency, security or property was acquired while they were resident in India or inherit from a person who was resident in India. The Foreign Exchange Management Act does not make distinction between an Indian and foreign national resident in India. It may be pointed out that despite several unexpected external and domestic developments, India’s external situation remained satisfactory during the post-reform period. It is possible for every Indian to take US $ 5,000 on the trips abroad in a year and also retain with him on return unspent foreign exchange upto US $ 2,000. We have thus come a long way from the maximum US $ 8 which one could take without a permit in 1970s.

The overall approach to the management of India’s foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the “liquidity risks” associated with different types of flows and other requirements. The policy of reserve management is, thus, built upon a judicious mix of identifiable factors and other contingencies. Such factors *inter alia* include the size of the current account deficit, the size of short-term liabilities (including current repayment obligations on long-term loans), the possible variability in portfolio investments and other types of capital flows, the unanticipated pressures on the balance of payments arising out of external shocks (such as the impact of East Asian crisis in 1997-98 or increase in oil prices in 1999-2000 or recent events in the US), and movements in the repatriable foreign currency deposits of non-resident Indians. The movements in India’s foreign exchange reserves in recent years have kept pace with our requirements on trade as well as capital account. The strength of the foreign exchange reserves has also been a positive factor in facilitating flow of portfolio investments by foreign institutional investors (FIIs) and in reducing the ‘risk premium’ on foreign borrowings and Global Depository Receipts / American Depository Receipt issued by Indian corporates. It is also necessary to ensure that, leaving aside short-term variations in levels, the quantum of reserves in the long run is in line with the growth in the economy, the share of external sector in the economy and the size of risk-adjusted capital

flows. This will provide the necessary security against unfavourable or unanticipated developments.

The present level of foreign exchange reserves based on various measures of reserve adequacy is quite comfortable, which is indicative of success of our reserve management policies. The foreign exchange reserves have increased substantially by US $ 7,198 million, facilitated by strong inflows from FIIs, FDI, exports and NRI deposits, during the period April-January 2001-02 to US $ 49,479 million at the end of January 2002 on top of an increase of US $ 4,245 million during 2000-01. The foreign currency assets rose by US $ 7,007 million to US $ 46,561 million during the same period. It may be noted that during the period November-January 2001-02, the reserves increased substantially, which could be explained by continued strong inflows coupled with lack of corporate demand resulting in accretion to reserves.

*Banking Functions*

The Reserve Bank is the banker to the Central Government and most State Governments. In this capacity, it manages their exchange, remittances and other banking operations including public debt. The Reserve Bank as the debt manager is responsible for the success of the government securities issue, and is also allowed to pick up government securities at the primary issue stage. However, there is a conflict between this role and its role as monetary authority. As a debt manager, the Reserve Bank wishes to minimise the cost of raising debt and would thus pick up large amounts of government securities to avoid creating interest rate 'spikes', which may have spillover effects on inflationary expectations. Recognising this, the Reserve Bank had set up a Working Group on Separation of Debt Management from Monetary Management, which recommended, *inter alia*, separation of debt management from monetary management and establishment of an independent company under Companies Act, 1956 to take over the debt management function. It was felt that the separation of the two functions would be dependent on the fulfillment of three preconditions, *viz.* development of financial markets, reasonable control over fiscal deficit and necessary legislative changes.

The Reserve Bank is also the banker to banks. It is in this capacity that it acts as a lender-of-the-last resort (LLR) to provide assurances of stability under all circumstances. The Reserve Bank as LLR accommodates demands for high-powered money in times of crisis, thus preventing panic-induced contractions of the money stock. Ideally, the LLR's announcement of its commitment would assuage fears of a shortage of cash and suffice to still panics without the need for taking action. However, it may also engender moral hazard problems if banks relying on this, take on unwarranted risks without sufficient mitigation measures.

Although the LLR function of the Reserve Bank has been extant, its scope and content have undergone a transformation. This is all the more so in recent times wherein concerns about financial stability have become paramount. Post-reforms the statutory pre-emptions from banks have been reduced. Concomitantly, banks are required to reduce their dependence on the Reserve Bank on a continuous basis.

*Currency Management*

The Reserve Bank is entrusted with the task of currency management in India. Currently it involves management of 3,800 crore pieces of currency notes valued at Rs. 2,33,000 crore. While currently 1,200 crore pieces are being printed every year, the printing capacity has been built up to a futuristic level of 1,800 crore pieces annually. Since the current position of supply of fresh notes is quite comfortable, the Bank is concentrating on faster and better distribution of notes and coins by augmenting its capacity to withdraw soiled notes from circulation and processing them in faster ways through increased mechanisation and automation. Towards this end, the Bank has embarked upon an ambitious scheme of mechanisation of all offices by introducing modern automatic high-speed banknote processing machines, which are efficient in sorting and destroying soiled notes. In order to comply with the requirements of environment-friendly disposal of soiled notes, the Bank has switched over to the process of shredding and briquetting the unfit notes rather than burning them as was done earlier. Apart from maintaining adequate supply of fit notes in circulation and disposal of unfit notes, preventing counterfeiting of high denomination bank notes is another major challenge faced by the Reserve Bank in the context of currency management. There are reports of organised counterfeiting from across the border. In order to combat the problem the Reserve Bank, in cooperation with the Government of India, has initiated various steps, which include strengthening security features on currency notes and launching awareness campaigns about the available identifiable features in genuine banknotes. In order to enhance the life of banknotes, the Reserve Bank has launched programmes to improve practices for handling of banknotes at both wholesale and retail ends.

*Developmental Role*

As a part of the developmental objectives, the Reserve Bank plays an important role in enlarging the reach of the organised financial sector to all parts of the economy, creating institutions for catering to certain specialised financial needs, etc. The Reserve Bank also initiated measures to channelise finance in line with the objectives of the Five Year Plans. A widely held view is that the best contribution that the Reserve Bank can make for the development of the country, including eradication of poverty, is through ensuring price stability. The current developmental role of the Reserve Bank, however, encompasses a more extensive canvas than this. Such activities include steps to safeguard the interest of depositors, especially small depositors, through the deposit insurance scheme, channelisation of credit towards export producing sector and priority sector, etc. Apart from directed lending through priority sector advances, the Reserve Bank has actively supported bank lending to the poor through innovative microfinance schemes actively sponsored through SHGs. Available evidence suggests that not only are microfinance schemes in India providing the poor the much-needed loans, the recovery performance under such schemes are extremely good. That is why many commercial banks are coming forward to support such schemes. The present level of low inflation, ample liquidity, low interest rates and comfortable forex reserves position clearly shows the continuous monitoring and fine tuning of various aspects of the monetary policy by the Reserve Bank and that the Reserve Bank is in touch with ground realities.

**Future Perspective**

Before closing this session I would like to say a few words about my perceptions of the future of Indian banking. Recent years have seen Indian banks make forays into several territories so far

uncharted by them. With the opening up of the insurance sector, several banks have started subsidiaries and undertaken joint ventures to enter the insurance market. Most commercial banks have started offering their customers remote banking services through automated teller machines and several have started offering electronic banking facilities as well. Other services offered by banks include electronic fund transfer, bill payment and custodial services. New areas of business include factoring, credit cards etc.

As new areas of business open up and demands for remote banking services rise, technology, particularly information technology, emerges as an important variable in profitable banking operations. The backbone of any banking system is its payment and settlement systems. Therefore, special emphasis has been accorded to improvements in the payments and settlements systems. Important initiatives in these areas include Electronic Funds Transfer (EFT), Real Time Gross Settlement System (RTGS), to substantially mitigate settlement risks and collapse of markets, Centralised Funds Management System (CFMS), the Negotiated Dealing System (NDS) and the Structured Financial Messaging Solution (SFMS). SFMS will be the backbone for all message-based communication over the Indian Financial Network (INFINET), which was started as a closed user group communication network for banks in India with PSBs as members. The INFINET has been operational for two years and its membership was thrown open to other banks and FIs in 2000-01. It may be pointed out that with effect from February 15, 2002 a screen based negotiated dealing system (NDS) has been introduced to further facilitate trade in government securities.

With competition within the banking industry increasing rapidly the volume of electronic and card based transactions are likely to increase manifold as banks compete with each other to offer their customers remote banking services including internet banking. Technology, therefore, is likely to assume greater importance than ever before. One may foresee the info-tech sector benefiting from a continuously increasing and changing demand for bank-specific packages. The point to remember here is that, more than increasing volumes and speed of transactions, technology is likely to change the very way that banks work. The electronic channel for delivery of services will sharply lower transactions costs, in the near future, but banks will have to first undertake large investments in information technology before they can reap the benefits of lower costs. The cost benefits of information technology, therefore, are likely to show up clearly only in the medium term. In the medium-term well-computerised banks will also benefit from lower establishment costs as a single remote back office can simultaneously service several front offices in branches located in different areas. A high degree of computerisation will also throw into high relief the issue of security of records and transactions which need to be put in place simultaneously.

The new capital accord proposed by the Basel Committee on Banking Supervision, is likely to bring about a fundamental change in the way risk is perceived and managed. This change will go beyond mere numbers or increasing supervisory stringency. With the onus on banks to assess their risks for capital requirements, the new accord makes it contingent on banks to switchover from mechanical calculations of risk on the basis of formulae provided by the regulator to advanced and systematic risk monitoring systems. From systematic risk monitoring systems it is but a short step to more forward-looking risk management systems. Allotting capital to credit and operational risk will ensure that banks are perforce required to monitor these on a regular

basis. Therefore, the salutary effects of the New Accord will go beyond mere higher capital ratios.

Another issue that assumes critical importance for transparent and orderly conduct of the financial sector relates to good corporate governance practices. This assumes special importance in the post-reform period since as a result of liberalisation and globalisation, competition from both domestic and foreign financial service providers has increased significantly. In recent times world-wide regulatory and supervisory authorities and multilateral organisations are taking increased cognisance of issues related to good corporate governance practices. It is being increasingly realised that a strengthened corporate governance framework is a *sine qua non* for achieving corporate excellence. Corporate excellence, in turn, has become an important precondition for a healthy economy. While peer pressure, market pressure, etc., are important components to ensure the effective implementation of the codes of good corporate governance, regulators can be an effective external pressure point in this context. In India, along with various other apex organisations, the Reserve Bank has also initiated various measures to identify, implement and supervise good corporate governance practices in the financial sector. Implementation of international best practices in the financial sector is being increasingly viewed as an important cornerstone for protection of the interests of the stakeholders of financial companies and in a broader sense it is one of the important preconditions for the maintenance of financial stability.

Finally, increased liberalisation of the banking sector and the consequent increase in competition has resulted in the narrowing of margins in traditional/core banking activities. This is likely to have two fallouts, which have already begun to take effect. First, banks are likely to put greater emphasis on off-balance sheet activities. Second, with new areas of activity being thrown open to banks, banks might find themselves transgressing into what were hitherto the sole preserves of FIs, insurance companies and even certain NBFCs. This will bring to the fore issues of convergence among the different types of institutions in the longer run. In the short-term this is likely to result in intense competition with a shakeout taking place in the medium-term when economies of scale and scope get exploited by larger institutions and mergers, joint ventures and strategic alliances rationalise the number of players in each market. One can also foresee banks making inroads into rural areas in a bid to expand markets. In the medium to longer term greater overseas expansion can also be perceived.

From the standpoint of a banker, I have tried to provide certain focussed perspectives about the financial sector reforms in India. It has been a pleasure for me to speak before you and I hope that this interactive session would enable a more holistic approach to policy framing when you all return to your regular assignments.

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*** Address delivered by Shri Vepa Kamesam, Deputy Governor, RBI at the National Defence College, New Delhi on April 3, 2002.**

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