Speech

TRENDS IN INTERNATIONAL BANKING*

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I am very happy to be with you on this occasion. I would like to commend the Indian Banks' Association for organising the International Banking Conference at a very timely and critical juncture.

The theme of the Conference assumes great significance in the current international environment. In the context of the Asian financial crisis and the continuing turbulence in the international financial markets, the formulation and application of international rules for sound banking practices has become a critical issue. The ongoing efforts in this direction are supported by extensive enquiry into the identification of the causes of banking crises, the conditions under which these crises are likely to occur and early warning systems which can trigger pre-emptive policy action.

As you know, international financing through bank lending grew at a vigorous pace in 1997 with a sharp increase in banks' involvement in the securities markets. Thus, international syndicated loan facilities reached a record volume of US $ 1.1 trillion and, credit flows intermediated by international banks rose to an all-time high of US $ 1.2 trillion, almost entirely through inter bank business. This picture has changed dramatically in 1998. In the first quarter of the year, there was a decline of US $ 0.4 billion in credit flows as against an expansion of US $ 451 billion in the last quarter of 1997. The decline in bank lending as well as overall private financing has been even sharper in Asia. During the first quarter of the current year, gross private financing from all sources to Asian economies is estimated to be 10 to 15 per cent of the monthly average of the previous year.

The unsettled environment in which international banking has operated in 1998 has underscored the complementarity between macroeconomic stability and financial sector strengthening. Domestic banking systems worldwide are going through a major restructuring. Over the recent years various committees of national experts supported by the BIS have focused increasing attention on the recommendation of international standards and practices for banking sectors to adopt in the context of the globalisation of financial markets. The Asian crisis has provided impetus for bringing forward these initiatives.

It is also interesting to know that with the phenomenal advances in telecommunications and the synthesis of information and computer technology, capital movements have completely dwarfed the cross-border movement of goods and services and have become the new engine of global integration. These developments have fundamentally changed the structure of the banking system, its orientation and its vulnerability to risks.

Until lately, banking systems were domestically oriented. National policy objectives embodied in the mobilisation of domestic saving, the adequate provision of credit with directed lending targeted at specific sectors of the economy, extending the geographical spread of the banking function and raising resources for financing public sector deficits primarily guided the conduct of banking activity. This necessitated specialisation, and segmentation between banks and other financial institutions was clearly defined. Foreign exchange constraints necessitated recourse to exchange control. Managed exchange rate and interest rate regimes also limited the exposure to external crises.

However, in the nineties, banks have become more global in their reach and in the diversification of their portfolios. They operate with greater freedom than before. Furthermore, there is more universal banking today than in the past. Banks' balance sheets have become more vulnerable to external shocks. The cross-border diversification of assets and liabilities has thrown up the potential of mismatches. In the globalised financial system, opportunities to maximise profits are accompanied by an explosion in the volume and nature of risks and banks are confronting increasing pressures in this high yield and high risk market environment.

At present there exists a large disparity in the risk management practices pursued by banks across countries. Given the growing integration of financial markets and the danger of contagion spreading from one country or region to other countries, for the regulators, identifying "best practices" reflecting the country specific requirements vis-à-vis the international norms has become necessary. In the management of systemic risk, co-ordinated international banking supervision is, therefore, gaining importance. Development of credit derivative markets and securitisation of bank assets are areas which increasingly absorb regulators' attention and involvement. Sound accounting and transparent financial disclosure constitute the key to the health of the banking system in a globalised market. As financial innovations render traditional techniques for assessing capital adequacy less appropriate, banks' internal risk measurement systems could provide valuable information for prudential oversight.

The process of achieving global convergence towards international rules for the banking sector has been provided strong momentum by the initiatives undertaken in the BIS under the Basle process, the Willard Working parties, the Institute of International Finance and the Federal Reserve System Task Force on Internal Credit Models. Efforts are underway to reach a broad consensus on the recommendations of these groups. In this process, emphasis has been placed on securing the participation of national experts from a large number of countries.

The multilateral accord on financial services, which came into being under the aegis of the World Trade Organisation in December 1997, also has significant ramifications for the alignment of domestic banking systems into the global order. Over 65 WTO members have made commitments in banking services involving an estimated US $ 38 trillion in global bank lending. As this process of closer external linkages gathers momentum and competition intensifies, domestic banking systems could expect to face increased competition with an emphasis on improving customer services, reduction of costs and strengthening of prudential norms, better risk management, higher level of professional expertise, technological upgradation and overall efficiency.

Banking Sector Reforms in India

It is against the above background that we have to consider the urgent need to accelerate the process of financial reforms in India. Initially, in India, banking sector reforms were undertaken as part of a comprehensive package of structural reforms. They took the form of modifications in the policy framework to improve the operational efficiency of the banking system, strengthening of the financial health of banks, building the infrastructure in terms of supervision, audit and technology and upgrading the level of managerial competence.

Significant progress has been made in the first phase of reforms introduced since 1992. The major achievements in the first phase are :

- The Statutory Liquidity Ratio (SLR) has been brought down from a pre-reform peak of an effective level of 37.5 per cent to an overall effective level of 25 per cent by October, 1997.

- Banks' lending rates have been progressively rationalised over the years. Beginning in October, 1994 lending rates have been deregulated and the structure of lending rates has been progressively linked to the bank rate. The bank rate has been activated to serve as a reference rate as well as an effective signaling mechanism for the stance of monetary policy. Today, the only lending rates, which are regulated, are for very small borrowers and for pre-shipment and post-shipment rupee export credit. Deposit rates have also been freed.

- Refinance facilities have gradually shifted from sector specific facilities to a general collateralised facility with interest rates linked to the bank rate. Export credit refinance continues to be the only sector-specific facility with a concessional interest rate.

- In order to improve the financial health of the banking system, the risk based capital standard for banks was introduced in 1992-93, drawing from the Basle Committee recommendations. Indian banks with branches abroad were required to achieve the norm of 8 per cent. Out of 27 public sector banks, 25 achieved the norm at the end of March, 1997. For this purpose, eight banks have accessed the capital market and four banks have been allowed to raise subordinated debt through private placement for inclusion under Tier II capital.

- Prudential accounting norms relating to income recognition, asset classification and provision of bad and doubtful debts were introduced in a phased manner, beginning 1992-93. These norms have been progressively tightened with a view to achieving international best practices. Banks have now met with the new provisioning requirement.

- The mark-to-market proportion of the approved securities has been enhanced over the years from 30 per cent in 1993 to 70 per cent in 1998-99 and this would be raised progressively to 100 per cent over the next three years.

- Credit delivery systems have been significantly improved with banks being endowed with greater freedom in assessing working capital requirements. Delivery systems for rural credit have been revamped. A Rural Infrastructural Development Fund was constituted at NABARD in 1995, the process of recapitalisation and restabilisation of RRBs has been carried forward and the share capital of NABARD has been increased. Several policy initiatives have been taken to accelerate the flow of credit to the agricultural sector in the light of the recommendations of the Committee on Credit to Commercial Banks. The system of extending credit to small scale industries has been simplified and recommendations for improving the delivery system are being examined.

- To infuse competition into the banking system, private sector banks have been allowed to enter the industry. Non-bank financial companies have emerged as a competitive force. In January 1998, a new regulatory framework was introduced to ensure compliance of NBFCs with prudential norms. A comprehensive mechanism of off-site supervision is under implementation.

- A strong system of external supervision has been put in place by setting up the Board for Financial Supervision with the Reserve Bank and by encouraging the strengthening of internal control mechanisms.

The first phase of banking sector reforms is now coming to a close and the second phase of reforms has been launched with the setting up of the Committee on Banking Sector Reforms (Chairman: Shri M. Narasimham). The thrust of the second phase of reform is on improvement in the organisational efficiency of banks. In the Monetary and Credit Policy for the first half of 1997-98, we have expressed our resolve to further strengthen the existing capital adequacy, income recognition and provisioning norms, the disclosure and auditing requirements of banks in the light of the recommendations of the Committee. The Reserve Bank proposes to move towards international best practices in these areas as early as possible.

The most critical area in the improvement of the profitability of banks continues to be the reduction of Non-Performing Assets (NPAs). In fact the issue is intimately connected with the overall stability of the financial system. The NPAs of all public sector banks constituted 23.2 per cent of total loan assets in 1992-93 when the financial sector reforms were implemented. By the end of March, 1997 the NPAs have declined to less than 18 per cent, despite the tightening of norms for asset classification and income recognition. Furthermore, it is important to note that the bulk of NPAs are provided for in the banks' capital. Net NPAs amounted to 8.69 per cent of net advances at the end of March, 1998 as against 9.18 per cent in 1996-97 and this is comparable with banking systems in other more developed countries. It needs to be recognised that reducing the level of NPAs is a time consuming process. Apart from internal factors such as weak credit appraisal, non-compliance and wilful default, there are several external factors such as preponderance of certain traditional industries in the portfolio of certain banks, natural calamities, policy and technological changes which increase the incidence of sickness, labour problems, non-availability of raw materials and other such factors which are not within the control of banks. Moreover, there are problems in effecting recoveries and write-offs and in compromise/negotiated settlements. Nevertheless, it is of utmost importance that no efforts are spared to reduce the extent of NPAs in the banking sector. The Government and the Reserve Bank are committed to persevere with efforts in several directions which would bring down the level of NPAs. Debt recovery tribunals will be strengthened and more tribunals will be set up to cover all States. Legal amendments in key laws would be worked out by experts to enable faster adjudication and recovery.

Looking beyond the problem of NPAs and prudential norms, there is need to move towards a more competitive, customer-friendly, and transaction-efficient financial system with standards of transparency and accountability that are comparable to the best in the world. The Reserve Bank is fully committed to this goal, and I will urge the chiefs of banks assembled here to develop a time-bound and concrete plan for achieving our country's objectives in this area.

The financial sector reforms are directed towards making the Indian banking system stronger, more resilient and geared to meet the challenges of globalisation. The lessons emerging from the recent international developments have vindicated our approach to financial sector reforms over the past four years and reinforce our commitment to broaden and deepen the reform process. As the reform measures get firmly entrenched over the next few years, the Indian banking system can be expected to emerge as among the best in the world.

*** Inaugural Address by Bimal Jalan, Governor, Reserve Bank of India at the International Banking Conference organised by Indian Banks' Association at New Delhi on September 16, 1998.**