Speech

EMERGING TRENDS IN REGULATION AND SUPERVISION*

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One of the major tasks the RBI has undertaken is building up of a sound and adequate banking and credit structure on modern lines. For this purpose, extensive powers for supervision and control of banks were acquired by the Bank over the years. The focus of statutory regulation of commercial banks (including the Regional Rural Banks) till the 1990s was mainly on licensing of banks and branches, administration of minimum capital requirements, reserves and liquid asset requirements, control over management, control over methods of operation and amalgamation, reconstruction and liquidation. In addition, the RBI has been vested with powers of supervision through the mechanism of inspection of the financial strength of the banks in India. The RBI enjoys operational independence and adequate resources to meet these objectives.

The regulation of banking system by the RBI had sought to ensure that the funds placed with the financial intermediaries are deployed by them in prudent fashion without jeopardising their safety and soundness. This follows from the fact that the institutional development can take place only if the depositing and investing public have confidence in the system.

As part of the on-going structural adjustment programme, the Government of India initiated in 1991, far-reaching reform measures for the financial sector with the Reserve Bank being instrumental in their formulation and implementation. As you may know, the first two decades of nationalisation saw a phenomenal expansion in the geographical coverage and financial spread of our banking system. The development of the financial sector has been a major achievement of independent India. It has contributed significantly to the increase of the savings rate, especially in the household sector. Nevertheless, over a period, certain rigidities and weaknesses also developed in the system which required to be addressed so as to enable the financial system play its role in ushering in a more efficient and competitive economy. The Government set up a high level Committee in August 1991 under the Chairmanship of Shri M. Narasimham (Narasimham Committee) to examine all aspects relating to structure, organisation, functions and procedures of the Indian financial system.

The Committee's approach to the issue of financial sector reforms was to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing productivity and profitability. Apart from making recommendations relating to the reduction in reserve requirements and interest rates, the Committee's major contribution was the introduction of prudential norms and regulations aimed at ensuring the safety and soundness of the financial system, imparting greater transparency and accountability in operations and restoring the credibility of the institutions and confidence in the Indian financial system. The adoption of prudential norms resulted in a specific regulatory shift towards the obligation of banks to maintain capital adequacy to cover the assets in a proportion understood internationally. The concept of identifying and classifying advances into standard, sub-standard and doubtful and loss assets was based on clear, identifiable and objective criteria with a view to ensuring that the banks in India book interest income only on actual realisation from out of performing advances. This regulation also cast the obligation on banks to provide against possible loan losses. This inter-nationally accepted prudential regulation has produced sea-change in the functioning of banks in India in the post-Narasimham Committee period. No doubt, a number of banks, particularly in public sector, had to face the brunt of the non-performing advances which had not been identified till then and this had its attendant impact on the profitability and owned funds of the banks concerned. As a regulator, the Reserve Bank had while adopting the prudential norms, carefully phased its introduction during 1993-96 in such a manner that the impact was not too sudden. Further, during this period the process of regulation sustained its emphasis on adoption of prudential norms at the policy level despite difficulties and was also pursued at micro level for bank specific action on the basis of its inspections. The measures have, in retrospect, produced the desired results. Almost all public sector banks reached capital adequacy. Among the public sector banks there is at present only one bank which is yet to reach capital adequacy of 8 per cent of its risk weighted assets. The Non-Performing Assets (NPAs) of the public sector banks measured on the gross level aggregated Rs.43,577 crore or 17.8 per cent of the total advances as of March 1997. The Non-Performing Assets reckoned after adjusting for the provisions made, and amount lying in interest suspense account and other unadjusted amounts aggregated Rs. 20,285 crore formed 9.2 per cent of the net advances. But the data shows that despite increase in absolute quantum of NPAs during 1993-97, the accretion of fresh NPAs was smaller in comparison to the expansion of credit. In other words, the incidence of fresh NPAs in respect of advances granted after adoption of regulatory prudential norms was clearly on the downward trend.

Likewise, the profitability of public sector banks too was affected due to the requirement of higher quantum of provisions towards identified NPAs in the initial years of reform. The banks have gradually improved their performance levels to remain profitable and competitive and except for one bank, all public sector banks have recorded operating profits during 1997-98 as compared to 21 banks that reported operating profits in the year 1993-94. The strain on profitability apart, the relative strength of banks has also grown with a significant portion of the NPAs being provided for against possible loan losses.

On the capital adequacy front, the positive development has been the initiatives towards dilution of government equity. With the amendment to Bank Nationalisation Act towards reduction of government equity to 51 per cent, the scenario has been moving away from the banks' dependence on capital infusion by the Government towards refund of capital to Government of India by financially stronger banks. During the last 3 years, banks have refunded to Government of India capital to the extent of Rs. 642.80 crore. As many as 8 public sector banks could recently access capital markets to raise Rs.6,042.25 crore (including premium) between 1994-98. There are more banks waiting to make public issues and it has been the experience that the equity issues of public sector banks have generated considerable public interest even in difficult market conditions. Simultaneously, the wider shareholding pattern of banks has also brought in greater accountability and responsibility to boards of the banks. Strategic long term planning for sustained progress, improvement of market share, carving out niche areas depending on individual strengths, are increasingly under discussion at various levels in banks.

The existing prudential framework in India is marked by simplicity in approach, transparency and objectivity. Even while maintaining this framework, the RBI has been examining changes required in regulatory approach on the basis of evolving developments without allowing relaxation in the prudential guidelines relating to NPAs, since the main objective is the long term viability and financial strength of the banks rather than short term gains in postponing identification of the Non-Performing Assets. It is heartening to observe that banks on their own have realised the need for identifying credit weaknesses in their asset portfolio at an early stage for corrective actions. The banks have inculcated a sensitivity to NPAs at all levels right from the board to the branches since NPAs have a direct impact on profitability as well as the image of the bank. More importantly, this has also led to improvement in credit appraisal techniques, credit review mechanisms to track early warning signals and rectifying systemic deficiencies in credit administration process. Clearly, this is fulfillment of the main objective of bringing an awareness of prudential management. The Reserve Bank of India on its part discusses with nationalised banks and arrives at certain committed levels of performance of business parameters including reduction of NPAs. This has also helped banks make concerted efforts towards the goal of prudential financial management.

Consistent with the need to make Indian banks adopt banking practices recognised internationally, the RBI has been asking the banks to move gradually but firmly towards the objective of marking their entire investment portfolio to market. Traditionally, banks in India with a large portfolio of Gilt securities have not been feeling the need towards market valuation of the securities. The absence of a well developed debt market has also been a contributory factor. However, with shift towards government borrowing at market related rates, it would be necessary to value such investments also with reference to market or yield to maturity. Taking however, into account the banks' portfolio in low coupon government investments of the past, the transition to mark a larger proportion of investments to regular category has to be gradual and smooth. The RBI has therefore, prescribed gradual reduction of the proportion of permanent category of investments from a high of 70 per cent in 1992-93 to 40 per cent for the year ended 1997-98. As a measure of prudence banks have also been advised to keep the excess depreciation due to lower YTM as reserves. Again many banks on their own have prudentially marked a higher proportion of their securities into current category, higher than that prescribed by the RBI.

Another area where the RBI has moved ahead, is to impart greater transparency to the balance sheets of the banks. This was a logical step after the adoption of prudential norms with the banks in India coming under greater international scrutiny. During the last couple of years, the range and extent of disclosures has been gradually increasing so as to provide a clearer picture to informed readers of balance sheets. The banks are now required to disclose the current break up of the provisions made towards NPAs, depreciation of investments and other purposes besides capital adequacy ratio, and the level of net non-performing assets. Additionally, with effect from 1997-98, banks are required to disclose business and accounting ratios relating to capital, income, operating profit, return on assets, business per employee and profit per employee, etc. Publication of these ratios would also help in inter-bank comparison and bringing in greater sensitivity towards performance and improvement in a competitive environment. The RBI has also been examining issues relating to accounting and other practices in close co-ordination with the Institute of Chartered Accountants of India to bring in greater uniformity in the adoption of accounting standards. It is the intention of the Reserve Bank to move gradually towards making the balance sheets more transparent by adopting best international practices.

The reform process has also brought in its wake competition for the existing banks, mainly public sector, who were so far complacent with themselves. In pursuance of the reforms, fresh guidelines were issued in 1993 and new banks in the private sector were allowed to be set up. Banks were also allowed to diversify their activities. Banking Regulation Act was amended to permit banks to undertake para-banking activities by forming separate capitalised subsidiaries. Banks have accordingly set up subsidiaries for undertaking merchant banking and securities related activities, equipment leasing and hire- purchase, factoring services, mutual funds, housing finance, venture capital, credit cards business, etc. While the sponsor banks are required to monitor the performance of the subsidiaries, they are expected to maintain an arm's length relation with their subsidiaries with regard to their business.

The supervisory structure and methods have also undergone sea-change in the era of reforms. To have an integrated supervisory system for such a vast and diverse field, an umbrella organisation in the form of Board for Financial Supervision (BFS) has been put in place since November 1994. The Board is drawn from the members of the Central Board of the RBI with Governor as Chairman. The BFS has mandate for supervision not only of banks but also the Development Financial Institutions (DFIs) and Non-Banking Financial Companies (NBFCs). Prior to the constitution of the BFS, the supervision on the commercial banks was mainly through the on-site inspections alone conducted at periodic intervals. However, to supplement that, there is now in place Off-Site Monitoring and Surveillance System (OSMOS) introduced in 1995, with focus on supervisory concerns such as capital adequacy, asset quality, large credits and concentrations, risk exposures, etc. The Annual Financial Inspection (AFI) system has also been recast in July 1997. The new revised AFI system based on CAMELS model focuses on mandated areas of solvency, liquidity and operational health of banks and will shed some elements which were in the nature of audit. Under the new dispensation also, the on-site examination of banks is the main instrument of the RBI's supervisory system. This system, however, lays greater reliance on the role of external auditors as supervisory resource. The auditors are requested to verify and certify certain other aspects like adherence to statutory liquidity requirements, prudential norms and financial parameters being disclosed in the balance sheet. External auditors are also entrusted specific areas for focused audit. The banks have also been advised to introduce the system of concurrent audit in major and specialised branches.

The reform process has thus brought about qualitative changes in the Indian Banking system. The relentless regulatory emphasis on the need for development of capital strength and cushion against erosion of assets has borne fruits. Achievement of quantitative business growth targets is no longer the goal but the requirement is the accompaniment of qualitative assets. It is appropriate to state that perhaps the greatest achievement in the reform process has been the awareness of healthy banking that has seeped into all levels of banking establishment replacing a sense of complacency that had set in prior to setting up of the Narasimham Committee in 1992.

With the first stage of reforms taking roots, we are now moving on to the next stage. In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and the financial markets acquire greater width and depth. While the policy environment will remain supportive of healthy growth and development with accent on greater operational flexibility as well as greater prudential regulation and supervision, the thrust of the second phase of reform would have to be on improvement in the organisational effectiveness of banks and other financial entities. In recognition of the above, the Government of India had appointed Shri M. Narasimham to again head a Committee this time exclusively to look into the Banking Sector Reforms, with a view to stock-taking of the implementation of the reforms so far and to look ahead and chart further reforms necessary for the Indian banking system to become healthier and stronger. The report of the Committee was received in April 1998. It has made a wide range of recommendations to consolidate the reform process set in motion in 1992. The recommendation relating to increasing of capital adequacy to 9 per cent from the current level of 8 per cent by the year 2000 has already been accepted.

The Committee has made far reaching recommendations on the restructuring of the banking sector including reduction of Government of India holding in the public sector banks, a fresh look at universal banking and has also stressed the need for regulating all players in the financial sector including co-operative banking sector under one umbrella towards integrated supervision. The other major proposals are reduction in the waiting period of identification of NPAs, recognition of market risks in securities, strengthening of capital adequacy and reduction of NPAs to international levels. Recognising of the impact of the inadequate legal framework that is crippling the banking system in recovery of its dues, several legal measure/reforms have been proposed. The Government of India have proposed to set up a high powered Expert Committee to look into the key enactments covering banking regulations.

The impact of the other measures of NPA norms, increase in risk-weights, changes in classification of assets, etc. on our banking system need to be studied in detail. The Committee has also recommended the need for dilution of Government equity to provide greater autonomy and cessation of capital infusion simultaneously with tight prudential discipline. The impact of the recommendations need to be carefully assessed and adopted sequentially to ensure their success. The recommendation of the Committee to stop further fiscal support by way of capital infusion to public sector banks even as the prudential norms require further tightening, calls for skills in sequencing the pace of reforms. The banking system derives its strength and progress from a robust economic climate and a well regulated payments system. Regulation of banking, therefore, has to be in tandem with the steps to improve these areas as well. It is, however, clear that banks in general and the public sector banks in particular face serious challenges in the years to come to pursue the path of reforms even while adjusting to a deregulated environment.

One of the major deficiencies in the Indian banks has been the absence of a proper asset-liability management system. With the liberalisation in financial markets and greater integration of domestic and external markets the risks associated with the banks operationally have become complex and call for strategic initiatives towards their management. Banks need to put in place comprehensive framework for measuring and monitoring risks associated with liquidity, interest rates, forex, etc. In recognition of this the RBI has been looking into the prescription of a broad framework for asset-liability management taking into account the variance in the business profile of banks in the public sector and private sector as well as the data/information base available to banks in India. The RBI has recently issued guidelines in this regard. Simultaneously, the RBI is also looking into the need for risk management systems and policies that need to be introduced for strengthening the Indian banking system.

To sum up, the evolution of the Indian banking and financial services sector over the last few years has been revolutionary, bringing it closer to international standards. This process has to be consolidated further and the RBI remains committed to this end.

*** Address by Shri Jagdish Capoor, Deputy Governor, Reserve Bank of India, organised by Indian Banks' Association at New Delhi on September 16, 1998.**