The significant transformation of the banking industry in India is clearly evident from the changes that have occurred in the financial markets, institutions and products. While deregulation has opened up new vistas for banks to augment revenues, it has entailed greater competition and consequently greater risks. Cross-border flows and entry of new products, particularly derivative instruments, have impacted significantly on the domestic banking sector, forcing banks to adjust the product mix, as also to effect rapid changes in their processes and operations in order to remain competitive to the globalised environment. These developments have facilitated greater choice for consumers, who have become more discerning and demanding compelling banks to offer a broader range of products through diverse distribution channels. The traditional face of banks as mere financial intermediaries has since altered and risk management has emerged as their defining attribute.

- Report on Trend and Progress of Banking in India 2001-02, Reserve Bank of India

It gives me great pleasure to deliver the valedictory address at the Bank Eonomists' Conference (BECON) 2002. I would like to thank the Corporation Bank and the Indian Banks' Association for giving me this opportunity. Over the years, the BECON has evolved as an important forum for intensive discussions on both contemporary and futuristic issues facing the Indian banking industry. This forum has served as an important platform for structured information-sharing among bankers, research analysts, credit rating agencies and other financial sector bodies.

Currently, the most important factor shaping the world is globalisation. The benefits of globalisation have been well documented and are being increasingly recognised. Integration of domestic markets with international financial markets has been facilitated by tremendous advancement in information and communications technology. But, such an environment has also meant that a problem in one country can sometimes adversely impact one or more countries instantaneously, even if they are fundamentally strong.

There is a growing realisation that the ability of countries to conduct business across national borders and the ability to cope with the possible downside risks would depend, *inter alia*, on the soundness of the financial system. This has consequently meant the adoption of a strong and transparent, prudential, regulatory, supervisory, technological and institutional framework in the financial sector on par with international best practices. All this necessitates a transformation: a transformation in the mindset, a transformation in the business processes and finally, a transformation in knowledge management. This process is not a one shot affair; it needs to be appropriately phased in the least disruptive manner. The subject of the Conference is, therefore, very timely and appropriate and I would like to take this opportunity to congratulate the organisers for this theme.

*** Valedictory address delivered by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India at the Bank Economists' Conference 2002 at Bangalore on December 29, 2002.**

Annual Report (2002) has observed that the loss of US $1 trillion in banking crises in the 1980s and 1990s is equal to the total flow of official development assistance to developing countries from the 1950s to the present date. As a consequence, the focus of financial market reform in many emerging economies has been towards increasing efficiency while at the same time ensuring stability in financial markets.

From this perspective, financial sector reforms are essential in order to avoid such costs. It is, therefore, not surprising that financial market reform is at the forefront of public policy debate in recent years. The burgeoning literature on endogenous growth theory has come to recognise the crucial role of sound financial markets in promoting rapid economic growth and ensuring financial stability. Indeed, it is by now widely documented that the structure of financial markets helps explain why some countries remain poor, while others grow richer. Financial sector reform, through the development of an efficient financial system, is thus perceived as a key element in raising countries out of their ‘low level equilibrium trap’. As the World Bank Annual Report (2002) observes, ‘a robust financial system is a precondition for a sound investment climate, growth and reduction of poverty’.

Financial sector reforms were initiated in India a decade ago with a view to improving efficiency in the process of financial intermediation, enhancing the effectiveness in the conduct of monetary policy and creating conditions for integration of the domestic financial sector with the global system. The first phase of reforms was guided by the recommendations of Narasimham Committee I. The approach was 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’. The second phase, guided by Narasimham Committee II, focused on strengthening the foundations of the banking system and bringing about structural improvements. While there may be some concern over the pace and sequencing of reforms in the financial sector *vis-à-vis* the real sector, you will agree with me when I say that we have traversed a considerable distance since 1991. Reforms in the financial sector and their beneficial impact have been well documented and I will not attempt to repeat them here. The text of the Governor’s inaugural address also covers at length important issues such as ownership, corporate governance, regulatory and supervisory issues and the like. I also see from the schedule that you have held intensive discussions on important issues related to corporate governance, reform of the capital structure (in the context of Basel II norms), retail banking, risk management technology, and human resources development, among others.

I would, therefore, like to sensitise this forum, where the intellectual elite of the banking industry is present, with certain important policy issues confronting the financial sector at the present juncture. I believe they are critical in my opinion because they have important ramifications for economic growth and for sustained profitability of the banking industry. These issues are at the forefront of policy discussions on Indian banking and would need to be pro-actively addressed, now.

As a result of interest rate deregulation, the interest rate structure of banks is competitively determined in the market, barring a few exceptions. A major factor that has influenced the trend in interest rates is the sustained decline in the inflation rate in the recent period. Notwithstanding year-to-year fluctuations, there has been a distinct downward drift in the inflation rate during the second half of the 1990s, which is now at around half the level as compared with the first half of the 1990s. Both the popular measures of inflation - the Wholesale Price Index (WPI) and the Consumer Price Index (CPI) – have shown a definite fall in the recent period. For example, the WPI on an average basis has declined from an average of about 10.5 per cent per annum between 1990-91 to 1995-96 to about 5 per cent per annum over the last 5 years. A similar trend can be observed with regard to the Consumer Price Index for industrial workers. In the current year so far, inflation as measured by variations in WPI, has remained benign around 3 per cent despite the adverse effect of drought and uncertainty on account of oil prices. As the inflation rate has decelerated, it has also had a positive impact on inflationary expectations. This is clearly reflected in the downward trend in nominal interest rates.

For instance, the overnight call money rate has fallen sharply from about 13 per cent in August 2000 to the current levels of 5.5 per cent. Similarly, the 91-day Treasury Bill rate declined from 10.5 per cent to 5.4 per cent and the 364-day Treasury Bill rate from 10.9 per cent to 5.6 per cent over the same period.

The long-term interest rates too have declined. The yield on 10-Year government securities has declined from 11.5 per cent in August 2000 to the current levels of about 6.3 per cent. Similarly, interest rates on corporate paper have fallen significantly. For example, the interest rate on 5-Year AAA rated corporate paper has declined from 12 per cent in August 2000 to about 6.7 per cent currently.

The banks have also reduced their deposit rates. The term deposit rates of public sector banks over one year maturity have declined from a range of 8-10 per cent in August 2000 to 6-8 per cent now. This fall in the interest rates in the recent period has been in consonance with the monetary policy stance of a soft and a flexible interest rate regime. Despite the fall in deposit rates, depositors have received positive real interest rates of close to 2 per cent in the second half of the 1990s, which is much higher than the real return on deposits during the first half of the 1990s.

On the other hand, lending rates of banks have not come down as much. While banks have reduced their prime lending rates (PLRs) to some extent and are also extending sub-PLR loans, effective lending rates continue to remain high (Table 1 and Chart 1). It is estimated that the average lending rate of scheduled commercial banks has declined from a peak of about 17 per cent in 1995-96 to about 14 per cent by 2001-02. Hence, while nominal interest rates have come down, they have not fallen as much as the inflation rate. Consequently, the effective real lending rate continues to remain high. This development has adverse systemic implications, especially in second half of that decade (1997-2001) as compared to the first half. In line with this, the average money market interest rates and government securities yields have also come down in real terms in most of these countries. On the lending side, however, prime rates in some countries have not shown similar falls in real interest rates (UK, Germany, Japan, Thailand and Hungary). Thus, the Indian experience of sticky real lending rates is not unique. But, preliminary estimates do show a high correlation between government securities yields and real lending rate in Japan, India and Germany during the 1990s as a whole. Hence, the downward rigidity in lending rates in India as compared with the government securities rates during the second half of the 1990s does seem more surprising in this context. It would seem that changes in inflationary expectations take a little longer to adjust than inflation rates themselves. It would be rational for interest rates to be related to inflationary expectations, and in particular long-term interest rates. Therefore, bank economists have an important role of informing the management of appropriate inflationary expectations so that interest rates can be adjusted more systematically.

Understandably, there are certain rigidities in the overall interest rate structure in the economy that constrain banks from reducing their lending rates. These have been well documented in the earlier monetary and credit policy statements of the Reserve Bank. Subsequently, interest rates on small savings have also moved down and there is a commitment from the Government to link these rates with market related rates. The recovery environment has also improved. A related issue pertains to transparency in lending rates. Especially after the introduction of sub-PLR lending by banks, the spreads between the minimum and maximum lending rates seem to have widened. The Reserve Bank is making efforts to publish on its website bank-wise information on the minimum and maximum lending rates. Our own internal exercises reveal that the concept of PLR may need to be reviewed in the current context. Perhaps, bank economists may like to study the international experience and come out with suggestions.

@ **USA, UK, Germany, Japan, Korea, Thailand, China and Hungary.**

Lending to Small and Medium Enterprises

The problem arising out of high lending rates gets accentuated due to segmentation in the credit market. The large corporates are able to negotiate fine rates with banks and are able to bring down their overall interest costs. In addition, the large corporates have the option of accessing the international capital markets for funds. The burden of adjustment has, therefore, fallen on small and medium enterprises (SMEs), which have limited access to funds. The high interest rates paid by SMEs may not always be in accordance with their risk profile.

It is clear that at present the Indian banking system is not fully equipped to promote small-scale enterprises around the country. The key issue is that banking institutions must be enabled to improve their credit assessment capabilities with regard to small-scale enterprises so that they can distinguish adequately between good and bad credit. Small-scale must not be equated with

The provision for Credit Information Bureaus and better exchange of information on credit risk between banks and financial institutions is also necessary to enable these institutions to recognise higher risk without excessive costs. Furthermore, the cost of credit assessment of small and medium enterprises can be reduced by a focused recognition of clusters of like small-scale industries that exist around the country. Such financial assistance programmes also need to be devised to provide assistance to those industries that are in the reserved list to enable them to expand and upgrade technology. This should be done both at the individual and group level. The focus of many such activities can be on the basis of industrial clusters so that economies of scale can be achieved both in financial assistance and in technology upgradation.

Very significant changes are also taking place in the agricultural sector. We can see the beginning of a much closer connection between primary producers, trade intermediaries, food processing entities, and eventual marketing of value added products. With the share of unprocessed foods falling, the real growth area in the agricultural sector is in value added food products such as meat, poultry, fish, vegetables, fruits and the like. There is an accelerating move of consumers to basic processed foods. These trends need to be studied carefully so that supporting policy changes and investments can be made. Banks should explore the feasibility of expanding substantially lending to these activities.

Apart from adequate quantum of credit at an affordable price, there are issues relating to provision of high processing costs and the attendant cumbersome paper work. There are lessons to be learnt from the experience of the Kisan Credit Card (KCC) Schemes and the Laghu Udhyami Credit Card Schemes to the agricultural and small entrepreneur borrowers. Surely, there is some scope for extending the benefits of hassle free credit facilities through similar innovative methods to other borrowers requiring credit limits of over Rs.2 lakh also. It needs to be recognised that the SME sector has tremendous growth potential and accordingly pricing of loans to this sector should be at commensurate rates. Thus, there is need for realignment of interest rates among various segments of the financial market. As the financial market develops, ideally the interest rates on all types of debt instruments, both in the government and private sectors, and in the credit market should align in a relatively narrow band, reflecting realistic risk premia.

There have been some signals of industrial pick up during the last few months. For the four months from July to October 2002, on a point to point basis, the rise in index of industrial production (IIP) has been above 6 per cent. A major contribution to the high growth rates has been from the manufacturing sector. In use-based classification also, the capital goods sector has registered impressive growth rates of over 15 per cent and 12 per cent in September and October 2002 respectively. Most (14 out of 17) industry groups in the index have shown positive growth rates. The increase in non-food credit of scheduled commercial banks during the current financial year also appears to be commensurate with the IIP performance.

bid to minimise credit risk while increasing profitability. Such large investments in government securities well beyond the statutory requirement reflect dissipation of banking knowledge capital with regard to credit appraisals. The interest rate risk on investments in gilts need hardly be over emphasised. Further, the current focus of banks is bound to exact some heavy costs in terms of efficiency and credit availability. There is a danger of the link between liquidity, credit, money and economic activity being severed in the long run as a result of continued over-investment in government securities as a substitute for bank financing to the commercial sector.

At a time when the industry is showing signs of pick up, banks should make efforts to increase commercial lending. The need of the hour is revival of the manufacturing sector and financing of the new slew of activities allied to agricultural lending. Of course, this would require focused attention through specialised branches, sound credit appraisals, adoption of sophisticated risk management techniques, and better information sharing. The legal environment has also improved with the passing of the new act to regulate securitisation and reconstruction of financial assets and enforcement of security interest.

Revival of Long-Term Financing

The development finance institutions (DFIs) were set up in the 1950s to provide medium and long-term finance to the private sector. Many of these institutions were sponsored by the Government. DFIs were expected to resolve long-term credit shortages and to acquire and disseminate skills necessary to assess projects and banks creditworthiness. DFIs were traditionally dependent on concessional sources of financing, guaranteed by Government. On the asset side, they were predominantly engaged in term lending with banks financing working capital requirements. The post-reform period has altered the domain of the operations of DFIs both on the liabilities and assets sides. While DFIs started competing for funds at market rates of interest, their asset profile also shortened. On the other hand, banks have entered the domain of term lending. The current trend is of DFIs converting themselves into banks. In this context, the future of long-term lending acquires great importance.

Finance theory suggests that banks can play an important role in corporate financing, especially in situations of asymmetric information, principal-agent problems, design of incentive compatible contracts and corporate governance issues. In their early stages of development, corporates are likely to rely on bank finance for working capital requirements. Bank financing is also likely to be predominant in an economy having a less-sophisticated legal framework. Considerations of lower transactions costs, efficient risk diversification, cost effective assessment, monitoring and renegotiation etc., are likely to make firms more reliant on bank finance than on market based debt instruments.

International evidence on industrialised countries indicates that since the early 1970s, banks have played an important role in corporate financing. The benefits of a bank-based financial system over long periods with the concomitant asset liability mismatches. The shift from a fixed to a floating interest rate regime, development of corporate debt market, introduction of derivatives instruments and further enabling changes in the regulatory and legal environment are likely to increase long-term financing by banks. Banks would need to think in terms of setting up special wings for term lending, development of consortia and syndication, and cooperation in assessment of projects. These are areas for further exploration by bank economists.

Non-Performing Assets

One of the main constraints to the above issues that I have raised is the level of non-performing assets. As of March 31, 2002, the gross NPAs of scheduled commercial banks stood at Rs.71,000 crore, of which the NPAs of public sector banks constituted Rs.57,000 crore. The absolute amount of NPAs continues to be a major drag on the performance of banks. The large volume of NPAs reflects both an overhang of past dues and on-going problem of fresh accretion. As we move towards the international norm of 90 days for recognition of loan impairment, there may be a temporary increase in crystalisation of NPAs in the banking sector. There is, therefore, a need to bring about improvements in credit administration and management of credit risk. In this context, the Credit Information Bureau (CIB) should help in improving credit decisions by providing institutional mechanism for sharing of credit information on borrowers and potential borrowers among banks and financial institutions. The Reserve Bank modified the guidelines for compromise settlements of NPAs of the small sector to provide a simplified, non-discretionary and non-discriminatory mechanism. Banks should work out processes for settlement procedures and expedite quick recovery of NPAs. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 should help in cleansing the balance sheet of banks by facilitating foreclosure. The constitution of an Asset Reconstruction Company (ARC) is another channel to remove NPAs from the balance sheets of banks through the processes of securitisation of assets. The Reserve Bank has recently posted on its website the draft of the directions on prudential norms proposed to be issued by it to securitisation companies/reconstruction companies. I hope despite the Christmas spirit and the Conference mood, experts would have studied the RBI proposals and sent their comments.

Risk Management

In the current interest rate environment, banks are finding it more profitable to invest in government securities. In 2001-02, trading profits of public sector banks more than doubled to Rs.5,999 crore from Rs.2,250 crore in 2000-01. The net profits of these banks during these two years were Rs.4,317 crore and Rs.8,301 crore respectively and this includes an additional Rs.1,365 crore and Rs.1,547 crore from forex operations. The Reserve Bank has been encouraging banks to be proactive in risk management. In this context, with a view to building up adequate reserves to guard against any possible reversal of interest rate environment in future, banks have been directed to maintain a certain level of Investment Fluctuation Reserve (IFR).

guidance note delineates the minimum requirements for a bank including approval levels and requirements for any exceptions, deviations or waivers. The note illustratively covers the responsibilities of risk management with regard to market risk management, the responsibilities of risk taking unit, the responsibilities of market risk manager, risk identification, risk monitoring, funding and liquidity, models of risk analysis, and risk reporting.

In a rapidly changing business environment, no business can afford to remain static. It is well understood that risk-taking is an integral part of any business enterprise. It is important that each bank needs to have in place the technical systems and management processes necessary to not only identify the risks associated with its activities, but also to effectively measure, monitor and control them. If Indian banks are to compete globally, the time is opportune for them to institute sound and robust risk management practices.

Conclusion

I have today highlighted the need to work towards reducing the real lending rates of banks. This would require concerted efforts on the part of the Government and the Reserve Bank in respect of removing certain structural rigidities and by banks themselves through improving efficiency. I have also focused on the need to increase credit to SMEs as also look into aspects of creating an enabling environment for long-term financing. Reduction in NPA levels and appropriate risk management by banks would go a long way in improving efficiency of banks and inculcating a sound credit culture.

TABLE 1 : REAL INTEREST RATES

Year Ended March	Weighted Average Lending Rate of SCBs	Weighted Average Interest Rate of Central Government Securities	Average Cost of Aggregate Deposits of SCBs	Average Cost of Time Deposits of SCBs	Inflation Rate			Real Interest Rate		
					WPI	Manufacturing Price	CPI-IW	Borrowers	Central Government	Depositors
1	2	3	4	5	6	7	8	9=(2-7)	10=(3-6)	11=(5-8)
1990-91	15.0	11.4	8.1	10.6	10.3	8.4	4.6	6.6	1.1	6.0
1991-92	16.5	11.8	7.1	9.1	13.7	11.3	13.5	5.2	-1.9	-4.4
1992-93	16.8	12.5	7.7	9.6	10.1	10.9	9.6	5.9	2.4	0.0
1993-94	16.5	12.6	6.9	8.7	8.4	7.8	7.5	8.7	4.2	1.2
1994-95	16.1	11.9	6.4	7.0	12.5	12.2	10.1	3.9	-0.6	-3.1
1995-96	17.1	13.8	6.9	8.5	8.1	8.6	10.2	8.5	5.7	-1.7
1996-97	16.9	13.7	7.6	9.4	4.6	2.1	9.4	14.8	9.1	0.0
1997-98	16.3	12.0	7.3	8.8	4.4	2.9	6.8	13.4	7.6	2.0
1998-99	15.5	11.9	7.4	8.9	5.9	4.4	13.1	11.1	6.0	-4.2
1999-00	15.0	11.8	7.1	8.6	3.3	2.7	3.4	12.3	8.5	5.2
2000-01	14.3	11.0	6.8	8.1	7.2	3.3	3.8	11.0	3.8	4.3
2001-02	13.9	9.4	7.0*	8.3*	3.6	1.8	4.3	12.1	5.8	4.0
Average										

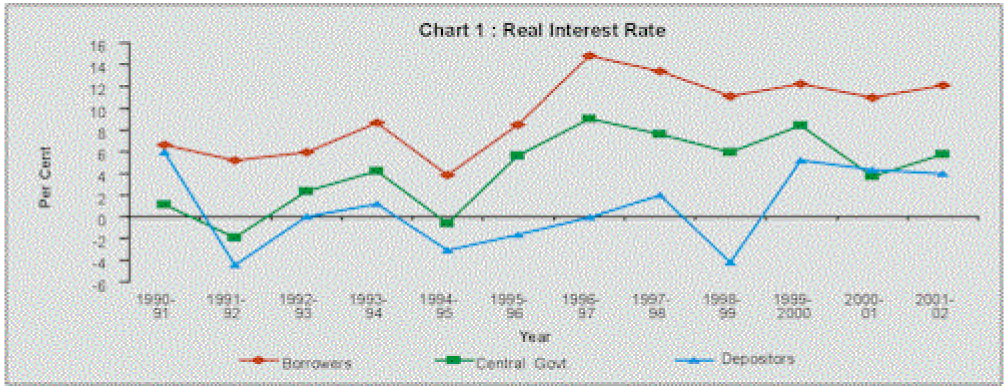

Table 2 : Comparative Position of International Real Interest Rates

Country / Period Average	Money Market Rate	Long-term G-sec Yield	Prime Rate	Inflation Rate	GDP Growth
United States					
1991 to 1996	1.50	3.71	4.40	3.09	2.58
1997 to 2001	2.73	3.20	5.73	2.46	3.37
United Kingdom					
1991 to 1996	4.05	5.30	4.25	3.25	1.92
1997 to 2001	3.40	2.77	3.46	2.57	2.76
Germany					
1991 to 1996	3.63	4.09	9.04	2.85	3.20
1997 to 2001	1.99	3.17	7.75	1.57	1.75
Japan					
1991 to 1996	2.00	2.78	3.57	1.16	1.74
1997 to 2001	0.09	1.40	2.07	0.13	0.69
Korea					
1991 to 1996	7.50	7.21	3.16	5.99	7.35
1997 to 2001	4.79	5.85	6.74	3.82	4.31
Thailand					
1991 to 1996	3.71	5.78	7.74	4.97	8.17
1997 to 2001	3.22	4.65	6.98	3.44	-0.20
China					
1991 to 1996	N.A.	N.A.	-2.09	12.32	11.61
1997 to 2001	N.A.	N.A.	6.28	0.23	7.93

Source : International Financial Statistics, November 2002.
N.A. : Not available.