

Speech

FINANCIAL SECTOR REFORM: REVIEW AND PROSPECTS *

(Part 1 of 2)

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I am thankful to Professor Nirvikar Singh for giving me this opportunity to be with a group of very eminent economists, with deep understanding of various aspects of India's economy. I have set, for myself, a humble task of presenting before you, a consolidated account of financial reform measures undertaken so far, and indicate where we were before reform and where we are now. Comments and outlook in regard to some of the measures would also be in order, keeping in view internationally acceptable standards or practices. The main focus would naturally be on the RBI's role in banking sector and financial markets. I will conclude by highlighting what emerge as the most critical issues that need to be currently addressed.

Main Features

The financial system in India built a vast network of financial institutions and markets over time, and the sector is dominated by banking sector which accounts for about two-thirds of the assets of the organised financial sector. The first phase of current reform of financial sector was initiated in 1992, based on the recommendations of Committee on Financial System (CFS or Narasimham Committee). Briefly stated, the main features of the financial sector reforms undertaken so far are: First, financial sector reforms (FSR) were undertaken as part of overall economic reform. Second, while the reform process itself commenced in India well after many developing countries undertook reform, FSR were undertaken early in the reform cycle. Third, these were orderly as designed by a high-level committee taking into account the prevailing circumstances. Fourth, while on the regulatory aspects and relevant financial ratios, there was discernible progress, on structural aspects, especially public ownership and incentive structures including autonomy of public sector banks, reform process fell short of expectations of CFS. Fifth, the reforms have brought about some efficiency, as for example evidenced by recent reduction in interest spreads or increasing trend in household savings, especially financial savings. Sixth, the financial system and in particular the banking system displays continued stability relative to other countries. While during the initial stages of the FSR, India was often criticised as being far too gradual, the financial crisis in the past two years which have afflicted a number of developing countries, not to talk about some developed countries, have shown the merits of India's gradual reforms.

Finally, the progress that has been made in a substantial yet non-disruptive manner, has given confidence to launch what has been described as second generation or second phase of reforms - especially in the banking sector.

In this background, a second Committee under Mr. Narasimham, who chaired the CFS, was constituted to advise Government on banking sector reforms (CBSR). The Report of the Committee (April 1998) provides a framework for the current phase of reforms. The RBI has already acted on many of the recommendations as per announcements made in Governor Jalan's October 1998 Monetary and Credit Policy Review statement.

Reserve Bank's Approach

|The Reserve Bank's approach to reform in financial sector has been ably articulated by Dr. C.Rangarajan in his speeches as Governor, RBI. The approach that governs both the first and second phase is similar and, could be summarised as *pancha-sutra* or five principles.

|First, cautious and proper sequencing of various measures - giving adequate time to the various agents to undertake the necessary norms; e.g., the gradual introduction of prudential norms.

|Second, mutually reinforcing measures, that as a package would be enabling reform but non-disruptive of the confidence in the system, e.g., combining reduction in refinance with reduction in the cash reserve ratio (CRR) which obviously improved bank profitability.

|Third, complementarity between reforms in banking sector and changes in fiscal, external and monetary policies, especially in terms of co-ordination with Government; e.g., recapitalisation of Government owned banks coupled with prudential regulation; abolition of *ad hoc* treasury bills and its replacement with a system of ways and means advances, coupled with reforms in debt markets.

|Fourth, developing financial infrastructure in terms of supervisory body, audit standards, technology and legal framework; e.g., establishment of Board for Financial Supervision, setting up of the Institute for Development and Research in Banking Technology, legal amendment to the RBI Act on Non-Banking Financial Companies (NBFCs).

|Fifth, taking initiatives to nurture, develop and integrate money, debt and forex markets, in a way that all major banks have an opportunity to develop skills, participate and benefit; e.g., gradual reduction in the minimum period for maturity of term deposits and permitting banks to determine the penalty structure in respect of premature withdrawal, syndication in respect of loans, flexibility to invest in money and debt market instruments, greater freedom to banks to borrow from and invest abroad.

Reform Measures and Outlook

|Reform measures have been grouped, for convenience, and presented in Annexure I. The pre-reform position, reform measures undertaken on an year wise basis, current status and comments on outlook are indicated. I will mention here only some significant aspects to link up with critical issues that we intend identifying.

Pre-emptions

|Major problem faced by the banking system was on account of constraints, mainly in terms of massive pre-emption of banks' resources to finance Government's budgetary needs and administered interest rates. Removal of these constraints meant a planned reduction in statutory preemption and a gradual deregulation of interest rate prescriptions. Since FSR, total effective pre-emption has been brought down from 54 per cent to less than 35 per cent. The effective CRR

which was as high as 16.5 per cent has been brought down to 9.75 per cent. CRR in excess of 3 per cent is currently remunerated at 4 per cent per annum. Given that the CRR is a tax on the banking system, it is better to gradually reduce the CRR rather than maintain a much higher CRR with a relatively higher remuneration on these balances. The medium-term objective of reducing CRR has to take account of money supply considerations and also the objectives of exchange rate stabilisation. Furthermore, reduction of the CRR would depend on manoeuvrability on money supply impact presently constrained by degree of monetisation of fiscal deficit and uncertainties in forex markets.

|Statutory Liquidity Ratio (SLR) has been gradually brought down from an average effective rate of 37.4 in 1992 to the statutory minimum of 25 per cent, though at present, many banks hold SLR well in excess of statutory prescription. Further reduction in SLR, though desirable, would have to await reductions in fiscal deficit apart from needed improvements in prudential standards including internal risk management systems. Of course, enabling legislative changes would also be needed.

Interest Rates

|Structure of administered interest rates has been almost totally dismantled. Prescriptions of rates on all term deposits, including conditions of premature withdrawal, and offering uniform rate irrespective of size of deposits have been dispensed with. Currently, there is a prescribed rate of 4.5 per cent for savings bank accounts, which are used by individuals virtually as current accounts and as the cost of servicing these accounts is high, the remuneration on these accounts has necessarily got to be low. There is yet to emerge a consensus on further deregulation of interest rate on savings deposits. There is understandably a differentiated interest rate ceiling prescribed for foreign currency denominated deposits from non-resident Indians, and such ceiling will have to continue as part of managing external debt flows, especially short-term flows till fuller liberalisation of capital account. Lending rates for different categories, which were earlier prescribed, have been gradually abolished but transparency is insisted upon. Each Bank is required to announce Prime Lending Rates (PLR) and the maximum spread that it charges. However, there are three exceptions. Currently interest rate on smaller advances (i.e., up to Rs.200,000) should not exceed PLR. The element of concessionality of very small loans below Rs.200,000 has to be seen in the context of very small loans. As the figure up to Rs.200,000 has not been adjusted since 1990, the real effective protection for small loans has been gradually reduced by the inflation drift. Lending rates for exports are still prescribed. The prescription of interest rates for exports linked to the period of availment is to some extent used as an instrument to influence leads and lags in repatriation of export proceeds. Finally, ceilings are prescribed in respect of certain advances in foreign currency, which could be reviewed.

Prudential Norms

|Prudential norms are being introduced gradually to meet the international standards. Consequent upon CBSR recommendations, action has already been initiated to increase the capital adequacy ratio; assign risk weights to Government approved securities; to take care of the market risks; and also assign risk weights to open position in forex and gold. In most of these, a time table has been indicated for the first phase only, so that banks are on notice for the first

phase while the RBI has retained the freedom to decide on the timing of the second phase. Given the normal growth of 17 to 18 per cent in credit, and the required level of capital adequacy after implementing CBSR recommendations, a substantial infusion of capital into the banking system will be warranted. This is likely to have significant implications for public sector. Government has to weigh the desirability of further budgetary support *vis-à-vis* substantial reduction in share of Government ownership of banks. Incidentally, as long as capital markets are sluggish, and their view on banks, bearish, a high proportion of divestment may be needed to raise the resources required, since share premia may be low.

|Similarly, internationally accepted norms of income recognition have been introduced except that income on asset is not recognised if it is not received within two quarters after it is past due, i.e., due date plus thirty days. The international norm is 90 days. Tighter standards, though desirable, have to be introduced gradually so that both banks and borrowers have notice to adjust their operations, and there is no serious disruption in the normal banking activity or erosion in public confidence in the banking system due to balance sheet impact. Also, a sharp tightening of the norms would pose an unbearable burden on banks and would serve no substantive purpose unless corresponding changes are made in credit appraisal systems and debt recovery mechanisms.

|Asset classification, which was introduced as per internationally acceptable practices early in the reform process is sought to be further strengthened gradually, as per CBSR. A significant decision taken relates to treatment of assets guaranteed by the State Government as non-performing under certain circumstances. This is a somewhat exceptional provision to take care of the temporary delays observed in respect of a few State Governments in honouring their guarantee obligations when invoked.

Competition and Transparency

|Competition is sought to be fostered by permitting new private sector banks, and more liberal entry of branches of foreign banks. The share of public sector banks in the banking business is going down, particularly in metropolitan areas. Competition is sought to be fostered in rural and semi-urban areas also by encouraging Local Area Banks. Some diversification of ownership in select public sector banks has helped the process of autonomy and thus some response to competitive pressures. The RBI's efforts to enhance competition do, however, take into account the response of public sector banks and their principal, i.e., the Government. There are some banking institutions such as co-operatives, regional rural banks and local area banks, which are yet to be brought fully into the discipline of reform process.

|The transparency and disclosure standards have been enhanced to meet international standards, though there are a few areas where we are lagging. These relate to maturity pattern of assets and liabilities, movements in provision account and NPAs and progress needs to be made in all these areas. To provide an authentic comparative information on the performance of banks, the RBI's annual publication, 'Trend and Progress of Banking in India' presents, since the last two years, detailed information on individual banks enabling public assessment of the working of banks.

Supervision

[An independent Board for Financial Supervision under aegis of the RBI has been established, and consistent with international practice, focus is also on offsite inspections and on control systems internal to the banks. Status of implementation of Core Principles of Banking Supervision (Annex II) shows that of 46 principles, 33 have been implemented, 11 are partially implemented, while only two are yet to be implemented. These two relate to the critical aspect of adequacy of reserves against country risk and transfer risk; and consolidated reporting. While the former is not a major issue at this juncture in view of limited cross border exposure, the latter is of significance warranting early action. Even in respect of the Core Principles, which have been implemented, the RBI is making constant efforts to improve the quality of supervision and the skills of supervisors.

Credit Controls

[Selective credit controls have been dispensed with. Micro-regulation of credit-delivery has been given up, and there is a greater freedom to both banks and borrowers in matters relating to credit. However, there are apprehensions on two counts, viz., the discipline of priority sector lending and flow of credit to the needy and deserving, on a timely basis. The advances eligible for priority sector lending have been enlarged, interest rates deregulated and alternate avenues of investment permitted, thus making the priority lending far more flexible than before. No doubt, banks are averse to sub-ceilings in priority sector, and have some problems with procedural requirements. The major area of serious concern relates to Government sponsored programmes involving subsidies, where there are serious problems of both co-ordination and recovery. CBSR has made some recommendations and these are still under consideration.

[There was a general consensus that the real issue in credit-delivery is more availability of credit than cost. Consequent upon the deregulation of interest rates, there was an expectation that credit flow to the needy will be enhanced, but there is some disappointment about the credit-delivery - especially to small industry. Procedural simplifications have been advised by the RBI for rural credit, credit to small industry and more recently the RBI is working on procedural streamlining for export credit.

Incentives and Legal Reforms

[The most critical issue in financial sector reform relates to consequences of the extent of public ownership and special laws governing publicly owned banks. CBSR has devoted a significant part of its report to reform of public sector banks, on which Government, as the principal, needs to act. At present, public ownership has adverse effects on level playing field among banks, capacity and willingness to compete in the market place, incentives to perform, and binding work practices/methods that inhibit efficiency. The issue of efficiency in public sector banks has several dimensions, and legal is one of them. Again, issues of optimal efficiency, autonomy and ownership are intertwined and need to be resolved. Reduction of public ownership below the majority level prescribed would need an amendment to the three different laws that govern public sector banks. Sale of shares already held by Government also needs amendments to law.

Debt Recovery

|Progress in establishing and operationalising debt-recovery systems has been painfully slow, partly due to judicial review. CBSR suggested several legislative measures that would facilitate debt-recovery, securitisation, electronic systems, etc. A serious consequence of tightening prudential norms and pressurising banks to reduce NPA without strengthening the debt-recovery system is the choking of credit. While large corporates may be partly spared by recourse to alternate sources such as debentures or commercial paper, the rest, especially medium and smaller corporates could face credit choke and hence the pace of introduction of measures needs to be carefully modulated.

Accounting Standards

|There is an apprehension in some quarters that the Indian Accounting Standards as followed by the Indian banks are not in line with International Accounting Standards. Annexure III gives a comparative position of some of the significant standards relevant to banking sector and comparative Indian standards/regulations. It will be seen that on accounting and valuation, Indian standards and *de facto* practices are comparable with international standards. The major area of divergence in accounting is in respect of group accounting and consolidation. In India, currently consolidation is not required and investments in associated companies are not accounted for under equity method. In regard to disclosure, Indian banks do not, at present, disclose maturity pattern of assets/ liabilities, concentrations of assets/ liabilities and off-balance sheet items, net foreign currency exposure, movement in provisions account, and gross non-performing assets and related party transactions in the financial statements. However, as regards disclosure of related party transactions, banks are prohibited from granting advances to firms in which a Director is interested. The Reserve Bank has formally stated that instructions on further disclosures will be announced in due course. Meanwhile, many banks are also taking steps to build appropriate information systems, which some disclosures entail.

Financial Markets

|Since April 1997, the RBI has been taking special efforts to develop the various segments of the financial markets, in particular, money market, Government securities market and foreign exchange market (Annexure IV to VI). Significant steps have been taken to introduce new instruments, strengthen the institutional infrastructure, widen the participant base, introduce efficient settlement mechanism, rationalise tax measures, and improve transparency in operations.

Money Market

|In order to facilitate the conduct of monetary policy, it is essential to improve the efficiency of transmission mechanism through the money market. Among the measures taken by the RBI in the recent past are: cautious entry to additional participants in the inter-bank call money market; actions to develop the term money market, the major among them being the exemption of inter-bank liabilities from CRR and SLR stipulations; and refinements in

instruments such as Commercial Paper, Certificates of Deposit, inter-bank participation certificate and rediscounting of commercial bills. The Reserve Bank has also been conducting repos of 3/4/14 days both on auction and fixed interest rate basis, depending on prevailing situation in the market. The medium-term objective is to make the call/term money market purely inter-bank market for banks, while non-bank participants, who are not subject to reserve requirements, can have free access to other money market instruments and operate through repos in a variety of instruments. The completion of documentation and operational details will pave the way for the introduction of interest rate swaps and other derivative instruments. With proper asset-liability management systems in place, the term money market can also be expected to develop. An electronic dealing system is envisaged to be operationalised by March 1999. The Reserve Bank recognises that a Liquidity Adjustment Facility (LAF) needs to be introduced, but this will depend on the replacement of General Refinance Scheme, though not necessarily on a review of export refinance.

Government Securities Market

|With the switchover to borrowings by Government at market related interest rates, and more recently, abolition of system of automatic monetisation, it was possible to progress towards a genuine market for Government securities. Reforms instituted by the RBI in this market include selling of Government securities through auctions; introduction of new instruments such as zero coupon bonds, floating rate bonds and capital indexed bonds; introduction of Treasury Bills of varying maturities; establishment of specialised institution, viz., Securities Trading Corporation; institution of system of Primary Dealers and Satellite Dealers; institution of the system of Delivery versus Payment; prescription of standard valuation norms; and transparency in operations through market process and dissemination of information.

|Future developments in the Government Securities market hinges on three main issues, viz., legal reforms, technological upgradation and achievement of standardised practices. The legislative measures relate to Public Debt Act, to be consistent with modern technology and market practices; Amendment to Securities Contract Regulations Act to allow derivatives and give formal jurisdiction to the RBI to regulate the Government debt market; and abolition of Stamp duty to avoid transaction costs in debt markets. These are essential for enabling the development of the market. Development of technology is an integral part of reforming the debt market and the RBI has embarked upon the technological upgradation of debt market. Introduction of the Electronic Dealing System, a Real Time Gross Settlement System, integrating the payments and settlement systems for Government securities are all part of the short-term agenda. Finally, standardisation of practices with regard to manner of quotes, conclusion of deals and code of best practices are being evolved for repo transactions.

Foreign Exchange Market

|Measures initiated to integrate the Indian forex market with global financial system include permitting banks to fix their own position limits as per international terms and aggregate Gap Limits; to borrow from and invest abroad up to 15 per cent of their Tier I capital; and to arrange to hedge risks for corporate clients through derivative instruments. Other measures such as permitting forward cover for some participants, and the development of the rupee-forex swap

markets also have provided additional instruments to hedge risks and help reduce exchange rate volatility. There has been a temporary slow down in further progress due to uncertainties in the market. These matters will have to be reviewed from time to time and the process of reform restored with appropriate change.

|The road map for longer-term developments in the forex markets has been drawn by the Committee on Capital Account Convertibility but a view will have to be taken on each one of them depending on domestic and international developments, especially the pace of liberalisation of the capital account. In any case, the process of liberalisation of capital account itself will, to a large extent depend, inter alia, on progress of financial sector reforms.

Critical Issues

|In identifying critical issues, it is necessary to recognise the strengths of the Indian banking sector. These include, long history of regulation, early start of financial reforms, stability imparted by reserve requirements, limited exposure to risky assets such as real estate or stocks or foreign currency, strict control over off-balance sheet transactions, and relatively well diversified credit exposures, rather than undue concentrations. However, greater efficiency can be brought about, only and only if co-ordinated efforts are made by the RBI, Government of India and banks themselves.

Reserve Bank of India

|First, the medium-term objective of reducing pre-emptions will be pursued, subject to reduction in fiscal deficit by Government, monetary developments vis-à-vis growth in real output, and uncertainties in forex markets. Reduction in CRR will help improve profitability of banks. No doubt, reduction in refinance window will give greater flexibility in this regard.

|Second, on interest rate regime, reform objectives continue to be further deregulation and enabling environment for reduction in interest spreads. These would again depend on the progress in reduction of fiscal deficit; reduction in non-performing assets which in turn needs changes in debt recovery system as also improvement in credit appraisal systems by banks themselves; and rationalisation of interest rates in small savings, bonds, etc., which are alternatives for savers. Furthermore, inflationary expectations do play a critical role in determining interest rates, and these in turn, are dependent on credibility of price stability.

|Third, the RBI will pursue with implementation of the first phase of reform announced in October, 1998 and mount the second phase of reform on prudential requirements soon. These requirements would, however, warrant significant additions to the capital of the banking system as a whole. Further progress will depend on resolution of issues in Government relating to budgetary support, permitting access to capital markets, the strategy for weak banks, mergers, possible changes in the percentage of public ownership, etc.

|Fourth, the RBI will continue to foster competition between banks and in due course between banks and other financial intermediaries. The issue of competition with other financial intermediaries has to recognise the level playing field argument warranting special treatment to

banks as long as they have large pre-emptions, especially CRR - again linked to fiscal deficit. As regards competition among banks, the issues relating to diversified ownership, incentive structure and reorganisation of public sector banks have to be addressed by Government to enable the RBI to pursue measures to enhance competition without serious systemic implications. RBI will intensify consultations with Centre and States, on issues relating to co-operatives and Regional Rural Banks.

|Fifth, the RBI would also pursue vigorously, improvements in transparency, disclosure standards as also accounting standards to attain the best international practices. Similarly, compliance with Core Principles is being expedited. To focus on criticality of payment and settlement systems, the October 1998 statement on Monetary Policy has laid out a concrete programme of implementing the banking sector reforms.

|Sixth, credit-delivery systems will be improved to ensure smooth credit flow but this is facilitated only when legal systems and judicial processes are reviewed to replace cumbersome, and time consuming procedures. In addition to laws relating to debt recovery, changes in bankruptcy law, tenancy laws, urban land ceilings, etc. would be needed to ensure that the collateral offered is in reality a realisable collateral.

|Seventh, improvements in financial markets are being so attempted by the RBI as to address both technological and procedural/documentation issues. Development of money and debt markets would also require, among other things, reduction in pre-emptions, amendments to Securities Contract Act, replacement of Public Debt Act and resolution of Stamp Duty issue.

Government of India

|It is very clear that further progress in financial sector would, to a significant extent, depend on the resolution of fiscal, legal, and structural issues.

|First, sustainable level of fiscal deficit is of paramount importance. Furthermore, cost of raising resources, viz., interest payment for small savings and tax treatment on income from Government securities need to be reviewed. A view has to be taken on budgetary support for recapitalisation of banks and contingent liabilities in case Asset Reconstruction Company route is favoured. An appropriate approach is also needed on how the Government sponsored subsidised special programmes of employment generation would operate in the new milieu.

Second, legislative changes that are essential for successful reform are many and CBSR had attempted to address these issues. In particular, legislative changes affecting debt recovery and growth of financial markets, as already listed, are very critical. Legislative changes may also be needed for greater flexibility in change of public ownership.

Third, structural issues affecting public sector banks have been dwelt at length by CBSR, and suffice to say that the reordering of relationship between Government as principal/owner and banks as agents, through legislative changes or otherwise, would influence the further direction of reform, introduction of competitive pressures and incentive-structures for efficiency-enhancement. Key to financial sector reform is banking reform; key to banking reform is public

sector banking reform; and key to public sector banking sector reform is Government's initiative.

Banks

It is clear that actions of RBI and initiatives of Government provide enabling environment, incentive framework and to some extent punitive measures. The outcome will depend on the response of banks, i.e., boards of banks, management, officers and staff. There are, in particular, four broad areas of internal systems which may need thorough overhauling and which need to be facilitated by Government and the RBI.

First, the internal control systems in the banks, especially Public Sector Banks.

Second, the placement, work practices etc., which inhibit incentives for efficiency and improved customer service.

Third, flexibility in obtaining and enhancing highly skilled or talented people.

Fourth, introduction and effective use of technology in banks, especially public sector banks.

Conclusion

I trust I have brought to your notice the efforts made by the RBI, the challenges before us, and the need for co-ordinated actions between the RBI, Government of India and banks themselves. You would appreciate that, by and large, we try to be aware of what is desirable and we are implementing whatever is feasible.

* Keynote Address by Dr. Y. V. Reddy, Deputy Governor, Reserve Bank of India, at the Conference on "Growth, Governance and Empowerment: The Future of India's Economy" at University of California, Santa Cruz on November 20, 1998. University of California, Santa Cruz on November 20, 1998.

Dr. Reddy is grateful to Smt. Shyamala Gopinath and Dr. A. Prasad for their valuable assistance. Dr. Reddy is thankful to Shri Malegam for his kind advice on accounting standards. He is also thankful to Shri D. Mohanty, Shri M. S. Mohanty, and Dr. D. Ajit for background notes.