

RBI and Banking Sector Reform*

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It is a great honour and privilege to be here in IIM - Ahmedabad to interact with distinguished scholars and brilliant students of management. You represent the cream of Indian intellect, and Indian intellect is recognised as perhaps the cream of world intellect. I am looking forward to a lively and fruitful discussion today.

In consultation with the organisers, I selected the topic for today's talk, viz., "RBI and Banking Sector Reform". Financial sector reform, of which banking sector reform is easily the most critical, is an important element of overall economic reform that we have undertaken. Naturally, the RBI plays the most significant role in banking sector reform. In fact, the latest statement on Monetary and Credit Policy issued on October 30, 1998, lists actions contemplated on a large number of structural aspects related to the banking sector following Narasimham Committee's recommendations. I do not intend repeating these actions in this forum, since they can be easily accessed, if you had not already done so.

Instead, I will start with some snippets on banking in our ancient history. You may find it amusing. I would, then, move to the serious business of explaining to you in detail how the services in the banking sector have changed dramatically in the recent past since the early 'nineties, i.e., between pre-reform and today. The idea is not merely to state the reforms in the banking sector that have been undertaken by the RBI, but to focus on how such reforms have changed banking services. Of course, there are a number of measures that are yet to be taken up to bring our banking to global standards. I will, therefore, place before you the current approach of the RBI to reforms in banking sector and conclude by listing some issues that need to be addressed in future.

History

Like in many other aspects, we have a long tradition of banking. Evidence regarding the existence of money-lending operations in India is found in the literature of the Vedic times, i.e., 2000 to 1400 B.C. The literature of the Buddhist period, e.g., the Jatakas, and recent archaeological discoveries supply evidence of the existence of sresthis, or bankers. From the laws of Manu, it appears that money-lending and allied problems had assumed considerable importance in ancient India.

What were the interest rates? They were prescribed almost by all Hindu law-givers Manu, Vasistha, Yajnavalkya, Gautama and Baudhayana as also Kautilya. A common base number was 15 per cent per annum - what the banker-economist Dr. Thingalaya calls Hindu rate of interest. Incidentally, this is close to current Prime Lending Rate (PLR) of many banks.

It is not as though everyone used to get loans at PLR. Only prime borrowers get at PLR, then, and even now, though the basis is different. According to Manu and Vasistha, the interest rates do not vary with the risk involved or the purpose for which the money is borrowed. But, they are directly linked to the caste classification of the borrowers. Brahmin is to be charged 2 per cent, Kshatriya 3 per cent, Vaishya 4 per cent and Shudra 5 per cent per month. We also have some differential rates of interest now, prescribed by the authorities.

Chanakya, however, gives a different approach. The interest rate works out to be 15 per cent per annum for general advances. The traders are charged a rate of 60 per cent per annum. Where the merchandise has to pass through forests, the traders have to pay 120 per cent while those engaged in the export-import business handling sea-borne cargo have to pay 240 per cent per annum. Chanakya's interest rate structure is risk-weighted; the rate of interest increases with the risk involved in the borrowers' business.

Again, it is not everyone who could take up banking business. The Dharmasastra laid down rates according to the castes of the borrowers, and the eligibility of men belonging to the Vaishya caste alone could take up the money-lending profession. In other words, in ancient times, your caste gave you licence to banking; not RBI!

What about disputes and debt recovery? Manu specifies the punishments to be given in case of disputes arising about loan repayment and lists 18 types of disputes. When a creditor sues the debtor for recovery of money, it is the duty of the king to ensure that the creditor gets back his money. Manu permits the king to employ all means, fair or foul, to recover the dues, for example, torturous punishment like killing the debtor's wife, children and cattle or obstructing his movements, which is described as Aacharita. Manu holds the view that a defaulter cannot absolve himself of his debt burden even by death. Chanakya says that sons shall pay with interest the debt of a deceased person or co-debtors or sureties. This phenomenon is likely to have prompted one of the committees on rural indebtedness to conclude that 'the Indian farmer is born in debts, lives in debts and dies in debts.' Chanakya does not prescribe elaborately different types of punishments for non-repayment but has shown some considerations to the government servants and agriculturists in the matter of debt repayment.

Was a spouse, i.e., husband or wife responsible to pay for the debts incurred? Yes, and no. Wife is exempted from debt burden of her husband if she has not given her assent to his borrowings. However, for the debt incurred by a wife, her husband is liable for repayment. So, there was some gender discrimination in the ancient times.

Let me now turn to serious business.

Why Reform and What Reform?

One of the objectives of nationalisation of the banks in 1969 was to extend the reach of organised banking services to rural areas and to the neglected sections/sectors of society. Since 1969, there has been a significant spread of the banking habit and a large mobilisation of savings by banks. Banking system also played a major role in widening the entrepreneurial base of the country. However, by 'eighties, it was clear that the operational efficiency was unsatisfactory. Banks were characterised by low profitability with high and growing non-performing assets. There was a problem of low capital base and also a belief that with Government ownership, there was little to worry about a low capital base. More important, the lack of proper disclosure norms led to many problems being kept under cover. Poor internal controls raised serious doubts about the integrity of the system itself. The quality of customer service did not keep pace with increasing expectations. In fact, there was a feeling that the inefficiency of the banking system was encouraging diversion of domestic financial savings away from banks. No doubt, a series of reform measures were undertaken since 1985 but the first phase of comprehensive reforms in the banking sector can be traced to the 1991 Report of the Committee on the Financial System, i.e., Narasimham Committee I. These reforms were undertaken in parallel with, and as an important element of the overall economic reforms of the 'nineties.

The major features of this phase of reforms can be summarised in the words of my predecessor, Dr. S. S. Tarapore:

First, the fisc undertook to restrict its demand for monetisation of its deficit and a concerted effort was made to move to market related rates of interest.

Secondly, the pre-emptions by way of the cash reserve ratio and the statutory liquidity ratio were reduced.

Thirdly, there was a total freeing of deposit and lending rates with only very limited controls (loans up to Rs.2 lakh, export credit and savings bank interest).

Fourthly, following the Basle Committee standards, prudential norms were prescribed for capital adequacy, income recognition and provisioning.

Fifthly, the banks were required to observe stricter disclosure norms.

Sixthly, the regulatory/supervisory system was strengthened by the setting up of a Board for Financial Supervision.

Lastly, institutional strengthening was undertaken to ensure the progressive development and integration of the securities, money and forex markets.

RBI and Banking Services

What effect did these reforms have on the services rendered by the banks? In the ultimate analysis, the banking reform should benefit the people, in all their transactions with banks. I intend elaborating on the changed scenario due to reform in regard to each service. I will also make an attempt to indicate further reforms that are needed.

Deposits

Prior to reforms, the RBI prescribed the deposit rates and the maturities of deposits that could be offered by banks. There was no price competition among suppliers of banking services and the customer had only limited products to choose from.

As a result of deregulation, barring saving deposits, banks are free to fix their own deposit rates for different maturities, which implies choices for the depositor. Also, a customer can earn interest on a term deposit for a minimum period of 15 days as against 30/46 days until recently. Banks are now also free to offer varying rates of interest for different sizes of deposits above a cut-off point since the cost of transaction differs by size.

Earlier, the RBI decided the penalty structure for premature withdrawal of deposits but this has now been left to each bank so that banks can manage interest rates.

Further, Certificate of Deposits (CDs) are available, at market related interest rate, and offer the additional facility of transferability. The minimum amount of CDs has also been brought down gradually to Rs.5 lakh and the minimum holding period has been brought down to 15 days.

Thus, as a result of reform, customers now can choose from a variety of banks and instruments and maturities. A number of add-on features are available to deposits such as floating rate deposits, automatic switch-over from time to saving deposits or saving to time deposits, withdrawal through ATMs, etc.

Incidentally, the retail depositors are protected through a Deposit Insurance and Credit Guarantee Corporation cover up to Rs. 1 lakh of deposits per insured bank.

Reform has certainly imparted greater flexibility to banks to offer products, keeping in view both the customer needs and the banks' own asset-liability management needs.

There are a couple of issues that remain to be resolved. These relate to reduction in the minimum period for term deposits and the interest rate on saving deposits. Removal of minimum period of 15 days could result in volatility of funds as deposits could tend to move into term deposits out of current accounts frequently, thereby adding to the cost of funds.

Saving account is presently offering an important source of comfort to middle class rural and semi-urban savers and many feel that interest offered to them needs to be increased, particularly since they do not really use the accounts for frequent transactions. The interest rate offered on saving deposits at 4.5 per cent is, in any case lower in terms of cost, compared to other resources to banks, except the current account which is cost free to banks but has full chequable facility. Two alternatives seem to be available in this regard. The first is to create two categories of saving account - chequable and non-chequable accounts. The option then is to reduce interest rate on saving account with cheque facilities and increase the interest rate on non-chequable accounts. The second alternative is to deregulate interest rates on saving bank accounts completely. The opinion among banks is divided and it is unclear whether banks are ready for this.

Advances

The Indian banking system was operating for a long time with a high level of reserve requirements both in the form of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR). Prior to reforms, these requirements effectively represented 54 per cent of deposits. Progressive reduction has brought down the effective SLR from 37.4 per cent in the pre-reform period to 25.0 per cent and the effective CRR from 16.5 per cent to 9.75 per cent.

Thus, for every rupee of deposit in banks, only about one-third to one-half was available for lending to commercial sector before reform, but now about two-thirds is available since statutory prescriptions have been reduced from 54 per cent to less than 35 per cent. Reform has effectively doubled the proportion of banks' resources available for commercial sector by drastically reducing statutory preemptions.

Until recently, banks were extending working capital finance to corporates through a system of cash credit. Under the new dispensation, much of the working capital finance would be in the form of demand/short-term loans. Now, corporates are expected to take care of treasury management and ensure sound management of funds. However, this shift from the cash credit system of financing to loan system was gradual and smaller borrowers still have the option of leaving treasury management to banks. Some banks charge a slightly higher interest rate if the customer takes cash credit instead of a loan.

Earlier, the level of credit to a corporate was determined on the basis of a maximum permissible bank finance (MPBF) - an elaborate but rigid procedure - to fix the eligible limits of credit. This mandated system was abolished and banks now have total freedom to decide on the methodology of assessing working capital requirements. It is for corporates to convince banks about their unique working capital needs.

Corporates can now choose to go through a single bank, consortium arrangement, or take a syndication route.

With the implementation of R.V.Gupta Committee recommendations in the agriculture sector and Kapur Committee recommendations in the SSI sector, the borrowers should find procedural requirements simplified and should be able to obtain credit in a timely and expeditious manner. Similar ease in credit delivery may be expected for exporters once the recently appointed Subrahmanyam Committee gives its recommendations and they are implemented.

Most important, lending rate was fixed for most credits during the pre-reform period - by size, purpose, etc. and there was no price competition among banks or even weight for creditworthiness of borrower. With gradual deregulation, lending rates are prescribed only for some of export finance and small borrowers. Now, each bank announces its own Prime Lending Rate (PLR) and a customer is charged at PLR or a higher rate but within a band announced. So, a customer with good credit record can get a better price or can pay higher price for better service from a bank of his choice. Of course, small borrower customers for loans up to Rs.2 lakh will get loans at PLR.

Some corporates, and in particular exporters, feel that interest rates in India are high as compared to international interest rates. The RBI has recently given an option to corporates. They can borrow in rupees at domestic interest rates or in foreign currency denominated loans at relevant foreign currency related interest rates - out of foreign currency denominated deposit resources available with the banks. The RBI ensures that such foreign currency resources are raised at reasonable cost, i.e., within ceilings prescribed; and when lent, at reasonable price, i.e., within prescribed margin. In this option, the borrower is taking foreign exchange risk, which is ideally hedged in forex market or naturally hedged by future earnings in foreign currency.

Investments

With the reform in the financial sector, banks have the flexibility to invest in a number of innovative instruments of different maturities including Commercial Paper, bonds and debentures of corporates, preference shares, etc. So, corporates now have the flexibility to raise money from banks through a variety of sources, and they can take advantage of lower rates in the market when they are lower than bank lending rate, which is generally more sticky than CP rate.

Now, issuers have the flexibility to raise funds from the banking system by structuring innovative customised instruments that would help drive down cost of borrowing, and banks too have a menu of options to choose from which will facilitate their asset-liability management.

Initially, a prudential limit of 5 per cent of incremental deposits was fixed, in terms of bank exposure to shares, bonds, debentures, preference shares, etc. More recently, all debt and quasi-debt instruments have been taken out of this limit. There is thus scope for larger access of funds to corporates.

Reforms also enable individuals to take loans more liberally than before, against shares and debentures subject to prudential limits.

The reform process has infused greater competition among banks and has given banks greater freedom to operate. This has enabled a reduction in the cost to the system and to the customer. The depositors and borrowers are likely to benefit because of a number of measures that have been initiated. For instance, the Government pays market related interest rates on its borrowings, the credit appraisal systems of banks are improving, banks have better resource management systems in place, and the NPAs are reducing.

Payments System and Technological Issues

RBI is encouraging banks to provide better service to customers by encouraging adoption of state-of-the art information technology.

To enable faster clearing of cheques, MICR processing centres have been established in major centres of the country.

In order to provide extended banking hours to customers, many banks are going in for Shared Payment Network Systems (SPNS), installation of Automated Teller Machines (ATMs) and cash dispensers. The SPNS will provide services like deposit/withdrawal of cash, balance enquiry, printing of statement of account, request for cheque book, standing instructions, etc. These apart, banks are providing services like tele-banking and internet banking services. These facilities enable customers to have round the clock access to banks.

Customers can now get access to international markets in a cost-effective manner since banks have become members of the Society for World-wide Inter-bank Financial Telecommunications (SWIFT).

Electronic clearing system (debit and credit) has been operationalised in all the four metropolitan cities in order to facilitate quicker remittances, faster clearing and more efficient service to the customers.

Non-Fund Based Business of Banks

Prior to reforms, banks were mostly engaged in traditional non-fund based business, viz., opening letters of credit, acceptances, issuing guarantees, remittance business and foreign exchange business such as offering forward contracts to exporters/importers. In the reform period, in order to cater to the increasing needs of customers, side-by-side with growth in traditional non-fund business, more innovative forms of off-balance sheet financing have emerged.

One area relates to merchant banking. Banks are allowed to undertake merchant banking activities in-house or through a subsidiary. As a result, corporates can now get an entire package of services from banks connected with the activity of primary issue, starting from project appraisal to advising capital structure, fund raising, loan syndication and lead managing and underwriting of the issues. The network of branches which banks have, also enables them to act as collection agents.

Corporates can appoint banks as underwriting agents or seek their assistance for private placements even where they may not be lead managers to the issue. The merchant banking departments also render advisory services to corporates including on mergers and acquisitions.

Banks offer a variety of agency services to corporates, whereby they retail securities and sell units of mutual funds.

In addition, they offer custodial and depository services for both domestic and foreign customers.

Corporates now have the facility to structure currency swaps, interest rate swaps and forward rate agreements through banks (i.e., authorised dealers in respect of foreign currency). These products enable corporates with foreign currency liabilities to manage currency and interest rate risks. These arrangements enable borrowers of foreign currency to access markets where they can get the finest rates and then swap these into currency of choice or interest rate (i.e., floating or fixed).

Banks have been given permission to enter into rupee dollar swaps which enable an Indian company which can raise foreign currency loans at attractive rates to swap these into rupees in case it requires only rupee funding or has problems managing the currency risk. In this arrangement, companies pass on the currency risk to the bank and obtain rupee funds.

Once rupee interest rate swaps are introduced, as recently announced, it would provide another option to corporates/banks to manage interest rate risk more efficiently.

Customers of banks now have a complaint redressal machinery. Under the Banking Ombudsman scheme, customers can obtain expeditious and inexpensive resolution of their complaints

Stability and Soundness

The East Asian crisis brought to fore the problems that a weak and fragile financial sector can pose for the real economy. Clearly, the objective of the reforms in the banking sector is to increase efficiency of banks while ensuring stability in the system. From the customer's point of view, it is important that while multiple services are made available, they do not in any way compromise the stability and soundness of the system. The measures that the RBI undertook aimed at preserving the stability of the banking system and warding off potential systemic risks. Measures were taken to strengthen the regulatory and supervisory framework, introduce prudential norms and reduce non-performing assets. Further, we discouraged banks' investments in real estate and stock markets. We applied limits to corporates' exposure on debt, especially external debt. Transparency was introduced in the operations of banks. Thus, it was the prudent policies that were undertaken that saved us from the South East Asian contagion and preserved our stability. Let me elaborate what these prudent policies were or rather what is the approach that ensures efficiency and stability.

The Approach to Reform

The approach of the RBI to banking sector reform may be viewed from a variety of angles, due to both the policy and institutional complexities involved. Striking features of the approach, in my view, are:

First, cautious sequencing of various measures - giving enough time and notice to the various participants to appreciate and respond; e.g., gradual increase in mark to market of Government securities.

Second, mutually reinforcing measures, that as a package would be non-disruptive, e.g., effect on profitability of banks taken into account by combining reduction in export refinance with reduction in CRR.

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; trade liberalisation coupled with current account convertibility; abolition of *ad hoc* treasury bills 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 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 deposits, 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.

Select Issues

I would now refer to some of the major issues that need our attention in the context of banking sector reform. Let me clarify that I have selected a few issues at random, and they are

not necessarily the most significant.

Reduction of Fiscal Deficit

It is the medium term objective of financial sector reforms to bring down the pre-emption of resources from commercial banks through reduction in SLR and CRR. Reduction in CRR will not only result in additional resources to banks for deployment but will also increase the profitability of banks since the CRR is not adequately remunerated. Reduction in statutory pre-emption is constrained as long as fiscal deficit, particularly revenue deficit, remains high.

Non-Performing Assets: Need for Clarity

There is no doubt that the level of non-performing assets should be properly assessed, accounted for, provided for adequately and reduced progressively. Yet, there are many strengths of our banking system which do not get adequately reflected in the simple ratios of non-performing assets to advances since our banks are currently subjected to extraordinarily rigorous prudential requirements at CRR of 11 per cent and SLR of 25 per cent. Let me illustrate with some data from the latest RBI's 'Report on Trend and Progress of Banking in India'. The quantum of gross NPAs as a percentage of advances of public sector banks (PSBs) declined from 17.8 per cent in 1996-97 to 16.0 per cent in 1997-98. However, gross NPAs as a proportion to total assets of PSBs declined from 11.8 per cent in 1992-93 to 7.0 per cent in 1997-98. Provisions have been made for one half of gross NPAs of PSBs. The net NPAs as percentage of net advances also declined from 9.2 per cent in 1996-97 to 8.2 per cent in 1997-98. Net NPAs to total assets declined from 4.0 per cent in 1994-95 to 3.3 per cent in 1997-98.

Debt-Recovery

While every effort needs to be made to improve the credit appraisal system and debt-recovery tribunals have been established, the legal framework should perhaps be reviewed and revamped in a comprehensive manner to facilitate recovery. In fact, it is alleged that some institutional arrangements like Board for Industrial and Financial Reconstruction, instead of facilitating, make debt-recovery prolonged. As pressure is mounted by the RBI to reduce NPAs, in the absence of effective debt-recovery, banks have no option except pick up gilt-edged securities or highly rated investments rather than credit, thus, choking credit delivery, particularly to medium and small-scale units. In brief, how to ensure credit-delivery at a time when banking reforms and legal reforms are under way?

Ownership, Regulation and Competition

A large part of banking operations in India is accounted for by public sector banks. The competitive impulses engineered by the RBI in the cause of enhancing efficiency have to take into account the extent of response of public sector banks and the Government as their principal to competitive pressures. Similarly, the regulatory and prudential considerations advanced by the RBI have to reckon with the impact on and response of the public sector banks and Government as their principal. It is not possible to ignore the systemic implications of the large sub-system (accounting for about three fourths of the banking business) of public sector banks.

Internal Systems

There are 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.

How Special are Banks?

The prudential requirements imposed on banks to protect the deposits and ensure systemic stability do imply a cost to the banks. In a way, this additional cost may give a relative advantage to financial intermediaries other than banks and capital markets. We should recognise that banks continue to be special in terms of distinct functions they perform as the core payments mechanism and as repositories of the economy's immediate liquidity. Thus, the policy has to ensure a balance between banks and non-banks - in terms of regulatory impact.

Additional Capital Requirements

The additional capital adequacy requirements announced in line with the recommendations of Narasimham Committee II and normal expansion of banks' business will require banks to explore various sources for enhancing their capital. Their efforts could impact the mix of public-private ownership of banks.

Flexibility

Apart from diversification of ownership, mergers and acquisition may also be needed even among public sector banks and financial institutions to cope with the consequence of financial sector reforms, in particular, market compulsions and prudential requirements. The public sector banks are currently governed by three different statutes. To impart the required flexibility for ensuring level playing field in the emerging competitive environment, the possibility of bringing all these institutions under the Companies Act by transforming them as companies needs to be explored.

Other Banks

The cooperative banks, especially urban banks are expanding rapidly and their operations affect the interest of depositors. Similarly, Regional Rural Banks in some areas are active. Detailed examination and early resolution of many problems of these banks, including dual control between State Governments and the RBI in cooperatives should also be considered.

Interest Tax

Interest tax adds to the cost of lending by banks. The intention to abolish this tax was announced in 1996-97 and the process was initiated by reducing the interest tax from 3 percent to 2 per cent. It is necessary to complete this process as soon as possible and abolish interest tax completely, as it will serve to reduce the transaction cost and cost to borrowers, thereby enhancing overall efficiency.

Conclusion

I trust I have amused you a bit, enlightened you also on what RBI has done, and created an appetite to address the issues. Please do pose questions and raise further issues so that some I could answer, and on others, I will ponder over.

I thank the organisers for this opportunity and wish all of you a bright future in your careers.

Thank you.

• Address by Dr. Y. V. Reddy, Deputy Governor, Reserve Bank of India, at Indian Institute of Management, Ahmedabad on November 14, 1998. I am grateful to Dr. A. Prasad for his valuable assistance.