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EMERGING ISSUES IN BANKING AND FINANCIAL SECTOR IN INDIA

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I. PRE- REFORM FINANCIAL SYSTEM IN INDIA AND RATIONALE FOR REFORMS

The Indian financial sector today is significantly different from what it used to be a few decades back, in the 1970s and 1980s. The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity. Fiscal activism to kick start economic growth took the form of large developmental expenditures by the public sector, much of it to finance long-gestation projects requiring long-term finance. This necessitated large borrowings by the Government and to facilitate the large borrowing requirements of the Government, interest rates on Government securities were artificially pegged at low levels, quite unrelated to market conditions. The accommodative fiscal stance had to be supported by issuances of *ad hoc* treasury bills (issued on tap at 4.6 per cent) leading to high levels of monetisation of fiscal deficit during the major part of the eighties. In order to check the monetary effects of such large-scale monetisation, the cash reserve ratio (CRR) was increased frequently to control liquidity. Thus, the financial sector prior to the 1990s was characterised by various features as detailed below.

First, financial markets were segmented and underdeveloped coupled with paucity of instruments. Second, there existed a complex structure of interest rates arising from economic and social concerns of providing directed and concessional credit to certain sectors, ensuing “cross subsidization” among borrowers. To maintain spreads of banking sector, regulation of both deposit and lending were effected. This resulted not only in distorting the interest rate mechanism, but also adversely affected the viability and profitability of banks. The lack of recognition of the importance of transparency, accountability and prudential norms in the operations of the banking system led also to a rising burden of non-performing assets. As has observed, there was a *de facto* joint family balance sheet of Government, RBI and commercial banks, with transactions between the three segments being governed by plan priorities rather than sound principles of financing.

The policies pursued did have many benefits, though such benefits came at a higher cost. The phase was characterised by significant branch expansion to mobilise savings and there was a visible increase in the flow of bank credit to important sectors like agriculture, small-scale industries, and exports. However, these achievements co-existed with emergence of macro-economic imbalances such as the persistent fiscal deficit and inefficient functioning of the financial sector. Excessive concentration of financial resources was contained to a significant extent. Importantly, there was no major episode of failure of financial intermediaries in this period.

Thus, the phase starting with nationalisation of Indian banks in 1969 till the 1990s, the state of the financial sector in India resembled the classic case of “financial repression” as propounded by MacKinnon and Shaw. The sector was characterised, *inter alia*, by administered interest rates, large pre-emption of resources by the State and extensive micro-regulations directing the major portion of the flow of funds to and from financial sector. The regulatory regime prior to the 1990s thus led to: (i) inefficiencies in the financial system; (ii) underdeveloped financial markets serving as a captive market for resource requirement by the State; (iii) limited product choice in all segments of the financial market; (iv) low level of liquidity in the securities market with new equity issues governed by extensive regulations, pre-emption of resources in Government debt market to fulfil high statutory reserve requirements and limited depth in the foreign exchange market as most such transactions were governed by inflexible and low limits and approval requirements. This resulted in low levels of competition, efficiency and productivity in the financial sector.

OBJECTIVES OF FINANCIAL LIBERALISATION IN INDIA

The main objectives, therefore, of the financial sector reform process in India initiated in the early 1990s have been to:

First, getting rid of the complexities created by excessive regulation and financial repression with a view to create an atmosphere conducive to the emergence of an efficient, productive and profitable financial sector industry;

Second, enabling the growth of financial markets that would facilitate price discovery, in particular, determination of interest rates by the market dynamics that later helps in efficient allocation of resources;

Third, to provide operational and functional autonomy to institutions to facilitate the growth of a healthy and robust financial system;

Fourth, the financial sector reforms were guided by the desire to prepare the financial entities to effectively deal with the impulses arising from the developments in the global economy by promoting measures of financial stability, which emerged as the third objective of monetary policy along with price stability and economic growth; and

Fifth, opening up the external sector in a calibrated fashion so that the domestic sector could withstand the challenges from international financial system.

As financial markets grew in size, especially since the late 1990s, the dominant fear of market failure receded, the process of financial sector reforms saw a decisive shift towards market-oriented strategies, enabling price discovery through deepening of the financial system with multiple and diverse financial entities of different risk profiles.

II. MAIN FEATURES OF THE REFORM MEASURES UNDERTAKEN SINCE 1992

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).The initiation of financial reforms in the country during the early 1990s was to a large extent conditioned by the analysis and recommendations of various Committees/Working Groups set-up to address specific issues. The process has been marked by 'gradualism' with measures being undertaken after extensive consultations with experts and market participants. From the beginning of financial reforms, India has resolved to attain standards of international best.

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.

RBI's approach to reform in financial sector 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, complementarily 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.

SOME CRITICAL ASPECTS OF FINANCIAL SECTOR LIBERALISATION IN INDIA

Financial sector liberalisation in India has been calibrated on cautious and appropriate sequencing of reform measures and was marked by a gradual opening up of the economy. This gradualist strategy seemed to have served the country well, in terms of aiding growth, avoiding crises, enhancing efficiency and imparting resilience to the system. From the vantage point of 2005, one of the successes of the Indian financial sector reform has been the maintenance of financial stability and avoidance of any major financial crisis since early 1990s - a period that has been turbulent for the financial sector in most emerging market countries.

The process of financial liberalization resulted in innovations in instruments and processes, technological sophistication and increased capital flows. In order to fulfil the broad objectives of the financial liberalisation in India, a multi-pronged approach was adopted. This included removing the constraints facing the financial system through the creation of an enabling policy environment; improving the functioning of the financial institutions, and through the pursuit of financial stability as an essential ingredient of macroeconomic stability.

As the Indian financial sector stands at a crucial juncture in 2005, it may be instructive to look back at some of the important steps taken in the last few years. Unshackling the financial system from excessive controls constituted an important element of financial liberalisation in India. This was necessary to enable the financial sector to perform efficiently and attain its true potential. To this end, major reform measures undertaken may be summed up as follows:

First, there was an increasing realisation that pre-emption of banks' resources to finance Government's budgetary needs through administered interest rates was a binding constraint to efficient functioning of the banking sector, structurally the dominant segment of the Indian financial system. Removal of these constraints meant a planned reduction in statutory pre-emption and a gradual deregulation of interest rate prescriptions. Since 1992, total effective pre-emption has been brought down from 54 per cent to around 30 per cent. The effective cash reserve ratio has been brought down to 5 per cent. The CRR in India, though raised marginally to manage liquidity in the system, is comparable with that of several EMEs. The medium-term objective of reducing CRR has to take account of money supply considerations and also the objectives of exchange rate stabilisation. . Also, the 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 at present.

Second, the complex 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. 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.

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Third, since the onset of the reforms process, monetary management in terms of framework and instruments has undergone significant changes, reflecting broadly the transition of the economy from a regulated to liberalized and deregulated regime. Reflecting the development of financial markets and the opening up of the economy, the use of broad money as an intermediate target has been de-emphasised, although the growth in broad money continues to be used as an important indicator of monetary policy. The composition of reserve money has also changed with net foreign exchange assets currently exceeding more than 100 per cent of reserve money. A multiple indicator approach was adopted in 1998-99, wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis were juxtaposed with output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since early nineties.

Fourth, there has been a sea change in the functioning of financial markets in India since the onset of financial liberalization. The responsibility of the Reserve Bank in undertaking reform in the financial markets has been driven mainly by the need to improve the effectiveness of the transmission of monetary policy. The developments of financial markets have therefore, encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and massive up gradation of technological infrastructure. Since the onset of reforms, a major focus of architectural policy efforts has been on the principal components of the organised financial market spectrum: the money market, which is central to monetary policy, the credit market, which is essential for flow of resources to the productive sectors of the economy, the capital market, or the market for long-term capital funds, the Government securities market which is significant from the point of view of developing a risk-free credible yield curve and the foreign exchange market, which is integral to external sector management. Along with the steps taken to improve the functioning of these markets, there has been a concomitant strengthening of the regulatory framework.

Furthermore, the Reserve Bank has achieved considerable success in attaining monetary stability through maintaining low and stable inflation. Since the second half of the 1990s, inflation has been brought down to an average of five per cent per annum compared to an average of around 8-9 per cent per annum in the preceding two and a half decades. The reduction in inflation since the early 1990s has also enabled inflation expectations to stabilise. Low and stable inflation expectations increase confidence in the domestic financial system and, thereby contribute in an important way to the stability of the domestic financial system .

Fifth, as observed by Former Governor Dr. Reddy, contextually, financial stability in India would mean: (a) ensuring uninterrupted settlements of financial transactions (both internal and external); (b) maintenance of a level of confidence in the financial system amongst all the participants and stakeholders; and (c) absence of excess volatility that unduly and adversely affects real economic activity . The overall approach of the Reserve Bank to maintain financial stability is three-pronged: maintenance of overall macroeconomic balance; improvement in the macro-prudential functioning of institutions and markets; and strengthening micro-prudential institutional soundness through regulation and supervision.

THE BANKING SECTOR

What strategies can be adopted by Indian financial sector to become and remain globally competitive? While there is no single *mantra* to become globally competitive, let me raise a few issues on this count.

In the context of the Banking Sector, there is the issue of **consolidation**, which is the current buzzword in the banking industry worldwide. The largest bank in China with an asset base of over US $400 billion. In contrast, the total asset of the largest two banks in India, one in public sector and another a private entity, are US $105 billion and US $38 billion. These figures are extremely illuminating and the onus is on Indian banks to take cognisance of this fact. The Government has raised the cap on FDI in private banks. The Reserve Bank has, on its part, suggested certain changes in the *Banking Regulation (Amendment) Bill, 2003* that seek to address some of the legal impediments arising in the consolidation process.

The second issue of import is that of **management of costs**. Cost containment is a key to sustainability of bank profits as well as their long-term viability. In 2003, operating costs of banks, expressed as per cent of total average asset, was lower than 2 per cent in major European economies like Sweden, Austria, Germany and France. In contrast, in 2004, operating costs of commercial banks in India were 2.2 per cent of total assets. The downward stickiness continued in 2005 as operating costs have remained well above 2 per cent, as percentage of total assets.

Another related challenge is in reducing the cost of funds of the banking sector. In tandem with the soft interest regime over the last few years, cost of funds of the banking sector has been declining. The cost of funds of public sector banks, which was 6.9 per cent in 1995-96 has since declined to 4.3 per cent in 2004-05. Other bank groups have also experienced concomitant declines. With the rise in oil prices and its cascading effects on inflation along with the raising of policy rates by several central banks, sooner or later, this reversal of the existing comfortable liquidity conditions is likely to have ramifications on domestic financial markets, and with that, on the cost of funds of banks as well. Diversification into fee-based activities coupled with prudent asset liability management hold the key to future profitability.

The issue of **credit delivery systems** has come into focus of late. The persistence of divergence between the informal and formal sector interest rates in effect has meant that, with deregulation, the formal credit mechanisms have not been able to pierce the informal system. The differences in 'apparent cost' and 'total real cost' might be an important factor behind this divergence. Reducing the 'total real cost' in the formal sector is likely to be an important consideration to bring about a degree of convergence between the price of credit between the formal and informal sectors. In recognition of this fact, the last several Annual policies have placed explicit emphasis on streamlining credit delivery through a gamut of measures, including, among others, widening the scope of infrastructure lending, revamping the rural credit delivery system by envisaged restructuring of the rural banking segment, widening the scope of priority sector lending, and the like. I am sure that Indian banks would be up to the task to address the issue of credit delivery.

The fourth issue is the **management of sticky assets**. This is a key to the stability and continued viability of the banking sector. Although the ratio of nonperforming loans to total assets are higher in comparison to international standards, the Indian banks have done a marvellous job in containment of standards, the Indian banks have done a marvellous job in containment of non-performing loans (NPL) in recent times. Non-performing loans to total loans of banks were 1.2 per cent in the US, 1.4 per cent in Canada and in the range of 2- 5 per cent in major European economies. In contrast, the same for Indian banks was 7.2 per cent in 2004-05. Gross NPL ratio for Indian scheduled commercial banks declined to 5.4 per cent in 2005 bearing testimony to the serious efforts by our banking system to converge towards global benchmarks.

The fifth issue concerns the **management of risks**. Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II is likely to lead to an even closer focus on risk measurement and risk management at the institutional level. Thankfully, Basel II has, through their various publications, provided useful guidelines on managing the various facets of risk. I believe institution of sound risk management practices would be an important plank for staying ahead of the growing competition. Over the past few years, the Reserve Bank of India has initiated several steps to promote adequate risk management systems across market participants. Among the measures that were instituted to insulate the financial institutions from the vagaries of the market was gradual increase in the cushion of capital, frequent revaluation of the portfolio based on market fluctuations, increasing transparency and a framework for asset liability management (ALM) to combat the risks facing the Indian financial Sector. The RBI has taken a lead in providing guidance to banks by bringing out guidance notes on how to identify, monitor, measure and control the various facets of risks. However, in the ultimate analysis, the onus is on the banks themselves to adopt an integrated risk management approach, based on coherent risk models suited to their risk appetite, business philosophy and expansion strategies. Such improved risk management systems are not only crucial stepping stones towards Basel II but also are expected to enable banks to shed their risk averse attitude and contributing more finance to hitherto unbaked segments of agriculture, industry and services. It is important that banks look at the expansion of the credit portfolio in a healthy way, particularly in the background of higher industrial growth, new plans of corporate expansion and higher levels of infrastructure financing.

Improved risk management practices by financial intuitions are the key to success in a competitive environment where new instruments such as derivatives are introduced in a gradual and progressive manner. Financial innovation provides opportunities and rewards to those with enterprise and vision. But at the same time, it exposes them to increased risks. Unless market participants institute sound risk management systems, holding trading positions tantamount expose them to severe risks. Indeed, risk taking and risk management must go hand in hand. The financial market needs players who are not afraid to take contrarian positions, who search for unoccupied habitats to provide diversity, provided they have adequate risk management systems in place. For market participants, there is little room for complacency and there appears to be no choice but to be pro-active in instituting appropriate risk management models. My view is that early adoption in this regard makes sound business sense and may prove immensely beneficial in a competitive financial sector.

CONCLUSION

Let me conclude. I have touched upon certain issues which, from the viewpoint of a central banker, are critical for Indian financial sector to become globally competitive. The Indian financial sector has taken several steps in the right direction, but much more needs to be done to ascend to commanding heights. A cautious approach towards increasing efficiency within the framework of overall financial stability can significantly contribute towards India becoming a leading financial force in the world.

KEYWORDS:-

- Asset liability Management, banking system, cash reserve ratio, debt market, financial sector reforms, government securities, Liberalization, Money market, monetary policy, non-performing loans, risk management, statutory liquidity ratio etc.

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