CHAPTER - V

CHAPTER V

OVERVIEW AND UNFINISHED AGENDA

5.1 Overview

The performance of the banking system is generally influenced by both external and internal factors operating in an economy. In India, a number of policy initiatives have been taken since April 1992 to bring about an improvement in terms of external factors influencing the operations of banks. However, a concrete improvement in financial performance of the banking system requires going beyond the aspiration for a better external environment. It calls for a careful look into their internal management and marketing strategies. Restructuring and business reengineering are both equally important. There is a need for an improvement in operational efficiency not through shedding of assets and manpower resources but along with a higher market share. It is not only proper credit management but also an active role in terms of investment operations, which offer substantial scope for an improvement in the bottomline of banks. If it is credit risk in the case of loans and advances, it is an interest rate risk in an environment of interest rate uncertainty in the case of investment operations which will have to be carefully calculated and monitored on an on-going basis to derive net benefits out of treasury and investment operations. The international banking operations have also assumed

significant importance subjecting the banking system to a new source of risk i.e., exchange rate risk.

There is an increasing realisation of the fact that there is an urgent need to improve the customer services in banks, increase transparency and accessibility while also providing more flexibility and autonomy in operation to banks. The banks will also have to put in place a modern system of corporate governance. There is an emphasis on the role of information technology particularly in customer service and quick delivery of payment to face competition with other players in the market.

With an increasing trend towards raising of capital from the market, the banks have begun to improve their performance through improvement in recoveries, reduction in NPAs, diversification of activities, better internal control and management practices, etc. The banks have passed through a learning phase and become more aggressive and market savvy. The banks are now coming to terms with the fact that the rules of the game have changed; they have to operate in a competitive environment. Banks now have to compete for deposits as well as loans. After interest rate deregulation, their portfolio is also being exposed to interest rate risks while foreign exchange risk is also assuming significance in the context of foreign exchange rate getting determined by market forces.

In the Indian context, while public sector banks have enjoyed the maximum competitive advantage from their extensive branch network both

in the mobilisation of funds and in the marketing of various financial products, the degree of competition in the market has increased. The public sector banks have started facing increased competition from new entrants and foreign banks particularly in urban/metropolitan areas. Notwithstanding the social responsibility thrust upon the domestic banks, a tendency to compete with other banks in some select areas of operations was noticed even during the pre-reform phase. In metropolitan areas, foreign banks compete with domestic banks not only in the area of mobilisation of resources but also in allocation of credit to select sectors/industries. It is in the case of merchant banking and a host of other off-balance sheet activities, that foreign banks have emerged as strong competitors to domestic banks and improved their market shares as measured by a rise in their share in total interest income of the banking system.

Table 5.1 :Some Financial Development Indicators

Sr. No.	Indicators	Pre-Reform Phase 1989-90	Post-Reform Phase 1998-99
A	Indicators of Financial development		
1	Financial Saving as percentage of total household saving	45.6	59.1
2	Financial Saving at percentage of GDP at current prices	8.3	10.9
3	Bank Deposits as percentage of GDP at current prices	42.5	71.2
4	Broad Money as percentage of GDP	50.6	89.9
5	Narrow Money as percentage of GDP	17.7	28.5
6	Ratio of Narrow to Broad Money	0.35	0.32
7	Central Bank domestic credit to M3	51.0	40.0
8	Bank Credit to Pvt. Sector/GDP	33.2	45.3

Sr. No.	Indicators	Pre-Reform Phase 1989-90	Post-Reform Phase 1998-99
9	Central Bank domestic Credit/GDP	25.6	35.7
B	Performance Indicators		
1	Capital Adequacy ratio of banks	< 4 per cent	11.2
2	Non-Performing advances of public sector banks as %age of gross advances	24.2[1]	15.89
3	Net Profit as percentage to Working Funds	0.22	0.81@
4	Spread as percentage to Working Funds	2.15	2.95@
5	Establishment expenses as percentage to total expenses	19.87	17.75?@
6	Deposits per employee (Rs. in lakh)	21.84	66.77@
7	Advances per Employee (Rs. in lakh)	13.51	33.65@
8	Capital (Rs. crore)	2256	19439@
9	Reserves (Rs. crore)	2454	34004@
10	Credit deposit ratio	61.86	50.40@
C	Indicators of competition		
1.	No. of Branches	44968	50139@
	Out of which : Public Sector Bank branches	41047 91.2	45293@ 90.3@
	Urban branches	7654 17.0	95472@ 19.0@
	Metropolitan Branches	5756 12.8	7432@ 14.8@
2	Bank Deposits	200126 91.8	644117@
3	Bank advances (Rs. crore) Of which : Share of public sector banks	123794 92.2	324642@ 80.0@
D	Indicators of diversification & Financial innovation		
1	Contingent liabilities	54723	466794@

[1] Relates to March 31, 1993

Sr. No.	Indicators	Pre-Reform Phase 1989-90	Post-Reform Phase 1998-99
2	Contingent liabilities as percentage of working funds	23.0	58.7@[2]
3	Non-interest income as percentage to total income	9.39	14.11@
E	Monetary Policy Indicators		
1	CRR	15.0	10.50[3]
	Quantitative Indicators		
	Ownership Pattern	Government ownership of public sector banks and FIs viz. IFCI, IRBI, IDBI, etc.	Diversified ownership of public sector banks by law subject to 51 percent holding of Govt/RBI/SBI, Conversion of IFCI & IRBI into public limited companies and allowing IDBI to raise capital up to 49 per cent of its paid up capital from the public.
	Regulatory Framesork		Pruential nroms relating to income recognition, asset classificationa nd provisioning have been tightened in a phased manner and brough at par (barring a few exceptions) with the international standards.
	Entry & Exit Restrictions		Liberalised Branch licensing policy in respect of banks having attained capital adequancy norm and prudential accounting standards. Greater freedom given to banks to rationalise their existing branch network.

[2] @ Relates to the year 1997-98

[3] Brought down further in phases and is presently 8.0 per cent

While the response to emerging competitive environment varies from bank to bank depending on their structural characteristics and other internal factors, there are indications that some banks have already gone in for specialisation through earmarking of some branches for catering to the needs of 'target' class of customers in their area of operations. There are some other banks which have shown a preference for confining their restructuring exercises to a few carefully identified and selected branches having large business potential and would extend the process to other branches in a phased manner. There are already signs of a shift from a 'Sellers' market to a 'Buyers' market and also a shift from 'credit rationing' approach in lending policies to the one based on the objective of income maximisation, on sound asset portfolio, simplification of administrative procedures and so on. In a competitive environment, there would be a further downward pressure on interest margins, necessitating an improvement in the quality of assets to survive in the market. The banks will have to continuously monitor and adapt their marketing and management strategies in line with the market demand as Hammer and Champy[16] put it, "In today's environment, nothing is constant or predictable – not market growth, customer demand, product life cycles, the rate of technological change, or the nature of competition. An adequate attention

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[16] Michael Hammer and James Champy, Reengineering the Corporation- A Manifesto for Business Revolution, Nicholas Brealey Publishing, London.

to the issues of human resource development, automation and effective means of communication would also become part and parcel of the banks restructuring exercises".

Product diversification is another by product of the impact of increasing competitive pressures. Of late, the banks have shown eagerness to offer insurance products to their customers. There has been a tremendous growth in financial innovations as a result of financial engineering in the wake of new technological developments. Many of the new products have been introduced as a response to high degree of volatility in both interest and exchange rates. Derivative products are becoming increasingly popular as hedging instruments, which have taken the form of futures, forwards, swap, and options in the forex market. These products themselves result in risk exposure of varying degrees making the task of regulation and supervision even more complicated. It is in this context that the issue of protecting the financial system against market risk is assuming significance. The policy response has been to prescribe standards for measurement of market risks and asking the financial institutions to have adequate safeguards in the form of capital reserves. Resultantly, the financial institutions are required to acquire the necessary expertise for risk control and risk management associated with these new products and instruments. The concept of securitisation of assets to increase liquidity and marketability is going to take off shape shortly after the necessary legal and institutional framework is put in place.

In India, there are already signs of growing linkages between markets, increasing integration between domestic and international markets and increasing interdependence among regulators. The existing banking and securities supervisory systems are well developed. There is an indication of moving ahead in this area by ensuring compliance of domestic regulations with various international standards by the Reserve Bank of India and Securities and Exchange Board of India. It is expected that with the setting up of an Insurance Regulatory & Development Authority, the appropriate regulatory procedures relating to insurance sector will also be put in place. As the inter-action among different players in financial market is getting increased, this has raised the issue of regulatory harmonisation among various regulators both domestic and international of the financial markets including capital market. This requires action on the part of regulators towards convergence of their policies and procedures. The regulatory concerns which were hitherto confined to issues of compliance with banking policy and credit allocative directives and foreign exchange regulations are showing a tilt towards issues of safety and soundness of the financial system depositor protection and reduction of systemic risk. Following the increasing integration of domestic markets with the global world, the regulators and supervisors are also trying to ensure that the domestic prudential and regulatory norms keep changing in line with the developments taking place the world over. Under an integrated global system, it becomes all the more risky to have a fragile financial system.

In such an environment, there is a premium on sound banking and a discount on unsound banking requiring strong regulation and effective supervision.

Technological up-gradation has also been receiving due attention during the reform phase in the wake of increasing volume of transactions and the need to attend to customer needs promptly and efficiently. The introduction of new financial products has also encouraged technological up-gradation of banks. The need to develop an efficient payments system network has also been an important factor necessitating up-gradation of technology and computerisation of operations. Another important development is a massive growth of large value funds transfer both at the national and international levels as a result of increasing integration of domestic financial system with the international financial markets. This has necessitated the development of network of payment system through which funds are transmitted and handled quickly and efficiently. Initiatives have already been taken in the direction of smooth transition from paper based payment system to electronic fund transfer system.

Legal infrastructure is also an integral part of the development of financial institutions and markets. Legislative changes and fundamental reforms of banking laws have also been brought about to improve the functioning of the banking system besides ensuring transparency

in operations. In the context of increasing integration of various segments of financial markets, risk management is also attracting a great deal of attention.

With the phased implementation of prudential norms relating to income recognition, classification of assets and provisioning against non-performing assets, and capital adequacy guidelines, the banks are becoming increasingly aware of the need to improve their financial performance and improve the quality of assets on their balance sheets. The commonality on restructuring of their marketing and management strategies is the objective to expand their operations in areas/products/services, which are more profitable, and as a result, competition in select areas of business would become more intense than in the past.

A question, which is generally raised in the context of financial liberalisation, relates to how far and how fast to open up markets in developing countries. There are risks attached to oversimplification of rules and haste exercised in opening up of markets. Although the IMF advocated full account convertibility and opening up of financial markets in mid-1990s, the East Asian crisis led to scepticism about success of this strategy[17]. The role played by large financial institutions of developed

[17] To quote Dani Rodrik " the question of whether developing nations should be pushed to open their capital accounts (in an orderly and progressive manner as the G 7 recommended,......) can ultimately be resolved only on the basis of empirical evidence. I know of plenty of evidence that financial liberalization is followed by financial crash, but

countries in worsening the crisis has also attracted public criticism. This has raised issues of defining the appropriate conditions in which developing countries could allow opening of their financial markets. There is a new kind of consensus emerging that capital account convertibility is a desirable end point but the sequencing of opening of financial markets will have to be done carefully. The domestic financial system will have to be strengthened through reduction in NPAs, cleansing of balance sheets of banks and exposing them to gradual competition. At the same time, regulatory system should be strong enough to discipline domestic financial institutions, and market surveillance mechanism should work effectively to provide timely inputs to regulatory authorities for initiating corrective measures. The route map to capital account convertibility for developing countries is a complicated one but if due caution is not exercised, volatile market conditions would result in serious damages to stability of the financial system. On the other hand, given the right kind of environment and regulatory system, the capital account convertibility would entail benefits by way of low cost of capital and better environment for investment opportunities.

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know of practically no evidence that suggests that capital account liberalisation is followed by higher rates of economic growth."

5.2 Unfinished Agenda

As regards supervision aspect, the core principles of banking supervision (barring a few exceptions) have been either fully or partially implemented. The principles that are yet to be implemented relate to adequacy of reserves against country risk and transfer risk, and consolidated reporting. The RBI has also been trying to improve the quality of supervision and the skill of supervisors in respect of those core principles that have already been implemented.

Given the fact that the public ownership of banks has an adverse effect on a level playing field among banks etc., the issues of reduction of public ownership below the majority level and sale of shares already held by the government through suitable amendments to laws governing public sector banks are under consideration. In order to improve the effectiveness of debt recovery system, the Debt Recovery Tribunal Act has been amended by an ordinance and the corresponding bill for replacement of the Ordinance by an Act is to be introduced in Parliament.

The fragmented nature of the Indian Financial Market is being viewed as one of the most important constraints to attaining high levels of investment and growth. The fragmentation arises on account of legal system viewing different segments of the financial sector as being distinct and stand-alone rather than as components of an integrated system designed for smooth transformation of savings into investment. Further,

the Indian Financial system is structured towards primarily providing short term and medium term funds whereas its ability to provide long term funds to the private sector for investment in infrastructure sector is limited. Given this, there is need to create conditions whereby the term structure of the supply of investible funds matches the term structure of demand. This would require a move towards greater integration of the financial sector.

Coming to the regulatory system in India, there are three principal agencies, namely Reserve Bank of India, Securities and Exchange Board of India and Insurance Regulatory and Development Authority with each one having its own area of jurisdiction for regulation and supervision. India has a long way to go before achieving the level and sophistication of regulatory knowledge necessary for each financial segment and there is, therefore, need for segment specific regulators till that level of sophistication is achieved. At the same time, the integration of domestic financial system with the international financial markets, against the backdrop of rapid spread of information technology and introduction of internet based financial services, implies that the domestic financial regulatory system will have to fall in line with the evolution of international financial architecture. Probably a middle path may be advisable for India to avoid both the problems of inadequately equipped regulators and that of fragmentation of financial sector.

Although the accounting and valuation standards followed by the Indian banks are more or less comparable with International standards, the areas of divergence in accounting relate to group accounting and consolidation. Presently, consolidation is not required and investments in associated companies are not accounted for under the equity method. Further, Indian banks do not at present disclose the maturity pattern of assets/liabilities, concentration of assets/liabilities and off-balance sheet items, net foreign currency exposure, movement in the provisions account, and gross non-performing assets and related party transactions in the financial statements.

The government securities market has emerged as a vibrant segment of the Indian capital market. Market perceptions are influencing the rates on government securities. The institutional developments in this area during the reform phase, namely the setting up of the Securities Trading Corporation of India, primary dealers and satellite dealers and introduction of delivery versus payment system and resultant faster handling of transactions in government securities have brought about an improvement in the functioning of this market besides providing additional liquidity in the secondary market. From the point of view of monetary policy formulation, this has facilitated the use of open market operations as an active instrument of monetary control. The RBI has been conducting repos of 3/4/14 days both on auction and at a fixed interest rate basis depending upon the prevailing

situation in the market. The objective is to make the call/term money market purely an inter-bank market for banks while non-bank participants (not subject to reserve requirements) will have free access to other money market instruments and be allowed to operate through repos in a variety instruments. It is expected that once the asset-liability management system stablises, the use of interest rate swaps and other derivative instruments will pick up. The interim liquidity adjustment facility has already been put in place by the Reserve Bank of India.

Although various policy measures have been undertaken to develop the government securities market, further developments in this area would depend on the progress made under legal reforms, technological upgradation and achievement of standardised practices. The legislative measures require the Public Debt Act to be consistent with modern technology and also market practices and abolition of stamp duty to reduce transaction cost in debt markets. The RBI has already embarked upon technological upgradation of the debt market. The introduction of the electronics dealing system, a real time gross settlement system, integrating the payments and settlement systems for government securities are the steps required for further development of the government securities market. Last but not the least, standardisation of practices with regard to the manner of quotes, the conclusion of deals and the code of best practices is being evolved for repo transactions.

An assessment of banking sector reforms measures initiated so far reveals that the commercial banks now enjoy greater freedom to sanction loans and advances and make investments in government and other securities. Banks have also started diversifying their activities to improve their bottomline. Efforts towards rationalisation and consolidation of branch network have also been strengthened. However, the rural branch network is yet to be rationalised to the extent desirable. The computerisation of banking operations is yet to pick up full momentum even in urban/ metropolitan branches. The problems of overstaffing and low business per employee continue to impact on their profitability. There is a lot more which needs to be done in the area of an improvement in customer services. The functioning of cooperative and regional rural banks needs to be toned up further. The directed credit lending stipulations, although diluted significantly in the recent past, continue to hamper operational flexibility of the commercial banks. Notwithstanding significant measures initiated to improve viability and profitability of regional rural banks, nothing much has been achieved in substance. Managerial reforms to improve motivation and operational efficiency need to be given due importance. In terms of efficiency and technical norms, the commercial banks in India are way behind the international levels. The operational efficiency of public sector banks is yet to show a significant improvement. Lack of professionalism is an important drawback due to which public sector banks find it difficult to compete with foreign banks and new private sector banks in the market.

While an improvement is evident in terms of number of efficiency indicators, there is a considerable scope for further improvements in this area. The banking system will have to continue with its strategy of bringing down net non-performing assets as part of the drive to improve its profitability in an increasingly competitive environment. The regulatory authorities, on their part, will have to bring down cash reserve ratio requirement, which acts as a drain on the profitability of commercial banks. We are yet to fully adopt international standards in respect of income recognition and provisioning norms.

In the past, the Government of India was liberal in providing support to commercial banks to strengthen their capital base. However, in the wake of financial constraint, a view is presently being expressed that the public sector banks will have to find out alternative resources for meeting the recapitalisation norms prescribed by the Reserve Bank of India. The banks have also been asked to liquidate NPAs through a two-way strategy of not allowing fresh build up of NPAs and by taking care of the existing NPAs. The recommendations of the Narasimham Committee II to create Asset Reconstruction Company and settlement Advisory Committee in banks are presently being debated and a consensus on the implementation of the same is yet to evolve. However, the commercial banks have been asked to examine the procedures for advances, appraisal and disbursement of loans with a view to make them more transparent and effective.

To sum up the pending issues include providing liquidity to debt markets, ensuring interest rate flexibility, further legal reforms to deal with the problems of insolvency, breach of contract, defaults and enforcement of security, further strengthening of regulatory and supervisory system to ensure transparency, stronger disclosures, strengthening of capital base and making prudential norms international and tougher. The objective would continue to be to ensure that greater liberalisation goes along with deeper supervision and higher degree of regulation to avoid undue volatility in financial markets. The use of information technology, which has already received its due attention in bringing about an improvement in procedures and efficiency levels, would also continue as an important thrust area. The human resources management, which has hitherto been a neglected area, would receive lot of attention to bring about a total restructuring of the banking industry. The corporate governance in banking and finance to ensure quality in the absence of transparency is also attracting due attention. It would assume further importance in the context of risk management strategies to be adopted by the banking system against the backdrop of extension of risk weighted capital norms to protect against market risks. This is essential to provide creditability and confidence to the functioning of financial markets. The RBI has already set up Regulation Review Authority with a view to making the regulatory systems contemporary while also protecting the interests of participants and markets.