EMERGING ISSUES IN BANKING AND FINANCIAL SECTORS

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ABSTRACT

As financial sector plays an important role in shaping up a country s economy, during the last decade and a half many developing countries have taken measures to reform their financial sectors so that it contributes immensely to their economy The present paper makes an attempt to analyses various aspects relating to reforms introduced in Indis s financial sector and compares them with the experience in some of the South East Asian economies such as Thailand, Malaysia and Indonesia. It also takes into account how regulation and competition can jointly play a crucial role in enhancing the growth of an economy.

The banking system in India has evolved over several decades and has helped to serve the credit and banking services needs of the economy. It plays a major role in the mobilization of savings and deployment of these resources and this role played by the banks has helped in significant economic development of India. Since the Indian economy is dynamic, the banking system needs to be flexible and competitive in the emerging milieu.

Keywords: Liberalise, Mobilisation, Banking system, Financial sectors

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.

II. 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.

III. MAIN FEATURES OF THE REFORMS IN FINANCIAL SECTOR AND BANKING SECTOR

Excerpts from the speech delivered by Dr. C. Rangarajan, Governor of Andhra Pradesh, recently at the Asian Regional Seminar on `Financial sector reforms and stability: systemic issues,' co- sponsored by Administrative Staff College of India, Hyderabad, along with the International Monetary Fund.

IT IS well recognised now that the financial sector plays a critical role in the development process of a country. Financial institutions, instruments and markets that constitute the financial sector act as a conduit for the transfer of resources from net savers to net borrowers, that is, from those who spend less than they earn to those who spend more than they earn.

The financial sector performs this basic economic function of intermediation essentially through four transformation mechanisms:

(1) Liability-asset transformation (that is, accepting deposits as a liability and converting them into assets such as loans);

(2) Size transformation (that is, providing large loans on the basis of numerous small deposits);

(3) Maturity transformation (that is, offering savers alternative forms of deposits according to their liquidity preferences while providing borrowers with loans of desired maturities); and

(4) Risk transformation (that is, distributing risks through diversification which substantially reduces risks for savers that would prevail while lending directly in the absence of financial intermediation).

The process of financial intermediation supports increasing capital accumulation through the institutionalisation of savings and investment. The gains to the real sector of the economy, therefore, depend on how efficiently the financial sector performs this basic function of financial intermediation.

Emerging financial risks

While recognising the key role played by the financial system in augmenting savings and investment and thereby accelerating growth, developments in the financial system, particularly in the last three decades, have raised concerns relating to the safety and soundness' of the financial system. The financial system has become more sophisticated; the volume of transactions has multiplied and competitive pressures have grown.

As a result of rapid increases in telecommunications and computer-based technologies, a dramatic expansion in financial flows, both crossborder and within countries, has emerged. Along with these changes, consolidation and increased geographic spread of banks and financial institutions and the blurring of distinctions between various financial institutions have also occurred.

Developments in technology and in the pricing of assets have enabled innovations and financial instruments that allowed risks to be separated and allocated to parties most willing and able to bear them. Thus the menu of financial products has expanded enormously.

All these changes have undoubtedly created new opportunities, but they have also magnified risks. Close interdependencies among markets and market participants have increased the potential for adverse events to spread quickly. They have increased significantly the scope for and speed of contagion.

Banks, for example, are highly leveraged institutions. The systemic risk attached to banking has always been recognised and that is why banks have been subject to controls of various types. It is reported that since the late 1970s, more than two thirds of all IMF (International Monetary Fund) members - industrial, developing and transition economies - have experienced banking crises.

Protecting the banking system

The evolution of the concerns relating to financial stability can be understood by looking at the series of measures taken in relation to banking. In the aftermath of the failure of BankhausHerstatt of Germany, the Basle Committee on Banking Regulation and Supervisory Practices was set up in 1974 by the Bank for International Settlements.

In the early 1980s, the committee was concerned that the capital ratios of leading international banks were deteriorating just at the time that international risks were growing. To halt the erosion of capital standards of banks, capital adequacy ratio was prescribed in 1988. Since 1988, this framework has been modified. The capital adequacy ratio now incorporates market risks besides credit risks. Market risks arise from banks' open positions in foreign exchange, traded debt securities, equities, commodities and options.

More recently in 1997, the BIS developed a set of "Core principles for effective banking supervision.' This provides a comprehensive blue-print for an effective supervisory system. These core principles besides laying down procedures for effective supervision over banking also lay down prudential rules and requirements. After describing in some depth the various types of risks in banking, the core document deals with capital adequacy, credit risk management, market risk management, other risk management including interest risk and liquidity management and internal controls.

While these prescriptions are suggested in the context of the supervisory role of central banks or banking supervisory authorities, they essentially refer to practices to be adopted by commercial banks. The IMF and the World Bank have taken more interest in the analysis of the functioning of the banking system in their country assessments. In April 1999, the Financial Stability Forum was set up to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. In addition, in 1999 a new forum known as 'G-20' was established comprising not only industrially advanced countries but also more leading developing countries such as India. The ministers and governors of the G-20 meet to take stock of the global financial system.

In the wake of the East Asian financial crisis, more attention is being paid on assessing the vulnerabilities of financial systems. An effort is in progress to develop macro prudential indicators that will serve as indicators of the health and stability of financial systems. These indicators comprise both aggregated micro prudential indicators of the health of individual financial institutions and macro economic variables associated with financial system soundness.

Prudential norms

A stable domestic financial system is characterised by financial soundness, efficient markets and integrity of financial operations. In creating a stable financial system, there are two sets of separate but inter dependent concerns. The first set relates to the functioning of individual institutions and markets. It is here the standard setting bodies in the banking, insurance and security sectors are playing a major role. Prudential regulations and supervision are assuming importance. In this context, considerable emphasis is being placed on transparency and disclosure by regulators, supervisors and financial intermediators. Market discipline is also considered an important complement, even though there is no general agreement on how far this can be relied on to promote prudent behaviour.

The second set of concerns relate to vulnerability of the economy as a whole to disruptions. As mentioned earlier, an effort is on to develop macro prudential indicators. In identifying appropriate indicators, we only learn by experience. In the case of at least some of the East Asian economies, the strong economic growth hid several weaknesses in the macro economic management. In fact they were not even recognised as weaknesses. Current account deficit going as high as eight per cent of the GDP, a high proportion of external debt in short maturity and a more or less pegged exchange rate despite deterioration in real terms are factors that were totally ignored.

Thus, maintaining the stability of the financial system requires careful specification of prudential indicators at macro and micro levels. Volatility is an inherent feature of financial markets. Despite capital adequacy ratios and risk management principles being put in place, it is not possible to eliminate volatility. What can, however, be achieved is to keep volatility under control and contain the contagion effect and systemic risk. Both crisis prevention and crisis management need attention.

Reforms in India

The financial sector reforms in India were an integral part of the economic reforms introduced in 1991. The motivations for reforms in India were somewhat different from other countries. Since the nationalisation of banks in 1969, there had been a considerable expansion in banking facilities. The geographical and functional coverage of the Indian banking system was impressive. However, serious concerns had been expressed on the quality and efficiency of the services rendered and more particularly on the viability and profitability of the public sector banks. Profits after provisioning were at a level providing cause for serious concern. This was in a situation when the norms adopted for provisioning themselves were not very strict.

The various measures that were introduced since 1991, as part of banking sector reforms, can be classified into three broad categories: (a) modifying the policy framework, (2) improving the financial health through prescription of prudential norms, and (3) institutional strengthening.

Policy framework

The external factors having a bearing on the functioning of the banking system related to the administered structure of interest rates, high levels of pre-emptions in the form of reserve requirements and mandatory credit allocation to certain sectors. Easing of these external constraints constituted an important part of the reform agenda. The administered structure of interest rates was progressively dismantled. Banks are free to determine the interest rates on all domestic bank deposits as well as on loans except for small loans and credit for export.The deregulation of the interest rate structure also meant that the Government had to borrow at more or

less market determined interest rates. This facilitated the introduction of treasury bills of various maturities and paved the way for the use of open market operations as an instrument of monetary and credit control. The "repos" market also emerged as a consequence. A significant aspect of the reform process was to reduce primary and secondary reserve requirements leading to an expansion in the lendable resources of banks.

Prudential norms relating to income recognition, asset classification, provisioning for bad and doubtful debts and capital adequacy were introduced to ensure proper assessment of the health of banks. The prudential norms were steadily tightened over a period of time. In fact, the process is still continuing so that ultimately Indian standards would be exactly the same as the international standards.Institutional strengthening included a variety of measures such as licensing of new banks in the private sector, enabling the public sector banks to go to the market and augment their capital base, creation of debt recovery tribunals to deal with loans owned to the commercial banks and the creation of an institutional agency such as ombudsmen to settle the grievances of bank customers. The licensing policy relating to opening of branches by foreign banks was also eased during this period. The public sector banks were recapitalised by the Government to the tune of Rs. 20,000 crores.To enhance the system of bank supervision, a separate Board for Financial Supervision was created within the Reserve Bank of India. On-site inspection was supplemented by off-site surveillance, which required information to be supplied by commercial banks quarterly in certain formats. A greater emphasis was laid on internal control systems in banks.

Cautious sequencing

A cautious sequencing of measures has been the strength and hallmark of banking sector reforms in India. While banking sector reforms have been proceeding in the right direction, there are a number of unresolved questions. The level of non-performing assets remains high in a number of banks. While there are alternative proposals to deal with accumulated non-performing assets, what is more important is to ensure that non-performing assets out of new loans are kept at a minimum through better assessment and monitoring of loas.

The prescription of prudential norms in the West started with the introduction of the capital to risk assets ratio. India too started with the prescription of the ratio at 8 per cent. Recently it has been increased to 9 per cent. The Narasimham Committee has recommended that it should be raised to 10 per cent by 2002. Capital serves an important purpose. It acts as a buffer to absorb losses. However, the answer to banking stability does not lie in the prescription of higher and higher levels of capital adequacy ratio.

Given the conditions in India, the prescription of 10 per cent as recommended by the Narasimham Committee may be acceptable. However, beyond that, a higher ratio can be counter productive and can, in fact, create a "moral hazard". The need to maintain a higher ratio may push banks into acquiring assets that have a higher earning potential but also carry with them higher risk. Therefore, along with the increase in the capital adequacy ratio, banks must ensure that they have a proper system to manage risks.

Accent on risk management

The old saying was `liquidity and profitability are opposing considerations'. But what is emerging as important now is the management of risk associated with the portfolio. This is what prudential norms taken together stress. Management of risk is much more important than providing for risk. The major focus of banks in India in the coming years will have to be on how to evaluate and manage risks.

Narasimham Committee on Banking Sector Reforms (1998)

From the 1991 India economic crisis to its status of third largest economy in the world by 2011, India has grown significantly in terms of economic development. So has its banking sector. During this period, recognising the evolving needs of the sector, the Finance Ministry of Government of India (GOI) set up various committees with the task of analysing India's banking sector and recommending legislation and regulations to make it more effective, competitive and efficient.[1]Two such expert Committees were set up under the chairmanship of M. Narasimham. They submitted their recommendations in the 1990s in reports widely known as the Narasimham Committee-I (1991) report and the **Narasimham Committee-II (1998)** Report. These recommendations not only helped unleash the potential of banking in India, they are also recognised as a factor towards minimising the impact of global financial crisis starting in 2007. Unlike the socialist-democratic era of the 1960s to 1980s, India is no longer insulated from the global economy and yet its banks survived the 2008 financial crisis relatively unscathed, a feat due in part to these Narasimham Committees.

Background

During the decades of the 60s and the 70s, India nationalised most of its banks. This culminated with the balance of payments crisis of the Indian economy where India had to airlift gold to International Monetary Fund (IMF) to loan money to meet its financial obligations. This event called into question the previous banking policies of India and triggered the era of economic liberalisation in India in 1991. Given that rigidities and weaknesses had made serious inroads into the Indian banking system by the late 1980s, the Government of India (GOI), post-crisis, took several steps to remodel the country's financial system. (Some claim that these reforms were influenced by the IMF and the World Bank as part of their loan conditionality to India in 1991). The banking sector, handling 80% of the flow of money in the economy, needed serious reforms to make it internationally reputable, accelerate the pace of reforms and develop it into a constructive usher of an efficient, vibrant and competitive economy by adequately supporting the country's financial needs.[4] In the light of these requirements, two expert Committees were set up in 1990s under the chairmanship of M. Narasimham (an ex-RBI (Reserve Bank of India) governor) which are widely credited for spearheading the financial sector reform in India. The first Narasimhan Committee (Committee on the Financial System – CFS) was appointed by Manmohan Singh as India's Finance Minister on 14 August 1991, and the second one (Committee on Banking Sector Reforms was appointed by P.Chidambaram] as Finance Minister in December 1997. Subsequently, the first one widely came to be known as the Narasimham Committee-I (1991) and the second one as Narasimham-II Committee(1998). This article is about the recommendations of the Second Narasimham Committee, the Committee on Banking Sector Reforms.The purpose of the Narasimham-I Committee was to study all aspects relating to the structure, organisation, functions and procedures of the financial systems and to recommend improvements in their efficiency and productivity. The Committee submitted its report to the Finance Minister in November 1991 which was tabled in Parliament on 17 December 1991. The Narasimham-II Committee was tasked with the progress review of the implementation of the banking reforms since 1992 with the aim of further strengthening the financial institutions of India.[4] It focussed on issues like size of banks and capital adequacy ratio among other things. M. Narasimham, Chairman, submitted the report of the Committee on Banking Sector Reforms (Committee-II) to the Finance Minister YashwantSinha in April 1998.

Recommendations of the Committee

The 1998 report of the Committee to the GOI made the following major recommendations:

Autonomy in Banking

Greater autonomy was proposed for the public sector banks in order for them to function with equivalent professionalism as their international counterparts.[citation needed] For this the panel recommended that recruitment procedures, training and remuneration policies of public sector banks be brought in line with the best-market-practices of professional bank management. Secondly, the committee recommended GOI equity in nationalized banks be reduced to 33% for increased autonomy. It also recommended the RBI relinquish its seats on the board of directors of these banks. The committee further added that given that the government nominees to the board of banks are often members of parliament, politicians, bureaucrats, etc., they often interfere in the day-to-day operations of the bank in the form of the behest-lending. As such the committee recommended a review of functions of banks boards with a view to make them responsible for enhancing shareholder value through formulation of corporate strategy and reduction of the government equity.

To implement this, criteria for autonomous status was identified by March 1999 (among other implementation measures) and 17 banks were considered eligible for autonomyBut some recommendations like reduction in Government's equity to 33%, the issue of greater professionalism and independence of the board of directors of public sector banks is still awaiting Government follow-through and implementation.

Reform in the role of RBI

First, the committee recommended that the RBI withdraw from the 91-day treasury bills market and that interbank call money and term money markets be restricted to banks and primary dealers. Second, the Committee proposed a segregation of the roles of RBI as a regulator of banks and owner of bank. It observed that "The Reserve Bank as a regulator of the monetary system should not be the owner of a bank in view of a possible conflict of interest". As such, it highlighted that RBI's role of effective supervision was not adequate and wanted it to divest its holdings in banks and financial institutions.

Pursuant to the recommendations, the RBI introduced a Liquidity Adjustment Facility (LAF) operated through repo and reverse repos to set a corridor for money market interest rates. To begin with, in April 1999, an Interim Liquidity Adjustment Facility (ILAF) was introduced pending further upgradation in technology and legal/procedural changes to facilitate electronic transfer. As for the second recommendation, the RBI decided to transfer its respective shareholdings of public banks like State Bank of India (SBI), National Housing Bank (NHB) and National Bank for Agriculture and Rural Development (NABARD) to GOI. Subsequently, in 2007–08, GOI decided to acquire entire stake of RBI in SBI, NHB and NABARD. Of these, the terms of sale for SBI were finalised in 2007–08 itself.

Stronger banking system

The Committee recommended for merger of large Indian banks to make them strong enough for supporting international trade. It recommended a three tier banking structure in India through establishment of three large banks with international presence, eight to ten national banks and a large number of regional and local banks This proposal had been severely criticized by the RBI employees union. The Committee recommended the use of mergers to build the size and strength of operations for each bank. However, it cautioned that large banks should merge only with banks of equivalent size and not with weaker banks, which should be closed

down if unable to revitalise themselves. Given the large percentage of non-performing assets for weaker banks, some as high as 20% of their total assets, the concept of "narrow banking" was proposed to assist in their rehabilitation.There were a string of mergers in banks of India during the late 90s and early 2000s, encouraged strongly by the Government of India|GOI in line with the Committee's recommendations. However, the recommended degree of consolidation is still awaiting sufficient government impetus.

Non-performing assets

Non-performing assets had been the single largest cause of irritation of the banking sector of India. Earlier the Narasimham Committee-I had broadly concluded that the main reason for the reduced profitability of the commercial banks in India was the priority sector lending. The committee had highlighted that 'priority sector lending' was leading to the buildup of non-performing assets of the banks and thus it recommended it to be phased out. Subsequently, the Narasimham Committee-II also highlighted the need for 'zero' non-performing assets for all Indian banks with International presence. The 1998 report further blamed poor credit decisions, behest-lending and cyclical economic factors among other reasons for the buildup of the non-performing assets of these banks to uncomfortably high levels. The Committee recommended creation of Asset Reconstruction Funds or Asset Reconstruction Companies to take over the bad debts of banks, allowing them to start on a clean-slate. The option of recapitalisation through budgetary provisions was ruled out. Overall the committee wanted a proper system to identify and classify NPAs NPAs to be brought down to 3% by 2002 and for an independent loan review meachnism for improved management of loan portfolios. The committee's recommendations let to introduction of a new legislation which was subsequently implemented as the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and came into force with effect from 21 June 2002.

Capital adequacy and tightening of provisioning norms

To improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms. This would also improve their risk taking ability. The committee targeted raising the capital adequacy ratio to 9% by 2000 and 10% by 2002 and have penal provisions for banks that fail to meet these requirements. For asset classification, the Committee recommended a mandatory 1% in case of standard assets and for the accrual of interest income to be done every 90 days instead of 180 days.

To implement these recommendations, the RBI in Oct 1998, initiated the second phase of financial sector reforms by raising the banks' capital adequacy ratio by 1% and tightening the prudential norms for provisioning and asset classification in a phased manner on the lines of the Narasimham Committee-II report The RBI targeted to bring the capital adequacy ratio to 9% by March 2001. The mid-term Review of the Monetary and Credit Policy of RBI announced another series of reforms, in line with the recommendations with the Committee, in October 1999.

Entry of foreign banks

The committee suggested that the foreign banks seeking to set up business in India should have a minimum start-up capital of $25 million as against the existing requirement of $10 million. It said that foreign banks can be allowed to set up subsidiaries and joint ventures that should be treated on a par with private banks.

Implementation of recommendations

In 1998, RBI Governor BimalJalan informed the banks that the RBI had a three to four-year perspective on the implementation of the Committee's recommendations Based on the other recommendations of the committee, the concept of a universal bank was discussed by the RBI and finally ICICI bank became the first universal bank of India. The RBI published an "Actions Taken on the Recommendations" report on 31 October 2001 on its own website. Most of the recommendations of the Committee have been acted upon (as discussed above) although some major recommendations are still awaiting action from the Government of India

IV. 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.

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