Financial Sector Reforms and Role of RBI[@]

Dear Friends,

It is indeed a rare privilege to address this constellation of officers from the Indian defence and civil services and defence forces from across the world. This is my first visit to NDC and it is sort of a pilgrimage for me to get the opportunity to touch base here. NDC is one of the major legacies of the Nehruvian era and unlike some of the other legacies of that period, this institution has consistently lived up to its larger than life image. NDC, in its training programme, provides the framework for the confluence of a truly interdisciplinary approach and exchange of views among the career defence personnel from across the world and Indian civil servants. Through this process NDC has made distinct contributions on numerous aspects of the contemporary Indian history ranging from strategic thinking to global understanding.

The topic on which I would deliberate today is financial sector reforms and the role of the Reserve Bank of India (RBI). This is of course an economic topic and going by the approval rating of economists, many of you must be dreading about the dry session for the next two hours. Talking about public perception about economists, the other day a colleague of mine told me a story. It goes like this: A lady went to a doctor for some check-up and she was diagnosed to be terminally ill. She was told that she would live only for six more months. Extremely anxious she asked the doctor, "Is not there any way to make me live longer?" The doctor thought for some time and told, "Marry an economist and go and live in the Thar desert". Perplexed by the unorthodox advice the lady enquired, "Would it cure my illness?" "No", came the reply, "but if you follow my advice, those six months would appear as if eternity". I would try my best so that this lecture does not appear to be going on for eternity. Also to make it more interesting, I would urge you to make it as interactive as possible.

[@] Address by Dr. Narendra Jadhav, Officer in Charge, Department of Economic Analysis & Policy, Reserve Bank of India at the National Defence College, New Delhi, March 18, 2003.

Overview of the Financial Sector

Since today's lecture is anchored around the role of RBI in financial sector reforms, my focus would mainly be on those segments of the financial sector, which are under the purview of the RBI. In order to initiate today's discussion, I would initially present an overview of the financial sector. Then, talk about the broad issues about the role of financial sector and identify its various components and from that I would analyse the relative importance of the various institutions in the Indian financial sector.

Role of Financial Sector

A major function of the financial sector is to provide the framework for management of cash flow situation of different economic units such as individuals, corporates, government agencies, etc. In simple words, the income and expenditure pattern of individual economic units may not match at every point of time. Financial sector helps bridging such gaps. In the process, the sector reallocates financial resources between deficit and surplus entities. Financial sector also facilitates management of various types of risks. For example, an economic unit may like to deploy its surplus fund for a short period of time and another economic unit may want to access funds for a longer period. Left to them, there would be no transfer of funds between these two units. But there are various mechanisms through which the financial sector can assume certain risks and transform the maturity of the short-term surplus of one economic unit and meet the longer term funding requirements of the other. Again given the shortage of public information, individuals may not be able to evaluate investment decisions by individual corporates and might shy away from lending money to them. Financial intermediaries such as banks can, however, apprise and monitor corporate investment decisions and therefore, act as intermediaries between savers and investors.

It might surprise you, but until almost the late-1960s, there was no consensus on what role financial sector plays in the development of an economy. On second thoughts, such lack of unanimity among economists might not surprise you. Non-economists claim economics is the only field in which two people can share a Nobel Prize for saying opposing things. They give the example of Myrdal and Hayek who shared the same prize for saying just the opposing things. But in defence of my fraternity, I must tell

you that according to a rumour, similar thing happened in neuroscience, when Golgi and Cajal shared the prize for saying the opposite things. May be economists are not so different, after all. At any case, since 1970s economists of all colours have found out under various rigorous tests that financial sector can play a very conducive role in the development of an economy.

Components of Financial Sector

For effective conduct of its role, however, financial sector needs three interrelated *albeit* distinct components – institutions, markets and instruments. Financial institutions include entities such as banks, development finance institutions, non-banking financial companies, insurance institutions, long-term contractual savings institutions, stock exchanges, clearing houses, etc. Financial institutions cannot work in a vacuum. They need various types of markets for their operations. Financial markets include money market, debt market, foreign exchange market, securities market, derivatives market, etc. Again no market can function without products and in the context of financial markets we call such products instruments. Financial instruments include money, interest rate, securities, etc.

Having identified the nuts and bolts of the financial sector, it is important to note that financial sector is not a stand-alone entity. For the functioning of the sector various arrangements and frameworks are required. Perhaps the most important of these is the legal framework within which the financial sector operates. Most of the financial dealings are contracts. Therefore, the framework within which such contracts can be drawn, enforced and the recourse, in the event of breach of contract, are very important determinants of the efficacy of any financial system. Another aspect, which needs to be emphasised at the onset is that developments in the financial sector are intertwined and interdependent with developments elsewhere in the economy. Therefore, the efficiency level of any financial system to a large extent is constrained by the efficiency of the overall economic set up within which it operates.

Composition of the Indian Financial Sector

Given the limitations of time I would discuss only the structure of financial institutions. Reference to financial markets and instruments would only be indirect.

In India, commercial banks are the most dominant entities. They account for nearly 45 per cent of the total financial savings. Commercial banks in India play leading and critical roles. On the one hand, by providing readily withdrawable, *i.e.* liquid, and safe bank accounts, they create habits for financial savings. On the other hand, banks provide funds for meeting the funding needs for government, corporates and individuals. Since independence there have been significant changes in the composition of the commercial banking sector of which two issues merit particular mention. First, in the first two decades since independence there were a large number of small commercial banks operating in the country and many of these banks were financially weak. Some of these banks actually failed during the early years, post-independence and there was also a consolidation process in the form of mergers and amalgamation. Through this process the number of commercial banks declined considerably by mid-1960s. Secondly, till late 1960s, private sector banks had a large share in the total assets of the banking sector. However, in two phases, once in 1969 and then in 1980, major commercial banks were nationalised and as a result, public sector banks started accounting for the dominant portion of assets in the Indian commercial banking system. Currently, public sector banks, taken together, account for nearly three-fourths of the total assets of the commercial banking sector. Apart from public sector banks there are two other types of commercial banks – Indian private sector banks and foreign banks. Since bank nationalisation and until the initiation of the financial sector reforms, Indian private sector banks had a limited role to play. These banks, however, have made considerable progress since then. There are also a large number of foreign banks operating in India. As on March 31, 2002 there were 97 commercial banks in India of which 27 were public, 30 private and the rest 40 were foreign banks.

Apart from commercial banks, the other major type of banks operating in India is the co-operative banks. There are two broad types of co-operative banks, rural and urban. There are further subcategories among each of these two types of co-operative banks. During the early phase of development of Indian banking, i.e., during the early twentieth century, co-operative banks were the dominant entities. Overtime, however, their share in the deposits of or advances made by the banking sector has declined. Notwithstanding such decline, the deposit base of co-operative banks remains significant and equivalent to about one-fifth of the total deposits of commercial banks. More importantly, co-operative

banks have a wide network and reach even to many remote areas of the country. In particular, co-operative banks are playing crucial roles in creating banking habits among the lower- and middle-income groups and in the rural credit delivery system. Currently, there are about 2,500 co-operative banks operating in India.

There are two other types of banks operating in India, regional rural banks and local area banks. The former are subsidiaries of commercial banks and the latter are still in the formative stage. Given the constraints on time and my sincere efforts not to stretch the same to eternity, I would not elaborate details about these, rather miniscule segment of banks.

Internationally as well as in India, banks are mainly providers of short-term funds. The development process in an economy, however, requires fund for long-term purposes. Infrastructure projects, heavy industries, social investments such as those relating to health, education, etc. warrant long-term funding. During the early days of independence it was realised that banks alone may not be able to meet such demands for long-term funds. Simultaneously, given the nascent state of most other components of the Indian financial sector such as stock exchanges, corporate debt market, long-term contractual saving institutions, etc. it was realised that for meeting long-term funding requirements of the economy, specialised long-term lending institutions would need to be set up. Concomitantly, a special class of financial institutions was created which were called the Development Finance Institutions or DFIs in short. The erstwhile Industrial Credit and Investment Corporation of India (*i.e.*, ICICI), Industrial Development Bank of India (*i.e.*, IDBI), National Bank for Agriculture and Rural Development (*i.e.*, NABARD) are examples of such DFIs. Broadly speaking there are two types of DFIs – direct financing DFIs and refinance DFIs. As the categorisation suggests, the first group of DFIs directly extend funds to the industry while the other group provides funds to other institutions such as banks against their long-term lending to industry. Of late, some DFIs, particularly, the direct financing ones, are facing some problems. One of them, ICICI Limited, has already converted into a bank and a few others are in the process of following suit. We would touch up on this issue again in the concluding portion of today's deliberation. As of now, there are nine all India DFIs, which are under the regulatory and supervisory purview of the RBI. There are also some State-level DFIs.

The last type of financial institutions, which we would cover today are called non-banking financial companies or NBFCs. This is a rather heterogeneous group, which specialises in such diverse niches of the financial sector as loan and investment, equipment leasing finance, higher purchase finance, etc. Though the NBFC sector has undergone a transformation during the 1990s and their share in the total public deposits mobilised by all financial institutions has gone down significantly, they remain important for various reasons. First, they have a big clientele base among the lower-income section of the Indian population. Secondly, many services provided by them are not extended by other type of institutions. Thirdly and perhaps most importantly, NBFCs innovate quickly and can structure their products in line with local and customer specific demand. Currently there are over 1,000 NBFCs operating in India, which accept public deposits.

Rationale for Financial Sector Reform

Having identified the major components of the Indian financial sector in terms of institutional structure, it is now time to turn our attention to the financial sector reform process, which has been initiated in the country during the early 1990s. The basic question that arises here is, why reforms? Naturally to give the answer to this question one needs to know what were the conditions under which these changes were introduced.

Just to recap, post-independence India adopted a planned economic development strategy with the aim of the public sector reaching the "commanding heights". It was argued that a predominantly privately owned banking structure would not be able to channelise resources according to plan priorities. In order to align the planned development of the real economy a policy of “Social Banking” was adopted and a series of measures were adopted towards this end. These included the following:

- Nationalisation: As I have alluded to earlier, this was done in two phases 1969 and 1980.
- Preemption: By increasing the levels for statutory reserves and liquidity requirements, Government preempted a major portion of bank resources. Banks were also given targets for channelisation of specific portion of their credit to certain sectors under the priority sector lending norms.

- <u>Administered Interest Rate</u>: On account of large investment expenditure, government incurred budget deficits, a portion of which had to be borrowed from the market. In order to keep interest rates on such borrowings low, a regime of administered interest rate was put in place. Under the same interest rate policy, banks were also specified the rates to be paid on different deposits as well as those to be charged on different credits.
- <u>Expansion of Banking</u>: Under the Lead Bank Scheme, specific banks were given the responsibility to expand banking networks in particular districts. Major emphasis was put on expansion of branches, deposits and credit amounts. Rather than competing with each other, banks were asked to complement each other through schemes such as consortium lending. While, banks were given various targets in terms of priority sector lending, branch expansion, deposit and credit growth, not much emphasis was put on the health including profitability of banks and transparency of the accounting process.
- <u>Supply of Low-Cost Fund to DFIs</u>: Given the lack of access of the DFIs to low cost fund such as savings deposits, on the one hand and the perceived need to keep the interest rate on long-term loans low, on the other, these institutions were provided mechanism to access funds at low cost. A part of such funds used to come directly from the Government and RBI.

The phase of social banking had several positive facets. There was a large geographic expansion of banking even to the remotest areas of the country. Even in the interiors hinterland of the country there was increase in exchange of goods for money rather than barter. There was stimulus to banking habits, which increased saving rates as well as the proportion of financial savings in total saving. There was increase in credit flows towards sectors such as agriculture, small-scale industries, etc., which were earlier deprived the access to institutional credit.

Notwithstanding such positive impacts, the basic deficiency of the phase of social banking was that these policies seriously impacted on the financial health and thereby the viability of the financial institutions. Administered policies and lack of competition resulted in low productivity and inefficiency in the financial sector and misallocation of resources, whereby there was severe lack of

credit in certain segments while excess capacities were created in others. Large preemption of financial resources by the public sector left little resources for the private sector. There were leakages because of which directed credit often did not reach the desired beneficiaries. Even when it reached the desired groups, the impact was not in conformity with the original objectives. This was the background against which reforms in the financial sector had to be introduced.

The restructuring of the banking sector has been one of the major components of the economic reform process initiated since the early 1990s. Financial sector reforms were initiated early within the overall economic reform cycle. Furthermore, various supportive measures were also initiated in other sectors, which reinforced the financial sector reforms. The restructuring of the financial sector aimed at enhancing the productivity and efficiency of the financial entities like banks, DFIs, NBFCs. There were also steps to improve the quality of services provided by them, increasing the transparency in operations and making the system viable and efficient in order to serve the emerging needs of the economy. The first phase of reforms, which were introduced in 1992 subsequent to the report of the Committee on the Financial System, 1992 (Chairman: Shri M. Narasimham), brought about reduction in statutory pre-emption levels, dismantled the administered interest rate structure, laid down capital adequacy requirements and other prudential norms such as income recognition, asset classification, provisioning, exposure norms, etc. Entry norms for Indian private sector banks and foreign banks were liberalised. The second phase of reforms, introduced subsequent to the recommendations of the Committee on Banking Sector Reforms, 1998 (Chairman: Shri M. Narasimham) placed greater focus on structural measures and improvement in standards of disclosure and levels of transparency in order to align Indian standards with international best practices. The major areas where reforms have been undertaken pertain to further improvements in capital adequacy standards, asset classification, focus on competitive forces with emphasis on profitability and improvements in efficiency.

Under the reform process an attempt has been made to establish international best practices in the regulation and supervision of financial entities operating in India. While such measures are crucial in enhancing the stability and efficiency of the financial sector, it is also important to realise that in today's

globalised environment, individual countries do not have the option to depart from such benchmark standards. In the absence of such convergence, in an interconnected world, failure of financial institutions in one country would get readily transmitted in other countries through what is known as contagion effect. After all there is an old saying, "a chain is as strong as the weakest link". During the East Asian crisis a few years back, we have witnessed the devastating consequences of the lack of prudential practices in the financial sector. I am proud to say that the measures initiated to strengthen the systemic stability of the Indian financial sector were one of the main reasons why our country can withstand any crisis unscathed.

Performance of the Financial Sector and the Impact of Reforms

The reforms have ushered in extensive improvements in the terms of various parameters, like capital adequacy and asset quality. There have also been considerable improvements in the efficiency of the financial intermediation process and profitability of banks. Closer to our hearts in the RBI, there has been a significant advancement in terms of systemic stability of the Indian financial sector. While my deliberations shortly would elaborate this point further, I would, however, emphasise that the impact of reforms across the financial sector has not been even. It is the commercial banking sector, which has fared the best under reform. The full and positive impact of reforms is yet to be realised in some other segments of financial sector.

I have already stated that enhancing stability and efficiency were the two main planks of the financial sector reforms in India and there has been visible improvement on both fronts. Capital position of any company is a good indicator of its viability and stability. This is more so for financial companies like banks since most of their resources are borrowed funds. In terms of capital requirement for banks, India has set norms, which are even stringent than the international benchmarks. As opposed to international norm of 8 per cent capital to risk-weighted asset ratio (or CRAR in short) in India banks need to maintain 9 per cent CRAR. It is heartening to see that as on March 31, 2002 among the 97 commercial banks operating in India, all but 5 had fulfilled this criterion. Among the DFIs, all but one fulfilled the minimum CRAR norm. Keeping the higher risk associated with the operations of

certain category of NBFCs, the minimum CRAR has been kept higher for them than commercial banks. In spite of this, an overwhelming proportion of NBFCs satisfy this requirement. The only segment of the financial sector where capitalisation level is a matter of concern is co-operative banks. Even in this segment a time frame has been fixed and by March 31, 2005 all co-operative banks are required to achieve minimum CRAR compatible with that for commercial banks.

Another way to measure the stability and soundness of a company is to examine the quality of its assets. In financial parlance, lower the level of non-performing assets or NPAs, for short, higher is the stability of the institution. An asset is defined as NPA if the interest or repayment due on that loan remains overdue even after a specified time period. Under the reform process, in line with international best practices, the asset classification norms in India have been made stringent. In spite of that, there has been considerable reductions in the NPA levels of commercial banks. In early 1990s, gross NPA of commercial banks were close to one-fourth of the total loans and advances extended by them. In ten years since then, this has come down to slightly above 10 per cent of the total advances. Though there has been considerable reduction in the NPA position of most of the DFIs, for some of them, the level remains high. There have, however, not been much reduction in the NPA position of NBFCs or co-operative banks. Various measures have been initiated to alleviate the NPA situation of all financial institutions.

As in case of stability, since the initiation of reforms, improvement in efficiency has taken place in almost all segments of the financial sector but it has been most marked for commercial banks. One measure of efficiency is competitiveness. The liberalisation of entry norms for private and foreign banks as well as private and foreign investment in the existing banks has enhanced the competitiveness of the commercial banking sector. This is reflected in the declining share of top five banks in the total deposit as well as assets of the total commercial banking sector. Another indication of larger competition and efficiency of the commercial banks in the post-reform period is the decline in the gap between the interest rates at which banks lend their fund and rates at which they themselves borrow such funds. In a simple sense this indicates that faced with competition, banks are selling their products at lower margins. But the important point is that even with this fall in margin, banks remained profitable and in fact many increased their

profitability. This signals an increase in efficiency of the banks. The lowering of interest margin has been observed for DFIs and co-operative banks as well. Due to increased competition between different segments of the financial sector, the interest rates charged by different types of institutions have moved closer. Not only that, there has also been a better alignment in the interest rates charged in India and those prevailing in the international market.

Role of RBI in the Management of Financial Sector

Having talked about financial sector and the ongoing reform process in the sector, let us now turn our attention to what exact role RBI is playing for the financial sector in general and the financial reform process in particular. As all of you know, RBI is the central bank of the country. Central banks are very old institutions. The Bank of England was set up way back in 1694, the Bank of France is more than 200 years old and the Federal Reserve Bank was set up in 1913. As aptly stated by our Governor, Dr. Bimal Jalan, although RBI, set up in 1935, may appear a 'toddler or at most a young adult', it is one of the oldest central banks among the developing world. Traditionally, central banks have performed roles of currency authority, banker to the Government and banks, lender of last resort, supervisor of banks and exchange control (now it would be more appropriate to call it exchange management) authority.

Generally, central banks in developed economies have price or financial stability as their prime objective. The RBI has the twin objectives of maintaining price stability and promoting growth. The objectives are the following:

- Provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level.
- In line with the above to continue the present stance on interest rates including preference for soft interest rates.
- To impart greater flexibility to the interest rate structure in the medium-term

In developing economies, however, the growth objective assumes greater importance. Recent experience has shown that during recessionary or deflationary conditions achievement of

higher growth becomes the dominant objective of central banks, both in developing and developed economies.

Let us now look at the evolution of RBI and its changing role and strategy over time. RBI was set up to regulate the issue of currency and keep reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage (RBI Act, 1934). Within these overall objectives, RBI performs a wide range of promotional functions, which are designed to support the country's efforts to accelerate the pace of economic development with social justice.

In keeping with the overall logic of reforms that market based allocation rather than directed allocation of resources led to greater efficiency, the functions of the RBI have undergone a strategic shift under the current reforms. The strategy shifted from controlling institutions and markets to facilitation of efficient functioning of markets and strengthening of the supporting institutional infrastructure. The preemptions in the form of CRR and SLR have been progressively reduced. The scope of priority sector has been expanded. The interest rate has been deregulated both on deposits and advances. Allowing DFIs and banks to lend in the short as well as the long end of the market has reduced segmentation of credit market. From conservation of foreign exchange through control of transactions, the focus has shifted to facilitation of foreign exchange transactions. Intervention in the foreign exchange market has shifted from fixing of exchange rate to merely curbing speculative volatility.

Stability issues came to the fore especially after the crises in South East Asian countries in late 1990s. The RBI progressively strengthened prudential regulation relating to capital adequacy, income recognition, asset classification, provisioning, disclosures and transparency. Sequencing of reforms among various segments of the financial sector (banks, DFIs, co-operative banks, NBFCs, money market, debt market and forex market) was determined by the importance of each segment, extent of regulatory powers enjoyed by the RBI and the evolving situation. Furthermore, institutional strengthening was undertaken to ensure the progressive development and integration of the securities, money and forex markets.

The RBI has made significant improvements in the quality of performance of regulatory and supervisory functions. Our standards

are comparable to the best in the world. Attention is being paid to several contemporary issues such as, relative roles of onsite and off-site supervision, functional versus institutional regulation, relative stress on internal management, market discipline and regulatory prescriptions, consolidated approach to supervision, etc. Several legislative initiatives have also been taken up with Government, covering procedural law, debt recovery systems, Credit Information Bureau, Deposit Insurance, etc. Progress in these is critical for effectiveness of RBI in the regulatory sphere. A recent important legislative development, which will improve the momentum of recovery of dues, is the enactment of Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SRFAESI) Act. Under this Act RBI has been entrusted with the role of stipulating suitable norms for registration of securitisation or reconstruction companies, prescribing prudential norms, recommending proper and transparent accounting and disclosure standards and framing appropriate guidelines for the conduct of asset reconstruction and securitisation.

Coverage of the RBI's regulatory and supervisory role, which is currently focused more strongly on banks, also extends to some extent in the case of NBFCs, especially those accepting public deposits, and DFIs. There are certain areas, which require or would entail changes in regulation and supervision by RBI. I am going to deal with those in the last part of my presentation.

Assessment and Prospects of the Financial Sector

There is clear evidence that the financial sector reform process has exerted considerable positive influence on both stability and efficiency of the Indian financial sector though the impact has not been even across all segments. Due to the differences in initial conditions in each segment of the financial sector and segment-specific considerations, the pace and sequencing of the reform programmes have been different for diverse financial institutions and markets. This, to some extent, explains the variation in the impact of reforms for special segments. In the past few years, there have, however, been efforts to achieve regulatory convergence between all types of financial institutions and various time bound programmes have been put in place to achieve the same. Notwithstanding considerable achievements, there is no sense of complacence in the financial community as we view reform as an ongoing process rather than a programme in force for limited time.

In order to make Indian financial sector one of the best in the world, there are literally miles to go before we can take even a short breaks let alone sleep.

Improving the productivity is one of the key areas where policy makers are increasingly devoting their attention. There has been lot of improvement in the operating efficiency of Indian financial sector in the past ten years but the operating cost in many of the institutions continue to remain high. In order to reduce wage costs in the public sector banks, voluntary retirement schemes were framed a few years back and the early results show encouraging impact. This process may need further reinforcement. Improving the information technology capability of the Indian banks, particularly public sector banks and old private sector banks is yet another area that needs concerted effort and lot of work is currently underway.

As I mentioned before, the capital position of an overwhelming majority of the commercial banks are well above the minimum stipulated level. With the increase in the balance sheet size of these banks, however, there would be need for additional infusion of capital in these banks. If the movements of equity prices of the Indian banks listed in stock exchanges are indicators, notwithstanding the general bearishness in such markets, there has been considerable investor interest in bank scrips over last two years. Many banks are taking this opportunity to raise capital by issuing new equity shares. Such new issues alone, however, may not be adequate to meet the entire need for fresh capital infusion. Internal generation of fund is likely to be crucial for Indian banks. In addition, banks also need to step up their provisioning. Like capital, provisioning provides cushion to banks in the face of adverse developments. Banks need to increase their provisioning particularly during the years when their profitability is high. This once more brings back the issue of improving the productivity of Indian banks, which would provide the enduring solution for improving the capital position and provisioning of banks.

Further improvement in the asset quality of the banks operating in India is also high on the RBIs agenda. Despite the fall in proportionate terms, as a ratio to advances, NPAs in absolute amounts are rising *albeit* at a low pace. There are indications that a large part of the stock of NPA is a legacy problem, which financial entities inherited from the past. It is also true that an industrial down turn and global recession, through which we are passing are

hindering our efforts to curb NPAs in a big way. Various procedural, institutional and legal reforms have been initiated to deal with the NPA problem. In particular the enactment of the securitisation and foreclosure bill is expected to facilitate banks to recover their dues. The arrangement for information sharing among financial institutions about borrowers is also being strengthened.

It has been observed that the level of NPAs in co-operative banks is generally higher than that of commercial banks. This is often due to the lack of adequate professional expertise, *ad hoc* manner of decision-making and politicisation of the Boards of some of these banks. It is, however, not proper to paint all co-operative banks in the same colour. As in the case of commercial banks, there are good and bad entities among the co-operative banks as well. In fact, the recent rise in NPAs of co-operative banks is due to the performance of a few banks in a single State; between these four walls I can even share the name of the State with you, Gujarat. The issue here is that all the co-operative banks, which have found themselves in trouble in the recent past, in the first place got into the trouble because they flouted extant norms. Prompt corrective actions stalled the problem from assuming crisis proportion. Legal recourse has been taken against erring entities and individuals and norms have been tightened further to guard against recurrence of such episodes. In this context it is important to note that co-operative banks are under the dual control of the State Government and the RBI, which often leaves certain gaps in their supervision. For quite some time the RBI is asking for appropriate measures to address these issues. Currently, this issue is under the consideration of the Government of India.

For co-operative banks as well as for other financial sector entities, appropriate framework for corporate governance is assuming greater importance in recent times. In a deregulated environment diligent corporate governance practice is the first and often the last line of defence against irregularities, frauds and malpractices. Setting up apt standards on qualifications, code of conduct, immunities, responsibilities and penal action for the Board of Directors, executives, employees, internal and external auditors and other stakeholders are very important in this context. Internationally in the face of large irregularities, corporate governance and associated issues have assumed the centre stage in recent times. We have also had our share of worries linked to corporate delinquency. The RBI in association with Government and

other concerned agencies has initiated numerous measures to address these issues. It is, however, important to realise that relatively stringent corporate governance norms could not stall corporate irregularities in the industrialised countries. Ultimately it is the corporates themselves who, to a large extent, have to take responsibilities for ensuring that appropriate governance practices are being followed.

In the context of financial entities, a major part of corporate governance is identification and containment of risk. Most financial entities are in the business of risk transformation and through such activities they aid the development of an economy. Therefore, risk management by financial entities certainly does not mean risk avoidance. The issue is of framing appropriate strategy to deal with various forms of risk. Though risk management is the integral part of core business of financial entities, in India prior to the initiation of economic reforms, such strategies were not overtly important. The combination of factors such as predominance of publicly owned banks, administered interest rate policy, large preemption of resources by government, directed lending policies, etc. made risk management less important in that period. Since the introduction of reforms, however, with increasing liberalisation and enhanced competition, risk management by financial entities has become very important not only for their own viability but also for systemic stability. Given the late start, risk management techniques in most Indian banks are still in early evolutionary stage and there is a need to strengthen such practices.

As I was mentioning earlier, DFIs in India, particularly those involved in direct lending are facing a difficult situation for past few years. While under the financial sector reform process their access to low-cost subsidised sources of fund has dried up, some of them also have accumulated large stocks of NPAs. Such NPAs are mainly due to their past lending activities. Faced with such situations, some of these DFIs are transforming themselves into commercial banks. There are commercial decisions of the concerned entities and only time can tell how this business model switching would aid the future growth of the erstwhile DFIs. At the same time, transformation of a few large DFIs into banks raises the question whether this would affect the supply of long-term funds to corporates. We in the RBI are closely watching this issue and have already come out with measures to aid flow of long-term fund towards important segments of the economy such as infrastructure development.

Well, these were the broad issues, which I wished to share with you and in a short while the floor would be open for interaction. Before that I would once more reiterate that the financial sector reforms initiated in 1990s have yielded positive results especially for the commercial banking sector. The reform process however, is far from over, and I have identified some of the crucial issues currently confronting the sector. I have also spoken about the crucial role that the RBI has played and is expected to play as the apex financial entity of the country. A couple of years back Jacques Delors, former president of European Commission, commented, "Not all Germans believe in God but they believe in the Bundesbank." Given the track record of the RBI in steering the financial sector towards efficiency, stability and prosperity, I am sure that in the near future all Indians would also have a similar attitude towards the RBI.

Thank you.