

Draft

Financial Sector Reform and the Role of RBI

Speech by

Dr. Narendra Jadhav

National Defence College

New Delhi

March 24, 2005.

Contents

- I. Overview of Financial Sector
- II. Financial Sector Reforms and Financial Stability
- III. Some Issues in Banking and Finance
- IV. Union Budget 2005-06 and Role of RBI
- V. The Road Ahead

I

Overview of Indian Financial Sector

Introduction

The Indian financial system comprises of various institutions, markets and infrastructure including a framework for regulation and supervision. The reform initiatives introduced since the 1992 have brought about a sea change in the operating environment of the financial sector. The financial sector now operates in a more competitive environment than before and intermediates relatively large volume of financial flows. Indian banking sector has already implemented international standards regarding prudential accounting norms for classification of assets, income recognition and loan loss provisioning. The level of disclosure and transparency has also been raised in accordance with international practices. India has complied with almost all the Core Principles of Effective Banking Supervision of the Basel Committee. Some of the Indian banks are also presenting their accounts as per the U.S. GAAP. The roadmap for adoption of Basel II by March 2007 is also under formulation. Thus the Indian financial sector is now more matured and poised for a bigger role in the international financial landscape.

Segments of the Financial Sector

Commercial banks are the most important financial intermediaries, accounting for about 66 per cent of total assets and public sector banks (PSBs) dominate the sector, comprising nearly 47 per cent of the financial system assets. New private and foreign banks, whose activities were limited until the onset of reforms, represent a rising share of the sector, promoting new financial products with strong technological backup.

A large network of regional rural banks (RRBs) and cooperative banks (rural and urban) serve borrowers in rural and urban areas. The RRBs were established under an Act of Parliament with the Central Government, State

Governments and sponsor PSBs all taking holdings in them to improve credit delivery in rural areas. The cooperative banks cater to the credit needs of specific communities or groups of people in a region and comprise both rural and urban entities.

The term-lending institutions are mostly government-owned and have been the traditional providers of long-term project loans. Accounting for approximately six per cent of total assets, these institutions raise funds in capital markets as well as through retail sales of savings instruments. Term lending institutions have been facing the problem of reduced demand for project financing and increased competition from commercial banks. Several of them are gearing up to migrate to an acceptable and viable variant of commercial banking to gain a foothold in the emerging financial system.

Investment institutions are currently largely in public domain, although the sector has since been opened up to private participation. The Life Insurance Corporation of India has a dominant position in the public sector category. Non-life insurance providers - the General Insurance Corporation of India and its four erstwhile subsidiaries - account for two per cent of total financial sector assets.

The State Financial Corporations registered under the State Financial Corporations Act, 1951 and the State Industrial Development Corporations (SIDCs) - purvey credit to industries/sectors in different states and account for about 0.8 per cent of total assets.

Other institutions established to meet specific financing needs include Power Finance Corporation (PFC) and Rural Electrification Corporation (REC) (financial assistance to the power sector) and Indian Railway Finance Corporation (IRFC), which is the capital market financing arm of Indian Railways. These institutions have been notified as Public Financial Institutions (PFIs) under the *Companies Act, 1956*. In addition, at the state-level, there exist the North Eastern Development Finance Corporation (extending credit to industry/agricultural concerns in the North Eastern region) and Technical

Consultancy Organisations (providing technical inputs for feasibility studies on viability of projects).

There are also the Deposit Insurance and Credit Guarantee Corporation (DICGC), a wholly-owned subsidiary of the Reserve Bank providing insurance for deposits with commercial and cooperative banks and the Export Credit Guarantee Corporation (ECGC), providing guarantee cover to exports. Their share of total financial sector assets approximates 0.3 per cent.

Non-bank financial companies provide a gamut of services and account for roughly two per cent of financial sector assets. This sector witnessed a rapid growth in the mid 1990s, but consequent upon the introduction of new norms for their registration and functioning, growth has since slowed down and the Reserve Bank has authorised 584 NBFCs to accept/hold public deposits.

Primary dealers are active players in the Government securities market. Numbering 17, they account for 0.5 per cent of assets. The majority of them are promoted by banks, which largely continue to retain majority stakes in their sponsored primary dealers. In 2003-04, they accounted for 25 per cent of the outright market turnover.

Performance of the financial sector

Adducing to the success of banking sector reforms, the various parameters of performance of banking sector has shown continuous improvement. The sources of income has witnessed increasing share of non-interest income amidst declining interest rate, increasing diversification of banks' portfolio and greater deepening of financial market. The share of non-interest income comprises fees, trading income, and gains from exchange operations in banks' total income has increased continuously from 9-10 per cent in early 1990s to about 22 per cent in 2003-04. On the expenditure side, there has been a containment of overall expenditure accompanied mainly by decline in interest expenditure. The provisions and contingencies, particularly, on account of non-

performing loans have shown higher growth due to tighter prudential norms in order to improve asset quality.

The profitability of banks has shown significant improvement, especially, during the last five years. During the last two years in particular, despite lower interest rates, the banks have recorded the momentum of high growth in profits of the range of 30-47 per cent attributing to improvement in asset quality, better loan recovery, rising non-interest income, and containment of expenditure. From cross-country perspective, India's banking sector now belongs to the most profitable category. The profitability of India's banking sector at 1 per cent is comparable to some of the advanced countries including U.K. and the U.S.A. The return on equity indicator of banks provides information as to how banks conduct business in the interest of shareholders. The ROE of the banking system, which was in the range of about 10-16 per cent during the period 1998-99 to 2001-02, increased to about 17 per cent in 2002-03 and further to about 19-20 per cent in 2003-04. The spread has shown a sustained movement in the range of 2.8-2.9 per cent during 2002-03 and 2003-04.

Banks have made substantial progress in cleaning off NPAs from their balance sheet adducing to various institutional measures pertaining to one-time settlement, debt recovery, asset reconstruction and securitisation, lok adalats, and corporate debt restructuring. Despite the switchover to 90-day delinquency norm with effect from March 2004, the gross and the net NPAs of SCBs declined in absolute terms for the second year in succession and stood at only 2.9 per cent as at end-March 2004 and further declined to 2.5 per cent as at end-September 2004. The Reserve Bank's thrust on adequate level of provisions is reflected in the fact that the cumulative level of provisioning for the scheduled commercial banks works out to 70.6 per cent of gross NPAs as at end-March 2004. This achievement is notable in comparison with the internationally prescribed benchmark of 50 per cent provisioning against NPAs.

The banking sector has shown sustained improvement in regard to solvency and soundness as revealed from the capital adequacy requirement. The capital to risk weighted assets ratio (CRAR) SCBs stood at 13 per cent in 2003-04, above the regulatory minimum of 9 per cent. In 2003-04, all but two commercial banks complied with the regulatory minimum CRAR of 9 per cent. The two banks, which did not comply with the regulatory minimum, accounted for a negligible 0.5 per cent of total assets of scheduled commercial banks in 2003-04.

Various other segments of the financial sector has also witnessed improvement during the recent years. The scheduled co-operative banks registered a net profit during 2003-04 as against losses in the previous year. The state co-operative banks registered profit during recent years while the financial health of central co-operative banks deteriorated. A large number of primary agricultural credit societies, however, faced severe problems due to significant erosion of own funds, deposits and low recovery rates. Various policies have been adopted to improve the financial health of the PACs including extension of funds by NABARD to develop the infrastructure of the PACs.

In the AIFIs group barring two institutions facing financial and organisational restructuring all other institutions registered positive operating and net profits. The business model of the AIFIs came under strain since the withdrawal of the concessional sources of funds and imposition of restrictions on raising short-term funds of maturity less than one year resulting in AIFIs raising high cost debt from the market. The net profit of the NBFCs sector has registered improved profit in the current years along with a strengthening of the soundness indicators.

Financial Markets

In India, development of financial markets has been pursued essentially for bringing about transformations in the structure, efficiency, and stability of markets as also integration of markets. The emphasis has been on strengthening

price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. Initially, under the reform process, the changes in the money market structure were brought in through a gradual shift from a regime of administered interest rates to a market-based pricing of assets and liabilities, development of infrastructure, and introduction of new instruments. The reform of money market also focused on greater and wider participation of other financial institutions for deepening of the market. The Reserve Bank influences liquidity and interest rates through a number of operating instruments, viz., cash reserve requirements of banks, conduct of open market operations, repo transactions, changes in the Bank Rate, and at times through foreign exchange swap operations. In recent times the Reserve Bank's strategy has focused on developing pure call/notice money market, instituting full-fledged Liquidity Adjustment Facility, developing infrastructure, promoting transparency, and various measures pertaining to instruments for non-bank participants. A revised LAF scheme was operationalised in April 2004. The LAF scheme has been operated with overnight fixed rate repo and reverse repo from November 1, 2004.

The development of a deep and liquid market for Government securities has been of critical importance to the Reserve Bank in facilitating price discovery and reducing the cost of Government debt. Efforts toward development of the Government securities market have focused on three areas: institutional measures, innovations through instruments, and enabling measures. During the 1990s, the approach to development of Government securities market focussed on removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions, and improvement in trading, clearing and settlement practices. Reforms also encompassed regulatory and legal changes, technological upgradation and refinement of the market microstructure.

The Indian forex market has widened and deepened during the 1990s on account of implementation of various measures recommended by the High Level

Committee on Balance of Payments in 1993 (Chairman: Dr. C.Rangarajan), the Expert Group on Foreign Exchange Markets in India in 1995 (Chairman: Shri O.P.Sodhani) and the Committee on Capital Account Convertibility in 1997 (Chairman: Shri S.S.Tarapore). With the transition to a market determined exchange rate system in March 1993 and the subsequent gradual liberalisation of restrictions on various external transactions, ensuring orderly conditions in the forex market in India has become one of the key objectives. The Reserve Bank has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. In recent years, forex flows, especially due to increasing capital flows, have posed various challenges for liquidity management since these have implications for the conduct of domestic monetary policy and exchange rate management. In the context of large forex inflows that India has been experiencing, the Reserve Bank has been reviewing the operational aspects of inflow of forex, *i.e.*, the extent of forex market intervention and consequent build up of reserves, and the need for and extent of sterilisation required. The Reserve Bank's approach towards ensuring stability of forex market has been evident on various occasions. During the late 1990s the forex market remained stable despite the Asian crisis. More recently the forex market exhibited orderly conditions despite the September 11 development in the US, international oil price movement in the external front and various adverse domestic developments arising from border tensions, natural calamities such as cyclone, earthquake, monsoon failure and Tsunami. The management of the forex flows in the wake of redemption of Resurgent India Bonds and the surge in capital flows was also testimony to the market maturity.

Regulatory and Supervisory Design

The first tier of governance is indeed provided by the laws relating to the banking and financial sector. The Reserve Bank, the central bank of the country is at the apex of the financial system having wide ranging regulatory and supervisory powers over the commercial and co-operative banks, the all-India financial institutions, the non-banking financial companies including the primary

dealers. Reserve Bank also exercises broad oversight in the development and stability of various segments of the financial markets besides taking a active role in payment and settlement system infrastructure.

The management of the financial system has been oriented towards maintaining a balance between efficiency and stability while pursuing gradual economic integration with the rest of the world. In India financial sector reforms have sought to strengthen the regulatory and supervisory framework and to bring it at par with international best practices. The Board for Financial Supervision (BFS) was constituted in November 1994, as a committee of the Central Board of Directors of the Reserve Bank of India. During the meetings, it deliberates upon inspection reports and other supervisory issues placed before it by the supervisory departments. Some of the initiatives taken by BFS include restructuring of the system of bank inspections, introduction of off-site surveillance, strengthening of the role of statutory auditors, and strengthening of the internal defences of supervised institutions. The supervisory mechanism has been refined with the introduction of the consolidated supervision and risk based supervision. The recent years has also witnessed a renewed emphasis on credit delivery and strengthening of measures to improve the technological and legal infrastructure so as to enhance the efficiency of the financial system.

The Basel norms were adopted since 1994-95 and recently banks have been to prepare roadmap for transition to Basel II. The Reserve Bank has been closely monitoring the progress in this regard. Draft guidelines for banks to migrate to Basel II has been circulated by the Reserve Bank on February 15, 2005 for their feedback. Keeping in view the Reserve Bank's goal to have consistency and harmony with international standards it has been decided that at a minimum, all banks in India will adopt Standardized Approach for credit risk and Basic Indicator Approach for operational risk with effect from March 31, 2007. After development of adequate skills, both in banks and at supervisory levels, some banks may be allowed to migrate to (Internal Ratings Based) IRB Approach after obtaining the specific approval of Reserve Bank. As regards operational

risks, a guidance note reflecting the international best practices in the area, has been issued for feedback from banks and other market players.

The banking sector reforms roadmap released by the Reserve Bank on February 28, 2005 suggests a two track approach. The first track would allow Indian banks sufficient time to prepare themselves for global competition, while the second track would allow entry of foreign banks in a phased manner.

Various measures have been undertaken to strengthen the co-operative banking system, in particular the Urban Co-Operative Banks (UCBs) in view of their weak financial condition and the need for alignment of urban banking sector with the other segments of banking sector for the application of prudential norms and removing the irritants of a dual control regime. A new system of grading of UCBs and a system of supervisory rating was introduced and the off-site surveillance system (OSS) for scheduled UCBs extended to all non-scheduled UCBs having deposit size of Rs.100 crore and above. The Task Force on cooperatives constituted by the Government of India has submitted its report in December 2004 and the proposals of the Report have been accepted in principle and would be implemented in consultation with the State Governments. Guidelines on merger and amalgamations of UCBs has been announced and a vision document for the future role of UCBs has been placed by the Reserve Bank for feedback and wider public dissemination

The Development Finance Institutions (DFIs) are presently undergoing a major restructuring phase. Taking into account the developmental functions and supervisory function exercised by some of these institutions – NABARD supervises state/central cooperative banks and regional rural banks, National Housing Bank (NHB) regulates and inspects housing finance companies, and IDBI inspects state financial corporations - a modified approach for supervisory assessment of these institutions has been introduced. With regard to the Non-Banking Financial Companies (NBFCs), both their asset and liability side has

been brought under the regulatory oversight through promulgation of the Reserve Bank of India (Amendment) Act, 1997 and strict entry norms were prescribed.

The architecture of financial system is well placed in India with the presence of three regulators and a multitude of self regulatory organisations coupled with various institutions for reducing the systemic risk. Regulatory co-ordination among the three regulators viz., the Reserve Bank for the banking sector and the non-banking financial intermediaries, the Securities and Exchange Board of India (SEBI) for the securities market, and Insurance Regulatory Development Authority (IRDA) for the insurance sector is ensured through a High Level Co-ordination Committee on Financial and Capital Market (HLCCFCM). Besides, a special monitoring system for Systemically Important Financial Intermediaries is being put in place in consultation with other regulators.

Payment and Settlement System

A holistic approach has been adopted towards designing and development of a modern, robust, efficient, secure and integrated payment and settlement system taking into account certain aspects relating to potential risks, legal framework and the impact on the operational framework of monetary policy. Recognising the need for providing a safe, sound and robust platform to facilitate the absorption of technology by banks, the Reserve Bank set up the Institute for Development and Research in Banking Technology (IDRBT) in 1996, which is an autonomous centre for providing essential core networking functions for banks. The development of the payment system infrastructure was strengthened with the introduction of the Negotiated Dealing System (NDS) in February 2002, formation of the Clearing Corporation of India Ltd. (CCIL) in 2001, and the implementation of real time gross settlement (RTGS) system from April 2004. The NDS enables screen based electronic dealing and reporting of transactions in money market instruments, secondary market transactions in Government securities and facilitates dissemination of information on trades with a minimum time lag. It also permits paperless settlement of transactions in Government securities given the

electronic connectivity with CCIL and the delivery vs. payment settlement system at the Public Debt Office. The CCIL acts as a central counterparty through novation and provides guaranteed settlement with risk management systems put in place to limit settlement risks. The RTGS system embodies instantaneous settlement of transactions on a gross basis thereby completely obviating the need for any clearing arrangement in the transaction.

II

Financial Stability as an Objective of Monetary Policy

It is recognised that increased competition in the financial system heightens the need for prudential regulation and supervision to ensure financial stability. In a highly competitive financial market, banks may engage in riskier operations due to the pressure of squeezed profit margins. In such a situation, several central banks have focused increasingly on financial stability, which is evident from various Reports produced on the subject on regular basis in recent years. The Reserve Bank of India, in its recent Report on Trend and Progress of Banking in India, 2003-04 and the latest Report on Currency and Finance, 2003-04 for the first time has devoted separate chapters to “Financial Stability”, thereby communicating to the market the importance it attaches to financial stability. Thus, apart from price stability and availability of credit, financial stability has emerged as an important objective of monetary policy.

Policy measures by the Reserve Bank

The pursuit of financial stability has emerged as the central plank of financial sector reforms in India. The Committee on Financial Systems, 1992 (Chairman: Shri M. Narasimham) recognised financial stability as the *sine qua non* of rapid and sustainable economic progress. The approach towards financial sector reforms is based on *panchasutra* or five principles; gradualism entailing cautious and appropriate sequencing of reform measures, mutually reinforcing norms, complementary reforms across sectors (most importantly monetary, fiscal and external sectors) based on extensive consultations with the stakeholders at each stage, development of financial institutions and development of markets. Although there is a broad commonality in the objectives and instruments of reform for all types of financial intermediaries, the pace and sequencing in each

segment of the financial sector is determined keeping in view its state of development.

In India, price stability has been an abiding objective of monetary policy since Independence. Compared to many other developing economies, the inflation record of India can be considered quite satisfactory although, the degree of success has varied over time. More recently, since the second half of the 1990s, inflation has been brought down to an average of five per cent per annum as compared to an average of around 8-9 per cent per annum in the preceding two and a half decades. The reduction in inflation since the early 1990s has also enabled to stabilise inflation expectations. Inflation expectation *inter alia* depends upon fiscal prudence. The recently enacted Fiscal Responsibility and Budget Management Act with its envisaged reduction in key deficit indicators is expected to reduce the fiscal dominance over time and in turn, provide the Reserve Bank further flexibility so as to maintain low and stable inflation. Adherence to these fiscal rules will stabilise inflation expectations and thus contribute to efforts of price stability.

The reform of banking sector has encompassed measures pertaining to competition, adoption of prudential norms, development of markets, institutions and the legal environment, and improvements in supervisory process. In India, concerted efforts have been made towards the development of a multi-institutional structure in the financial sector and the emphasis has been on the increased efficiency of institutions through competition. Competition has been infused into the financial system principally through entry liberalisation, easing of statutory pre-emption, deregulation in interest rates, granting of functional autonomy to banks and allowing greater participation of private sector and foreign banks.

Prudential Norms

In the Indian context, a major element of financial sector reforms has been the adoption of a set of prudential measures relating to capital adequacy, income

recognition, asset classification and provisioning, exposure norms, disclosures, investment and risk management as well as asset-liability management aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and credibility. In keeping with the vision of developing an internationally competitive and sound domestic banking system, the deepening and broadening of prudential norms have been the core of the approach to financial sector reforms. The calibration of the convergence with international standards is conditioned by the specific realities of the domestic situation.

Ownership Structure

The criticality of the ownership structure of banks for financial stability arises in the context of the concentrated shareholding in banks controlling huge public funds, and the risk of concentration of ownership leading to potential problems of moral hazard and linkages of owners with businesses. In order to promote diversified ownership of private sector banks, guidelines were issued by the Reserve Bank in February 2004 in regard to acquisition / transfer of shares of a private sector bank which would take the aggregate shareholding of an individual or a group to equivalent of five percent or more of the paid up capital of the bank. In July 2004, a comprehensive policy framework for ownership and governance in private sector banks has been placed in the public domain by the Reserve Bank in the form of draft guidelines, for wider public debate.

NPA Management

The Reserve Bank along with the Government, has initiated several institutional measures to contain the levels of NPAs. Notable among these include Debt Recovery Tribunals, *Lok Adalats* (people's courts) and Asset Reconstruction Companies (ARCs). A set of guidelines has been issued to financial entities, so that the process of instituting ARCs proceeds on smooth lines. The Reserve Bank has given license to three ARCs out of which one has started functioning. Settlement Advisory Committees were formed at regional and

head office level of commercial banks. Corporate Debt Restructuring (CDR) mechanism was institutionalised in 2001 to provide a timely and transparent system for restructuring of large corporate debts with the banks and financial institutions. While several measures, as mentioned above, have been undertaken towards preventing the accumulation of NPAs, the issue of creditor rights has been addressed through the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act in April 2002. The Reserve Bank's thrust on adequate level of provisions is reflected in the fact that the cumulative level of provisioning for the scheduled commercial banks works out to 70.6 per cent of gross NPAs as at end-March 2004. This achievement is notable in comparison with the internationally prescribed benchmark of 50 per cent provisioning against NPAs. The gross NPAs to gross advances ratio during 2003-04 registered a sharp decline to 7.2 per cent despite a switchover to 90 days delinquency norm from 15.7 per cent during 1996-97. Increased higher provisioning together with falling gross NPAs led to a decline in net NPAs to net advances ratio declining to 2.9 per cent during 2003-04 from 8.1 per cent during 1996-97. In an open economy environment, several banks have witnessed significant internationalisation of their balance sheets arising from cross border capital flows and international banking operations. In order to guard against the risks associated with country exposures, banks have been advised to make provisions, with effect from March 31, 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent, depending upon the risk categories prescribed in the country risk management (CRM) guidelines.

Capital Adequacy and Basel II Norms

A strong capital base of banks is essential for ensuring sustained growth of banks' business and for absorbing unexpected losses. The capital to risk weighted assets ratio (CRAR) based on Basel Capital Accord I has evolved as the widely accepted method of measuring soundness and solvency of banks. The

CRAR system requires banks to hold different categories (tiers) of capital against assets and off-balance sheet items with different risk weights. With a view to adopting the Basel norms, the Reserve Bank decided in April 1992 to introduce the CRAR system for banks (including foreign banks). Initially, the CRAR was fixed at 8 per cent on par with the international benchmark. With greater deepening of the financial sector in the 1990s, the focus shifted to having tighter prudential norms, and the CRAR was raised to 9 per cent in March 2000.

The Basel Committee on Banking Supervision (BCBS) released the New Capital Accord (Basel II) on June 26, 2004 which is expected to be implemented by the end of 2006 (Box II.10). Since well-established risk management system is a pre-requisite for implementation of advanced approaches under Basel II, banks were advised to examine in-depth the options available under Basel II and draw a road map by end-December 2004 for migration to Basel II and review the progress made thereof at quarterly intervals. The Reserve Bank would be closely monitoring the progress made by banks in this direction.

Investment Portfolio

In order to make the valuation of the banks' investment portfolio reflective of the purpose, commercial banks have been urged to classify their entire investment portfolio, with effect from September 30, 2000 (from March 31, 2001, in the case of select FIs) under three categories, viz., 'held to maturity (HTM)', 'available for sale (AFS)' and 'held for trading (HFT)'. Banks have been urged to prepare themselves to comply with the prudential requirements in regard to their investment in non-SLR securities by the end of December 2004. The investment portfolio has been subjected to the discipline of marked-to-market accounting norm and strict rules regarding realisation of profit and loss.

Transparency and Disclosure

The range of disclosures have gradually been expanded over the years and presently includes a host of indicators relating to capital adequacy (Tier I and

Tier II capital separately), Government shareholding, NPAs, and also movements in NPAs, exposure to sensitive sectors (capital market, real estate and commodities), movements in provisions for NPAs and investments as also information on corporate debt restructuring. These are being further enhanced to incorporate asset-liability management, risk management policies, concentrations, connected lending, evaluation of investment in subsidiaries, various performance measures and indicators thereof. Banks are providing information on various indicators in the form of notes to accounts and schedules in their balance sheets. In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks have been advised on October 19, 2004 that all cases of penalty imposed by the Reserve Bank as also strictures/directions on specific matters including those arising out of inspection will be placed in the public domain with effect from November 1, 2004.

Banks, which have issued shares to the public and are listed on stock exchanges, have been advised to form committees to look into redressal of shareholders' complaints and to provide un-audited financial results on a half yearly basis to their shareholders with a summary of significant developments. It was observed that the procedures in regard to appointment and removal of external auditors are more stringent in banks than those recommended by the SEBI Committee.

Strengthening Markets

With the ongoing financial liberalisation, a number of measures have been taken to widen, deepen and integrate various segments of the financial markets. In India, development of financial markets has been pursued essentially for bringing about transformations in the structure, efficiency, and stability of markets as also integration of markets. The emphasis has been on strengthening price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. Initially, under the reform process, the changes in

the money market structure were brought in through a gradual shift from a regime of administered interest rates to a market-based pricing of assets and liabilities, development of infrastructure, and introduction of new instruments. The reform of money market also focused on greater and wider participation of other financial institutions for deepening of the market. The Reserve Bank influences liquidity and interest rates through a number of operating instruments, viz., cash reserve requirements of banks, conduct of open market operations, repo transactions, changes in the Bank Rate, and at times through foreign exchange swap operations. In recent times the Reserve Bank's strategy has focused on developing pure call/notice money market, instituting full-fledged Liquidity Adjustment Facility, developing infrastructure, promoting transparency, and various measures pertaining to instruments for non-bank participants. A revised LAF scheme was operationalised in April 2004. The LAF scheme has been operated with overnight fixed rate repo and reverse repo from November 1, 2004. From October 29, 2004, a switchover to the international usage of the terms 'repo' and 'reverse repo' has been effected.

As a debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank in facilitating price discovery and reducing the cost of Government debt. Efforts toward development of the Government securities market have focused on three areas: institutional measures, innovations through instruments, and enabling measures. During the 1990s, the approach to development of Government securities market focussed on removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions, and improvement in trading, clearing and settlement practices. Reforms also encompassed regulatory and legal changes, technological upgradation and refinement of the market microstructure.

The Indian forex market has widened and deepened during the 1990s on account of implementation of various measures recommended by the High Level Committee on Balance of Payments in 1993 (Chairman: Dr. C.Rangarajan), the

Expert Group on Foreign Exchange Markets in India in 1995 (Chairman: Shri O.P.Sodhani) and the Committee on Capital Account Convertibility in 1997 (Chairman: Shri S.S.Tarapore). With the transition to a market determined exchange rate system in March 1993 and the subsequent gradual liberalisation of restrictions on various external transactions, ensuring orderly conditions in the forex market in India has become one of the key objectives. The Reserve Bank has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. In recent years, forex flows, especially due to increasing capital flows, have posed various challenges for liquidity management since these have implications for the conduct of domestic monetary policy and exchange rate management. In the context of large forex inflows that India has been experiencing, the Reserve Bank has been reviewing the operational aspects of inflow of forex, *i.e.*, the extent of forex market intervention and consequent build up of reserves, and the need for and extent of sterilisation required. The Reserve Bank's approach towards ensuring stability of forex market has been evident on various occasions. During the late 1990s, in particular, 1997-98, the forex market remained stable despite the Asian crisis. The forex market exhibited orderly conditions during 2001-02 and 2002-03 despite the September 11 development in the US, international oil price movement in the external front and various domestic developments arising from border tensions, natural calamities such as cyclone and earthquake, and monsoon failure. During 2002-03 and 2003-04, forex market again attested to stability and orderly conditions in the wake of redemption of Resurgent India Bonds, and the surge in capital flows.

Risk Management

At the same time, several efforts were directed towards tackling risks that exist in a market-oriented economy. Over the past few years, the Reserve Bank of India has initiated several steps to promote adequate risk management systems across market participants. Among the measures that were instituted to insulate the financial institutions from the vagaries of the market were gradual

increase in the cushion of capital, frequent revaluation of the portfolio based on market fluctuations (marking to the market) and a framework for asset liability management (ALM) to combat the risks facing the Indian financial Sector. For active players in the Government Securities market such as the Primary Dealers, sophisticated Value at Risk (VaR) models were introduced in December 2000. Initially introduced to measure market risk capital for regulatory purposes, the PDs are increasingly using VaR measures for their day-to-day risk management practices. The Reserve Bank has also encouraged better risk assessment within banks and financial institutions, both public and private. Such improved risk management systems are not only crucial stepping stones towards Basel II mandate but also are expected to enable banks to shed their risk averse attitude and contributing more finance to hitherto unbanked segments of agriculture, industry and services. The necessity of risk identification, measurement and management by market players assume critical importance in view of the recent hardening of interest rates owing to rising inflationary expectations, increase in international interest rates and profit booking by investors. The Reserve Bank is overseeing the migration to Basel II norms as part of its commitment towards convergence with international standards and best practices, with suitable country specific adaptations.

Interest Rate Risk

Given the significant share of investments especially in Government securities in the assets portfolio of commercial banks, the interest rate sensitivity of their balance sheets is critical. The Reserve Bank conducts periodic sensitivity analysis of banks' investment portfolio, based on the Standardised Duration Approach suggested by the BIS. Along with this, the Reserve Bank also estimates the cushion available in terms of unrealised gains on banks' investments portfolio and assesses their ability to withstand the impact of rising yields on their balance sheets. Banks have been sensitised about the need to take adequate measures to address the interest rate sensitivity of their portfolio.

Building up of IFR discussed earlier has been an integral part of the strategy to deal with the interest rate risk.

Exchange Rate Risk

The policy pronouncements of the Reserve Bank continue to express concern over unhedged foreign currency borrowings by corporates, which could impact their overall financial status leading to instability in the financial system under severe uncertainties. Recognising such potential risks, the Reserve Bank in its mid-term Review of October 2001 has stressed the importance of banks' monitoring of large unhedged foreign currency exposures of corporates. Further in the mid-term Review of November 2003, banks have been advised to adopt a policy, which explicitly recognises and takes account of risks arising out of foreign exposures of their clients. Accordingly, banks have been advised that all foreign currency loans above US dollar 10 million or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolio of such exposures could be extended by them on the basis of a well laid out policy of their Boards except in cases of export finance and loans extended for meeting forex expenditure. Banks were advised to ensure hedging of significant but avoidable risks to corporate balance sheets on account of their forex exposures, which might also possibly impact the quality of banks' assets. In view of the implications of unhedged foreign currency exposures of corporates for financial stability in the event of unforeseen adverse conditions, banks have been advised to adopt a policy, which explicitly recognises and takes into account risks arising out of foreign currency exposures of their clients. Further, in view of the systemic risk, banks have been encouraged to obtain information from their large borrowers on their unhedged forex exposures, so that the banks, in turn, can assess the risk of their own exposure to such corporates on an on-going basis.

Derivatives

Credit exposures on derivative products have important ramifications for banks. Therefore, it is crucial that these are measured appropriately. As per the

instructions, prior to March 31, 2003, exposures by way of non-funded credit limits were captured at 50 per cent of such limits or outstandings, whichever is higher. Besides, the exposure of banks on derivative products, such as, Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRS) was captured for computing exposure by applying the conversion factors to notional principal amounts as per the original exposure method. With effect from April 1, 2003, in addition to reckoning non-fund based limits at 100 per cent, banks have been advised to include forward contracts in foreign exchange and other derivative products at their replacement cost value in determining individual / group borrower exposure.

The Reserve Bank set up an Internal Working Group on Derivatives in September 2003 which recommended, *inter alia*, (i) harmonisation of regulations between OTC interest rate derivatives and exchange traded interest rate derivatives; and (ii) permission to those banks to hold trading positions in IRF market which have adequate internal risk management and control systems and robust operational framework subject to certain conditions. The recommendations of the Working Group are under examination.

As the Indian financial system underwent structural changes relating to ownership, competition and integration of financial markets, the necessity of an ongoing restructuring of the regulatory framework and improved monitoring of the embedded risks in the financial system was also recognised. The hallmark of Indian regulatory response has been its inclusive approach through a consultative framework, increased emphasis on self regulation and strengthening of market participants through measures of capital adequacy, corporate governance and effective internal control mechanisms. Like the regulated entities, the regulators must improve their risk measurement and management systems in the light of BASEL II process. Increasingly, on-site supervision is being complemented by Risk based supervision. Presently, the RBS has been used in 23 Banks on a pilot basis, but one can certainly visualize the extensive use of RBS by regulators in India in the near future. In view of the complex nature

of operation of financial conglomerates, the Reserve Bank of India is putting in place appropriate supervisory strategies.

Framework of Crisis Prevention and Management

The framework of crisis prevention and management has encompassed various methods and instruments. These include the Early Warning System (EWS), Prompt Corrective Action (PCA), exposure norms for single and group borrowers and exposure to sensitive sector and derivative products, prescription of safeguards for prevention of frauds, guidelines on 'Know Your Customer' (KYC) to combat money laundering and financing of terrorism, setting up of Credit Information Bureau of India Ltd. (CIBIL) in 2001 to compile and disseminate credit information and managing troubled banks through capital restructuring, consolidation and liquidity support. India is the second country to institute a Deposit Insurance Scheme way back in 1961 in the wake of failure of a few banks. In India, the Deposit Insurance System is mandatory and covers all commercial banks and all 'eligible' cooperative banks, with the exception of certain co-operative banks in some States, which do not comply with the provisions of the DICGC Act, 1961 relating to 'eligible banks'.

As part of the Reserve Bank's initiatives in adopting best international practices for monitoring the stability of financial system in India, the Reserve Bank has been compiling macro-prudential indicators (MPIs) since March 2000. The review of MPIs covers the areas of capital adequacy, asset quality, risk management, management soundness, earnings and profitability liquidity, interest rate, maturity structure of assets and liabilities, and various indicators pertaining to major segments of financial markets such as debt, forex, capital market segments, besides macroeconomic indicators such as growth, inflation, interest rate, exchange rate, *etc.* The MPI review is accompanied by a review of developments in the global environment. The MPI review is prepared on a half-yearly basis and covers commercial banks, financial institutions and the co-

operative banks. As part of the efforts to disseminate these Financial Soundness Indicators (FSIs), the Reserve Bank has started publishing the core set of indicators in its various publications.

The achievements so far

There is very little doubt that the profitability of the banking system has improved during the 1990s. The net profits of the scheduled commercial banks climbed steadily from 0.2 per cent of total assets as at end-March 1996 to 1.1 per cent as at end-March 2004. This increase in profitability was achieved despite a narrowing of spreads and higher provisions for non-performing loans.

How was this increase in profitability possible? While one expects that the competitive forces during a period of financial sector reforms will drive the profits down, competitive forces also results in making a firm more conscious about its cost structure, so as to improve its bottom line. In fact, in the Indian case, the improvement in profitability was primarily due to a combination of larger non-interest incomes and a curtailment in operating expenses, including the wage bill.

The improvement in the profitability of the banking system has been reinforced by an improvement in its health. The CRAR of the banking system, as at end-March 2004, worked out to 12.9 per cent of assets, far above the stipulated 9 per cent. The ratio of net performing assets to net advances declined to 2.9 per cent as at end-March 2004 from 8.1 per cent as at end-March 1997. It will be appreciated that the improvement in CRAR partly reflects the recapitalisation of banks by the Government. At the same time, it is also true that a number of banks have been accessing the capital market for funds since the mid-1990s.

How do the Indian banking sector stand vis-à-vis banks in other countries? Spreads in India were marginally higher than those in East Asian countries and

major developed economies.

The profitability of the Indian banking system was reasonably in line with the international experience. The level of competition, as measured by concentration ratio, in India compared favourably with several Asian and Latin American countries. The overall CRAR of the Indian banking system, although much above the prescribed level, was significantly lower than that of several countries in Asia and Latin America. Finally, overall asset impairment in India was also at a much higher level in comparison with several other countries.

III

Some Issues in Banking and Finance

I. Banking and Finance

When we look at the major features of international banking and financial scenario, the following characteristics come immediately to mind.

First, in terms of **the structure of the industry**: the number of large and medium domestic banks¹ tends to be much larger in developed countries as compared with emerging economies. The developed countries thus enjoy a major size advantage and the reality can't be wished away.

Second, given the dominance of banks in the financial system the **share of bank asset** in total financial sector asset in most emerging markets, bank assets comprise a significant proportion of total financial sector assets, whereas these figures are much lower in developed economies.

Third, compared to the developed countries, emerging markets are characterised by **industry concentration**, measured by the percentage of a country's banking sector assets controlled by the largest banks. In most emerging market economies, the five largest banks (usually domestic) account for over two-thirds of bank assets. According to the BIS, in 1999, the share of assets held by the five largest institutions was 43 per cent in East Asia and 59 per cent in Latin America.² These figures tend to be much lower in developed economies.

Fourth, the **internationalisation** of banking sector of emerging markets, defined by the share of foreign-owned banks as percentage of total bank assets, has increased significantly in recent years. For example, in Eastern Europe, the

¹Defined as the number of banks ranked in the world's top 1000.

² BIS (2001), *The Banking Industry in Emerging Market Economies: Competition, Consolidation and Systemic Stability*, BIS Paper No. 4, August.

share of banking assets under foreign control increased from 25 per cent in 1995 to 30 per cent in 2000. In Latin America, almost 40 per cent of total bank assets was controlled by foreign banks in 2000, following a series of cross-border mergers and acquisitions. Indonesia, Korea and Thailand have also raised allowable foreign equity levels in local banks to 100 per cent.

Finally, the **share of state-owned banks** in total banking sector assets is considerably higher in many emerging economies. Illustratively, in 2000, the share of state-owned banks was well over 90 per cent in China and in the range of 12-30 per cent in Asian economies such as Korea, Philippines and Thailand.

In recent times, the process of **consolidation of banking industry has accelerated**. The consolidation process has, however, been much more rapid in developed countries due to the overwhelming nature of cross-border mergers and acquisitions.

Issues facing the Indian Banking Sector

What strategies can be adopted by Indian banks to become and remain globally competitive? While there is no single *mantra* to become globally competitive, let me raise a few issues on this count, which have relevance to the central theme of the Conference.

The first is the issue of **consolidation**, which is the current buzzword in the banking industry worldwide. According to *The Banker 2004*, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan and around 40 in the UK. Even China has as many as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. The largest bank in China with an asset base of over US \$400 billion. In contrast, the total asset of the largest two banks in India, one in public sector and another a private entity, are US \$127 billion and US \$29 billion. These figures are extremely illuminating

and the onus is on Indian banks to take cognisance of this fact. The Government has raised the cap on FDI in private banks. The RBI has, on its part, suggested certain changes in the *Banking Regulation (Amendment) Bill, 2003* that seek to address some of the legal impediments arising in the consolidation process.

The second issue of import is that of **management of costs**. Cost containment is a key to sustainability of bank profits as well as their long-term viability. In 2003, operating costs of banks, expressed as per cent of total average asset, was lower than 2 per cent in major European economies like Sweden, Austria, Germany and France. In contrast, in 2003, operating costs of commercial banks in India were 2.24 per cent of total assets. The downward stickiness continued in 2004 as operating costs have remained well above 2 per cent, as percentage of total assets. If we combine this fact with bank size in these economies, the evidence comes across loud and clear.

Another related aspect is the cost of funds of the banking sector.³ In tandem with the soft interest regime over the last few years, cost of funds of the banking sector has been declining. The cost of funds of public sector banks, which was 6.9 per cent in 1995-96 has since declined to 5.0 per cent in 2003-04. Other bank groups have also experienced concomitant declines. With the rise in oil prices and its cascading effects on inflation along with the raising of policy rates by several central banks, sooner or later, this reversal of the existing comfortable liquidity conditions is likely to have ramifications on domestic financial markets, and with that, on the cost of funds of banks as well. Diversification into fee-based activities coupled with prudent asset liability management hold the key to future profitability.

The issue of **credit delivery systems** has come into focus of late. The persistence of divergence between the informal and formal sector interest rates in effect has meant that, with deregulation, the formal credit mechanisms have not been able to pierce the informal system. The differences in 'apparent

³ Cost of funds=[(Interest paid on deposits *plus* interest paid on borrowing)/(Deposit plus borrowing)]

cost' and 'total real cost' might be an important factor behind this divergence.⁴ Reducing the 'total real cost' in the formal sector is likely to be an important consideration to bring about a degree of convergence between the price of credit between the formal and informal sectors. In recognition of this fact, the last several Annual policies have placed explicit emphasis on streamlining credit delivery through a gamut of measures, including, among others, widening the scope of infrastructure lending, revamping the rural credit delivery system by envisaged restructuring of the rural banking segment, widening the scope of priority sector lending, and the like. I am sure that Indian banks would be up to the task to address the issue of credit delivery.

The fourth issue is the **management of sticky assets**. This is a key to the stability and continued viability of the banking sector. Although the ratio of nonperforming loans to total assets are higher in comparison to international standards, the Indian banks have done a marvellous job in containment of non-performing loans (NPL) in recent times. Non-performing loans to total loans of banks were 1.2 per cent in the US, 1.4 per cent in Canada and in the range of 2-5 per cent in major European economies. In contrast, the same for Indian banks was 8.8 per cent. Gross NPL ratio for Indian scheduled commercial banks declined to 7.3 per cent in 2004 bearing testimony to the serious efforts by our banking system to converge towards global benchmarks. In fact, recovery management is also linked to banks' interest margins. Net interest margins of scheduled commercial banks in India was 2.8 per cent in 2003, whereas it stood far lower in the range of 0.6-2.4 per cent at major European and Japanese banks.

The fifth issue concerns the **management of risks**. Banking in modern economies is all about risk management. The successful negotiation and implementation of Basel II is likely to lead to an even closer focus on risk measurement and risk management at the institutional level. Thankfully, Basel II

⁴ 'Apparent cost' is what is shown in the loan document, whereas 'total real cost' includes cost incurred on formalities, including documentation (number of photocopies required, the paper work, transportation cost, etc.)

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

It must be noted in this context that for active players in the Government Securities market such as the Primary Dealers, Value at Risk (VaR) models were introduced in December 2000. Initially introduced to measure market risk capital for regulatory purposes, the PDs are increasingly using VaR measures for their day-to-day risk management practices.

Improved risk management practices by financial intuitions is the key to success in a competitive environment where new instruments such as derivatives are introduced in a gradual and progressive manner. Financial innovation provides opportunities and rewards to those with enterprise and vision.

But at the same time, it exposes them to increased risks. Unless market participants institute sound risk management systems, holding trading positions tantamount expose them to severe risks. Indeed, risk taking and risk management must go hand in hand. The financial market needs players who are not afraid to take contrarian positions, who search for unoccupied habitats to provide diversity, provided they have adequate risk management systems in place. For market participants, there is little room for complacency and there appears to be no choice but to be pro-active in instituting appropriate risk management models. My view is that early adoption in this regard makes sound business sense and may prove immensely beneficial in a competitive financial sector.

Challenges to Financial Modelling

Let me add a few technical issues which are at the very core of an effective risk management system. While putting in place internal risk management models, particularly the Value at Risk models that are fast becoming industry standards, it is necessary to examine their relevance in the Indian financial markets that are characterized by fat tail behaviour. In this context, normal distribution based models may prove inadequate as they are prone to serious model risks. Historical simulation models that rely on full valuations are free from model risks, but may face data constraints. In such situations, extreme value models and models based on Monte Carlo simulations can improve the accuracy of risk measurement. At the same time, attention needs to be paid to correlations amongst assets in diversified portfolio for purposes of risk aggregation. It is also necessary to conduct periodic scenario analysis and stress testing to supplement risk models.

Regulatory and Supervisory Initiatives

As the Indian financial system undergo structural changes relating to ownership, competition and integration with global financial markets, the necessity of an ongoing restructuring of the regulatory framework and improved monitoring of the embedded risks in the financial system was also recognized. The hallmark of Indian regulatory response has been its inclusive approach through a consultative framework, increased emphasis on self regulation and strengthening of market participants through measures of capital adequacy, corporate governance and effective internal control mechanisms. Increasingly, on-site supervision is being complemented by Risk based Supervision(RBS). Presently, the RBS has been used in 23 Banks on a pilot basis, but one can certainly visualize the extensive use of RBS by regulators in India in the near future. In view of the complex nature of operation of financial conglomerates, the Reserve Bank of India is putting in place appropriate supervisory strategies. Regulatory initiatives also include consolidation of domestic banking sector; restructuring of Development Finance Institutions; and appropriate timing for the significant entry of foreign banks so as to be co-terminus with the transition to greater capital account convertibility while being consistent with our continuing obligation under the WTO commitments. In respect of foreign banks, regulatory initiatives are directed at: choice of the mode of presence, acceptable transition path, according national treatment, addressing supervisory concerns, linkages between foreign banks and their presence in other (non-banking) financial services.

Addressing Systemic Volatility

Another concern in financial market is the risks arising from market liquidity which may create adverse impact on volatility of interest rates. Since 2001, the Liquidity Adjustment Facility (LAF) has been instrumental in smoothening temporary liquidity mismatches while at the same time contributing to stability in short term rates within the repo-reverse repo corridor. The Reserve

Bank of India has kept a close watch on the liquidity situation. Financial markets in India were characterized by ample liquidity in recent times, mainly due to persistent capital inflows. During 2004-05, liquidity absorption through Market Stabilization Scheme (MSS) was Rs.54,146 crore up to October 21, 2004. With the issuance of MSS, the repo volumes tendered under liquidity adjustment facility declined from an average of Rs.70,523 crore in April to Rs.13,805 crore in October 2004 (up to October 21). In addition to MSS and repo, surplus balances in the Central Government account with the Reserve Bank also helped in sterilizing excess liquidity from time to time. The Reserve Bank presently has sufficient flexibility in terms of instruments to contain market fluctuations through conduct of Open Market Operations(OMO). This apart, the Reserve Bank continues to monitor day-to-day liquidity through liquidity models and several measures of liquidity aggregates.

Improving Payment and Settlement Systems

Several efforts at reducing Settlement Risks have been undertaken in recent years. The payment system in India has been considerably strengthened in 2003-04 with the introduction of Real time Gross Settlement System (RTGS), the Special Electronics Funds Transfer System and the Online Tax Accounting System. Liquidity in the Government Securities Market was enhanced by the introduction of Delivery versus Payment (DvP III) mode from April,2004. Automated value-free transfer of securities between market participants and the CCIL was facilitated to further develop the collateralized borrowing and lending obligation (CBLO) segment. CCIL has also developed the pricing and risk models for settling OTC derivatives, that is expected to be operationalised by March 2005. The national settlement system which would link up different clearing houses managed by RBI and other banks for centralized settlement is expected to be operationalised in early 2005. Appropriate risk mitigation mechanism for the retail payment systems is also under the active consideration

of RBI and IBA. A Working Group under the Chairmanship of Dr. R.H. Patil reviewed the performance of NDS in the context of its operational efficiency and recommended an anonymous electronic screen based order matching trading system on the NDS. These measures are likely to reduce settlement risks while cutting down the costs of intermediation in the near future.

Finally, I would be failing in my duty if I am silent on **governance**. Governance issues in banks as also in capital markets have come to occupy centre-stage in recent times, in view of the irregularities involving accounting firms in the US and elsewhere. The quality of corporate governance becomes critical as competition intensifies, ownership is diversified and banks strive to retain their client base. You would be aware that the RBI has, on its part, made significant efforts to improve governance practices in banks, drawing upon international best practices. Thus, the recommendations of the Consultative Group under the Chairmanship of Dr. A.S. Ganguly were forwarded to banks for implementation. It is heartening to note that corporate governance presently finds explicit mention in the annual reports of several banks. Having said that, it is important to recognize that there is nothing like 'optimal' level of corporate governance. As banking business becomes more and more complex, banks should continuously strive to improve shareholder value through better governance practices.

In this context, governance issues in private banks have lately received a lot of attention, more so in view of the recent draft guidelines in this regard by the Reserve Bank. The intention of the draft policy has been to ensure adequate capital and consolidation in the banking industry with the regulator being aware of the intention of existing and potential shareholders. As announced in the recent Mid-term Review, the RBI is consolidating the feedback received and after dialogues with various stakeholders, a draft policy framework has been finalised and would shortly be placed in public domain.

Section IV

Proposals in Union Budget 2005-06 : MEASURES RELATING TO RBI

(i) Rural Infrastructure

It is proposed to provide a corpus of Rs.8,000 crore in 2005-06 to the Rural Infrastructure Development Fund which was revived last July.

(ii) Rural Credit and Indebtedness

The Reserve Bank of India (RBI) is requested to examine the issue of allowing banks to adopt the agency model, by using the infrastructure of civil society organisations, rural kiosks and village knowledge centres, to provide credit support to rural and farm sectors.

(iii) Micro Finance

The programme of linking Self Help Groups (SHGs) with the banking system has emerged as the major micro-finance programme in the country. The Budget proposes to enhance the target for credit-linking in the next fiscal from 2 lakh SHGs to 2.5 lakh SHGs.

(iv) Special Purpose Vehicle

A financial Special Purpose Vehicle (SPV) to be established to finance infrastructure projects that are financially viable; SPV to lend funds, especially debt of longer term maturity directly to eligible, appraised projects to supplement other loans; limit for 2005-06 to be fixed at Rs.10,000 crore. A provision of Rs.1500 crore for "viability gap" funding for infrastructure projects has also been made. That mechanism will be used also in conjunction with the funding mechanism through the SPV.

The road ahead – Some concluding remarks

Financial sector reforms adopted in the 1990s have enhanced the strength of banks and financial institutions in India. The reform measures adopted have ensured that their asset quality and profitability have improved. A striking feature of these institutions has been their improved resilience to the domestic and the external environment. The reform process has changed the relationship between the Reserve Bank and commercial banks from one of micro regulation to that of macro management.

Consistent with the shift in the functioning in a competitive economy and to the adoption of prudential best practices, the major challenges facing the banking sector are the deployment of funds in quality assets and the management of risks and returns. Concurrently, the issues of corporate governance and appropriate disclosures for enhancing market discipline have received regulatory attention for ensuring increased transparency and greater accountability. The importance of building an investment fluctuation reserve for dealing with the interest rate risk has been emphasised by the Reserve Bank. As Indian banks gear up for migration to Basel II, the progress made by banks in this direction is being monitored by the Reserve Bank with reviews at quarterly intervals. However, as a logical step before migration to capital adequacy norms under Basel II, banks have been mandated to maintain capital charge for market risk. The Reserve Bank on its part is making efforts to formulate policies to deal with risks arising on account of operations of large and complex financial institutions and issues relating to the adoption of Basel II in the form of supervisory and regulatory challenges. In view of complexities involved in migrating to Basel II, a Steering Committee comprising members from banks, Indian Banks' Association and the Reserve Bank has been constituted for implementation of Basel II. Besides migration to Basel II, issues of corporate governance and ownership, risk based supervision, technological innovation and its spread and improved transparency

would be the focus area in the near future. There still remains scope for improvements in the operational efficiency of the banking sector. Moreover, despite the decline in the stock of NPLs in the banking system their absolute amount remain high. The legal provisions and practice in bankruptcy of the real sector are still inadequate and need further reform.

A vision document for the future role of UCBs is being evolved to ensure depositors' interests and avoid contagion while providing useful service to the local communities. In regard to structural issues, the Reserve Bank would be encouraging growth of strong and viable entities within the sector through consolidation. Further, the Reserve Bank would continue to pursue with the Central and State Governments regarding the issues that arise in their jurisdiction.

The Working Group on Development Financial Institutions while recognising the transition that the sector is undergoing, recommended various measures including permitting long term finance, conversion of DFIs into banks or NBFCs, revival of financially sick SFCs and eventual phasing out of SFCs, portfolio shift toward more liquid assets, corporatisation with wide shareholding, strengthening of regulatory framework, *etc.*

In order to bring NBFCs in line with international practices, the Reserve Bank intends to initiate a consultative process with the NBFCs with regard to their plan of action for voluntarily phasing out of their acceptance of public deposits. Recently, the Reserve Bank has envisaged a road map for Residuary Non-banking Companies (RNBCs) with a view to smoothening the process of transition of these institutions to compliance with the Reserve Bank's directions.

In retrospect, the weight accorded to financial stability in India appears to be higher than in many other countries. But there is hardly any room for complacency. The regulator and the market must join hands together to strive towards financial stability. The complementary role of the central bank and market players needs to be appreciated. The risk management efforts of market

entities when coupled with efforts by the central bank to ensure systemic stability can indeed be beneficial for the health and soundness of the Indian financial sector.