

## Y V Reddy: Towards globalization in the financial sector in India

Inaugural address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Twenty-Fifth Bank Economists' Conference - 2003, Mumbai, 11 December 2003.

*The references for the speech can be found on the website of the Reserve Bank of India.*

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Mr. Chairman, distinguished panelists, participants and friends,

I am indeed very happy to be, once again, amongst friends - albeit in a slightly different capacity. All of you have been totally supportive to me and, I must express my deep sense of gratitude to you for the warm and affectionate welcome that you gave for my appointment. My address today is in the nature of sharing of some of my preliminary thought processes on the subject of globalisation and the financial sector. The presentation today starts with a framework for appreciating globalization and then provides some insights in the context of the financial sector, with special reference to banking. In the Indian context I would set out some of the initiatives by Reserve Bank of India, which are relevant to the issue of globalisation.

### **Globalisation: a framework**

The concept of globalization, in the sense in which it is used now, can be traced to the phenomenon of nation states. Government-imposed restrictions on movement of goods, services, people and capital are less than a hundred years old; in fact, passports and visas and the whole gamut of restrictions are a feature of the late 19<sup>th</sup> Century and the first half of the 20<sup>th</sup> Century. The nation state put restrictions on its citizens in their involvement with other nation states in what was perceived as the collective self-interest of its citizens. In the context of public policy relating to globalization, a critical issue is the trade-off between individual freedom and collective self-interest as also where the burden of proof lies, namely, with individuals or national authorities.

Globalisation has several dimensions arising out of what may be called the consequential enhanced connectivity among people across borders. While such enhanced connectivity is determined by three fundamental factors, viz., technology, taste and public policy, cross-border integration can have several aspects: cultural, social, political and economic. For purposes of this presentation, however, the focus is on economic integration. Broadly speaking, economic integration occurs through three channels, viz., movement of people, goods and services, and movements in capital and financial services.

The most notable achievement of recent globalization is the freedom granted to some, if not all, from the tyranny of being rooted to a place and the opportunity to move and connect freely. For example, many Indians relatively from poorer sections have benefited by developments in Middle East while many talented professions gained from movement to UK and USA. At the same time, in reality, there are several economic as well as non-economic, especially cultural or emotional reasons for people not globalising.

In regard to trade in or movement of goods and services across borders, there are two types of barriers, viz., what are described as natural and artificial. Natural barriers relate to various costs involved in transportation and information over distances. Artificial barriers are those that are related to public policy, such as, import restrictions by way of tariff or non-tariff barriers. The pace and nature of globalization will depend on the combined effect of technology and public policy, both at national and international levels.

In regard to capital movement also, the interplay between technology and public policy becomes relevant. There are, however, some special characteristics of capital flows. These characteristics have highlighted the issue of what is described as contagion, namely, a country is affected by developments totally outside of its policy ambit though domestic policy may, to some extent, determine the degree of vulnerability to the contagion. In any case, cross-border flows of capital have wider macroeconomic implications, particularly in terms of the exchange rate that directly affects the costs and movement of people as well as goods and services; the conduct of monetary policy and the efficiency as well as stability of the financial system. Furthermore, capital flows by definition involve future liabilities or assets and could involve inter-generational equity issues.

Developments in technology and innovation in financial services impact both domestic and cross-border transactions. The implications for public policy of such developments in the domestic area are on a different footing in the sense that domestic financial markets are in some ways subject to governmental regulation by national authorities while cross-border flows are not as susceptible to governmental regulation. Finally, in the context of cross-border capital flows, in the absence of procedures for dealing with international bankruptcy and facilities for the lender of last resort, the liabilities incurred on private account can devolve on public account. In brief, at this juncture, in respect of global economic integration through movement of capital, several risks devolve on domestic public authorities, especially in the case of developing countries.

Globalisation is a complex phenomenon and a process that is, perhaps, best managed by public policies. In managing the process, developing countries face challenges from a world order that is particularly burdensome on them. Yet, as many developing countries have demonstrated, it is possible for public policy to manage the process with a view to maximizing benefits to its citizens while minimizing risks. The nature of optimal integration, however, is highly country specific and contextual. On balance, there appears to be a greater advantage in well-managed and appropriate integration into the global process, which would imply not large-scale but more effective interventions by governments. In fact, markets do not and cannot exist in a vacuum, *i.e.*, without some externally imposed rules and such order is a result of public policy.

The poor, the vulnerable and the underprivileged will continue to be the responsibility of national governments and hence of concerns to public policy. Sound public policies at the national level in countries like ours are very critical in the current context of levels of development and extent of globalization. In brief, it is necessary to recognize that nation-states, as those still primarily responsible for social order in the communities in which people live, have a duty to manage the process of globalization. This challenge is particularly complex in the area of financial services, more so in the case of banks in the larger emerging economies.

### **Globalisation in the context of the financial sector**

At the outset, it would be useful to consider the emerging picture of financial flows as per the latest data released by IMF in the context of increasing globalisation. For almost all the years from 1999, the current account balance of advanced economies has been negative and it is estimated to reach US 225 billion in the year 2004 from a positive of US \$ 41 billion in 1998. The developing countries, which had a current account deficit of US \$ 83 billion in 1998, are estimated to have a surplus balance of a projected US \$ 28 billion in 2004. It is interesting to note that while globalization is expected to result in flows of capital from developed to developing countries, it is not clear whether the turn arounds in the current account deficits is a temporary phenomenon. The removal or attenuation of cross-border barriers to trade and capital flows renders assessment of international financial flows that much more difficult to capture in the data.

It is also interesting to consider the pattern of net capital flows to emerging market economies. While private net direct investment has been consistently positive and above US \$ 100 billion since 1995 to 2003, private net portfolio investment which was positive in the years 1995 to 1999 is since negative in the rest of the years. The range during 1995-2003 has been from a positive US \$ 83 billion to a negative of US \$ 53 billion. It is, thus clear that both in terms of magnitude and stability, private direct investment seems to have a significant edge over portfolio investment.

On the quality of capital flows, it is interesting to note that at the end of 1997, the estimated share of Off-shore Financial Centres in the total of cross border assets stood at 54.2 per cent, as per a recent study by OECD discussed in the G-20 meeting in Mexico. The study mentions that inadequate access to bank information in such centres greatly facilitates money laundering, smuggling of goods, counterfeiting and financing terrorism, *etc.* In any approach to the policies relating to the financial integration, it may be useful to keep these facts in mind, particularly both quantitative and qualitative factors in such flows, particularly in the context of the banking sector.

As already mentioned, there is an increasing recognition of a distinction between trade integration and financial integration and this distinction has been recognized forcefully in a recent study made a few months ago by the IMF. The summary of the study reads as follows:

“The empirical evidence has not established a definitive proof that financial integration has enhanced growth for developing countries. Furthermore, it may be associated with higher consumption volatility. Therefore, there may be value for

developing countries to experiment with different paces and strategies in pursuing financial integration. Empirical evidence does suggest that improving governance, in addition to sound macroeconomic frameworks and the development of domestic financial markets, should be an important element of such strategies.

It might not be essential for a country to develop a full set of sound institutions matching the best practices in the world before embarking on financial integration. Doing so might strain the capacity of the country. An intermediate and more practical approach could be to focus on making progress on the core indicators noted above, namely transparency, control of corruption, rule of law, and financial supervisory capacity.....”

Apart from this interesting research on the subject, on a judgemental basis, considering the cross-country experiences, it is possible to discern some disconnects between impressions and reality. Though many developing countries have adopted significant policy measures for financial integration with the rest of the world, capital flows both foreign direct investment and portfolio investment, are predominantly accounted for by a few countries which are not very high in terms of financial integration with rest of the world. In other words, *de jure* financial integration seems to be distinct from *de facto* integration. Furthermore, the way the financial markets as well as international financial institutions respond to economies requiring adjustment problems appear to be asymmetrical. The financial markets, in fact, tend to be far more pro-cyclical in the case of the emerging economies, thus making emerging economies subject to greater volatility in flows than the other countries. It is essential to recognise that the capacity of economic agents in developing economies, particularly poorer segments, to manage volatility in all prices, goods or forex are highly constrained and there is a legitimate role for non-volatility as a public good.

### **Globalization and the banking sector**

It is in this overall scenario, the policy relating to the financial services, and in particular banking, must be considered. It is interesting to note that WTO negotiations on financial services have been cautious and the commitments of many larger economies in the banking sector are rather particularly limited. In other words, in the context of issue of national ownership of financial intermediaries, banks appear to have a unique place in public policy. There are several noteworthy features of ownership and control of banks in all major economies - irrespective of whether they are developed or emerging. In almost all cases, banks are either widely held or have substantial State ownership. Furthermore, there are special conditions governing the extent of ownership, the nature of ownership and control, and transfers of such ownership or control through statutory backing. These are justified since the banks are admittedly special. The discussions in WTO on Commitments relating to opening of domestic banking sector to foreign banks/ownership reflects these concerns in most of the major economies.

It is worth recalling what Sir Eddie George, the Governor of Bank of England had said on the subject banks being special: *“they remain special in terms of the particular functions they perform - as the repository of the economy’s immediately available liquidity, as the core payments mechanism, and as the principal source of non-market finance to a large part of the economy. And they remain special in terms of the particular characteristics of their balance sheets, which are necessary to perform those functions - including the mismatch between their assets and liabilities which makes banks peculiarly vulnerable to systemic risk in the traditional sense of that term.”* He is even more forthright in making it clear that treatment of banks can not be on par with non-banks. *“On the other hand, I am not persuaded that the special public interest in banking activity extends to non-banking financial institutions, though different functional public interests in many cases clearly do.”*

Data clearly indicates that banks continue to play a pre-dominant role in financial intermediation in developing countries. This is understandable for several reasons *viz.* the savers’ eagerness for assured income; inadequate capacity to manage financial risks and the fact that the banking institutions in some sense and in different degrees, enjoy deposit insurance and either implicit or explicit guarantee of government.

It is important to note that banking crisis invariably results in heavy costs to the Government, whether they are publicly owned, privately owned, domestically owned or foreign owned. The fiscal costs of banking crises are ownership-neutral.

An important question in this context is whether the role of banks in financial integration in developed countries is different from that in the emerging market economies. It is useful to assess the significant differences in the structure of the banking industry in emerging *vis-à-vis* developed markets.

In most emerging markets, banks assets comprise well over 80 per cent of total financial sector assets, whereas these figures are significantly lower in developed economies. In most emerging market economies, the five largest banks (usually domestic) account for over two-thirds of bank assets. These figures are much lower in developed economies. Another difference in the banking industry in developed and emerging economies is the degree of internationalisation of banking operations. Internationalisation defined as the share of foreign-owned banks as a percentage of total bank assets, tends to be much lower in emerging economies. This pattern is, however, not uniform within world regions.

Finally, a significant feature of banking in developed versus emerging economies, especially in recent years, has been the process of consolidation. The most notable difference between the consolidation process in developed and emerging markets is the overwhelming cross-border nature of mergers and acquisitions in the latter. In particular, cross-border merger activity in continental Europe and also between US and European institutions has been more of an exception rather than the rule. In contrast, there has been a sharp increase in foreign ownership of some emerging market banks due to process of privatisation often associated with crises.

An important difference in this context has been the role played by the authorities in the financial sector consolidation process. In mature markets, consolidation has been seen as a way of eliminating excess capacity and generating cost savings to the institution. In emerging markets, on the other, consolidation has been predominantly a way of resolving problems of financial distress, with the authorities playing a major role in the process.

### **Indian context**

While there has been a significant progress towards globalisation in the recent past and policy-wise, there have been impressive initiatives, the extent to which India is globalised is considerably at the lower end of the emerging economies. This indicates enormous opportunities but also challenges in terms of transition from a stage of low base. More importantly, the issue of financial integration and in particular the integration of banking sector has to be considered in terms of overall sequencing in this process of integration with the rest of the world. The overriding issue is not whether to globalise or not, but how best to manage the process of globalization, particularly with a view to accelerating the process at the current juncture where the global outlook on India and India's confidence as well as competitiveness are strong.

There is now a consensus among academicians and policy makers that trade liberalization should take precedence over financial liberalisation. Even in the context of financial liberalisation, the liberalisation in regard to borrowings in foreign currency should have a lower priority compared to all other capital flows. There is also consensus that the foreign currency exposures of households, corporate sectors and financial intermediaries should be assessed separately and in a continuous fashion to assess the gains as well as the vulnerabilities to the system. In particular, there is a greater recognition of the need to put in place appropriate prudential regulation in regard to the financial intermediaries insofar as foreign currency transactions are concerned in all emerging countries. There is virtual unanimity that the currency mismatches of financial intermediaries is a major source of downside risks of financial integration which can be mitigated by monitoring and regulations. Among the financial intermediaries, banks no doubt have a unique place. There is also a strong consensus, globally, on the importance of what have been described as preconditions for capital account convertibility - in particular on the fiscal front and efficiency of the financial sector.

In the context of maximising benefits of financial integration and minimising the risks, the link with conditions in the real sector cannot be lost sight of. In China, reforms in real sector preceded reforms in the financial sector and it was possibly the reason for some vulnerability of the latter. In India, reforms in financial sector started early in the reform cycle which imparts significant efficiency, and stability to the financial sector. The financial sector can add competitive strength and growth if reforms in the financial and real sectors keep apace. In other words, flexibility in product and factor markets play a part not only in capturing the gains from financial sector reform but also more generally from globalisation. A major agenda for reform at this juncture for us, given the impressive all-round confidence in the economy, relate to the structure and functioning of institutions and in particular the

high transaction costs prevalent in our systems. There are several dimensions to the transaction costs - ranging from legal provisions, judicial system, procedures, etc. to attitudes. It is proposed to mention a few measures being contemplated by RBI in this direction.

### **Some measures by RBI**

At the outset it must be recognized that the improvements in efficiency of the financial sector in India, in particular banking sector have won the respect and admiration of most observers, including capital markets. The banking sector in India is poised for a quantum jump in productivity and scope for expansion in view of the competitive strengths acquired in Indian industry. Public sector banks have shown substantial improvements, though in view of their large presence and some institutional constraints, further progress in reform is desirable. The analysis in the Report on Trends and Progress of Banking in India a few weeks ago provides an excellent overview of problems, prospects, and areas for further reforms, and hence that will not be covered here. The ongoing efforts of RBI, in close co-ordination with Government and consultations with market participants, especially in moving up the policy as well as regulatory regimes to global standards, have been narrated in successive announcements on Monetary and Credit Policy statements by Dr. Rangarajan, Dr. Bimal Jalan, and most recently in the Mid-term Review. These narrations would indicate that RBI's effort is to open up the economy, maximize benefits from globalization while minimizing risks and enable as well as equip banks to face global competition. This is an ongoing process and I believe we in India are better equipped now than ever before to globalise with a sense of confidence and pride. Having said this, it is useful to mention a few initiatives being considered by RBI at this juncture.

Governor Jalan in his Inaugural address to this forum in January 2001, said - "The long term vision for India's banking system to transform itself from being a domestic one to the global level may sound far fetched at present. However, it is not beyond our capacity provided we have the will and the determination". It is interesting that this year, the subject chosen relates to globalization and perhaps I should enlist a few measures taken by RBI to demonstrate the will and determination to make our banking industry really global.

### **Consolidation**

As mentioned by Governor Jalan in his address to this forum in 2002, "In financial systems worldwide, today's buzzwords are competition, consolidation and stability". There has been impressive stability and considerable competition in India but the process of consolidation in banking industry has just commenced. The issue of consolidation has been addressed by the Narasimham Committee Report on Banking Sector Reforms (1998) but the issue in regard to policy is yet to be pursued vigorously. There are three aspects to consolidation viz. clear cut legal and regulatory regime governing consolidation, enabling policy framework especially where several banks are owned by Government, and market conditions that facilitate such consolidation, recognising that all mergers and acquisitions may not necessarily be in the interests of either the parties concerned or the system as a whole.

As regards the legal framework, the Reserve Bank is not very comfortable with lack of clear statutory provision regarding takeover of management of banks. In 1970, the Reserve Bank had issued directions to the banks requiring them to seek the Reserve Bank's permission or acknowledgement before effecting any transfer of shares in favour of any person which would take the holding of shares to more than one per cent (subsequently raised to five per cent) of the total paid up capital of such banking company. Since shares are acquired first and then lodged for registration, the Reserve Bank's directions create a somewhat piquant situation. To plug the gap, a Bill has now been introduced in the Parliament relating to banking regulation. The RBI's proposals in this regard should reasonably take care of takeover of the management by one from another and Reserve Bank will have appropriate regulatory power to satisfy itself that persons proposing to acquire such shares are fit and proper persons.

The procedure for amalgamation of two banking companies under Section 44A of the Banking Regulation Act, 1949 (the Act) is easy to follow and cost effective. After the two banking companies have passed the necessary resolution in their general meetings representing not less than two third value of the shareholding of each of the two banking companies, proposing for the amalgamation of one bank with another bank, such resolution containing scheme of amalgamation is submitted to the Reserve Bank for its sanction and if sanctioned, by an order in writing by the Reserve Bank, is binding not only on the banking company concerned, but also on all shareholders thereof. While sanctioning

the scheme of amalgamation, the Reserve Bank takes into account the financial health of the two banking companies to ensure, *inter alia*, that after the amalgamation, the new entity will emerge as much stronger bank. The experience of the Reserve Bank has been by and large satisfactory in approving several schemes of amalgamation in the recent past.

These provisions, however, do not apply to the banks in public sector, viz., the nationalised banks, State Bank of India and its subsidiary banks. As regards the nationalised banks, the Act authorises the Central Government, after consultation with Reserve Bank, to prepare or make a scheme, *inter alia*, for transfer of undertaking of a corresponding new bank (i.e. a nationalised bank) to another corresponding new bank or transfer of whole or part of any banking institution to a corresponding new bank. Under this procedure, the New Bank of India was amalgamated with Punjab National Bank but the experience in this regard was considered to be not altogether satisfactory. Unlike the sanction of schemes by the Reserve Bank under Section 44A of the Act, the scheme framed by the Central Government is required under Section 9(6) of the Nationalisation Act to be placed before the two Houses of Parliament.

The State Bank of India Act, 1955, empowers the State Bank of India with the consent of the management of any banking institution (which would also include a banking company) to acquire the business, including the assets and liabilities of any bank. Under this provision, what is required is the consent of the concerned bank and the approval of the Reserve Bank and the sanction of such acquisition by the Central Government. Several banks were acquired by the State Bank of India by invoking this section.

Section 23A of the Regional Rural Banks Act, 1976 (RRBs Act), empowers the Central Government, in consultation with the NABARD, concerned State Government and sponsored bank, to amalgamate two RRBs, by issue of notification in the official gazette, with such liabilities, duties and obligations as may be specified in the notification. As in the case of amalgamation of a nationalised bank under Section 9(2) of the Nationalisation Act, every notification under this section is also required to be laid before both the Houses of Parliament.

Of course, in the case of a banking company in financial distress and having been placed under the order of moratorium, on an application being made by the Reserve Bank to the Central Government under sub-section (2) of Section 45 of the Act, the Reserve Bank can frame a scheme of amalgamation for transferring the assets and liabilities of such distressed bank to a much better and stronger bank. Such a scheme framed by the Reserve Bank is required to be sanctioned by the Central Government and has to be notified in the official gazette. As in case of amalgamation sanctioned by the Central Government under the Nationalisation Act and RRBs Act, the notification issued for compulsory amalgamation under Section 45 of the Act is also required to be placed before the two Houses of Parliament.

One area of concern to the Reserve Bank is amalgamation of non-banking companies with banking companies as the law does not impose any obligation on the part of such non-banking company (for that matter, even of the concerned banking company) to seek the Reserve Bank's regulatory approval before filing the scheme of amalgamation in the High Courts under Sections 391 of the Companies Act, 1956. To take care of these gaps, Reserve Bank has proposed some amendments to the legislation on Banking Regulation Act that amalgamation of a non-banking company with a banking company will be made by following the similar procedure which is applicable for amalgamation of two banking companies.

### **Payment system**

Payment and settlement systems in India have had a long history. The current predominant mode of funds settlement is through the clearing process - achieved by the functioning of about 1050 clearing houses in the country. These clearing houses function on the basis of the 'Uniform Regulations and Rules for Bankers' Clearing Houses' (URR), a model regulation propounded by the Reserve Bank. Though the systems are predominantly confined to cheque clearing, many other types have also gained significance - such as electronic payment and settlement, securities settlement, and foreign exchange settlement. All these are regulated by their respective rules and procedures, as in the case of the Rules relating to Electronic Clearing Service (ECS), the Electronic Fund Transfer (EFT) Regulations and the bye-laws relating to the operations of the systems of the Clearing Corporation of India Ltd.

The Bank for International Settlements, Basel, has formulated a set of 'Core Principles for Systemically Important Payment Systems' which are the minimum requirements for a sound payment system. These requirements were also highlighted in the year 2000 by the Bhide Advisory Group which examined the International Standards and Codes relating to payment systems, from the perspective of conformity in the Indian context.

With the growing importance being ascribed towards payment and settlement systems the world over, and in view of their significance for financial stability, most central banks have set up an appropriate machinery to regulate and supervise such systems to provide for an explicit legal base for payment and settlement systems. In this background, a draft 'Payment and Settlement Systems' bill was prepared by the Reserve Bank and forwarded to the Government of India.

In anticipation of the statutory changes, certain preliminary steps are proposed to be taken by the Reserve Bank to build the requisite infrastructure for having effective supervision over payment and settlement systems. A *Board for Payment and Settlement Systems (BPSS)* is proposed to be constituted soon. The Board would function in a manner similar to the Board for Financial Supervision. BPSS would provide policy directions in areas relating to regulation and supervision of payment and settlement systems, approval of payment systems, criteria for membership, various aspects relating to admission, continuation and denial of membership, handling of offences etc. This initiative would ensure that all the payment and settlement systems in the country are subject to good and efficient governance and that they adopt the best practices in risk management which is a prime requirement relating to a safe, secure and efficient payment and settlement systems. These arrangements should facilitate easy transition to a more formal statutory system.

### ***Rating of supervision***

The supervision of banks is, on all accounts, becoming extremely complex. The supervisors are required to acquire technical skills, exhibit considerable judgements on systems and develop inter-institutional interactions on a continuing basis. While every effort is made by the Reserve Bank in this regard, there is considerable benefit in introducing a system of feedback from the supervised banks on the adequacy, appropriateness and quality of supervision. This would help in rating of our supervisory performance from time to time and obtain suggestions for improvements from a range of banks, large and small foreign and local. In the light of discussions in the RBI earlier this week, a decision has been taken to introduce such a system of feedback on supervision from the supervised on a regular and continuing basis. We expect to seek further guidance from Board for Financial Supervision, due to hold its meeting next week and finalise an ongoing system of feedback.

It is hoped that with these arrangements, some of the unnecessary elements will be eliminated while enhancing quality of supervision particularly in terms of its utility to the supervised and result in overall reduction of transaction costs.

### ***Users' panel on regulatory instructions***

A *Standing Technical Committee on Financial Regulation* has been constituted recently to advise on regulatory regimes administered by RBI. It is recognised that in spite of existing consultative process, several regulatory instructions, while laudable in their context are not clear or unambiguous in capturing operational issues at the implementation stage. On the basis of discussions in the RBI, it has been decided to prepare, in consultation with self regulatory organisations, a Users' Consultative Panel consisting of those incharge of compliance in the regulated institutions. The intention is to obtain feedback on regulations at the formulation stage to avoid ambiguities and operational glitches. The Reserve Bank will, from time to time, seek advice from select members of the panel to avoid burdening all officials in the regulated units. I would seek full co-operation from the banking industry in this regard.

### **Conclusions**

In conclusion, I would like to emphasise the role of institutions and incentives in ensuring globalization that benefits all. The global giants in banking all over the world are manned by Indians, educated and trained in India. The best of technology for the most sophisticated banks in the world is provided by Indian companies and by Indians in foreign companies. Yet, banks in India do not as yet appear to be world class, though I have, no doubt, that our banks could well be on the anvil of being reckoned to be

on par with international banks. My submission is that, to reach global standards, and hopefully surpass them, we need to focus on legal, institutional and transactions aspects; and the RBI's measures detailed today try to make a small beginning in addressing some of these issues.

Let me thank the organizers for the opportunity and RBI looks forward to getting the benefit of your discussions in this Conference.