Mr Jalan looks towards a more vibrant banking system

Inaugural address by the Governor of the Reserve Bank of India, Mr Bimal Jalan, to the Bank Economists [apostrophe?]Conference (BECON'98) held at Bangalore on 16/12/1998.

Introduction

I am happy to join this special gathering of bankers and deliver the inaugural address to the conference of bank economists. This year's meeting of bank economists is particularly important as it is being held against the background of one of the worst meltdowns of the financial system experienced by a number of economies.

The recent financial market developments show that we have come to live in a world of considerable uncertainty, where prudence and foresight get rewarded while errors, inadequate judgements and bad decisions impose severe costs on the individual financial intermediary as well as on the financial system as a whole. In today's liberalised financial environment, savers, investors and financial intermediaries are widely dispersed, not necessarily confined to domestic boundaries. This has made capital extremely fluid and highly sensitive to policies and performance of the financial systems of the recipient countries. Pursuing policies and practices that ensure improved efficiency and continued stability of the financial system has assumed critical importance in the present context of a more open world economy.

In India, over the past few years, we have made substantial progress towards improving the performance of our financial system and putting in place a new financial regime which relies less on detailed controls and directions and more on initiative, autonomy in decision-making and accountability. Policy initiatives since 1992 in this regard have been directed at building strength and ensuring the safety and stability of the financial system. Compared with the experience of many developing countries embarking on financial sector reform, we have trodden cautiously and in an orderly fashion, which has helped us in minimising the adjustment costs involved in the process. This, however, should not lead to any complacency, particularly in the context of the present fluidity of international capital markets and the increased vulnerability of developing economies to sharp fluctuations in macroeconomic situations. These disturbances tend to get exaggerated if the financial system is fragile and lacks depth in absorbing internal and external shocks.

It is important to note that the number and frequency of bank failures in the world have increased rapidly in recent years. These failures have occurred both in countries which followed relatively more open policies as well as the ones exercising control in different degrees. Recent experiences in East Asia and elsewhere have brought to fore the criticality of a financial system's stability for ensuring sustainability of openness in invigorating economic growth. In one important sense it also marks a departure from the excessive emphasis laid on the proposition that financial liberalisation *per se* will lead to higher growth. While developing financial institutions and markets is important for growth, it may not, however, prove sufficient to provide desirable outcomes if the safeguard systems are not very sound and the financial system is unstable.

It is in the above context that the theme of this year's bank economists' conference, namely to strengthen the Indian financial system, assumes critical importance. Indeed this is a concern for most developing countries at present. Many of them have initiated a fresh round of structural reforms in their financial systems. A number of international agencies, including the Bank for

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International Settlements (BIS), are also currently engaged in identifying factors that raise the vulnerability of financial systems and devising new safety standards that would help promote stability. In India, the second Report of the Narasimham Committee has recently addressed a number of vital issues pertaining to the health and stability of the financial system and the action that is necessary to strengthen it. Some of these recommendations have been implemented in the recent monetary and credit policy announcements.

As professional bankers and economists, you are no doubt seized of the challenges that the recent developments in international financial markets have posed for the Indian financial system. What has been our experience of financial reforms so far? Where do we stand in terms of financial stability considerations? What are the tasks ahead if the Indian financial system is to improve its competitive strength substantially and strengthen itself to withstand the pressures of instability? What role should the bank economists be playing in this environment? Let me try and address a few of these issues in my remarks this morning.

A Review of Directions

The significance of the financial system for an economy arises from at least three major sources. First, it performs various transformation functions relating to intermediation of funds in the economy. Secondly, it provides the mirror image of the underlying real economy and the basic macroeconomic balances. Thirdly, it is one industry whose basis of operation is underpinned in public trust. The strength of this bond between the banking system and people in general depends on how the financial viability of the banking system is perceived. The organisation and conduct of financial markets should be such that they reflect the underlying fundamentals of the economy. The financial system as a whole must remain sound and stable in order to enjoy a high level of public confidence.

Until recently, the improvement in various transformation functions of the financial system was the focal point of reform initiatives in many developing countries. The basic issue was how to create a competitive environment for the financial system and to put in place a policy regime which would lead to improved allocative efficiency of the financial sector and enhancement of saving and investment activities of the economy for attaining faster rates of economic growth. As financial markets developed and matured, the two-way interaction between the financial and nonfinancial policies grew in importance. In the recent years, the increased market exposure of the financial system and its vulnerability to macroeconomic shocks have highlighted the need for greater internal controls and the need for strengthening prudential norms and regulations. In an environment of rising importance of cross border capital flows, perceptions and expectations play major roles in shaping events and this consideration can be particularly heightened if the financial system is perceived to be weak and unsound. It is not surprising that financial reform initiatives globally have now moved to the strategic considerations of ensuring continued stability of the financial system.

In India, since the formal announcement of the first initiative of financial sector reform in the Union budget of 1991–92 to the Second Report of the Narasimham Committee in 1998, considerable ground has been covered in putting in place a financial system which can meet the requirements of a more competitive and open economy. By and large, financial reforms in India have proceeded in four major directions.

First, setting the policy conditions right and removing the operational constraints of the financial system. What the reform process has tried to achieve is to lower the share of pre-empted resources in the total resources of the banking system through gradual liberalisation of the cash

reserve ratio and the statutory liquidity ratio. While the medium term target of 25% and 10% set for the CRR and SLR, respectively, have been, by and large, achieved, these ratio levels are still higher than what would perhaps look ideal in the international context. Our relatively high reliance on the cash reserve ratio has been necessitated by the needs of monetary policy operations. As financial markets develop, allowing for a greater role for the interest rate in the economy, the dependence on this instrument of monetary policy would need to come down in future.

The second directional change has been in the area of creating a more competitive environment in the financial sector through reform measures such as relaxation of entry and exit norms, reduction in public ownership in the banking industry and letting banks access the capital market in order to meet their funding requirements. The objective is to bring out the best result in terms of pricing and quality of banking services over a period of time.

The third important direction of reform has been the strengthening of market institutions and allowing greater freedom to financial intermediaries. These reforms have taken the form of gradual liberalisation of interest rates, development of money, capital and debt markets and giving operational flexibility to banks in the management of their assets and liabilities subject, of course, to prudential guidelines. In simple terms, these changes imply a greater degree of exposure of individual financial institutions to the domestic and international economic environment.

In this connection, a distinction needs to be made between two types of market developments, which have implications for the financial system. One is developments in respect of macroeconomic fundamentals of the economy which impact on the interest rate, exchange rate and other asset prices. This is a normal phenomenon in any economy and has implications for the balance sheets of the financial intermediaries. Institutions which do not have an organised approach in anticipating events, undertaking pre-emptive actions and designing a suitable response to unanticipated developments can find themselves in a difficult situation, particularly in times of a large degree of fluctuations in macroeconomic variables. The dangers posed by market and credit risks arising out of macroeconomic shocks need to be given special attention in a liberalised financial system. Our reform initiatives in this area are still in the formative stage. The second type of market developments which have implications for the financial sector relates to asset price bubbles, which may be related to a high concentration of bank lending to one or two sectors which have a boom and bust cycle of their own. This form of market exposure can be unhealthy and lead to irreparable shocks. Although the impact of such cycles on our banking system is quite limited, international experience suggests that, unless prudential measures are in place, banks can be potentially vulnerable to asset price pressures that can generate systemic risks for the financial system.

The fourth important element of reform concerns the “safety” aspects of the financial system. This is the core of the challenges facing the financial system at present. When the reform process was started in 1992, there was a massive problem of cleaning the balance sheets of banks which had deteriorated over the years. Successive reform initiatives in this area have been aimed at prescribing certain prudential standards for the financial system and addressing certain structural weaknesses which could minimise their recurrence in future. Measures such as income recognition norms, asset classification, meeting minimum capital adequacy standards through recapitalisation and devising a supervisory framework are steps in the direction of ensuring the safety of the financial system.

Where Do We Stand?

The key indicators of banking sector performance during the past few years mark certain noticeable changes. For example, the net profit of the scheduled commercial banks as a percentage of their total assets has been turned around from a negative figure of –1.0% on an average during 1992–93 and 1993–94 to a positive of 0.5% during 1994–95 to 1997–98. In the case of most public sector banks, business per employee and profit per employee have shown improvement in the recent period. Certain other indicators also look good. By 1997, almost all public sector banks had achieved the minimum capital adequacy norm of 8%. The gross and net non-performing assets of the banking system as a percentage of advances declined to 16% and 8.2%, respectively, by March 1998. In terms of percentage to total assets, gross and net non-performing assets declined to 7.0% and 3.3%, respectively, by March 1998.

I think the present statistics are not unfavourable for the banking system as a whole. As the second report of the Narasimham Committee has observed, “this improvement has arrested the deterioration in these parameters that had marked the functioning of the system earlier”. Keeping in view the current macro economic and international financial situation, the Committee has noted that:

“There is still, however, a considerable distance to traverse. The process of strengthening the banking system has to be viewed as a continuing one. There is no finite end to improving the levels of efficiency and profitability. In fact, the situation is one where the system has to cope constantly with changes in the broader environment in which it functions and face new challenges that these developments impose on it” (p. 18).

The banking sector indicators in India need to be seen against the backdrop of increased vulnerability of the financial systems of developing countries and the need for improving its efficiency and stability. The Narasimham Committee has presented a detailed analysis of various problems and challenges facing the Indian banking system and made wide-ranging recommendations for improving and strengthening its functions. Let me shortlist a few key areas, which must concern us at this stage.

The Indian banking system is still perceived as a relatively high cost banking. This is because of the relatively high operating cost of the banking system. A comparative analysis indicates that while the average operating cost of banks as a percentage of assets was about 2.3% in India during 1990–91 to 1995–96, it was 1.1% in China, 1.6% in Malaysia, 1.9% in Thailand, 1.0% in Japan and 2.1% in G10 Europe. One of the major problems posed by a relatively high intermediation cost in our case is that it gives rise to uneconomical banking. It raises the necessity of maintaining a relatively high interest income spread and a high real lending rate. This adversely affects financial intermediation and growth in the economy.

Operating costs depend on labour productivity, technology, innovation and organisational effectiveness of a bank to harness various static and dynamic economies from the production process. On the economy-wide scale, these factors differentiate the weak from the strong banking system and provide internal strength and stability to the system. Without gaining sufficient advantage in this respect, it is difficult to think of a significant improvement in the banking system in future.

A key issue relates to the banking sector’s non-performing assets (NPAs). The amount of gross and net NPAs have been on the rise, although the rate of their growth has been below the overall rate of expansion of advances. Apart from absolute size, the distribution of non-performing

assets is skewed across banks. Still a large number of public sector banks have net non-performing assets ranging between 10 to 20% of net advances. The Narasimham Committee has underlined the need to reduce the average level of net NPAs for all banks to 3% by 2002 and to zero for banks with international presence. I think this is an important requirement for our banking system and is crucial to maintaining the viability of the system in future. A two-pronged strategy identified by the Committee viz., to reduce the backlog NPAs and improve the management efficiency and stricter enforcement of prudential norms, has to be acted upon to deal with this challenge.

Another critical aspect is the soundness of the banking system and how this is reflected in the practices and principles followed by banks. Prudential norms and supervision are necessary, but they are no substitute for the internal control system and sound business practices. The ability to distinguish between a normal business risk and an abnormal one, managing such risks and defining a prudent limit for risks are essential functions for the bankers. For a long time, Indian banking did not have a tradition of dealing with various forms of market risks. The critical role of managing such risks has now come into the open, especially against the experience of the recent East Asian crisis, where markets fell precipitously because banks and corporates did not accurately measure the risk spread that should have been reflected in their lending activities. Nor did they manage such risks or provide for them in their balance sheets. In India, the Reserve Bank has recently issued comprehensive guidelines to banks for putting in place an asset-liability management system. Formal guidelines will be issued shortly in the light of suggestions received from banks. But, ultimately risk management is a culture that has to develop from within the internal management systems of the banks. Its critical importance will come into sharp focus once current restrictions on banks' portfolios are further liberalised and are subjected to the pressure of macro economic fluctuations.

While developing a system of internal control and risk management is of critical importance for the banking system, there is no escaping the fact that a permanent improvement in the state of Indian banking is not possible without addressing the long-term structural weaknesses of the system. Our banking system operates with a large continent-wide network of branches, yet the scale economies in the banking industry are limited, owing to the fragmented organisational structure. Today, size is becoming increasingly important for strategic business planning in every sphere of the economy. The banking sector is no exception. When competition is the key issue, it is the market structure and regulation that need careful attention. Furthermore, given the multi-tier financial system of our economy, and the complementarity and synergetic relations among these different tiers, it is difficult to isolate the efficiency of the banking system from that of the long-term financial institutions, cooperatives, rural banks and non-bank financial companies. A more meaningful reorientation of objectives and functions of various tiers of financial institutions would be necessary in dealing with the long-term issue of enhancing the competitiveness of the system as a whole. It is also important to ensure that the ownership structure of Indian banks is such that managerial decision-making is not affected by non-economic considerations, and banks are able to raise sufficient capital in line with their increasing volume of business.

Another crucial issue, especially in the present context, relates to banks' special role in the credit delivery system. There is no inherent conflict between the canons of sound banking and banks' proactive role in credit disbursements to promote growth. These two objectives are complementary to each other. High growth leads to high credit off-take and credit availability conditions influence growth prospects of an economy. Ultimately, it is the credit business which is central to the profitability of the banking system. To the extent that excessive risk aversion

among bankers restricts credit growth in the economy, it has adverse effects on the profitability of the banking system as well as on economic growth.

Credit disbursement to the rural sector and small-scale industries require special attention from banks. The Gupta Committee recommendations involving greater flexibility and discretion to the lending banks in the agricultural sector in matters of collateral, margin, security, no dues certificate, composite cash credit limits etc., have to be implemented by the banks expeditiously. Similarly, special treatment has to be accorded to small-sector units in improving their accessibility to institutional finance with a view to enabling them to emerge as profit centres for the banking system. Given its critical importance in the manufacturing and export activities in the economy, it is unlikely that the banking system's profitability and efficiency can grow without exploiting the opportunity provided by the small-scale industrial sector. The Kapur Committee has recently made a comprehensive set of recommendations for improving the credit delivery system for small-scale industries, which are being implemented in phases.

The International Context

An important effect of the Asian economic crisis, and of the recent developments in Japan, has been that there is now a much greater international focus on the soundness of the domestic banking system in all countries – developed and developing. Unlike previous financial crises, the persistent crisis in the real economy in East Asia and also Japan is generally believed to have been accentuated by the weakness in the financial sector rather than the other way round. The health of the banking sector and the prudential and regulatory framework are thus no longer a matter of domestic concern only. A country's ability to access capital markets as well as investments abroad is likely to depend on whether the domestic financial system is perceived to broadly conform to international prudential and supervisory norms. In fact, the world standards themselves are being put to a severe test by the changing nature and ramifications of banking crises in several parts of the world. What were earlier considered to be the ideal prudential norms for preventing individual bank failures have been proved to be severely inadequate to deal with systemic instability or prevent the contagion effects.

In various international fora, an intensive effort is now underway to evaluate the existing norms and practices being followed by banking systems in different countries and to assess how far these norms have helped or prevented instability in the banking system. India has been fully participating in these discussions and is helping in the formulation of norms and guidelines which take into account the views of the developing countries, where market structures and growth objectives are different than in industrial countries. Issues currently under scrutiny include: the corporate governance system in banks, risk management, banking regulation and supervision, transparency and accountability and public policies relating to moral hazards in banking sector. The *Basle Core Principles for Effective Banking Supervision* have underlined the need to adhere to 25 basic principles for adopting an effective supervision system in the aftermath of the East Asian crisis. More detailed work is now in progress after the recent publication of three reports by the Willard Group, constituted by the Bank for International Settlements, on enhancing transparency and accountability, strengthening financial systems and managing international financial crises.

The Willard Group reports have argued for improving the credibility and accountability of the banking system through more transparent accounting practices and better disclosure norms. They have drawn attention to the need to develop a stable and efficient financial system through strengthening the corporate governance system and risk and liquidity management among banks and putting in place a proper safety net arrangement for the banking system. They have also

argued for a more organised approach in preventing international financial crises and a more orderly system of creditor and debtor coordination and effective solvency laws.

The recent international consensus on preserving the soundness of the banking system has veered around certain core themes. These are: effective risk management systems, adequate capital provision, sound practices of supervision and regulation, transparency of operation, conducive public policy intervention and maintenance of macroeconomic stability in the economy.

An important issue which we, along with other countries, would need to address is how to ensure that individual banks govern themselves according to the best practices in corporate governance. This, as mentioned before, involves according utmost importance to prudent business practices, such as developing an effective internal control system, monitoring and managing the whole range of financial and commercial risks, and instituting a proper system of asset and liability management in order to avoid term mismatches in portfolios. A proper cushion needs to be kept by way of capital reserves against market exposure and capital size should set a limit for the risk exposure of an individual financial institution. Apart from capital adequacy standards, the new international norms of banking regulation and supervision require a more proactive role for the regulator in enforcing an effective mechanism for evaluating, monitoring and managing risks in the financial system. This in turn would need stricter accounting, valuation and reporting norms on the part of banks.

The Basle core principles have also identified a number of challenging areas for regulators and supervisors, which must be satisfied to ensure orderly conduct of financial system and to promote its soundness and stability. Transparency in banking operation is also something which has to receive top priority given the current nature of capital markets. Transparency and accountability demand realistic valuation of assets, public disclosure norms and prudential reporting by banks to help depositors and investors form an informed opinion about the state of the financial system, thereby enabling them to react in an orderly fashion to asset price changes. Moreover, public intervention policies in the form of explicit or implicit guarantees may have to be such that they do not lead to "moral hazard" in the form of undue risk-taking by banks and laxity in observing market disciplines.

India must remain in the forefront of the movement for ensuring soundness of the banking system by adopting best practices and best international standards of performance and prudence. Actions have already been initiated in this direction. The challenge now is to accelerate this process so that the banking and the financial system in our country can contribute to the sustained growth of the real economy with price stability.

Role of Bank Economists

Before I conclude, let me say a word about the role of Bank economists in facilitating the reform process. This annual conference is a testimony to the economic talent that our banking system has developed over the years. Almost all our banks have economic research departments or economic cells which are staffed by highly qualified economists with long experience in banking and the financial sector. The issue that I would like to pose before this conference is: are we making the best and most effective use of economists working in the banking sector to improve the functioning of banks, and for that matter, the operational efficiency of the financial sector as a whole? In commercial organisations like banks, economics departments have the advantage of not being excessively burdened with day-to-day problems of running the banks or ensuring the safety and profitability of individual transactions. They are in a position to take a strategic or longer-term view of the comparative or competitive advantage of their individual banks as well

as identify areas of portfolio weaknesses and the costs/benefits of various kinds of services and products offered by them. They also have the opportunity to study from their vantage point and from a practical angle the working of the financial system and various improvements needed to strengthen the financial intermediation function.

However, for bank economists to be able to perform these functions, it seems that some reorientation of the role that is assigned to them is necessary. There is also a need for some "attitudinal" change on the part of economists themselves. Those who work in the commercial banking sector have to be prepared to accept operational responsibility, to work in the field, and to familiarise themselves fully with the commercial aspects of their bank's work. Their work has to be operationally relevant, and it must contribute to the financial soundness of bank's operations. This is possible if bank economists also have branch-level experience and experience of working in non-economic departments with line responsibility.

At present, the role of economists in our banking sector seems to be too narrowly defined. They are viewed as keepers of data, particularly macroeconomic data, and undertake periodic review or analysis of macroeconomic trends in the economy. They are seldom involved in undertaking any operational work or in developing strategic policy choices or even in treasury or foreign exchange functions. All over the world, with deregulation and globalisation of the financial sector, the role of economists in the banking sector has been changing and becoming more and more focussed on the analysis and valuation of the risk associated with various alternatives, particularly in emerging economies that are subject to greater volatility in the financial sector. In India, however, the role of economists has been somewhat slow in changing.

It may perhaps be useful for this conference to initiate a process of discussion on the various issues and to reassess the role that members of this distinguished body can play in pushing forward the process of reform in our country. The challenges ahead are gigantic, but they are also exciting. Given the determination, I have no doubt that India can have one of the most vibrant financial systems in the world.

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