Recent banking developments in India

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The Indian banking sector has witnessed wide ranging changes under the influence of the financial sector reforms initiated during the early 1990s. The approach to such reforms in India has been one of gradual and non-disruptive progress through a consultative process. The emphasis has been on deregulation and opening up the banking sector to market forces. The Reserve Bank has been consistently working towards the establishment of an enabling regulatory framework with prompt and effective supervision as well as the development of technological and institutional infrastructure. Persistent efforts have been made towards adoption of international benchmarks as appropriate to Indian conditions. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards.

Statutory Pre-emptions

In the pre-reforms phase, the Indian banking system operated with a high level of statutory pre-emptions, in the form of both the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR), reflecting the high level of the country's fiscal deficit and its high degree of monetisation. Efforts in the recent period have been focused on lowering both the CRR and SLR. The statutory minimum of 25 per cent for the SLR was reached as early as 1997, and while the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, the CRR of the Scheduled Commercial Banks (SCBs) is currently placed at 5.0 per cent of NDTL (net demand and time liabilities). The legislative changes proposed by the Government in the Union Budget, 2005-06 to remove the limits on the SLR and CRR are expected to provide freedom to the Reserve Bank in the conduct of monetary policy and also lend further flexibility to the banking system in the deployment of resources.

Interest Rate Structure

Deregulation of interest rates has been one of the key features of financial sector reforms. In recent years, it has improved the competitiveness of the financial environment and strengthened the transmission mechanism of monetary policy. Sequencing of interest rate deregulation has also enabled better price discovery and imparted greater efficiency to the resource allocation process. The process has been gradual and predicated upon the institution of prudential regulation of the banking system, market behaviour, financial opening and, above all, the underlying macroeconomic conditions. Interest rates have now been largely deregulated except in the case of: (i) savings deposit accounts; (ii) non-resident Indian (NRI) deposits; (iii) small loans up to Rs.2 lakh; and (iv) export credit.

After the interest rate deregulation, banks became free to determine their own lending interest rates. As advised by the Indian Banks' Association (a self-regulatory organisation for banks), commercial banks determine their respective BPLRs (benchmark prime lending rates) taking into consideration: (i) actual cost of funds; (ii) operating expenses; and (iii) a minimum margin to cover regulatory requirements of provisioning and capital charge and profit margin. These factors differ from bank to bank and feed into the determination of BPLR and spreads of banks. The BPLRs of public sector banks declined to 10.25-11.25 per cent in March 2005 from 10.25-11.50 per cent in March 2004.

With a view to granting operational autonomy to public sector banks, public ownership in these banks was reduced by allowing them to raise capital from the equity market of up to 49 per cent of paid-up capital. Competition is being fostered by permitting new private sector banks, and more liberal entry of branches of foreign banks, joint-venture banks and insurance companies. Recently, a roadmap for the presence of foreign banks in India was released which sets out the process of the gradual opening-up of the banking sector in a transparent manner. Foreign investments in the financial sector in the form of Foreign Direct Investment (FDI) as well as portfolio investment have been permitted. Furthermore, banks have been allowed to diversify product portfolio and business activities. The share of public sector banks in the banking business is going down, particularly in metropolitan areas. Some diversification of ownership in select public sector banks has helped further the move towards autonomy and thus provided some response to competitive pressures. Transparency and disclosure standards have been enhanced to meet international standards in an ongoing manner.

Prudential Regulation

Prudential norms related to risk-weighted capital adequacy requirements, accounting, income recognition, provisioning and exposure were introduced in 1992 and gradually these norms have been brought up to international standards. Other initiatives in the area of strengthening prudential norms include measures to strengthen risk management through recognition of different components of risk, assignment of risk-weights to various asset classes, norms on connected lending and risk concentration, application of the mark-to-market principle for investment portfolios and limits on deployment of funds in sensitive activities.

Keeping in view the Reserve Bank's goal to achieve consistency and harmony with international standards and our approach to adopt these standards at a pace appropriate to our context, it has been decided to migrate to Basel II. Banks are required to maintain a minimum CRAR (capital to risk weighted assets ratio) of 9 per cent on an ongoing basis. The capital requirements are uniformly applied to all banks, including foreign banks operating in India, by way of prudential guidelines on capital adequacy. Commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will initially adopt the Standardised Approach for credit risk and the Basic Indicator Approach for operational risk. After adequate skills have been developed, at both bank and supervisory level, some banks may be allowed to migrate to the Internal Ratings-Based (IRB) Approach. Banks have also been advised to formulate and operationalise the Capital Adequacy Assessment Process (CAAP) as required under Pillar II of the New Framework.

Some of the other regulatory initiatives relevant to Basel II that have been implemented by the Reserve Bank are:

- Ensuring that banks have a suitable risk management framework oriented towards their requirements and dictated by the size and complexity of their business, risk philosophy, market perceptions and expected level of capital.
- Introducing Risk-Based Supervision (RBS) in select banks on a pilot basis.
- Encouraging banks to formalise their CAAP in alignment with their business plan and performance budgeting system. This, together with the adoption of RBS, should aid in fulfilling the Pillar II requirements under Basel II.
- Expanding the area of disclosures (Pillar III) so as to achieve greater transparency regarding the financial position and risk profile of banks.
- Building capacity to ensure the regulator's ability to identify eligible banks and permit them to adopt IRB/Advanced Measurement approaches.

With a view to ensuring migration to Basel II in a non-disruptive manner, a consultative and participative approach has been adopted for both designing and implementing the New Framework. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) with representation from the Indian Banks' Association and the Reserve Bank has been constituted. On the basis of recommendations of the Steering Committee, draft guidelines on implementation of the New Capital Adequacy Framework have been issued to banks.

In order to assess the impact of Basel II adoption in various jurisdictions and re-calibrate the proposals, the BCBS is currently undertaking the Fifth Quantitative Impact Study (QIS 5). India will be participating in the study, and has selected 11 banks which form a representative sample for this purpose. These banks account for 51.20 per cent of market share in terms of assets. They have been advised to familiarise themselves with the QIS 5 requirements to enable them to participate in the exercise effectively. The Reserve Bank is currently focusing on the issue of recognition of the external rating agencies for use in the Standardised Approach for credit risk.

As a well-established risk management system is a pre-requisite for implementation of advanced approaches under the New Capital Adequacy Framework, banks were required to examine the various options available under the Framework and draw up a roadmap for migration to Basel II. The feedback received from banks suggests that a few may be keen on implementing the advanced approaches. However, not all are fully equipped to do so straightaway and are, therefore, looking to migrate to the advanced approaches at a later date. Basel II provides that banks should be allowed to adopt/migrate to advanced approaches only with the specific approval of the supervisor, after ensuring that they satisfy the minimum requirements specified in the Framework, not only at the time of adoption/migration, but on a continuing basis. Hence, banks desirous of adopting the advanced approaches must perform a stringent assessment of their compliance with the minimum requirements before they shift gears to migrate to these approaches. In this context, current non-availability of acceptable and qualitative historical data relevant to internal credit risk ratings and operational risk losses, along with the related costs involved in building up and maintaining the requisite database, is expected to influence the pace of migration to the advanced approaches available under Basel II.

Exposure Norms

The Reserve Bank has prescribed regulatory limits on banks' exposure to individual and group borrowers to avoid concentration of credit, and has advised banks to fix limits on their exposure to specific industries or sectors (real estate) to ensure better risk management. In addition, banks are also required to observe certain statutory and regulatory limits in respect of their exposures to capital markets.

Asset-Liability Management

In view of the growing need for banks to be able to identify, measure, monitor and control risks, appropriate risk management guidelines have been issued from time to time by the Reserve Bank, including guidelines on Asset-Liability Management (ALM). These guidelines are intended to serve as a benchmark for banks to establish an integrated risk management system. However, banks can also develop their own systems compatible with type and size of operations as well as risk perception and put in place a proper system for covering the existing deficiencies and the requisite upgrading. Detailed guidelines on the management of credit risk, market risk, operational risk, etc. have also been issued to banks by the Reserve Bank.

The progress made by the banks is monitored on a quarterly basis. With regard to risk management techniques, banks are at different stages of drawing up a comprehensive credit rating system, undertaking a credit risk assessment on a half yearly basis, pricing loans on the basis of risk rating, adopting the Risk-Adjusted Return on Capital (RAROC) framework of pricing, etc. Some banks stipulate a quantitative ceiling on aggregate exposures in specified risk categories, analyse rating-wise distribution of borrowers in various industries, etc.

In respect of market risk, almost all banks have an Asset-Liability Management Committee. They have articulated market risk management policies and procedures, and have undertaken studies of behavioural maturity patterns of various components of on-/off-balance sheet items.

NPL Management

Banks have been provided with a menu of options for disposal/recovery of NPLs (non-performing loans). Banks resolve/recover their NPLs through compromise/one time settlement, filing of suits, Debt Recovery Tribunals, the Lok Adalat (people's court) forum, Corporate Debt Restructuring (CDR), sale to securitisation/reconstruction companies and other banks or to non-banking finance companies (NBFCs). The promulgation of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 and its subsequent amendment have strengthened the position of creditors. Another significant measure has been the setting-up of the

Credit Information Bureau for information sharing on defaulters and other borrowers. The role of Credit Information Bureau of India Ltd. (CIBIL) in improving the quality of credit analysis by financial institutions and banks need hardly be overemphasised. With the enactment of the Credit Information Companies (Regulation) Act, 2005, the legal framework has been put in place to facilitate the full-fledged operationalisation of CIBIL and the introduction of other credit bureaus.

Board for Financial Supervision (BFS)

An independent Board for Financial Supervision (BFS) under the aegis of the Reserve Bank has been established as the apex supervisory authority for commercial banks, financial institutions, urban banks and NBFCs. Consistent with international practice, the Board's focus is on offsite and on-site inspections and on banks' internal control systems. Offsite surveillance has been strengthened through control returns. The role of statutory auditors has been emphasised with increased internal control through strengthening of the internal audit function. Significant progress has been made in implementation of the Core Principles for Effective Banking Supervision. The supervisory rating system under CAMELS has been established, coupled with a move towards risk-based supervision. Consolidated supervision of financial conglomerates has since been introduced with bi-annual discussions with the financial conglomerates. There have also been initiatives aimed at strengthening corporate governance through enhanced due diligence on important shareholders, and fit and proper tests for directors.

A scheme of Prompt Corrective Action (PCA) is in place for attending to banks showing steady deterioration in financial health. Three financial indicators, viz. capital to risk-weighted assets ratio (CRAR), net non-performing assets (net NPA) and Return on Assets (RoA) have been identified with specific threshold limits. When the indicators fall below the threshold level (CRAR, RoA) or go above it (net NPAs), the PCA scheme envisages certain structured/discretionary actions to be taken by the regulator.

The structured actions in the case of CRAR falling below the trigger point may include, among other things, submission and implementation of a capital restoration plan, restriction on expansion of risk weighted assets, restriction on entering into new lines of business, reducing/skipping dividend payments, and requirement for recapitalisation.

The structured actions in the case of RoA falling below the trigger level may include, among other things, restriction on accessing/renewing costly deposits and CDs, a requirement to take steps to increase fee-based income and to contain administrative expenses, not to enter new lines of business, imposition of restrictions on borrowings from the inter bank market, etc.

In the case of increasing net NPAs, structured actions will include, among other things, undertaking a special drive to reduce the stock of NPAs and containing the generation of fresh NPAs, reviewing the loan policy of the bank, taking steps to upgrade credit appraisal skills and systems and to strengthen follow-up of advances, including a loan review mechanism for large loans, following up suit-filed/decreed debts effectively, putting in place proper credit risk management policies/processes/procedures/prudential limits, reducing loan concentration, etc.

Discretionary action may include restrictions on capital expenditure, expansion in staff, and increase of stake in subsidiaries. The Reserve Bank/Government may take steps to change promoters/ ownership and may even take steps to merge/amalgamate/liquidate the bank or impose a moratorium on it if its position does not improve within an agreed period.

Technological Infrastructure

In recent years, the Reserve Bank has endeavoured to improve the efficiency of the financial system by ensuring the presence of a safe, secure and effective payment and settlement system. In the process, apart from performing regulatory and oversight functions the Reserve Bank has also played an important role in promoting the system's functionality and modernisation on an ongoing basis. The consolidation of the existing payment systems revolves around strengthening computerised cheque clearing, and expanding the reach of Electronic Clearing Services (ECS) and Electronic Funds

Transfer (EFT). The critical elements of the developmental strategy are the opening of new clearing houses, interconnection of clearing houses through the Indian Financial Network (INFINET) and the development of a Real-Time Gross Settlement (RTGS) System, a Centralised Funds Management System (CFMS), a Negotiated Dealing System (NDS) and the Structured Financial Messaging System (SFMS). Similarly, integration of the various payment products with the systems of individual banks has been another thrust area.

An Assessment

These reform measures have had a major impact on the overall efficiency and stability of the banking system in India. The dependence of the Indian banking system on volatile liabilities to finance its assets is quite limited, with the funding volatility ratio at -0.17 per cent as compared with a global range of -0.17 to 0.11 per cent. The overall capital adequacy ratio of banks at end-March 2005 was 12.8 per cent as against the regulatory requirement of 9 per cent which itself is higher than the Basel norm of 8 per cent. The capital adequacy ratio was broadly comparable with the global range. There has been a marked improvement in asset quality with the percentage of gross NPAs to gross advances for the banking system declining from 14.4 per cent in 1998 to 5.2 per cent in 2005. Globally, the NPL ratio varies widely from a low of 0.3 per cent to 3.0 per cent in developed economies, to over 10.0 per cent in several Latin American economies. The reform measures have also resulted in an improvement in the profitability of banks. RoA rose from 0.4 per cent in the year 1991-92 to 0.9 per cent in 2004-05. Considering that, globally, RoA was in the range -1.2 to 6.2 per cent for 2004, Indian banks are well placed. The banking sector reforms have also emphasised the need to review manpower resources and rationalise requirements by drawing up a realistic plan so as to reduce operating cost and improve profitability. The cost to income ratio of 0.5 per cent for Indian banks compares favourably with the global range of 0.46 per cent to 0.68 per cent and vis-à-vis 0.48 per cent to 1.16 per cent for the world’s largest banks.

In recent years, the Indian economy has been undergoing a phase of high growth coupled with internal and external stability characterised by price stability, fiscal consolidation, overall balance of payments alignment, improvement in the performance of financial institutions and stable financial market conditions and the service sector taking an increasing share, enhanced competitiveness, increased emphasis on infrastructure, improved market microstructure, an enabling legislative environment and significant capital inflows. This has provided the backdrop for a more sustained development of financial markets and reform.