BANKING SECTOR REFORMS – A MAKE-OVER STORY

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ABSTRACT

Globalization is in fact a 'state of mind' or worldview in which international dimension is a central consideration. Keeping ih view with this trend, India also went ahead with a series of reforms including the reforms in the Banking Sector. In a spectrum between Big Bang and Gradualism, India's initial reforms are best described as 'medium bang'.

INTRODUCTION

Banking sector reforms in India were initiated in 1992 on the basis of the recommendations of the Committee on the Financial System headed by M. Narasimham. Several of these recommendations were implemented during the first phase of reform and the second phase of reform began after the Committee on Banking Sector Reform also headed by M. Narasimham, which submitted its report in 1998. The two reports of M. Narasimham committee have been instrumental in bringing about a major shift in the approach to the development of the banking sector in India. Attempts have been made since 1992 to overcome several of the deficiencies of the banking system mentioned above. SLR has been reduced to the statutory minimum of 25 percent of net demand and time liabilities and CRR, which had been reduced from 15 percent to 8 percent. Second, the committee on financial system made a strong case for a re-examination of the relevance of the directed credit program and argued in favor of a gradual phasing out of this program. It recommended that the priority sector should be redefined and earmarking of credit to priofity should be reduced from 40 percent to 10 percent of total bank credit. This recommendation was not implemented but the definition of priority sector has been enlarged in the reform era and now it includes loans to traditional plantation, crops, housing transport operators, software industry to name a few.

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Based on the Basel Committee international norms, RBI prescribed capital to risk asset ratio of 8 percent. That this has been reached in a phased manner. The working group on weak banks headed by Verma has suggested the criteria for identifying the weak banks and the measures to be undertaken for strengthening these banks. The committee on financial system had recommended that the entire banking system should be restructured in such a way that there would be 3 or 4 large banks of international character, 8 or 10 national banks, local banks and rural banks. It has suggested a four-pronged strategy consisting of operational, organizational, financial and systemic restructuring in the first stage and privatization or merger in the second stage. The branching policy advocated by the Narasimham committee II and I also need careful examination. Both advocated that unremunerative rural branches, which are responsible for high level of NPAs and low profitability, should be closed down. It is, being argued that instead of closing down the non-viable rural branches, an attempt should be made to restructure them so that they may become viable. What helped the transformation of non-viable Indonesian rural bank branches into viable ones was the introduction of measures like deregulation of interest rates, autonomy, accountability, incentives and proper training for staff, hiring of local staff for keeping the costs low, treating each branch as a separate profit centre with its own balance sheet, computerization, etc. Similar measures can be tried in India instead of resorting to closing down of non-viable rural branches.

EMERGENCE OF PRIVATE SECTOR BANKS

The major chunk of Indian banking being handled by the public sector, there was virtually no competition in the banking sector and this was found to be one of the factors responsible for the growing inefficiency in Indian banking. The committee on financial system, which was very much concerned with efficiency and productivity of Indian banking, recommended that the entry of new private sector banks should be permitted. This recommendation paved the way for the establishment of new private sector banks. In all, nine private sector banks were established and after the merger of Times Bank Ltd. with HDFC Bank there are currently forty new private sector banks.

MANAGING NON-PERFORMING ASSETS OF COMMERCIAL BANKS

The assets of banks should yield positive returns. The assets, which do not yield positive returns, become non-performing assets. In a narrow sense, non-performing assets refer to loans and advance, which do not yield any positive returns or contribute to the profits of banks. In a broader sense, non-performing assets include the unutilized cash balances, physical assets and the workforce. The international practice in respect of non-performing assets outlined in the Narasimham committee I was gradually adopted by all banks in India. According to the definition now uniformly adopted, "A credit facility is classified as non-performing if interest and/or installment of principal have remained unpaid for two quarters after it has become past due." Since 1992, a new system of classification has been followed according to which all advances are classified into four broad groups, namely, standard, sub-standard, and doubtful and loss and the last three categories constitute non-performing assets. An asset becomes sub-standard when interest is past due for two quarters. An asset will be treated as doubtful when it has remained in sub-standard category for eighteen months and an asset becomes a loss asset when it is irrecoverable, but not written off. The committee on banking sector has stressed the need to reduce the average level of net NPAs for all banks to three percent and for banks with international presence to zero by 2002.

The objective of reducing the volume of NPAs of the commercial banks has received great attention in recent years and several measures have been introduced in the reform years. The following are the major initiatives undertaken since early 1990s.

DEBT RECOVERY TRIBUNALS (DRTs)

Delay in settling the suit-filed cases by the courts of law was an important factor responsible for the accumulation of NPAs. Debt recovery tribunals have since been established. There are 22 DRTs and 5 Debt Recovery Appellate Tribunals as of March 2002.

SECURITISATION ACT

A very significant initiative undertaken for reducing the stock of NPAs is the passing of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act in 2002. The act has two very important provisions: 1. Securitization and reconstruction of assets, 2. Enforcement of security interest. The proposal to establish asset reconstruction companies made in the securitization bill is based on the recommendation of the Narasimham Committee. The committee recommended the setting up of an Asset Reconstruction Fund. It also recommended that the government of India, the Reserve Bank of India and public sector banks and financial institutions should contribute to the share capital of the fund. The function of the securitization/ reconstruction companies is to take over NPAs of banks/ financial institutions at a discount in exchange for special bonds and subsequently collect the dues from the defaulters. Securitization and reconstruction of financial assets and enforcement of security interest act also provides for acquisition of security offered for the loan directly 60 days after serving notice on the defaulter and realize the value by selling away the security without any intervention of the court.

CREDIT INFORMATION BUREAU

A good information system is required to prevent loans from turning into non-performing assets. In the absence of good information, a defaulter in one bank may borrow from another bank and continue to be a defaulter. If a borrower is a defaulter to one bank, this information should be available to all the banks so that they may avoid lending to him. A credit Information Bureau can be of help in this regard. It can maintain a data bank, which can be accessed by all lending institutions. It can be privately owned as in U.S.A, U.K, Australia and New Zealand or it could be a division or department of the central bank of the country as in France, Germany, Belgium, Sri Lanka, and Bangladesh.

LOK ADALATS

For recovery of smaller loans, the mechanism of Lok Adalats has been found to be suitable. According to the guidelines issued by all the RBI in 2001, Lok Adalats cover NPAs up to Rs. Five lakhs; both suit-filed and non-suit filed cases can be covered and the settlement formula should be flexible. For NPAs of Rs. Ten lakhs and above, Debt Recovery Tribunals have been authorized to arrange Lok Adalats. Public sector banks had recovered Rs. Forty crores by September 2001 through Lok Adalats.

CORPORATE DEBT RESTRUCTURING

This system works through voluntary agreement between debtors and creditors. A three-tier structure comprising of a CDR Standing Forum, a CDR Empowered Group and a CDR Cell has been proposed by the RBI. The CDR Standing Forum would lay down policies and guidelines. The CDR Empowered Group to assess and approve a restructuring plan.

The CDR Cell would provide the basic information for decision-making. This method relates to large sized loans, Rs. Twenty crore and above.

MOVEMENT TOWARDS UNIVERSAL BANKING

Commercial banks by and large specialize in short- term lending or in providing working capital and the Development Financial Institutions specialize in long-term lending and investment banking. When this barrier is removed and the same institution combines commercial investment and development banking, it becomes universal banking. A distinction can be made between narrow universal banking and broad universal banking. The former represents a combination of commercial banking and investment banking (issuing, underwriting, investing and trading securities), while the latter also includes insurance and various other financial services. Three forms of universal banking are found in practice, namely, 1. Fully Integrated Universal Bank, 2 Bank Subsidiaries, and 3. Bank Holding Company. In the case of fully integrated universal bank, all financial services are provided in-house through various departments of the same institution. In the case of bank subsidiaries, different financial services are provided through separate subsidiaries. In the case of bank holding company, one company owns subsidiaries for banking and non-banking activities, which are legally separate and individually capitalized. The rationale behind universal banking is that it is more efficient as compared with specialized banking arising from diversification and large-scale operation.

INDIAN SCENARIO

Commercial Banks do provide term loans, but in a limited way. It is the DFIs, which became important in the field of term lending and investment banking. DFIs also of late provide short-term loans, but in a limited way. Thus, the distinction between commercial banks and DFIs in India has tended to narrow. Banks are providing financial services like investments, merchant banking, participation in government securities market, leasing, hire purchase, project finance, factoring, mutual fund activity, venture capital, etc., either in-house or through subsidiaries. State Bank of India has greatly diversified its activities and it now covers most of the financial services viz., project finance, and leasing, factoring, credit card, merchant banking, mutual fund, gilts and insurance and it is expected to become a world class universal bank.

It is desired; that the DFIs should over period of time, convert themselves into banks. There would then be only two forms of intermediaries, viz., banking companies and non-banking finance companies. Those DFI's that do not acquire a banking license would be categorized as non- banking finance companies.

Merger of ICICI Ltd. with ICICI Bank in 2001 marks a further and .very important step towards universal banking in India and this is the first DFI to be converted into a bank.

GLOBAL SCENARIO

Universal banking has been in practice in different countries of the world in different forms. It originated in central and northern Europe. In the U.S and Japan, there are restrictions on combining commercial banking and investment banking and there is rigid bifurcation between the two. These activities have to be carried out through separately capitalized subsidiaries. The European countries and the U.S have already demonstrated the possibility of combining banking with insurance. The European concept of 'bank assurance' or 'Alfinanz' has found acceptance in India of late, according to which banking and insurance services can be offered by a single organization. Recognizing the importance of the concept of 'bank assurance', the Reserve Bank of India issued guidelines for entry of banks into insurance business in 2000, according to which banks can take to one of the following: 1. Banks can undertake agency service for insurance companies. They can sell insurance products for a fee and make this a source of their earning. 2. Banks can make investment in insurance companies. 3. Banks can establish joint venture companies for insurance business. Conversion of DFIs into banks and the introduction of 'bank assurance' scheme will no doubt accelerate the move towards universal banking. But this development will also create certain problems. First, though the DFIs can extend term loans even after their conversion into banks, they are likely to lose interest in term lending since banks' major sources of funds are short and medium-term deposits which cannot be used for extending long-term loans. Second, after conversion into banks, DFIs will have to meet statutory liquidity ratio and cash reserve ratio requirements. To the extent they contribute to SLR and CRR, the funds available for their operations will get reduced. Third, conversion into banks will not solve the problem of huge NPAs of DFIs and it will only add to the problems of the institution with which merger takes place.

RECENT DEVELOPMENTS IN BANKING REGULATION AND SUPERVISION

Recent efforts at improving the regulatory and supervisory system are based on the recommendations of the Basel Committee on Banking Supervisions. This committee has been functioning since 1975. It is a club of G-10 countries formed by the central banks of these countries to work out the standards relating to banking supervision for adoption by all the countries of the world.

1. Capital Adequacy Ratios

Banking regulation in India had prescribed only the minimum capital for establishing a bank. The concept of risk-weighted capital adequacy was introduced in 1992 as per Basel norms. A capital adequacy ratio of 8 percent for all banks not dealing in gold/silver/platinum and 9 percent for those dealing in them was prescribed. Banks were expected to reach this level gradually over a period of time. Most of the banks comply with this ratio now. The committee on banking sector reforms suggested that there should be further increase in the capital adequacy ratio to 9 percent by 2000 and 10 percent by 2002. Thus, the earlier argument that the banks owned by the government need not prescribe capital adequacy ratios has been rejected.

2. Asset Quality

The performance of any banking institution depends very much on the quality of assets held by it. Therefore, income recognition, asset classification and provisioning norms have received great attention. The practice of taking income into account only on actual basis and not accrual basis and the practice of classifying assets into standard, sub-standard, doubtful and loss assets were brought in. A clear definition of NPAs has been adopted: "A credit facility is classified as non-performing if interest and /or installment of principal have remained unpaid for two quarters after it has becomè past due."

3. Risk Management

Risk management is one of the important areas in which Indian regulatory system was found to be deficient and attempts have been made to bridge this gap. Accordingly banks were expected to put in place an Asset-Liability Management (ALM) system with effect from April 1999. The system covers such risks as liquidity risk, interest rate risk and currency risk "An effective banking supervisory system should consist of some form of both on-site and off-site supervision." (RBI, 1999) On-site inspection has been the main instrument of supervision in India for long. Now it is further improved by basing the inspection on **CAMELS** (capital adequacy, asset quality, management, earning, liquidity and systems and controls) model. This is supplemented by off-site monitoring and surveillance system. A second working group under S. Padmanabham was set up in 1995 where in the Reserve Bank of India emphasized an off-site monitoring and surveillance system which requires banks to submit quarterly and half-yearly returns on asset quality, capital adequacy, large exposures, etc. Introduction of consolidated supervision is another important recent step towards strengthening the supervisory system. On-site inspection now covers the performance of the subsidiaries and joint ventures of banks and also banks have to conduct inspection of their subsidiaries as a means of exercising control over them. As a part of the move towards consolidated supervision of banking groups, off-site monitoring is expected to cover the subsidiaries also and therefore banks have to submit a return covering critical information about their subsidiaries.

FINANCING FISCAL DEFICIT - THE CHANGING ROLE OF RBI AND COMMERCIAL BANKS

There has been a growing concern about the fiscal deficit in India since the early nineties. Not only about its size about the way it is financed. To bridge the gap between the total expenditure and the current revenues of the government two ways are adopted:

1. Money creation or monetization i.e. net RBI credit to Govt. and 2.Borrowing within the company and abroad; the former taking the form of investment in Govt. securities by banks and NBFIs and the latter taking of bilateral and multilateral loads.

According to an agreement between RBI and Government of India in 1955, the Govt. of India had to maintain with the RBI a balance of 50 crores on Fridays and whenever the balance fell below this level the RBI would replenish the balance against creation of ad-hoc treasury bills. Till 1982 ad-hoc treasury bills were converted into dated securities of specific maturity periods, after 1982 no specific date of redemption was to be maintained. Automatic monetization of government deficit through ad-hoc treasury bills implied involuntary funding by the RBI Financing government deficit became an overriding consideration undermining the primary responsibility of RBI of maintaining price stability through its monetary policy.

It was decided in 1994 that a ceiling on net issue of treasury bills should be fixed and eventually this system should be replaced by a system of **Ways and Means Advances**. Under this system temporary mismatches between receipts and expenditure are met by the advances made by the RBI and have to be paid of within 3months. Any withdrawal in excess of this should be treated as an overdraft. The Fiscal Responsibility and Budget Management Bill has proposed total ban on direct investment by the RBI in govt. securities.

In conclusion, the recent change in the role of the Reserve Bank of India in financing the fiscal deficit is a welcome development. With a shift away from automatic monetization, involuntary funding of fiscal deficit by the Reserve Bank of India has come to an end and this has imparted operational autonomy to the Reserve bank of India as a result fiscal monetary policy interface has also improved.

RECENT POLICY CHANGES

RBI accepted certain recommendations of the Vyas Committee for Implementation including:

1. Loans for storage facilities under priority sectors
2. Securitised agricultural loans as priority sector landing
3. Waiving margins/security requirements for certain agricultural loans up to a limit
4. NPA norms for crop loans aligned to crop seasons.

The much-awaited new policy regarding foreign banks has been promulgated to give unprecedented flexibility to them. For instance, it allows foreign banks to establish a presence by either setting up a wholly owned subsidiary or by converting their existing branches into a wholly owned subsidiary, with a minimum equity base of a modest 3 billion rupees ($69 million). It also allows foreign banks, for the first time, to acquire up to a 74 percent stake in local private banks, and insists that voting rights in private banks should reflect the ownership.

"Appropriate amending legislation has to be proposed to the Banking Regulation Act, 1949, to provide that the economic ownership of investors is reflected in the voting rights," In other words, the central bank intends to do away with the contentious 10 percent cap on voting rights of foreign banks' holdings in Indian banks that the Indian government imposed last year.

The policy for the "next stage of banking reforms" comes in two phases. In the first phase, March 2005 to 2009, although foreign banks will be allowed to own a 100 percent subsidiary, at least half of its board members will have to be Indian nationals resident in the country. Moreover, if a foreign bank does not wish to set up a subsidiary but establish a presence through acquisitions of privately-owned Indian banks, it will have to acquire stakes only in the weak ones that are identified by the RBI as candidates for acquisitions (the names of such banks have not been specified yet). Again, existing foreign banks will need to give up their branch licenses should they opt for the subsidiary route. Significantly, all wholly owned subsidiaries will be treated on a par with the existing branches of foreign banks for branch expansion with the flexibility to go beyond the existing World Trade Organization commitments of 12 branches a year and preference for branch expansion in under-banked areas.

The new policy, which has also stipulated guidelines for privately owned Indian banks, mandates that all Indian banks must have a minimum net worth of 3 billion rupees within "a reasonable time frame", which cannot be more than four years. So all Indian banks with capital bases lower than this norm- (there are at least a dozen of them) would have to consolidate and grow up. The larger local banks, too, would have to ramp up both in terms of size and efficiency in the next four years, not only to face the competition from foreign banks, but also to thwart any takeover bids by them.

The second phase commencing in April 2009, however, is more liberal, and allows foreign banks to acquire any privately owned Indian bank. During this phase, wholly owned subsidiaries, too, can go for listing and foreign banks may dilute their holding to the extent that at least 26 percent of the paid-up capital is held by resident Indians at all times. In today's volatile times these will go a long way in meeting global standards.

CONCERNS & CHALLENGES

- Reducing the fiscal deficit, to lessen the risk of macro economic instability and to increase the availability of finance to the private sector.
- Improving banks credit and risk management, including priority credits.
- Improving systems for identifying and dealing with weak banks.
- Efficiency of the banks, like other organizations depends very much on human resources so they have to be trained to deal with complexities.
- Reducing the Legacy NPAs (accumulated in the past) and incremental NPAs to a reasonable level.

The make over story of the Indian Banking System is bound to provide qualitative services, new financial products, improved regulatory system leading to its enhanced efficiency.

Nevertheless, the risk it faces due to the presence of the foreign banks due to their financial strength cannot be marginalized.

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