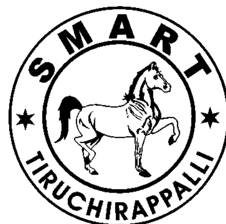
SMART

JOURNAL OF BUSINESS MANAGEMENT STUDIES

Vol.1 Number. 1 January - June 2005 Rs. 200

Dr. M. SELVAM, M.Com., Ph.D.,
Chief Editor



SCIENTIFIC MANAGEMENT AND ADVANCED RESEARCH TRUST
(SMART)
TIRUCHIRAPPALLI (INDIA)

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FINANCIAL SECTOR REFORMS : IMPLICATIONS ON BANKING SECTOR

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The process of financial sector reform was initiated in 1992 following the report of the committee on the financial systems (CFS), whose recommendations were framed with the object of consolidating the quantitative progress achieved in our financial system in the preceding quarter century even while arresting the qualitative deterioration of services that had accompanied quantitative growth. The implementation of the recommendations pertaining to accounting, asset classification and income recognition has certainly helped to make the accounts of our banks more transparent and credible. Capital adequacy norms were also prescribed and most banks have now reached the set levels. However, the equally and perhaps more important recommendations relating to systemic and structural aspects are yet to be properly addressed. At this stage, it is more important to take stock of the present situation and move ahead, which is what the second committee on banking sector reform, which reported in April 1998, sought to do. The second phase of financial sector reform has to be set against broader macro economic changes. This paper highlights the implications of finance sector reform measures on banking sector.

The economic reform process has many segments - trade and exchange rate, foreign investment, domestic industry, reform of the financial system and monetary and fiscal policy. The central objective of the reform is to provide an efficient and competitive financial system. As the financial sector is mobiliser of savings, for the reform to be successful it should provide allocative efficiency of resources and thereby facilitate accelerated real growth of the economy. With the spate of globalisation initiatives and the economic nature of financial crisis, there has been a growing recognition that safeguarding the health of the financial system is of paramount importance for maintaining financial stability.

The financial system is possibly the most important institutional and functional vehicle for economic transformation. Finance is a bridge between the present and the future and whether it be the mobilisation of savings or their efficient, effective and equitable allocation for investment, it is the success with which the financial system performs its functions that sets the pace for the achievement of broader national objectives.

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The implementation of the recommendations pertaining to accounting, asset classification and income recognition has certainly helped to make the accounts of our banks more transparent and credible. Capital adequacy norms were also prescribed and most banks have now reached the set levels. However, the equally and perhaps more important recommendations relating to systemic and structural aspects are yet to be properly addressed. At this stage, it is more important to take stock of the present situation and move ahead, which is what the second committee on banking sector reform, which reported in April 1998, sought to do.

The second phase of financial sector reform has to be set against broader macro economic changes. One important aspect of this is that we are now on a higher growth trajectory. This would call for a continuing and indeed expanding role of the financial system in mobilising savings and allocating these savings in an efficient and effective manner. Meanwhile, a major policy development affecting the financial sector has been the increasing importance being given to indirect monetary instruments of control in place of direct discretionary action and, in this process, acting on the cost of money to impact on its availability. Financial liberalisation calls for a measure of market determination of interest rates.

Implications

- One of the aspects of the macro policy environment that has constrained the operations of the financial system in India is the continued high level of fiscal deficit which tends to restrict the boundaries for the operation of the system by crowding out non governmental claimants to the national pool of financial savings. The continuance of the high fiscal deficit is a major element in the measure of macro economic imbalance, the correction of which along with a strong and healthy financial system should be regarded as a sine qua non for moving towards capital account convertibility.
- We are also now witness to the phenomenon of globalisation of finance and as the Indian economy integrates itself more closely with the international economy, our financial system also would increasingly be drawn into the dynamics of international finance, and face in increasing measure, competition from abroad given also our acceptance of some aspects of the WTO requirements relating to financial services. The globalisation of finance provides great opportunities but it also carries considerable risks.

The financial sector reform can be broadly classified into two parts, the shift in the overall monetary policy and the improvement of the structure of banks and financial institutions. On the monetary policy front, there is a distinct move from the use of direct instruments of control such as prescription of reserve requirements for banks, administered interest rates and direct controls on credit to indirect instruments of control, viz., the freeing of interest rates and the use of open market operations as the major instrument of monetary policy. The agreement to phase out automatic

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monetisation of the budget deficit and the move to market related interest rates on government borrowing is a historic step which would contribute to a significant improvement in financial and monetary discipline and give the Reserve Bank greater scope for effective monetary management. The advantage of indirect instruments of monetary control is that the overall liquidity control in the economy is done through purchase and sale of securities rather than through direct monetary controls on banks.

In the pre- liberlization period, banks and financial institutions were weakened by administered controls and excessive directions on the deployment of resources. But things have changed and prudential norms have been prescribed for banks, financial institutions and non-bank financial companies. Banks are being strengthened by phased provisioning for the non-performing assets of banks and this will bring about a strengthening of the balance sheets of these institutions and also ensure greater transparency of operations. With the decrease in intrusive controls, banks will have greater flexibility. Banks and non- bank institutions will increasingly compete with each other and the distinction between different types of financial institutions will soon disappear. With entry rules being relaxed, there will be increased efficiency and the range of financial services would increase. More importantly, there will be much greater transparency of operation in both credit and investment operations. As the non-bank financial companies increase their operations, they will have to recognise that adherence to prudential norms would be strictly enforced and violations of the regulatory framework would not be countenanced.

- An important element of the financial sector reform is to bring about a significant improvement in customer service and there will be a need to assess the degree of satisfaction. Increased competition in this area will result in improved customer service. Banks and institutions, which are unable to provide satisfactory customer service, would inevitably be by passed. In this connection, the larger banks and financial institutions (including investment institutions) need to rethink their corporate strategies. In the case of these institutions, it may be prudent to grow at a slower pace and concentrate on providing improved customer service.
- As one progresses on the path of deregulation, there will be pressure on the margins of banks and institutions. It will no longer be possible for these institutions to price their products on a cost plus basis using a minimum margin between the cost of funds and the returns on funds. It would be reasonable to expect that in the next few years, banks and other institutions will have to reduce their margins by between a fourth and a third if they are to remain competitive.

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- As the government budget comes under greater pressure, the need to curtail Government expenditure becomes progressively stronger. As such, as part of the overall reform process, it needs to be recognised that the capacity of the fisc to provide unlimited subsidies would be severely curtailed and all economic agents must recognise that subvention as a way of living is on the way out.

As the banking sector is the mainstay of financial intermediation (accounts for more than half of the assets of the financial sector), developing a sound and healthy banking system through promotion of prudential practices is viewed as a sine qua non of financial stability. In the Indian context, banks are undergoing the crucial transition phase wherein they are striving hard to attune themselves to the growing uncertainties, stiff prudential norms, fierce competitive pressures and to make forays into new areas.

Reforms Implications in PSBs

Banking reform since 1991 has been mainly in the areas of disclosure, regulation and supervision. Deregulation continues to be implemented in a selective way. Most large public sector banks have a large proportion of their assets in government securities or as loans to the priority sectors.

Their management autonomy is severely constrained. Strictly regimented lending practices of the past have resulted in a high level of non- performing assets which continue to grow despite the fact that in the post- reform period, there has been greater emphasis on improving asset quality. Outdated management practices, which the reform process has so far not done enough to correct (b) Low levels of automation. (c) Inadequate credit assessment skills (d) A slow legal system and inappropriate legislation for recovering their loans (e) Infrastructural bottlenecks which slow down economic growth thereby adding to the problems regarding bank assets. (f) Need for further tightening of regulation.

The problems of banks have been further aggravated because the environment in which they now operate has become far more competitive than ever before. The limited range of deregulatory measures introduced in the wake of the still incomplete reform has blunted the competitive edge. Two important policy measures that are seen as liberalising the Indian financial sector have been in the interest arena and in the licensing of new banks. But over the short-term, the competitive forces unleashed by such measures have proved troublesome for the government banks. Their existing margins have come under pressure. Although the new environment has thrown up opportunities, the public sector banks have been unable to capitalize because of some major deficiencies - low automation levels, labour market rigidity and constraints on management. PSBs cannot improve their financial strength without greater managerial autonomy and fundamental steps to improve loan recovery.

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(1) The high degree of state involvement in the ownership and running of PSBs suggests that the Government will support them in times of need. Recent precedents support the view. However, over the longer term, budgetary constraints or privatization will force the government to reconsider their level of commitment.

(2) The operating environment for banks will become even more competitive.

(3) Asset quality will continue to cause concern.

(4) Their wide network has given them access to low cost deposits. However competition for deposits will grow from mutual funds and insurance.

(5) Capital adequacy ratios are barely adequate. Raising new capital in the current environment becomes extremely difficult

(6) Earning capacity of Indian banks is low and not commensurate with the high risk inherent in the operating environment.

(7) While regulation needs to be further tightened, the pace of further reform is constrained by the bank's ability to comply and the availability of government assistance.

(8) The millennium bug confronts the government banks.

Another all too familiar shortcoming is inadequate managerial skills at the top and in credit areas. What it could have done is to highlight in depth the connection between their government ownership and the perceived managerial deficiencies. Any objective study would quickly identify this as the major inhibiting factor blocking the resurrection of public sector banks. However, there are two key issues which are likely to engage the attention of bankers for some more time. The first issue concerns the unabated flow of NPAs, estimated in excess of Rs.56,600 crore by Sept. 2001, for public sector banks. Amazingly, these NPAs are more than half of the fiscal deficit of the government during last year.

The second issue of concern pertains to the Basel II norms, under its Capital Accord. When implemented, the Accord may have far reaching implications. It presupposes enormous skills, especially in the realms of risk management, exposure limits and internal controls. Increased reliance on external rating agencies perforce calls for the operational and supervisory mechanisms to be in tune with internationally accepted best practices. Market discipline also forms one of the three pillars under the Accord which will set out disclosure requirements of the highest order.

There has been a steady decline in the level of resource preemption from the banking system. Interest rates in various segments of financial markets have been deregulated in a phased manner. This had preceded the abolition of control on capital issues and freezing of interest rate on private bonds and debentures. While the government borrowing rates are now market determined, there has been a gradual phasing out of interest rate subsidies on bank loans. Wide ranging reforms have been initiated to develop and deepen the government securities market, money market, and

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capital market and foreign exchange market. The Bank Rate has been reactivated, regular short-term Repos at a pre-announced rate are being conducted, and a system of prime lending rate has been introduced to provide direction to movement of interest rates in the credit market.

There has also been a significant liberalisation of policy regarding industry's access to foreign equity and borrowing through long term debt instruments. The banking sector has been given a greater degree of freedom with regard to raising funds abroad and managing their external liability, subject to prudential guidelines.The end result of all these and other reforms has been the growing integration among various segments of financial markets., closer convergence of Indian financial system with practices prevailing in international financial markets, and greater opportunity for investors to access both domestic and international markets. Competitive condition in the banking industry has been facilitated by relaxing entry and exit norms and permitting the public sector banks to raise additional capital from the market (*up to a certain level). While public sector banks continue to be predominant, the changing competitive environment in the banking sector has made a significant difference to banking practices and disclosure requirements. Prudential regulation and supervision have formed a critical component of the financial sector reform programme. India has adopted international prudential norms and practices with regard to capital adequacy, income recognition, provisioning requirement and supervision. These norms have been progressively tightened over the years, particularly against the backdrop of the Asian crisis. Recently the required capital adequacy ratio has been increased to nine percent, from eight per cent, in the banking sector.

In the area of supervision, a full-fledged institutional mechanism has been developed keeping in view the needs of a strong and stable financial system. The Basle core principles for effective banking supervision are substantially being adhered to. A "CAMELS" based rating system for Indian banks have also been introduced. The Reserve Bank's regulatory and supervisory responsibility has been widened to include financial institutions and non-banking financial companies. As a result of these and other measures, some progress in the performance of the Indian banking system in recent years is noticeable. The trend in erosion of profit and capital base has been reversed. Currently most of them are on the threshold of the prescribed nine per cent ratio by March 2000. The improved performance has enabled most of the banks to meet their capital requirement from internal resources and the market without dependence on budgetary support. The level of non-performing assets (NPAs) of the banking system in India has shown an improvement in recent years, but it is still too high.

Imperatives

A vigorous effort has to be made by these banks to strengthen their internal control and risk management systems, and to set up early warning signals for timely detection and action. The

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resolution of the NPA problem also requires greater accountability on the part of corporates, greater disclosures in the case of defaults, and an efficient credit information system.The problem of NPAs is also tied up with the issue of legal reform. This is an area, which requires urgent consideration, as the present system, involving substantial delays in arriving at a legal solution of disputes, is simply not good enough. It is hoped that recent efforts, such as establishing more debt recovery tribunals and setting up of settlement advisory committees in banks, would help. However, there is an urgent need to institute a proper legal framework to ensure expeditious recovery of debt and give adequate legal powers to banks to effect property transfers. The absence of quick and efficient system of legal redressal constitutes an important "moral hazard" in the financial sector as it encourages imprudent borrowing.

In order to allow for growth in their assets in line with real growth in the economy, banks and financial institutions should increase their capitalization quite substantially in the next few years. Contribution to banks' capital by Government would only create more Government's deficit, which is already very high. Government, in any case, would need to provide additional capital to weak banks which are not in a position to raise capital on their own. Over the years, progressive liberalisation of financial markets and institutional reforms have led to growing inter-links among various segments of financial markets. The emergence of different types of financial intermediaries, in addition to banks and financial institutions, is healthy and desirable. A diversified structure contributes to greater stability of the financial system in the event of unanticipated problems.

Conclusion

Successful financial reforms would result in strengthening the ability of governments to do what they need to do by helping to generate higher growth, higher revenues and higher productivity. In developing countries, the main challenge is to raise the level of potential output by removing the constraints of infrastructure and low human resource development. Alongside financial reform and development of markets, country's attention must also turn to fiscal empowerment of the state and improvement in public administration. With a revitalized fiscal situation and further progress in establishing a forward looking, strong and stable financial system, the third millennium can truly be a century of development.

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