Perspectives on Banking

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The strategy of banking development during the period 1969-1992, following nationalisation of major banks, first in 1969 and later in 1980, paid rich dividends to the Indian economy. This was demonstrated in the expansion of the banking network, as well as, various indicators reflecting financial deepening and widening. Nevertheless, from the vantage point of 2003, it seems that there were a number of costs associated with this strategy. Two major costs were: (a) sacrifice of the efficiency gains in banking (in terms of lack of improvement of productivity), and (b) large pre-emption of lendable resources of the banks. Besides, the instruments of "social control", in the form of credit controls and concessional lending, had the effect of segmenting financial markets, blunting the process of price discovery and undermining the efficiency of resource allocation.

Banking sector reforms, launched ten years ago in 1992-93, were a key constituent in the wider macroeconomic strategy of financial liberalisation. The 1990s took the process of institution-building to its logical conclusion by creating an environment in which these institutions could function effectively. The challenge before the Reserve Bank was, thus, to rejuvenate the process of price discovery, without either sacrificing the social imperatives of a developing economy or compromising financial stability.

Banking sector reforms involved a three-pronged macro-economic strategy of dismantling the regime of administered interest rates, introducing financial instruments and making financial markets capable of allocating resources in line with market signals, and at the same time, ensuring credit delivery for the relatively disadvantaged sections of society. This was reinforced by a series of micro-economic measures to introduce more private sector players (domestic and foreign) to infuse competition and accord freedom of portfolio allocation across markets, especially centring around withdrawal of balance sheet restrictions in the form of statutory pre-emptions, such as, the cash reserve ratio (CRR) and statutory liquidity ratio (SLR). Besides, an incentive structure had to be put in place to channel funds to areas of social concern in tune with the spirit of financial liberalisation and the imperatives of poverty eradication. A new development is the experiment of micro-finance, through self-help groups either funded by banks directly or through intermediaries. Finally, there was the need to harness the developments in information technology to improve the functional efficiency of the banking system.

The Reserve Bank now accords banks substantial freedom in determining their portfolios as well pricing their products, except in specific cases such as interest rates chargeable on small loans and priority sector advances. The Reserve Bank has instituted a number of measures to ensure the healthy functioning of the banking system including prudential norms pertaining to capital adequacy, income recognition and asset classification backed by strict provisioning norms. This is being supplemented by the institution of asset-liability management and risk management systems in line with the best international practices. In view of the growing complexities of the economy, the Reserve Bank has supplemented the micro- on-site supervision system with a macro-based supervisory strategy based on off-site monitoring and control systems internal to the banks, on the lines of CAMELS (Capital Adequacy, Management, Liquidity and Systems).

In the realm of carefully sequenced banking sector reforms, India has a lot to cheer about. The improvement in the profitability of the banking system in the recent years has been accompanied by an enhancement in asset quality (Table 1).

Table: Important Commercial Bank Parameters

(Per cent)

Bank Group	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-2003
	2	3	4	5	6	7	8
1. Operating Expenses/Total Assets	2.9	2.6	2.7	2.5	2.6	2.2	2.2
2. Spread/Total Assets	3.2	3.0	2.8	2.7	2.9	2.6	2.8
3. Net Profit/Total Assets	0.7	0.8	0.5	0.7	0.5	0.8	1.0
4. Net NPAs to Net Advances	8.1	7.3	7.6	6.8	6.2	5.5	4.4
5. CRAR	10.4	11.5	11.3	101.1	11.4	11.9	N.A.

N.A. Not available.

There is, however, no room for complacency, and all the stake-holders in the banking sector have to strive hard. As far as the Reserve Bank is concerned, we have come a long way from micro-monitoring to macro-supervision of the banking sector. Recent initiatives, such as, risk-based and consolidated supervision, adoption of various international standards and codes, as well as, moving closer towards Basel II are all symptomatic of the Reserve Bank's commitment towards building a robust and vibrant banking sector. The key challenge in the future is to build in appropriate risk management practices to consolidate the gains of the past and fully exploit the opportunities while managing the threats emanating from increasing financial globalisation and integration.

References:

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