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Emerging Issues in International Scenario :
Banking and Financial Sector Reforms

By

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Introduction

I am indeed happy to be in your midst today to share my views on the subject “Emerging Issues in International Scenario: Management of Business, Industries, Investor Protection, Banking and Financial Sector Reforms- Challenges and Opportunities”. Considering the profound changes that are rapidly sweeping the global economic environment, the theme of this session is very apt and timely. My present lecture will be in three parts. First, I would like to highlight the issues that warrant attention in the emerging global environment. In the second part, I shall focus on the emerging issues in international banking scenario. The third part of my lecture will focus on issues in Indian banking and financial sector in the light of the changing global milieu.

I. Issues relating to Global Economy

The positive news about the global economies the process of global recovery is gathering momentum. Presently, while the US growth engine continues to chug along strongly, growth in Japan and emerging market economies (EMEs) has been higher than previous expectations. Among the EMEs, China and India led the high growth of the Asian EMEs. Global GDP growth in 2004 is expected to average 4.8 percent by the IMF. With the continuation of accommodative macroeconomic policies, rising corporate profitability, positive wealth effect of asset prices, and rising employment, the recent phase of global recovery has been much more broad-based with increasing contribution of the developing economies, particularly EMEs.

The broadening of economic growth and the benign inflationary environment, notwithstanding the recent spike in oil prices has, in turn, improved financial stability and created a more favourable environment for financial markets. The spread on emerging market bonds continues to remain at low levels, the appetite for new emerging market issuance has strengthened and markets are differentiating increasingly based on fundamentals. Thus, the overall funding condition for capital markets remain favourable.

On the monetary policy front, the global policy cycle is surely bound northward as both the industrialised as well as EMEs transit from the present soft policy stance to a relatively higher interest rate regime. In many emerging market economies, especially in Central Europe and Latin America, policy rates have been raised substantially. With respect to the emerging market economies in Asia, the change in the policy regime is carried out both through rise in policy rates as well as adoption of direct measures to curb unbridled credit growth, as in China. In sum, the graduated increase in the Federal Fund rate and the increase in policy rates by the Chinese authorities after 9 years strongly signals the transition to a tighter monetary policy environment. Simultaneously, there has been some modest withdrawal of fiscal policy stimulus worldwide which would be beneficial in this stage of the global economic cycle. Moreover, several countries seem to be committed to a somewhat more restrictive fiscal stance in the medium run, which may, in turn result in a lower global fiscal stimulus in 2005. On the other hand, the adjustments of the dollar depreciation have been relatively smooth against other major currencies.

There are, however, several 'soft patches', which warrants global attention. First, the U.S. current account deficit has further widened during 2004 and is expected to reach 6 per cent of GDP. Secondly, fiscal deficit of US continues to remain at historical high levels and may increase further given the new governments fiscal stance. Moreover, the net savings of the US economy continue to remain quite low, at around 1.5 percent. The twin deficits in the US economy present a challenge not only for the US economy, but also to the rest of the world. Earlier experience of the 1980s show that such an adjustment in current account may lead to a sudden slowdown in GDP growth in US. Though the recovery in Euro area is underway *albeit* at modest pace which is largely export dependent. Future growth prospects in Euro area therefore crucially hinges on the sustained growth in US and China. Further, the 'right' sequencing of the process of managing the global hardening of interest rate so as to have a minimal effect on the balance sheets of households, corporates and financial institutions remains a serious challenge.

Thus, the global economic environment is rapidly evolving and in today's complex and dynamic world, the only constant factor is change. We are today progressively becoming part of the global market and the world's largest corporations are now eyeing Indian markets, changing the nature and character of competition. Tariff barriers are being lowered to stimulate trade. In each business segment, a strong grasp of consumer needs, continuous innovation in building brands, use of appropriate product and process design and technology would influence success. This calls for substantial investments in capital and technical expertise. As has been the case with a number of emerging economies, the financial sector in India is also being rapidly transforming.

II. Emerging Issues in International Scenario: Banking and Financial Sector Reform

With the evolving global scenario at the background, let us now discuss the challenges and opportunities facing the financial sector around the globe. The present trend towards financial sector liberalization and globalisation, especially with respect to the EMEs has resulted in a overall trend towards conglomeration, internationalisation and dollarisation in the financial systems of many of the countries notably the EMEs. Such trends have important implications for financial sector regulation. I would like to highlight the main issues in this respect:

It also needs to be recognised that in recent times, there has been growing concern worldwide about the need for preserving financial stability. This is true in the Indian context as well where the erstwhile Government-dominated financial system was, so to speak, imparting stability under rigid regulation, possibly at the cost of efficiency. In this context, the pursuit of financial stability in India, viewed from the standpoint of banking system, has sought to (a) ensure uninterrupted financial transactions and (b) maintain confidence in the financial system amongst all stakeholders. Viewed in this light, interest in financial sector reforms also gains prominence from the standpoint of preserving financial stability.

What I would attempt to do is to provide some broad contours of International banking and dwell upon certain areas which I believe are germane to the Indian banking system at the present juncture. Subsequently, I would raise certain issues, which I believe have assumed relevance in the changing financial landscape.

When we talk of the major features of international banking scenario, the following observations come immediately to mind.

First, **the structure of the industry**. In the world's top 1000 banks, there are many more large and medium-sized domestic banks from the developed countries than from the emerging economies. Illustratively, according to *The Banker 2004*, out of the top 1000 banks globally, over 200 are located in USA, just above 100 in Japan, over 80 in Germany, over 40 in Spain and around 40 in the UK. Even China has as many as 16 banks within the top 1000, out of which, as many as 14 are in the top 500. India, on the other hand, had 20 banks within the top 1000 out of which only 6 were within the top 500 banks. This is perhaps reflective of differences in size of economies and of the financial sectors.

Second, the **share of bank asset** in total financial sector assets. In most emerging markets, banking sector assets comprise well over 80 per cent of total financial sector assets, whereas these figures are much lower in developed economies. Thus, Banking Sector reforms are of paramount importance in many emerging markets.

Third, **industry concentration**, measured by the percentage of a country's banking sector assets controlled by the largest banks. In most emerging market economies, the five largest banks (usually domestic) account for over two-thirds of bank assets. These figures tend to be much lower in developed economies.

The fourth factor is the growing **internationalisation of banking operations**. Internationalisation, defined as the share of foreign-owned banks in total bank assets, is increasing fast in emerging economies from very low levels not too long ago. However, this pattern is not uniform across world regions. One important indicator of internationalisation, the presence of foreign banks in countries, suggests a substantial rise in foreign controlled

asset share by banks across regions from 19.7 per cent in 1995 to 21.5 per cent in 2002: the increase being particularly noticeable in Europe (from 23.1 per cent in 1995 to 32.5 per cent in 2002 possibly due to ownership consolidation) and Latin America (from 12.4 per cent in 1995 to 24.8 per cent in 2002 possibly due to progress in privatisation). The phenomenon of internationalisation has primarily been polarized on medium- to high-income countries, likely owing to attractive risk-return investment opportunities for foreign banks in such countries. However, foreign banks are often viewed to be 'cherry-picking' host country corporations, leaving domestic banks with less creditworthy customers, increasing the overall risk of domestic bank portfolios. Additionally, increased competition arising out of foreign bank entry could prompt domestic state-owned banks to venture into high-risk areas in an attempt to maintain their franchise value, with implications for their prudential ratios.

Fifthly, financial sectors across the globe has witnessed **increased conglomeration** to survive in a milieu of financial liberalization and technological improvements. Globalisation of clients of major financial instruments who, in turn, demand global access to services and a wide product mix has also been a contributory factor. The growth of such conglomeration has raised the possibility of vulnerabilities including systemic risk due to contagion and the possibility of opportunities for regulatory and supervisory arbitrage. A notable difference between the consolidation process in developed *versus* emerging markets is the overwhelming cross-border nature of mergers and acquisitions in the latter. In particular, cross-border merger activity in continental Europe and also between US and European institutions has been more an exception rather than the rule. In contrast, there has been a sharp increase in foreign ownership of emerging market banks. Some recent evidence by Di Nicolo *et al.* (2003)¹ a substantial increase in consolidation: the predominance of conglomerates within the top financial institutions increased markedly between 1995 and 2000 from 42

¹Di Nicolo, G., P.Bartholomew, J.Zaman and M.Zephirin (2003), 'Bank Consolidation, Internationalisation and Conglomeration: Trends and Implications for Financial Risk', IMF Working Paper No.158, Washington DC.

percent to 60 percent, as measured by the number of conglomerates and from 72 per cent to 80 per cent as measured by assets held by conglomerates.

Further, the **growing dollarisation**, especially in Latin America and transition economies raises several vulnerabilities in the financial system, salient among them being (a) diminished role of central banks to act as lenders of last resort, (b) possibility of dollar deposits being subject to ‘runs’ since such deposits are usually close substitutes for deposits abroad or dollars cash and (c) limited ability² of central banks to raise the interest rate on dollar deposits to act as ‘interest rate defenses’ against deposit withdrawals.

The global banking scenario is going to be influenced by implementation of the Basel II Accord. It seems at this point that Basel II may be beneficial to many of the EMEs including India. While the Pillar I of the New Accord signifies a refinement of existing capital charge by making it more correlated with the credit risk of the banks’ assets and an extension of the capital charges for risks not considered in the current Accord, such as interest rate risk in the banking book, and operational risk, Pillar II, which focuses on the supervisory review process, aims to ensure that a bank’s capital position is consistent with its overall risk profile. Finally, Pillar III aims at encouraging banks to disclose information in order to enhance the role of market participants in monitoring banks. It appears to me that Basel II will make the capital allocation of Banking Sector more risk-sensitive. The use of supervisory oversight with market discipline, as laid out in Basel II, would broad base and reinforce the supervisory framework and financial stability. Moreover, the New Accord would also lead to increased cooperation between supervisors, especially for the cross-border supervision of complex international banking groups.

In this context, the continuing **weaknesses in infrastructure underpinning regulatory systems**, especially with respect to the EMEs,

² First, increasing interest rates on dollar deposits may distort market signals and its consequent effects on exchange rates. Additionally, this may be interpreted as signs of weakness, exacerbating deposit withdrawals.

remain another area of concern. In many instances, the weaknesses in the regulatory infrastructure have further inhibited the development of a strong financial sector regulation. The observed deficiencies include, among others, areas such as **transparency, bankruptcy laws, judicial framework, forbearance and inefficient resolution of problem bank.**

The recent survey by the IMF on the implementation of financial sector regulation in 36 Fund member countries³ based on the Financial Sector Assessment Programmes (FSAPs) completed over the period 2000-03 reveals the following interesting points about the global financial system. On the positive side, there has been relatively high level of implementation with respect to legal foundations , rationalisation of the licensing process and minimum entry standards in most countries.

In terms of regulatory weaknesses, recent evidences point out to a number of deficiencies including;

- (i) The problems associated with regulatory forbearance.
- (ii) Deficiencies have been observed in the oversight of country risk⁴, issues of connected lending and corporate governance practices.
- (iii) deficiencies have been observed in respect of the design/implementation of consolidated supervision.
- (iv) With regard to financial integrity and development of safety net, the observed deficiencies mainly relate to timeliness of disclosure, protection of minority shareholders, accounting and auditing procedures and procedures for orderly winding up of failed insurers and securities firms.
- (v) Inadequate framework for harmonising cross-border regulatory cooperation given the growing cross-sectoral and cross-border linkages in the financial sector has posed risk-assessment problems, creating arbitraging opportunities.

³The 36 sample countries comprised of 10 industrialised countries, 12 emerging market economies and 14 developing countries. In terms of regions, the sample comprised of African (3), Asian (4), European (21), Middle East and Central Asian (6) and Western Hemisphere (2) countries.

⁴ In terms of specifics, certain deficiencies were unique to certain sectors, such as insufficient guidance with regard to credit risk and monitoring compliance with capital and prudential requirements (in banking), weak regulation of asset quality (in insurance) and asset valuation and pricing of units in collective investment schemes (in securities).

The Indian Financial Sector in the Evolving International Milieu

The Committee on Financial Systems, 1992 (Chairman: Shri M. Narasimham) recognised financial stability as the *sine qua non* of rapid and sustainable economic progress. The approach towards financial sector reforms is based on *panchasutra* or five principles; gradualism entailing cautious and appropriate sequencing of reform measures, mutually reinforcing norms, complementary reforms across sectors (most importantly monetary, fiscal and external sectors) based on extensive consultations with the stakeholders at each stage, development of financial institutions and development of markets.

It is recognised that increased competition in the financial system heightens the need for prudential regulation and supervision to ensure financial stability. In a highly competitive financial market, banks may engage in riskier operations due to the pressure of squeezed profit margins. In such a situation, several central banks have focused increasingly on financial stability, which is evident from various Reports produced on the subject on regular basis in recent years. The Reserve Bank of India, in its recent Report on Trend and Progress of Banking in India, 2003-04 and the latest Report on Currency and Finance, 2003-04 for the first time has devoted separate chapters to “Financial Stability”, thereby communicating to the market the importance it attaches to financial stability. Thus, apart from price stability and availability of credit, financial stability has emerged as an important objective of monetary policy.

The achievements so far

There is very little doubt that the profitability of the Indian banking system has improved during the 1990s. The net profits of the scheduled commercial banks climbed steadily from 0.2 per cent of total assets as at end-March 1996 to 1.1 per cent as at end-March 2004. This increase in profitability was achieved despite a narrowing of spreads and higher provisions for non-performing loans.

How was this increase in profitability possible? While one expects that the competitive forces during a period of financial sector reforms will drive the profits down, competitive forces also results in making a firm more conscious

about its cost structure, so as to improve its bottom line. In fact, in the Indian case, the improvement in profitability was primarily due to a combination of larger non-interest incomes and a curtailment in operating expenses, including the wage bill.

The improvement in the profitability of the banking system has been reinforced by an improvement in its health. The CRAR of the banking system, as at end-March 2004, worked out to 12.9 per cent of assets, far above the stipulated 9 per cent. The ratio of net performing assets to net advances declined to 2.9 per cent as at end-March 2004 from 8.1 per cent as at end-March 1997. It will be appreciated that the improvement in CRAR partly reflects the recapitalisation of banks by the Government. At the same time, it is also true that a number of banks have been accessing the capital market for funds since the mid-1990s.

How do the Indian banking sector stand vis-à-vis banks in other countries? Spreads in India were marginally higher than those in East Asian countries and major developed economies. The profitability of the Indian banking system was reasonably in line with the international experience. The level of competition, as measured by concentration ratio, in India compared favourably with several Asian and Latin American countries. The overall CRAR of the Indian banking system, although much above the prescribed level, was significantly lower than that of several countries in Asia and Latin America.

Policy measures by the Reserve Bank

The reform of banking sector has encompassed measures pertaining to competition, adoption of prudential norms, development of markets, institutions and the legal environment, and improvements in supervisory process. In India, concerted efforts have been made towards the development of a multi-institutional structure in the financial sector and the emphasis has been on the increased efficiency of institutions through competition. Competition has been infused into the financial system principally through entry liberalisation, easing of statutory pre-emption, deregulation in interest

rates, granting of functional autonomy to banks and allowing greater participation of private sector and foreign banks.

Prudential Norms

In the Indian context, a major element of financial sector reforms has been the adoption of a set of prudential measures relating to capital adequacy, income recognition, asset classification and provisioning, exposure norms, disclosures, investment and risk management as well as asset-liability management aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and credibility. In keeping with the vision of developing an internationally competitive and sound domestic banking system, the deepening and broadening of prudential norms have been the core of the approach to financial sector reforms. The calibration of the convergence with international standards is conditioned by the specific realities of the domestic situation.

Ownership Structure

The criticality of the ownership structure of banks for financial stability arises in the context of the concentrated shareholding in banks controlling huge public funds, and the risk of concentration of ownership leading to potential problems of moral hazard and linkages of owners with businesses. In order to promote diversified ownership of private sector banks, guidelines were issued by the Reserve Bank in February 2004 in regard to acquisition / transfer of shares of a private sector bank which would take the aggregate shareholding of an individual or a group to equivalent of five percent or more of the paid up capital of the bank. In July 2004, a comprehensive policy framework for ownership and governance in private sector banks has been placed in the public domain by the Reserve Bank in the form of draft guidelines, for wider public debate.

NPA Management

The Reserve Bank along with the Government, has initiated several institutional measures to contain the levels of NPAs. Notable among these include Debt Recovery Tribunals, *Lok Adalats* (people's courts) and Asset

Reconstruction Companies (ARCs). A set of guidelines has been issued to financial entities, so that the process of instituting ARCs proceeds on smooth lines. The Reserve Bank has given license to three ARCs out of which one has started functioning. Settlement Advisory Committees were formed at regional and head office level of commercial banks. Corporate Debt Restructuring (CDR) mechanism was institutionalised in 2001 to provide a timely and transparent system for restructuring of large corporate debts with the banks and financial institutions. While several measures, as mentioned above, have been undertaken towards preventing the accumulation of NPAs, the issue of creditor rights has been addressed through the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act in April 2002. The Reserve Bank's thrust on adequate level of provisions is reflected in the fact that the cumulative level of provisioning for the scheduled commercial banks works out to 70.6 per cent of gross NPAs as at end-March 2004. This achievement is notable in comparison with the internationally prescribed benchmark of 50 per cent provisioning against NPAs. The gross NPAs to gross advances ratio during 2003-04 registered a sharp decline to 7.2 per cent despite a switchover to 90 days delinquency norm from 15.7 per cent during 1996-97. Increased higher provisioning together with falling gross NPAs led to a decline in net NPAs to net advances ratio declining to 2.9 per cent during 2003-04 from 8.1 per cent during 1996-97. In an open economy environment, several banks have witnessed significant internationalisation of their balance sheets arising from cross border capital flows and international banking operations. In order to guard against the risks associated with country exposures, banks have been advised to make provisions, with effect from March 31, 2003, on the net funded country exposures on a graded scale ranging from 0.25 to 100 per cent, depending upon the risk categories prescribed in the country risk management (CRM) guidelines.

Capital Adequacy and Basel II Norms

A strong capital base of banks is essential for ensuring sustained growth of banks' business and for absorbing unexpected losses. The capital

to risk weighted assets ratio (CRAR) based on Basel Capital Accord I has evolved as the widely accepted method of measuring soundness and solvency of banks. The CRAR system requires banks to hold different categories (tiers) of capital against assets and off-balance sheet items with different risk weights. With a view to adopting the Basel norms, the Reserve Bank decided in April 1992 to introduce the CRAR system for banks (including foreign banks). Initially, the CRAR was fixed at 8 per cent on par with the international benchmark. With greater deepening of the financial sector in the 1990s, the focus shifted to having tighter prudential norms, and the CRAR was raised to 9 per cent in March 2000.

The Basel Committee on Banking Supervision (BCBS) released the New Capital Accord (Basel II) on June 26, 2004 which is expected to be implemented by the end of 2006 (Box II.10). Since well-established risk management system is a pre-requisite for implementation of advanced approaches under Basel II, banks were advised to examine in-depth the options available under Basel II and draw a road map by end-December 2004 for migration to Basel II and review the progress made thereof at quarterly intervals. The Reserve Bank would be closely monitoring the progress made by banks in this direction.

Investment Portfolio

In order to make the valuation of the banks' investment portfolio reflective of the purpose, commercial banks have been urged to classify their entire investment portfolio, with effect from September 30, 2000 (from March 31, 2001, in the case of select FIs) under three categories, viz., 'held to maturity (HTM)', 'available for sale (AFS)' and 'held for trading (HFT)'. Banks have been urged to prepare themselves to comply with the prudential requirements in regard to their investment in non-SLR securities by the end of December 2004. The investment portfolio has been subjected to the discipline of marked-to-market accounting norm and strict rules regarding realisation of profit and loss.

Transparency and Disclosure

The range of disclosures have gradually been expanded over the years and presently includes a host of indicators relating to capital adequacy (Tier I and Tier II capital separately), Government shareholding, NPAs, and also movements in NPAs, exposure to sensitive sectors (capital market, real estate and commodities), movements in provisions for NPAs and investments as also information on corporate debt restructuring. These are being further enhanced to incorporate asset-liability management, risk management policies, concentrations, connected lending, evaluation of investment in subsidiaries, various performance measures and indicators thereof. Banks are providing information on various indicators in the form of notes to accounts and schedules in their balance sheets. In view of the added emphasis on the role of market discipline under Basel II and with a view to enhancing further transparency, banks have been advised on October 19, 2004 that all cases of penalty imposed by the Reserve Bank as also strictures/directions on specific matters including those arising out of inspection will be placed in the public domain with effect from November 1, 2004.

Banks, which have issued shares to the public and are listed on stock exchanges, have been advised to form committees to look into redressal of shareholders' complaints and to provide un-audited financial results on a half yearly basis to their shareholders with a summary of significant developments. It was observed that the procedures in regard to appointment and removal of external auditors are more stringent in banks than those recommended by the SEBI Committee.

Strengthening Markets

With the ongoing financial liberalisation, a number of measures have been taken to widen, deepen and integrate various segments of the financial markets. In India, development of financial markets has been pursued essentially for bringing about transformations in the structure, efficiency, and stability of markets as also integration of markets. The emphasis has been on strengthening price discovery, easing of restrictions on flows or transactions, lowering of transaction costs, and enhancing liquidity. Initially, under the reform process, the changes in the money market structure were brought in

through a gradual shift from a regime of administered interest rates to a market-based pricing of assets and liabilities, development of infrastructure, and introduction of new instruments. The reform of money market also focused on greater and wider participation of other financial institutions for deepening of the market. The Reserve Bank influences liquidity and interest rates through a number of operating instruments, viz., cash reserve requirements of banks, conduct of open market operations, repo transactions, changes in the Bank Rate, and at times through foreign exchange swap operations. In recent times the Reserve Bank's strategy has focused on developing pure call/notice money market, instituting full-fledged Liquidity Adjustment Facility, developing infrastructure, promoting transparency, and various measures pertaining to instruments for non-bank participants. A revised LAF scheme was operationalised in April 2004. The LAF scheme has been operated with overnight fixed rate repo and reverse repo from November 1, 2004. From October 29, 2004, a switchover to the international usage of the terms 'repo' and 'reverse repo' has been effected.

As a debt manager to the Government, the development of a deep and liquid market for Government securities is of critical importance to the Reserve Bank in facilitating price discovery and reducing the cost of Government debt. Efforts toward development of the Government securities market have focused on three areas: institutional measures, innovations through instruments, and enabling measures. During the 1990s, the approach to development of Government securities market focussed on removal of structural bottlenecks, introduction of new players and instruments, free pricing of financial assets, relaxation of quantitative restrictions, and improvement in trading, clearing and settlement practices. Reforms also encompassed regulatory and legal changes, technological upgradation and refinement of the market microstructure.

The Indian forex market has widened and deepened during the 1990s on account of implementation of various measures recommended by the High Level Committee on Balance of Payments in 1993 (Chairman: Dr. C.Rangarajan), the Expert Group on Foreign Exchange Markets in India in 1995 (Chairman: Shri O.P.Sodhani) and the Committee on Capital Account Convertibility in 1997 (Chairman: Shri S.S.Tarapore). With the transition to a

market determined exchange rate system in March 1993 and the subsequent gradual liberalisation of restrictions on various external transactions, ensuring orderly conditions in the forex market in India has become one of the key objectives. The Reserve Bank has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. In recent years, forex flows, especially due to increasing capital flows, have posed various challenges for liquidity management since these have implications for the conduct of domestic monetary policy and exchange rate management. In the context of large forex inflows that India has been experiencing, the Reserve Bank has been reviewing the operational aspects of inflow of forex, *i.e.*, the extent of forex market intervention and consequent build up of reserves, and the need for and extent of sterilisation required. The Reserve Bank's approach towards ensuring stability of forex market has been evident on various occasions. During the late 1990s, in particular, 1997-98, the forex market remained stable despite the Asian crisis. The forex market exhibited orderly conditions during 2001-02 and 2002-03 despite the September 11 development in the US, international oil price movement in the external front and various domestic developments arising from border tensions, natural calamities such as cyclone and earthquake, and monsoon failure. During 2002-03 and 2003-04, forex market again attested to stability and orderly conditions in the wake of redemption of Resurgent India Bonds, and the surge in capital flows.

Payment and Settlement System

A holistic approach has been adopted towards designing and development of a modern, robust, efficient, secure and integrated payment and settlement system taking into account certain aspects relating to potential risks, legal framework and the impact on the operational framework of monetary policy. Recognising the need for providing a safe, sound and robust platform to facilitate the absorption of technology by banks, the Reserve Bank set up the Institute for Development and Research in Banking Technology (IDRBT) in 1996, which is an autonomous centre for providing essential core networking functions for banks. The development of the payment system

infrastructure was strengthened with the introduction of the Negotiated Dealing System (NDS) in February 2002, formation of the Clearing Corporation of India Ltd. (CCIL) in 2001, and the implementation of real time gross settlement (RTGS) system from April 2004. The NDS enables screen based electronic dealing and reporting of transactions in money market instruments, secondary market transactions in Government securities and facilitates dissemination of information on trades with a minimum time lag. It also permits paperless settlement of transactions in Government securities given the electronic connectivity with CCIL and the delivery vs. payment settlement system at the Public Debt Office. The CCIL acts as a central counterparty through novation and provides guaranteed settlement with risk management systems put in place to limit settlement risks. The RTGS system embodies instantaneous settlement of transactions on a gross basis thereby completely obviating the need for any clearing arrangement in the transaction.

Regulation and Supervision

The first tier of governance is indeed provided by the laws relating to the banking and financial sector. Besides there is a fairly well placed architecture of regulation and supervision comprising three regulators viz., the Reserve Bank for the banking sector and the non-banking financial intermediaries, the Securities and Exchange Board of India (SEBI) for the securities market, and Insurance Regulatory Development Authority (IRDA) for the insurance sector. Regulatory co-ordination is ensured through a High Level Co-ordination Committee on Financial and Capital Market (HLCCFCM). Besides, a special monitoring system for Systemically Important Financial Intermediaries is being put in place in consultation with other regulators. Reserve Bank also proposed to constitute a Working Group on avoidance of conflicts of interest. The Working Group will identify the sources and nature of potential conflicts of interest, the international practices to mitigate this problem, the existing mechanisms in India in this regard and make recommendations for avoidance of such conflicts of interest.

The Board for Financial Supervision (BFS) was constituted in November 1994, as a committee of the Central Board of Directors of the Reserve Bank of India. The Board is required to meet normally once in a

month. During the meetings, it deliberates upon inspection reports and other supervisory issues placed before it by the supervisory departments. Some of the initiatives taken by BFS include restructuring of the system of bank inspections, introduction of off-site surveillance, strengthening of the role of statutory auditors, and strengthening of the internal defences of supervised institutions. Besides modifying the on site inspections system on the basis of CAMELs methodology, an elaborate off-site surveillance system has been put in place besides various other components including consolidated supervision and risk based supervision.

The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS) have underscored this requirement of consolidated supervision as an independent principle. Keeping in view the development of the financial sector, there has been an increased focus on empowering supervisors to undertake consolidated supervision of bank groups and monitoring of systemically important institutions during 2002-03 and 2003-04. The Reserve Bank set up a multi-disciplinary Working Group in November 2000 (Chairman: Shri Vipin Malik) to examine the feasibility of introducing consolidated accounting and other quantitative methods to facilitate consolidated supervision. On the basis of the recommendations of the Working Group, guidelines on consolidated supervision were issued to banks for implementation with effect from the year ended March 2003. Banks were advised to ensure strict compliance commencing from the year ended March 31, 2003. The components of consolidated supervision to be implemented by the Reserve Bank include Consolidated Financial Statements (CFSs) for public disclosure and Consolidated Prudential Reports (CPRs) for supervisory assessment of risks which may be transmitted to banks or other supervised entities by other Group members. Moreover, there would be application of certain prudential regulations like capital adequacy and large exposures/risk concentration on group basis. Initially, consolidated supervision has been mandated for all groups where the controlling entity is a bank.

The Urban Co-operative Banks (UCBs) form an important constituent of the co-operative credit system. Various measures have been undertaken to strengthen the existing UCB structure particularly in the experience of an

increasing number of weak banks and alignment of urban banking sector with the other segments of banking sector for the application of prudential norms and removing the irritants of a dual control regime. In order to strengthen the supervisory system, the Reserve Bank extended the off-site surveillance system (OSS) to all non-scheduled UCBs having deposit size of Rs.100 crore and above.

The Development Finance Institutions (DFIs) are presently undergoing a major restructuring phase. Taking into account the developmental functions and supervisory function exercised by some of these institutions – NABARD supervises state/central cooperative banks and regional rural banks, National Housing Bank (NHB) regulates and inspects housing finance companies, and IDBI inspects state financial corporations - a modified approach for supervisory assessment of these institutions has been introduced. With regard to the Non-Banking Financial Companies (NBFCs), both their asset and liability side has been brought under the regulatory oversight through promulgation of the Reserve Bank of India (Amendment) Act, 1997 and strict entry norms were prescribed.

Risk Management

At the same time, several efforts were directed towards tackling risks that exist in a market-oriented economy. Over the past few years, the Reserve Bank of India has initiated several steps to promote adequate risk management systems across market participants. Among the measures that were instituted to insulate the financial institutions from the vagaries of the market were gradual increase in the cushion of capital, frequent revaluation of the portfolio based on market fluctuations (marking to the market) and a framework for asset liability management (ALM) to combat the risks facing the Indian financial Sector. For active players in the Government Securities market such as the Primary Dealers, sophisticated Value at Risk (VaR) models were introduced in December 2000. Initially introduced to measure market risk capital for regulatory purposes, the PDs are increasingly using VaR measures for their day-to-day risk management practices. The Reserve Bank has also encouraged better risk assessment within banks and financial institutions, both public and private. Such improved risk management systems

are not only crucial stepping stones towards Basel II mandate but also are expected to enable banks to shed their risk averse attitude and contributing more finance to hitherto unbanked segments of agriculture, industry and services. The necessity of risk identification, measurement and management by market players assume critical importance in view of the recent hardening of interest rates owing to rising inflationary expectations, increase in international interest rates and profit booking by investors. The Reserve Bank is overseeing the migration to Basel II norms as part of its commitment towards convergence with international standards and best practices, with suitable country specific adaptations.

Interest Rate Risk

Given the significant share of investments especially in Government securities in the assets portfolio of commercial banks, the interest rate sensitivity of their balance sheets is critical. The Reserve Bank conducts periodic sensitivity analysis of banks' investment portfolio, based on the Standardised Duration Approach suggested by the BIS. Along with this, the Reserve Bank also estimates the cushion available in terms of unrealised gains on banks' investments portfolio and assesses their ability to withstand the impact of rising yields on their balance sheets. Banks have been sensitised about the need to take adequate measures to address the interest rate sensitivity of their portfolio. Building up of IFR discussed earlier has been an integral part of the strategy to deal with the interest rate risk.

Exchange Rate Risk

The policy pronouncements of the Reserve Bank continue to express concern over unhedged foreign currency borrowings by corporates, which could impact their overall financial status leading to instability in the financial system under severe uncertainties. Recognising such potential risks, the Reserve Bank in its mid-term Review of October 2001 has stressed the importance of banks' monitoring of large unhedged foreign currency

exposures of corporates. Further in the mid-term Review of November 2003, banks have been advised to adopt a policy, which explicitly recognises and takes account of risks arising out of foreign exposures of their clients. Accordingly, banks have been advised that all foreign currency loans above US dollar 10 million or such lower limits as may be deemed appropriate *vis-à-vis* the banks' portfolio of such exposures could be extended by them on the basis of a well laid out policy of their Boards except in cases of export finance and loans extended for meeting forex expenditure. Banks were advised to ensure hedging of significant but avoidable risks to corporate balance sheets on account of their forex exposures, which might also possibly impact the quality of banks' assets. In view of the implications of unhedged foreign currency exposures of corporates for financial stability in the event of unforeseen adverse conditions, banks have been advised to adopt a policy, which explicitly recognises and takes into account risks arising out of foreign currency exposures of their clients. Further, in view of the systemic risk, banks have been encouraged to obtain information from their large borrowers on their unhedged forex exposures, so that the banks, in turn, can assess the risk of their own exposure to such corporates on an on-going basis.

Framework of Crisis Prevention and Management

The framework of crisis prevention and management has encompassed various methods and instruments. These include the Early Warning System (EWS), Prompt Corrective Action (PCA), exposure norms for single and group borrowers and exposure to sensitive sector and derivative products, prescription of safeguards for prevention of frauds, guidelines on 'Know Your Customer' (KYC) to combat money laundering and financing of terrorism, setting up of Credit Information Bureau of India Ltd. (CIBIL) in 2001 to compile and disseminate credit information and managing troubled banks through capital restructuring, consolidation and liquidity support. India is the second country to institute a Deposit Insurance Scheme way back in 1961 in the wake of failure of a few banks. In India, the Deposit Insurance System is mandatory and covers all commercial banks and all 'eligible' cooperative banks, with the exception of certain co-operative banks in some States, which

do not comply with the provisions of the DICGC Act, 1961 relating to 'eligible banks'.

As part of the Reserve Bank's initiatives in adopting best international practices for monitoring the stability of financial system in India, the Reserve Bank has been compiling macro-prudential indicators (MPIs) since March 2000. The review of MPIs covers the areas of capital adequacy, asset quality, risk management, management soundness, earnings and profitability liquidity, interest rate, maturity structure of assets and liabilities, and various indicators pertaining to major segments of financial markets such as debt, forex, capital market segments, besides macroeconomic indicators such as growth, inflation, interest rate, exchange rate, etc. The MPI review is accompanied by a review of developments in the global environment. The MPI review is prepared on a half-yearly basis and covers commercial banks, financial institutions and the co-operative banks. As part of the efforts to disseminate these Financial Soundness Indicators (FSIs), the Reserve Bank has started publishing the core set of indicators in its various publications.

Concluding Remarks

In India, the financial sector issues on regulation has gained momentum since 1993 and the regulatory and supervisory system are being progressively sequenced and fine-tuned, taking into account the diversity of the financial system. It is, however, pertinent to observe that right from the beginning, no distinction was made between state-owned enterprises and other banks in the matter of application of prudential regulations and standards. The key to implementation was in sequencing the reforms including the prudential standards, rather than trying to device two different sets of regulatory standards. The Reserve Bank had in April 2003 itself accepted in principle to adopt the new capital accord Basel II. We have already initiated steps for the establishment of a risk management system as a pre-requisite for implementation of advanced approaches under Basel II.

The experience of India has been that there has been no difficulty in adoption of sector-neutral uniform standards and this has, to a significant extent, sensitised the public sector banks in adopting a gradual disinvestment approach and working to meet market expectations. The benefits are

improved efficiency and productivity levels in adoption of processes, technology and delivery of customer service.

The reality of Indian financial sector thus needs to be viewed against the present dynamics of global growth. Though the rhetoric may sound repetitive, efforts at strengthening banking systems, enhancing shareholder rights, improving the effectiveness of corporate governance and increasing the transparency and efficiency of the financial markets, especially the domestic banking system with respect to the EMEs should be accorded the highest priority.