Perspectives on Banking

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The strategy of banking development primarily under government auspicious, during the period 1969-1992, paid rich dividend to Indian economy. This is reflected in the expansion of banking network, as well as, various indicators capturing financial deepening and widening. Nevertheless, from the vantage point of 2003, it seems that there were a number of costs associated with this strategy of banking; the two major costs were: (a) sacrifice of the efficiency gains in banking (in terms of lack of improvement of productivity), and (b) high pre-emption of lendable resources of the banks. Besides, the instruments of "social control", in the form of credit controls and concessional lending, segmented financial markets, blunted the process of price discovery and limited 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 of the past 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 and directed credit, 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 (including foreign) players to infuse competition, accord the 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, such as non-governmental institutions. 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. While necessary for economic efficiency, this also escalates the threat of contagion. 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, based on the CAMELS (Capital Adequacy, Management, Liquidity and Systems).

In the realm of banking sector reforms, India has a success story to tell. The improvement in the profitability of the banking system 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	11.1	11.4	11.9	

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 Reserve Bank is concerned, we have come a long way from micro-monitoring to macro-supervision of the banking sector. Recent initiatives like risk-based and consolidated supervision, adoption of various international standards and codes, as well as, moving closer towards Basel II are all illustrations to create an enabling atmosphere in the banking sector. The key challenge in the future is to build in risk management practices to further the gains of the past, as well as manage the threats and optimizing on opportunities, emanating from increasing financial globalisation and integration.

References:

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