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Banking Sector Reforms : an Analytical Overview and Challenges Ahead

Saran Pal Singh
Lecturer, Economics, Rajkiya Mahavidyalaya Tilhar Shahjahanpur

ABSTRACT

Embarking upon a course of economic Reforms in 1991, it was realized that financial sector reforms are must to streamline the economic system with the whole course of economic reforms. Not only theoretical but the practical scenario of the entire banking industry was much demanding for the reforms at that time. Plagued by the administered interest rates, high statutory reserve ratios, absence of prudential accounting and legal norms, disguised balance sheets due to non transparent disclosures, mounting levels of NPA, less per capita profit and capital in banking industry, low advance and deposit ratio, poor staff and fund management, monopoly of public sector banks and lack of competition by the private sector and foreign banks, protection to inefficiencies and political disruption in banking etc. all demanded an instant course of necessary action. Narsimhan committee, Tarapore committee on conversion of rupee, Reddy report etc have thus suggested the measures to be taken. A lot of recommendation of first phase of reforms have been accepted and implemented also yet a long distance has still to be covered.

The present article takes an analytical overview of the banking reforms in India and hereby suggests that Convergence Consolidation and Convergence will remain the key of the Banking Sector Reforms. Up gradation of the accounting norms according to Basle Capital Adequacy Accord and greater autonomy in staff management and in up gradation of the organizational structure of specially the public sector bank and more specifically of the rural sector banks is essential. Providing flexibility in prescribing the statutory CRR and SLR and inviting legislative changes accordingly is also requirement of the day. Vertical and horizontal integration of all the banks with the help of intensive exploration of Information Technology is also must to provide a reliable network of financial services to the growing number of consumers across all the categories. To improve on the lower advance and deposit ratios and to improve on the NPA level and risk management techniques and strategies, such type of integrated network and Biometric identification of customers in all categories should be mandatory. This will help the banking industry to expand its credit base in agricultural, industrial and tertiary sector of the economy with more precision and less risk. Evolution of corresponding regulatory framework according to needs of globalization is also must. E business, global movement of heavy capital due to transnationalism of big business houses, cartels and multinational corporations, money laundering and parallel economy are the emerging challenges for appropriately designing and effectively implementing such type of framework and are the greatest concern of the day for the industry.

For consolidation of the banks, not only supporting the banks with larger volumes of capital against greater risks, but also upgrading asset classification system and appropriating a suitable risk management system in face of Basle accord and latest concurrent practices of the other globalize countries, is necessity. Effective

Management of funds and optimizing returns from portfolio management, updating accounting and disclosure norms, and providing functional and operational autonomy to the banks are also helpful to consolidation of the internal structure of the banks. Consolidation of the banks at the structural level is therefore a prerequisite of the financial consolidation of the banks, however attended late.

Thus the corresponding roadmap prescribed by the government hereby contains a plethora of corresponding measures including providing guidelines for the expansion of foreign banks, merger and acquisition games, ownership and governance issues of Private sector banks, Recapitalization of public sector banks and upgradation of their internal structure and prudential norms according to global practices etc. visualizes changes in two distinct phases. During the first phase beginning March 2005 and ending March 2009, foreign banks can establish wholly owned subsidiaries (WOS) or convert existing branches into WOS. Detailed guidelines have been issued by the RBI. They cover eligibility criteria for the applicant foreign bank, ownership pattern, international ranking and capital adequacy (at least Rs. 300 crores).

At last but not the least RBI is putting its stake on reforms with due attention. However the course is always unending due to limitation posed by the status of overall economy, its difference from the developed countries, prevailing fiscal and monetary considerations, limitation of the resource base for financing infrastructural, and development of the banking industry and infusing private and foreign capital in the industry, all require a lot of attention in a very dynamic perspective. Hence any static course of reform is thus neither sufficient nor practically possible. Only a gradual, speedy and effective process of reform can do the justice. Overview of the reforms only suggests that a lot of work is still to be done.

Keywords - Banking Reforms , Non Performing Assets, Basel Norms , Financial Sector Reforms, Capital Adequacy Ratio, Debt Recovery Tribunal.

"Banking Sector Reforms : An Analytical Overview And Challenges Ahead"

Embarking upon a course of economic Reforms in 1991, it was realized that financial sector reforms are must to streamline the economic system with the whole course of economic reforms. Not only theoretical but the practical scenario of the entire banking industry was much demanding for the reforms at that time. Plagued by the administered interest rates, high statutory reserve ratios, absence of prudential accounting and legal norms, disguised balance sheets due to non transparent disclosures, mounting levels of NPA, less per capita profit and capital in banking industry, low advance and deposit ratio, poor staff and fund management, monopoly of public sector banks and lack of competition by the private sector and foreign banks, protection to inefficiencies and political interference in banking etc. all demanded an instantaneous course of necessary action. Narsimhan committee, Tarapore committee on conversion of rupee, Reddy report etc have thus suggested the measures to be taken. A lot of recommendation of first phase of reforms have been accepted and implemented, yet a long distance has to be covered still.

Theoretically, sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks. Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation. In many cases, the timing of financial sector liberalization coincided with that of capital

account liberalization. Domestic banks were given access to cheap loans from abroad and allocated those resources to domestic production sectors. The importance of balancing financial liberalization with adequate regulation and supervision prior to full capital account liberalization has been increasingly recognized. Proper sequencing of financial sector and capital account liberalization is one of the most important policies in preventing another Asian-type “capital account” crisis. It is now widely accepted that capital account liberalization should follow current account and domestic financial sector liberalization. This sequence issue is even more important for countries such as China and India, which have not yet launched full capital account convertibility and where public-sector banks still remain dominant. In such countries, financial sector liberalization comes against more politically difficult issues than those that have already opened up their capital account to a substantial degree since they have to first restructure predominant public-sector banks.

The major factors that contributed to deteriorating bank performance in the pre reform period included (a) too stringent regulatory requirements (i.e., a cash reserve requirement [CRR][2] and statutory liquidity requirement [SLR] that required banks to hold a certain amount of government and eligible securities); (b) low interest rates charged on government bonds (as compared with those on commercial advances); (c) directed and concessional lending; (d) administered interest rates; and (e) lack of competition. These factors not only reduced incentives to operate properly, but also undermined regulators’ incentives to prevent banks from taking risks via incentive-compatible prudential regulations and protect depositors with a well-designed deposit insurance system. While government involvement in the financial sector can be justified at the initial stage of economic development, the prolonged presence of excessively large public-sector banks often results in inefficient resource allocation and concentration of power in a few banks.

Against this background, the first wave of financial liberalization took place in second half of the 1980s, mainly taking the form of interest rate deregulation. Prior to this period, almost all interest rates were administered and influenced by budgetary concerns and the degree of concessions of directed loans. To preserve some profitability, interest rate margins were kept sufficiently large by keeping deposit rates low and non-concessional lending rates high. Based on the 1985 report of the Chakravarty Committee, coupon rates on government bonds were gradually increased to reflect demand and supply conditions.

Following the 1991 report of the Narasimham Committee, more comprehensive

Reforms took place in same year. The reforms consisted of (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms.[3] Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basle Accord capital adequacy standards. The government also established the Board of Financial Supervision in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with

industrial groups. The Reserve Bank of India also imposed some restrictions on new banks with respect to opening branches, with a view to maintaining the franchise value of existing banks.

While India's financial reforms have been comprehensive and in line with global trends, one unique feature is that, unlike with other former planned economies such as Hungary and Poland, the Indian Government did not engage in a drastic privatization of public-sector banks. Rather, it chose a gradual approach toward restructuring these banks by enhancing competition through entry deregulation of foreign and domestic banks. This reflects the view of the Narasimham Committee that ensuring the integrity and autonomy of public-sector banks is the more relevant issue and that they could improve profitability and efficiency without changing their ownership if competition were enhanced.

Hence the banking sector reforms in India, initiated since 1992 in the first phase has provided necessary platform to the banking sector to operate on the basis of operational flexibility and functional autonomy, thereby enhancing efficiency, productivity and profitability. The reforms brought out structural changes in the financial sector, eased external constraints in their working, introduced transparency in reporting procedures, restructuring and recapitalisation of banks and have increased the competitive element in the market. The salient features of these reforms include:

- Phasing out of statutory pre-emption - The SLR requirement have been brought down from 38.5% to 25% and CRR requirement from 7.50% to 5.75%. (Presently 4.5%)
- Deregulation of interest rates - All lending rates except for lending to small borrowers and a part of export finance have been de-regulated. Interest on all deposits are determined by banks except on savings deposits.
- Capital adequacy - CAR of 9 % prescribed with effect from March 31, 2000.
- Other prudential norms - Income recognition, asset classification and provisioning norms has been made applicable. The provisioning norms are more prudent, objective, transparent, uniform and designed to avoid subjectivity.
- Debt Recovery Tribunals - 22 DRTs and 5 DRATs have already been set up and 7 more DRTs will be set up during the current financial year. Comprehensive amendment in the Act have been made to make the provisions for adjudication, enforcement and recovery more effective.
- Transparency in financial statements - Banks have been advised to disclose certain key parameters such as CAR, percentage of NPAs, provisions for NPAs, net value of investment, Return on Assets, profit per employee and interest income as percentage to working funds.
- Entry of new private sector banks - 9 new private sector banks have been set up with a view to induce greater competition and for improving operational efficiency of the banking system. Competition has been introduced in a controlled manner and today we have nine new private sector banks and 36 foreign banks in India competing with the public sector banks both in retail and corporate banking

- Functional autonomy - The minimum prescribed Government equity was brought to 51%. Nine nationalised banks raised Rs.2855 crores from the market during 1994-2001. Banks Boards have been given more powers in operational matters such as rationalization of branches, credit delivery and recruitment of staff.
- Hiving off of regulatory and supervisory control - Board for financial supervision was set up under the RBI in 1994 bifurcating the regulatory and supervisory functions.

Industry has also made significant progress in payment systems by introducing modern payment media viz., smart/credit cards, electronic funds transfer, debit/credit clearing, e banking, etc. RBI would soon put in place Real Time Gross settlement System (RTGS) to facilitate efficient funds management and mitigating settlement risks.

The issues of infusion of FDI and corresponding Phenomenon of Competition consolidation and convergence have also been treated with respect. The corresponding roadmap prescribed by the government thus hereby includes a roadmap which visualizes changes in two distinct phases. During the first phase beginning March 2005 and ending March 2009, foreign banks can establish wholly owned subsidiaries (WOS) or convert existing branches into WOS. Detailed guidelines have been issued by the RBI. They cover eligibility criteria for the applicant foreign bank, ownership pattern, international ranking and capital adequacy (at least Rs. 300 crores).

During the first phase the RBI will permit eligible foreign banks to buy shares of identified Indian private banks that, in the central bank's view require restructuring. The investment will be in the long-term interests of all stakeholders. The second phase will commence in April 2009. Based on a review of the first phase and after due consultations, the RBI will allow the foreign banks greater freedom including the facility to take over the private banks and diluting stake.

Private banks get a breathing space of four years to shape up .The guidelines on ownership and governance released simultaneously are a road map for them to shape up before the end of the first phase when foreign banks may have fewer fetters to indulge in the mergers and acquisitions game.

Thus Indian banking has made significant progress in recent years. The prudential norms, accounting and disclosure standards and risk management practices, etc. are keeping pace with global standards. The financial soundness and enduring supervisory practices as evident in our level of compliance with the Basle Committee's Core Principles for Effective Banking Supervision have made our banking system resilient to global shocks. The need for further refinements in our regulatory and supervisory practices has been recognized and steps are being taken by RBI to move towards the goal in a phased manner without destabilizing the system. Success of the second phase of reforms will depend primarily on the organizational effectiveness of banks, for which the initiatives will have to come from banks themselves. Imaginative corporate planning combined with organizational restructuring is a necessary pre-requisite to achieve desired results. Banks need to address urgently the task of organizational and financial restructuring for achieving greater efficiency.

Reforms in the rural and co-operative banking sector have also been introduced with the same vigor and have been outlined as following.

- All public sector banks, private sector banks and foreign banks as a group has achieved the over all target of priority sector for the last 3 years.
- NABARD's resource base has been considerably augmented and its paid-up capital has been increased from Rs.100 crore in 1991-92 to Rs.1000 crore at present, and its overall resource position has been enhanced substantially by other means as well. NABARD has sanctioned and disbursed Rs.19849 crores and Rs. 10078 crores respectively to various State Governments under RIDF I to VII, as on 30th September, 2001.
- Share of commercial banks, cooperatives and RRBs in the production credit amounted to 38%, 55% and 7% respectively.
- There are 196 RRBs functioning in 26 States (including 3 newly creates states) covering 495 districts with a network of 14311 branches. Number of profit making RRBs increased from 44 to 172 during 1996-1997 to 2000 to 2001 and the amount of profit of RRBs increased from Rs.69.68 crores to Rs.681 crores during the same period.

While the first phase of banking sector reforms contained in the report of Narasimhan Committee have been implemented, the second phase of reforms in the Banking sector is currently under implementation.

India's banking reforms differ from those in other developing countries in one important respect and that is the policy towards public sector banks which dominate the banking system. The government has announced its intention to reduce its equity share to 33-1/3 percent, but this is to be done while retaining government control. Improvements in the efficiency of the banking system will therefore depend on the ability to increase the efficiency of public sector banks.

Skeptics doubt whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise. The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share.

If privatization is not politically feasible, it is at least necessary to consider intermediate steps which could increase efficiency within a public sector framework. These include shifting effective control from the government to the boards of the banks including especially the power to appoint the Chairman and Executive Directors which is at present with the government; removing civil servants and representatives of the Reserve Bank of India from these board; implementing a prompt corrective action framework which would automatically trigger regulatory action limiting a bank's expansion capability if certain trigger points of financial soundness are breeched; and finally acceptance of closure of insolvent public sector banks (with

appropriate protection for small depositors). Unless some initiatives along these lines are taken, it is highly unlikely that public sector banks can rise to the levels of efficiency needed to support rapid growth.

Another major factor limiting the efficiency of banks is the legal framework, which makes it very difficult for creditors to enforce their claims. The government has recently introduced legislation to establish a bankruptcy law which will be much closer to accepted international standard. This would be an important improvement but it needs to be accompanied by reforms in court procedures to cut the delays which are a major weakness of the legal system at present.

Briefly over viewing the contours of banking sector reforms in Indian industry thus suggest a following gradual procedure to implement the process according to the consistent requirement of the economy with reference to globalization and a jest to adopt the international norms of banking in order to make this sector really modern in real time phenomenon.

Before we move on the suggested course of reforms it is better to scrutinize at some basic indicators of the banking industry including regional rural banks

Select Indicators of Scheduled Commercial Banks (excluding regional Rural Banks)

Year	March 1980	March 1990	March 2000	March 2010	March 2015
No. of Banks	75	75	101	85	91
Credit Deposit Ratio	63.32	61.64	49.26	73.66	78.31
Investment Deposit Ratio	31.50	33.58	45.97	36.42	33.59
(Credit+Investment) Deposit Ratio	94.82	95.22	95.23	110.09	111.90
Deposits to Total Liability Ratio	73.78	70.60	81.08	78.76	78.40
Ratio of Net Interest Margin to Total Assets	NA	3.48	5.24	2.54	2.64
Ratio of Intermediation cost to Total Assets	NA	4.61	4.79	1.78	1.77
Ratio of wage Bills to Intermediation Cost	NA	65.68	66.96	55.23	54.26
Ratio of wage Bills to Total Expense	NA	19.77	19.06	14.85	13.13

Raio of Operating Profits to Total Assets	NA	.39	3.21	2.17	2.02
Return on Assets (ROA)	NA	.39	1.28	1.05	0.81
Return on Equity	NA	23.37	22.58	14.31	10.42

Source : RBI handbook and bulletin various issues

Data shows that credit deposit ratio has improved consistently after March 2000. Increasing Ratio of Deposits to total liabilities reflects increasing trust of depositors. However ratio of net interest margins and ratio of intermediation costs to total assets reflect competitive pressure on banks which has helped them reducing their wage bills as a ratio to total expense. However Ratio of Operating Profit to Total Assets and Return on Equity and Assets shows considerable pressure on their performance and indicates the performance issues such as bad loans and political manhandling of this sector. This is a rising concern because of the escalating value of the banks in our rural and urban economy and the expanding loan base of the economy, chiefly being financed by the public sector banks. This reflects the need of the reforms and it is easy to now elaborate and scrutinize on the procedures and scope of the reform processing in banking sector.

First, reform measures were initiated and sequenced to create an enabling environment for banks to overcome the external constraints – these were related to administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. Sequencing of interest rate deregulation has been an important component of the reform process which has imparted greater efficiency to resource allocation. The process has been gradual and predicated upon the institution of prudential regulation for the banking system, market behavior, financial opening and, above all, the underlying macroeconomic conditions. The interest rates in the banking system have been largely deregulated except for certain specific classes; these are: savings deposit accounts, non-resident Indian (NRI) deposits, small loans up to Rs.2 lakh and export credit. The need for continuance of these prescriptions as well as those relating to priority sector lending have been flagged for wider debate in the latest annual policy of the RBI. However, administered interest rates still prevail in small savings schemes of the Government.

Second, as regards the policy environment of public ownership, it must be recognised that the lion's share of financial intermediation was accounted for by the public sector during the pre-reform period. As part of the reforms programme, initially, there was infusion of capital by the Government in public sector banks, which was followed by expanding the capital base with equity participation by the private investors. The share of the public sector banks in the aggregate assets of the banking sector has come down from 90 per cent in 1991 to around 75 per cent in 2004. The share of wholly Government-owned public sector banks (i.e., where no diversification of ownership has taken place) sharply declined from about 90 per cent to 10 per cent of aggregate assets of all scheduled commercial banks during the same period. Diversification of ownership has led to greater market accountability and improved efficiency. Since the initiation of reforms, infusion of funds by the Government into the public sector banks for the purpose of recapitalization amounted, on a cumulative basis, to less than one per cent of India's GDP, a figure much lower than that for many other countries. Even

after accounting for the reduction in the Government's shareholding on account of losses set off, the current market value of the share capital of the Government in public sector banks has increased manifold and as such what was perceived to be a bail-out of public sector banks by Government seems to be turning out to be a profitable investment for the Government.

Third, one of the major objectives of banking sector reforms has been to enhance efficiency and productivity through competition. Guidelines have been laid down for establishment of new banks in the private sector and the foreign banks have been allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As already mentioned, an element of private shareholding in public sector banks has been injected by enabling a reduction in the Government shareholding in public sector banks to 51 per cent. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

Fourth, consolidation in the banking sector has been another feature of the reform process. This also encompassed the Development Financial Institutions (DFIs), which have been providers of long-term finance while the distinction between short-term and long-term finance provider has increasingly become blurred over time. The complexities involved in harmonizing the role and operations of the DFIs were examined and the RBI enabled the reverse-merger of a large DFI with its commercial banking subsidiary which is a major initiative towards universal banking. Recently, another large term-lending institution has been converted into a bank. While guidelines for mergers between non-banking financial companies and banks were issued some time ago, guidelines for mergers between private sector banks have been issued a few days ago. The principles underlying these guidelines would be applicable, as appropriate, to the public sector banks also, subject to the provisions of the relevant legislation.

Fifth, impressive institutional and legal reforms have been undertaken in relation to the banking sector. In 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of the RBI Board with a variety of professional expertise to exercise 'undivided attention to supervision'. The BFS, which generally meets once a month, provides direction on a continuing basis on regulatory policies including governance issues and supervisory practices. It also provides direction on supervisory actions in specific cases. The BFS also ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban cooperatives banks and primary dealers. A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has also been recently constituted to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorize the payment and settlement systems and determine criteria for membership to these systems. The Credit Information Companies (Regulation) Bill, 2004 has been passed by both the Houses of the Parliament while the Government Securities Bills, 2004 is under process. Certain amendments are being considered by the Parliament to enhance Reserve Bank's regulatory and supervisory powers. Major amendments relate to requirement of prior approval of RBI for acquisition of five per cent or more of shares of a banking company with a view to ensuring 'fit and proper' status of the significant shareholders, aligning the voting rights with the economic holding and empowering the RBI to supersede the Board of a banking company.

Sixth, there have been a number of measures for enhancing the transparency and disclosures standards. Illustratively, with a view to enhancing further transparency, all cases of penalty imposed by the RBI on the banks as also directions issued on specific matters, including those arising out of inspection, are to be placed in the public domain.

Seventh, while the regulatory framework and supervisory practices have almost converged with the best practices elsewhere in the world, two points are noteworthy. First, the minimum capital to risk assets ratio (CRAR) has been kept at nine per cent i.e., one percentage point above the international norm; and second, the banks are required to maintain a separate Investment Fluctuation Reserve (IFR) out of profits, towards interest rate risk, at five per cent of their investment portfolio under the categories 'held for trading' and 'available for sale'. This was prescribed at a time when interest rates were falling and banks were realizing large gains out of their treasury activities. Simultaneously, the conservative accounting norms did not allow banks to recognize the unrealized gains. Such unrealized gains coupled with the creation of IFR helped in cushioning the valuation losses required to be booked when interest rates in the longer tenors have moved up in the last one year or so.

Eighth, of late, the regulatory framework in India, in addition to prescribing prudential guidelines and encouraging market discipline, is increasingly focusing on ensuring good governance through "fit and proper" owners, directors and senior managers of the banks. Transfer of shareholding of five per cent and above requires acknowledgement from the RBI and such significant shareholders are put through a `fit and proper' test. Banks have also been asked to ensure that the nominated and elected directors are screened by a nomination committee to satisfy `fit and proper' criteria. Directors are also required to sign a covenant indicating their roles and responsibilities. The RBI has recently issued detailed guidelines on ownership and governance in private sector banks emphasizing diversified ownership. The listed banks are also required to comply with governance principles laid down by the SEBI – the securities markets regulator.

These reform measures have had major impact on the overall efficiency and stability of the banking system in India. The present capital adequacy of Indian banks is comparable to those at international level. There has been a marked improvement in the asset quality with the percentage of gross non-performing assets (NPAs) to gross advances for the banking system reduced from 14.4 per cent in 1998 to 7.2 per cent in 2004. The reform measures have also resulted in an improvement in the profitability of banks. The Return on Assets (ROA) of the banks rose from 0.4 per cent in the year 1991-92 to 1.2 per cent in 2003-04. Considering that, globally, the ROA has been in the range 0.9 to 1.5 per cent for 2004, Indian banks are well placed. The banking sector reforms also emphasized the need to review the manpower resources and rationalize the requirements by drawing a realistic plan so as to reduce the operating cost and improve the profitability. During the last five years, the business per employee for public sector banks more than doubled to around Rs.25 million in 2004.

With Reference to adopting prudential norms for banking operations it is also appropriate to look at the Basel accord and other potential regulatory measures which can provide a framework to improve on the efficiency criterion in banking.

RBI's association with the Basel Committee on Banking Supervision dates back to 1997 as India was among the 16 non-member countries that were consulted in the drafting of the Basel Core Principles. Reserve Bank of India became a member of the Core Principles Liaison Group in 1998 and subsequently became a member of the Core Principles Working Group on Capital. Within the Working Group, RBI has been actively participating in the deliberations on the New Accord and had the privilege to lead a group of six major non-G-10 supervisors which presented a proposal on a simplified approach for Basel II to the Committee.

Commercial banks in India will start implementing Basel II with effect from March 31, 2007. They will adopt Standardized Approach for credit risk and Basic Indicator Approach for operational risk, initially. After adequate skills are developed, both at the banks and also at supervisory levels, some banks may be allowed to migrate to the Internal Rating Based (IRB) Approach.

Briefly reviewing the steps taken for implementation of Basel II and the emerging issues is thus must. The RBI had announced in its annual policy statement in May 2004 that banks in India should 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 at quarterly intervals. The Reserve Bank organized a two-day seminar in July 2004 mainly to sensitize the Chief Executive Officers of banks to the opportunities and challenges emerging from the Basel II norms. Soon thereafter all banks were advised in August 2004 to undertake a self-assessment of the various risk management systems in place, with specific reference to the three major risks covered under the Basel II and initiate necessary remedial measures to update the systems to match up to the minimum standards prescribed under the New Framework. Banks have also been advised to formulate and operationalize the Capital Adequacy Assessment Process (CAAP) within the banks as required under Pillar II of the New Framework.

It is appropriate to list some of the other regulatory initiatives taken by the Reserve Bank of India, relevant for Basel II. First, RBI has tried to ensure that the banks have suitable risk management framework oriented towards their requirements dictated by the size and complexity of business, risk philosophy, market perceptions and the expected level of capital. Second, Risk Based Supervision (RBS) in 23 banks has been introduced on a pilot basis. Third, RBI has been encouraging banks to formalize their capital adequacy assessment process (CAAP) in alignment with their business plan and performance budgeting system. This, together with the adoption of RBS would aid in factoring the Pillar II requirements under Basel II. Fourth, RBI has been expanding the area of disclosures (Pillar III), so as to have greater transparency in the financial position and risk profile of banks. Finally, RBI has tried to build capacity for ensuring the regulator's ability for identifying and permitting eligible banks to adopt IRB / Advanced Measurement approaches.

As per normal practice, and with a view to ensuring migration to Basel II in a non-disruptive manner, a consultative and participative approach has been adopted for both designing and implementing Basel II. A Steering Committee comprising senior officials from 14 banks (public, private and foreign) has been constituted

wherein representation from the Indian Banks' Association and the RBI has also been ensured. The Steering Committee had formed sub-groups to address specific issues. On the basis of recommendations of the Steering Committee, draft guidelines to the banks on implementation of the New Capital Adequacy Framework have been issued.

Implementation of Basel II will require more capital for banks in India due to the fact that operational risk is not captured under Basel I, and the capital charge for market risk was not prescribed until recently. Though last year has not been a very good year for banks, they are exploring all avenues for meeting the capital requirements under Basel II. The cushion available in the system, which has a CRAR of over 12 per cent now, is, however, comforting.

India has four rating agencies of which three are owned partly/wholly by international rating agencies. Compared to developing countries, the extent of rating penetration has been increasing every year and a large number of capital issues of companies has been rated. However, since rating is of issues and not of issuers, it is likely to result, in effect, in application of only Basel I standards for credit risks in respect of non-retail exposures. While Basel II provides some scope to extend the rating of issues to issuers, this would only be an approximation and it would be necessary for the system to move to rating of issuers. Encouraging rating of issuers would be essential in this regard. In this context, current non-availability of acceptable and qualitative historical data relevant to ratings, along with the related costs involved in building up and maintaining the requisite database, does influence the pace of migration to the advanced approaches available under Basel II.

Above all, capacity building, both in banks and the regulatory bodies is a serious challenge, especially with regard to adoption of the advanced approaches. We have initiated supervisory capacity-building measures to identify the gaps and to assess as well as quantify the extent of additional capital which may be required to be maintained by such banks. The magnitude of this task, which is scheduled to be completed by December 2006, appears daunting since we have as many as 90 scheduled commercial banks in India.

Hence to conclude, in the current scenario, banks are constantly pushing the frontiers of risk management. Compulsions arising out of increasing competition, as well as agency problems between management, owners and other stakeholders are inducing banks to look at newer avenues to augment revenues, while trimming costs. Consolidation, competition and risk management are no doubt critical to the future of banking but governance and financial inclusion would also emerge as the key issues for a country like India, at this stage of socio-economic development.

Hence this brief overview of the Banking Sector Reforms suggests the relevance and shortlisting of the following main measures.

- Prudential Measures
  - Phased implementation of international best practices (CRAR / Provisioning / NPL Norms / Exposure Limits)
  - Measures to strengthen risk management

- Competition Enhancing Measures
  - Operational autonomy and disinvestment of public ownership in public sector banks
  - Transparent entry norms for private and foreign banks
  - Permission for FDI and portfolio investment in banking
- Measures Enhancing Role of Market Forces
  - Interest rate deregulation
  - Reduced pre-emption
  - Enhanced transparency and disclosure
- Institutional and Legal Measures
  - Strengthening of credit information and creditors' rights,
  - Measures to improve recovery/ restructuring environment
  - Improved framework for payments and settlement
- Technology Related Measures
  - dedicated communication backbone for banks
  - Introduction of products through this network
- Supervisory Measures
  - Setting up an autonomous body for supervision
  - Restructuring of on-site supervision
  - Introduction of off-site surveillance
  - Recasting norms on external auditors, internal control, corporate governance
  - Monitoring Systematiaclly Important Financial Institutions

Following are still the main challenges and consideration with respect to the global linkages of economy in the post reform period specially.

- Complete absence of basic building blocks of banking in all banks:
  - Risk Quantification Mechanisms
  - Funds Transfer Pricing Mechanisms
  - Activity Based Costing
- Very high continuing levels of interest rate risk and credit risk – entirely out-of-line with the current levels of capitalisation

Regulation and disclosure in the banking system

- Does not assess (or require disclosure of) current levels of:
    - Credit risk and market risk on a balance sheet wide basis.
    - Capital Adequacy against these risks on a current basis.
    - Return on Capital by each segment of business (product, customer).

Focus on procedure and operations through: branch licensing, advances and investments, NPA norms, interest rate regulation, caps.

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