

**First R.K. Talwar  
Memorial Lecture – 2007**

**By  
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**on  
“ The Indian Banking System – Challenges Ahead”**

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Financial and Banking Sector Reforms in India  
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Distinguished ladies and gentlemen,

I deem it a great honour to be invited to deliver the first R.K. Talwar Memorial Lecture. Shri. R.K. Talwar was one of India's most distinguished bankers who became a legend in his own time. He was a man of skills, vision and courage. His chairmanship of the State Bank of India was marked by several outstanding achievements. As early as 1970s, he had the foresight and vision to understand the importance of organizational structure and instituted a study for this purpose. The organizational structure of SBI that was adopted in his period has stood the test of time, even though it has undergone further changes in keeping with the needs of the time. Another area which received his major attention was human resources development. His pioneering work in the area of financing small-scale industries earned him the title of the Father of SSI Finance. The one dominant characteristic of his entire professional career was his courage. He stood by certain values with which he was not willing to compromise and this had not made life easy for him. In short, for any one entering the banking career, there can be no better role model than that of Shri R.K. Talwar. I deem it a great privilege to deliver this lecture. I congratulate SBI and IIBF in instituting this commemorative lecture. It is a fitting tribute to an illustrious son of India.

India has presently entered a high-growth phase of 8-9 per cent per annum, from an intermediate phase of 6 per cent since the early 1990s. The growth rate of real GDP averaged 8.6 per cent for the four-year period ending 2006-07; if one considers the last two years, the growth rates are even higher at over 9 per cent. There are strong signs that the growth rates will remain at elevated levels for several years to come. This strengthening of economic activity has been supported by higher rates of savings and investment. While the financial sector reforms helped strengthening institutions, developing markets and promoting greater integration with the rest of the world, the recent growth phase suggests that if the present growth rates are to be sustained, the financial sector will have to intermediate larger and increasing volume of funds than is presently the case. It must acquire further sophistication to address the new dimensions of risks.

It is widely recognised that financial intermediation is essential to the promotion of both extensive and intensive growth. Efficient

intermediation of funds from savers to users enables the productive application of available resources. The greater the efficiency of the financial system in such resource generation and allocation, the higher is its likely contribution to economic growth. Improved allocative efficiency creates a virtuous cycle of higher real rates of return and increasing savings, resulting, in turn, in higher resource generation. Thus, development of the financial system is essential to sustaining higher economic growth.

## **I. Banking in the Pre-reform Period**

It is useful to briefly recall the nature of the Indian banking sector at the time of initiation of financial sector reform in India in the early 1990s. This would facilitate a greater clarity of the rationale and basis of reforms. The Indian financial system in the pre-reform period, i.e., upto the end of 1980s, essentially catered to the needs of planned development in a mixed economy framework where the government sector had a domineering role in economic activity. The strategy of planned economic development required huge development expenditures, which was met through the dominance of government ownership of banks, automatic monetization of fiscal deficit and subjecting the banking sector to large pre-emptions – both in terms of the statutory holding of Government securities (statutory liquidity ratio, or SLR) and administrative direction of credit to preferred sectors. Furthermore, a complex structure of administered interest rates prevailed, guided more by social priorities, necessitating cross-subsidization to sustain commercial viability of institutions. These not only distorted the interest rate mechanism but also adversely affected financial market development. All the signs of ‘financial repression’ were found in the system.

There is perhaps an element of commonality in terms of such a ‘repressed’ regime in the financial sector of many emerging market economies at that time. The decline of the Bretton Woods system in the 1970s provided a trigger for financial liberalization in both advanced and emerging markets. Several countries adopted a ‘big bang’ approach to liberalization, while others pursued a more cautious or ‘gradualist’ approach. The East Asian crises in the late 1990s provided graphic testimony as to how faulty sequencing and inadequate attention to institutional strengthening could significantly derail the growth process, even for countries with otherwise sound macroeconomic fundamentals.

India, in this context, has pursued a relatively more 'gradualist' approach to liberalization. The bar was gradually raised. Each year the Central Bank slowly, in a manner of speaking, tightened the screws. Nevertheless, the transition to a regime of prudential norms and free interest rates had its own traumatic effect. It must be said to the credit of our financial system that these changes were absorbed and the system has emerged stronger for this reason.

## **II. Contours of reforms**

Financial sector reforms encompassed broadly institutions especially banking, development of financial markets, monetary fiscal and external sector management and legal and institutional infrastructure.

Reform measures in India were sequenced to create an enabling environment for banks to overcome the external constraints and operate with greater flexibility. Such measures related to dismantling of administered structure of interest rates, removal of several preemptions in the form of reserve requirements and credit allocation to certain sectors. Interest rate deregulation was in stages and allowed build up of sufficient resilience in the system. This is an important component of the reform process which has imparted greater efficiency in resource allocation. Parallel strengthening of prudential regulation, improved market behaviour, gradual financial opening and, above all, the underlying improvements in macroeconomic management helped the liberalisation process to run smooth. The interest rates have now 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. Without the dismantling of the administered interest rate structure, the rest of the financial sector reforms could not have meant much.

As regards the policy environment on public ownership, the major share of financial intermediation has been on account of public sector during the pre-reform period. As a part of the reforms programme, initially there was infusion of capital by Government in public sector banks, which was subsequently followed by expanding the capital base with equity participation by private investors up to a limit of 49 per cent. The share of the public sector banks in total banking assets has come down from 90 per cent in 1991 to around 75 per cent in 2006: a decline of about one percentage point every year over a fifteen-year period. Diversification of ownership, while retaining public sector character of these banks has led to greater market

accountability and improved efficiency without loss of public confidence and safety. It is significant that the infusion of funds by government since the initiation of reforms into the public sector banks amounted to less than 1 per cent of India's GDP, a figure much lower than that for many other countries.

Another major objective of banking sector reforms has been to enhance efficiency and productivity through increased competition. Establishment of new banks was allowed in the private sector and foreign banks were also permitted more liberal entry. Nine new private banks are in operation at present, accounting for around 10-12 per cent of commercial banking assets. Yet another step towards enhancing competition was allowing foreign direct investment in private sector banks up to 74 per cent from all sources. Beginning 2009, foreign banks would be allowed banking presence in India either through establishment of subsidiaries incorporated in India or through branches.

Impressive institutional reforms have also helped in reshaping the financial marketplace. A high-powered Board for Financial Supervision (BFS), constituted in 1994, exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and non-banking companies, creating an arms-length relationship between regulation and supervision. On similar lines, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) prescribes policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.

The system has also progressed with the transparency and disclosure standards as prescribed under international best practices in a phased manner. Disclosure requirements on capital adequacy, NPLs, profitability ratios and details of provisions and contingencies have been expanded to include several areas such as foreign currency assets and liabilities, movements in NPLs and lending to sensitive sectors. The range of disclosures has gradually been increased. In view of the increased focus on undertaking consolidated supervision of bank groups, preparation of consolidated financial statements (CFS) has been mandated by the Reserve Bank for all groups where the controlling entity is a bank.

The legal environment for conducting banking business has also been strengthened. Debt recovery tribunals were part of the early reforms process for adjudication of delinquent loans. More recently, the Securitisation Act was enacted in 2003 to enhance protection of creditor rights. To combat the abuse of financial system for crime-related activities, the Prevention of Money Laundering Act was enacted in 2003 to provide the enabling legal framework. The Negotiable Instruments (Amendments and Miscellaneous Provisions) Act 2002 expands the erstwhile definition of 'cheque' by introducing the concept of 'electronic money' and 'cheque truncation'. The Credit Information Companies (Regulation) Bill 2004 has been enacted by the Parliament which is expected to enhance the quality of credit decisions and facilitate faster credit delivery.

Improvements in the regulatory and supervisory framework encompassed a greater degree of compliance with Basel Core Principles. Some recent initiatives in this regard include consolidated accounting for banks along with a system of Risk-Based Supervision (RBS) for intensified monitoring of vulnerabilities.

The structural break in the wake of financial sector reforms and opening up of the economy necessitated changes in the monetary policy framework. The relationship between the central bank and the Government witnessed a salutary development in September 1994 in terms of supplemental agreements limiting initially the net issuance of ad hoc treasury Bills. This initiative culminated in the abolition of the *ad hoc* Treasury Bills effective April 1997 replaced by a limited ways and means advances. The phasing out of automatic monetization of budget deficit has, thus, strengthened monetary authority by imparting flexibility and operational autonomy. With the passage of the Fiscal Responsibility and Budget Management Act in 2003, from April 1, 2006 the Reserve Bank has withdrawn from participating in the primary issues of Central Government securities

Reforms in the Government securities market were aimed at imparting liquidity and depth by broadening the investor base and ensuring market-related interest rate mechanism. The important initiatives introduced included a market-related government borrowing and consequently, a phased elimination of automatic monetisation of Central Government budget deficits. This, in turn, provided a fillip to switch from direct to indirect tools of monetary regulation, activating open market operations and enabled the development of an active secondary market. The gamut of changes in market development included introduction of newer instruments, establishment of new

institutions and technological developments, along with concomitant improvements in transparency and the legal framework.

### **III. Processes of Reform**

What are the unique features of our reform process? First, financial sector reform was undertaken early in the reform cycle in India. Second, the banking sector reforms were not driven by any immediate crisis as has often been the case in several emerging economies. Third, the design and detail of the reform were evolved by domestic expertise, while taking on board the international experience in this regard. Fourth, enough space was created for the growth and healthy competition among public and private sectors as well as foreign and domestic sectors.

How useful has been the financial liberalization process in India towards improving the functioning of institutions and markets? Prudential regulation and supervision has improved; the combination of regulation, supervision and safety nets has limited the impact of unforeseen shocks on the financial system. In addition, the role of market forces in enabling price discovery has enhanced. The dismantling of the erstwhile administered interest rate structure has permitted financial intermediaries to pursue lending and deposit taking based on commercial considerations and their asset-liability profiles. The financial liberalisation process has also enabled to reduce the overhang of non-performing loans: this entailed both a 'stock' (restoration of net worth) solution as well as a 'flow' (improving future profitability) solution.

Financial entities have become increasingly conscious about risk management practices and have instituted risk management models based on their product profiles, business philosophy and customer orientation. Additionally, access to credit has improved, through newly established domestic banks, foreign banks and bank-like intermediaries. Government debt markets have developed, enabling greater operational independence in monetary policy making. The growth of government debt markets has also provided a benchmark for private debt markets to develop.

There have also been significant improvements in the information infrastructure. The accounting and auditing of intermediaries has improved. Information on small borrowers has improved and information sharing through operationalisation of credit information bureaus has helped to reduce information asymmetry. The

technological infrastructure has developed in tandem with modern-day requirements in information technology and communications networking.

The improvements in the performance of the financial system over the decade-and-a-half of reforms are also reflected in the improvement in a number of indicators. Capital adequacy of the banking sector recorded a marked improvement and stood at 12.3 per cent at end-March 2006. This is a far cry from the situation that prevailed in early 1990s.

On the asset quality front, notwithstanding the gradual tightening of prudential norms, non-performing loans (NPL) to total loans of commercial banks which was at a high of 15.7 per cent at end-March 1997 declined to 3.3 per cent at end-March 2006. Net NPLs also witnessed a significant decline and stood at 1.2 per cent of net advances at end-March 2006, driven by the improvements in loan loss provisioning, which comprises over half of the total provisions and contingencies. The proportion of net NPA to net worth, sometimes called the solvency ratio of public sector banks has dropped from 57.9 per cent in 1998-99 to 11.7 per cent in 2006-07.

Operating expenses of banks in India are also much more aligned to those prevailing internationally, hovering around 2.1 per cent during 2004-05 and 2005-06. These numbers are comparable to those obtaining for leading developed countries which were range-bound between 1.4-3.3 per cent in 2005.

Bank profitability levels in India have also trended upwards and gross profits stood at 2.0 per cent during 2005-06 (2.2 per cent during 2004-05) and net profits trending at around 1 per cent of assets. Available information suggests that for developed countries, at end-2005, gross profit ratios were of the order of 2.1 per cent for the US and 0.6 per cent for France.

The extent of penetration of our banking system in our country as measured by the proportion of bank assets to GDP has increased from 50 per cent in the second half of nineties to over 80 per cent a decade later.

#### **IV. Way ahead**

While we have made a significant progress, let me highlight a few issues that I believe would need significant attention in the near term.

The first is the issue of consolidation. The emergence of titans has been one of the noticeable trends in the banking industry at the global level. These banking entities are expected to drive the growth and volume of business in the global segment. In the Indian banking sector also, consolidation is likely to gain prominence in the near future. Despite the liberalization process, state-owned banks dominate the industry, accounting for three-quarter of bank assets. The consolidation process in recent years has primarily been confined to a few mergers in the private sector segment, although some recent consolidation in the state-owned segment is evident as well. These mergers have been based on the need to attain a meaningful balance sheet size and market share in the face of increased competition, driven largely by synergies and locational and business-specific complementarities. Efforts have been initiated to iron out the legal impediments inherent in the consolidation process. As the bottom lines of domestic banks come under increasing pressure and the options for organic growth exhaust themselves, banks in India will need to explore ways for inorganic expansion. This, in turn, is likely to unleash the forces of consolidation in Indian banking. However, there are two caveats. First, any process of consolidation must come out of a felt need for merger rather than as an imposition from outside. The synergic benefits must be felt by the entities themselves. The process of consolidation that is driven by fiat is much less likely to be successful, particularly if the decision by fiat is accompanied by restrictions on the normal avenues for reducing costs in the merged entity. Thus, any meaningful consolidation among the public sector banks must be driven by commercial motivation by individual banks, with the government and the regulator playing at best a facilitating role. Second, the process of consolidation does not mean that small or medium sized banks will have no future. Many of the Indian banks are of appropriate size in relation to the Indian situation. Actual experience shows that small and medium sized banks even in advanced countries have been able to survive and remain profitable. These banks have survived along with very large financial conglomerates. Small banks may be the more natural lenders to small businesses.

The second issue is related to capital adequacy. Basel I standards have been successfully implemented in India and the authorities are presently moving towards adoption of Basel II tailored to country's specific considerations. Adoption of Base II norms will enhance the required capital. Besides, banks' assets will grow or will have to grow in tandem with the growth of the real sectors of the economy. The

public sector banks' ability to meet the growing needs will be inhibited, unless the government is willing to bring in more capital. At present, the share of the government in the public sector banks cannot go below 51 per cent. While there is some scope for expanding capital through various modalities, tier-I capital, that is equity, is still critical. While this constraint may not be binding immediately, sooner or later it will be. If growth is modest, retained earnings may form an adequate source of supply. However, when growth is rapid which is likely to be the case, there is need for injection of equity, enlarging the shareholding. In this situation, the government will have to make up its mind either to bring in additional capital or move towards reducing its share from 51 per cent through appropriate statutory changes. A third alternative could, however, be to include in the definition of government such entities as the Life Insurance Corporation that are quasi-government in nature and are likely to remain to be fully owned or an integral part of the government system in the future. However, even to do this an amendment is needed in the statute.

The third aspect concerns risk management. The most important facet of risk in India or for that matter in most developing countries markets remains the credit risk. Management of credit risks is an area which has received considerable attention in recent years. The new Basle accord rests on the assumption that an internal assessment of risks by a financial institution will be a better measure than an externally imposed formula. The economic structure is undergoing a change. The service sector has emerged as major sector. Assessing credit risk in lending to service sectors needs a methodology different from assessing risks while lending to manufacturing. There are other areas of lending such as housing and consumer credit which will need new approaches. Equally important will be the area of management of exchange risk. Besides enabling customers to adopt appropriate exchange cover, banks themselves will have to ensure that their exposure is within acceptable limits and is properly hedged. The entire area of risk management encompassing all aspects of risk including credit risk, market risk and operational risk will have to receive prime attention.

The fourth and final concern I want to refer to is improvement in customer service. Banks exist to provide service to customers. With the introduction of technology, there has been a significant change in the way banks operate. This is a far cry from the situation that existed even 15 years ago. The induction of technology has enabled several transactions to be processed in a shorter period of time. Transmission

of funds to customers takes less time now. ATMs provide easy access to cash. Nevertheless, it is not very clear whether the customers as depositors and users of other banking services are fully satisfied with the services provided when they come to a bank. This is an area, which must receive continuous attention. The interface with the customers needs to improve.

Provision of credit is a basic function of banks. The effective discharge of this function is part of the intermediation process. The sectoral deployment of credit must keep pace with the changes in the structure of the economy. The banking industry in India must equip itself to be able to assess and meet the credit needs of the emerging segments of the economy. In this context, two aspects require special attention.

First, as the Indian economy gets increasingly integrated with the rest of the world, the demands of the corporate sector for banking services will change not only in size but also in composition and quality. The growing foreign trade in goods and services will have to be financed. Apart from production credit, financing capital requirements from the cheapest sources will become necessary. Provision of credit in foreign currency will require in turn a management of foreign exchange risk. Thus, the provision of a whole gamut of services related to integration with the rest of the world will be a challenge. Foreign banks operating in India will be the competitors to Indian banks in this regard. The foreign banks have access to much larger resources and have presence in many parts of the world. Therefore, Indian banks will have to evolve appropriate strategies in enabling Indian firms to accessing funds at competitive rates. Another aspect of global financial strategy relates to the presence of Indian banks in foreign countries. Indian banks will have to be selective in this regard. Here again the focus may be on how to help Indian firms acquire funds at internationally competitive rates and how to promote trade and investment between India and other countries. We must recognize that in foreign lands, Indian banks will be relatively smaller players. The motivation to build up an international presence must be guided by the route Indian entities take in the global business.

Second, despite the faster rate of growth of manufacturing and service sectors, bulk of the population still depends on agriculture and allied activities for its livelihood. In this background, one cannot over-emphasize the need for expanding credit to agricultural and allied activities. While banks have achieved a higher growth in provision of

credit to agriculture and allied activities last year, this momentum has to be carried further. In this context, it has to be noted that credit for agriculture is not a single market. Provision of credit for high-tech agriculture is no different from providing credit to industry. Provision of credit to farmers with a surplus is also of similar nature. Commercial banks in particular must have no hesitation in providing credit to these segments where the normal calculation of risk and return applies. It is only with respect to provision of credit to small and marginal farmers, special attention is required. They constitute a bulk of the farmers and accounting for a significant proportion of the total output.

The National Sample Survey Organization has recently released a Report entitled, "Indebtedness of Farmer Households". This Report contains a wealth of data relating to the extent and nature of indebtedness. As per NSSO data 51.4 per cent of the total farm households did not have access to credit. Another fact that emerges is that there is a substantial difference between marginal and sub-marginal farmers on the one hand and the rest of the farmer households on the other regarding the purpose for which loans are obtained and the sources of credit. For all farmer households taken together, at the all-India level, institutional sources were responsible for providing 57.5 per cent of the total credit. But as far as farmer households owning one hectare and less, this proportion is only 39.6 per cent. For all farmer households, the proportion of loan going for production purposes is 65.1 per cent as against 40.2 per cent for marginal and sub-marginal farmer households. Thus, for sub-marginal and marginal farmers, the proportion of production loan is lower than for all farmers. Similarly, the proportion of institutional credit is lower for sub-marginal and marginal farmers than for all farmers. This, in fact, is true of every state of the country. Thus, a critical issue is how to meet the credit requirements of marginal and sub-marginal farmers. What changes do we need to introduce so that credit can flow to this class of farmer households? Can the banking system through its present mode of distribution of credit meet this challenge? Should we think in terms of banks supporting other institutions who are in a better position to lend to marginal and sub-marginal farmers? Banks need to think hard on how to effectively use the 'facilitator and correspondent' models. These models have great potential to reach out to small borrowers and depositors. In any case, a re-look at the organizational structure of our rural branches is called for. Banks need to think deeply on how to meet this challenge of meeting the credit needs of marginal farmers. Financial inclusion is no longer an option; it is a compulsion.

The task to be fulfilled by the Indian banks is truly formidable. At one end we expect banks to be able to lend billions of rupees to large borrowers. At the same time we want them to be able to deliver extremely small loans to meet the requirements of the small borrowers. We must reflect on the kind of organizational structure and human talent that we need in order to achieve these twin goals which are at the two extreme ends of the spectrum of lending.

The first phase of banking sector reform has come to a close and we are moving on to the second phase. In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and as financial markets get more and more integrated. As globalisation accelerates, the Indian financial system will also get integrated with the rest of the world. As the task of the banking system expands, there is need to focus on the organizational effectiveness of banks. To achieve improvements in productivity and profitability, corporate planning combined with organizational restructuring become necessary. Issues relating to consolidation, competition and risk management will remain critical. Equally, governance and financial inclusion will emerge as key issues for India at this stage of socio-economic development.