THE MALAISE OF THE INDIAN FINANCIAL SYSTEM : THE NEED FOR REFORMS*

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I am deeply honoured at being invited to the Madras School of Economics by Dr.Raja Chelliah and Dr. Appasamy to deliver this Special Lecture under the auspices of the T.S. Santhanam Chair in Financial Economics established by Sundaram Finance. Although I have known Dr. Chelliah for many years I do not think he is fully aware of my indebtedness to him. As I was approaching my Final Examination at University in 1960, Dr. Chelliah's book on *Fiscal Policy in Underdeveloped Countries* was published and imbibing the book made all the difference between an average performance and a good performance. In my years at the Reserve Bank of India I handled the portfolio of Finance Companies over an extended period and I had the opportunity of interacting with Sundaram Finance on many occasions. Mr. T.S. Santhanam is the founding father of hire purchase finance in India. The preeminence of Sundaram Finance is essentially because of its basic values : ethical standards of operation, equity and debt conservatism, exacting accounting norms and personal knowledge and close rapport with their customers, both depositors and borrowers. These are enduring values which pay rich dividends in the long run. I salute Mr. Santhanam and his colleagues for their long and meritorious service in the financial sector which is unequalled and certainly unsurpassed. If all financial

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organisations in India were like Sundaram Finance the Indian financial system would be one of the strongest in the world.

2. The world over, the financial sector is faced with adjustment problems of facing up to rapid changes in the environment. The Indian financial system cannot be immune to this universal phenomenon. What I propose to do today is to discuss some of the problems of the Indian financial system and while recognising the progress made, I would attempt to address some of the hard issues in the reforms which do not seem to have easy solutions.

Backdrop to the Problems

3. One of the fundamental problems which have all along afflicted the Indian economy is the lack of proper pricing of factor endowments. I do not propose to go into abstruse analytics but would merely set out certain issues in layman's language. In an increasingly integrated world economy nominal interest rate differentials need to reflect inflation rate differentials so that real rates of interest are equilibrated as between countries. To the extent that capital is more scarce in India, than say in most developed countries, one would expect real rates of interest to be higher in India. I would not wish to get into the *cul-de-sac* of how one should measure inflation, which interest rate to use and what time period to use. Suffice it to say that we in India have all along endeavoured to artificially keep down the cost of capital and this distortion has had serious repercussions on the viability of the Indian financial sector.

4. In a capital scarce economy we have used the interest rate mechanism to encourage the use of capital and discourage financial savings. Above all the government, as the biggest guzzler of resources, demanded and obtained resources at

artificially low rates of interest. In such a milieu, a whole range of economic activity got generated based on an artificially low rate of interest. The Indian entrepreneur fitted in with the typical Hayekian entrepreneur, weak and excessively dependent on borrowered funds at low rates of interest. Like the Hayekian entrepreneur Indian industry found itself unable to adjust to a market related interest rate system and removal of the distortions in interest rates resulted in exposing the fragility of industry.

5. More importantly, the overall policy thrust was on ensuring that financial intermediaries fully met the credit demands for *"productive purposes"* and, therefore, the felt need of the borrower gained primacy over the viability of the financial intermediary and the safety and security of the saver was put at a discount. What was most disconcerting was the fact that borrowers defaulted on loans without inviting any adverse action. Lest this sound like a denigration of the Indian system let me hasten to add that this was a world-wide phenomenon. In the context of the increasing fragility of the financial system, the world over, there emerged in the eighties the now famous *Basle prudential norms*. With the requirement for proper asset classification, income recognition, provisioning and stipulations on minimum capital adequacy, large holes appeared in the balance sheets of banks requiring a rethinking on lending policies to reduce risks. In the worst cases major restructuring by way of recapitalisation, downsizing, mergers and in some cases closure of financial intermediaries become necessary.

6. The Indian financial system also faced problems which took on a very different dimension. After three decades of a *dirigiste* regime the Indian financial

system found it exceedingly hard to adjust to the sweeping changes in the international financial system. With a monolithic public sector predominance in terms of ownership the emphasis was on carrying out the edicts set out and commercial decision taking, based on the viability of lending, took a backseat. Again, as ownership, regulation and borrowing became increasingly intertwined, regulatory forbearance become endemic. The level of non-performing assets of public sector banks in March 2000, as a proportion of advances, was estimated at 14.3 per cent gross and 7.4 per cent net which was very high as compared with other countries. Despite all these adverse features the burden on the Indian fisc of recapitalisation of banks and financial institutions has been minimal at less than one per cent of GDP as compared with as large as 15 per cent in some extreme cases. The saving grace in the Indian system was the prohibitive reserve requirement for banks which, at the time of initiating the financial sector reforms, was as high as an average of 53.5 per cent. This, in a sense, minimised the cost of restructuring the Indian financial system. Again, another reason for the low fiscal burden in the Indian case is the possibility that at least, in some banks/institutions we are witnessing only the tip of the iceberg of non-performing assets.

Impact of the First Phase of the Reforms

7. In the first phase of the reforms, which can be broadly identified as the period 1992-98, a number of measures were taken. While I would not wish to burden this well informed audience with a full narration, suffice it to say that the authorities moved swiftly on a broad front. First, the government on its part recognised the damage to the financial system of large automatic monetisation of the fiscal deficit

and it entered into two historic supplemental agreements to phase out this obnoxious practice. Furthermore, government agreed to pay close to market related rates of interest on government paper. More importantly, it bore the brunt of its responsibility as owner of public sector banks by recapitalising them to the tune of Rs. 20,000 crore. After this recapitalisation the government agreed to lower its holding in public sector banks to a minimum of 51 per cent. Secondly, reserve requirements were brought down drastically from 53.5 per cent to 33 per cent. More particularly, the cash reserve ratio, which is the major drag on the banking system is now an average prescription of 8 per cent and with various exemptions the effective ratio is now only 7 per cent. Thirdly, significant steps were taken to develop the money, securities and forex markets. Fourthly, prudential norms were introduced in a phased manner. Fifthly, the interest rates of banks and non-bank financial entities were, for all practical purposes, fully deregulated. Sixthly, the government backed off to a significant extent from behest lending and lending decisions were largely left to banks. Seventhly, serious attempts were made to deal with the legal and other infirmities which stood in the way of recovery of debts.

8. All these measures made up an impressive array of reforms but while acknowledging these positive steps there are a number of critical areas which require hard decisions. There is a need for a free and well structured debate to enable a broad consensus of support for the second generation financial sector reforms.

Emerging Structures in the Financial Sector

9. The banking system is still predominantly in the public sector which accounts for 80 per cent of the total. While a number of new well capitalised private sector

banks have been set up they account for only 3 per cent of total deposits. Even under a best case scenario of new private sector banks growing at twice the pace of public sector banks, in five years the efficient *Lilliputians* would account for only 6 per cent of the banking system. While the new private sector banks would, hopefully, provide efficient service, the quality of the system as a whole will be largely determined by what happens to public sector banks.

10. The *All-India financial institutions* (FIs) have provided yeoman service in the past but their *raison d'exister* is now under question. These institutions are increasingly moving into areas in the domain of banking and regulatory issues are coming to the fore in terms of the extensive debate on *Universal Banking.*

11. The *non-bank financial companies* (NBFCs) are indeed a motley crowd. At one extreme are the likes of Sundaram Finance which are well run efficient and responsible units and at the other extreme are the fly-by-night operators which violate the regulatory framework with impunity. The Reserve Bank of India (RBI) has been making commendable efforts in the recent period to ensure an element of order in the system.

12. The *mutual funds* (MFs) are a set of institutions, quite apart from the others, but an insensate fiscal system has resulted in MFs giving torrid and grossly unfair competition to banks. I would come back to this issue when discussing the need for evolving a reasonably equitable financial architecture.

Issues in Second Generation Reforms

13. There is a popular misconception that there has been considerable soft-peddling on the second generation reforms. Such a view is unwarranted, unfair and

unappreciative of the dimensions of the problems which are being tackled. It is necessary to go into the intracacies of the problems and to work out viable solutions in our milieu. This will require sensitising public opinion to ensure a better understanding of the need for adjustment and at the same time there is a need to assure all stakeholders that it is possible to work towards efficiency of operations without derailing the system.

Tackling the NPA Problem

14. The NPAs of the banking system are reportedly in the region of Rs. 52,000 crore and it is clearly recognised that the drain on the system of such a large burden needs early resolution. It is expected that the one-time settlements for NPAs below Rs. 10 crore will be non-discretionary and uniform and a number of banks have focussed their energies on a one point agenda of recovery of loans. It is recognised that recovery of NPAs is not an easy task and the sheer attrition of time results in an accretion to NPAs as loans are down-graded on the asset classification ladder. There is a general perception, reinforced by the global rating agencies, that actual NPAs are higher than indicated by the numbers as there is atleast anecdotal evidence of ever-greening and stipulation of weaker norms in India. Legal infirmities are by far the most formidable impediments to a strengthened banking system. The *Andhyarujina Committee* has recommended the creation of a new law granting statutory power of possession and sale of security directly to banks and FIs and creation of a new securitisation act which would confer legal sanctity to transfer of future receivables. Action on this front would be the most important measure in the second generation reforms.

Government Ownership of Banks

15. While Narasimham Committee-I had taken the stance that efficiency of operation was ownership neutral, Narasimham Committee-II indicated that predominant public ownership of banks is in conflict with efficiency of operations. Narasimhim-II advocated a reduction in the minimum public ownership from 51 per cent to 33 per cent and the government has formally announced the acceptance of this recommendation. Capital adequacy requirements would require that banks raise substantial amounts by way of fresh capital but the fisc is far too burdened to be able to provide the necessary resources. This provides the rationale for reduction of the minimum public ownership of banks. Governor Dr. Bimal Jalan has indicated in his *Administrative Staff College* lecture in December 1999 that while the minimum public sector holding would be reduced to 33 per cent the public sector character of banks would remain unchanged. This has been misunderstood in some quarters to imply that inefficiencies in the system would be tolerated and that these banks would be strangulated by the overarching role of government. What Governor Jalan has set out is a pragmatic policy of meeting the additional capital requirements of banks by raising money from the capital market without a take over by predatory elements of these public sector banks for their narrow sectarian interests. This would ensure that while banks function on commercial terms the wider national interest would be taken into account and responsibility would not remain vague during the transition from predominant public ownership. It is hoped that the necessary legislative changes would be enacted in the current financial year.

16. Since the government is not willing to provide capital to these banks, only the relatively strong banks will be able to raise capital from the market and, therefore, those banks will grow at a faster pace than the weaker banks and the banking system would eventually become stronger.

17. The other related issue is the track record of public sector banks which have gone to the market. The market's assessment of these stocks has been distinctly adverse. Most of these banks have gone to the market at inflated values and investors who have put their faith in these banks have been badly singed and they would not be gullible to put more of their resources into these banks. Banks must recognise the ground realities and build back credibility by entering the market at par or at a very modest premia. It may be contended that each bank has a dedicated set of captive investors drawn from loyal depositors. From the long-term interest of banks, however, it would be advisable for these banks to approach the market with defensible valuations. Banks which go to the market for their capital requirements will need to recognise that they will have to pay greater attention to the opinion of shareholders and banks would be able to raise capital from the market only if they give attention to creating *shareholder value*. This will require adequate ploughing back of profits into the reserves. In the first flush, as banks raised funds from the market, insufficient attention was paid to this aspect.

18. Apart from the three weak public sector banks, the Verma Panel identified six public sector banks which were showing signs of distress and were running high risk of slipping into the category of weak banks. What is of concern is some of these banks are bravely entering the market for raising capital and unless these banks show

a vast improvement, shareholders faith in these banks could be belied and damage the credibility of public sector banks in the eyes of investors.

19. A recent report by *Crisil* has highlighted that while Indian banks are taking steps towards improved disclosures which meet the RBI regulatory requirements, Indian banks have a long way to go to come up to international best practices. A few banks are attempting to achieve international disclosure standards in the context of their plans to raise capital from international markets.

20. For the three weak banks the government has indicated that it would provide recapitalisation funds after being satisfied about the viability of the strategic action plans of these banks. This issue needs more detailed discussion and I would come back to this later on.

21. The fact that banks have started raising money from the capital market does not mean that the burden on the fisc of an eventual bailout would be any less. As Deputy Governor Dr. Y.V. Reddy has pointed out (in his lecture at the *Bank Economists' Conference*, December 1998), the experience the world over is that the fiscal burden is ownership neutral.

Prudential Norms

22. Based on the 1988 Basle Accord, prudential norms were introduced in India in 1992. Since then there has been a progressive move towards international norms. We do not need to be defensive but it is necessary to recognise that there are specific areas wherein our norms are clearly below the best international practices.

23. As against the international 90 days norm we still continue to use a criteria of 180 days plus 30 days past due for non-payment of principal and interest before we

classify an account as sub-standard. Deputy Governor Shri S.P. Talwar has cogently argued that unless the underlying commercial and payments system moves to an improved settlement system it would not be feasible to shift the norms to one quarter in respect of past dues. This is a chicken and egg problem and unless the RBI is stricter on the norms it is unlikely that the payments system would improve. It is important that we do not further delay the movement to a 90 days norm albeit, in a phased manner, say over 2-3 years. Continuing with the 180 days norms would be clearly indefensible.

24. The Basle Committee is in the process of developing *A New Capital Adequacy Framework* which would be more sensitive to the level of underlying economic risk. The 1988 Basle Accord had the disadvantage that various kinds of risks, such as interest rate risks and operational risks were not explicitly addressed and the earlier Accord provided an incentive for high-risk high-reward activity and encouraged regulatory arbitrage. In addition to the minimum capital standards taking into account the credit rating, the new norms give emphasis to supervisory oversight of capital adequacy at the individual bank level together with market discipline and better public disclosure. The RBI has expressed reservations on relying on *external* rating agencies for assigning risk weights on exposures and has instead preferred greater reliance on *domestic* rating agencies and also the internal rating by banks themselves. The RBI has recognised that emerging economies would have considerable difficulty in adhering to the new Framework and has rightly argued that these countries will need a longer transition period. In an increasingly integrated world we in India need to take cognisance of the fact that this time round the phasing in period will be much

shorter than at the time of the Basle norms of 1988 and therefore concerted efforts should be made to first understand and then implement the new framework.

25. Narasimham-II had argued that with the difficulties that Indian banks would have with implementing international risk management guidelines it may be best to move to a 10 per cent capital to risk assets ratio (CRAR). Some observers have argued that raising the CRAR further, beyond the present 9 per cent, would be counterproductive in an already risk-averse Indian financial system. The Bank of International Settlement (BIS) guidelines on risk management at the level of individual banks would be far too complex for Indian banks to operate in any meaningful manner. Risk management does not mean that a bank/financial institution merely employs a couple of technical personnel. Effective risk management is something which just cannot be delegated and the top management and the boards of banks/institutions should be adept at risk management techniques. It will take a new generation of top management to have a clear appreciation of risk management. In the interregnum, till a new generation of top management appears on the scene and can effectively deal with risks in a meaningful manner, it would be desirable to use the crude CRAR as an effective instrument by raising it to 10 per cent by say 2002. A further reason for increasing the CRAR to 10 per cent is that bank solvency is undermind as many risks are off the balance sheet. While an attempt is made to bring these risks under the umbrella of total risks a full coverage is not easily obtained and, therefore, there is merit in the raising of the present CRAR to 10 per cent. Where the new risk assessment models require sophisticated statistical

techniques, it is necessary to develop a holistic approach wherein statistical models are combined with sound judgement.

26. While on the matter of risk management it is pertinent to mention that in the more recent period, the question of counterparty risk has come to the fore in the context of ring-fencing by the branches of certain foreign banks in India. If this issue really becomes a full fledged reality, in the context of the evolving international norms, it would be only appropriate for Indian banks to seriously reconsider their exposures on these banks.

Issues in Regulation / Supervision

27. The regulators no doubt wish to believe that the regulations are now less on micro management and more by way of prudential norms with greater emphasis on *internal controls.* While the direction of change is welcome it is only if there is a comprehensive codification of the regulations that it would become clear as to how the system is operating. A codification would also provide a sharp focus on redundant regulations.

28. The objective should be to ensure that regulation is light and supervision is scrupulously strict. Moreover, supervision should largely be in the nature of on-going disclosures by the supervised institution. Banks and others which are deposit taking institutions owe it to their depositors to provide relevant information on performance in simple language easily understood by depositors. The present disclosure standards in India can, by no means, be considered to be satisfactory. While stressing the need for greater disclosure, there should be legitimate protection

for proprietal information. Adequate disclosure becomes particularly relevant as banks progressively base capital requirement on internal risk measures.

29. Another important issue which needs attention is adverse action by the supervisor. It is not at all necessary to unleash a reign of terror. All that the supervisors needs to do is to take contemporaneous adverse action as soon as there are incipient signs of violation. On taking adverse action there should be comprehensive publicity. Sometimes supervisors fight shy of publicity because of fears of adverse action snow-balling into systemic problems. This is a totally unwarranted fear. So long as adverse action is taken at the incipient stage of infringement the adverse action would be mild and there would not be a systemic fall out. When penalties are imposed, they should be widely publicised however small the penalties. Minimal, but timely, adverse action would alert all stakeholders viz. owners, depositors and employees and there would be early convergence to least cost remedial action.

30. The supervisor should, however, have the authority to require individual banks to operate at higher capital adequacy ratios in view of the higher perceived risks. Moreover, if the stipulated capital is not maintained the supervisor should take early action to remedy the situation and not wait till the situation deteriorates to a point of no return.

31. The legislative framework should be made a lot more flexible to give the regulatory/supervisory authority sufficient powers to adequately deal with rapid financial innovations. Furthermore, as internal controls develop and banks undertake fuller disclosures, the supervisory function should become more in the nature of a

backstop and should concentrate on inspecting systems rather than individual transactions.

32. Ownership by the government / RBI of financial intermediaries impinges on regulatory/supervisory freedom of action because the close links result in a regulatory capture. Supervisory forbearance is probably the most dangerous aspect of this intertwining relationship and this is yet one more reason for divesting government ownership of financial intermediaries. In this context it is unconscionable for the RBI to put its nominee directors on the boards of banks. Sometimes it is argued that the RBI is passive and merely fulfils the legal requirement. In the interregnum, till the law is changed, the least the RBI could do is to atleast withdraw its front line *A team* from the boards of public sector banks. Translating this into specific action, no officer of the rank of Chief General Manager and above should be nominated to the board of a bank/institution.

33. The RBI is committed to implementing the *BIS Core Principles for Effective Banking Supervision* (1997). While most of the Core Principles are enshrined in the Indian legislative and regulatory framework, there are gaps in a number of areas wherein further progress is necessary before India can claim full compliance. One of the aspects of the Core Principles is that the supervisor should be neutral as between public and private sector institutions. There is an impression that in India we are stricter with public sector banks than private sector banks as public sector banks are subject to a lot more regulation; this erroneous impression emanates from the fact that the public sector banks are saddled with a lot more directions from the authorities than private sector banks. But, when it comes to a bank making losses there is

unlimited forbearance in the case of public sector banks and it is this infirmity which is a major departure from adherence to the Core Principles.

34. A cardinal principle of sound regulation/supervision is that it should never be varied over the business cycle. It is entirely a monetary policy function to deal appropriately with the business cycle. *Per contra,* monetary policy should not be diluted to make it less costly for financial intermediaries to comply with prudential norms.

35. The regulator/supervisor has to ensure that a period of good macro economic performance does not create euphoria which results in a dropping of the supervisory guard to ignore prudential management. This is particularly important because of the old adage that *bad loans are made in good times.*

36. While in some countries regulation/supervision has been separated from the central bank there are some disadvantages in doing so. In a crisis it is the central bank which has to act and a central bank without hands on experience of banking organisations faces a tremendous handicap. Hence, at this stage of our financial development, there is much merit in keeping regulation/supervision within the RBI.

37. While on the issue of regulation and supervision it is necessary to recognise that the days when more administrative controls would restrict activity are clearly over. Thus regulators/supervisors have to learn to work with, rather than against, market forces.

Future of Financial Institutions (FIs)

38. The future of financial institutions has been the centre of debate for the last two years. It should be clear to all that with the cessation of concessional resources

and concessional lending and the blurring of short-term and long-term lending the question of continuing with the special status of FIs comes to the fore. Narasimham-II had set out that the FIs should either become banks or NBFCs. What is emerging is a cafeteria approach under which a FI can either itself become a bank or use the conglomerate approach and set up a banking subsidiary. The present environment is excessively permissive. There must be an incentive/disincentive system and FIs should be given a clear outer time frame by which they would have to become banks. The FIs are far too big to be allowed to function outside the regulatory framework for banks, and yet enjoy a favourite son status.

Non-Bank Finance Companies (NBFCs)

39. A peculiar feature of the Indian financial system is the extensive system of non-bank institutions raising deposits. The NBFCs are a group of vastly different units from the best run financial units in the country to rampant and outright predatory elements. The RBI has all along had a difficult time reigning in obstreperous elements. There have, in recent years, been admirable efforts by the RBI to bring an element of order into the system. The shake out was to expected and sooner or later the permissive mushrooming of these companies had to stop. The well-run units should work closely with the regulator/supervisor to develop strong self-regulatory organisations. No tears need be shed over the disappearance of poorly run units. Ultimately, the regulatory/supervisory framework for banks and non-banks should converge and in such a scenario the well run NBFCs should be provided strong incentives to become banks. Over time, the asset side controls on the Residuary Non-Bank Companies should gradually become applicable to all NBFCs

and the RBI should device special incentives for well run NBFCs to become banks. I am confident that some of the best run NBFCs could become the best run banks in the country. If after all the FIs are to be given incentives upfront to converge, a similar treatment should be given to the strongly capitalised well run NBFCs.

40. Providing deposit insurance cover to the non-bank sector would be detrimental to the development of a strong financial sector as the stronger units would be subsidising the weaker units. Deposit insurance should, as at present, remain strictly restricted to banks. It is reported that consideration is being given to providing insurance for depositors in the corporate sector. If this is implemented it would be difficult to resist pressures to provide deposit insurance for NBFCs. While deposit insurance in the non-bank segment is being mooted as part of investor protection this would be a wrong signal to depositors. Such deposits carry a substantial risk and deposit insurance would give a false sense of security.

41. In the recent period there have been ominous noises about separating regulation/supervision of NBFCs from the RBI. In the last four years the RBI has performed magnificently in dealing with the NBFCs. It is not as if the RBI would wish to cling on to this function but the pertinent question is whether there can be any other organisation which can handle the regulation/supervision of the NBFCs better than the RBI. To the extent the NBFC sector needs closer regulation/ supervision, the RBI's staff resources in this sphere need to be augmented and the RBI run Board for Financial Supervision could be split into two, one for banks and one for NBFCs but the important point is that the regulation/supervision of NBFCs

should continue to be under the aegis of the RBI. In my view, separating the regulation/supervision of NBFCs from the RBI would be a serious mistake.

Mutual Funds

42. Developments in the area of mutual funds have had reverberations in the entire financial system. In the aftermath of the UTI imbroglio the government provided largesse to all mutual funds by making the income distributed by mutual funds totally tax free in the hands of the recipient. Earlier on, company dividends were also exempt from income taxation. This resulted in the income funds of mutual funds becoming extremely competitive *vis-a-vis* bank deposits, deposits of NBFCs and bonds of FIs. To assuage criticism of this exemption the government has imposed a 22 per cent tax on the dividend distributed by mutual funds. The rationale for exempting these incomes from income tax is based on the premise that double taxation should be avoided. While the tax on mutual funds and bank deposits is broadly equated at the macro level the system is iniquitous in that in the mutual funds sector the lower income holders subsidise the higher income holders. There has been a perceptible shift of bank deposits of longer maturities to mutual funds. In the longer run, continuing with this taxation system will progressively reduce the average maturity of term deposits of banks and generate serious asset-liability maturity mismatches. Moreover, it is against all cannons of distributive justice. Individual measures to tackle a specific problem can have a systemic fall out. Hence a holistic view should be taken to avoid such distortions.

Corporate Governance in the Financial Sector

43. The issue of governance in the Indian financial sector has received benign neglect essentially because of the predominant role of government. With the changing role of government, issues of governance are coming to the fore. The quality and character of management of banks and financial institutions should develop as the first line of defence and no system of regulation/supervision can be a substitute for good management. In the present system there is a total obfuscation between the role of management and the role of managers. In the public sector financial system management vests with the government and the top officials are merely the managers acting at the beckoning of government.

44. There has been considerable discussion about the need for greater autonomy of financial intermediaries and a concomitant of this is greater transparency and increased responsibility for banks and institutions. As the government gradually reduces its overarching role in the running of public sector banks, the boards of banks and top management will have to take on a significantly greater role in decision taking. The powers of the board, the structure and formation of the boards, the role and functions of the Chairman and the Chief Executive Officer will all need to be examined in some detail. While banks at present have the comfort of governmental control the dilution of such control can lead to a crisis of governance.

45. The boards of banks, top management as well as the supervisory authority need to recognise that there must be a fine balance between risk models and judgement based on experience. Moreover, mere reliance on heavier regulation and supervision is not a solution and in fact intensification of supervisory oversight can undermine market discipline and increasingly, there will need to be more reliance on

market forces and less on the supervisory authority. In this context *internal* governance of banks will gain primacy. Enhanced transparency in disclosures is reflective of good corporate governance and it gives credibility to banks' financial statements.

46. While transparency, *per se*, is highly desirable it cannot be the be all and end all of corporate governance in the financial sector. In any effective system of corporate governance in the financial sector, the board of directors would have to device relevant strategies and be fully responsible for the working of the organisation. The board of directors should be subject to a considerable degree of accountability. Suppression of facts or misinformation should be made a criminal offence. The directors should be duly elected by the shareholders. To ensure that unsuitable persons are not on the boards of banks it is not necessary to take away the voting rights of shareholders. The regulator/supervisor should have the power to use the standard *fit and proper* criteria to ensure that the boards of banks are appropriately manned.

47. The issue of corporate governance in the financial sector is much more complex than in other sectors. The depositor, as a stakeholder, should get precedence over the shareholder who has much less at stake in a bank. The real challenge in the Indian system is not merely how quickly banks migrate out of the public sector but how banks are governed in an optimal manner. There are no parallel models to draw on and corporate governance in the Indian financial sector will need to chart its own course.

48. There have been so many Committees and Working Groups to examine specific issues but for some reason we do not seem to be giving sufficient attention to issues of governance in the context of change in government ownership in the financial sector. The time is apposite to give early attention to this matter.

Offshore Banking

49. The feasibility of allowing offshore banking to develop has been debated for the last 30 years. This is an idea whose time has past. In today's internationally integrated world it no longer makes sense to have a mere offshore financial pocket. In the inexorable march towards international financial integration the authorities should prepare the Indian system for meaningful integration and not be content with off-shore pockets which in any case cannot be separated from the rest of the financial system in these days of complex financial transactions.

Weak Banks

50. It is now over two years since Narasimham-II was submitted and nine months have passed since the Verma Panel report on weak banks. The government has rightly maintained confidence in the banking system by categorically indicating that no weak public sector bank would be closed down. This is indeed a very appropriate response but now serious thought has to be given to what to do with the three weak public sector banks. Discussions and debate on the weak bank dates back to as far back as 1988. Had these banks merely allowed the natural attrition of staff through retirement during the 1990's the weak banks would not have had any problems of excess staff. The time has come to close the debate and to take decisive action.

51. The government appears inclined to set up a *Financial Restructuring Authority* (FRA) to deal with the problems of these banks, which is a positive step. It would be highly desirable to set up the FRA as part of the RBI infrastructure rather than create a new institution and a predictable turf war.

52. The weak banks have been asked to submit their strategic action plans to pull themselves out of their difficulties. All the three banks have submitted plans based on a step up in the rate of growth of deposits and advances and it is reported that all these proposals have been rejected.

53. The authorities have also rejected the concept of *narrow banking* which has been a time tested concept, the world over, under which weak banks reduce their exposure to risk assets and invest their resources in government securities. The authorities do not favour narrow banking despite the clear evidence that a number of Indian public sector banks pulled themselves out of problems precisely using the strategy of narrow banking. The fact of the matter is that in the Indian context, on a risk adjusted basis, the return on government securities is higher than on bank lending. This would clearly show that it is best for weak banks to slowdown lending.

54. The government would be well advised to avoid the recapitalisation route as it is a bog from which the government would not be able to extricate itself. Providing largesse for the three weak banks would encourage the six potentially weak banks identified by the Verma Panel to put out their bowls to receive the government's munificence.

55. It would be best to let the three weak banks use a bootstraps operation to come out of their problems. The problems of these banks are mind boggling and it is

necessary to take all possible steps to remedy the position : sell overseas offices to other Indian banks, sell real estate, sell branches in areas where these banks do not enjoy a competitive advantage and reduce staff by a rigorously enforced ban on fresh recruitment. Rather than considering very ambitious VRS schemes these banks should endeavour to reduce their staff by 6 per cent per annum as opposed to a natural attrition rate of 3 per cent per annum through retirements. Whatever be the strategy adopted it would take these weak banks *at least a decade* to reconstruct their balance sheets and it is totally unrealistic to expect a turnaround in a year or two. Let us hope that the authorities are able to pull it off with an alternative strategy through what that viable strategy would be is yet to be revealed. I would readily concede that my advocacy of narrow banking has failed to convince the government, the RBI, the weak banks, economists and the public at large. So what are we left with?

56. When the financial policies of the present period are evaluated, in a historical perspective, the RBI and the government would be indicted for their inaction in devising an effective strategy for weak banks. Bureaucratic brilliance of equivocation can be no substitute for hard action. The problem of weak banks is not a uniquely Indian phenomenon. It has been tackled elsewhere and it has to be tackled in India. This is the most crucial issue, and the future course for the Indian financial system is essentially contingent on what is done regarding weak banks. If the authorities fail to take action a *Pro bono publico* (for the public good) has to speak up.

Human Resource Development, Technology,
Industrial Relations and Customers Service

57. HRD, technology, IR and customer service are the four pillars of the banking system of the future. Each of these issues deserves a full fledged and exclusive examination and any meaningful assessment of the financial sector without taking cognisance of these vital matters would be incomplete. On these issues the public sector banking system has operated as a monolith. Continuing such an approach will be sub-optimal and competitive forces will eventually result in the stronger elements unleashing themselves from the drag of the weaker elements. At the present time these are sensitive issues which create tensions but they need urgent attention. An early resolution of these dilemmas would be in the interest of all concerned.

Concluding Observations

58. Financial crises the worldover have revealed that weaknesses in financial systems and their supervision contribute to macro instability. The prescription therefore is the strengthening of the financial system. Not only is stronger supervision necessary but the discipline of the market needs to be reinforced. Corporate governance needs to be strengthened and bankruptcy legislation made more robust. With rapid technological changes, the leaders in innovation would claim the best business. Banks and financial institutions which resist change would, like dinosaurs, become extinct. The financial system would need to be guided by three requirements viz. transparency, rigorous norms and appropriate incentives. It is hoped that in the years to come the Indian financial system would face upto these challenges

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